Recent Developments With Conservation Easements

by Jeffrey R. Bergstrom

This article discusses recent developments with regard to efforts to maximize the tax benefits for granting Conservation Easements and the responsive efforts by the Internal Revenue Service to strictly enforce the Internal Revenue Code and Treasury Regulations.

Like many provisions of the Internal Revenue Code (Code), especially items that might benefit a taxpayer, conservation easements arise out of an exception to a prohibition. In the case of conservation easements, the general prohibitive rule is that "a charitable deduction is not allowed for the contribution of a partial interest in property."[1] However, Congress later provided an exception permitting a deduction for certain contributions of a partial interest in real property.[2] The contribution must be to a qualified organization (QO).[3] It must also be exclusively for conservation purposes.[4] Lately, it appears that the contributions most likely to find their way into the judicial system are those involving either an easement or a restrictive covenant that prevents the development of the land, purporting to safeguard its natural character. These are called "conservation easements."

Increased IRS Scrutiny of Easement Contributions

Increased scrutiny of conservation easements began after June 30, 2004, when the Internal Revenue Service (IRS) released IRS Notice 2004-41.[5] This Notice addressed charitable contributions and conservation easements and stated in part:

> The Internal Revenue Service is aware that taxpayers who (1) transfer an easement on real property to a charitable organization, or (2) make payments to a charitable organization in connection with a purchase of real property from the charitable organization, may be improperly claiming charitable contribution deductions under § 170 of the Internal Revenue Code. The purpose of this notice is to advise participants in these transactions that, in appropriate cases, the Service intends to disallow such deductions and may impose penalties and excise taxes.

Thus, the IRS publicly announced its awareness of abuses related to conservation easement contribution deductions and put taxpayers on notice that easement contribution deductions would likely be examined, scrutinized, and challenged. Despite the IRS's warning, taxpayers continue to challenge and push the conservation easement rules to their limits. Recently, many of these controversies have worked their way into the judicial system and are available for the education of attorneys practicing tax law.

Conditional Gifts

In *Graev v. Commissioner*, the taxpayer contributed a façade conservation easement to a QO.[6] Before the contribution, at the taxpayer's request, the QO issued a side letter to the taxpayer that stated:

> [I]n the event that the IRS disallows the tax deductions in their entirety, we will promptly refund your entire cash endowment contribution and join with you to immediately remove the facade conservation easement from the property's title.[7]

The taxpayer then claimed a charitable contribution deduction for the easement donation. The question before the court in *Graev* was whether the contribution of the easement to the QO should be disallowed because it was a conditional gift.[8]

On review, the *Graev* court stated that "a fundamental principle underlying the charitable contribution deduction is that the charity actually receive and keep the contribution."[9] The court said that this requirement is clarified in the portion of § 1.170A-1(e) of the Treasury Regulations that provides that:

> no deduction for a charitable contribution that is subject to a condition (regardless of what the condition might be) is allowable, unless on the date of the contribution the possibility that the charity's interest in the contribution would be defeated was negligible.[10]

The IRS contended that the side letter made the contribution a conditional gift and, therefore, not deductible under Code § 170.

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The court agreed and concluded that the likelihood that the QO would be divested of the easement was not a nullity.[11] Specifically, the court disallowed the taxpayer's charitable contribution deduction after determining that:

> at the date of the contribution the possibility that the IRS would disallow the deductions and that NAT would return the cash to Mr. Graev and "remove" the easement was not "so remote as to be negligible."[12]

The court later cited §§ 1.170A-1(e), 1.170A-7(a)(3), and 1.170A-14(g)(3) of the Treasury Regulations.[13]

The reasoning behind this decision was two-fold. First, a substantial risk obviously arose from the IRS's previously announced intention to scrutinize charitable contribution deductions for easement contributions.[14] Second, the risk was evident because the taxpayer insisted on getting the QO's side letter.

> We need not wonder how a donor or donee would have responded to this risk if he had foreseen it; we know how Mr. Graev (the taxpayer) did respond when he did foresee it: He did not "disregard" or "ignore" it, but rather went out of his way to address it and hedge against it.[15]

In other words, if the likelihood was negligible, the taxpayer would not have provided for what would happen after its occurrence.

In a final effort to salvage the deduction, the taxpayer attempted the "no harm no foul" argument by asserting that the deduction was otherwise proper and the claimed deduction amount was reasonable.[16] The court, however, maintained that even if

> a valuation is reasonable does not mean that it is correct; a reasonable but incorrect valuation may be challenged and disallowed; consequently, someone who assigns a reasonable value to his donation may nonetheless face a non-negligible risk of disallowance.[17]

Option to Substitute Different Land

In *Belk v. Commissioner*, the taxpayer also granted a conservation easement to a QO.[18] In this case, the conservation easement covered 184.627 acres of land on which a golf course was located. The conservation easement agreement permitted the taxpayer and the QO, in the future, "to change what property was subject to the conservation easement."[19] This easement was called into question by the IRS.

