April 22-24, 2015

Sirote Presents:

Defending Conservation Easements in an Adverse Tax Environment

Florida Tax Institute
170(f)(3) Denial of deduction in case of certain contributions of partial interests in property

(a) In general - In the case of a contribution (not made by a transfer in trust) of an interest in property which consists of less than the taxpayer's entire interest in such property, a deduction shall be allowed under this section only to the extent that the value of the interest contributed would be allowable as a deduction under this section if such interest had been transferred in trust. For purposes of this subparagraph, a contribution by a taxpayer of the right to use property shall be treated as a contribution of less than the taxpayer's entire interest in such property.

(b) Exceptions - Subparagraph (a) shall not apply to:
(i) a contribution of a remainder interest in a personal residence or farm,
(ii) a contribution of an undivided portion of the taxpayer's entire interest in property, and
(iii) a qualified conservation contribution.
170(h) Qualified conservation contribution

a) In general: For purposes of subsection (f)(3)(B)(iii), the term “qualified conservation contribution” means a contribution –

(i) of a qualified real property interest,
(ii) to a qualified organization,
(iii) exclusively for conservation purposes.
Conservation Easement

- A set of restrictions on taxpayer’s USE of property
- Taxpayer still owns property, but has more limited use
- Preserves the property for wildlife habitat, outdoor recreation, green space, scenic vistas, or historical areas or structures
A Little History and Background

• Conservation Easements are widely supported on both sides in Congress.
• In the late 1990s and early 2000s, was a sleepy, mostly ignored charitable giving technique.
• Various states have enacted tax credits to encourage use of Conservation Easements.
• Quickly rising property values and state incentives lead to more aggressive use.
• Façade Easements in NYC, Boston, Chicago and other large cities.
• Now one of the most highly coordinated issues.
Conservation Easement

Key Players for the Government

• Ruth Madrigal in Treasury
• Karin Gross: Queen Bee for IRS
• Area Counsel: Mark Caine, Anita Gill, Alex Nicoladis
• Appeals: Allen Harriett
• Cabal of activity in Atlanta run by engineers Rick Nixon and Gary McGurrin
Conservation Easement

Parties Involved in Grant of Conservation Easements

• Landowner (Taxpayer)
• Land Trust or Governmental Organization
• Qualified Appraiser
• Biologist or other scientist
• Lawyer/CPAs
• After the fact, the IRS
Structure – “Bundle of Sticks”

- **OWNER**
  - Legal Title
    - Allowed, Limited Use

- **Conservation Easement**
  - PROPERTY
    - Development Rights & Prohibited Uses
    - Allowed & Ltd Uses

- **LAND TRUST**
  - Rights to Enforce
Examples

High income, high net worth client
• Land with Wildlife, Vistas, Open Space values
• Intent to preserve; keep in the family
• Has development potential, now or in future

Owner with less taxable income
• “Capital asset” / “capital gain” preserved
• Development potential; Conservation values
• Possible “monetization”

Owner wants to retain Property for CURRENT USE
• Wishes to generate liquidity
• To be able to maintain Property For Other Purposes
• Income, Estate tax reduction
Why Bother?

• Charitable deductions & exclusions

• To keep land in current use

• To ensure property stays in family, by discouraging sale, development, etc.

• To benefit environment, wildlife, perhaps provide walking trails, vista
Basic Tax Benefits

- **INCOME TAX** deduction for donation of easement, **IF** meet conservation purposes & other test. IRC §170 (h)

- **ESTATE TAX** deduction, **IF** less onerous test met. IRC §2055 (f)

- **ESTATE TAX** exclusion, **IF** property in gross estate is subject to a §170 (h) easement. IRC §2031(c) (election)
Donation During Life

- Donor gets §170 Income Tax Deduction

- At Death, Donor’s remaining interest in land is valued at “After Value” – i.e., subject to easements restrictions

- If elected, Estate may exclude AN ADDITIONAL 40% of the remaining land value (not improvements), up to a maximum of $500,000 (per person)

- This benefit Replicates over generations
Donation AFTER Death; not by will - Deduction

• NO §170 Income Tax Deduction

• Donor’s FULL interest in land is INCLUDED in gross estate; BUT Estate gets deduction for charitable contribution, equivalent to 170 amount – By Election before 706 due

• If elected, Estate may still exclude an additional 40% of the remaining land value (not improvements), up to a maximum of $500,000 (per person)

• This benefit Replicates over generations
Donation by Will - Exclusion

- NO §170 Income Tax Deduction
- Donor’s FULL interest in land is INCLUDED in gross estate; BUT Estate gets deduction for charitable contribution, equivalent to 170 amount
- If elected, Estate may still exclude an additional 40% of the remaining land value (not improvements), up to a maximum of $500,000 (per person)
- This benefit replicates over generations
- Puts Estate/Family into same position as if Decedent donated by Will
- They get both the Estate Tax Charitable deduction and the 40% exclusion
- Alternatively, the Family can choose to give the easement & take the Income Tax Deduction personally
- Their estate receives the same benefit described above for lifetime donations.
Key Technical Issues Under 170(h)

1) What type of properties qualify?
2) Due Diligence on various issues: dealer property, holding period
3) Proving Conservation Purposes
4) Perpetuity Issues – Forever and ever, Amen – landowner cannot get his land back free of restrictions!!
   a) Subordination
   b) Title Issues
   c) Mineral Rights
   d) Other encumbrances
   e) Do retained rights interfere with conservation purposes (Butler analysis)
5) Ability and Desire of Land trust to enforce and monitor
Issues: “ Conservation Purpose”

