

# WEALTH MANAGEMENT

VOLUME 11 NUMBER 1

[www.ijwm.com](http://www.ijwm.com)

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# Preservation Easements

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**K**ilpatrick [2007] outlined the general precepts for using real estate to address behavioral needs in portfolios, including intergenerational estate planning, charitable giving, and wealth preservation. One of the least understood real estate planning tools is the preservation easement. A well-constructed easement may provide for preservation of family assets and significant tax benefits. In addition, creation of an easement can provide significant nonpecuniary benefits to the family, in effect creating a monument to the family beneficence with little additional expenditure beyond the existing asset basis. Finally, control of the asset remains with the family, and the asset can be sold later, albeit with restrictions that will run with the property.

Preservation easements fall into two general categories:

- Cultural heritage preservation
  - o Historic Preservation Easements
  - o Architectural Preservation Easements
  - o Special Purpose Preservation Easements
- Natural heritage preservation
  - o Open Space Preservation Easements
  - o “Conservation” easements to protect biological or ecological values such as endangered species or rare communities of flora and fauna

The basics are fairly simple and require three components: a donor (the property owner), a donee (usually a not-for-profit entity, such as the Trust for Architectural Easements or the National Trust for Historic Preservation), and a property that has qualities deserving of preservation. The allowable deduction is the difference between the unencumbered “value before” and the “value after” with the preservation easement in place. A review of relevant tax court cases and appraisal evidence leads us to conclude in another article that for historic preservation easements, such diminution in value usually falls in the range of 10%–30% of the property’s value, depending on various circumstances specific to particular properties.

Essentially the easement creates a right for a preservation organization or government body to prevent changes to an existing structure. In many but not all cases, the preservation organization that receives a donation of a preservation easement may also require a cash donation for monitoring costs.<sup>1</sup>

Properties deserving of preservation may overlap among categories. For example, many properties with significant architectural features may also have historic value. The Farnsworth House, in Plano, Illinois, was designed by Mies van der Rowe, one of the world’s premier architects. Its truly significant design qualities (the house is built primarily

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The donor may be a long-term property owner, or the property may be a new acquisition. In historic or architecturally significant neighborhoods, many properties are acquired for development with the understanding that a preservation easement will accompany the development process and generate tax benefits that offset a portion of the investment. In fact, investors can wind up with a win-win situation, in that redevelopment or adaptive re-use of a property may enhance its value while at the same time a preservation easement can generate a tax deduction. The tax deduction depends on the owner's ability to demonstrate that the burdens of the easement will either result in a restriction on the highest-and-best-use of the site or necessitate increased costs over time as a result of the burden of preserving the easement.

It is important to note that a preservation easement does not require that the donor give up ownership or occupancy of the property. The easement modifies the bundle of rights constituting ownership by a positive requirement to maintain historical features and consequently a limitation on redevelopment. Other than those modifications, the property can continue in present uses or, in the case of a façade easement, the interior can be recycled and modernized for an adaptive re-use. For example, a residence could be converted to an office building with updated interior design and function, provided the exterior remains unchanged. The donor takes on an additional commitment to the property by making a promise to maintain it in a certain condition in perpetuity. The easement runs with the property, and so the costs of maintaining this burden (either loss of use or increased maintenance costs) diminish the market value, which generates the tax deduction.

However, in many situations, it may be in the donor's best interests to maintain the property in a preserved state anyway due to some special value or significance the building has for its current owners. For example, a "collectable" office building in a historic part of town may have architectural importance that makes a significant statement about the owner or the owner's business. Maintaining the property in its original state may entail a significant future cost and reduction in development

opportunities, but the owner willingly bears these, out of altruism or even self interest. Either way, this burden, if formally preserved in perpetuity, may create a significant tax deduction against current income and reduce the basis for property taxes and will also reduce estate taxes.

The remainder of this article provides some of the basics wealth managers need to understand when considering these real estate tools and some examples of how preservation easements can be put to work to enhance portfolio value, provide tax opportunities, and make significant charitable contributions.

## TYPES OF EASEMENTS AND DONATIONS

The terms "easements" and "donations" are frequently used interchangeably to refer to a preservation action involving high-amenity real estate. Notably, similar preservation results are often obtained through outright gifts of the asset or through negotiated sales. Often, aspects of all three (easement, gift, and sale) are combined into a single charitable transaction, depending on the needs of the donor, the recipient (usually referred to as the "donee"), the facilitation of regulatory or other government entities, public policy considerations, and the availability of third-party investors or donors who may assist with the transaction. This article focuses on the preservation easement donation, but readers should seek advice in structuring these sometimes complex transactions involving transfer of partial property interests to ensure that they meet IRS requirements, maximize benefits to owners' interests, and fulfill the objectives of the non-profit or governmental organization recipient of the preservation easement.