The taxpayer asserted that "I.R.C. § 170(h)(2)(C) does not require the donation of an interest in an identifiable, unchanging, static piece of real property."[20] The taxpayer argued that there was too much emphasis being placed on the specific identity of the real property, and that the IRS did not give enough consideration to the fact that the taxpayer did donate a use restriction granted in perpetuity. According to the taxpayer, as long as they (fee owner and easement owner) agreed not to develop the agreed-upon amount of land (the 184.627 acres), the court and the IRS should not be concerned with what land actually comprised those acres.

The court rejected the notion of such a "floating easement" and found that Code § 170(h)(2)(C) requires the taxpayer to donate an interest in an identifiable, specific piece of real property.[21] For the court, the bottom line appeared to be that because the conservation easement agreement contained a substitution provision, the taxpayer had not agreed to restrict the use of the specific land in perpetuity. Nonetheless, the court did acknowledge that "the regulations permit property to be substituted when the continued use is impossible or impractical."[22] Citing § 1.170A-14(g)(6) of the Treasury Regulations, the court also pointed out that the easement may be extinguished by judicial proceeding "if subsequent unexpected changes in the conditions surrounding the property make impossible or impractical the continued use of the property for conservation purposes."[23]

Not willing to concede, the taxpayer offered an alternative argument. The taxpayer argued that even without a substitution provision, state law would permit the parties to modify the terms of the contract by mutual agreement; thus, the court could not deny their deduction just because there was a substitution provision in the conservation easement agreement.[24] However, the taxpayer confused its right under state law to modify the terms of a contract by mutual consent with the effect such a modification would have for tax purposes. The court concluded that:

> [e]ven if petitioners and SMNLT had the right to modify the terms of the conservation easement agreement under State law by mutual agreement, North Carolina law does not dictate the resulting tax consequences of the modification.[25]

In other words:

> Whatever modifications petitioners might have envisioned making to the conservation easement agreement after the fact are irrelevant in determining the tax consequences of those provisions that were, in fact, included.[26]

The taxpayer "chose to include a provision in the conservation easement agreement that permit[ted] substitutions" and the inclusion of such a provision disqualified the contribution.[27] The *Belk* court then stated:

> While a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, and may not enjoy the benefit of some other route he might have chosen to follow but did not.[28]

Conservation Easement With Mutual Extinguishment Clause

Perhaps the aforementioned impossible or impractical exception (that allows changes to the property) may have been the intended underlying support for the taxpayer in *Carpenter v. Commissioner*, but it ultimately was not enough.[29] In *Carpenter*, the conservation easement contained a provision permitting the parties to extinguish the conservation easement by mutual agreement, if the purpose of the conservation easement became impossible to accomplish.[30] The court concluded that because the easement could be extinguished by the mutual consent of the parties, the easement was not protected in perpetuity; therefore, the contribution was not a qualified conservation contribution.[31] The court essentially held that it was the inclusion of the right of the parties to extinguish or terminate the conservation easement that caused the issue, not whether the parties did, in fact, extinguish the conservation easement.

Unreliable or Unrealistic Valuations

The issue that probably leads to the most challenges by the IRS and the most scrutiny by the courts is the claim that the taxpayer is using an unreliable or unrealistic valuation. The amount of the possible charitable deduction is limited to the difference between the fair market value of the property before and after the granting of the easement.[32] The principle is sometimes stated as the difference between the unencumbered value of the property and its value as encumbered by the easement or restrictive use.

For any claimed valuation in excess of $500, it is required that there is a declaration, completed by a qualified appraiser.[33] The details for what constitutes a qualified appraisal and a qualified appraiser are primarily set forth in Code § 170(f)(11)(E) and § 1.170A-17 of the Treasury Regulations, and as recently interpreted by *Friedberg v. Commissioner*.[34]

If an otherwise qualified appraiser disregards relevant facts affecting the valuation or exaggerates the value to incredible levels in an otherwise qualified appraisal, the so-called expert opinion will be disregarded. In *Boltar, LLC v. Commissioner*, the court was not very impressed with taxpayer's appraiser.[35] The court said that "an expert loses usefulness to the Court and loses credibility when giving testimony tainted by overzealous advocacy."[36] A reading of the entire case would suggest that this stated criticism was a bit restrained. Nonetheless, the taxpayer is certainly not going to prevail after the court makes that type of statement about his or her appraiser.