The term “conservation purpose” is defined in 170(h)(4) to include one of the following:

• 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, or plants, or similar ecosystem
• The preservation of open space (including farmland and forest land) where such preservation is –
  1. For the scenic enjoyment of the general public, or
  2. Pursuant to a clearly delineated Federal, State, or local governmental conservation policy, and will yield a significant public benefit, or
• The preservation of a historically important land area or a certified historic structure.
Issues: “Conservation Purpose”

• Preservation/Protection must be “significant” (per regs.)
• Wildlife need not be endangered, etc.
  1. But “significance” enhanced by presence

  2. “Presence” of migratory species:

  3. “Relatively” natural – appearance, function;

  4. Some man made features ok (e.g., dams)
The Alabama Beach Mouse

- An endangered species

- Resident on Ft. Morgan Peninsula and Gulf Shores beaches
  - “Primary Habitat” is among the “primary” and “secondary” dues along the coast

- US Fish & Wildlife Service must issue “Incidental Take” Permits to allow construction within the “primary habitat”
Issues: “Conservation Purpose”

- Independent experts support habitat, recreation or historic values
- “Scenic vista” purpose
  1. Viewable by public
  2. “Significance” – proof is problematic
- Green Space (as “Open Space”)
  - Must be pursuant to clearly delineated governmental policies
- Recreation requires public access
1) Limited areas for residential use
   a) Value reduces deduction
   b) Possible enhancement issues

2) Size, type, number of structures

3) Commercial & other uses
   a) Agriculture
   b) Recreation (golf, campground, hunting, etc)
      • Section 2031(c) has additional limitations
   c) Timber cutting (with/without limitations)
Issues: Substantiation

- Baseline Documentation
- Qualified Appraisal by Qualified Appraiser
- Acknowledgement by Qualified 501(c)(3) – 170(f)(8)
- Form 8283
Issues: Substantiation

• Dotting I’s and crossing T’s – essential

• Sequencing, Recording, Timing

• Subordination of mortgagees, lessees, etc.

• Retained uses must not conflict with conservation purpose
  • Mineral interests (< remote chance)
  • Agricultural uses; chemicals; maintenance

• Negotiation of Easement terms desirable
• Substantial Compliance? So Remote Rule?
Issues: Valuation

- Detailed Valuation Rules in 170(h) regs
- Comparable sales of easements, if available (Typically not available)
- “Before and After” Methodology
  1. “Before” = Value of Property disregarding the Easement
  2. “After” = Value of Property with only the uses permitted by the Easement
  3. Difference = Value of Easement
- DCF approach blessed by courts, but hated by IRS
Issues: Valuation

- Highest and Best Use – Second Best Use post Whitehouse?

- Protected species are helpful to conservation purpose, but can become a problem in valuation

- Defending a valuation controversy
  1. detailed understanding of appraisal methodology
  2. subjective nature of appraisal and adversarial nature of experts

- IRS claims rules changed after PPA 2006
Issues: Valuation

• Deduction reduced by “enhancement” of other properties of Owner or related parties
  • E.g., adjoining property may benefit (increased value) from preserving pristine views or recreational areas

• Feasibility issues
  1. Zoning
  2. Permits (local, FWS, Corps of Engineers)
  3. Wetlands & protected species
  4. Utilities
  • Reasonably Probable Standard
Issues: Valuation

- Subdivision Method
  - Hybrid of Comparable Sales & Income Approaches to Appraisal
  - Projected revenues & costs
  - Discounted cash flow
  - Not favored by IRS
  - Numerous subjective assumptions
The Good & Bad News

- 2004: Congressional hearings highlight abuses in conservation easement area (primarily valuation & purpose)
- IRS Notice 2004-41
- Dirty Dozen list
- 2006-2013: Congress encourages easements by extending carryover period and income percentage limitation (etc.)
- Conservation community has substantial support in Congress
- Conservation Easement Audit Techniques Guide (September 30, 2011)
More Bad News

Aggressive Examinations

• Particularly Southeast, Mountain West

• Engineers play key role
  1. Brought in for valuation issue
  2. Conservation purpose
  3. Substantiation
  4. “Qualified” appraisal
  5. Appraisal methodology

• Penalties used as a sword
Issues to Watch For

• Reserved home sites ("floating")

• Cash contributions

• Title & subordination questions

• Timing of appraisal, grant of easement, subordination

• Feasibility of hypothetical development

• “Significance” of preserved habitat
IRS Attacks

- Coordinated effort
- Foot faults
- Conservation purpose
- HBU (highest and best use)
- Value
- Driven by Engineers
- Appeals is where cases settle
- Tax Court is a battlefield (What Judge you draw matters)
IRS Attacks

- IRS concentrates its attacks on appraisers, normally basing attacks on bad comparable, absorption analysis, feasibility issues and most recently ethical attacks on qualified appraiser status.
- IRS used penalties as a sword – gross valuation now applies per se if final value less than 50% of amount deducted.
- IRS pressing aiding and abetting and appraiser penalties against appraisers.
List of Appendices

- Sirote White Paper – Conservation Easement Overview
- Summary of Recent cases / Releases
- Circuit Courts Speak on Conservation Easements, But is the IRS Listening?", 24 Taxation of Exempts 35, January/February 2013
- Conservation Easement Confusion in the Tax Court and Fifth Circuit," 41 Real Estate Taxation 129, 2014
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