What's the "Beef" With Conservation Easements?

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June 2021
Agricultural Law and Taxation Blog, by Roger McEowen: https://lawprofessors.typepad.com/agriculturallaw/

Overview

The donation of a permanent conservation easement on farm or ranch land can provide a significant tax benefit to the donor. 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). For others, the limit is 50 percent of annual income.

But, the IRS has a history of auditing returns claiming deductions for conservation easements, and winning in court on the issue. But, is the tide starting to turn with respect to one of the IRS "arrows" it uses to attack conservation easement deductions?

The trouble with permanent conservation easement donations and current litigation on the "extinguishment" regulation – it's the topic of today's post.

In General

The donation of a permanent conservation easement is accomplished via a transaction that involves a legally binding agreement that is voluntarily entered into between a landowner and qualified charity – some form of land trust or governmental agency. Under the agreement, the landowner allows a permanent restriction on the use of the donated land so as to protect conservation characteristics associated with the tract. *See I.R.C. §170(h).* But, all of the applicable tax rules must be precisely complied with in order to generate a tax deduction. This is one area of tax law where a mere "foot-fault" can be fatal.

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 caselaw 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 problem with easement deeds that the IRS watches for is whether the deed language allows the donor and donee to mutually agree to amend the deed. If this reserved right is present, the IRS takes the position that the easement is not perpetual in nature and does not satisfy the perpetuity requirement of I.R.C. §170(h)(2)(C). But, there is an exception. Amendment language is allowed if any subsequent transfer by the donee (via amendment language in the deed) facilitates the conservation purpose of the original transfer to the donee organization. *Treas. Reg. 1.170A-14(c)(2); see also Butler v. Comr., T.C. Memo. 2012-72.*

The Extinguishment Regulation

Another requirement of securing a charitable deduction for a donated conservation easement is that the charity must be absolutely entitled to receive a portion of any proceeds received on account of condemnation or casualty or any other event that terminates the easement. *Treas. Reg. §1.170A-14(g)(6).* This is required because of the perpetual nature of the easement. But, exactly how the allocation is computed is difficult to state in the easement deed. The basic point, however, is that the allocation formula cannot result in what a court (or IRS) could deem to be a windfall to the taxpayer. *See, e.g., PBBM-Rose Hill, Ltd. v. Comr., 900 F.3d 193 (5th Cir. 2018); Carroll v. Comr., 146 T.C. 196 (2016).* In addition, the allocation formula must be drafted so that it doesn't deduct from the proceeds allocable to the donee an amount that is attributable to "improvements" that the donor makes to the property after the donation of the permanent easement. If such a reduction occurs, the IRS presently takes the position that no charitable deduction is allowed because the specific requirements of the proceeds allocation formula are not satisfied. This seems counter-intuitive, but it is an IRS audit issue with respect to donations of permanent conservation easements.

If the donee acquires the fee simple interest in the real estate that is subject to the easement, the donee's ownership of both interests would merge under state law and thereby extinguish the easement. This, according to the IRS, would trigger a violation of the perpetuity requirement. Consequently, deed language may be included to deal with the merger possibility. But, such language is problematic if it allows the donor and donee to contractually agree to extinguish the easement without a court proceeding. Leaving merger language out of the easement deed would seem to result in the IRS not raising the merger argument until the time (if ever) the easement interest and the fee interest actually merge.

Litigation on the extinguishment regulation. The Tax Court has decided a couple of cases recently involving the extinguishment regulation. In *Oakbrook Land Holdings, LLC v. Comr., 154 T.C. No. 10 (2020),* various investors created the petitioner in 2007 and bought 143 cares on a mountain near Chattanooga, Tennessee for $1.7 million. The following year, the petitioner donated 106 acres to a qualified land trust as a permanent conservation easement and claimed a $9.5 million deduction. The easement deed specified that upon extinguishment of the conservation restriction the donee would receive a share of the proceeds equal to the fair market value of the easement as of the date of the contribution. That value, the deed specified, was to be reduced by the value of any improvements that the donor made after granting the easement.

The IRS denied the charitable deduction for violating the extinguishment regulation of Treas. Reg. §1.170A-14(g)(6), because the qualified land trust was not entitled to a proper proportionate share of proceeds if the easement were acquired through eminent domain at some future date. On the contrary, the easement language in the deed had the effect of allocating to the petitioner all of the value of any land improvements made after the easement was donated. The full Tax Court agreed with the IRS position on the allocation issue, and also upheld the validity of the regulation on the basis that the extinguishment regulation had been properly promulgated and did not violate the Administrative Procedure Act (APA). The full Tax Court also determined that the construction of I.R.C.§170(h)(5), as set forth in the extinguishment regulation, was valid under the agency deference standard set forth in *Chevron, U.S.A. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984)*.

In a related memorandum opinion, *Oakbrook Land Holdings, LLC v. Comr., T.C. Memo. 2020-54,* the Tax Court held that the easement deed did not create a perpetual easement because the donee's share of the extinguishment proceeds was based on fixed historical value, reduced by the value of improvements that the donor made. It was not, as it should have been, based on a proportionate share of extinguishment proceeds that are at least equal to the total proceeds (unadjusted by the value of the petitioner's improvements), multiplied by a fraction defined by the ratio of the fair market value of the easement to the fair market value of the unencumbered property determined as of the date of the execution of the deed. However, the Tax Court did not uphold penalties that the IRS imposed, finding that the petitioner's position was reasonable.

The Tax Court again upheld its proportionate value approach in a case where the deed granting the easement reduced the donee's share of the proceeds in the event of extinguishment by the value of improvements (if any) that the donor made. *Smith Lake, LLC v. Comr., T.C. Memo. 2020-107.* As such, the petitioner had not satisfied the perpetuity requirement of I.R.C. §170(h)(5)(A). The Tax Court upheld the validity of the regulation and the petitioner's claimed deduction was denied.

Litigation continues at the appellate court. The petitioner in the *Oakbrook* case has appealed the Tax Court's opinion to the U.S. Circuit Court of Appeals for the Sixth Circuit, claiming that the Treasury violated the APA in creating the extinguishment regulation by not soliciting comments and failing to reasonably interpret the underlying statute. The petitioner latched onto the Judge Holmes' dissent in the full Tax Court opinion, that determined that the IRS had not properly considered public comments as the APA required. Judge Holmes viewed the majority interpretation as having the future effect of denying many more charitable deductions associated with conservation easements. The petitioner is also claiming on appeal that the deed language satisfied the perpetuity requirement, and that the petitioner shouldn't be liable to "predict and compensate the donee for hypothetical events outside of the donor's control." The petitioner is also claiming that the IRS arguments concerning the deed language relating to the perpetuity requirement weren't raised at the Tax Court level and should be barred on appeal. The petitioner also claims that the deed language has been commonly used for over 30 years, and, as such, the current IRS position is contrary to the Congressional purpose of the statute to incentivize conservation.

Conclusion

It will be interesting to see how the Oakbrook case is decided at the Sixth Circuit. A decision is expected by the end of summer. Thousands of permanent conservation easement donations hang in the balance.