

# TAX INCENTIVES FOR CONSERVATION EASEMENT DONATIONS\*

*Jeffrey O. Sundberg and Richard F. Dye, Lake Forest College*

## INTRODUCTION

UNDEVELOPED LAND GENERATES A WIDE variety of benefits to the public, including use, existence, and amenity values. Conservation easements,<sup>1</sup> one tool used to prevent the development of open space, are a legal transfer of property development rights from the owner to another entity. The easement holder agrees to not use the right, but to monitor the property and enforce the agreement for its duration.<sup>2</sup>

Congress and numerous state governments have created special tax incentives to encourage donations of easements to government agencies and conservation organizations. The number of easements held by land trusts has skyrocketed in recent years.<sup>3</sup> Between 1988 and 1998 the amount of acreage protected by local and regional land trusts via easements grew by over 370 percent (Brewer 2003, 148); the subsequent five years saw additional growth of more than 360 percent compared to the 1998 figure. Easements now account for more than half of the nearly 9.5 million acres protected by local and regional land trusts (Land Trust Alliance, 2005).

This paper assesses the various tax incentives created to encourage the donation of conservation easements. It begins by discussing the relevant incentives, examines the benefits created under several sets of assumptions, and considers the efficiency consequences of such a system.<sup>4</sup>

## TAX INCENTIVES FOR EASEMENT DONATIONS

If an easement meets specified criteria, its donation to a qualified conservation organization is treated as a charitable contribution for federal tax purposes. This directly or effectively results in eligibility for additional incentives in many states. Numerous sources provide sample calculations of tax benefits from donating a conservation

easement, including Daugherty (1977), Davenport (2003), and Parker (2005). These calculations typically ignore the timing of the savings from various incentives by assuming that all tax savings, including estate or capital gains savings, occur in the year of donation. In addition, there should be a distinction between tax savings that are determined at the time of the donation of the easement versus tax savings that are determined at the time of the disposition of the property. This section of the paper discusses the various types of tax incentives that are in place, providing examples of incentives offered by different states.

### Income Tax Effects

The value of the federal income tax deduction will depend on the taxpayer's marginal rate and the size of the easement in comparison to Adjusted Gross Income (AGI). If the easement is worth more than 30 percent of AGI, the deduction must be spread out over multiple years, requiring a conversion into present value.<sup>5</sup> It is also likely that in some cases the value of the easement will be large enough relative to AGI as to make it impossible for the property owner to use all the deductions.

Easement donations result in an immediate reduction in state income taxes in one of two ways.<sup>6</sup> Twenty-eight states currently use the federal itemized deductions to determine state deductions, so contributions reduce state taxable income.<sup>7</sup> However, state income tax liabilities are also federally deductible, so the reduction in state taxes paid has a feedback effect that increases federal tax liability in the subsequent year. If the taxpayer is subject to the Alternative Minimum Tax (AMT), the feedback effect does not exist, since under the AMT the charitable contribution is deductible but the state tax is not.

Ten states currently have incentives in the form of tax credits, rather than deductions, for easement donations. These credits can be used to offset existing state individual income tax liabilities on a dollar-for-dollar basis. The specific details of these programs vary widely. Mississippi, for example, only offers credit toward 50 percent of the transaction costs associated with donating an easement. Several states offer an income tax

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credit equal to 25 percent or more of the value of the easement. In Colorado the credit in 2006 can be 100 percent of the first \$100,000 in value and 40 percent of the next \$400,000 of value. If the value of the donation exceeds the maximum size for a credit after the expiration of the carryforward period, the remainder can be taken as a charitable contribution deduction.

Three states have made credits transferable, so that taxpayers who are unable to use the full amount of their credits can sell them to other taxpayers to offset their tax liability. This ensures that taxpayers will be able to use the full credit, less a discount to the buyer, and should make such programs particularly attractive to property owners with very low income tax liabilities.

### **Property Tax Effects**

As with many aspects of easement policy, property tax incentives show substantial variation across states. In some cases, assessors are directed to reassess the property, taking into account the reduction in value from the easement. Other states specify the amount of tax relief. For example, Illinois offers owners of eased parcels a 75 percent reduction in their property tax, while Maine offers owners a reduction of either 50 percent or 70 percent, depending on the purpose of the easement. Several other states allow parcels under conservation easements to qualify for the same use value assessment available to agricultural land, even if the parcels are not used for agricultural purposes.

