Dollars for Donations: Conservation Easements

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Sometimes doing the right thing pays off financially. Take, for example, conservation easements. A conservation easement is a way for a land owner to preserve property by donating the right to develop to a conservation group. The conservation group will have an easement over the property to keep nature intact. The landowner still owns the land, but the land will remain unchanged due to the restrictions imposed by the easement, even if the landowner sells it. Under U.S. law, the landowner can claim a tax deduction for the value of the lost development rights. In some cases, this can mean millions.

Sometimes, however, people donating a conservation easement claim too large of a tax deduction or misrepresent that the property will be conserved when it will actually be developed. The Internal Revenue Service (IRS) pursues those taxpayers.

The article discusses three recent cases where the IRS denied conservation easement deductions. The easements involve giant tracts of land in scenic areas – think the rolling hills of Alabama or the mountains in Tennessee – on which housing lots are plotted but with the majority of the land donated as a conservation easement. The homeowners have a preserved scenic place to live, and they benefit from tax deductions equal to what their property would be worth if they could develop to the extent permitted by law. Their profit is both intangible – increased enjoyment of their home due to the surroundings – and tangible – the value of the tax deduction as well as the increased value of their home due to its preserved surroundings.

Introduction to Conservation Easements

To claim a tax deduction for a conservation easement, a taxpayer must follow the law found in 26 U.S.C. § 170, which describes all deductible charitable contributions. The law is administered by the IRS. The specific rules pertaining to a conservation easement are found at 26 U.S.C. § 170(h). According to that provision, a qualified conservation contribution must be:

- A qualified real property interest
- To a qualified organization
- Exclusively for conservation purposes.

Each of these terms is defined in the statute.

Some baseline information first. "Real property," in law, means something other than "personal property." Real property is frequently described as a bundle of rights as it includes many things: the land, the buildings and structures on that land, and the things growing on the land (while they are growing); and also certain rights, such as the right to develop minerals or the right to occupy the property. Things that are movable, like cars or boats, are personal property. The distinction is found not in the value of the item but in its relation to land. In the case of an easement, some of the real property rights are given by the property owner to the easement holder. An easement is permanently tied to the property, meaning it "runs with the land."

A conservation easement is formed when the real property rights to develop and occupy land are separated from the title of the land. Once burdened by a conservation easement, the land's use is limited to conserving the natural resources of the property, diminishing the land's value. When a conservation easement is donated to a qualified nonprofit, the donation may be claimed as a charitable contribution equal to the value the landowner has lost by donating the right to develop the property to its highest and best use.

To qualify for a tax deduction, a conservation easement must convey a qualified real property interest that meets these three criteria:

- The entire interest of the donor,
- A remainder interest,[1] and
- A restriction granted in perpetuity on the use of the property.[2]

Under the law, a nonprofit organization known as a 501(c)(3) (so named for the part of the Internal Revenue Code which defines it), may hold the conservation easement.

The easement is for "perpetuity" and so the charitable organization must be able to administer and monitor the easement forever and not merely for a period of years.

This type of easement is distinguished from other easements, such as for power lines or access, because its purpose is to conserve the land. Section 170(h)(4) offers four ways to demonstrate a "conservation purpose":

- Preserve land for public outdoor recreation or education,
- Protect the relatively natural habitat of fish, wildlife, or plants,
- Preserve open space including farmland and forestland for the scenic enjoyment of the general public, or pursuant to a government policy that will yield a significant public benefit, or
- Preserve an historically important land area or a certified historic structure.

Thus, a conservation easement does not require setting aside pristine wilderness to satisfy the law. While the donated property may create a public recreation area, it may also confer a benefit for the public to enjoy from afar – by preserving open vistas or farmland.

Tax Benefits for Donating a Conservation Easement

The law allows a percentage of the donation to be deducted from the taxpayer-donor's income. In 2015 the law was amended to allow 50 percent of income to be deducted for making a conservation easement, an increase from 30 percent.[3] If the value of the donation is greater than 50 percent of that taxpayer's income for the year, the deduction may be carried forward for 15 years.

