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Top 6 IRS Attacks On Conservation Easement Deductions

By **Gregory Rhodes and Tucker Thoni** (July 5, 2018, 6:15 PM EDT)

Conservation easements, like diamonds, are forever. Similarly, the Internal Revenue Service believes that, just like diamonds, the tiniest imperfection in a conservation easement deed is fatal to its value. Like inclusions in diamonds, the alleged technical deficiencies in conservation easements are often inconspicuous to the untrained eye. However, the exacting scrutiny of an IRS audit has a way of magnifying — and at times skewing — a conservation easement's true color and clarity. This article serves as an alert to potential donors of conservation easements regarding the top six IRS attacks that could render an easement valueless for federal income tax purposes.

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1. The Deemed Consent Provision

Recent summary judgement motions have addressed situations in which donors have reserved certain rights in easement deeds, the exercise of which were conditioned upon donee consent. The IRS interpreted the easement deeds at issue to provide a "deemed consent" in the event the donee failed to affirmatively object to a proposed exercise of rights within a given period of time — i.e. the deeds at issue stated the donee was deemed to approve of an action in the event the donee did not affirmatively oppose the action within a stated period of time. The U.S. Tax Court agreed with the IRS that the deemed consent provision at issue in one of those cases caused the easement to fail to protect the conservation purposes in perpetuity.

The IRS is now contending that charitable deductions should be disallowed under Treasury regulation section 1.170A-14(e)(2) whenever easement deeds contain deemed consent provisions. The IRS argues that these deeds permit the donor to use the property in a manner destructive of the conservation purposes protected by the conservation easement.

The IRS also argues that deemed consent provisions strip land trusts of their ability to protect conservation values in perpetuity as required by Treasury regulation section 1.170A-14(g)(1), which instructs that the rights retained by the donor must be subject to legally enforceable restrictions that would prevent a use inconsistent with the conservation purposes of the donation. Unfortunately, such deemed consent language was present in a Model Conservation and Historic Preservation Easement Deed Agreement, which has been relied on by large numbers of taxpayers and land preservation trusts.

2. The Proceeds Clause

If a condemnation, casualty or other extinguishing event occurs with respect to easement property, the land trust — donee — must be entitled to a portion of any proceeds attributable to the extinguishment or sale of the property at least equal to the land trust's proportionate value in the property at the time of the easement donation.[1] This "proceeds requirement" is meant to ensure that the donation is perpetual even in the event the easement is extinguished. Below are the three most common proceeds-clause-based arguments the IRS is making to disallow conservation easement deductions:

Proceeds Allocation Formula

The IRS argues that any extinguishment clause that does not precisely track the Treasury regulation's proceeds allocation formula fails to protect conservation purposes in perpetuity. For example, in Carroll v. Commissioner of Internal Revenue,[2] the Tax Court disallowed a conservation easement deduction because the easement deed stated that the numerator fixing the land trust's proportion would be the "deduction for federal income tax purposes allowable by reason of this grant," rather than the "fair market value of the perpetual conservation restriction on the date of the gift."[3] The court viewed this as allowing a "potential windfall" for the landowner if the easement was extinguished and the deduction were to be disallowed for reasons unrelated to valuation. Carroll is currently on appeal before the Fourth Circuit Court of Appeals.

Taxpayers and their tax advisers can — and should — avoid the defect in Carroll by carefully wording conservation easement deeds. However, Carroll is merely a symptom of a much larger issue, i.e., that the relevant Treasury regulation is very unclear — if not inconsistent — in its description of the required proceeds allocation formula. This ambiguity has provided the IRS wide latitude to attack conservation easements as allegedly failing to allocate proceeds appropriately. Accordingly, simply avoiding the specific defect in Carroll will not place an easement deed's proceeds allocation formula beyond IRS reproach.

Proceeds Attributable to Post-Easement Improvements:

If an easement deed's proceeds allocation formula deducts, from the proceeds allocable to the donee, an amount attributable to "improvements" made by the owner after the contribution of the conservation easement, the IRS is arguing that the easement donation is not deductible because it violates the proceeds allocation formula required by Treasury regulation section 1.170A-14(g)(6)(ii). The IRS is making this argument notwithstanding its prior published guidance stating such language is permissible.[4]

The IRS position is based on a bench opinion from the Tax Court in PBBM-Rose Hill v. Commissioner of Internal Revenue.[5] Bench opinions are not supposed to have precedential value.[6] Accordingly, the IRS often cites to Carroll, in lieu of PBBM-Rose Hill, in support of the contention that reserving proceeds attributable to post-easement improvements violates the perpetuity requirement. Ironically, the proceeds clause at issue in Carroll allocated proceeds attributable to post-easement improvements to the owner, and the Tax Court's opinion does not mention — much less rely — on such allocation. PBBM-Rose Hill is currently on appeal before the Fifth Circuit Court of Appeals.