### Historic Preservation Easements

Much of the focus of historic preservation is on the designation of neighborhoods, although individual properties with valid historic significance may be donated as well. Historic preservation easements for individual properties may entail one of two situations: preservation of the façade (see below) or preservation of the whole building (interior included).

This latter category is of the most interest, since it impacts the property in two ways. First, the property owner is obligated to maintain the property in "as-is" condition in perpetuity, and any sale of the property will be subject to that maintenance requirement. In general,

the market value of the property is negatively impacted by the obligation to maintain, since the assumption, which will have to be supported by the appraisal, is that this maintenance will be more costly in the future than the normal “economic” maintenance of the property. Second, the property owner gives away the highest-and-best-use of the property, assuming that the best use is something legally permitted and economically and financially superior to any uses that would be accommodated by the historically preserved structure.

For example, a historically preserved building in one of the older neighborhoods of a major city may be adaptable for use as an office or dwelling. As such, the current “historically preserved” value is \$750,000, which takes into account both the “as-is” rents and the increased future maintenance costs. However, assume the building is situated on a site zoned for high-rise offices, and if the building was demolished the lot could be sold for \$1 million net after costs of demolition. By agreeing to preserve the building in perpetuity, the owner becomes eligible for an immediate \$250,000 tax deduction (assuming all of the other thresholds, such as basis in the property, are met) from income reported to the IRS. In addition, local property tax assessors should agree to an ongoing reduction in property taxes resulting from the reduction in the property’s market value.

The shortcoming of easements requiring preservation of building interiors (as opposed to merely preservation of the building exterior) is that the more comprehensive easement does not allow redevelopment and reuse that may be helpful in the long run for keeping the building economically viable. For example, many truly historic buildings often do not have interior features that allow for any sort of adaptive re-use under current occupancy requirements (i.e., health and safety concerns, ADA access, or functionality). On the other hand, some buildings gain their historic quality from those interior spaces, and thus interior preservation may be necessary to gain acceptance by the donee and it may be appropriate to maintain the interior features. However, in the case of a building that has value mainly from the exterior façade, a less restrictive preservation easement may satisfy both the donee requirements and the future adaption needs of the donor. Recycling the interior into modernized design and uses could actually contribute to the preservation objectives by prolonging the property’s ability to generate the cash flows from rents needed to maintain the structure in the long run.

According to the Department of the Interior, National Park Service, a certified historic structure is one that satisfies one of the two following requirements:

- Listed in the National Register of Historic Places
- Located in a Registered Historic District and certified by the National Park Service as being historically significant to that district

Recent tax law changes have significantly tightened the rules for preservation easements, but these still provide an excellent opportunity for both personal residences and real estate investments to be preserved in perpetuity with substantial tax savings. Today, the easement must preserve the entire exterior of the property, not just the front, and it may also be necessary to include a dedication of the air rights above the building. This latter restriction prevents many of the “wrap around” preservations that were previously common in major east-coast U.S. cities.

Note that this easement also includes an open space preservation requirement. In other words, if a large portion of the property was vacant at the time of the donation, then that property must remain vacant. This may make a significant impact on the development possibilities of the property, but in fact may also satisfy some public policy requirements in other situations. One handy use of the preservation easement is as a “trade-off” for other nearby development activities. The investor agrees to maintain a particular architectural *objet d’art* in perpetuity, including the open space around it, to facilitate development rights on another property. In these circumstances, the tax benefits of the easement may be lost as a result of this quid pro quo arrangement. However, investors find it useful to grant such an easement if the collateral benefits outweigh the burdens on the property subject to the easement.

The Department of the Interior notes that, for preservation easement purposes, a “structure” may include a building, ship, bridge, railroad car, dam, or other property eligible for listing on the National Register.

### Open Space and Land Easements

These really fall into two categories: open space within a city and natural resource preservation in rural areas. At last count, there were over 1,600 not-for-profit trusts in the United States capable of accepting open-space donations, and this has been a particularly valuable

way to preserve high-amenity “trophy” lands in the western U.S. In recent years, many of these trusts have also become involved with open-space preservation within cities and in suburbs and stand ready to facilitate a conservation easement donation of even small tracts of land.

One of the more unique open-space preservation opportunities is the trophy ranch. Investors acquire either a fee interest or an undivided partial interest in a large tract of high-amenity rural land, such as ridgetops, old-growth forests, river or stream beds, or other areas with significant conservation value. The investors may use a small portion of the property as a personal ranch, then grant a preservation easement by giving away the development rights for the remainder of the property. Naturally, the remainder of the property has valuable development rights only to the extent that there is demand to purchase these trophy ranches. Thus, the demand for trophy ranches has fueled the value, and provides an important basis for the facilitating appraisal.

