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A Rare Victory For Taxpayers in the Fight For Conservation Easements

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The long saga regarding charitable conservation easements is getting a bit more balanced with the recent opinion from the Eleventh Circuit Court of Appeals in *Hewitt v. Commissioner*.[1] However, the Eleventh Circuit's opinion raises additional questions for pending cases, of which there are many, due to a backlog at the Tax Court among taxpayers whom I suspect were waiting and hoping for a favorable opinion, such as *Hewitt*.

As a brief background to charitable conservation easements, Congress provided a tax incentive[2] to taxpayers to encourage investments in charitable conservation easements. Many taxpayers did so through flow-through entities, in which newly created limited liability companies or partnerships purchased property worth conserving for environmental reasons. The conservation easements on the land were donated, primarily to charitable land trusts. The charitable deductions then ''flowed through'' to the taxpayers who claimed their proportionate share of the charitable deduction attributable to the charitable easement donation. These deductions sometimes substantially reduced the taxpayers' tax liability in multiple years due to the annual limitations on charitable deductions and the ability to ''carryover'' charitable deductions to future years. Many of the valuations assigned to charitable conservation easement donations were many multiples of the purchase price of the underlying property. The IRS did not agree with the high valuations or apparently the concept of charitable conservation easements in general, and so disallowed 100% of these charitable conservation easement donations for many taxpayers. The IRS, and then the Tax Court, relied upon a very narrow provision in the Treasury regulations regarding language in the easement document which addressed the required perpetuity of the easement, to disallow the deductions in full. It appears that most easement documents follow the same template and use the same or very similar language regarding extinguishment proceeds, thus marking an easy path for the IRS and Tax Court to disallow 100% of these charitable deductions in cases involving hundreds, if not thousands, of taxpayers.[3]

In *Hewitt*, the Eleventh Circuit has now provided a path forward for taxpayers who have not yet given up the fight to claim charitable deductions for conservation easements. In this case, the Hewitts are a bit unusual in that they are not investors in a syndicated conservation easement partnership, but husband and wife donating an easement to a charity on land that they have owned for a long time. The Hewitts challenged the validity of the Treasury regulation upon which the Tax Court relied to disallow their charitable deduction.

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[1] No. 20-13700, 2021 BL 495044 (11th Cir. 2021), *rev'g* and *rem'g* T.C. Memo 2020-89.

[2] §170(h). 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.

[3] The limited liability companies tend to have many members, and so the exact number of disallowed charitable deductions is unknown due to the murkiness of protected taxpayer information, unless the individual investors/partners are explicitly named in the court opinions. *See Oakbrook Land Holdings, LLC, v. Commissioner*, T.C. Memo 2020-54, n. 2 (''There is reason to believe thousands of conservation easements have similar language [in the easement document.]'').

The Treasury regulation[4] (Regulation) requires that in the unlikely event the conservation easement is ''extinguished'' and sold, the charity must receive a proportionate share of the proceeds based upon the ratio in valuation at the time of the donation. The easement is required to be perpetual, and so the likelihood of this happening is remote. The language in many easement deeds allows landowners to subtract out the value of any improvements, prior to applying the calculation to split the extinguishment proceeds between the charity and the landowner. However, the IRS's and Tax Court's interpretation of the Regulation disallows any subtractions, which thereby voids the easement. An inequity arises if the property owner improves the property in any manner prior to extinguishment. The charity would then receive the benefit of 100% of that improvement upon extinguishment. The landowner would get nothing, even though many easements allow landowners limited building and improvement rights on their property, as long as the conservation purpose is not impacted. This unfairness was pointed out in several significant submissions to Treasury during the public comment period prior to finalization of the Regulation, as noted by the Eleventh Circuit.[5]

In *Hewitt*, the court found that the IRS's and Tax Court's interpretation of the Regulation is arbitrary and capricious due to violation of the Administrative Procedures Act, 5 U.S.C. §706 (APA). Under the APA, the Treasury is required to respond to significant comments provided by the public, prior to finalizing the Regulation. Treasury, including the IRS, did not do so. Substantive comments regarding the inequity of the Regulation, then issued as a proposed regulation, were submitted prior to Treasury's issuance of the final Regulation. Treasury completely disregarded those comments, with no reasoning provided. Pursuant to the Eleventh Circuit's interpretation, this constituted a violation of the APA.[6] The court found that because the Regulation is invalid ''the easement deed's subtraction of the value of post-donation improvements from the extinguishment proceeds allocated to the donee does not violate §170(h)(5)'s protected-in-perpetuity requirement.''[7]

After many losses taxpayers have now found a winning argument: The Regulation upon which the IRS relies is invalid, despite the Tax Court's ruling otherwise. Accordingly, in the Eleventh Circuit which includes taxpayers in Alabama, Florida, and Georgia, the easement deed is no longer invalidated by the Regulation. The same issue is before the Sixth Circuit Court of Appeals in *Oakbrook Land Holdings*.[8] The Sixth Circuit includes taxpayers in Kentucky, Michigan, Ohio, and Tennessee. In a review of pending cases, there is evidence that taxpayers in these seven states make up the majority of the multitude of conservation easements pending in federal courts.[9]

