

S.2187

Executive Summary: Goals, Policy and Method

What national problem does S.2187 address? The United States' development and land use patterns are out of balance, which is dramatically altering our way and quality of life. Denominated as "sprawl", it is impacting essentially every area of the Country. According to the Department of Agriculture's most recent land census numbers, the United States created 15% of its total urban footprint between 1992 and 1997, and is developing an estimated 400 acres of land per hour on average throughout America. In addition to wasting our land base, this pattern of development and the life styles that it encourages are also diminishing our water quality, our air quality, our sense of community, our natural habitat for plants and animals, and our culture. It is especially harmful to our ranching and farming communities because so much of their land is being irreparably lost to other land uses.

What is the goal of S.2187? S.2187 will direct and empower all levels of government, land trusts, taxpayers and private landowners to work in an aligned partnership, focused at the local level and consistent with our heritage of private property rights, to conserve and restore our natural infrastructure for all generations to come.

How does S.2187 achieve this goal? S.2187 provides for \$25 billion in transferable tax credits over a five year period for the sole purpose of acquiring and supporting conservation easements. The dollars are allocated annually on a state-by-state basis pursuant to a formula that is based on private open space (farm, ranch and forest lands) in each state. The scale, focus, requirements and pace of the program are set by the Federal Government; each State administers its performance under the program; and existing non-profit land conservation organizations are tasked with acquiring the conservation easements and the tax credit participants. If a State is unable to place its allocation in a given year, the unspent balance will be reallocated under the program based on regulations to be developed by the Secretary of Agriculture and the Secretary of the Interior.

Why was the program structured in this manner? To be successful, S.2187 had to scale to the needs of the Country, to be based on our heritage of private property rights, to evolve from tested strategies, to leverage our resources in the most financially efficient manner, to be focused at the local level and to involve as many people as possible. As explained in more detail in Exhibit A, S.2187 incorporates each of these concepts in its structure.

What are the "tested strategies" upon which S.2187 is based? S.2187 incorporates two primary legal strategies: the existing law concerning conservation easements and the highly successful structure for the low income housing tax credits. Conservation easements have been shown to be an extraordinarily effective means of accomplishing conservation requirements at the lowest cost while also retaining lands in private ownership and under private stewardship. Likewise, the low income housing tax credit system has been extraordinarily successful in resolving a national problem in a time and asset efficient manner.

How is S.2187 consistent with private property rights? All dollars allocated under S.2187 may only be spent on acquiring and supporting conservation easements. As a result, the following principles consistent with our heritage of private property rights will be part of every dollar spent:

- All conservation easements will be voluntarily negotiated and, only if the terms are acceptable, binding upon the landowner.
- The landowner will be paid a voluntarily negotiated value not to exceed the fair market value for any property rights that he voluntarily elects to convey.
- Notwithstanding conveyance of the conservation easement, all land made subject to it will remain in private ownership and, just as importantly, under private stewardship and management.

How much control and participation will the Landowner have under S.2187? The landowner cannot be compelled to participate under S.2187; his participation will only be on a voluntary basis. Likewise, however, the landowner cannot act unilaterally. He must negotiate and convince the public, as represented by the State, the non-profit land conservation organization and the participating taxpayers, that the conservation easement that he seeks to sell is worthy of this program. He also may not be directly involved with the non-profit organization. The result is voluntary, effective and real third-party, arm's length, negotiations.

Will the natural infrastructure investments made under S.2187 also produce economic returns? The investments made through S.2187 will produce substantial economic returns: they will filter our water and protect it; they will clean our air and mitigate our escalating human respiratory and related health problems; they will keep our fisheries and food stocks healthy and productive; they will support and conserve our private farm, ranch and forest lands; they will help assure genetic diversity; and they will provide the much needed relief of "green space" for all of us, while simultaneously allowing us to avoid the costs of artificially replacing these same services. As shown in "The Value of Conservation Easements: The Importance of Protecting Nature and Open Space", a report published by the World Resources Institute in April, 2002, these savings and returns will significantly exceed the entire cost of this program. (See Exhibit B).

How does S.2187 relate to the current Tax Code and how would a transaction work under its provisions? (See Exhibit C).

