CONSERVE TAX DEDUCTIONS FOR CONSERVATION EASEMENT CONTRIBUTIONS

Both the donated interest itself and the paperwork substantiating the gift must pass muster to secure a tax deduction for a qualified conservation easement contribution.

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Our current culture of tax enforcement involves significant attention to substance over form inquiries, and increased scrutiny to transactions that appear to be motivated more by taxes than economics. In this milieu, one particular corner of the charitable contribution law seems to have been given special focus. For some time now, the IRS and Congress have expressed concern that certain charitable contributions receive larger tax benefits than they should, thus prompting inappropriate behavior by taxpayers and charitable organizations.[1]

Concern about qualified conservation contributions is nothing new. Although the case law is not voluminous, some of it focuses on the technical requirements for such contributions. More interesting is the authority that consistently litigates the line between true conservation contributions motivated solely by conservation intent (coupled with the understandable desire to obtain the congressionally available tax benefits), on the one hand, and quid pro quo contributions on the other. The latter are generally scrutinized for real or perceived benefits affecting the development of the taxpayer's other property, including the easing of legal or development restrictions.

The other constant in this field is valuation disputes. It is standard to appraise property before and after the imposition of a conservation deed restriction. The appraisal's pre- and post-deed restrictions have the usual appraisal dynamics and incentives.

Section 170(h) basics

To qualify for a conservation easement deduction, a conservation purpose test must be met. Permissible conservation purposes include:

- The preservation of land areas for outdoor recreation by, or the education of, the general public.
- The protection of a relatively natural habitat of fish, wildlife, plants, or similar ecosystem.
- The preservation of open space (including farmland and forest land) where such preservation is for the scenic enjoyment of the general public, or pursuant to a clearly delineated federal, state, or local

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governmental conservation policy, and will yield a significant public benefit.

- The preservation of a historically important land area or a certified historic structure.

If a taxpayer makes a contribution of a conservation easement with one of these conservation purposes, thus protecting legislatively designated conservation values of some import, a tax deduction is available.

A "qualified conservation contribution" is a contribution of a qualified real property interest to a qualified organization exclusively for certain conservation purposes.[2] A "qualified real property interest" is any of the following:

1. The taxpayer's entire interest other than a qualified mineral interest.
2. A remainder interest.
3. A restriction (granted in perpetuity) on the use of the real property.[3]

The discussion that follows focuses on the third type of qualified real property interest, described in Section 170(h)(2)(C), and commonly referred to as conservation easements.

One of the permitted conservation purposes is the protection of a relatively natural habitat of fish, wildlife, plants, or similar ecosystem.[4] Another permitted conservation purpose is the preservation of open space ("open space easement"), including farmland and forest land, for the scenic enjoyment of the general public or pursuant to a clearly delineated governmental conservation policy. However, if the public benefit of an open space easement is not significant, the charitable contribution deduction will be disallowed.[5] Many other requirements also must be satisfied for a contribution of a conservation easement to be allowed as a deduction.

IF THE PUBLIC BENEFIT OF AN OPEN SPACE EASEMENT IS NOT SIGNIFICANT, THE CHARITABLE CONTRIBUTION DEDUCTION WILL BE DISALLOWED.

A taxpayer must substantiate its contributions of $250 or more by obtaining from the charitable organization a statement that includes:

1. A description of any return benefit provided by the charitable organization.
2. A good faith estimate of the benefit's fair market value.[6] In appropriate cases, the IRS will disallow deductions for conservation easement transfers if the taxpayer fails to comply with the substantiation requirements.

The instructions to Form 8283 state that a taxpayer must complete section B of the form for a contribution of more than $5,000. The taxpayer must obtain an appraisal within 60 days of the contribution from a qualified appraiser, defined in the instructions as an individual who either: (1) has earned an appraisal designation from a recognized professional appraiser organization, or (2) has met certain minimum education and experience requirements. The appraiser must also regularly prepare appraisals for payment, and demonstrate verifiable education and experience in valuing the type of property being appraised.

The appraiser must complete and sign a Form 8283 for each item of property. Once signed, the organization must acknowledge receipt of the property and complete Part IV of Section B of the Form 8283. The Form 8283 must be signed by an official authorized to sign the tax returns of the organization. The organization must then return the Form 8283 to the taxpayer who must provide a copy to the organization.

