



Guidance on the Phasing of Conservation Easements for Colorado Conservation Entities

September, 2005

I. INTRODUCTION

Colorado is fortunate to have one of the country's most successful state conservation incentives in the conservation easement tax credit program. Since its inception in 2000, this unique program has helped preserve thousands of acres of critical agricultural lands, wildlife habitat, water resources and scenic vistas across the state. Moreover, the program has provided the financial means necessary to help many ranching and farming families pass their land on to new generations, thus maintaining an important rural economy.

In spite of its successes, one of the unexpected consequences of the conservation easement tax credit has been a dramatic increase in the phenomenon of "phasing" conservation easement projects. Phasing can come in several forms: 1) placing an easement on only a portion of the landowner's total property, with the expectation that additional property will be placed under conservation easement in subsequent years; 2) dividing the property into smaller parcels under different, but related ownerships prior to placing conservation easements on them—also called "fragmentation"; 3) retaining additional development rights within a single conservation easement with the expectation that these development rights will be extinguished through easement amendments in subsequent years.

While the fragmenting phenomenon described in #2 above is a slightly different issue than phasing, this paper addresses both issues simultaneously and from here on the term "phasing" is meant to include both concerns over fragmenting ownership prior to donating an easement as well as phasing the protection of an individual parcel over multiple easements.

Well planned phasing projects can have the mutual benefits of achieving an organization's conservation objectives while still maximizing the landowner's financial goals. In fact, in some situations, phasing has provided the necessary economic incentives to protect lands that otherwise could not be protected.

However, the unique structure of the Colorado tax credit—primarily the \$260,000 cap and the two tiered structure—has led to unprecedented pressures to phase projects. In order to address this issue, the Colorado Coalition of Land Trusts (CCLT) issued a "best practices" document in 2003 which offered advice to land trusts and local governments

on how to deal with the phasing phenomenon. While the best practices document provided helpful guidance, CCLT and its partners across the state continue to have concerns over poorly-designed and excessive conservation easement phasing. In order to help address this issue and develop additional guidance for conservation easement holders, CCLT recently convened a working group comprised of dedicated conservation practitioners from around the state (see attached list).

Below is the product of the working group's discussions. It includes a brief overview of the conservation purposes test and Internal Revenue Code 170(h); a description of the nature of the concerns regarding phasing; an outline of "red flags" or cautions for phasing; and finally a list of recommendations for organizations considering the acceptance of phased conservation easements. In addition, included with this paper are two relevant attachments: 1) Internal Revenue Code Section 170(h); 2) Treasury Regulations Section 1.170A-14; and 2) the Department of Revenue's recently released *FYI Income 39*.

Land trusts and public agencies are operating in an atmosphere of increasing public scrutiny of charitable entities of all kinds. It is in all our interests to maximize the public benefit of conservation projects and to conduct these transactions in an ethical and technically sound manner.

II. CONCERNS REGARDING PHASING

These concerns fall into several general categories:

1. Public Perception of Program's Purpose

- There are concerns that some phased conservation easements may be predominantly driven by the financial benefits received from the tax credit program, not by conservation purposes.
- There is a legitimate public interest in ensuring that conservation efforts strive to achieve maximum conservation rather than maximum tax benefits.
- Unstructured or inappropriate phasing could lead to negative scrutiny of the program's overall purpose.

2. Public Benefit of Individual Transactions

- It is the Land Trust's responsibility to ensure that each project qualifies under the conservation purposes test of section 170(h) of the Internal Revenue Code.
- Easements conducted in small phases or broken into several ownerships can often stretch the limits of the conservation purposes definition which potentially reduces the public benefit of a given transaction.

3. Inadequate Planning

- Unstructured or poorly planned phases appear to be randomly determined and not developed with overall conservation interests in mind

- If not planned properly, a project completed in many phases can lead to an undesirable amount of development or an undesired location of such development. This is especially true if additional reserved rights are considered for each phase and the easement phases are not consolidated into one easement deed at the end of the project.
- There is always the possibility that the anticipated later phases will not happen.

4. Organizational Efficiencies and Capacity

- From an appraisal standpoint, it is much more difficult to determine the value of multiple easements on the same property and later phases may have much less monetary value than a landowner expects. This is because appraisers must take “enhancement” into account, which requires them to assess the impacts of the easement on other adjacent or nearby property owned by the same owner or their family.
- Conservation entities have limited staff and financial resources. Doing a project in multiple phases may consume more of these limited resources both in completing the transaction and in the long-term monitoring and enforcement.