The tax savings discussed previously create benefits that are defined at the time of the donation. Subsequent tax treatment depends on the disposition of the property; it could be sold by the owner, in which case a capital gains tax could apply, or it could become part of an estate upon the death of the owner and create possible estate tax consequences. The present value of these tax effects also depends on the length of time between the donation of the easement and disposition of the property.

### **Capital Gains Tax Effects**

If the property had been sold without any conservation easement in place, the entire difference between the market value and the owner's basis would be taxable at the appropriate capital gains rate. If a conservation easement is donated, the owner's basis must be adjusted downward by the fraction of market value lost at the time of the

easement donation, reducing the value of the tax savings.

Most states treat realized capital gains as identical to earned income, so the tax savings can be calculated by applying the state income tax rate to the federal capital gains savings. As with income taxes, any reduction in the capital gains tax paid at the state level will have a feedback effect that reduces the federal deduction for state tax liability.

### **Estate Tax Effects**

If the property becomes part of an estate that is taxable at the federal level, there are two tax effects that could apply. For every taxable estate, the easement donation will reduce the value of the estate by the value of the easement at the time of the disposition and increase it by the present value of the perpetual property tax reduction.

The easement may also meet the requirements of Section 2031(c) of the tax code, in which case the tax benefits may increase substantially. On top of the reduced value due to the donation of the easement, the estate is also allowed to exclude up to 40 percent of the remaining market value of the parcel from the taxable portion of the estate (up to a maximum is \$500,000 in 2005). If the value of the easement is less than 30 percent of the market value of the parcel, this benefit is reduced by a formula that has the unusual result of offering a greater subsidy for easements that are on parcels where the owners retain a greater fraction of the property's value.

Fewer than half of the states currently have an estate tax; those that do are adjusting to a federal tax phase-out of credits for state estate taxes. The minimum size of estate subject to taxation varies dramatically across states. In cases where excluding the easement does not affect the marginal state estate tax rate, donating an easement results in an estate tax savings similar to the federal case (but with 2031(c) not available).

### **AGGREGATE TAX EFFECTS**

The aggregate of all these different tax effects of conservation easement donations—federal and state income and capital gains taxes, federal and state estate taxes, and local property taxes—can be combined in a unified formula and evaluated in specific cases or by assumption. (See the Appendix and Sundberg and Dye, 2006, for additional detail.) The range of possible aggregate tax effects depends

on the assumptions used, including timing and corresponding discounting to a present value.

To generate numerical values of the aggregate tax effect, reasonable values are chosen for what could be expected by a wealthy donor in a state that has typical tax rates. It is assumed that the easement is small enough to avoid hitting any donation ceiling or to change the taxpayer's marginal tax rate ( $t$ ). The stream of property tax savings is calculated in present value terms, using the conservative assumption that the savings are based on reassessment at post-donation value. All other figures assume that the savings occur in the year of donation and in the year of disposition, as appropriate.

The combined effects of these assumptions under different scenarios are presented in Table 1. The taxpayer donates an easement worth \$1, reducing the value of the property from \$3 to \$2. The calculations assume no real appreciation in property values. The scenarios distinguish between: income tax incentive through either deduction or credit; disposition through either sale or bequest; that some taxpayers may not have enough income to use the income tax deductions; others may not be subject to the estate tax.

For the purposes of these estimates, all income tax incentives are assumed to be taken in the year of donation. Disposition of property is assumed to take place five years after the donation of the easement. A 3 percent real discount rate is used to calculate the present value of capital gains and estate tax effects.

Scenario I examines a taxpayer who pays no federal income tax, but is able to take a state tax credit (perhaps by transferring it to a higher-income taxpayer). The only other tax effect is the reduction

in property taxes. The estate is assumed to be too small to be subject to any estate tax. Under these assumptions, the taxpayer is still able to achieve a savings of \$0.83 for donating an easement worth \$1. A similar magnitude of savings is available for taxpayers in Scenario II, who are able to take the federal and state income deduction, and in Scenario III, who also pay future capital gains taxes.

