Bloomberg
Tax

bloombergindustry.com

Reproduced with permission. Published September 10, 2020. Copyright © 2020 The Bureau of National Affairs, Inc. 800-372-1033. For further use, please visit https://www.bloombergindustry.com/copyright-and-usage-guidelines-copyright/

INSIGHT: Conservation Easements—Will They Be Saved on Appeal?

BY NANCY ORTMEYER KUHN

As documented by an extensive review of the last eight years of U.S. Tax Court opinions on the topic of charitable conservation easements, accompanied by the Internal Revenue Service's programs to shut down the conservation opportunities offered by tax code Section 170(h) (Notice 2017-10; IR 2020-130), the question becomes whether the appellate courts that review these cases, almost universally adverse to taxpayers, will restore the legislative purpose of the statute. The standards currently set forth in the Treasury Regulations, as interpreted inconsistently by the IRS and affirmed by the Tax Court, are almost impossible for taxpayer compliance. It's a game of ''gotcha'' by the IRS as generally confirmed by the Tax Court.

The current stumbling block is the language in the easement deeds regarding distribution of proceeds, in the highly unlikely situation of a judicial extinguishment of the easement. Although the IRS and the Tax Court emphasize that these easements must be perpetual as statutorily required, the regulatory language that is causing the IRS and the Tax Court to deny any tax advantage to the easements is the clause that applies when the property is sold after a judicial extinguishment of the easement.

It seems as if the IRS and Tax Court want it both ways—yes, it must be perpetual but in the highly unlikely event it is extinguished judicially due to an inability to continue the charitable conservation purpose, the proceeds are required to be distributed proportionally. This proportion is based upon the value of the easement as compared to the value of the encumbered property *on the date of the donation*. Thus, the distribution is not based on the history of expenditures after the donation but is exactly the same ratio in value as at the time of the donation.

Multiple taxpayer litigants have presented the argument that improvements made to the property after the donation should be subtracted out of the sales proceeds prior to the proportional split between the charitable easement owner and the property owner. Logically, subtracting out the improvements made by the landowner after the easement was donated makes sense. Of course, the improvements on the property made prior to donation of the easement add to the value of the property retained by the property owner. Allowing later improvements to accrue to the charity's benefit, even though the property owner was responsible for all improvements, does not make economic sense.

If a judicial extinguishment occurs to defeat the perpetual nature of the easement, a proportional distribution calculated as of the date of the donation could result in an additional donation to the charity by the landowner. However, no additional charitable deduction is contemplated by the IRS and Tax Court. There is no provision in the regulations allowing an additional charitable deduction under Section 170(h) for this highly unlikely, yet now IRS and court sanctioned, ''proportional'' distribution.

To put real dollars in place to illustrate this concept: an easement is donated to a charity and at the time of the donation the encumbered property was worth $1 million and the easement $1 million. Total value of the property, including the easement, is $2 million at the time of the donation with 50-50 ownership. In some of these easements, the original owner of the property may reserve the right to improve the property over time, as long as the improvements do not impact the conservation purpose of the property.

For example, if the property owner built a home on a corner of the property referenced above while still maintaining all environmental protections, the property

COPYRIGHT © 2020 BY THE BUREAU OF NATIONAL AFFAIRS, INC.

owner would not be able to recoup its investment if the property is eventually sold after a judicial extinguishment. In this example, the home cost $4 million. Ten years later, the easement is judicially extinguished for unforeseen reasons. The total value of the property is now $6 million with the addition of the home. Rather than the landowner recouping its investment in the home of $4 million and retaining its investment in the real estate of $1 million, the charity gets the benefit, and the proceeds of $6 million are split 50-50 with both the landowner and the charity receiving $3 million. That does not make economic sense, nor does it comport with the reality of the expectations of the charity. Economically, the home and land owner should receive $5 million and the charity $1 million.

The interpretation by the IRS and Tax Court results in a windfall to the charity without an additional charitable donation for the landowner. This becomes even more absurd if the homeowner eventually sells his or her home at fair market value to an unrelated third party buyer. Subsequently, if there is a judicial extinguishment, the unrelated home owner will lose millions on the sale using a proportional distribution from the date of the original easement donation. That outcome does not make any logical or economic sense. This cannot be the outcome envisioned by Treasury, let alone Congress, when promulgating the statutory and regulatory sections at issue.

