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## Charitable Conservation Easements: Is There a Need for Tax Planning?

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President Biden's Executive Order 14008<sup>1</sup> issued January 27, 2021, sets forth the beginning impetus for the Biden Administration's plan to conserve the United States' land and water resources. Four U.S. agencies, including the U.S. Departments of Interior, Agriculture, and Commerce, submitted a report to the National Climate Task Force entitled "Conserving and Restoring America the Beautiful 2021."<sup>2</sup> By 2030, the goal is for every state to have preserved at least 30% of its land and water resources. This "30 by 30" goal is to be achieved through a combination of state and local initiatives, along with voluntary actions by farmers, indigenous communities, local municipalities, and local land owners including the use of conservation easements.

Tax advantages are frequently used to incentivize human behavior. Incentives for taxpayers to combat climate change and preserve land and water are included in the I.R.C. One such incentive is §170(h),<sup>3</sup> which allows a charitable deduction for conservation easements donated to charitable land trusts or other §501(c)(3) organizations. Section 170(h)(4) and Reg.

§1.170A-14(d) set forth detailed requirements that must be met before an easement will be classified as a "qualified conservation easement" eligible for the §170 charitable deduction. However, perceived abuses associated with charitable conservation easements have developed in recent years, along with the IRS' and Tax Court's attempts to disallow all charitable contributions connected to conservation easements.<sup>4</sup> These actions put a damper on incentivizing such easements. Conservation easements, whether charitable or not, are needed now more than ever due to the increasing perils of climate change and loss of natural resources.

On September 29, 2020, the Senator Steve Daines (R-MT) introduced legislation<sup>5</sup> which would amend §170(h) by adding a new subsection. On December 2, 2020, Representative Mike Thompson (D-CA) introduced legislation<sup>6</sup> with a similar amendment to §170(h). Taxpayers interested in investing in a charitable conservation easement should be aware of the legislative proposals and engage in tax planning with an eye on these proposals. Also, taxpayers who have previously claimed a charitable deduction for a conservation easement should also watch these legislative proposals closely to see if the bills are reintroduced and given new life. This is important in part because the legislation may be retroactive in nature. In both H.R. 8842 and S. 4751, the Charitable Conservation Easement Program Integrity Act would add §170(h)(7) and would disallow a deduction if it is more than 2.5 times the taxpayer partner's adjusted basis in his or her partnership interest. The deduction would be disallowed in full, rather than just disallowing the portion of the deduction that is above 2.5 times the adjusted basis. This rule would apply for the first three taxable years after formation of the partnership and three years after the investment by the partner. It also would apply to S corporations and limited liability companies taxed as partnerships. Family partnerships, however, would be excepted. If a partnership, in which "substantially all" of the partnership interests are held by individuals who are related

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<sup>1</sup> E.O. 14008 of January 27, 2021, 86 Fed. Reg. 7619, Doc. #2021-02177.

<sup>2</sup> <https://www.doi.gov/pressreleases/biden-harris-administration-outlines-america-beautiful-initiative>.

<sup>3</sup> All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

<sup>4</sup> Kuhn, *Charitable Conservation Easements—IRS and Tax Court Act to Shut Them Down*, Daily Tax Rep. (July 22, 2020).

<sup>5</sup> S. 4751, Charitable Conservation Easement Program Integrity Act of 2020, 116th Cong.

<sup>6</sup> H.R. 8842, Charitable Conservation Easement Program Integrity Act of 2020, 116th Cong.

within the meaning of §152(d) donates a conservation easement, that partnership would be excluded from these proposed new rules. Individual landowners would also not be included in the legislation and so deductions claimed for charitable conservation easement donations on land owned by an individual would not be impacted by the proposed legislation.