Scenario IV considers a taxpayer who takes federal and state income tax deductions and pays federal and state estate taxes. Here, the present value of a \$1 easement donation is greater than \$1. If the property also qualifies for the 2031(c) partial exclusion (V), the tax effect increases to \$1.42. If the state offers a 50 percent credit rather than a deduction (VI), the value of the donation increases to \$1.89 in present value terms. In this last scenario, the combination of the 2031(c) estate tax and property tax effects alone are almost enough to compensate for the entire cost of the easement donation.

Savings will vary as assumptions change. If disposition occurs more than five years in the future or the discount rate is lower, the present value will be smaller. If the state allows property assessment fraction reduction, the savings are likely to increase dramatically.<sup>8</sup> Failure to use all the deductions, or use that decreases the marginal tax rate, will reduce the value.

In cases where the present value of the tax savings is greater than \$1, the donation should make the taxpayer better off compared to not donating the easement. Consider Scenario IV: the value of the property in the estate will be \$3 without an easement, or \$2 if an easement has been donated (ignoring property tax effects). If the estate has to pay a combined 60 percent federal and state

*Table 1*  
**Aggregate Tax Effects Under Different Scenarios: No Real Growth in Property Values  
Present Value Based on Five Years Until Disposition**

<i>Tax Effects</i>	<i>I</i>	<i>II</i>	<i>III</i>	<i>IV</i>	<i>V</i>	<i>VI</i>
Federal Income ( $t=.35$ )		0.350	0.350	0.350	0.350	0.350
State Income – Deduction ( $t=.05$ )		0.033	0.033	0.033	0.033	
State Income – Credit (50%)	0.500					0.500
Federal Capital Gains ( $t=.15$ )			0.022			
State Capital Gains ( $t=.05$ )			0.005			
Federal Estate (basic); present value ( $t=.45$ )				0.259		
Federal Estate basic + 2031(c); present value					0.621	0.621
State Estate; present value ( $t=.15$ )				0.086	0.086	0.086
Property, based on reassessment; PV	0.333	0.333	0.333	0.333	0.333	0.333
Aggregate Tax Effect	0.833	0.716	0.742	1.061	1.423	1.891

estate tax, the value after taxes will be \$1.20 with no easement or \$0.80 if the easement has been donated. However, the donation created an income tax benefit worth \$0.40, which occurred five years earlier and makes the present value of the donation greater than the present value of the property without an easement. Including a property tax effect favors the donation even more.

Table 1 also indicates the relative burden of tax effects on various groups of taxpayers. For example, the tax effects of an easement on a parcel owned by a low-income taxpayer who receives a credit and property tax relief (Scenario I) will fall entirely on state and local taxpayers. A wealthy taxpayer, subject to state and federal estate tax and receiving the 2031(c) exclusion (Scenario V), will create tax effects borne primarily by federal taxpayers, and secondarily by local taxpayers. The existence of any state credit program will shift a considerable share of the burden onto state taxpayers, since the state credits are much more generous than the state income tax deductions.

#### POLICY IMPLICATIONS AND CONCLUSION

The donation of an easement can have a positive net present value. While the expected present value would be very difficult to forecast at time of donation, given the uncertainty of disposition time and method, growth in property values, and future tax rates, it is clear that the donation creates value for the property owner under a wide variety of reasonable assumptions and existing tax regimes. At the same time, other donors are likely to receive very little tax relief.

These findings raise a number of important questions. It is clear that the cost of accepting a donated easement, as measured by the tax consequences for the affected governments, will vary widely—with the tax treatment easements receive in a particular state, the tax rates in that state, the income and estate tax brackets faced by the property owner, and the development pressure in a particular region. This creates several associated problems.

First, if landowners respond to financial incentives to donate easements, they will respond very unequally. Landowners with the largest potential tax effects will be much more likely to donate easements, while those with low income and small estates will see very little benefit from making an equivalent donation, especially in states with no assured property tax relief. This is almost certain

to be inefficient if the goal is to use tax revenue to ensure as much conservation value as possible; the parcels chosen are likely to have high tax effects, but some of them may have less conservation value than parcels owned by taxpayers who cannot take advantage of tax effects. Some potential donors are likely to be overcompensated, while others are certain to be undercompensated.