Additionally, in Mississippi, an eligible taxpayer may claim a state tax credit up to $10,000 for the costs incurred in making the transaction, such as surveys, appraisals, legal fees, and title insurance.[4]

Tax Fraud and Conservation Easements

Nationwide, conservation easements protect property equal to the size of Minnesota. Approximately 56 million acres were under a conservation easement in 2015, compared to 47 million acres in 2010, and 500,000 acres in 1990.[5] Consequently, the number of deductions for conservation easements have increased significantly. According to *Forbes*, the IRS estimates that syndicated conservation easement transactions led to nearly $27 billion in charitable deductions.[6] In 2017, the IRS declared that the deduction was one of the most abused tax deductions.[7] As of January 2020, the IRS had 80 cases pending in tax court against groups that organized investors for the purpose of buying property to claim more in deductions than the cost of the property.[8]

When taxpayers challenge an IRS ruling, the dispute is brought before the Tax Court, which is a federal trial court not associated with the IRS. Appeals from the Tax Court regarding conservation easement deductions may be brought in a federal court of appeals.

In Perpetuity

The law requires that to qualify for the deduction, a conservation easement must be donated in perpetuity. Courts have considered whether tax benefits can be voided when the language in the agreement between the donating party and the nonprofit does not establish that the donation is permanent.

In October 2020, the Eleventh Circuit Court of Appeals decided whether three conservation easements in Alabama were consistent with the law based on whether the easements were granted in perpetuity and preserved in perpetuity.[9] In that case, 1,282 of 6,224 acres near Birmingham owned by Pine Mountain Preserve LLLP were protected under three conservation easements donated in 2005, 2006, and 2007. Each of the three easements reserved the right to build on the conserved property. The first (559 acres) allowed 10 single family residences, barns, roads and driveways on 1-acre lots, 5 ponds, 2 scenic overlooks with structures, and an unspecified number of hunting blinds. The second (499 acres) allowed six residences; the third (224 acres) allowed construction of a water tower. The land was purchased for $37 million or $5,945 per acre. The taxpayer valued the easement at $26,443 per acre on average, making tax deductions of $16.5 million, $12.7 million, and $4.1 million for each donation, respectively. The IRS did not allow the deductions, and the matter was brought before the Tax Court.

The Tax Court agreed with the IRS that the first two easements were not made in perpetuity, in part because of the reserved rights to build, and also because a provision in the donation allowed the covenants to be amended. The 11th Circuit disagreed with that holding, in part. The 11th Circuit held that the easements were granted in perpetuity, determining that the rights to build at unspecified locations within protected areas of the property did not thwart the fact that the easement was granted forever. However, the court found that the Tax Court had not considered whether the easements ensured the property was *conserved* in perpetuity and sent the case back for the Tax Court to consider that issue.

Extinguishing an Easement

In a different case, in May 2020, the Tax Court wrestled with a provision in the terms of an easement known as an extinguishment clause. A donated easement typically will include language for what happens when the easement is "extinguished." Of course, easements are intended to be tied to the land forever, but an outside force could nullify the intent. For example, the property could be seized by eminent domain for some use that eliminates the conservation value.

In law, extinguishment means an easement is formally cancelled. In practical terms, it means that the nonprofit holding the easement would be paid for its property right. In the May 2020 case, the IRS objected to a $9.545 million deduction for a 106-acre conservation easement near Chattanooga, TN. The 143-acre property had been purchased for $1.7 million. The Tax Court found that the terms of the extinguishment provision meant the easement was not granted in perpetuity.[10]

The concern of the Tax Court in that case was that the extinguishment provision allowed the nonprofit holding the easement to recover only the fair market value (FMV) of the property at the time the easement was donated, and not any increased FMV due to improvements made to the property at the time the easement was extinguished. Any increased value of the property would benefit only the donor. Both parties thought that was fair because the nonprofit would not have paid for the improvements. However, according to federal regulations pertaining to conservation easements, a nonprofit "must be entitled to a portion of the proceeds at least equal to that proportionate value."[11] The court was concerned that the donating party could get a windfall if the easement were extinguished. If that happened, the donor would have claimed the tax deduction, yet get back the right to develop and receive the value of any improvements to the property. That decision is being appealed to the 6th Circuit Court of Appeals.

The extinguishment clause was also at issue before the Tax Court in a case involving a 135-acre conservation easement near Savannah, Georgia.[12] The taxpayer claimed a $4.582 million deduction for the donation. The Tax Court found no deduction was allowed because the extinguishment clause meant the easement was not protected in perpetuity. The Tax Court focused on how the proceeds would be distributed if the easement were dissolved. The court faulted the easement language that would reduce the nonprofit's proceeds at the time of extinguishment by the amount of all improvements to the property.