Presently, reserving proceeds attributable to post-easement improvements to the owner of the property in priority to the land trust — donee— is, although logical and sensible, probably the most

prevalent technical issue being raised by the IRS in audits of conservation easements. Such clauses are nearly ubiquitous within conservation easement deeds — because they make logical sense. Accordingly, donors of conservation easements should keep an eye on this issue moving forward.

Proceeds from Third Party Contracts

The IRS argues that land trusts must have a vested interest in proceeds of third party contracts, such as insurance contracts. For example, in Palmolive Building v. Commissioner of Internal Revenue,[7] a taxpayer had a $33.4 million charitable deduction disallowed for the donation of a façade easement over a historic building in Chicago because the mortgage holders of the property were entitled to insurance proceeds in preference to the land trust.

The IRS argued that the easement deed did not protect the conservation values in perpetuity, as required by Internal Revenue Code section 170(h)(5)(A) and Treasury regulation section 1.170A-14(g)(2) and (6)(ii), because the deed provided the mortgagees with prior claims to insurance proceeds in preference of the land trust. The Tax Court agreed with the IRS holding that providing the mortgagees a preference to insurance proceeds violated the perpetuity requirement.

3. The Amendment Clause

The IRS contends that the presence of a clause permitting the parties to mutually agree to amend an easement deed, i.e., an "amendment clause," causes a conservation easement to violate the perpetuity requirement of Code section 170(h)(2)(C). Troubling — general amendment clauses are found in the overwhelming majority of easement deeds. Moreover, retaining the right to amend protects conservation purposes by allowing amendments necessary to ensure conservation purposes are perpetual. Indeed, the Land Trust Alliance, or LTA,[8] has unequivocally expressed its support for amendment clauses as "an important stewardship tool. ... [Because] [p]erpetuity is enhanced by the ability to appropriately respond to change."[9]

The right to amend an easement deed enhances the perpetuity of the easement by allowing modifications needed to accommodate future circumstances that cannot be anticipated when a deed is being negotiated. Similarly, Treasury regulations clearly contemplate situations where an "unexpected change in the conditions surrounding the property" might require a land trust to reassess the terms and validity of a conservation easement.[10]

The IRS position is contrary to several Tax Court cases implicitly blessing amendment clauses.[11] Nonetheless, taxpayers should keep an eye on this issue because there are several cases pending before the Tax Court in which the IRS has contended that a general amendment clause is fatal to a conservation easement deduction.

4. The Merger Clause

It is common under real property law for a dominant estate and a lesser estate to merge if both estates come under common ownership, e.g., fee owner and lessee. The merger extinguishes the lesser estate, often, by operation of law and without any action — apart from the combination of estates — by the landowner. For purposes of a conservation easement, this could theoretically occur under state law if the land trust were to acquire the fee simple interest in conservation easement property thereby merging the conservation easement and fee simple interest under common ownership.[12]

Conservation easement deeds often include a “merger clause” that addresses what should happen in the unlikely event of a joinder of ownership of estates. The approaches vary: (1) expressly prohibiting the merger of estates under any circumstance, (2) prohibiting the merger of estates unless the parties expressly state that they intend a merger of estates or interests to occur or (3) taking no position regarding merger of estates, thereby punting the determination to what state law provides regarding merger of estates.

The IRS is arguing that a conservation easement deed that permits the merger of estates violates the perpetuity requirement because it could permit the parties to agree to extinguish the easement without a judicial proceeding. In a recent summary judgement motion, the IRS chief counsel argued that a clause similar to (2) above “show[ed] the parties’ unambiguous intent to reserve the right to eliminate the easement through a merger of estates in the future.”[13] If an easement deed takes the approach similar to (3) above and state law provides for merger of estates, then the easement deed is similarly vulnerable to IRS scrutiny.

The IRS takes this position notwithstanding the fact that the merger of estates would result with the land trust holding a greater estate — i.e., a fee simple interest — than it did prior to the merger of estates — i.e., a conservation easement restriction. One is left to question whether a contractual prohibition on the merger of estates is even enforceable under state law, and if not, whether a deed can be drafted which would be immune from IRS attack under this theory.

