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The Eleventh Circuit Court of Appeals: The Current Focus for Conservation Easements

By Nancy Ortmeyer Kuhn

Charitable conservation easements are currently one of the most litigated tax issues. Many of these easements are located in Georgia, Alabama and Florida. Therefore, we are now seeing a mini-explosion of cases appealed to the 11th Circuit Court of Appeals, with many more to follow. This article analyzes the breadcrumbs dropped by the 11th Circuit to date and opines as to a possible outcome based upon prior opinions from the Court. First a brief background of the issues.

Conservation easements were created by Congress and codified as charitable in tax code Section 170(h). The intent of Congress was to motivate taxpayers to conserve property for environmental purposes. This intent has been realized and 32.7 million acres of property have been conserved through 191,476 easements as of March 2021. More recently taxpayers have taken advantage of this charitable tax deduction by syndicating conservation easements through partnerships. Partnership interests are then offered to investors who may have income to offset and are motivated by conservation preservation efforts. This tax motivation is similar to the syndication of tax credits, such as Section 42 low-income housing tax credits or Section 47 historic investment tax credits. These credits have long been sanctioned by Congress and encouraged by the IRS and the courts. Conservation easements are a bit different, in that the tax benefit is a charitable deduction rather than a dollar for dollar tax credit. Through syndication, the investor still buys into a partnership and still realizes the tax benefits through the flow-through nature of the partnership. However, valuation of the property subject to the easement is determinative of the amount of the charitable donation and resulting deduction. Rather than a tax credit based upon a percentage of the adjusted basis in the property, a conservation easement is determined based upon the very subjective valuation of a partial property interest. A qualified appraiser must value the easement to determine the amount of the charitable deduction that is available to the investors/donors.

When the easement is perpetual, it is very difficult to evaluate what that easement is worth. It is a negative limitation on the property, so that the underlying property owner gives up the right to develop the property and cannot make money off prospective development. What is that worth? Perhaps as a result of this very real uncertainty, the U.S. Tax Court has now decided multiple conservation easement cases by relying upon a technicality that appears in many of the standard easement documents. The IRS, and then the Tax Court, relied upon a Treasury Regulation to invalidate the charitable contributions claimed by possibly thousands of investors in conservation easements. It is a very simple pathway to denial—if the language in the easement document does not conform to the very rigid language set forth in the Treasury Regulation (as currently interpreted), the charitable deduction is summarily denied. *See* Treasury Regulation 1.170A-14(g)(6)(ii)(Regulation)

This Regulation requires the property owner and easement owner to split the proceeds, possibly inequitably, in the very unlikely event the easement is ultimately extinguished. It is a perpetual easement, and so extinguishment of the easement is highly unlikely.

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However, if extinguished, the proceeds must be split in some yet-to-be-determined number of years proportionally by comparing the value of the easement to the value of the property at the time the easement was donated to the charity. That percentage allocation is then the same percentage allocation that is to be applied to the gross amount realized when liquidated at that future date, without regard for any improvements that were added to the property by either the property owner or the easement owner after the initial easement transfer. Many easement agreements allow improvements, such as homes, to be built on specified portions of the property as long as conservation purposes are preserved. The inequity is obvious, but the Tax Court has not been persuaded by fairness, or really any arguments, that the Regulation is invalid or should not be interpreted so narrowly.

The scenario in which the owner of the underlying property builds a home on his or her property, as allowed in many easements, and then is required to forfeit a portion of the value of that home to the charitable easement holder in the event the easement is extinguished, is grossly inequitable. One wonders whether the corollary also applies? Is the charitable easement holder also liable if the home goes into foreclosure or is otherwise subject to a lien or levy? If the easement is extinguished and the property sold, how does a lien on any improvements on the property impact the distribution allocation? If the IRS seizes the property in a levy action, how is the allocation handled in that scenario? Is the charity still entitled to its proportional share?