Finally, the Department of the Interior delineates what are called “historically important land areas” that may qualify for historic preservation easements. These include:

- Independently significant land areas, including any related to historic resources
- Land areas within listed historic districts
- Land areas next to a property listed in the National Register

Examples of historically important land areas include battlefields, cultural landscapes, and scenic views.

### **Special Purpose Easements**

These fall into many categories, such as:

- Archaeologically significant sites, such as Native American dwellings, holy places, or petroglyphs
- Paleontologically significant sites
- Endangered species habitats
- Headwaters sites
- Beachfront dunes or other recreationally important sites
- Wetlands or wetlands mitigation

While these tend to be few in number and highly specialized, they usually provide the wealthy family with

the opportunity to attach its name to an important forest or other unique site. In many situations, the family has acquired the site without knowledge of the underlying significance or has owned a significant site for many generations.<sup>3</sup>

## **PRESERVATION EASEMENTS—BASIC LEGAL AND TAX PROVISIONS**

Effecting a preservation easement requires an eye to both tax law and the structures that govern the granting of the easement. Importantly, there are certain economic and social advantages to granting a binding easement even in the absence of the tax benefits, such as lowering the property’s market value (for property tax purposes), under certain circumstances lowering the basis for estate tax purposes, estate planning (that is, easing intergenerational transfers), and establishing a charitable family legacy.

However, most easements are driven by federal tax consequences, which are both immediate and significant. The donor is allowed an immediate charitable deduction based on the loss in market value resulting from the easement, subject only to the taxpayer’s basis in the property and any other legal limitations on charitable deductions.

### **Applicable Federal Tax Code**

The Federal Historic Preservation Tax Incentive Program is administered by the U.S. Department of the Interior, but the charitable tax deductions are recognized via IRS Code Section 170(h) (“Code”). The Code requires that the property owners formally agree to maintain and preserve forever the significant features of the property.

In 2006, the President signed H.R. 4 into law. This act, also known as the Pension Protection Act (P.L. 109–280), increases incentives to property owners for donations of historically significant easements, but also increases penalties for abusive deductions. For example:

- With respect to historic buildings, easement donations after July 25, 2006, must preserve the entire building exterior.
- The easement must prohibit changes to the exterior that are inconsistent with the building’s historic character.
- Donations’ value must be supported by a qualified appraisal meeting certain requirements specified in the law.

The law also specified certain requirements for a qualified appraiser, language for the donee's pledge to maintain the property, and penalties for abusive deductions.

### General Requirements of All Easements

In general, Small [2002] notes that easement donations must include four features:

1. The easement must include a restriction on the use, development, redevelopment, or modification of the property that is enforceable under law.
2. The easement must be granted to an eligible donee organization. While some state or local governments are set up to accept these, more often the recipient donee is a 501(c)(3) organization such as the Trust for Architectural Easements or one of the many local historic preservation or land preservation trusts. Note that while the property owner gives up the right to alter the property without the consent of the donee, the donee organization doesn't *gain* these rights in a marketable sense. These rights are simply extinguished by virtue of the donation.
3. The easement must protect some significant community value or benefit, such as a historic façade, historic interiors, architectural importance, conservation value, wildlife habitat, or other significant preservation.
4. The easement must be perpetual to satisfy the requirements of the federal tax code.

Many easement donations include both a sale component and a donation component. One example discussed later in this article preserved important paleontological assets via an easement to university researchers, but also included a sale of the post-easement property to a trust established to preserve the research sites.

It is also important to note that the law does not require that *all* usefulness of the property needs to be donated. Many preservation easements simply require that the donor maintain the building exterior in its historically valuable state, even though the property can continue to be used as a residence, office building, or other economically valuable purpose. In a minority of cases, preservation easements also cover the property interior, adding significantly to the economic value of the easement and therefore the size of the allowable tax deduction.

Interestingly, while easements tend to reduce the value of an individual property by increasing the long-run costs of maintenance and restricting redevelopment of the site, evidence demonstrates that preservation easements tend to increase the value of nearby properties and thus facilitate neighborhood revitalization and reinvestment. By ensuring predictability and preserving the historical character of an area that the market recognizes as valuable, the easement that penalizes the value from an individual owner's point of view delivers an "external" benefit to the community. Recognition of historical quality as a "public good" that aids community stability, housing stock conservation and quality of life provides a sound economic rationale for the tax incentive enacted by Congress for preservation easements.