There have been concerns expressed about potential abuses of the use of conservation easements: does the Bill address these concerns? The Senate Finance Committee has recently completed exhaustive hearings on this issue. While isolated cases of abuse were cited, the significance and effectiveness of conservation easements as currently structured was dramatically endorsed on November 17, 2005, when the United States Senate, in part as a result of these Hearings, passed legislation that would significantly enhance tax incentives to encourage the use and donation of conservation easements. Notwithstanding this endorsement of conservation easements, the Bill provides at least six safeguards against abuse: (1) current law concerning conservation easements must be satisfied; (2) easements are acquired through true arm's length negotiations where buyer and seller have equal leverage; (3) notwithstanding such negotiations, no dollars may be spent under the Bill in excess of the appraised fair market value of the conservation easement; (4) the attorney general in each state is authorized to enforce the

public's rights and interests in the easements; (5) the Bill endows a fund whose proceeds are to be used for the monitoring and enforcement of the easement; and (6) the transactional architecture and process required by the Bill enforces a transparency that will greatly limit the opportunity for abuse.

Exhibit A

While one can debate many of the details, the following principles, strategies and values must be incorporated in any plan for it to be successful against the goal sought to be achieved through S.2187:

- (1) Hybrid land estate: We must recognize that our emphasis on land being either public or private has been too simple and a real part of the problem. A great deal of the required solution is coming to understand that we need a greater emphasis on the creation of a larger hybrid land estate throughout America that can achieve our conservation needs and in many instances connect our fully public land to our fully private and enhance them both. This hybrid land estate must remain privately owned and managed, but simultaneously must also be burdened with the loss of certain development rights that the public has acquired voluntarily from the owner at fair market value and holds in perpetuity for the benefit of all of us. These hybrid lands, while staying in private ownership and supporting private purposes, would also serve the public and its collective needs by protecting our water, cleaning the air, conserving habitat for our natural species, maintaining our farm and ranch lands and by offering "green" space to all of us. Fortunately, we have a 25-year history of working with conservation easements, which is the legal tool that creates this hybrid estate. Funding conservation easements must therefore be at the center of any such program.
- (2) Leveraged Focus: The program's focus must be sharp and it must be on reinvesting in, and thereby strengthening, our natural estate. The use of conservation easements would allow us to acquire from the landowner only that portion of the real estate necessary to accomplish our goals. Use of conservation easements would therefore offer the substantial advantage of allowing us to accomplish a great deal more conservation than we would with equivalent dollars expended for the full acquisition of the property. This strategy would also allow us to avoid the on-going costs associated with managing and operating the property.¹
- (3) State Involvement: Every state must be involved and incented to participate in this program. While a portion of this reflects that every state has environmental

¹ This is more succinctly stated in the report published by the Western Governors' Association, The Trust for Public Land, and National Cattlemen's Beef Association, entitled "Purchase of Development Rights: Conserving Lands, Preserving Western Livelihoods", January, 2001: "[Purchase of development rights through conservation easements] makes economic sense in the West: it is a compensatory approach to conservation that protects land from development pressure at prices that are more affordable for the public than outright purchase, and it helps keep farmers and ranchers on the land, providing essential stewardship and contributing to the tax base." (Page 5) and "The dire need to create substantial, dedicated funding sources for state and local [Purchase of Development Rights] programs can hardly be overstated." (page 12)

stresses that must be addressed, this also recognizes that environmental systems, such as rivers, prairies, forests, and all of the species that they support, do not know state lines. To be successful over time, and to protect our overall investment, we must therefore have every state moving in a similar direction.

- (4) Partnerships: We must recognize that the most effective conservation has been the result of public/private partnerships and therefore any plan must put their creation at its center. Congress must set the strategic direction and must set both the importance and pace of the program by the amount of capital that it allocates to it; the states must be involved in coordinating the activities at their level and in helping to set local priorities; and the private sector must lead the execution. As part of this, we must understand and appreciate that conservation easements are bought and sold one family landowner at a time. The best and most expeditious way to negotiate and close those transactions will be to leverage the existing resources of the nonprofit conservation community, including the community leaders across America that serve on their board of directors. The nonprofit land conservation organizations therefore must also be at the center of any such plan.
- (5) Use and scale of capital: Use of capital under this program should be limited to the costs of acquiring and supporting conservation easements. By doing so, Congress would be putting specific restrictions on the use of the capital in accordance with existing law that happens to be consistent with our program's objectives. The scale of the capital should reflect the deep needs of our country but should also be calibrated between what is possible to execute as well as what is needed to unlock the focus, imagination and energy of the most people to respond to this challenge.
- (6) Urgency: The dollars should be allocated to states pursuant to specific deadlines and, if the money is not spent within those deadlines, it should be redistributed to those parts of our country with more pressing needs and that also have the immediate capacity and desire to execute.
- (7) Equity: We must recognize that the conservation and restoration of our natural estate is everyone's responsibility. Paying for it rather than simply accomplishing it through regulation or relying on the generosity of the few reflects this value. We should certainly keep our current donation system in place and encourage its generous use. But by creating a system that is based on acquisitions of conservation easements at fair market value, we can move to a program that not only allows everyone to participate, but also allows us to negotiate for clearer results, act more strategically, and establish our own pace of execution: all critically important to the success of our effort.
- (8) Tax credits: To be successful, we must get as many people involved in America as possible. The best way to achieve this is not through direct appropriations, which is a process involving relatively few people, but instead to use tax credits, which is a process that ultimately includes a lot of people. A program based on tax credits will invite and incent those organizations that wish to deploy the credits to get more individuals and businesses involved in these issues and their solutions. This will require a process of education and engagement that will result