5. Overall Fiscal Impact to Program

- Phasing may achieve less conservation per easement with more transaction costs and expenditure of public dollars or loss of tax revenue.
- While there is no overall statutory limit to the program, excessive phasing could lead to an annual fiscal impact on the program that future legislators find unacceptable.

III. CONSERVATION PURPOSE AND PUBLIC BENEFIT

In order to qualify for either a state tax credit or federal tax deduction, all easement donations must comply with Internal Revenue Code Section 170(h) and its companion Treasury Regulation Section 1.170A-14. While neither of these sections specifically address the phasing of easements, it is clear that all easements—phased or not—must meet one or more of the conservation purposes as outlined in Section 170(h) to qualify for tax benefits. And Treasury Regulation Section 1.170A-14 further states that “All contributions made for the preservation of open space must yield a significant public benefit.” Thus while there is no regulatory prohibition against landowners realizing their financial goals through phasing an easement donation, it should not come at the expense of the public benefit.

Conservation Purposes are defined in Section 170(h) as:

- (i) the preservation of land areas for outdoor recreation by, or the education of, the general public,
- (ii) the protection of a relatively nature habitat of fish, wildlife, or plants, or similar ecosystem,
- (iii) the preservation of open space (including farmland and forest land) where such preservation is –

- (I) for the scenic enjoyment of the general public, or
- (II) pursuant to a clearly delineated Federal, State, or local governmental conservation policy, and will yield a significant public benefit, or
- (iv) the preservation of an historically important land area or a certified historic structure.

While both the Code and the Treasury Regulations are at times vague and inconsistent, all conservation easement holders, landowners, and consultants should be familiar with the Regulations prior to considering phasing a conservation easement. These two documents help determine whether a particular phase has sufficient conservation purpose—and public benefit—to stand on its own should the other phases not be completed.

Furthermore, easement holders should also be familiar with *Land Trust Standards and Practices*, which provide important ethical and technical guidelines for conducting a responsible easement program. As with all transactions, phased projects should meet the applicable standards and practices, especially the guidance on Public Benefit (Standard 8, Practice D):

The Land Trust (or easement holder) evaluates and clearly documents the public benefit of every land and easement transaction and how the benefits are consistent with the mission of the organization. All projects conform to applicable federal and state charitable trust laws. If the transaction involves public purchase or tax incentive programs, the land trust (or easement holder) satisfies any federal, state or local requirements for public benefit.

The conservation purposes of easement donations will likely face increasing scrutiny at the state and federal level, as evidenced by recent congressional investigations and IRS reviews. As such, it will continue to be important for conservation organizations to not only ensure that each transaction has a legitimate public purpose, but that we collectively share the stories about how our conservation work is benefiting our communities.

IV. RED FLAGS OR CAUTIONS IN PHASING

As seen in the discussions above, the appropriateness of a phased project is not often a black and white issue. However, the list below illustrates potential thresholds at which all parties in an easement transaction might want to question the project's phasing structure. There could very well be legitimate projects that include phases as structured below. However, these cautions are intended to be used as a checklist or filter for determining which projects would require some further questioning or explanations prior to their acceptance.

- **Conservation purposes that are defined only in broad, general terms and are poorly documented.** Per Colorado statute, all conservation easements that are

intended to generate an income tax credit must meet the conservation purposes test as defined in 170(h). Projects that stretch the limits of this definition or have only general conservation values not specific to each phase should be looked at more closely.

