

Tax Treatment of Conservation Easements: Navigating the Changes

TELEPHONE SEMINAR | AUDIO WEBCAST



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1:30 pm to 3 pm Eastern**



OVERVIEW



Overview

1. What Are Conservation Easements?

- An easement, restriction, covenant or condition restricting the use of land or buildings for natural habitat, open space, scenic, agricultural or historic purposes

Overview (cont.)

- ## 2. Characteristics of Conservation Easements
- Conservation easements are voluntarily granted by the property owner
 - Conservation easements are permanent and bind all successor owners
 - Conservation easements are held and enforced by “qualified” non-profit or governmental entities
 - Conservation easements vary in scope depending on the language of the deed
 - The property owner retains ownership and use of the underlying property
 - The property does not become public

Overview (cont.)

3. History of Conservation Easements

- Negative easements disfavored at common law
- Intended to reduce development pressure on agricultural and open space land starting in the 1960s
- Authorized by statutes starting in 1960s and 1970s
- Preferential property tax treatment authorized by state law
- *Mohonk Trust v. Assessors*, 47 N.Y.2d 476 (1979)
- Preferential income tax treatment authorized by federal and state law in 1970s and 1980s
- Federal and state funding became available for less-than-fee purchases

Overview (cont.)

4. Effect on Development Rights

- Relinquishment or transfer of development rights
- May limit but not extinguish development rights
- Development rights may be clustered
- Rarely affects existing structures

Overview (cont.)

5. Advantages of Conservation Easements

- To public agencies
- To conservation organizations
- To property owners
- To neighboring owners



SECTION I

Conservation Easements as Charitable Contributions

SECTION I - Conservation Easements as Charitable Contributions

- IRC § 170(h) governs charitable contributions of conservation easements
- Treasury Regulation 1.170A-14 – twenty six pages of regulations



Requirements

- Restrictions must be perpetual
- Conveyance to a qualified organization either a 501(c)(3) public charity or any unit of government
- The recipient must have “the commitment to protect the conservation purposes of the donation and have the resources to enforce the restrictions”

Requirements (cont.)

- Must meet the “exclusively for conservation purposes” test
- The term “conservation purpose” means—
 - (i) the preservation of land areas for outdoor recreation by, or the education of, the general public,
 - (ii) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem,
 - (iii) the preservation of open space (including farmland and forest land) where such preservation is—
 - (I) for the scenic enjoyment of the general public, or
 - (II) pursuant to a clearly delineated Federal, State, or local governmental conservation policy, and will yield a significant public benefit, or
 - (iv) the preservation of an historically important land area or a certified historic structure.

Requirements (cont.)

- Charitable Contributions Generally
 - Disinterested generosity
 - No quid pro quo
 - Not required by contract
- Qualified Appraisal
 - Treasury Regulation § 1.170A-13



Fair Market Value of Conservation Easement

- Determined by appraisal
- Measured as the difference between the value of the property before it is encumbered by the easement and after the property is encumbered by the easement, known as the “Before and After” approach
- Example:
 - KKR Ranch, 1000 acres, is worth \$3,000,000 before the easement and \$1,700,000 after the easement. The value of the easement is \$3,000,000 less \$1,700,000, or \$1,300,000 and will qualify for a federal charitable deduction if all the rules are followed

Donation or Sale

- A bargain sale is a part gift/part sale transaction in which a conservation easement is sold for less than its fair market value. The difference between the fair market value and the sale price will qualify as a federal charitable deduction if all the rules are followed
- Example:
 - KKR Ranch conservation easement, appraised at \$1,300,000 is sold for \$1,000,000. The value of the gift is the difference between the appraised fair market value of \$1,300,000 and the sale price of \$1,000,000, or \$300,000

SECTION II

THE NAT PROBLEM



The NAT Problem

1. Allegations Against Trust for Architectural Easements (formerly NAT)
 - Marketing Charitable Deductions
 - Inflating Easement Values
 - Lack of Monitoring
 - Ties to For-Profit Enterprise
2. 2011 TAE-IRS Settlement