### EXAMPLES OF PRESERVATION EASEMENTS

No two easement situations are alike, and each requires the input of knowledgeable and experienced legal, tax accounting, and real estate advisors. However, the following examples, drawn from experiences of our clients, provide a glimpse at a broad array of situations where preservation easements have been a useful tool. Note, of course, that client names and certain facts have been altered to protect client confidentiality. Otherwise, all of these are real examples.

#### Preserving the Family Estate

The Smiths own a 25-acre estate near New York City that has been in the family for many years, and that they intend to keep in the family, intact, in perpetuity. However, local land use ordinances call for five-acre estate lots, and from a development perspective, they technically could sell off 20 acres into four new home sites at a significant profit—a profit for which they have no need or intention of ever reaping. As a result of the local land use ordinance, they face two significant tax burdens: a current and future property tax bill that grows every year and an eventual estate tax bill. Creating an open-space conservation easement allows them to maintain the property in its undisturbed state without actually donating the property for public use. In other words, the property remains the Smiths and totally in the Smiths' control, save that they no longer have the right—which they never planned to exercise anyway—to develop four more homes on their estate.

## Preserving Habitat and Open Space

The Hearst family owns, among other things, 83,000 acres of undeveloped land and about two-and-a-half miles of pristine Pacific coastline in Southern California, near the base of the famed Coastal Highway near San Luis Obispo. The demand for coastal real estate in California is nearly infinite, and notwithstanding the potential for public opposition, the Hearst family owned important development rights that they did not intend to exercise. To facilitate the donation, they first needed to estimate the optimum development of the site and appraise the development rights *as if they intended to use them*. Then, by gifting away the development rights, they were able to preserve the Ranch at San Simeon in perpetuity without losing control of the site itself.<sup>4</sup>

## Preserving Paleontology

The Joneses own a large and productive cattle ranch in the western U.S. that has extraordinary scenic beauty and the opportunity for development as multiple ranch estates. If the Joneses were to develop the site, they could retain ranch uses and sell off portions for vacation homes. However, much of the ranch has also been determined to be a paleontologically rich site, with an extraordinary density of undug dinosaur bones. The complexity with the Jones ranch was to gift away a preservation easement, based on the forgone development rights, thus generating a tax deduction, and then negotiate a sale of the site containing the bones to entities set up to receive the donation and buy the rights and the site. Funding came from third-party donors, and negotiations, fundraising, and facilitation required several years.

## Preserving Residences

A partnership acquired an apartment building in the French Quarter of New Orleans. This neighborhood, also known as Vieux Carre, is one of the oldest preserved neighborhoods in the United States. It is a listed historic district, and as such all of the buildings in the neighborhood are subject to certain development restrictions. The partners also wanted to grant a preservation easement to local authorities, which would generate tax deductions to offset redevelopment costs. In the end, the partners were able to profitably redevelop the building into nine condominiums, to preserve a significant historic structure,

and to enjoy a tax deduction of about 10% of the total purchase and development costs of the site.

## Preserving Open Space with Commercial Development

The building at 3000 Magazine Street in New Orleans was already designated as a historic landmark when the new owners opted to grant a preservation easement to a donee, the Preservation Resource Center. This easement gave a perpetual veto to the Center for all external surface modifications or demolitions, subject to appeal to the City Council or the courts. The owners thus were able to claim a tax deduction of 10% of the market value of the building in the year of the donation. Since easements must be perpetual to qualify for a tax deduction, the specific language of the preservation easement must be carefully written to meet this criterion. This case also underlines a distinction between easements and historic listing. Easements “run with the land” and are therefore perpetual, while historic districts can be modified or even abolished by the same governmental bodies that create them. Easements and historical districts commonly differ in the degree of protection (how much properties can be modified) and monitoring and enforcement mechanisms used to ensure compliance. In this case, by allowing an appeal to the city or the courts, the easement appears to provide less protection to the property than would be the case in most easements. Nevertheless, the additional restrictions were judged to reduce the property value.

## Urban Open Space

A family portfolio purchased a building in the DuPont Circle area of Washington, DC., within a neighborhood listed on the National Register of Historic Places. While renovating the property, the family conveyed an easement to the National Trust for Historic Preservation that included not only a preservation easement, but also a partial interior easement and conservation of urban open spaces. As a result of forgone development rights, as well as increased maintenance and management costs, the family enjoyed a 15% tax deduction for the easement.