- **Multiple 35-40 acre phases.** This is especially true if each small phase contains some retained development rights, as this is the minimum developable lot size throughout most of the state.
- **Phases which are valued at or near the \$100,000 or \$500,000 tiered caps.** This might suggest that the project phases were driven solely by appraised values and not by conservation values in which case the conservation values should be carefully scrutinized.
- **Multiple phases or fragmented ownerships on a given original parcel.**
Because parcel sizes and conservation purposes vary so much, it is difficult to put a number on how many phases or ownerships are too many. However, the more phases or ownerships a property is to be divided into, the more scrutiny the project should undergo. This is especially true when combined with smaller acreages. The conservation purposes and public perception of such transactions should be closely evaluated and the project should not be undertaken if the organization is concerned that the number and size of the phases diminish the overall public benefit of the project.
- **Projects with a phasing structure that will require many years to complete the overall conservation objective.** Similar to the point above, many organizations have different comfort levels and abilities to extend projects for multiple years. However, most organizations would be wise to question transactions that will take many years to complete, as projects can be jeopardized by many factors, including changes in legislation, property ownership and the organization's staff/volunteers.
- **Projects with little or no planning for how the phasing will ultimately work.**
While proper planning is essential for any project, it is even more important for projects in which the property will be preserved through a series of phases. As seen above, accepting one phased parcel without an overall understanding or prior negotiation of how or when the remainder of the project will be phased could lead to an unwanted amount or location of development or other reserved rights.
- **The creation of individual approved building lots for the purposes of eliminating them through donated easements.** In some cases, landowners have created multiple legal lots and intend to phase the project by donating individual lots over a long course of time. While there is no prohibition on creating approved lots prior to donating an easement, easement donees may want to look more closely at this structure for a number of reasons, including the potential of not protecting all the building lots, having the easement potentially tied to the approval of such lots (e.g.; quid pro quo issue), the public benefit of an easement that merely protects a small building envelope, and others.

V. RECOMMENDATIONS

In general, CCLT recommends that land trusts and other conservation agencies only accept phased easements in unique circumstances and under the guidance of a policy on accepting phased conservation easements. Such a policy should be developed in conjunction with or in addition to a policy on project acceptance criteria. Moreover, such a policy should address the following issues, which are in concert with the Land Trust Alliance's *Land Trust Standards and Practices*:

- 1) Every conservation easement (including phased easements) must stand-alone and meet the requirements of the Internal Revenue Code 170(h)(4)(A). Each stage of a multiple-stage easement transaction must be evaluated independently on its own merits.
- 2) Land Trusts/Agencies should have strong and defensible conservation criteria to help them screen potential phased easements
- 3) Land Trusts/Agencies should consider accepting the larger and/or more critical portions of a conservation property in the first phase if phasing is necessary
- 4) If any subdivision of the Property is permitted it should be based on the conservation values of the larger parcel, not on the phasing of the conservation easement.
- 5) When additional stages of a phased easement are added, the conservation easements should reassemble the land into a single parcel if feasible.
- 6) Land Trusts/Agencies should consider requiring a phasing plan/agreement, including a map, of the easement phases before a first phase is accepted. Such a plan should be done in a manner not to jeopardize the deductibility of the easement.
- 7) Land Trust/Agencies should consider developing a policy regarding the number of phases that they will accept that is based on the property sizes and development threats in their area of operation.
- 8) Land Trusts/Agencies should have a clear policy regarding endowments for phased easements. At a minimum, land trust/agency should require an endowment for the first phase and an additional transaction fee for subsequent phases if not an equal endowment fee for successive phases.
- 9) The number of phases in a phased easement should be limited and defined by the criteria listed above. In addition, when designing a phased easement transaction the Land Trust/Agency should also consider any potential negative public perceptions that could lessen public support and endanger the tax credit program

PHASING WORKING GROUP

CCLT would like to thank the member of the Phasing Working Group for their time, energy and great insights:

Shannon Meyer

Aspen Valley Land Trust
320 Main St. Suite 204
Carbondale, CO 81623
(970) 963-8440
shannon@avlt.org

Kris William Larson

Colorado Coalition of Land Trusts
1410 Grant St., Suite C209
Denver, CO 80203
303-271-1577 (phone)
klarson@cclt.org

Dieter Erdmann

Colorado Open Lands
274 Union Blvd., Ste. 320
Lakewood, CO 80228
p:(303)988-2373
www.coloradoopenlands.org

K-Lynn Cameron and Jerry White

200 West Oak, Suite 3000
Ft. Collins, CO 80521
(970) 498-5715
gwhite@larimer.org ;
kcameron@larimer.org

Don Glaser

Douglas County Land Conservancy
P.O. Box 462
Castle Rock, CO 80104
(303) 688-8025
drglaser@comcast.net

Dave Nichols

Montezuma Land Conservancy
P.O. Box 1522
Cortez, CO 81321
(970) 565-1664
mlc@frontier.net

Arnie Butler

Arnie Butler & Company
300 Main St., Suite 301
Grand Junction, CO 81501
(907) 241-2716
arnie@wic.net

Allan Beezley

Allan C. Beezley, P.C.
1327 Spruce St., Suite 302
Boulder, CO 80302
(303) 440-5867
acbpc@infionline.net