This suggests that a system of credits, which does not penalize landowners in low income brackets, will provide incentives for more property owners to consider donating easements. While these credits have been criticized by some (Pidot 2005), the criticism is more about the size of the subsidy than about the form. Credits for contributions that provide public benefit are likely to be more efficient, since parcels with high conservation values are not limited to landowners in high tax brackets.

A second concern is the raw size of the tax effects. The subsidies that are available under some circumstances increase the incentives for landowners to make donations that may be of marginal conservation value, or even to act fraudulently. Such concerns led the IRS to announce an Abusive Transactions Settlement Initiative (IRS 2004, 2005), urging taxpayers to come forward and acknowledge inappropriate transactions and settle before being audited. Reducing the maximum possible tax subsidy to return it to the realm of an incentive would reduce some of these concerns.

Third, the wide variation among state incentives creates additional efficiency concerns. Equivalent easements in different states can receive income tax effects ranging from 100 percent of the easement value to effectively zero, and property tax treatments vary over almost as large a range. While the same federal standards apply in every state, relatively few states apply their own standards or review the benefits of particular easements before granting them legal status. While all easements might meet a minimal standard, there is certain to be a mismatch between the size of the tax savings and the conservation value of the easement resulting in both undercompensation and overcompensation.

In addition, the wide variation in criteria for qualification as a charitable contribution allows very different kinds of public benefits to benefit from identical tax incentives.<sup>9</sup> For example, an open space easement on an infrequently-traveled road would qualify for the same incentives as an easement protecting property that provided habitat for a

critically endangered species or a property available for public recreation (whether or not that property was frequently used). Perhaps certain types of easements could qualify for tax incentives at the state or federal level, depending on the size and distribution of those benefits among taxpayers.

Finally, the impact of increasing property values is very important in determining the tax effects resulting from the disposition of the property. In some cases, a portion of the tax benefit will be determined by the increase in property values in the area after the donation. While the increase in property values due to development pressure does suggest that the value of the rights given up by the landowner have increased, that does not necessarily indicate that the conservation value of the property has similarly increased. In fact, high development pressure could make the conservation value of a parcel higher because of the loss of substitute parcels, or make it much smaller if it merely protects an island of habitat of no use to wildlife or of no real scenic value.

Tax policy could be better used to provide conservation if policy makers had a better sense of the kinds of value generated by different types of conservation easements. Understanding sources of value would allow tax incentives to be better tailored to support those donations that are likely to generate the greatest public benefit, rather than those coming from taxpayers facing the highest tax liabilities. The economics literature on valuing environmental and natural resource amenities could be usefully applied in this area.

## Endnotes

- <sup>1</sup> There is some variation among state names for what are similar programs; the term "conservation easement" is used here to generically refer to these programs.
- <sup>2</sup> A much more detailed discussion of easements and their legal requirements is presented in Boyd, Caballero, and Simpson (1999). Bowles et al. (1998) provide some international examples of easements. Small (2002) provides a discussion from the perspective of potential easement donors.
- <sup>3</sup> Government agencies hold easements on a substantial amount of acreage, according to various reports. However, no specific information is available on the number of easements held by government agencies, or the acreage controlled via easements. It has been suggested that some agencies may not even have a register listing the easements for which they are responsible (Pidot 2005, 12).

- <sup>4</sup> See Sundberg and Dye (2006) for a general overview of the requirements needed to meet federal standards for a charitable donation.
- <sup>5</sup> For recent changes and additional restrictions, see Sundberg and Dye (2006).
- <sup>6</sup> Information on state treatment of easements was taken from state individual income tax forms and instruction packets.
- <sup>7</sup> Eight states do not have an income tax, 1 allows a credit but not a deduction, and another 13 do not allow any reduction of income tax for a donation of a conservation easement.
- <sup>8</sup> Using existing fractional assessment incentives, this number could have a present value of \$0.75 or more.
- <sup>9</sup> There are some cases in which this is not true. For example, historical preservation easements do not qualify for the 2031(c) exclusion benefit, and states sometimes restrict the type of easements that can receive property tax reductions.