## Adaptive Re-Use of Historic Buildings

A partnership acquired four buildings in the Lafayette Square area of New Orleans, a historic district about six

blocks south of the French Quarter. The partners committed to restoring the buildings for commercial use; which included a substantial reconstruction and restoration of the historic façades, repair of substantial fire damage, and modernization of the building interiors. The partners granted an easement to Historic Fauborg, a Louisiana charity set up to facilitate historic preservation. The partners were able to deduct up to 20% of the acquisition and redevelopment costs, even though the buildings were not in their original historic condition.

### Preservation of Private Residences

Kummerow and Kilpatrick [2007] summarize significant examples of single-family residences in New York, Boston, and Washington, DC., in historically preserved neighborhoods that are the subjects of architectural façade easements. In most cases, property owners enjoy an 8% to 11% tax deduction based on the pre-easement market value of the residence.

### SUMMARY AND CONCLUSION

High-net-worth individuals and families frequently own significant or important real estate that they plan to preserve in perpetuity as part of their family estate. Significant tax savings and estate-planning enhancements can be achieved through easement donations, with continued use of the property itself. In addition, acquisition of property, either for development investment or for personal use, can be facilitated by tax deductions generated by preservation agreements. Finally, use of these tools, while financially motivated, may result in significant non-pecuniary benefits, particularly by attaching the family name to an important and preserved landmark, by creating linkages to the preservation community, or by creating perpetually preserved family estates.

### ENDNOTES

<sup>1</sup>Generally, organizations such as the National Architectural Trust monitor compliance by annual inspections of properties where preservation easements are in place. The IRS will require monitoring provisions as one of the criteria for a valid preservation deduction.

<sup>2</sup>The authors of this article were advisers to friends of the Chicago Art Museum who were also pursuing the property for preservation as an *object d'art*.

<sup>3</sup>In the case, for example, of the Hearst Ranch at San Simeon, while the site and the property were intrinsically valuable, the attachment of the Hearst name probably enhanced the value. In short, the Hearst family gained a valuable deduction as a result of being the Hearst family.

<sup>4</sup>The Hearst's retained a small portion of the development rights for family use only.

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The remainder of this article provides some of the basics wealth managers need to understand when considering these real estate tools and some examples of how preservation easements can be put to work to enhance portfolio value, provide tax opportunities, and make significant charitable contributions.

## TYPES OF EASEMENTS AND DONATIONS

The terms "easements" and "donations" are frequently used interchangeably to refer to a preservation action involving high-amenity real estate. Notably, similar preservation results are often obtained through outright gifts of the asset or through negotiated sales. Often, aspects of all three (easement, gift, and sale) are combined into a single charitable transaction, depending on the needs of the donor, the recipient (usually referred to as the "donee"), the facilitation of regulatory or other government entities, public policy considerations, and the availability of third-party investors or donors who may assist with the transaction. This article focuses on the preservation easement donation, but readers should seek advice in structuring these sometimes complex transactions involving transfer of partial property interests to ensure that they meet IRS requirements, maximize benefits to owners' interests, and fulfill the objectives of the non-profit or governmental organization recipient of the preservation easement.

### Historic Preservation Easements

Much of the focus of historic preservation is on the designation of neighborhoods, although individual properties with valid historic significance may be donated as well. Historic preservation easements for individual properties may entail one of two situations: preservation of the façade (see below) or preservation of the whole building (interior included).

This latter category is of the most interest, since it impacts the property in two ways. First, the property owner is obligated to maintain the property in "as-is" condition in perpetuity, and any sale of the property will be subject to that maintenance requirement. In general,

the market value of the property is negatively impacted by the obligation to maintain, since the assumption, which will have to be supported by the appraisal, is that this maintenance will be more costly in the future than the normal "economic" maintenance of the property. Second, the property owner gives away the highest-and-best-use of the property, assuming that the best use is something legally permitted and economically and financially superior to any uses that would be accommodated by the historically preserved structure.

For example, a historically preserved building in one of the older neighborhoods of a major city may be adaptable for use as an office or dwelling. As such, the current "historically preserved" value is \$750,000, which takes into account both the "as-is" rents and the increased future maintenance costs. However, assume the building is situated on a site zoned for high-rise offices, and if the building was demolished the lot could be sold for \$1 million net after costs of demolition. By agreeing to preserve the building in perpetuity, the owner becomes eligible for an immediate \$250,000 tax deduction (assuming all of the other thresholds, such as basis in the property, are met) from income reported to the IRS. In addition, local property tax assessors should agree to an ongoing reduction in property taxes resulting from the reduction in the property's market value.