in much more attention, understanding, and commitment to the resolution of these issues. It will also allow us to move at the much quicker response pace that our natural estate crisis requires.

- (9) Strategic conservation: Because of the way in which we have financed a great deal of conservation in this nation, much of it has been done opportunistically as distinct from strategically. What this means by example is that we have acquired a site here and there as they have become available or as someone has been able to afford to give them, but collectively they do not necessarily support or maintain an ecosystem. In those instances, not only do they not fully accomplish a natural estate goal, but by failing to do so they devalue, in some instances, the investment or gift that has been made. The system that we establish must allow us to move to strategic conservation. By allocating a set amount on an annual basis on a state-by-state basis with appropriate sunset provisions, we would allow and incent states and landowners to respond strategically to these issues.

S.2187 prescribes a plan that reflects each of the nine values, strategies, and principles stated above. It is entirely centered on conservation easements; dollars are allocated to every state on a fair basis which assures the participation of every state; it puts a non-profit conservation organization at the center of the plan, but in the context of a direct working partnership with federal and state government; the capital that it allocates may only be used for the acquisition and requirements of conservation easements; it proposes a spending level that scales to the need as well as communicates the importance of the need; there are specific deadlines that will motivate states and land owners alike; it allows each of us to participate in the conservation and restoration of our natural estate; it is centered on tax credits rather than direct appropriations; and it will allow strategic conservation planning and execution.

EXHIBIT "B"

**RANGE OF POTENTIAL ANNUAL ECONOMIC RETURNS
FROM PROTECTING OPEN SPACE**

WEST HILL FOUNDATION FOR NATURE, INC.

The World Resources Institute ("WRI") completed its study entitled "The Value of Conservation Easements: The Importance of Protecting Nature and Open Space" (the "Study") in April, 2002.

Extrapolating from the Study, we are able to illustrate a range of potential annual economic benefits to be gained by investing in conservation easements to protect open space.

Based on actual land conservation expenditures by various conservation organizations totaling more than \$2.5 billion over the last fifteen years, it can be conservatively assumed that each acre protected with a Conservation Easement would cost on average \$2,000, including a 10% set aside reserve for transaction and ongoing monitoring costs.

The WRI Study provides a summary of annual per acre ecosystem benefits for four categories of land from a variety of independent studies. The resulting range of these economic benefits by land type are as follows:

	<u>Range of Annual Economic Benefits Per Acre</u>	<u>Mean Annual Economic Benefit Per Acre</u>
Forest Land	(\$821 - \$1,156)	\$988
Grass and Rangelands	(\$596 - \$596)	\$596
Wetlands	(\$1,395 - \$86,425)	\$43,910
Lakes and Rivers	(\$1,514 - \$14,248)	\$7,881

Using the average estimated acquisition cost of \$2,000 per acre, if our nation invested dollars to buy easements to conserve or restore "Grass and Rangelands", the annual economic return would be just over 25% per acre; whereas if, at the other end of the spectrum, it used all of the dollars to protect the highest valued Wetlands, the potential annual economic benefit would provide annual returns of more than 43 times.

The greater probability, however, is that our nation would invest the available dollars across all four land categories and that the annual benefit would be close to an average of the mean values. Therefore, assuming an equal acreage allocation among each of the above four categories at an annual benefit approximating the mean values, the annual return from the estimated \$2,000 per acre original investment would exceed \$13,000. Thus, this one-time investment of \$2,000 per acre would yield a 6.5x return in the first year, and this return would be the same or greater each and every year thereafter. Using these mid-range assumptions, a nationwide aggregate investment in conservation easements of \$5 billion (protecting 2,500,000 acres) would, beginning at the end of the first year investment, produce annual ecosystems benefits exceeding \$30 billion.