The issue of unrealistic valuations was also the main focus of a recent and locally challenged conservation easement case.[37] In *The Bluffs Destination Resorts, LLC v. Greenberg Traurig LLP*, multiple taxpayers pooled their resources and purchased a piece of land, divided the land so that each taxpayer would receive one parcel, and then each parcel granted a separate conservation easement to a QO.[38] The value placed on the easements, collectively, far exceeded the original purchase price for the entire land.[39] The IRS and the Colorado Department of Revenue audited the entire transaction and disallowed the claimed deductions.[40] This lawsuit by the taxpayers against the promoters of the transaction ensued. Eventually, the parties stipulated to the dismissal of the action with prejudice, presumably because the case settled.[41]

An unrealistic valuation was also at the center of another local case that focused more on the sale of state tax credits than on the federal tax deduction amount.[42] Colorado law authorizes a tax credit for qualifying conservation easements.[43] The tax credit provides a dollar-for-dollar reduction against the Colorado income tax owed by the taxpayer granting the conservation easement.[44] Colorado law also permits a person who conveys a conservation easement to sell and assign the resulting tax credit to a third party.[45]

In *Basin Wind and Energy, LLC v. Snell & Wilmer*, the taxpayer wanted to purchase a piece of real property, but did not have sufficient funds.[46] The taxpayer proposed to have the property conveyed to a new entity, subdivided into many parcels, and then have conservation easements placed on each parcel.[47] Each conservation easement "would then create a state tax credit which [w]ould be sold and those proceeds [were to] be used to fund the purchase."[48] Once again, the Colorado Department of Revenue maintained that the value of the property with the easement or use restriction was overstated because of

> the appraisal's failure to take into account the limitation on development rights for subsequent purchasers, the presence of the wind farm Lease encumbering the property at the time of the placement of the conservation easements and its assignability.[49]

The lesson learned from both of these cases is that when the IRS and the Colorado Department of Revenue discover that the sum of the value of the easements greatly exceeds the value of the original, unencumbered land, the proposed conservation easement transactions will likely be challenged.

The Quid Pro Quo *Agreement*

Pollard v. Commissioner involved an easement that placed a variety of limitations on the use of the taxpayer's property.[50] According to the language of the easement, the stated limitations were to "protect the land's natural beauty and rural character," which qualified as a valid conservation purpose.[51] The problem arose, however, when it was discovered that the external features of the transaction demonstrated that the taxpayer's granting of the conservation easement to the county was part of a *quid pro quo* exchange for the county's approving the taxpayer's subdivision exemption request.[52] The taxpayer argued that there was not a *quid pro quo* arrangement because "the approval of his subdivision exemption request was 'virtually guaranteed' and therefore there was no need for any such arrangement."[53]

However, the court found the taxpayer's subdivision exemption request was far from being virtually guaranteed and held that there was "little chance of it being granted without petitioner's promise to grant a conservation easement to Boulder County."[54] In that case, the smoking gun was that the county's "Land Use staff recommended that the subdivision exemption request be rejected unless petitioner granted a conservation easement."[55] Additionally, the county commissioners "were unanimous in their insistence that petitioner grant a conservation easement before they would consider granting his subdivision exemption request."[56] In sum, the court held against the taxpayer because the taxpayer did not convey the conservation easement for a qualified charitable purpose—instead, the court found the easement was given "to secure a personal benefit."[57]

Conclusion

It is well settled that a taxpayer's expectations and hopes as to the tax treatment of his or her conduct alone have nothing to do with the matter. There must be an objective inquiry. "The proper criterion is one that inquires what the basic reason for his conduct was in fact—the dominant reason that explains his action in making the transfer."[58] The court in *Garcia v. Commissioner* found that "the bare fact that a taxpayer desires to fall within a particular section of the Internal Revenue Code is not controlling where actions belie expressed intent."[59] Stated differently, matters of taxation must be determined in light of what was actually done, rather than the declared purpose of the participants.

For many taxpayers, conservation easements are exactly what they would hope for—a tax deduction for agreeing not to develop land that they had never planned on developing. For these taxpayers, contributing a partial interest in their real property to a QO exclusively for a conservation purpose is a straightforward, permitted transaction. For other taxpayers, however, the availability of a tax deduction is the goal, seeking the largest deduction possible. For these taxpayers, the donation of a conservation easement is simply the means to the end. It is from the experiences of these taxpayers that we are provided the knowledge necessary to appropriately advise clients on how to structure sustainable conservation easements.