SECTION III

IRS Audits



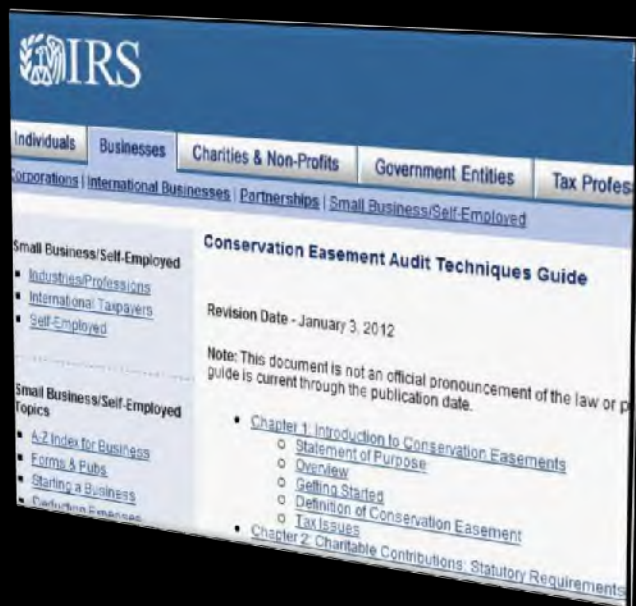
SECTION III – IRS Audits

- 2004 Washington Post Headline & stories
- Internal Revenue Bulletin July 2004
- In 2006, the IRS Commences Audits of 200 Colorado Conservation Easements and Urban Historic Preservation Easements in several cities
- Bases for Challenge
 - Zero valuation
 - Procedural defects (silver bullets)

Examples

- Failure of taxpayer to obtain contemporary written acknowledgment from donee
- Mortgage subordinations that do not comply with the Treasury Regulation § 1.170A-14(g)(6)
- Failure to comply with the Conservation Purposes Test
- Failure to obtain a Qualified Appraisal from a Qualified Appraiser

IRS Conservation Easement Audit Techniques Guide published in September 2011 and most recently revised on January 3, 2012 and updated on March 15, 2012



68 pages of IRS Guidance

www.irs.gov/businesses/small/article/0,,id=249135,00.html

Tax Issues

Taxpayers must satisfy numerous statutory provisions in order to claim a noncash charitable contribution deduction for the donation of a conservation easement. Some deficiencies revealed in examinations of conservation easements include:

- Failure to meet charitable contributions rules.
- Noncompliance with [substantiation](#) requirements.
- Inadequate documentation or lack of [conservation purpose](#).
- Lack of [perpetuity](#) evidenced by deeds allowing for abandonment or termination of easement.

Tax Issues (cont.)

- Reserved property rights inconsistent with the claimed conservation purpose.
- Failure to comply with subordination rules.
- Failure to provide the donee organization with a right to proceeds in the event of termination.
- Use of improper appraisal methodologies and overvalued conservation easements.
- Failure to report income from the sale of state tax credits.

Tax Issues (cont.)

The IRS has also identified some promoters and appraisers involved in conservation easement tax schemes.



SECTION IV

CASES AND OTHER RECENT DEVELOPMENTS



Cases and Other Recent Developments

- Deductibility of Stewardship Contribution
 - *Scheidelman v. Commissioner*, Nos. 10-3587-ag(L), 10-5316-ag(XAP) (6/15/12)
 - *Dunlap v. Commissioner*, T.C. Memo 2012-126 (5/1/12)
- Valuation Methodology
 - *Scheidelman v. Commissioner*, Nos. 10-3587-ag(L), 10-5316-ag(XAP) (6/15/12)
 - *Commissioner v. Simmons*, 646 F.3d 6 (D.C. Cir. 2011)
 - *Dunlap v. Commissioner*, T.C. Memo 2012-126 (5/1/12)

Cases and Other Recent Developments (cont.)

- Valuation Methodology, p. 2
 - *Friedberg v. Commissioner*, T.C. Memo 2011-238 (10/3/11)
 - *Whitehouse Hotel Ltd. Partnership v. Commissioner (Whitehouse II)*, 615 F.3d 321 (5th Cir. 2012)
 - *Rothman v. Commissioner (Reconsideration/Rothman II)*, T.C. Memo. 2012-218 (7/31/12)

Cases and Other Recent Developments (cont.)

- Conservation Purpose
 - *Turner v. Commissioner*, 126 T.C. 16 (2006)
 - *Glass v. Commissioner*, 124 T.C. 258 (2005)
 - *RP Golf v. Commissioner*, T.C. Memo 2012-282 (10/03/12)
- Contemporaneous Acknowledgment
 - *Irby v. Commissioner*, 139 T.C. 14 (10/25/12)

Cases and Other Recent Developments (cont.)

- In Perpetuity Requirement
 - *Dunlap v. Commissioner*, T.C. Memo 2012-126 (5/1/12) (monitoring obligations)
 - *Kaufman v. Schulman (Kaufman III)*, Nos. 11-2017; 11-2022 (1st Cir. 7/19/12)

Cases and Other Recent Developments (cont.)

- Proceeds Clause
 - *Scheidelman v. Commissioner*, Nos. 10-3587-ag(L), 10-5316-ag(XAP) (6/15/12)
 - *Commissioner v. Simmons*, 646 F.3d 6 (D.C. Cir. 2011)
 - *1982 East, LLC v. Commissioner*, T.C. Memo 2011-84 (04/12/11) (subordination)
 - *Irby v. Commissioner*, 139 T.C. 14 (10/25/12)
 - *Kaufman v. Schulman (Kaufman III)*, Nos. 11-2017; 11-2022 (1st Cir. 7/19/12)
 - *Wall v. Commissioner*, T.C. Memo 2012-169 (6/18/12)

Cases and Other Recent Developments (cont.)