Value of the Tax Deduction

According to the IRS regulations, a conservation easement's value is the fair market value, meaning "the price at which the property would change hands between a willing buyer and a willing seller."[13] That price can be assessed based on comparable sales in the area. Where there are no comparable sales, a common situation for conservation easements, the value of the easement is the difference between the value of the property before the easement and the value of the property after the easement. According to the IRS, it "has seen abuses of this tax provision [where] taxpayers, often encouraged by promoters and armed with questionable appraisals, take inappropriately large deductions for easements."[14] One Alabama appraiser reportedly surrendered his appraiser's license after offering artificially high appraisals for conservation easements.[15]

The value of an easement is frequently at issue before the Tax Court, and it is there that expert appraisals are weighed: the IRS's expert vs. the taxpayer's expert. Based on recent cases, that amount can be wildly different. For example, when it came to valuing the easement in the Pine Mountain Preserve case, the IRS argued that the easements were worth about one-tenth of the deduction, and nowhere near what Pine Mountain Preserve's assessor claimed at trial. The IRS value for all three easements was $2.576 million; the taxpayer's assessor's value was $97.41 million.

The Tax Court, which had rejected two of the three easements before considering their value, valued the third at $4,779,500, which is the amount the IRS said it was worth ($449,000) plus the amount claimed by the assessor ($9.11 million), divided by two. The 11th Circuit did not care for the guesswork, and told the Tax Court to establish the value of the easements, this time using a "discernible methodology that is appropriately tied [to the regulations]."

Conclusion

By allowing a tax deduction for conserving property, tax law has led to the protection of millions of acres in the United States. However, according to the IRS, that deduction has led to significant fraud. As valuation is in the eye of the beholder – and the beholder's appraiser – the Tax Court is sorting through dozens of cases to identify where property is being conserved or where cheating is occurring.

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Endnotes

1. A remainder interest would occur if someone was entitled to the property upon the current owner's death. This may be established in a will that gives property to someone until they die, and then the property is given to another named party.
2. 26 U.S.C. § 170(h)(2). Mineral rights do not have to be donated to qualify.
3. Qualified farmers and ranchers are allowed to deduct up to 100% of income. 26 U.S.C. § 2032A(e)(5).
4. Miss. Code Ann. § 27-7-22.21. No similar provision was found in Alabama.
5. *See* Land Trust Alliance, *2015 National Land Trust Census Report*; Logan Yonavjak and Todd Gartner, *Gaining Ground: Increasing Conservation Easements in the U.S. South*, World Resources Institute (Sept. 2011). Minnesota is 55,640,877 acres. *See* Beef 2 Live, *Ranking of States by Total Acres* (Jan. 12, 2021).
6. Jason B. Freeman, *Charitable Conservation Easements Remain Under Attack – The Latest IRS Data*, Forbes (Sept. 28, 2020). A syndication is a group of investors.
7. IRS Notice 2017-10, *Recognized Abusive and Listed Transactions* (2017-4 IRB 544) (last updated Jan. 31, 2020).
8. Peter Elkind, *The IRS Tried to Crack Down on Rich People Using an "Abusive" Tax Deductions: It Hasn't Gone So Well*, ProPublica (Jan. 3, 2020).
9. Pine Mountain Preserve LLLP v. Commissioner of Internal Revenue, 978 F.3d 1200 (11th Cir. 2020).
10. Oakbrook Land Holdings, LLC v. Commissioner of Internal Revenue Service, 119 TCM (CCH) 1352 (TC Memo 2020-054) (May 12, 2020).
11. 26 C.F.R. § 1.170A-14(g)(6)(ii).
12. Cottonwood Place, LLC v. Comm'r of Internal Revenue, 120 TCM (CCH) 91 (TC Memo 2020-115) (Aug. 4 2020).
13. 26 C.F.R. § 1.170A-1(c)(2).
14. IRS, *Background - Abusive Transactions Involving Charitable Contributions of Easements*.
15. Peter Elkind, *The IRS Tried to Crack Down on Rich People Using an "Abusive" Tax Deductions: It Hasn't Gone so Well*, ProPublica (Jan. 3, 2020).

In Sum.

A Summation of the Facts and Figures of Interest in this Edition

Size of Alabama beach mouse's historic habitat in acres:	8,000 to 9,000
Remaining Alabama beach mouse habitat in acres:	2,300 to 2,400
Size of Flower Gardens National Marine Sanctuary in 2020 in square miles:	56
Size after the expansion is final, in square miles:	160
Size of Minnesota in acres:	56,000,000
Size of land preserved by U.S. conservation easements in acres (as of 2015):	56,000,000