Document ID#: 547200610022

AMERICAN BAR ASSOCIATION -- SECTION OF TAXATION

2006 Joint Fall CLE Meeting

TITLE: Tax Benefits Threatened

AUTHOR: Silberstein, Bill

PANEL: Family Tax Planning using Conservation and Historic Easements

DATE: 10/20/06

COMMITTEE: Individual and Family Taxation

ABA SECTION OF TAXATION & SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW

INDIVIDUAL AND FAMILY TAXATION COMMITTEE

FAMILY TAX PLANNING USING CONSERVATION AND HISTORIC EASEMENTS

By: Bill Silberstein
Email: bsilberstein@ir-law.com
Isaacson Rosenbaum P.C.
Denver, Colorado

Tax Benefits Threatened

Conservation easements and their associated tax benefits are under scrutiny by U.S. Congressional Committees and the Internal Revenue Service. For many years land trusts, façade easements and conservation easements multiplied largely under the radar screen. In its national census of November 2004, the Land Trust Alliance reported 1500 land trusts held conservation easements covering more than five million acres in the United States. The era of intense scrutiny of conservation easements began on May 4, 2003, with the publication by the Washington Post of the first of a series of articles critical of conservation and façade easements and focusing on The Nature Conservancy. The Washington Post and others published examples of abusive conservation easements, including conservation easements on golf courses, on lots within gated subdivisions, and on backyards. As a result of increasing attention by IRS and congressional staffers, the IRS issued a press release on June 30, 2004. "We've uncovered numerous instances where the tax benefits of preserving open spaces and historic buildings have been twisted for inappropriate individual benefit" said IRS Commissioner Mark W. Everson. He added, "Taxpayers who want to game the system and the charities that assist them will be called into account." In the accompanying IRS notice 2004-41 the IRS published "If the public benefit of an open space easement is not significant, the charitable contribution will be disallowed."

Subsequently, the Joint Committee on Taxation of the U.S. Congress published "O*ptions to Improve Tax Compliance and Reform Tax Expenditures*" on January 27, 2005. This report included, among dozens of other tax reform proposals, a proposal to severely reduce the tax benefits for conservation and façade easements. The proposal included limiting the deduction for conservation easements to 33% of the value of the easement, eliminating the deduction for property which contains a residence and restricting the deductibility of façade easements. This was a real wake up call for the land conservation and historic preservation communities. For the first time, the tax subsidies underlying land conservation and historic preservation were seriously threatened. These proposals seem to have faded at present, but they may rise again as Congress searches for revenue.

On June 8, 2005, the Senate Finance Committee held a hearing on "The Tax Code and Land Conservation: Report on Investigations and Proposals for Reform." Although most of the Senators present testified in support of conservation easements, it is likely that reform legislation

will be proposed. The focus of the staff recommendations was on conservation organizations, including revoking the tax exempt status of a conservation organization that fails to monitor and enforce conservation easements, modifying the tax exempt organization tax return Form 990 to require conservation organizations to provide information regarding monitoring and enforcement, and the implementation of an accreditation system for conservation organizations. The staff also recommended consideration of limiting charitable deductions for conservation easements on less than ten acres, requiring IRS pre-approval of these small easement donations and more strictly regulating appraisers and appraisals.

Among the reasons cited by the Joint Committee for change is the difficulty in establishing and substantiating whether a significant public benefit or conservation purpose is served by a conservation easement. The Joint Committee also observed that the IRS lacks the expertise and resources to assess conservation purposes.

History of the Public Benefit Test

Prior to 1976, the deductibility of conservation easements was not specifically provided for in the Internal Revenue Code. The IRS first ruled in Revenue Ruling 64-205 that a gratuitous conveyance to the United States of a restrictive easement to preserve the scenic view to a nearby federal highway qualifies as a charitable deduction. The Revenue Ruling emphasized that under existing authority the contribution qualified if the "gift is made for exclusively public purposes."

In 1980 Section 170(h) in its modern form was added to the Internal Revenue Code. It sets forth the requirement that a qualified conservation contribution must be made exclusively for conservation purposes and must be perpetual. Conservation purpose is defined as follows:

> 4) Conservation purpose defined.--
>
> (A) In general.-- For purposes of this subsection, 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.

The accompanying Senate Finance Committee Report (96-107) stated that "the requirements of this conservation purpose are intended to insure that deductions are permitted only for open space easements that provide significant benefits to the public . . . the preservation of an ordinary tract of land would not, in and of itself, yield a significant public benefit…."

The Treasury Department published final regulations interpreting IRC § 170(h) in January, 1986. The Treasury Regulations (§1.170A-14) contain further requirements to be satisfied in order to meet the conservation purposes test. For example: the donation of a conservation easement "to protect a significant relatively natural habitat in which a fish, wildlife or plant community or similar ecosystem normally lives will meet the conservation purposes test . . ." The Regulations state "the fact that the habitat or environment has been altered to some extent by human activity will not result in a deduction being denied under this section if the fish, wildlife or plants continue to exist there in a relatively natural state . . . Significant habitats and ecosystems include, but are not limited to, habitats for rare, endangered or threatened species of animal, fish or plants; natural areas that represent high quality examples of a terrestrial community or aquatic community, such as islands that are undeveloped or not intensely developed where the coastal ecosystem is relatively intact; and natural areas which are included in or which contribute to the ecological viability of a local state or national park nature preserve wildlife refuge wilderness area or other similar conservation area." Regarding open space easements, factors are set forth to establish scenic values. The Treasury Regulations state "the preservation of an ordinary tract of land would not in and of itself yield a significant public benefit, but the preservation of ordinary land areas in conjunction with other factors that demonstrates significant public benefit or the preservation of unique land area for public employment would yield a significant public benefit.… A deduction will not be allowed for preservation of open space . . . if the terms of the easement permit a degree of intrusion or future development that would interfere with the essential scenic quality of the land or with the governmental conservation policy that is being furthered by the donation."