The Eleventh Circuit relied heavily on the ''concurring in result'' opinion of Tax Court Judge Toro in *Oakbrook Land Holdings, LLC*[10] along with the dissenting opinion of Tax Court Judge Holmes, also in *Oakbrook Land Holdings*.[11] Both judges took issue with the procedural path of the Regulation and urged the Tax Court to invalidate the Regulation under either the APA or *Chevron*.[12] Unfortunately, the majority of the Tax Court judges did not agree. The Tax Court has relied upon *Oakbrook Land Holdings* as authority for many conservation easement cases decided subsequently, including *Hewitt*. The Eleventh Circuit concluded that not only was the Regulation in violation of the APA, but that ''the Commissioner's interpretation of [the Regulation] to disallow the subtractions of the value of post-donation improvements to the easement property in the extinguishment proceeds allocated to the donee, is arbitrary and capricious and therefore invalid . . .''[13] Accordingly, by this language the Eleventh Circuit concluded that procedurally the Regulation was invalid, and also that the IRS's interpretation of the Regulation was invalid.

In *TOT Property Holdings*[14] the Eleventh Circuit held, six months before releasing the *Hewitt* decision, that the Regulation ''does not indicate that any amount, including that attributable to improvements, may be subtracted out.''[15] As quoted in the *TOT Property Holdings* and *Hewitt* opinions, the key language in the respective easement deeds is substantively iden-

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[4] Reg. §1.170A-14(g)(6)(ii).

[5] *Hewitt*, 2021 BL 495044.

[6] Administrative Procedure Act, 5 U.S.C. §706(2)(A): ''To the extent necessary to decision and when presented, the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action. The reviewing court shall hold unlawful and set aside agency action, findings, and conclusions found to be arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.''

[7] *Hewitt*, 2021 BL 495044, *2.

[8] *Oakbrook Land Holdings, LLC v. Commissioner*, No. 20-2117 (6th Cir. 2020) (filed Nov. 16, 2020).

[9] *See* Nancy O. Kuhn *Charitable Conservation Easements — IRS and Tax Court Act to Shut Them Down*, Daily Tax Rep. (Aug. 18, 2020).

[10] *Oakbrook Land Holdings, LLC*, 154 T.C. 180, 200-230.

[11] *Oakbrook Land Holdings, LLC*, 154 T.C. 180, 230-259.

[12] *Chevron U.S.A., Inc. v. Nat. Res. Def. Council, Inc.*, 467 U.S. 837 (1984) (the Supreme Court set forth a procedure to determine whether the government's interpretation of a regulation reflects a permissible reading of the statute).

[13] *Hewitt*, 2021 BL 495044, *17.

[14] *TOT Property Holdings, LLC v. Commissioner*, 1 F.4th 1354 (11th Cir. 2021).

[15] *Hewitt*, 2021 BL 495044, *1 (quoting *TOT Property Holdings, LLC*, 1 F.4th at 1363).

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tical.[16] The Eleventh Circuit in *Hewitt* explained: ''while we agreed with the Commissioner's interpretation of the proceeds regulation in *TOT*, we expressly did not consider the validity of the regulation under the APA as the taxpayers there did not make such a challenge.''[17] In the *Hewitt* opinion, the Eleventh Circuit separately concludes that the Regulation is invalid because Treasury violated the APA's procedural requirements. However, the language used in the opinion is a bit nebulous: ''the Commissioner's interpretation of [the Regulation] is arbitrary and capricious and therefore invalid under the APA's procedural requirements.''[18] It is unclear whether the Eleventh Circuit's opinion in *TOT Property Holdings* is now overruled, in effect, because in June 2021, the Eleventh Circuit specifically agreed with the IRS's interpretation of the Regulation, while in December 2021 the court specifically states that the ''Commissioner's interpretation of the Regulation is invalid.''[19] *TOT Property Holdings* and *Hewitt* are now at odds as to whether the operative Regulation was interpreted correctly by the IRS, regardless of whether that interpretation was based upon procedural issues or substantive grounds. Interestingly, the Honorable Barbara Lagoa was on the panel of judges for both *TOT Property Holdings* and *Hewitt*, and is the author of the *Hewitt* opinion.[20] A Petition for a Rehearing En Banc filed by the taxpayers was denied on October 20, 2021, in *TOT Property Holdings*, with a mandate to the taxpayers entered on October 28, 2021.[21]

