



# Communities on Course

## *Land Use*

## Conservation Easements in Indiana

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### Introduction

Landowners may grant conservation easements out of a personal desire or under a public policy to keep specific land in its current use, thus preventing its further development. A landowner may grant an easement out of charitable motives or only with compensation. If a qualified entity, under the Internal Revenue Code, acquires the easement for less than the market value of the easement, the taxpaying property owner making the grant may obtain income and transfer tax benefits.

While “easements” and “conservation” are familiar terms, a “conservation easement” is less familiar, and a relatively recent legal notion. For example, “conservation easement” is not listed among several easements defined in a 1960’s law dictionary.

A conservation easement that prevents or limits the development of a land parcel for all time is contrary to common law. However, it has become the policy in many states to preserve lands indefinitely, not only for recreation, maintenance of wildlife, and scenic value, but also for maintenance of agriculture and of a way of life.

This publication covers basic and complex issues. It explains conservation easements and how the property and federal tax laws have been amended to encourage gifts of conservation easements. Public policy reflected in past and

recent changes to the Internal Revenue Code make the donation of a conservation easement highly favored.

### What is an easement?

An easement is a right of use over the property of another. A landowner granting an easement gives up, either for a time or permanently, certain rights in the bundle of rights that constitutes full ownership of land. A landowner may grant an easement in real estate to accommodate a neighbor by, for example, granting a right of way over his land so the neighbor may access his property. An easement may arise out of the law where a roadway is necessary to reach a landlocked parcel. Utility companies and government entities acquire easements to deliver services essential to the community or public, for example, pipelines for water or gas, electric power lines, communications cables, and roadways.

### What is a conservation easement?

A conservation easement is a legal agreement a landowner makes to limit the type and amount of development on his property (Diehl and Barrett). This is a granting of rights associated with adding improvements to property or otherwise changing its use or character. It is a conservation restriction. It is established with recorded deed restrictions. The restrictions are flexible, and they may be tailored to the needs of individual

landowners. However, these restrictions attach to the land and are forever, except for special instances. The land may go from owner to owner, but conservation restrictions must be enforced.

Conservation easements are alternatives for the management of development in rural or “undeveloped” areas. Conservation easements may be gifted or sold to an appropriate private or public agency (e.g., a private land trust or to a public park service). Individuals may gift part and sell part of a conservation easement to make an arrangement feasible or practical from a financial planning point of view. (A sample form for a deed of a conservation easement may be obtained by contacting a lawyer experienced in these matters or the American Farmland Trust listed in “References & Additional Resources”.)

### **Why use conservation easements?**

Acquisition of conservation easements reduces the cost of accomplishing policy objectives. Government agencies and private land trusts may acquire full title to property to provide scenic, recreational, and other land-based benefits to the public. Government agencies may use the power of eminent domain to obtain property for public use. However, the value of a conservation easement may be only half the market value of a parcel. Cost savings from obtaining only a conservation easement (the development rights) versus paying for the full title to the property have contributed to the trend of acquiring development rights.

### **What are the tax benefits of donating a conservation easement?**

There are four types of potential tax savings associated with donating a conservation easement: income tax, real property tax, federal gift and estate tax, and an estate tax exclusion.

### **Potential Income Tax Savings**

Gifts of all or part of a qualified conservation easement provide a charitable income tax deduction to the contributing taxpayer. An annual deduction is limited to 30% of the donor’s adjusted gross income. If the donor cannot use the whole deduction in the year of the gift, he may deduct a portion of a current gift in each of the next five years, but subject to the 30% limitation.

For example, if the fair market value of a donated conservation easement is \$200,000 and the taxpayer has an adjusted gross income of \$80,000, then the charitable deduction for the year of the transfer is \$24,000 (30% x \$80,000). This leaves \$176,000 (\$200,000 - \$24,000) to carryover. A lifetime gift of a conservation easement does provide substantial income tax savings; however, at the \$80,000 level of adjusted gross income, only \$144,000 of the \$200,000 would be deductible over a six-year period (6 years x \$24,000/year = \$144,000).

If the taxpayer is in a 28% income tax bracket, a \$24,000 reduction in taxable income provides an income tax savings of \$6,720 (.28 x \$24,000). If that is the savings in each of six years, the tax savings is more than \$40,000 (6 years x \$6,720 = \$40,320 [without discounting for the passage of time]). Individuals in a higher tax bracket (say 31%) would realize greater savings. Taxpayers might make gifts over several years to overcome the annual charitable deduction limitation.