The shortcoming of easements requiring preservation of building interiors (as opposed to merely preservation of the building exterior) is that the more comprehensive easement does not allow redevelopment and reuse that may be helpful in the long run for keeping the building economically viable. For example, many truly historic buildings often do not have interior features that allow for any sort of adaptive re-use under current occupancy requirements (i.e., health and safety concerns, ADA access, or functionality). On the other hand, some buildings gain their historic quality from those interior spaces, and thus interior preservation may be necessary to gain acceptance by the donee and it may be appropriate to maintain the interior features. However, in the case of a building that has value mainly from the exterior façade, a less restrictive preservation easement may satisfy both the donee requirements and the future adaption needs of the donor. Recycling the interior into modernized design and uses could actually contribute to the preservation objectives by prolonging the property's ability to generate the cash flows from rents needed to maintain the structure in the long run.

According to the Department of the Interior, National Park Service, a certified historic structure is one that satisfies one of the two following requirements:

- Listed in the National Register of Historic Places
- Located in a Registered Historic District and certified by the National Park Service as being historically significant to that district

Recent tax law changes have significantly tightened the rules for preservation easements, but these still provide an excellent opportunity for both personal residences and real estate investments to be preserved in perpetuity with substantial tax savings. Today, the easement must preserve the entire exterior of the property, not just the front, and it may also be necessary to include a dedication of the air rights above the building. This latter restriction prevents many of the "wrap around" preservations that were previously common in major east-coast U.S. cities.

Note that this easement also includes an open space preservation requirement. In other words, if a large portion of the property was vacant at the time of the donation, then that property must remain vacant. This may make a significant impact on the development possibilities of the property, but in fact may also satisfy some public policy requirements in other situations. One handy use of the preservation easement is as a "trade-off" for other nearby development activities. The investor agrees to maintain a particular architectural *objet d'art* in perpetuity, including the open space around it, to facilitate development rights on another property. In these circumstances, the tax benefits of the easement may be lost as a result of this quid pro quo arrangement. However, investors find it useful to grant such an easement if the collateral benefits outweigh the burdens on the property subject to the easement.

The Department of the Interior notes that, for preservation easement purposes, a "structure" may include a building, ship, bridge, railroad car, dam, or other property eligible for listing on the National Register.

### Open Space and Land Easements

These really fall into two categories: open space within a city and natural resource preservation in rural areas. At last count, there were over 1,600 not-for-profit trusts in the United States capable of accepting open-space donations, and this has been a particularly valuable

way to preserve high-amenity “trophy” lands in the western U.S. In recent years, many of these trusts have also become involved with open-space preservation within cities and in suburbs and stand ready to facilitate a conservation easement donation of even small tracts of land.

One of the more unique open-space preservation opportunities is the trophy ranch. Investors acquire either a fee interest or an undivided partial interest in a large tract of high-amenity rural land, such as ridgetops, old-growth forests, river or stream beds, or other areas with significant conservation value. The investors may use a small portion of the property as a personal ranch, then grant a preservation easement by giving away the development rights for the remainder of the property. Naturally, the remainder of the property has valuable development rights only to the extent that there is demand to purchase these trophy ranches. Thus, the demand for trophy ranches has fueled the value, and provides an important basis for the facilitating appraisal.

Finally, the Department of the Interior delineates what are called “historically important land areas” that may qualify for historic preservation easements. These include:

- Independently significant land areas, including any related to historic resources
- Land areas within listed historic districts
- Land areas next to a property listed in the National Register

Examples of historically important land areas include battlefields, cultural landscapes, and scenic views.

### Special Purpose Easements

These fall into many categories, such as:

- Archaeologically significant sites, such as Native American dwellings, holy places, or petroglyphs
- Paleontologically significant sites
- Endangered species habitats
- Headwaters sites
- Beachfront dunes or other recreationally important sites
- Wetlands or wetlands mitigation

While these tend to be few in number and highly specialized, they usually provide the wealthy family with

the opportunity to attach its name to an important forest or other unique site. In many situations, the family has acquired the site without knowledge of the underlying significance or has owned a significant site for many generations.<sup>3</sup>

## PRESERVATION EASEMENTS—BASIC LEGAL AND TAX PROVISIONS

Effecting a preservation easement requires an eye to both tax law and the structures that govern the granting of the easement. Importantly, there are certain economic and social advantages to granting a binding easement even in the absence of the tax benefits, such as lowering the property’s market value (for property tax purposes), under certain circumstances lowering the basis for estate tax purposes, estate planning (that is, easing intergenerational transfers), and establishing a charitable family legacy.

However, most easements are driven by federal tax consequences, which are both immediate and significant. The donor is allowed an immediate charitable deduction based on the loss in market value resulting from the easement, subject only to the taxpayer’s basis in the property and any other legal limitations on charitable deductions.