Another consequence that may result from these decisions: a claw-back of the easement by the original property owner. A claw-back could occur in the following scenario: a charitable conservation easement is donated to a charity whose purpose is to promote environmental initiatives, save green space, and protect endangered species. The IRS, as upheld by the Tax Court, ruled that the easement does not comply with the Treasury Regulations and thus does not qualify for favorable tax treatment as a charitable easement. No charitable deductions were allowed. The charity, now holding a property easement that is not charitable, generally should sell that property interest rather than hold it as an investment.

It is highly likely that the IRS, in its examination of the easement, declared the easement to be worthless. Thus, the environmental charity should not hold on to a worthless property interest. That property interest could expose the charity to liability of all types. Rather than saving trees, the charity could be liable if a tree falls, or if tortious activity takes place on the property subject to the easement. It is possible the easement deed may contain indemnification provisions, but it is still better for the charity to get rid of the property interest.

Thus, the owner/donor could accept it back from the charity as a returned gift, or better yet, the charity could sell it back to the donor for a nominal amount. The IRS undoubtedly valued the easement at zero at some point during the examination, in writing, and so the government's valuation would certainly provide protection to the charity and to the property owner against any future IRS inquiries. Accordingly, the legislative purpose in enacting Section 170(h), which was to provide tax incentives to property owners to further conservation purposes, has been defeated. As Judge Holmes stated in his dissent: The Tax Court has ''taken the ax to entire forests of these deductions.'' *Oakbrook Land Holdings, LLC v. Commissioner*.

The Senate Finance Committee issued a comprehensive report on Aug. 25, 2020, analyzing Syndicated Charitable Conservation Easements. Not surprisingly, the committee highlighted the valuation disparities on those projects in which the easement valuation was many multiples of the property's purchase price. The committee also highlighted the alleged motivation of many of the investors, noting a tax planning motive rather than a conservation motive. However, not one paragraph was included addressing the conservation value of any of the projects reviewed by the committee. This oversight is glaring given that the original legislative purpose of Congress was a desire to protect the environment. S.Rep. 96-1007, *6744 (9-30-1980), P.L. 96-541. As is common knowledge, Congress frequently incentivizes desired social conduct by providing tax incentives to taxpayers. Yet the Senate Finance Committee's report only analyzed the alleged loss of tax revenue in monetary terms without any acknowledgement that conservation of real property and endangered species has a societal value beyond tax revenue.

Appellate Court Review

It is very likely that several of the many Tax Court opinions recently released on this topic will be appealed. The seminal case of *Oakbrook Land Holdings, supra,* issued May 12, 2020, sets the stage for multiple appeals in several circuits. In the three months following issuance of *Oakbrook Land Holdings*, 15 cases were released by the Tax Court in reliance on the judicial extinguishment clause as interpreted in *Oakbrook*. More are sure to follow. All of these recent Tax Court decisions deny the respective taxpayers any charitable deduction for their easements. The IRS and Tax Court generally use cookie-cutter decisions relying upon perceived issues with the language in the easement deeds relating to judicial extinguishment and proportional distributions, as discussed above. Most decisions barely mention the environmental conservation purpose, let alone analyze whether that charitable purpose has been satisfied.

The issue on appeal is likely to be whether Treasury Regulation 1.170A-14(g)(6)(ii) is valid, as interpreted by the IRS and Tax Court. One assumes that the legislative purpose of the charitable conservation easement provision in Section 170(h) will be part of the argument on appeal, along with countervailing provisions in the Treasury Regulations that have been disregarded by the IRS and Tax Court. For example, the regulations contemplate that the property owner may reserve rights in the property, and that ''remote future events'' shall not cause the charitable aspect of the conservation easement to fail and the deduction disallowed. Treas. Reg. 170A-14(g)(5); Treas. Reg. 1.170A-14(g)(3). A judicial extinguishment seems to be just such a ''remote future event.'' This is so because the statute requires that the easements be granted in perpetuity. Section 170(h)(2)(C).