Following the above example, the landowner may decide to give only half of the \$200,000 and wants to receive \$100,000 in cash (part sale, part gift). Part of the income tax basis of the entire parcel must be allocated to the conservation easement in a proportion equal to the value of the easement divided by the total value. If the basis on the entire parcel is \$100,000, and the entire parcel is worth \$400,000, then \$50,000 ( $[\$200,000 / \$400,000] \times \$100,000$ ) in basis must be assigned to the conservation easement. If \$100,000 is received, rather than making a full gift of

\$200,000, the taxpayer has a gain for income tax purposes of \$50,000 (\$100,000 - \$50,000). A landowner, rather than take money for development rights, may trade for appropriate replacement property to defer taxable income.

### ***Real Property Tax Savings***

Because the market value of the real estate is reduced after granting a conservation easement, a real property tax savings may result. The Indiana Uniform Conservation Easement Act (at IC 32-5-2.6-7) indicates that easements under the Act must be taxed on a basis that reflects the easement's qualification under applicable tax statutes. Easements for certain wildlife habitats may be assessed at \$1 per acre.

In fact, the Department of Revenue is to consider a conservation easement's effect on the assessed value of the property for property tax purposes. However, farmland assessment in Indiana is based on an agricultural-use value and not on the fair market value of the property. Thus, the granting of a conservation easement on farmland may not have a noticeable impact on the current property tax assessment.

However, changes in the administration of the real estate tax because of recent court cases involving the application of the real estate tax in Indiana could bring higher assessments for farmland. If farmland is assessed at a higher value relative to the fair market value than in the past, a conservation easement on farmland may mean a lower real estate tax.

### ***Federal Gift & Estate Tax Savings***

Conservation easements may be transferred to the appropriate charitable or government entity free of federal gift and estate taxes. The federal unified gift and estate transfer tax is based on the fair market value of property on the date of the lifetime gift or on the date of death. Amounts that qualify as charitable transfers are exempt from federal

gift or estate transfer tax. Thus, land in a decedent's estate reduced in value by the value of a conservation easement has less exposure to the federal gift and estate tax. Recent amendments to the federal gift and estate tax law promise further savings with respect to conservation easements. The granting of a conservation easement may also reduce the Indiana inheritance tax because the inheritance tax is based on the market value of interests passing from a decedent to individual heirs.

Actual estate tax savings for a decedent's estate depends upon the taxable value of the estate and whether the tax law will otherwise allow for avoiding the estate tax. Because of the features of the estate tax, decedents' estates of small and modest values will have no federal estate tax liability. The value of property that an individual may gift or devise tax-free increased to \$675,000 in 2000. This exclusion amount will increase, in steps, to \$1,000,000 by 2006. Special use valuation of farmland may remove up to \$770,000 (now indexed) in value of land from an estate. Finally, the new family-owned business deduction allows a deduction of up to \$675,000 from a decedent's estate for federal estate tax purposes. These three features permit an individual who is in a farming business (or whose family is in farming in the case of the retired individual) to avoid the federal estate tax on up to \$2.07 million in 2000.

### ***Estate Tax Exclusion for Qualified Conservation Easements***

Starting in 1998, a federal estate tax provision allows excluding land value from a decedent's estate if the land is subject to a qualified conservation easement (QCE). When a QCE meets the requirements of the new law, as much as 40% (or the applicable percentage) of the date-of-death land value may be excluded from the federal estate tax estate. This exclusion from the value of land applies after the value of the conservation easement is subtracted from the fair market value of the land.

However, a **location rule** limits the use of this new exclusion. Only land located: (1) in or within 25 miles of a metropolitan area as defined by the Office of Management and Budget, or (2) within 25 miles of a national park or wilderness area, or (3) within 10 miles of an Urban National Forest qualifies for this exclusion.

Indiana has numerous metropolitan areas, three national parks (Indiana Dunes National Shore, George Rogers Clark National Historical Park, and Lincoln Boyhood National Memorial), but no urban national forests.

The maximum amount that can be excluded is the lesser of the “applicable percentage” (40% max.) or the “exclusion limit” (\$100,000 in 1998, \$200,000 in 1999, \$300,000 in 2000, \$400,000 in 2001, and \$500,000 in 2002 and thereafter).

The percentage exclusion may be as high as 40%, but it is reduced by two percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30% of the value of the land. For this purpose, the value of the land is determined without regard to the value of the easement, and it is reduced by the value of any retained development rights.