### Applicable Federal Tax Code

The Federal Historic Preservation Tax Incentive Program is administered by the U.S. Department of the Interior, but the charitable tax deductions are recognized via IRS Code Section 170(h) (“Code”). The Code requires that the property owners formally agree to maintain and preserve forever the significant features of the property.

In 2006, the President signed H.R. 4 into law. This act, also known as the Pension Protection Act (P.L. 109–280), increases incentives to property owners for donations of historically significant easements, but also increases penalties for abusive deductions. For example:

- With respect to historic buildings, easement donations after July 25, 2006, must preserve the entire building exterior.
- The easement must prohibit changes to the exterior that are inconsistent with the building’s historic character.
- Donations’ value must be supported by a qualified appraisal meeting certain requirements specified in the law.

The law also specified certain requirements for a qualified appraiser, language for the donee's pledge to maintain the property, and penalties for abusive deductions.

### General Requirements of All Easements

In general, Small [2002] notes that easement donations must include four features:

1. The easement must include a restriction on the use, development, redevelopment, or modification of the property that is enforceable under law.
2. The easement must be granted to an eligible donee organization. While some state or local governments are set up to accept these, more often the recipient donee is a 501(c)(3) organization such as the Trust for Architectural Easements or one of the many local historic preservation or land preservation trusts. Note that while the property owner gives up the right to alter the property without the consent of the donee, the donee organization doesn't *gain* these rights in a marketable sense. These rights are simply extinguished by virtue of the donation.
3. The easement must protect some significant community value or benefit, such as a historic façade, historic interiors, architectural importance, conservation value, wildlife habitat, or other significant preservation.
4. The easement must be perpetual to satisfy the requirements of the federal tax code.

Many easement donations include both a sale component and a donation component. One example discussed later in this article preserved important paleontological assets via an easement to university researchers, but also included a sale of the post-easement property to a trust established to preserve the research sites.

It is also important to note that the law does not require that *all* usefulness of the property needs to be donated. Many preservation easements simply require that the donor maintain the building exterior in its historically valuable state, even though the property can continue to be used as a residence, office building, or other economically valuable purpose. In a minority of cases, preservation easements also cover the property interior, adding significantly to the economic value of the easement and therefore the size of the allowable tax deduction.

Interestingly, while easements tend to reduce the value of an individual property by increasing the long-run costs of maintenance and restricting redevelopment of the site, evidence demonstrates that preservation easements tend to increase the value of nearby properties and thus facilitate neighborhood revitalization and reinvestment. By ensuring predictability and preserving the historical character of an area that the market recognizes as valuable, the easement that penalizes the value from an individual owner's point of view delivers an "external" benefit to the community. Recognition of historical quality as a "public good" that aids community stability, housing stock conservation and quality of life provides a sound economic rationale for the tax incentive enacted by Congress for preservation easements.

### EXAMPLES OF PRESERVATION EASEMENTS

No two easement situations are alike, and each requires the input of knowledgeable and experienced legal, tax accounting, and real estate advisors. However, the following examples, drawn from experiences of our clients, provide a glimpse at a broad array of situations where preservation easements have been a useful tool. Note, of course, that client names and certain facts have been altered to protect client confidentiality. Otherwise, all of these are real examples.

#### Preserving the Family Estate

The Smiths own a 25-acre estate near New York City that has been in the family for many years, and that they intend to keep in the family, intact, in perpetuity. However, local land use ordinances call for five-acre estate lots, and from a development perspective, they technically could sell off 20 acres into four new home sites at a significant profit—a profit for which they have no need or intention of ever reaping. As a result of the local land use ordinance, they face two significant tax burdens: a current and future property tax bill that grows every year and an eventual estate tax bill. Creating an open-space conservation easement allows them to maintain the property in its undisturbed state without actually donating the property for public use. In other words, the property remains the Smiths and totally in the Smiths' control, save that they no longer have the right—which they never planned to exercise anyway—to develop four more homes on their estate.

### **Preserving Habitat and Open Space**

The Hearst family owns, among other things, 83,000 acres of undeveloped land and about two-and-a-half miles of pristine Pacific coastline in Southern California, near the base of the famed Coastal Highway near San Luis Obispo. The demand for coastal real estate in California is nearly infinite, and notwithstanding the potential for public opposition, the Hearst family owned important development rights that they did not intend to exercise. To facilitate the donation, they first needed to estimate the optimum development of the site and appraise the development rights *as if they intended to use them*. Then, by gifting away the development rights, they were able to preserve the Ranch at San Simeon in perpetuity without losing control of the site itself.<sup>4</sup>

### **Preserving Paleontology**

The Joneses own a large and productive cattle ranch in the western U.S. that has extraordinary scenic beauty and the opportunity for development as multiple ranch estates. If the Joneses were to develop the site, they could retain ranch uses and sell off portions for vacation homes. However, much of the ranch has also been determined to be a paleontologically rich site, with an extraordinary density of undug dinosaur bones. The complexity with the Jones ranch was to gift away a preservation easement, based on the forgone development rights, thus generating a tax deduction, and then negotiate a sale of the site containing the bones to entities set up to receive the donation and buy the rights and the site. Funding came from third-party donors, and negotiations, fundraising, and facilitation required several years.