Over the years the IRS has issued a number of private letter rulings in which conservation easements have been determined to meet the conservation purposes test. However, there are only two federal court decisions pertaining to the conservation purposes test. The first case, *Great Northern Nekoosa Corporation and Subsidiaries v. United States*, 38 Fed.Cl. 645 (1997) is a case pertaining to reserved mineral rights. The taxpayer reserved the right to extract sand and gravel in the conservation easement. The application by the court of the Treasury Regulations to the conservation easement is confusing. However, it appears that the degree of surface mining retained under the conservation easement failed to meet the requirements for a charitable gift and the deduction was disallowed.

The United State Tax Court recently rendered its decision in *Charles F. and Susan G. Glass v. Commissioner of Internal Revenue*, 124 T.C. No. 16 (2005). It appears that the IRS decided to attack the donation of a series of very small conservation easements and lost, creating bad precedent for the IRS. The taxpayers had previously donated a conservation easement on approximately 2.64 acres of a 10 acre parcel located on a bluff on the shore of Lake Michigan. Subsequently the taxpayers donated a conservation easement containing 150 feet of shoreline

extending inland 120 feet and a second conservation easement containing 260 feet of shoreline and also extending inland for 120 feet. Much of the 120 feet covered by both easements included a steep bluff rising from the shore of Lake Michigan to the top of the bluff above. The IRS assessed deficiencies against the landowner alleging that the conservation easements did not meet the conservation purposes test. The Tax Court sided with the landowner, finding that the property was worthy of preservation because the bluff was both an important roosting spot for bald eagles and contained two threatened species of plants.

More recently, in May 2006, the United States Tax Court decided *Turner v. Commissioner*, 126 T.C. 16 (2006). The Tax Court affirmed the IRS's determination that Turner was not entitled to a charitable contribution deduction because the purported conservation easement did not satisfy the Code's conservation purposes test. The property consisted of 29.3 acres, approximately 15 of which were located in a floodplain and therefore not available for development. The remaining 14.3 acres were zoned to allow residential development of 30 residences. The conservation easement over all 29.3 acres restricted residential development to 30 residences. The owner claimed a right to construct up to 62 residences, even though it had only obtained approval to construct 30 residences. The Court also upheld the IRS's imposition of 20% accuracy-related penalty. The Court found that the appraisal supporting the deduction was based on erroneous assumptions about the property's development potential, and that Turner was negligent in allowing the appraisal to stand as support for the valuation claimed for his deduction.

Applying the Public Benefit Test

If conservation easement tax benefits are to survive recent scrutiny, it will be necessary to refocus on the premise that the tax subsidies for conservation easements in both the federal and state tax codes are given to land owners because land owners are providing a public benefit. The Treasury Regulations are not that helpful as a tool to determine whether or not a conservation easement provides a public benefit. It is an inherently difficult topic to define by legislation or regulation.

This is an area where lawyers can provide good guidance for their land owner clients. To determine whether or not a typical conservation easement meets the conservation purposes test, consider and determine whether or not the easement provides a public benefit worthy of a tax subsidy. Often, a conservation easement will preserve both natural habitat and open space. Here are some suggestions.

Natural Habitat

1. Is habitat of endangered or threatened species involved? Is it significant habitat for these species?

2. If not, what elements are present that characterize the land as significant, or high quality plant or animal habitat or ecological community?

3. Will preservation of the land add to or buffer significant, protected habitat?

4. Consider engaging a biologist to assist in making these determinations, particularly in a close case.

Open Space

1. Is the preserved open space visible by the public? The IRS may consider this mandatory.

2. What qualities or characteristics make the preservation of the open space important? This could include preservation of prime agricultural land, greenbelt or community separators, and buffers that protect scenic views.

3. What differentiates the open space from an ordinary parcel of land? Is the public benefit resulting from preservation of the property significant?

4. Is the open space preservation consistent with a government open space policy? The more detailed the government policy, such as an open space plan, the more helpful this factor.

General

1. The Baseline or Present Conditions Report, which is a required component of the transaction under the Treasury Regulations, must document the quality and quantity of the conservation purposes, including natural habitat, open space and public benefit.

2. Is it possible that exercise of rights reserved in the conservation easement will defeat the characteristics that qualify the conservation easement at the time of the donation?

3. Is the land covered by the conservation easement large enough to provide a public benefit and deserve a tax subsidy?

4. Does the public benefit provided significantly outweigh any benefit to the landowner.

5. Is this truly a land conservation transaction as opposed to a real estate development?

By considering these and other factors, the lawyer will be able to counsel the client to structure a transaction which clearly provides a public benefit, meets the conservation purposes test, and is entitled to tax benefits.

1325805_1.doc