- Effect of Existing Land Use Regulations
 - *Scheidelman v. Commissioner*, Nos. 10-3587-ag(L), 10-5316-ag(XAP) (6/15/12)
 - *Commissioner v. Simmons*, 646 F.3d 6 (D.C. Cir. 2011)
 - *Friedberg v. Commissioner*, T.C. Memo 2011-238 (10/3/11)
 - *1982 East, LLC v. Commissioner*, T.C. Memo 2011-84 (04/12/11)

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 - *Kaufman v. Schulman (Kaufman III)*, Nos. 11-2017; 11-2022 (1st Cir. 7/19/12)

Cases and Other Recent Developments (cont.)

- Substantial Compliance
 - *Dunlap v. Commissioner*, T.C. Memo 2012-126 (5/1/12)
 - *Friedberg v. Commissioner*, T.C. Memo 2011-238 (10/3/11)
 - *Rothman v. Commissioner (Reconsideration/Rothman II)*, T.C. Memo. 2012-218 (7/31/12)
 - *Kaufman v. Schulman (Kaufman III)*, Nos. 11-2017; 11-2022 (1st Cir. 7/19/12)

Cases and Other Recent Developments (cont.)

- Penalties
 - *Whitehouse Hotel Ltd. Partnership v. Commissioner (Whitehouse II)*, 615 F.3d 321 (5th Cir. 2012)
 - *Whitehouse Hotel Ltd. Partnership v. Commissioner (Whitehouse III)*, 139 T.C. 13 (10/23/12)
- Burden of Proof
 - *Whitehouse Hotel Ltd. Partnership v. Commissioner (Whitehouse III)*, 139 T.C. 13 (10/23/12)
- IRS, “*Conservation Easement Audit Techniques Guide*,” Rev. 03/15/12

Contemporaneous Written Acknowledgment

- *Bruzewicz v. Commissioner*, 604 F. Supp. 2d 1197 (N.D. Ill 2009)
- *Schrimsher v. Commissioner*, T.C. Memo 2011-71
 - In both cases deductions were denied.
- *Cohan v. Commissioner*, T.C. Memo 2012-8
 - On convoluted facts, taxpayers lost their deduction because the donee failed to properly value traded property interests.

Mortgage Subordination Proceeds Clause

- *Kaufman v. Shulman*, 2012 WL 2926164 (1st Cir. July 19, 2012)
 - The First Circuit reverses the Tax Court over the proceeds clause issue.
- *Irby v. Commissioner*, 139 T.C. No. 141 (October 25, 2012)
 - Tax Court approves proceeds clause where donee agreed to refund a portion of condemnation proceeds to funders.

Conservation Purposes

- *Glass v. Commissioner*, 471 F.3d 698 (6th Cir. 2006)
 - The Sixth Circuit reverses the Tax Court and finds the conservation easements protected significant plant and wildlife habitat.

Appraisals

- *Whitehouse Hotel Limited Partnership v. Commissioner*, 615 F.3d 321 (5th Cir. 2010)
 - The Fifth Circuit reverses and remands to Tax Court on valuation issues. Tax Court had disallowed \$5.7 million of claimed \$7.5 million historic preservation easement deduction.
- *Scheidelman v. Commissioner*, 682 F.2d 189 (2d Cir. 2012)
 - Second Circuit reserves Tax Court and finds that the appraisal was qualified
- *Commissioner v. Simmons*, 646 F.3d 6 (D.C. Circuit 2011)
 - The D.C. Circuit upholds the Tax Court finding that the appraisal was qualified

SECTION V

“SETTLED” ISSUES



“Settled” Issues

1. Valuation Methodology
 - “before and after”
2. Appraisal Requirements
3. Appraiser Requirements
4. Stewardship Requirements
 - qualified non-profit
 - endowment for monitoring costs
 - monitoring program

SECTION VI

UNRESOLVED ISSUES



Unresolved Issues

- Relationship to local land use restrictions
- Lack of comparable sales
- Effect of procedural defects
- Landowner appraisal obligations

THE FUTURE OF CONSERVATION EASEMENTS



DISCLAIMER

As good as this presentation has been, please understand that it is not intended to be tax advice. A client should consult a knowledgeable attorney and other professionals before undertaking a conservation easement transaction.

Circular 230 Disclosure

The IRS requires a disclosure that this communication is not in a form intended or written to be used for purposes of avoiding Internal Revenue Code penalties or for the promotion, marketing or recommendation to another party of the transaction referenced herein.

Questions?

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