To illustrate the above rule, consider that a property owner died and that a qualified conservation easement was granted on his land. The fair market value of the land on the date of death before considering the conservation easement is \$900,000. The value of the QCE is \$200,000. First of all, the \$200,000 of the QCE is fully deductible from the estate tax estate. The \$200,000 value of the QCE is 22.22% of the total value of the property (before the QCE). The applicable percentage must be reduced by 16% (twice the difference between 30% and 22%). In this example, the applicable percentage equals 24% (40 - 16). That leaves an exclusion amount of \$168,000 (24% x \$700,000). For estate tax purposes this real estate’s value is \$532,000 (\$900,000 - \$200,000 - \$168,000).

An election under this exclusion is irrevocable. The income tax basis for the land that benefits from this new exclusion is reduced by the amount of the allowable exclusion. If the election to grant a conservation easement is done in an estate, there is no income tax deduction for the estate or the heirs.

### **What does a conservation purpose require?**

Generally, for a taxpayer’s qualified conservation easement to qualify as deductible for income and transfer tax purposes, the grantee agency must have a charitable or similar standing under the Internal Revenue Code and Treasury Regulations. It is essential that the acquisition agency have a “conservation purpose.” According to the Treasury Regulations, one or more of the following satisfies the conservation purpose requirement:

- the preservation of land areas for outdoor recreation by, or the education of, the general public,
- the protection of a natural habitat of fish, wildlife, plants, or similar ecosystem,
- the preservation of open space (including for farming and forestry) where such preservation is:
  - for the scenic enjoyment of the general public, or
  - pursuant to a clearly delineated federal, state or local governmental conservation policy, and will yield significant public benefit, or
- the preservation of a historically important land area, or a certified historic structure.

### **How long must a conservation easement last to gain the tax benefits?**

To satisfy the federal income tax charitable deduction requirements and for public policy reasons, “qualified” conservation easements must be established to last forever. The recorded restrictions that limit the use of the land are permanent and stay with the land. The grantee agency has the responsibility and must

have the resources to enforce the restrictions against any owner or tenant on the land. However, a utility or government entity might still have a valid reason to take the property (and violate the conservation easement restrictions) under the power of eminent domain.

Restrictions on real estate that last forever are contrary to common law. Indiana has adopted the Uniform Conservation Easement Act [See IC 32-5-2.6-1 to -7], which provides legality for a conservation easement in Indiana, as do similar Acts in other states. This Act also permits assignment of conservation easements between agencies and entities. For example, land trusts and similar charitable entities may acquire and sell conservation easements to state or federal agencies. A sale of easements may be an important source of capital and operating funds for land trusts.

## Summary & Conclusion

Conservation easements are an important tool for managing real estate development. Indiana law was modified to permit the establishment of conservation easements to last forever. The Internal Revenue Code provides that gifts for a "conservation purpose" of "qualified real property interests" to a "qualified organization" are deductible for federal income, gift, and estate tax purposes. Another feature in the tax law allows for an additional exclusion of land value from an estate tax estate under limited circumstances.

Other features in the federal tax law, such as special use valuation of farmland and the new family-owned business interest deduction, are available for avoiding estate tax on modest farmland holdings. Further, the applicable exclusion amount available to all decedents increases to \$1 million in 2006. These tax laws work to keep farmland in an agricultural use.

Land trusts and other entities exist in Indiana for acquiring and holding

conservation easements. While certain land trusts exist for the purpose of preserving farmland, they may or may not accept an easement without an additional contribution to help protect the easement.

There may be few individuals willing to make substantial gifts of conservation easements. However, increased tax advantages, such as the new estate tax exclusion, and education about the tax advantages may persuade individuals and their heirs to contribute conservation easements.

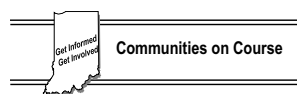
In a few states, there are programs for the purchase and transfer of conservation easements. That is, where a community or other state or local government agency decides to protect farmland and open spaces, there is a systematic process for acquiring development rights and applying these rights where permitted to accomplish further development. The American Farmland Trust promotes and assists with agricultural conservation easement (ACE) programs, and is a source of information on these matters (See "References & Additional Resources".)

A federal program, Farmland Protection Program (FPP), has supplied a small amount of matching funds to leverage state and local funds in the acquisition of ACEs. The FPP is credited with encouraging at least four states (California, New Hampshire, Kentucky, and Ohio) to initiate state-level farmland protection programs. Indiana and its local governments may wish to become more involved in the management of local growth by establishing programs for acquiring ACE for the transfer of development rights.

**Disclaimer:** The material in this publication is intended for general education. Individuals and business and government entities who have questions about the law of the matters discussed should consult their legal counsel or other specialists and references for assistance.

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