If all requirements of Section 170 are satisfied and a deduction is allowed, the deduction may not exceed the fair market value of the contributed property (in this case, the contributed easement) on the date of the contribution (reduced by the fair market value of any consideration received by the taxpayer).[7] Fair market value is the price at which the contributed property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and each having reasonable knowledge of relevant facts.[8]

If the donor reasonably expects to receive financial or economic benefits greater than those that will inure to the general public as a result of the donation of a conservation easement, no deduction is allowable.[9] The same rule applies if a person related to the donor can reasonably expect such a benefit. If the donation of a conservation easement has no material effect on the value of the real property, or enhances rather than reduces the value of real property, no deduction is allowable.[10]

Donors vs. developers

It is useful to separate property developers from non-developer owners, because developers may not have conservation purposes foremost in their minds in at least some cases. Developers are in business to make a profit, not to benefit the community. It is not surprising that a developer may want to suggest a density of homes in a subdivision that is buffered by an open space designation fostered by a conservation easement.

Is this prohibited, at least on a deductible basis? If the conservation easement benefits only the homeowners in the surrounding lots, the charitable contribution deduction is not available. In fact, the regulations expressly note this with an illustration, showing that in this circumstance a deduction is not available because the general public does not benefit.[11]

Quite apart from valuation—which is often the most nagging question—the motive of the taxpayer may be questioned. In *McConnell*,[12] for example, the Tax Court disallowed a deduction for a contribution of property to a municipality on the grounds that the transfer was motivated by an anticipated benefit "beyond the mere satisfaction flowing from the performance of a generous act." The court found that the McConnells' motives in transferring their interests in donated streets and sewers were: (1) to avoid responsibility for future maintenance of the streets and sewers, and (2) to enhance the value of their interest in the remaining property. In the Tax Court's view, this rendered Section 170 inapplicable.

Similarly, in *Sutton*[13] the donor granted a perpetual easement that the court found was for the primary purpose of allowing the donor to develop his property. Thus, a charitable contribution deduction was denied. In *McLennan*[14] a scenic easement was donated in conjunction with a retained right to develop. The Claims Court held the McLennans had transferred the easement with donative intent and with an exclusive conservation purpose. In the court's view, the McLennans were concerned about the pristine quality of the surrounding land, and were also aware that the grant of the easement would reduce the total value of their property.

The government's argument was not very sophisticated. The government contended that the McLennans were motivated by tax savings rather than by a desire to preserve and protect the land. The Claims Court, convinced that the taxpayers met the donative intent and conservation purpose thresholds, allowed the deduction.

Statutory changes

Several statutory changes to the qualified conservation regime were made in 2006. The Pension Protection Act of 2006 complicated the percentage tests typically applying to charitable contributions of property. For contributions made in 2006 and 2007 tax years, the 30% contribution base limit on contributions of capital gain property by individuals no longer applies to qualified conservation contributions.

Instead, individuals may deduct the fair market value of any qualified conservation contribution to certain qualified organizations (described in Section 170(b)(1)(A)) to the extent of the excess of 50% of the contribution base over the amount of all other charitable contributions.[15] Not only that, but to the extent these new limits preclude the use of a portion of a qualified conservation contribution in a particular year, the excess (exceeding the 50% limitation) can be carried forward up to 15 years.[16]

For example, prior to the change, a landowner earning $100,000 a year, who makes an $800,000 contribution, could take a $30,000 yearly deduction for the year of donation and an additional five years (total of $180,000). Now, the same individual can deduct $50,000 in the year of donation plus $50,000 a year for an additional 15 years (total of $800,000).

A second statutory change relates to individuals who are qualified farmers or ranchers during the tax year of contribution. Here, the qualified conservation contribution is allowable up to 100% of the excess of the taxpayer's contribution base over the amount of all other allowable charitable contributions.[17] A qualified farmer or rancher is a taxpayer whose gross income from the trade or business of farming is greater than 50% of his gross income for the year.[18]

Like so many liberalizing tax rules in recent years, these too have a sunset provision. These more generous percentage limitations applicable to qualified conservation contributions apply for contributions made in only tax years beginning after 2005 and before 2008.

Administrative guidance

The IRS provided significant guidance about qualified conservation contributions in Notice 2007-50.[19] Nearly all of the guidance relates to the 2% limitation changes effected by the 2006 legislation. Fortunately, the guidance is provided in question and answer (Q&A) format. Many of these Q&As answer nitty-gritty points about percentage calculations. Although these are obviously liberalizing statutory changes, the Q&As indicate a narrow focus.

IF THE CONSERVATION EASEMENT BENEFITS ONLY THE HOMEOWNERS IN THE SURROUNDING LOTS, THE CHARITABLE CONTRIBUTION DEDUCTION IS NOT AVAILABLE.