The saga continues with the battle lines already forming between taxpayers defending their conservation easements and Department of Justice and IRS attorneys defending the government's position. In letters to the Sixth Circuit Court of Appeals, the attorneys on each side of *Oakbrook Land Holdings*[22] interpret the Eleventh Circuit's opinion in *Hewitt* differently, as expected. The taxpayers interpret the Eleventh Circuit as invalidating the totality of the Regulation paragraph[23] regarding allocation of proceeds after extinguishment.[24] On the other side, the government has taken the position that the *Hewitt* opinion is much narrower, and only invalidates the Regulation as to the factual scenario that exists when allocating post-donation improvements between the donee and donor.[25] In my opinion, the taxpayers' argument appears stronger in that the Regulation was ruled to be arbitrary and capricious due to procedural defects, without any language in the deficient procedural history limited to the factual scenario in *Hewitt*. In fact, the comments submitted to the government taking issue with the proposed regulation's proceeds clause listed multiple problems with the clause, not just the issues with post-donation improvements.[26]

As discussed in my previous article,[27] there are many cases that have been decided by the Tax Court in reliance on its *Oakbrook Land Holdings* opinion that are appealable to the Eleventh Circuit. Presumably, the *Hewitt* opinion will now allow the Eleventh Circuit to quickly reverse and remand all of those Tax Court cases in the Eleventh Circuit pipeline back to the Tax Court for additional review, although the government is sure to parse the words of *Hewitt* in an attempt to narrow the opinion as much as possible. Any future cases before the Tax Court that are appealable to the Eleventh Circuit will need to be decided by the Tax Court without reliance on the Regulation, at the very least as to those easements which allow post-easement improvements to benefit the landowner/donor.

It has always been my position that the vast majority of the easements have merit and effectively conserve land and species, but many may be over-valued. Without an objective view of the subjective issue of valuation, a difficult and time-consuming process, these cases are not going to be equitably resolved and the land preserved. In *Hewitt*, the Tax Court notably did not agree with the IRS that the penalty for gross valuation misstatement was appropriate and ruled in favor of the Hewitts on the penalty issue. The Tax Court held that David and Tammy Hewitt did not grossly misstate the value. The court held that the value was at least $1.4 million, based upon David Hewitt's opinion and the opinion of the valuation expert. The Hewitts' deduction was calculated from a $2.78 million valuation and thus was not more than

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[16] *See and compare, TOT Property Holdings, LLC*, 1 F.4th 1354, 1358-1359 and *Hewitt*, 2021 BL 495044, *2.

[17] *Hewitt*, 2021 BL 495044, *7 (quoting *TOT Property Holdings, LLC*, 1 F.4th at 1362, n. 13).

[18] *Hewitt*, 2021 BL 495044, *2.

[19] *Hewitt*, 2021 BL 495044.

[20] Judge Lagoa was appointed to the Eleventh Circuit Court of Appeals by former President Donald Trump in December 2019.

[21] As reported by PACER on January 14, 2022.

[22] See Note 8, above.

[23] Reg. §1.170A-14(g)(6)(ii), pgr. (ii) ''Proceeds.''

[24] Letter from Oakbrook Land Holdings' Counsel David W. Foster, Skadden Arps, Slate, Meagher & Flom to the Clerk of Court for the Sixth Circuit (Jan. 3, 2022).

[25] Letter from Department of Justice, Tax Division Attorney Nathaniel Pollock to the Clerk of Court for the Sixth Circuit (Jan. 4, 2022).

[26] *See, e.g., Hewitt*, 2021 BL 495044, *8 (the New York Landmarks Conservancy urged Treasury to delete the paragraph because it contained pervasive ''problems of policy and practical application'').

[27] Nancy O. Kuhn, *The Eleventh Circuit Court of Appeals: The Current Focus for Conservation Easements,* 37 Tax Mgmt. Real Est. J. No. 4 (Apr. 21, 2021).

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200% of the correct amount.[28] The IRS did not challenge the penalty issue on appeal and the Eleventh Circuit only noted the issue in a footnote, without comment.[29]

The Tax Court opinion in the *Hewitt* case is unusual in that penalties were not imposed, and the valuation was at least partially determined. Congress has indicated that it is a priority to protect and preserve land through conservation easements, and that goal has just been made a bit easier by the Eleventh Circuit Court of Appeals. However, it remains to be seen how the Tax Court will handle these cases. Prior to use of the Regulation as the cure-all for the vast quantity of conservation easement cases clogging the Tax Court pipeline, valuation of the easements was the primary issue. If the valuations are found to be ''grossly misstated,'' the penalties and adjusted valuations will provide a more nuanced approach to the issue of conservation easements. In his dissent in *Oakbrook Land Holdings*, Judge Holmes expressed his dismay with the majority opinion: ''Our holding today will likely deny any charitable deduction to hundreds or thousands of taxpayers who donated the conservation easements that protect perhaps millions of acres.''[30]

Practitioners and taxpayers are waiting to see if the Sixth Circuit will agree with the Eleventh Circuit or set up a conflict within the circuit courts to pave the way for an appeal to the Supreme Court. Either way, the *Oakbrook Land Holdings* opinion is anxiously awaited by those connected to this issue with hopes that millions of acres will continue to be protected.

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[28] §6662(h).

[29] *Hewitt*, 2021 BL 495044, *4, n. 3.

[30] *Oakbrook Land Holdings*, LLC, 154 T.C. 180, 230.

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