Notes

1. IRC § 170(f)(3)(A); Treas. Reg. § 1.170A-7.

2. The disallowance of a deduction for partial interests was added to the Code as § 170(f)(3) by the Tax Reform Act of 1969. In that provision's original form, the only exceptions to disallowance of a deduction for contributions of partial interests were for contributions of "a remainder interest in a personal residence or farm" and "an undivided portion of the taxpayer's entire interest in property." In 1976, Congress permitted a deduction for the contribution of an easement with respect to real property of not less than thirty years' duration granted to a charitable organization exclusively for conservation purposes. The following year, Congress eliminated the "30-year duration" provision and required that easements with respect to real property be granted in perpetuity.

3. A qualified organization includes certain governmental units, public charities that meet certain public support tests, and certain supporting organizations.

4. A qualified conservation purpose includes: (1) preserving land for public outdoor recreation or education of the general public; (2) protecting a relatively natural habitat of fish, wildlife, or plants; (3) preserving open space for the public's scenic enjoyment or under a governmental conservation policy that will yield significant public benefit; and (4) preserving an historically important land area or certified historic structure. IRC § 170(h)(4).

5. IRS Notice 2004-41, 2004-2 C.B. 31.

6. *Graev v. Comm'r*, 140 T.C. No. 17 (June 24, 2013).

7. *Id.* slip op. at 11.

8. *Id.* slip op. at 17.

9. *Id.* slip op. at 22.

10. *Id.*

11. *Id.* slip op. at 18.

12. *Id.* slip op. at 28.

13. *Id.* slip op. at 35.

14. *Id.* slip op. at 29.

15. *Id.*

16. *Id.* slip op. at 31.

17. *Id.*

18. *Belk v. Comm'r*, T.C. Memo 2013-154, 105 T.C.M. 1878 (June 19, 2013).

19. *Id.* slip op. at 3.

20. *Id.* slip op. at 7.

21. *Id.* slip op. at 7-8.

22. *Id.* slip op. at 9-10.

23. *Id.* slip op. at n. 6

24. *Id.* slip op. at 13.

25. *Id.*

26. *Id.*

27. *Id.*

28. *Id.* (quoting *Comm'r v. Nat'l Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974)).

29. *Carpenter v. Comm'r*, TC Memo 2012-1, 103 T.C.M. (CCH) 1001 (Jan. 3, 2012).

30. *Id.* slip op. at 4.

31. *Id.* slip op. at 19.

32. Treas. Reg. § 1.170A-14(h)(3)(i). If no substantial record of marketplace sales is available to use as a meaningful or valid comparison, as a general rule (but not necessarily in all cases), the fair market value of a perpetual conservation restriction is equal to the difference between the fair market value of the property it encumbers before the granting of the restriction and the fair market value of the encumbered property after the granting of the restriction.

33. Treas. Reg. § 1.170A-13(c)(4)(ii)(K) and (L).

34. *Friedberg v. Comm'r*, T.C. Memo 2013-224, 106 T.C.M. 360 (Sept. 23, 2013).

35. *Boltar, LLC v. Comm'r*, 136 T.C. 326 (April 5, 2011).

36. *Id.* slip op. at 14.

37. *The Bluffs Destination Resorts, LLC v. Greenberg Traurig LLP*, 2011 CV 3219 (Denver County District Court).

38. *The Bluffs Destination Resorts, LLC*, Complaint at 10-12.

39. *Id.* at 12 and 14. Although the appraisal amounts varied slightly from parcel to parcel, each was determined to be in excess of $500,000. Thus, while the land was bought for $1.5 million, the taxpayers then collectively valued their conservation easements at more than $10 million for purposes of the tax deductions and credits they intended to claim.

40. *Id.* at 16 and 24.

41. *The Bluffs Destination Resorts, LLC*, Stipulation for Dismissal with Prejudice.

42. *Basin Wind and Energy, LLC v. Snell & Wilmer, LLP*, 2013 CV 31635 (Denver County District Court).

43. CRS § 39-22-522.

44. CRS § 39-22-522(2) and (2.5).

45. CRS § 39-22-522(7).

46. *Basin Wind and Energy, LLC*, Complaint and Jury Demand at 14.

47. *Id.* at 6.

48. *Id.*

49. *Id.* at 9.

50. *Pollard v. Comm'r*, TC Memo 2013-38 (Feb. 6, 2013).

51. *Id.* slip op. at 2.

52. *Id.* slip op. at 17.

53. *Id.* slip op. at 22.

54. *Id.*

55. *Id.*

56. *Id.* slip op. at 22-23.

57. *Id.* slip op. at 24.

58. *Comm'r v. Duberstein*, 363 U.S. 278, 286 (1960).

59. *Garcia v. Comm'r*, 80 T.C. 491, 498 (1983). ■