The Notice makes clear that income from a sale (including a bargain sale) of a conservation easement is not included in an individual's gross income from the trade or business of farming.[20] Of course, the income is included in the individual's gross income; it just does not count for the farming calculation. Conversely, income from a timber sale is part of the income from the trade or business of farming.[21] However, income from fees to permit hunting and fishing on the property is not considered attributable to farming.[22]

Logically, many contributions of qualified conservation property by farmers are of property used in farming. Yet, the Notice makes clear that it need not be. In other words, if a taxpayer qualifies as a farmer, his or her qualified conservation contribution may be of other property. An individual must be a qualified farmer or rancher to qualify for the 100% limitation, but the qualified conservation contribution need not actually be of property used or available for use in agriculture or livestock production.[23]

The IRS Notice also underscores the fact that the enhanced percentage limits for 2006 and 2007 qualified conservation contributions apply only to individuals. If a qualified conservation contribution is made by a pass-through entity such as a partnership or S corporation, the determination is made at the partner or shareholder level as to whether an individual is a qualified farmer or rancher.[24]

Recent case law

Several cases within the last year underscore the importance of detail in conservation easement donations. In *Glass*,[25] the Sixth Circuit upheld the Tax Court in allowing a conservation easement deduction. *Glass* involved two conservation easement donations made in perpetuity to a nonprofit organization called the Lake Traverse Conservancy.

The donee organization prepared the deeds, which stated that the purpose of the easements was to ensure that scenic and natural resource values of the property would be forever retained. The easements restricted certain activities, prohibiting development of the encumbered property. The donee organization was granted enforcement rights, and was allowed to transfer or assign the easements to only qualified conservation organizations that would agree to enforce these restrictions. The Glasses claimed charitable contribution deductions based on independent appraisals. Although agreeing that the donee organization was qualified, the IRS contended that the contributions were not made "exclusively for conservation purposes." Thus, the IRS disallowed any deduction.

In Tax Court, the Glasses prevailed, showing that their contributions were for a conservation purpose. The Tax Court quoted from the regulations to the effect that contributions to protect a significant relatively natural habitat in which a fish, wildlife, or plant community lives, does qualify. The Tax Court found that the Glasses presented credible evidence that the easements would protect and preserve the habitat of bald eagles as well as communities of endangered plant species.

The IRS appealed to the Sixth Circuit, contending that the Tax Court had effectively ignored the word "significant" in the regulations. The Sixth Circuit responded to the IRS stating that:

> while it is true that the relatively natural habitat where a wildlife or plant community normally lives must be significant to meet the "conservation purposes" test, habitats for rare, endangered or threatened species of animals or plants are expressly recognized as significant. [Citations omitted.] Moreover, it was not error for the Tax Court to give the words "habitat" and "community" their plain meaning.[26]

The Sixth Circuit upheld the Glass's deduction, distinguishing *Turner*.[27] Comparing *Turner* to *Glass* is instructive. Mr. Turner was a real estate lawyer who owned 60% (and was general manager) of a limited liability company formed to acquire and develop real estate. Turner (or the LLC) purchased land in Mount Vernon next to President Washington's grist mill. Because more than half of the property was located in a flood plain, about half the land could not be developed.

Turner tried mightily to sell the property. Eventually, Turner sold the property to Mount Vernon development in an agreement that suggested he could have developed 62 lots, not merely 30. Certain correspondence also suggested that Turner might develop and build 60 homes. In any case, Turner (or his LLC) executed a conservation deed reciting the sale and noting that development would be restricted to 30 single-family residential lots.

In reliance on this deed, Turner claimed an income tax deduction for a conservation easement of $342,781. The donee was Fairfax County, Virginia, but it did not sign or acknowledge either the deed or the taxpayer's Form 8283 (the IRS donee acknowledgment form). In many ways, the Turner case reads like a monograph on how not to claim a charitable contribution deduction. Turner failed in nearly every respect, not even proving that the purported donation had served a conservation purpose under Section 170(h)(4). The court therefore did not even analyze the exclusivity requirement of Section 170(h)(5).

Valuation problems

Even if one circumnavigates all of the other issues applicable to conservation easements, there are valuation issues that clearly need to be addressed. The charitable contribution deduction should be equal to the value of all the contiguous property the landowner owns before the easement, less the value of all of the contiguous property after the easement. That is supposed to reflect any enhancement to (or increase in the value of) the land adjacent to the restricted land, reducing the charitable contribution by any ancillary benefit that property receives.

What if a landowner donates a conservation easement and there is an increase in the value of other (noncontiguous) land owned by the landowner? The value of the charitable contribution deduction will be reduced by any such increase in value to other property. In fact, not only does one have to take into account other noncontiguous land that is owned by this land-owner/contributor, but any land that is owned by family members or any related party. A related party for this purpose is defined quite broadly, including the usual shareholders, trusts, beneficiaries, corporations, partnerships, etc.

PLANNING TIP

In an effort to prevent abusive practices involving taxpayers claiming charitable contribution deductions in excess of the value of the property interests they actually relinquished, Section 170(f) restricts deductions for contributions of partial interests in property. Section 170(f)(3)(B)(iii), however, contains an exception that permits deductions for contributions of qualified conservation contributions. Section 170(h), in turn, defines "qualified conservation contribution" to include the donation to a qualified charity, exclusively for conservation purposes, of a restriction (granted in perpetuity) on the use that may be made of real property—in short, a conservation easement contribution.