Exhibit C

Tax Law and Transaction Examples

Current Law

Internal Revenue Code section 170 provides for an income tax deduction for a "qualified conservation contribution." The deduction generally is based on the difference in the value of the property before and after the conservation restriction is imposed. The deduction is subject to a percentage of income limitation in the year the contribution is made, with any unused deduction being carried forward for an additional 5 years. The donor's basis in the remaining property is reduced proportionately.

Internal Revenue Code section 2031(c) provides for an estate tax exclusion for property owned by the decedent that is subject to a qualified conservation easement. Up to 40% of the value of the property can be excluded from the gross estate, subject to a maximum limitation. For 2000, the maximum exclusion is \$300,000, which will increase to \$400,000 in 2001, and \$500,000 in 2002.

Reasons for Change

Many large landholdings are used for farming or ranching purposes. An ever increasing number of farmers and ranchers are succumbing to economic pressures to develop their property. Open spaces and other natural resources are being destroyed in the process. Due to the often marginal economics of their operations, farmers, ranchers and other landowners generally cannot benefit from additional income tax deductions, which is the only income tax incentive current law provides for the contribution of a conservation easement.

The proposed change in the law would establish an income tax credit as an inducement for the imposition of conservation easements.

The proposed change would provide a nonrefundable tax credit on funds used for the purchase of conservation easements. The tax credit would enable charitable organizations to raise funds that they would use to purchase easements from farmers and ranchers. Once the easements were purchased, financial contributors to those efforts would receive the tax credit for their capital contributions, similar to the way that low income housing currently is subsidized by tax credits. The proposed change would serve the dual purposes of conserving open space while keeping it in private ownership and providing economic relief to landowners, including especially farmers and ranchers.

Explanation

The Act provides that a charity or other qualified entity controlled by a charity is eligible for the conservation credit. A charity could use the credit to offset its unrelated business income tax. Alternatively, the credit could flow through to the individual partners of a partnership and be used by them to offset their income tax liabilities. The amount of the credit is limited to the sum of (i) the costs of acquiring the conservation easements, (ii) transaction expenses of up to 2% of the purchase prices, and (iii) funds set aside to be used to enforce and monitor the easements acquired. The Act incorporates the definitions used in Code section 170(h), which remains unaffected. The estate tax provisions of section 2031(c), which apply only to contributions of conservation easements, likewise are not affected by the Act.

The Act provides that landowners who sell conservation easements would be able to allocate in full their adjusted basis in the property to which the easement relates. They would recognize a capital gain to the extent that proceeds of the sale exceeded their basis. The Act also provides for a corresponding adjustment to the basis of the remaining property.

The Act provides that purchases of conservation easements would not be subject to the passive loss rules, which would permit charities to form limited partnerships with private investors in order to raise the capital necessary to acquire the conservation easements.

The Act would be effective for taxable years beginning on or after January 1, 2002.

Example

Landowner owns property worth \$10,000,000 at its highest and best use. His basis is \$1,000,000. Landowner imposes a conservation easement limiting development. The property is worth only \$2,000,000 subject to the conservation easement. Landowner has no taxable income in the year of donation.

Under current law, Landowner would be entitled to an income tax deduction of \$8,000,000, subject to a 30% of adjusted gross income limitation. Landowner would have a total of 6 years in which to use the deduction. Unless Landowner's income increased dramatically, it is unlikely that his contribution would provide any income tax benefit.

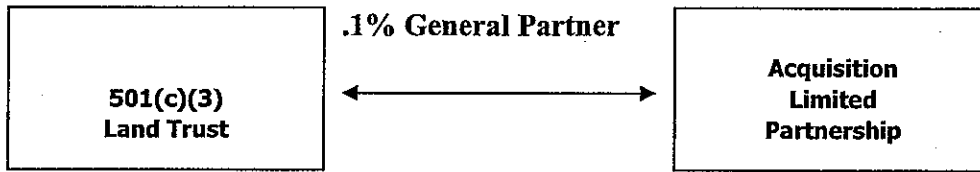
At Landowner's death (in 2002), the property would be includible in his estate at its reduced value of \$2,000,000. If Landowner's executor so elected, his estate could exclude up to 40% of that value, subject to the \$500,000 ceiling. The election could save up to \$250,000 in estate taxes at Landowner's death. Landowner's heirs' basis in the property would be \$1,750,000, which would be relevant if the heirs were forced to sell the property to pay estate taxes.