If judicial extinguishments are not a remote possibility, then it follows that the IRS and Tax Court are recognizing that these easements are not, in fact, perpetual. Lack of an expectation of perpetuity is a more serious violation of the statutory and regulatory requirements, as compared to the distribution of proceeds after an unlikely judicial extinguishment. The IRS and Tax Court have no evidence that any of these ease-

COPYRIGHT © 2020 BY THE BUREAU OF NATIONAL AFFAIRS, INC.

ments will not be perpetual in existence. Only time will tell. In the meantime, the IRS and Tax Court are being inconsistent at best, hypocritical at worst, in expansively enforcing the perpetual distribution requirements without the expectation that the easements will live in perpetuity. As the U.S. Court of Appeals for the Fifth Circuit opined, such unlikely scenarios as a judicial extinguishment are to be disregarded: ''*de minimis non curat lex*'' (''the law does not concern itself with trifles.'') *Bosque Canyon Ranch, L.P. v. Commissioner*, 867 F.3d 547, 554 fn. 21 (5th Cir. 2017), *vacating and remanding* T.C. Memo. 2015-130.

In *Kaufman v. Commissioner*, 134 T.C. 182 (2010), *motion for reconsideration denied*, 136 T.C. 294 (2011), *vacated and remanded by* 687 F.3d 21 (1st Cir. 2012); T.C. Memo. 2014-12, *aff'd* 784 F.3d 56 (1st Cir. 2015), the First Circuit vacated the Tax Court's grant of the IRS' motion for summary judgment that the faæade easement was invalid due to the extinguishment clause, finding genuine issues of fact. On remand, the Tax Court found the easement to be valid, but the value was zero. The Tax Court upheld the IRS' penalties. The First Circuit affirmed the second Tax Court decision regarding penalties. The zero value was not appealed by the taxpayers, presumably due to the factual nature of a valuation determination.

The First Circuit's analysis of Treas. Reg. 1.170A-14(g)(6)(ii), the same clause currently causing the vast majority of cases to result in summary judgments granted in favor of the IRS, dealt with the preference to the mortgage holder in a judicial extinguishment. The First Circuit states as follows: ''the IRS's reading of its regulation would appear to doom practically all donations of easements, which is surely contrary to the purpose of Congress. We normally defer to an agency's reasonable reading of its own regulations. . . but cannot find reasonable an impromptu reading that is not compelled and would defeat the purpose of the statute, as we think is the case here.'' (Internal citations omitted). *Kaufman*.

In the more recent opinions, the Tax Court is maintaining its rigid interpretation of the requirements for an extinguishment clause in a charitable easement's deed. By doing so, the Tax Court is encouraging the IRS to similarly continue to interpret the regulation which is, as the First Circuit predicted, having an adverse impact on ''practically all donations of easements, which is surely contrary to the purpose of Congress.'' So those taxpayers in Maine, Massachusetts, New Hampshire, Puerto Rico, and Rhode Island, i.e., the First Circuit, are relatively safe from attacks to their charitable conservation easements, at least as to the extinguishment clause. Indeed, it appears that none of the cases issued by the Tax Court recently are appealable to the First Circuit.

In *Bosque Canyon Ranch, L.P. v. Commissioner*, two related partnerships sold property on a trapezoid piece of ranchland to partners for purposes of development and conservation. The property consisted of two conservation areas of 1,750 acres and 1,732 acres respectively. In addition, the partnership sold 47 five-acre homesites, totaling 235 acres, most of which were contiguous and all were located at the top of the trapezoid. The conservation easement on the property was found by the court to permanently protect the habitat of the gold-cheeked warbler, a listed endangered species, among other birds and plant species.

However, the IRS disallowed all easements as not compliant with the requirement that the easement be held in perpetuity, because purchasers of the partnership units were permitted by deed to slightly modify the easement boundaries by mutual agreement with the charitable donee land trust. The Tax Court agreed with the IRS and disallowed the charitable deductions. The Fifth Circuit disagreed and reversed and remanded the case for valuation purposes. As indicated above, the court stated the modifications would be de minimis at most: ''*de minimis non curat lex*'' (''the law does not concern itself with trifles.'') The appellate court remanded the case to the Tax Court for a determination as to the correct valuation of the easements and to determine whether the gross valuation overstatement penalty applied to the partners.