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**APPENDIX: VARIABLES USED IN CALCULATION OF AGGREGATE TAX EFFECTS**

Let:

- [1] M = full market value of parcel (with no easement) at time of donation;
- [2] C = value of conservation easement = rights given up at the time of the donation;
- [3] B = property owner's basis in the parcel;
- [4]  $\alpha$  = fraction of market value represented by the easement, such that  $C = \alpha * M$ ;
- [5]  $t_{FI}$  = marginal federal income tax rate of property owner;
- [6]  $t_{SI}$  = marginal state income tax rate of property owner;
- [7]  $\beta$  = state income tax credit as a fraction of C;
- [8]  $t_p$  = effective property tax rate per dollar of market value of property.
- [9]  $t_{FK}$  = marginal federal capital gains tax rate of property owner;
- [10]  $t_{FE}$  = marginal federal estate tax rate of property owner;
- [11]  $t_{SE}$  = marginal state estate tax rate of property owner;
- [12] r = real interest rate for discounting;  
 Then (with additional assumptions stated in Sundberg and Dye, 2006):
- [13]  $T_{FI}$  = value of federal income tax deduction =  $t_{FI} * C$ ;
- [14]  $T_{SID}$  = value of the state income tax deduction =  $t_{SI} * (1 - t_{FI}) * C$ ;
- [15]  $T_{SIC}$  = value of the state income tax credit =  $\beta * C$ ;
- [16]  $T_p$  = annual property tax savings =  $t_p * (C)$ , based on reassessment;
- [17]  $PV(T_p)$  = present value of the property tax savings =  $PV(T_{pa}) = [t_p * (C)] / r$ ;

For disposition at sale or death: If,

- [18]  $M^n$  = market value of the property in year n; and
  - [19]  $C^n$  = value of the easement at the time of the donation; then
  - [20]  $M^C$  = post-easement value of the property =  $M^n - C^n + PV(T_p)$ ;
  - [21]  $t_{FK} * (M^n - B)$  = capital gains tax liability without any conservation easement;
  - [22]  $t_{FK} * [(C^n / \alpha^n) - C^n + PV(T_p) - (1 - \alpha) * B]$  = capital gains tax with easement, where the adjusted basis =  $(1 - \alpha) * B$  and  $\alpha^n = C^n / M^n$ ;
  - [23]  $T_{FK}$  = federal gains tax savings = [22] - [23] =  $t_{FK} [C^n - PV(T_p) - \alpha * B]$ ;
  - [24]  $T_{SK}$  = state gains tax savings =  $t_{SI} * (1 - t_{FI}) * [C^n - PV(T_p) - \alpha * B]$ ;
  - [25]  $T_{FE1}$  = basic federal estate tax savings =  $t_{FE} * [C^n - PV(T_p)]$ ;
  - [26]  $T_{FE2}$  = additional estate tax savings due to section 2031(c)  
 $= \min((t_{FE} * .4 * [M^n - C^n + PV(T_p)]) = t_{FE} * .4 * [(C^n / \alpha^n) - C^n + PV(T_p)])$ , \$500,000);
  - [27]  $T_{SE}$  = state estate tax savings =  $t_{SE} * [C^n - PV(T_p)]$
- Specific values used in Table 1 calculations (with commentary):*
- [1]  $M = M^n = 3$  (property values are constant in real dollars);
  - [2]  $C = C^n = 1$  (easement values are likewise constant in real dollars);
  - [3]  $B = 1.5$ ;
  - [4]  $t_{FI} = .35$  (top marginal federal rate on income tax in 2005);
  - [5]  $t_{SI} = .05$  (most states have a top marginal rate in excess of 5%);
  - [6]  $\beta = .5$  (most credits range from 25% to 50%, with one state offering 100%);
  - [7]  $t_p = .01$  (representative of effective property tax rate in many states);
  - [8]  $t_{FK} = .15$  (top marginal rate in 2005 for long-term capital gains);
  - [9]  $t_{FE} = .45$  (equivalent to the top marginal rate scheduled for 2007-2009);
  - [10]  $t_{SE} = .15$  (most states use a top marginal rate of 15-16%); and
  - [11]  $r = .03$  (assumed real rate of interest).