CONSERVATION EASEMENT VALUATION UPHELD – REASONABLE CAUSE DEFENSE AT ISSUE

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Overview

The donation of a permanent conservation easement on farm or ranch land can provide a significant tax benefit to the donor. The donor can receive an income tax deduction equal to the FMV of the contributed conservation easement at the time of the donation (I.R.C. §170(h); Treas. Reg. §1.170A-14); an estate tax benefit at death by excluding the fair market value of the donated easement from the donor's (landowner's) gross estate (I.R.C. §2031(c)(1)-(2)); and a possible reduction in property taxes (dependent on state law). In addition, during life, the donor retains the right to sell or transfer the property subject to the easement restrictions.

Note: The rules are complex and must be carefully complied with to obtain the tax benefits that are possible – qualified farmers and ranchers can deduct up to 100 percent of their income (i.e., the contribution base). *I.R.C. §170(b)(1)(E)(iv)(I).* For others, the limit is 50 percent of annual income. *I.R.C. §170(b)(1)(B).*

IRS CONCERNS

The key to securing a tax deduction for the donation of a permanent conservation easement is the proper drafting of the easement deed (as well as an accurate and detailed appraisal of the property). That's the instrument that conveys the legal property interest of the easement to the qualified charity (qualified land trust, etc.). This document must be drafted very precisely. For example, the donor must not reserve rights that are conditioned upon the donee's consent. This is termed a deemed consent provision, and it will cause the donated easement to fail to be a perpetual easement – one of the requirements to get a charitable contribution deduction. *See Treas. Regs. §§1.170A-14(e)(2); 1.170A-14(g)(1); 1.70A-14(g)(6)(ii).*

The IRS also takes the position that the perpetuity requirement is not met if a mortgage on the property is not subordinated. For instance, in *Palmolive Building Investors, LLC v. Comr., 149 T.C. 380 (2017),* a charitable deduction was denied because the mortgages on the property were not subordinated to the donated façade easements as Treas. Reg. §1.170A-14(g)(2) requires. In addition, the deed at issue stated that the mortgagees had prior claims to extinguishment proceeds. That language violated the requirement set forth in Treas. Reg. §1.170A-14(g)(6)(ii). A savings clause in the deed did not cure the defective language because the requirements of I.R.C. §170 must be satisfied at the time of the easement is donated.

The case law also supports the IRS position that development rights and locations for development cannot be reserved on the property subject to the easement if it changes the boundaries for the easement. In other words, the IRS position is that the easement deed language must place a perpetual encumbrance on specifically defined property that is fixed at the time of the grant. However, if the

easement only allows the boundary of potential development to be changed on a portion of a larger parcel that is subject to the easement restrictions and neither the acreage of potential development nor the easement is enhance, the perpetuity requirement remains satisfied. *See, e.g., Bosque Canyon Ranch II, L.P. v. Comr., 867 F.3d 547 (5th Cir. 2017); Treas. Reg. §1.170A-14(f).*

Another requirement is that the taxpayer must disclose (on Form 8283) the income tax basis in the property being subjected to a conservation easement that is donated to a qualified charity. This is part of the substantiation requirements for non-cash charitable donations.

Recent Case

In *Murfam Enterprises, LLC v. Comr., T.C. Memo. 2023-73,* the petitioner was a partnership owned by the Murphy family who began a hog empire in North Carolina and is largely credited with reshaping the hog production industry into the large-scale, confinement facility, contract production structure that it is today. In 1999, the partnership acquired a 6,171-acre tract of undeveloped rural land in North Carolina, largely covered in trees. The partnership obtained a certificate permitting it to engage in raising hogs on 1,115 acres of the property. The certificates were a restriction that "ran with the land" subjecting any future owner to the same restriction. The certificates authorized the raising of up to 58,752 swine in a feeder-to-finish facility, or 19,538 sows in a "farrow-to-wean" facility. In 2007, the state of North Carolina imposed a moratorium on any new certificates, but existing certificates would remain honored. In 2010, the family decided not to clear the land and build more hog facilities, preferring instead to use the land for recreational purposes. The partnership then donated a permanent conservation easement on the 1,115 acres where hog production was allowed, thereby making the certificates useless. An expert valued the easement at $5.745 million (based on the before-and-after approach).

The IRS audited the partnership return and proposed to reduce the charitable contribution to $446,000. The IRS did not assert any penalty and did not claim that the charitable deduction should be denied based on the partnership's failure to fully complete Form 8283.

The partnership challenged the IRS position in Tax Court. In its answer, the IRS (for the first time) asserted a gross valuation misstatement penalty under I.R.C. §6662(e) or (h). The IRS also, alternatively, argued for an accuracy-related penalty under I.R.C. §6662(a).

Note: On the penalty issue, the IRS bore the burden of proof, which also meant that the IRS had to establish that the partnership lacked reasonable cause for any errors on the return regarding the charitable deduction.

Later, in a pretrial memo, the IRS claimed that the charitable deduction should be denied in full because of the partnership's failure to substantiate the donation by not providing the income tax basis of the property on Form 8283.

Tax Court agreed with the IRS that the partnership's failure to report the basis for the land on Form 8283 did not comply with the applicable regulations, but that a deduction could still be allowed if the failure to comply with the regulation was due to reasonable cause and not a result of willful neglect. I.R.C. §170(f)(11)(A)(ii)(II). The Tax Court noted that the partnership relied on professional tax

preparers to prepare the return and that the partnership had provided accurate and necessary information to the CPA firm to prepare the return appropriately (as testified to by the CPA firm).

Note: The record did not reveal whether the partnership actually provided the basis information to the CPA firm, there was also no evidence showing why it was not provided. The IRS failure to cross examine witnesses and not claim that the partnership withheld evidence from the preparers until its reply brief was fatal to its position.

On the valuation, the Tax Court determined the value of the easement was $5.637 million rather than the $5.745 million reported on the return (and substantially more than IRS claimed). The Tax Court also determined that the highest and best use of the property was as a farrow-to-wean operation, and that the expert report of the IRS was flawed in several respects.

Ultimately, the partnership avoided the imposition of any penalties. Importantly, the IRS did not assert a gross valuation misstatement penalty for which reasonable cause would not have been a defense. *See, e.g., Murphy v. Comr., T.C. Memo. 2023-72* (in a case involving the same family, a charitable deduction not disallowed due to omission on return because of reasonable reliance, but gross valuation penalty imposed because the petitioner seriously overstated the value of the donated easements).

Conclusion

Murfam Enterprises, LLC v. Comr., T.C. Memo. 2023-73, was a big win for the partnership on the novel issue which party bears the burden of proof on the reasonable cause defense when the IRS raises the issue of noncompliance with the substantiation rules of I.R.C. §170(f)(11) as a new matter in litigation and reasonable cause for the noncompliance is at issue.

Fortunately, the partnership hired competent professionals to prepare the return. It was not the partnership's fault that the CPA firm failed to follow the rules associated with preparing the return on which a large charitable deduction was claimed. Clearly, the shift of the burden of proof to the IRS aided the partnership (along with the procedural failures of the IRS leading up to and at trial in the case).

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