

April 22-24, 2015

Sirote Presents:

# **Defending Conservation Easements in an Adverse Tax Environment**

Florida Tax Institute

# No Deduction for Charitable Gift of Partial Interest

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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.

# Conservation Easement

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## 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

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- 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

# Conservation Easement

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## 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

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## 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

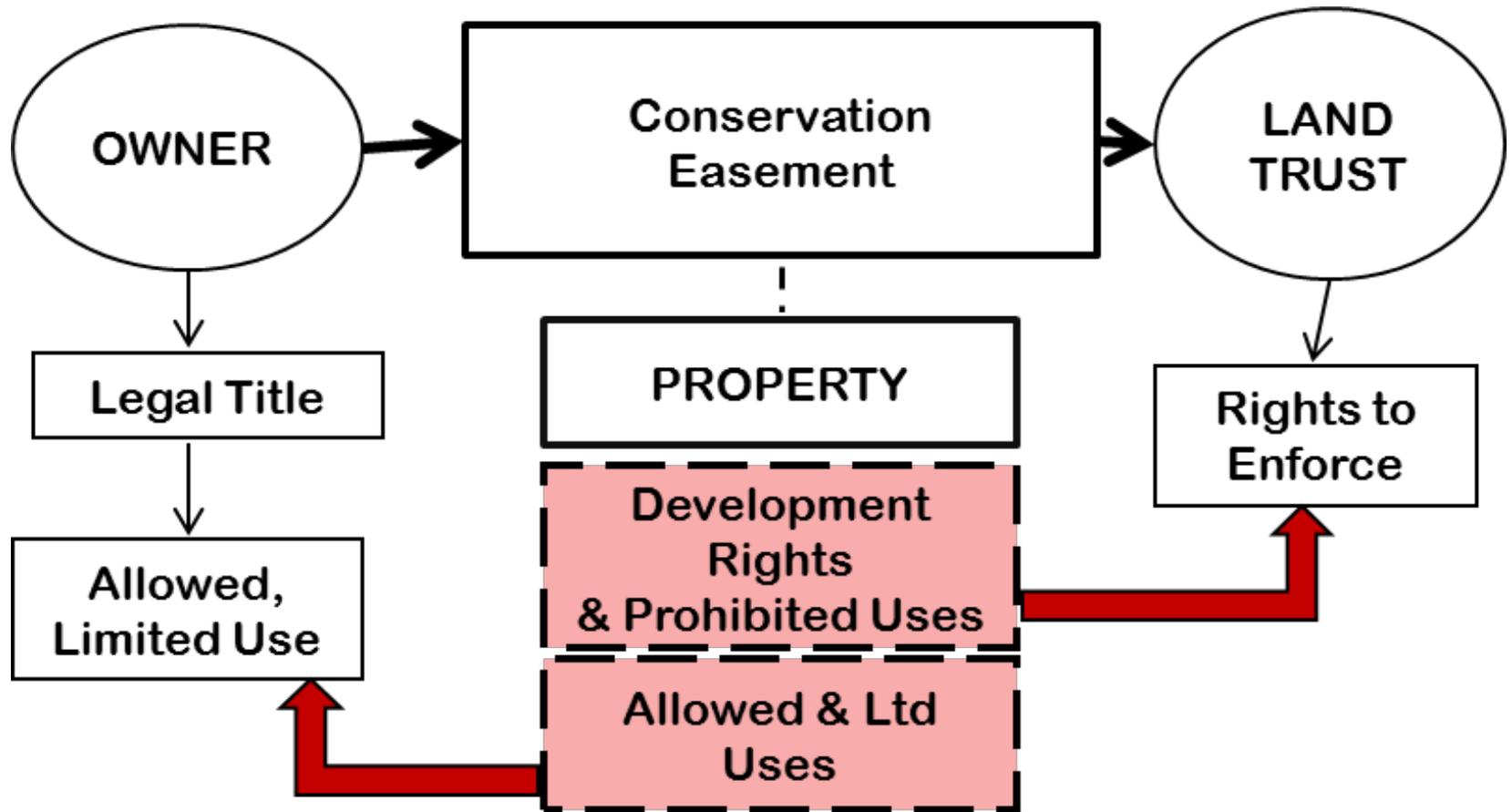
# Conservation Easement

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## 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"



# Examples

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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?

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- 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

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- **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

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- 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

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- 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

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- 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)

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- 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”

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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”

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- 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

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- An endangered species
- Resident on Ft. Morgan Peninsula and Gulf Shores beaches
  - “Primary Habitat” is among the “primary” and “secondary” dunes along the coast
- US Fish & Wildlife Service must issue “Incidental Take” Permits to allow construction within the “primary habitat”

# Issues: “Conservation Purpose”

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- 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

# Issues: Retained Rights & Uses

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- 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

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

# Issues: Substantiation

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- 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

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- 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

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- 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

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- 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

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- 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

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- 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

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## 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

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- 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

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- 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

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- 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

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- 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
- Navigating the Defenses to Valuation Penalties in Charitable Deduction Cases," 121 Journal of Taxation 255, December 2014



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