As currently drafted, the legislation would apply to donations of conservation easements for tax years ending after December 23, 2016. The proposed legislation attempts to address concerns regarding a partner's ability to manipulate his or her adjusted basis in their partnership interest, along with requiring the partner to hold the interest directly, and not use a complex structure that complicates or makes it impossible to accurately determine adjusted basis. Also, a loophole would be proactively closed by adding language that the three-year rule is applied to the later of the date the partnership acquired the real property and the date on which the partner acquired his or her interest in the partnership. If the partnership is part of a tiered structure and the investment was made several tiers above the taxpayer's investment, the House and Senate both would defer to the Department of Treasury and agency regulations yet to be written. Both bills provide that if the contribution is made outside the three-year holding period of the partner and partnership(s), then the disallowance provisions do not apply. For those partners whose interests are not directly held but held through another pass-through entity, denial of the deduction (regardless of amount) would be effective only for contributions made after the date of enactment.

Legislation with an effective date that changes the rules for years for which returns have already been filed is likely to be challenged judicially. An *ex post facto* defense comes to mind, although that defense primarily applies to criminal matters.<sup>7</sup> Other arguments could also challenge this legislation and send the issues to court. However, litigation takes many years to resolve, and taxpayers should plan to deal with retroactive application should this legislation in its current form become law.

The first and foremost tax planning strategy is for taxpayers, including the partnerships, to timely file their tax returns. At this point, a timely filed calendar year 2016 tax return's three-year statute of limitations set forth in §6501(a) has expired. The IRS would not be able to disallow the charitable deduction unless the numbers are so large that the six-year statute of limitations applies under §6501(e). If the legislation is passed, investors who are impacted by the legislation, i.e., those with valuations claimed that are greater than 2.5 times adjusted basis, should seriously consider amending the prior year returns still open under the statute of limitations to comply with the new legislation to claim a deduction that is limited to 2.5 times adjusted basis. Playing the tax audit lottery is rarely a good idea, particularly since all of these syn-

dicated partnership conservation easements are now reported to the IRS and generally disallowed.<sup>8</sup>

For future investments and tax planning strategies, partnerships would need to organize and invest in real property and then wait for three years. After a three-year waiting period for both the partnership and partner, the partnership could donate the conservation easement and the investors could claim the deduction based upon a qualified appraisal without regard to the 2.5 times adjusted basis limitation. After the three-year holding period, the limitation on the amount of the charitable deduction does not apply other than the requirement that it be supported by a qualified appraisal. Another option is to invest in a syndicated partnership with the expectation that the charitable deduction will be no more than 2.5 times the investment made. While other factors can impact a partner's adjusted basis in the partnership, a general expectation of it being the amount of money invested is a good start. The proposed would limit the use of debt in calculating adjusted basis.

Other options for tax planning include investors purchasing property directly, with the conservation easement contributed without using a partnership or S corporation structure. If an individual purchases property in his or her name or through a single-member limited liability company, this legislation does nothing to discourage that individual from donating a conservation easement and claiming a charitable contribution deduction under §170(h) based upon a qualified appraisal without regard for the 2.5 times adjusted basis numbers. The same is true if an individual already owns real estate and decides to donate a conservation easement to a charity. Another option is to gather your relatives and set up a family partnership which is also excluded from these limiting rules. The new legislation only applies to limit charitable contribution deductions attributable to investments structured through flow-through entities such as third-party partnerships, including syndicated partnerships.

There is no magic 8-ball to determine whether this proposed legislation will be enacted, either separately or as part of a larger bill. Because the proposal would, at least theoretically, raise revenue it could be used as a funding source for one of the larger bills that Congress is considering. This provision could easily be included in a reconciliation bill as part of the annual budgetary process. If added, a budget bill subject to reconciliation limits the Senate's ability to filibuster the legislation and it could be passed by majority vote of the Senate, along with a more customary vote by the House. One item of note is that the Budget proposed by President Biden on May 28, 2021, does not include any reference to conservation easements.<sup>9</sup> However, budgets are rarely (if ever) passed in the form proposed by the White House and so there are no guarantees that this legislation will die in Committee. Watch this space!

<sup>7</sup> U.S. Constitution Article I, §9, as interpreted by *Calder v Bull*, 3 U.S. 386, 393 (1798).

<sup>8</sup> See Notice 2017-10.

<sup>9</sup> <https://www.whitehouse.gov/omb/budget>.