There are several hypotheticals that render this interpretation by the IRS and Tax Court inequitable and unexpected. In the first scenario, the landowner donates a conservation easement on its land to a charitable land trust. The landowner reserves the right, in the easement deed, to construct one or more homes on the property in specified location(s). The landowner then builds a home on the property, has equity in that home, but fails to pay federal taxes over a period of years. The IRS ultimately seizes the property in a levy proceeding due to the homeowner's tax debts, the easement is extinguished for unanticipated reasons and the property sold. Will the IRS continue to argue that the nonprofit is entitled to proceeds attributable to the sale of the home, based upon the proportional value at the time of the donation of the easement before the home was built? Or, when the scenario is reversed, will the IRS argue that the homeowner is entitled to 100% of its equity from proceeds allocable to the more recently constructed home, which then should go to the IRS to satisfy the lien on the property in payment of the homeowner's tax debts. The latter is what happens in normal circumstances but is not the current position of the IRS and Tax Court in easement cases. The current position is that the charity will get its proportional interest in the property, which includes the proportional value of the home.

A second scenario that could occur is if the property owner builds several homes on the property post-easement, as was allowed in *Carter v. Commissioner*, T.C. Memo. 2020-21 (Feb. 3, 2020) (appealed to 11th Circuit Court of Appeals, June 16, 2020). If the property owner then sells those homes to unrelated third parties, is the property owner required to inform the new homeowner that in the unlikely event of an extinguishment of the easement, the homeowner will lose a relatively large proportionate value of their home? That would seem to be a deal-breaker for the prospective homeowner. If the charity's right to a portion of the proceeds is not communicated, will the subsequent homeowner have a cause of action against the original property owner? Against the charity? The scenario of an IRS lien and/or levy against the subsequent homeowner also could play out similarly as discussed above, and the charity would be allocated a large percentage of the proceeds. Will the mortgage holder's lien on the home take precedence over the charity's interest? The charity's interest in any improvements on the property predates the mortgage. It is doubtful the future IRS agent would anticipate that a charity would have greater claim to the homeowner's interest in the home than the IRS. The charity, after all, would not have a recorded lien on the property. In fact, the deed for the property and the recorded easement will not necessarily give future lenders or creditors of the third-party home owner any notice of the superiority of the charity's interest in the post-easement improvements on the property. It is doubtful future lenders or creditors would read the easement deed, and if so, it is doubtful they would put it together with the Regulation and interpret it in the same manner as the IRS and the Tax Court. It is doubtful future creditors, or even future IRS agents, would be aware of court opinions impacting future third party homeowners.

Another scenario—if the third party homeowners have an equity interest in their home, and for an unanticipated reason the easement is extinguished with the proceeds distributed based upon the original proportions, the charity will then at least partially own the home that was built after the easement was donated. Assuming the extinguishment of the easement does not change the ability of the homeowners to continue to live in the home, which is not unreasonable to assume given the large footprint of some of these easement properties, will the homeowners then be living in a home owned in part by the charity? Will they be required to pay rent to remain in their home? Will the charity become liable for a portion of the mortgage? What happens when the homeowner goes to a state or local court to enforce the homeowner's real estate deed and ownership interest. What happens when the bank holding the mortgage tries to enforce its right to the property? State and local laws regarding real property may prevail to save the homeowner and defeat the IRS'S arguments made many years prior. Needless to say, there are many long-term complications to the scenario created by the IRS and the Tax Court.

As indicated, the IRS's interpretation of the Regulation has many unintended consequences. Unfortunately for taxpayers, those consequences are not likely to be realized until many years in the future. At that time, the inequitable allocation of proceeds from any extinguishment actions will likely be inflicted upon innocent third parties. If the charity takes pity on the homeowner whose home the charity now partially owns, the charity will be prevented from benefiting the homeowner through a gift or other arrangement, due to the private benefit and inurement prohibitions between charities and individuals. The tax code and the accompanying Treasury Regulations weave a tangled web. It does not need to be this complicated.

The 11th Circuit is the current focus of much interest due to the volume of conservation easement cases that it has considered and is considering. The 11th Circuit

has already decided three cases that address charitable conservation easements, correctly seeing through the Tax Court's rush to judgment. In all three cases, the 11th Circuit reversed the opinion of the Tax Court which had adopted the IRS'S position on a variety of conservation easement issues. The extinguishment clause cases are just now being appealed.