### **Preserving Residences**

A partnership acquired an apartment building in the French Quarter of New Orleans. This neighborhood, also known as Vieux Carre, is one of the oldest preserved neighborhoods in the United States. It is a listed historic district, and as such all of the buildings in the neighborhood are subject to certain development restrictions. The partners also wanted to grant a preservation easement to local authorities, which would generate tax deductions to offset redevelopment costs. In the end, the partners were able to profitably redevelop the building into nine condominiums, to preserve a significant historic structure,

and to enjoy a tax deduction of about 10% of the total purchase and development costs of the site.

### **Preserving Open Space with Commercial Development**

The building at 3000 Magazine Street in New Orleans was already designated as a historic landmark when the new owners opted to grant a preservation easement to a donee, the Preservation Resource Center. This easement gave a perpetual veto to the Center for all external surface modifications or demolitions, subject to appeal to the City Council or the courts. The owners thus were able to claim a tax deduction of 10% of the market value of the building in the year of the donation. Since easements must be perpetual to qualify for a tax deduction, the specific language of the preservation easement must be carefully written to meet this criterion. This case also underlines a distinction between easements and historic listing. Easements "run with the land" and are therefore perpetual, while historic districts can be modified or even abolished by the same governmental bodies that create them. Easements and historical districts commonly differ in the degree of protection (how much properties can be modified) and monitoring and enforcement mechanisms used to ensure compliance. In this case, by allowing an appeal to the city or the courts, the easement appears to provide less protection to the property than would be the case in most easements. Nevertheless, the additional restrictions were judged to reduce the property value.

### **Urban Open Space**

A family portfolio purchased a building in the DuPont Circle area of Washington, DC., within a neighborhood listed on the National Register of Historic Places. While renovating the property, the family conveyed an easement to the National Trust for Historic Preservation that included not only a preservation easement, but also a partial interior easement and conservation of urban open spaces. As a result of forgone development rights, as well as increased maintenance and management costs, the family enjoyed a 15% tax deduction for the easement.

### **Adaptive Re-Use of Historic Buildings**

A partnership acquired four buildings in the Lafayette Square area of New Orleans, a historic district about six

blocks south of the French Quarter. The partners committed to restoring the buildings for commercial use, which included a substantial reconstruction and restoration of the historic façades, repair of substantial fire damage, and modernization of the building interiors. The partners granted an easement to Historic Fauborg, a Louisiana charity set up to facilitate historic preservation. The partners were able to deduct up to 20% of the acquisition and redevelopment costs, even though the buildings were not in their original historic condition.

### Preservation of Private Residences

Kummerow and Kilpatrick [2007] summarize significant examples of single-family residences in New York, Boston, and Washington, DC., in historically preserved neighborhoods that are the subjects of architectural façade easements. In most cases, property owners enjoy an 8% to 11% tax deduction based on the pre-easement market value of the residence.

### SUMMARY AND CONCLUSION

High-net-worth individuals and families frequently own significant or important real estate that they plan to preserve in perpetuity as part of their family estate. Significant tax savings and estate-planning enhancements can be achieved through easement donations, with continued use of the property itself. In addition, acquisition of property, either for development investment or for personal use, can be facilitated by tax deductions generated by preservation agreements. Finally, use of these tools, while financially motivated, may result in significant non-pecuniary benefits, particularly by attaching the family name to an important and preserved landmark, by creating linkages to the preservation community, or by creating perpetually preserved family estates.

### ENDNOTES

<sup>1</sup>Generally, organizations such as the National Architectural Trust monitor compliance by annual inspections of properties where preservation easements are in place. The IRS will require monitoring provisions as one of the criteria for a valid preservation deduction.

<sup>2</sup>The authors of this article were advisers to friends of the Chicago Art Museum who were also pursuing the property for preservation as an *object d'art*.

<sup>3</sup>In the case, for example, of the Hearst Ranch at San Simeon, while the site and the property were intrinsically valuable, the attachment of the Hearst name probably enhanced the value. In short, the Hearst family gained a valuable deduction as a result of being the Hearst family.

<sup>4</sup>The Hearst's retained a small portion of the development rights for family use only.

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