The Fifth Circuit in *PBBM-Rose Hill Ltd v. Commissioner*, disallowed the charitable contribution. The PBBM-Rose Hill partnership owned a golf course in a gated community. After filing a bankruptcy petition, PBBM-Rose Hill contributed a conservation easement to a land trust, burdening 234 acres of the golf course and claiming a $15.16 million charitable contribution deduction for the easement. The Fifth Circuit affirmed the Tax Court's decision disallowing the charitable deduction. Although the Fifth Circuit found that the outdoor recreation conservation purpose was met, both courts held that the perpetuity/extinguishment clauses were not met. The Fifth Circuit examined the regulatory language and found that the clause in the easement deed allowing the cost of improvements to be subtracted from the proceeds of an extinguishment sale and distributed to the party that financed the improvements, violated the plain language of the regulation's proportional allocation based on values at the time of the donation. The appellate court did not address the issue raised in more recent cases regarding whether Treas. Reg. 1.170A-14(g)(6)(ii) is valid.

While the analysis by the appellate court did not address the validity of the regulation, the Fifth Circuit expressed willingness to ignore trifles and uphold the legislative intent of Congress. Thus, taxpayers in Louisiana, Mississippi, and Texas have some hope if a challenge to the validity of Treas. Reg. 1.170A-14(g)(6)(ii) is presented to the Court.

The Eleventh Circuit has issued several opinions addressing a variety of issues surrounding conservation easements, but none of the opinions have directly addressed the extinguishment clause controversy discussed above. *See Palmer Ranch Holdings Ltd. v. Commissioner*, T.C. Memo. 2014-79, rev'd in part 812 F.3d 982 (11th Cir. 2016); on remand T.C. Memo. 2016-190. (Valuation Issues); *Champions Retreat Golf Founders, LLC. v. Commissioner*, T.C. Memo. 2018-146; vacated and remanded, 959 F.3d 1033 (11th Cir. 2020) (Charitable conservation purpose disputed). Two other Tax Court opinions have been appealed to the 11th Circuit and are pending. *See Pine Mountain Preserve v. Commissioner*, 151 T.C. 247 (2018) and T.C. Memo. 2018-214 both issued on Dec. 27, 2018. (Appeal filed May 7, 2019); *Carter et al. v. Commissioner*, T.C. Memo. 2020-21 (Feb. 3, 2020) (Appeal filed June 16, 2020).

It is not currently apparent whether any of these cases, or additional cases already decided adversely to taxpayers but yet to be appealed, will address the validity of the regulation which is being enforced in such a draconian manner by the IRS and Tax Court.

COPYRIGHT © 2020 BY THE BUREAU OF NATIONAL AFFAIRS, INC.

With so much litigation around the issue of syndicated conservation easements and charitable conservation easements in general, this is a fascinating area of the law to watch. Whether appellate courts will require a more careful review of the conservation purpose of these easements and the impact on the environment, along with a focus on the valuation issues, remains to be seen. Stay tuned!

APPENDIX - CASE SUMMARIES

This column does not necessarily reflect the opinion of The Bureau of National Affairs, Inc. or its owners.

Author Information

Nancy Ortmeyer Kuhn is a Director at Jackson & Campbell, P.C. in Washington, D.C. and is chair of the Tax Group. Nancy's legal practice focuses on litigation and Federal tax matters. She was a law clerk at the United States Tax Court for two years and then a litigator in Chief Counsel's office of the Internal Revenue Service for approximately nine years. Nancy then switched sides and represent taxpayers before the Internal Revenue Service, the Tax Court and District Courts. In addition, she handles general litigation matters in various state and federal courts. She is an active member of the Women's Bar Association of the District of Columbia and is a founding board member of 131 & Counting, a nonprofit organization celebrating women in elective office.

COPYRIGHT © 2020 BY THE BUREAU OF NATIONAL AFFAIRS, INC.