A more likely scenario is that, instead of granting a conservation easement, Landowner would sell his property for \$10,000,000, pay \$1,800,000 in capital gains tax, and net \$8,200,000 on the transaction. At Landowner's death, his heirs would have \$8,200,000 in liquid assets to pay the \$4,100,000 in estate taxes. If Landowner did not grant the easement and did not sell the property, at his death his heirs would be faced with a potential \$5,000,000 estate tax liability,

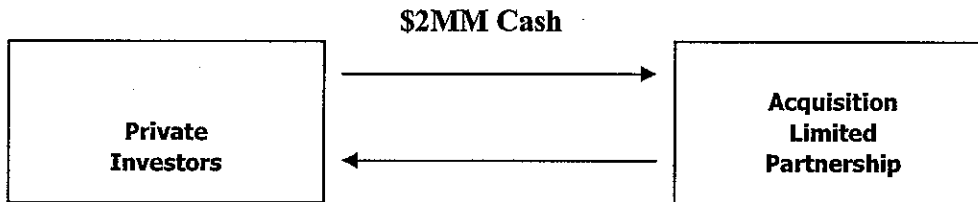
which could force them to sell the property (unless the requirements for special use valuation and deferred tax payment could be met).

If the Act were in effect, Landowner might instead elect to sell a conservation easement to a charity. As in the preceding example, the imposition of the easement would reduce the value of the property by \$8,000,000, so presumably that would be Landowner's sales price. His basis would be applied to the sale, resulting in a \$7,000,000 capital gain. Landowner would pay \$1,400,000 in capital gains tax. His basis in the remaining property would be reduced to zero. Landowner would net \$6,600,000 on the transaction and would retain his \$2,000,000 land. As a result, Landowner would have assets of \$8,600,000, or \$400,000 more than if he had sold the entire property. At Landowner's death, his estate would include the reduced value of the land (i.e., \$2,000,000) plus \$6,600,000 in liquid assets with which to pay the estate tax. Landowner's heirs' basis in the property would be \$2,000,000, but there would be no pressing need to sell it given the liquidity provided by the prior transaction.

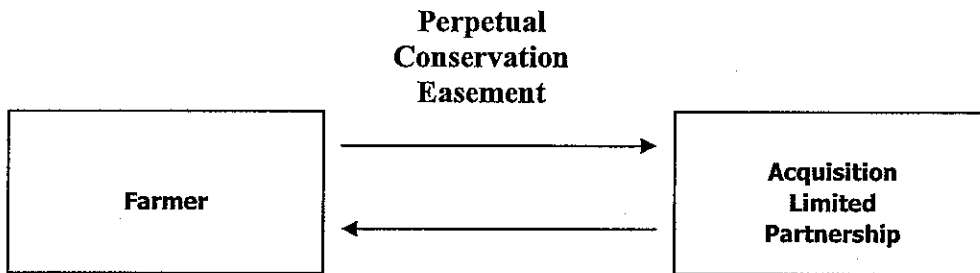
STEP 1: FORM LIMITED PARTNERSHIP



STEP 2: SYNDICATE LIMITED PARTNERSHIP INTERESTS



STEP 3: ACQUIRE CONSERVATION EASEMENTS



ANALYSIS

Landowner has property worth \$1,100,000, if valued for development, but only \$200,000 if valued as a farm. His basis in the farm property is \$100,000. If Landowner sold the farm to developers he would recognize a gain of \$1,000,000 and pay tax (state and federal) of \$250,000, leaving him a net of \$850,000, but no farm.

Instead, Landowner sells to Land Trust Acquisition Limited Partnership ("LTALP") a perpetual conservation easement that ensures the property will remain a farm. LTALP pays Landowner \$900,000 in cash. Landowner recognizes a gain of \$800,000 and pays tax of \$200,000, leaving him with \$700,000 in cash and his \$200,000 farm. LTALP could pay up to \$18,000 in closing costs and could establish a \$73,000 reserve fund to monitor and enforce the easement without exceeding the proposed legislation's percentage limitations.

Because LTALP incurred \$991,000 of qualified conservation expenditures, the limited partners of LTALP (i.e., the private investors) would be entitled to tax credits of \$990,009 (99.9% of \$991,000). The revenue loss associated with the tax credits would be partially offset by the taxes paid by the sellers, and would be more than offset by the value of the conservation services offered by the land as well as the virtually inestimable value of protecting property for future generations of Americans to enjoy.

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