The Code also requires that substantiation requirements be met. The precise requirements depend on the value of the contribution. In valuing the deductible contribution, the IRS will look at the effect of the easement on the land over which it is granted and on nearby property owned by the donor. Thus, the deduction for placing a restriction on the development of one parcel of property could be reduced or disallowed entirely if the restriction increases the value of adjoining property owned by the donor.

If charitable contributions of real estate underscore the need to understand the quid pro quo problem, then conservation easements may be the most likely type of charitable contribution of real estate to raise this issue. Conveying an asset to a charitable organization as part of a deal or arrangement to get something in return taints the contribution.[28]

IRS scrutiny

In Notice 2004-41[29] the IRS noted potentially abusive problems in the conservation easement field. Notice 2004-41 indicates that the IRS will be scrutinizing transfers of easements on real property to charitable organizations, and on the making of payments to charitable organizations in connection with a purchase of real property from the organization.

This scrutiny has teeth. The IRS may also disallow all or part of any improper deductions, and may impose penalties. Moreover, the IRS can assess excise taxes under Section 4958 against any disqualified person who receives an excess benefit from a conservation easement transaction, and against any organization manager who knowingly participates in the transaction. In appropriate cases, the IRS can even challenge the tax-exempt status of the organization, based on the organization's operation for a substantial nonexempt purpose or impermissible private benefit.

Notice 2004-41 also announced the IRS's intent to review the promotion of transactions involving improper deductions for conservation easements. Promoters, appraisers, and other persons involved in these transactions may be subject to penalties under Sections 6700, 6701, and 6694.

One of the transactions identified in Notice 2004-41 involves purchase transactions. Notice 2004-41 states that some taxpayers claim inappropriate charitable contribution deductions for cash payments or easement transfers to charitable organizations in connection with the taxpayers' purchases of real property. In some of these questionable cases, the charitable organization purchases the property and places a conservation easement on it.

Then, the charitable organization sells the property subject to the easement to a buyer for a price that is substantially less than the price paid by the charitable organization for the property. As part of the sale, the buyer makes a second payment, designated as a "charitable contribution," to the charitable organization. The total of the payments from the buyer to the charitable organization fully reimburses the charitable organization for the cost of the property. Notice 2004-41 announces that the IRS may treat the total of the buyer's payments to the charitable organization as the purchase price paid by the buyer for the property.

Conclusion

Charitable conservation easements offer significant benefits, and may be on the rise. However, they are more likely to be scrutinized today than in the past. ■

NOTES

[1] For example, see letter from Governor Mark Sanford of South Carolina to Senator Charles Grassley, Tax Analysts Doc. # 2005-6692, 2005 TNT 62-30; and letter from Senator Rick Santorum (R-PA) to Senator Grassley and Buncus, Tax Analysts Doc. # 2005-6911, 2005 TNT 64-30.

[2] Sections 170(h)(1), (2), (3), and (4); Reg. 1.170A-14(a).

[3] Section 170(h)(2); see also Reg. 1.170A-14(b).

[4] Section 170(h)(4)(A)(ii); see also Regs. 1.170A-14(d)(1)(ii) and (3).

[5] See Section 170(h)(4)(A)(iii); see also Regs. 1.170A-14(d)(1)(iii) and (4)(iv), (v), and (vi).

[6] See Reg. 1.170A-13 for additional substantiation requirements.

[7] See Regs. 1.170A-1(c)(1), and (h)(1) and (2).

[8] Reg. 1.170A-1(c)(2).

[9] Reg. 1.170A-14(h)(3)(i).

[10] Reg. 1.170A-14(h)(3)(ii).

[11] See Reg. 1.170A-14(f), Example 4.

[12] TCM 1988-307, *aff'd without opinion* CA-3 (1989).

[13] 57 TC 239 (1971).

[14] 68 AFTR2d 91-5572 (Cls. Ct., 1991).

[15] See Section 170(b)(1)(E)(i).

[16] See Section 170(b)(1)(E)(ii).

[17] See Section 170(b)(1)(E)(i)(v)(I).

[18] See Section 170(b)(1)(E)(v). Farming is defined in Section 2032A(E)(5).

[19] 2007-25 IRB 1430.

[20] *Id. at* Q&A 6.

[21] *Id. at* Q&A 7.

[22] *Id. at* Q&A 8.

[23] *Id. at* Q&A 9.

[24] *Id. at* Q&A 5.

[25] 471 F.3d 698, 98 AFTR2d 2006-8309 (CA-6, 2006).

[26] *Id.*

[27] 126 TC 299 (2006).

[28] See Reg. 1.170A-14(h)(3)(I).

[29] 2004-2 IRB 31.