In *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. The taxpayer provided a wildlife corridor to protect the American bald eagle, and then donated an easement with that purpose to Sarasota County, a qualified entity for purposes of charitable deductions. The Tax Court found that the taxpayer overstated the fair market value of the conservation easement in part, and thus overstated the charitable deduction. The 11th Circuit agreed with a portion of the Tax Court's valuation method but not entirely and held that the ''highest and best use'' standard of valuation must be used both to determine the fair market value before the easement and the fair market value after the easement is donated. Thus, the 11th Circuit reversed the Tax Court's opinion in part after a careful analysis of the valuation methods used by the Tax Court. The Tax Court's second opinion, after the 11th Circuit reversed and remanded the case, found in favor of the taxpayer thus the charitable conservation easement deduction claimed originally by the taxpayer was upheld.

In *Champions Retreat Golf Founders, LLC. v. Commissioner*, T.C. Memo. 2018-146, *vacated and remanded*, 959 F.3d 1033 (11th Cir. 2020), the Tax Court adopted the IRS'S position that the 348-acre easement on a golf course and surrounding property did not have the requisite purpose of preserving its habitat for ''species of conservation concern'' and did not offer open space for scenic enjoyment for the general public. The charitable deduction for the easement contribution was not allowed by the Tax Court. However, the 11th Circuit disagreed and vacated the Tax Court's opinion, remanding it for further consideration in line with their opinion that the conservation purpose had been met by the taxpayers. The 11th Circuit carefully analyzed the endangered species that were protected by the easement, including the abundant species of birds, the southern fox squirrel, and the rare denseflower knotweed. Also, the location of the property along a river frequented by kayakers and across the river from a large national forest added to the 11th Circuit's analysis of the value of the conservation easement. The appellate court upheld the easement as protecting wildlife and also as protecting the scenic enjoyment for people canoeing or kayaking on the river. As indicated, the case was vacated and remanded to the Tax Court for further consideration regarding valuation issues of the charitable easement. The case on remand is still pending with the Tax Court in March 2021.

A third case considered by the 11th Circuit is *Pine Mountain Preserve v. Commissioner*, 978 F.3d 1200 (11th Cir. Oct. 22, 2020) rev'g in part, aff'g in part and remanding 151 T.C. 247 (2018) and T.C. Memo. 2018-214 both issued on Dec. 27, 2018. The taxpayer contributed three conservation easements on three separate parcels of land in three consecutive years to a qualified charity. The Tax Court held, in part, that reserving a limited right to build on the property subject to a conservation easement with ''moveable homesites,'' destroys the taxpayer's claim of a charitable deduction. The 11th Circuit reversed the Tax Court and held that as long as the boundaries of the entire easement are not moved, boundaries within the easement may be moved if the conservation purpose is protected. The 11th Circuit adopted the Tax Court's analogy of swiss cheese in which the holes cannot be moved. The Court ruled the situation was more akin to pepper jack cheese in that the pepper is sprinkled throughout the cheese, but the piece of cheese remains the same. The 11th Circuit remanded the valuation issue on all three years and instructed the Tax Court to use the standards set forth in the Treasury Regulations to determine valuation. The notable quote from the 11th Circuit opinion is as follows:

''Finally, we address the Tax Court's valuation of the 2007 easement. It seems to us obvious that in valuing the easement the court simply 'split the baby' and picked a number that was almost exactly midway between the parties' (wildly divergent) estimates. While we appreciate the difficulty of determining the exact value of a conservation easement, we must insist that the Tax Court apply a discernible methodology that is appropriately tied to the standard set out in the governing regulations.'' *Id.* at p. 1210.

The case is pending in Tax Court on remand regarding the valuation issues as of March 2021.

But that is not all: three additional Tax Court cases have recently been appealed to the 11th Circuit. Two of the cases will require the 11th Circuit to consider the Regulation and extinguishment clause, as discussed above. In the third case, *Carter v. Commissioner, supra,* the Tax Court followed its ruling in *Pine Mountain Preserve, supra,* now reversed by the 11th Circuit. It is safe to assume that the 11th Circuit will follow its more recent opinion in *Pine Mountain*, and thus *Carter* will also be reversed. The other two yet-to-be-decided cases both address the same issue regarding the extinguishment clause and whether the Tax Court's interpretation of the Regulation is correct. In both cases, the taxpayers' easement deeds allowed a more equitable distribution of proceeds if the easements are extinguished, with post-easement improvements subtracted out before allocating proceeds proportionally. The IRS and then the Tax Court ruled those provisions did not comply with the Regulation. A subsidiary issue that may be considered is whether the Regulation is valid. The validity of the Regulation is beyond the scope of this article, but it is an interesting legal argument with merit that the 11th Circuit will undoubtedly review.

