

Doing Well by Doing Good: Conservation Easements and 1031 Exchange

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ARTICLE HIGHLIGHTS

- Definition of 1031 Exchange and Conservation Easement
- 3 Structures for Conservation Easements: Donation, Sale, Bargain Sale
- Combining Conservation Easements with 1031 Exchange
- Practical Example

INTRODUCTION

Section 1031 of the Internal Revenue Code allows savvy real estate investors to defer taxes while strategically exchanging properties. The popular “1031 Exchange” has been called the greatest wealth building tool for real estate investors as it allows investors to continuously unleash earned equity by exchanging into larger or better positioned properties. Simply stated, a 1031 Exchange investor receives an interest free loan from the government, which may never require repayment, as long as the investor continues to invest in real estate.

Conservation easements are voluntary, legally binding restrictions on the use of land for conservation, environmental, or historic purposes. A proper conservation easement requires a landowner to contract with a government agency or qualified land trust in creating a perpetual binding restriction on land usage. The use restrictions in a conservation easement generally prohibit or significantly curtail commercial, industrial or residential development from occurring on the land. Landowners who voluntarily restrict the use of their land do so primarily as philanthropists, knowing that the permanent conservation of their land will benefit society through preservation of open space and environmentally sensitive lands.

It would seem that 1031 Exchange and conservation easements do not have much in common. The former tool is for owners looking to build their personal wealth, while the latter is traditionally reserved for owners more interested in creating a lasting public benefit. There are, however, ways to structure a conservation easement so that the landowner gains some economic benefit, while still conserving the property in a socially responsible manner.

STRUCTURING CONSERVATION EASEMENTS

The first structure for conservation easements is donation. In such a structure, the landowner does not receive payment in exchange for the easement. However, Section 170 of the Internal Revenue Code does allow for a charitable tax deduction equal to the appraised value of the rights donated, provided the easement is established according to specific guidelines. Alternatively, instead of making a donation, a landowner can sell the conservation easement to the government or land trust. With sales, the parties agree what the fair value of the easement is by estimating the value of the land without the restrictions and deducting the estimated value of the land with the restrictions, the difference being the value of the restrictions. Finally, a landowner can do a partial donation and partial sale, also known as a bargain sale. With bargain sales, the value of the restriction is estimated and the sale price is something less than the estimated value. The bargain sale landowner receives cash for the sale portion and a charitable deduction for the donation portion of the transaction.

For landowners who choose either a sale or a bargain sale, a taxable gain often will be realized if the value received, whether full or partial, is more than the adjusted tax basis of the property. Determining the adjusted tax basis for the easement is very technical and should be done with the assistance of a CPA or tax attorney. For land that has been owned for many years, it is a near certainty that gain will be realized in sales and is very likely in bargain sales. If there is a gain from the sale or the bargain sale, a tax will be owed. However, the tax can be deferred by performing a 1031 Exchange.

COMBINING CONSERVATION EASEMENTS AND 1031 EXCHANGE

Most real estate investors think of 1031 Exchanges involving commercial or rental property. However, all real property held for investment or use in a business can be exchanged for any other real property held for investment or business use. Real property law in every state considers easements to be a part of the real property. By selling an easement, an investor is selling real property, even if the underlying land the easement pertains to is still owned by the investor. A conservation easement can be exchanged for any other type of real property, while still qualifying for tax deferral under Section 1031.

EXAMPLE

Parcel A is a 20 acre plot of land near the coast in California. Parcel A has been owned by the Smith family for 3 generations and has always been vacant land, with natural vegetation growing in abundance. Recently, local developers have been inquiring with the Smiths and their neighbors about buying land to develop a golf community. The Smiths and some of their neighbors agree that the land should not be used for commercial development and instead should be kept vacant to preserve its natural beauty for future generations. The Smiths approached a local qualified Land Trust to inquire about establishing a conservation easement for their Parcel A. The Land Trust performed an appraisal and deemed the value of Parcel A's conservation easement to be \$5MM. However, given the finances of the Land Trust, they were only able to offer the Smith's \$3MM to buy the conservation easement. The Smith's agreed to the structure and went forward with the bargain sale of the conservation easement of Parcel A to the Land Trust.

Given the many generations of ownership, the Smith's had very little tax basis in Parcel A and thus were faced with a taxable gain of approximately \$3MM for the sale portion and a charitable deduction of \$2MM for the bargain portion. Instead of paying the taxes, the Smiths decided to do a 1031 Exchange and purchase a \$3MM apartment complex near their family home. The end result of the conservation easement and 1031 Exchange is that the Smiths continue to own Parcel A, they have conserved the natural state of the property forever, they have acquired a \$3MM income generating investment property, and they have a \$2MM charitable deduction since they sold the easement for less than its appraised value.

This article was prepared for informational purposes only and should not be relied upon as legal or accounting advice. All 1031 Exchanges and conservation easements should be completed with the guidance of independent tax counsel.

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