5. Floating Homesites

Donors of conservation easements generally reserve specific development rights for the property encumbered by an easement. These reserved development rights might include the ability to build residences, barns, sheds, gazeebos, corals, clubhouses, roads, trails and various other improvements. Sometimes the location of the reserved development sites will be fixed at the time the easement is granted. However, it has also been common for donors to simply reserve development sites and determine the specific locations at a later date, so-called “floating” development sites.

Reserved development sites, whether fixed or floating, are either “outparcels” or “in-parcels.” Outparcels are carved out of the property protected by the easement and are not subject to the easement’s restrictions. Comparatively, in-parcels are located within the property protected by the easement and remain encumbered by at least some of the easement’s restrictions.

In-parcel and outparcel development sites are considered permissible when fixed in location — although the IRS frequently argues otherwise. However, the Tax Court in Bosque Canyon v. Commissioner of Internal Revenue[14] determined that when outparcel development sites are floating the taxpayer can change the boundaries of the easement, and therefore change what property is subject to the easement’s restrictions. This would violate the perpetuity requirement, as interpreted in Belk v. Commissioner of Internal Revenue,[15] that the easement’s restrictions must perpetually encumber a specific, defined parcel of real property.

The IRS contends, based on Bosque Canyon and Belk, that any reserved development rights that are floating violate the perpetuity requirement, regardless of in-parcel or outparcel status. The IRS position is contrary to the Treasury regulations[16] and IRS guidance,[17] both of which bless floating development rights. The IRS position also contravenes the general preference of the land trust community, which prefers reserved development rights so that landowners can be on-site, active stewards of the properties encumbered by conservation easements.

In BC Ranch v. Commissioner of Internal Revenue,[18] the Fifth Circuit Court of Appeals vacated and remanded the Tax Court opinion in Bosque Canyon. However, due to the Golsen Rule,[19] the IRS has largely ignored BC Ranch and continues to cite Bosque Canyon as black letter law. It is unclear if the Tax Court will let the Fifth Circuit's opinion in BC Ranch affect the weight and reliance it places on Bosque Canyon prospectively.

6. Form 8283

Filers are required to attach IRS Form 8283, also known as an "appraisal summary," to any tax return claiming a charitable deduction for a donation of property with a fair market value in excess of $500. There are various items the taxpayer must report on Form 8283, including but not limited to a description of the property and its condition, the appraised fair market value of the property, the date and manner of acquisition, and the donor's basis in the property. The IRS carefully scrutinizes Forms 8283, often contending that entire deductions should be disallowed for minor omissions.

For example, in RERI Holdings I v. Commissioner of Internal Revenue,[20] the IRS successfully challenged a taxpayer's $33 million charitable deduction because the donor did not report the cost or adjusted basis of the donated property on Form 8283. The Tax Court determined that omitting the donor-taxpayer's cost or adjusted basis from Form 8283 caused the donation to fail to comply with Treasury regulation section 1.170A-13(c)(4)(ii)(E) resulting in a total disallowance of the taxpayer's charitable deduction.

RERI Holdings is surprising in light of the Instructions to Form 8283 (Rev. 2014), which indicate that the cost or adjusted basis may be left blank if the taxpayer has reasonable cause for not completing the form and attaches an explanation of that reasonable cause. Moreover, the instructions to Form 8283 indicate that a taxpayer's deduction will not be disallowed for failing to complete Section B of Form 8283, if the taxpayer provides the IRS a complete Form 8283 within 90 days of an IRS request. The court's opinion does not indicate if the taxpayer attached an explanation for why the basis was not provided or subsequently provided the basis within 90 days of an IRS request.

The Tax Court had previously held, in Dunlap v. Commissioner of Internal Revenue[21] and Friedberg v. Commissioner of Internal Revenue,[22] that omitting the "cost or adjusted basis" from Form 8283 is not fatal to a taxpayer's conservation easement deduction, and the opinion in RERI Holdings does not mention — much less reject — these cases.

The taxpayer in RERI Holdings donated a remainder interest in property, not a conservation easement. And while the Form 8283 substantiation requirement applies to all contributions of property in excess of $500, there are specific provisions in the instructions to Form 8283 for contributions of conservation easements, which could arguably distinguish them from RERI Holdings.