The first of the two remaining cases is *TOT Property Holdings, LLC v. Commissioner,* Docket No. 5600-17 (Bench opinion issued Dec. 13, 2019) A trial was held, and then shortly thereafter the Tax Court Judge read his bench opinion into the record. The Tax Court relied upon *Coal Property Holdings, LLC v. Commissioner*, 153 T.C. 126 (2019) *Coal Property* was recently settled pursuant to the IRS'S settlement initiative. (It was appealable to the 6th Circuit.) The Tax Court denied the charitable deduction due to the easement language relating to extinguishment. The Tax Court summarily found that the easement deed violated the Regulation, and so did not provide an opinion on alternative arguments advanced by the taxpayer and the IRS. The Tax Court also adopted the valuation of the property alleged by the IRS. In comparison, the taxpayer's valuation yielded a 69% allocation in favor of the charity upon ex-

tinguishment. The IRS'S and Tax Court's valuation yielded a 44% allocation in favor of the charity. If, subsequently, a home is built on that property the charity would receive 44% of the value of that home upon extinguishment, despite not providing any support for its construction. The taxpayer in *TOT Property Holdings* filed an appeal with the 11th Circuit on March 11, 2020. The appeal of *Hewitt v. Commissioner*, T.C. Memo. 2020-89 (June 17, 2020) was filed on Oct. 9, 2020 and is also pending with the 11th Circuit. *Hewitt* is similar to *TOT Property Holdings* and will require a review of the Regulation.

In addition to the cases discussed above, there are many more cases in the pipeline. I have counted sixteen (see appendix below) conservation easement cases appealable to the 11th Circuit in which the Tax Court has already granted the IRS partial summary judgment, based upon the IRS'S interpretation of the Regulation. The Tax Court is now deciding the remaining issues in each of the cases. Typically, the remaining issues relate to penalties due to the disallowance of the charitable deductions. If the 11th Circuit reverses the Tax Court yet again in *TOT Property Holdings* or *Hewitt*, there will be numerous cases that are downstream and impacted by said opinion. Numerous acres of land will be preserved, numerous species saved and beautiful vistas enjoyed. My understanding is that there are many, many more conservation easement cases in which the IRS denied the charitable deduction due to the extinguishment clause (''There is reason to believe thousands of conservation easements have similar language.'' *Oakbrook Land Holdings, LLC, v. Commissioner*, T.C. Memo. 2020-54, note 2) Those cases are still working their way through the system, whether still in examination at the IRS or docketed with the Tax Court. Many of those cases will also be appealable to the 11th Circuit, with most containing the identical language in the easement deed as in *TOT Property Holdings* and *Hewitt.* Thus, much is riding on the next opinion issued by the 11th Circuit. I am anticipating another thoughtful and thorough opinion from the Court.

I believe the Treasury Regulation was not correctly applied by the IRS or the Tax Court. There are also strong arguments that the Regulation is invalid. *See Oakbrook Land Holdings, LLC v. Commissioner*, 154 T.C. 180, 230-259 (2020) (J. Holmes dissent). The 11th Circuit Court of Appeals, given its history in this area, will certainly thoroughly analyze the issues including a re-evaluation of the Regulation, state and local property laws, liens, levies, and other equitable issues. We will wait with bated breath to see what happens. In the event of another reversal of the Tax Court by the 11th Circuit, the many cases in the Tax Court pipeline that are appealable to the 11th Circuit will need to be reviewed by the Tax Court and the outcome most certainly changed for a ruling in favor of the taxpayer as to the extinguishment clause. There may still be valuation issues in these cases, and so the Tax Court's work will not be done. The short cuts taken by the IRS and the Tax Court do not work, are inequitable, and have many unintended consequences. If these conservation easements are allowed as charitable, the 11th Circuit's actions will continue to encourage the conservation of land and species as Congress intended.

APPENDIX — 16 cases appealable to the 11th Circuit

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