Notwithstanding this distinction and the conflicting conservation easement case law, the IRS has interpreted RERI Holdings broadly and is aggressively using its reasoning to attack conservation easement contributions that fail to report the donor's cost or adjusted basis in the contribution property. It is unclear if the Tax Court will agree with the IRS and extend the reasoning in RERI Holdings to donations of conservation easements. At the time of this writing, RERI Holdings is on appeal before the D.C. Circuit Court of Appeals.

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[1] See Treas. Reg. § 1.170A-14(g)(6)(ii).

[2] Carroll v. Comm'r, 146 T.C. 196 (2016) (Judge Ruwe) appeal docketed No. 16-2417 (4th Cir. Dec. 15, 2016).

[3] See Treas. Reg. § 1.170A-14(g)(6)(ii), (h)(3)(3)(i).

[4] IRS Priv. Ltr. Rul. 2008-36-014 (IRS determined that a conservation easement was protected in perpetuity notwithstanding the fact that the easement deed allocated proceeds attributable to post-easement improvements to the owner).

[5] PBBM-Rose Hill, Ltd. v. Comm'r, No. 26096-14 (Oct. 7, 2016) (bench opinion Judge Morrison) appeal docketed No. 17-60276 (5th Cir. Apr. 20, 2017).

[6] I.R.C. § 7459(b); Tax Court Rule 152(c).

[7] Palmolive Building, LLC v. Comm'r, 149 T.C. No. 18 (Oct. 10, 2017) (Judge Gustafson).

[8] The Land Trust Alliance ("LTA") is an umbrella organization consisting of over 1100 land trusts throughout the United States. The LTA "accredits" land trusts that comply with certain "standards and practices" and provides guidance and instruction to such land trusts.

[9] http://www.landtrustalliance.org/amendments.

[10] See Treas. Reg. § 1.170A-14(c)(2).

[11] See, e.g., Butler v. Comm'r, T.C. Memo. 2012-72, at 9, 39 ("The 2004 conservation deed amends several portions of the 2003 conservation deed, enlarging the portion of the property encumbered by the easement and permitting the encumbered property to be subdivided into 15 tracts instead of only 5.")

[12] The land trust is prohibited from selling the conservation easement except to another land trust (or similar qualified organization), so the example is only feasible when the land trust subsequently acquires a fee simple interest in the conservation easement property. Treas. Reg. § 1.170A-14(c)(2).

[13] Respondent's Motion for Partial Summary Judgment at 11-16, Smith Lake, LLC v. Comm'r, No. 4980-17 (T.C. May 8, 2018).

[14] Bosque Canyon Ranch, L.P., v. Comm'r, T.C. Memo. 2015-130 (Judge Foley) rev'd 867 F.3d 547 (5th Cir. 2017).

[15] Belk v. Comm'r, 774 F.3d 221 (4th Cir. 2014) aff'g 140 T.C. 1 (2013) (Judge Vasquez).

[16] See Treas. Reg. § 1.170A-14(f) (Ex. 4) (twenty (20) reserved floating homesites did not preclude deduction because precise location of homesites was subject to land trust notice and approval)

[17] I.R.S. Priv. Ltr. Rul. 96-03-018 (Jan. 1, 1986) (easement that allowed taxpayers to relocate building sites for residences and improvements constituted the donation of a "qualified real property interest" because the restrictions were granted in perpetuity); I.R.S. Priv. Ltr. Rul. 2004-03-044 (Jan. 16, 2004) (easement allowing taxpayer to exempt a number of building areas from certain easement restrictions constituted qualified real property interest).

[18] BC Ranch II, L.P. v. Comm'r, 867 F.3d 547 (5th Cir. 2017) rev'g T.C. Memo. 2015-130 (Judge Foley).

[19] The Golsen Rule requires the Tax Court to apply the law applicable to the Federal Circuit Court to which the case would be appealable. This effectively allows the Tax Court to ignore BC Ranch and apply its reasoning in Bosque Canyon to any taxpayer whose appeal lies outside the Fifth Circuit Court of Appeals. See Golsen v. Comm'r, 54 T.C. 742, 757 (1970).

[20] RERI Holdings I, LLC v. Comm'r, 149 T.C. No. 1 (2017) (Judge Halpern) appeal docketed No. 17-1266 (D.C. Cir. Dec. 18, 2017).

[21] Dunlap v. Comm'r, T.C. Memo. 2012-126, at *28-29.

[22] Friedberg v. Comm'r, T.C. Memo. 2011-238, at *8, 22-23.