Conservation Easements Under Fire: A Five-Point Strategy to Defend the Deduction

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Conflict Between Statutory Incentive and IRS Enforcement

Comments by IRS officials and government reports reveal that the IRS is heightening its scrutiny of deductions claimed for the charitable contributions of conservation easements under Internal Revenue Code section 170 (h). The IRS is devoting increased resources and coordinating the issue on a nationwide basis.

At the same time, Congress and the states continue to increase the statutory tax incentive for individuals to donate conservation easements. For example, during 2006 and 2007, Congress reduced the limitation on the deduction and extended the carry-forward period from 5 years to 15 years.(1) Thus, the Federal and state tax writers' encouragement have left taxpayers wondering why the IRS is devoting considerable resources in order to disallow the deductions.

(1) IRC § 170(b)(1)(E)(i); Pension Protection Act of 2006 § 1206; see also, § 1213 of the Act (tightening rules regarding historic façade easements); and Notice 2007-50 (explaining percentage limitations).

IRS Audits On the Rise

As a result of IRS efforts, audits of conservation easement donations continue to rise. In 2005, Steven Miller, IRS Tax Exempt and Government Entities Division Commissioner, testified before the Senate Finance Committee that 240 donors were under audit in high-dollar cases concerning open-space easements, and a smaller number of cases concerning façade easements. Mr. Miller explained that the audits were straining IRS resources, as over one-third of its appraisers were working in whole or in part on the valuation issues presented by conservation easement exams.

In 2006, Mr. Miller informed the Spring Public Lands Conference that the Service was examining approximately 425 donors of open-space easements, and 75 donors of façade easements. The Service took the additional step of referring 9 of 25 so-called “promoters” for further investigation. In the National Taxpayer Advocate 2007 Annual Report to Congress, deductions under Code section 170 were noted as the eleventh most litigated issue in 2007—many of those deductions likely pertained to conservation easements. In 2007, the Service was examining over 200 taxpayers in Colorado alone with respect to conservation easements, according to an open letter from Mr. Miller to Senator Ken Salazar. Mr. Miller stated that the Service proposed tax assessments with respect to nearly 90% of those Colorado taxpayers.

Until January 23, 2006, most taxpayers were permitted and encouraged to enter a settlement initiative, described in Announcement 2005-80. The settlement terms required full payment of tax, calculated without regard to the deduction. In addition, the taxpayer had to pay interest and, generally, penalties. However, the taxpayer was allowed to deduct transaction costs as an ordinary loss. That window has closed. In this climate, a taxpayer selected for audit should count on a thorough examination of any conservation easement deduction.

The Elements and the Issues Involved in Deductibility

As IRS agents are well-trained in analyzing conservation easements, experienced taxpayer representatives must articulate a strong defense of any deduction arising from a conservation easement contribution. Code section 170(h), which provides the deduction, sets out three essential requirements: a taxpayer must donate (1) a “qualified” real property interest (2) to a “qualified” organization (3) exclusively for a conservation purpose defined therein. These elements generate three seemingly bright-line tests: (1) did the taxpayer donate a sufficient interest; (2) was the donee organization qualified to accept it; and (3) does the easement serve one of the four conservation purposes enumerated in the statute? The typical conservation easement will meet these requirements, at least on paper, because the easement will be a restriction in perpetuity enforceable by a Code section 501(c)(3) tax-exempt organization that preserves land for public recreation, protects a natural habitat, preserves open space for public enjoyment or pursuant to a government policy, or preserves historic property. Even so, attempting to meet that basic test with recitations on the deed will leave a taxpayer woefully unprepared to lock horns with the IRS.

The 5-Point Strategy

To defend the deduction arising from the donation of such an easement with confidence, the following five-point strategy will serve the taxpayer well:

1. Show the detriment to the property.

The taxpayer must demonstrate that the restriction of his property detrimentally affected the property value, from an objective standpoint. For example, the Tax Court found that a developer that limited the number of houses it would develop suffered no detriment because a flood plain in fact necessitated the same limit. Turner v. Comm’r, 126 T.C. 299 (2006). Likewise, historical façade easements have come under attack for purporting to restrict the right to change the façade in ways already restricted by local laws protecting historical structures.

2. Document enforcement of the easement.

The taxpayer can strengthen his showing of detriment by demonstrating that the donee is likely to enforce the easement. Evidence that the donee has the right and resources to take legal action to enforce the easement is a good starting point. Documentation that the donee has already taken even simple steps to enforce the easement against the donor, or against similarly-situated donors, will demonstrate that the taxpayer and donee are not colluding against the IRS. For example, the donor may have enforced the easement by properly recording it and making annual visits to the property to ensure that the donor is not infringing on the easement.

3. Establish that valuation was reasonable.

Defending the valuation of the donation of the easement is a highly technical process. While reliance on an independent, qualified appraiser, as instructed by Form 8283, is certainly helpful, the underlying appraisal will be examined thoroughly. Generally, a “before and after” valuation methodology is employed to determine the reduction in value that the property suffers as a result of the easement. The amount deducted must also be reduced for any increase in the value of the donor’s property, including contiguous and non-contiguous property. For example, the deduction for a conservation easement placed on beach front property would have to be reduced to reflect any resulting increase in the value of the donor’s beach house. In addition, be aware that there is a “related party” rule that requires reduction of the deduction by any increase in value to a related party’s land.

4. Confront quid-pro-quo issues.

As with any charitable donation, if the taxpayer received an economic benefit in exchange for the contribution of the easement, he should be prepared to demonstrate that the amount he deducted was reduced by the value of what he received. For example, if a developer donates a conservation easement to a locality in exchange for a zoning variance allowing him to develop a condominium high-rise, he can only deduct the donation of the easement to the extent its value exceeds the value of the zoning variance.

Could the Maryland Property Tax Credit constitute a quid-pro-quo?

The Service has recently begun arguing that a taxpayer who benefits from a state tax credit such as Maryland’s Conservation Property Tax Credit is not entitled to a Federal deduction because the state tax credit results in an economic benefit constituting a quid-pro-quo. For Marylanders, this would mean that the value of the credit —100% of property taxes assessed on the burdened property for 15 years—would reduce or eliminate the Federal deduction allowed.
In defending a taxpayer who did not reduce the Federal deduction to reflect the value of the Maryland Property Tax Credit, legal representation may be essential to challenge IRS arguments that caselaw supports its interpretation of “economic benefit.”

5. Show the conservation purpose is served.

Finally, the taxpayer should be prepared to defend the conservation purpose. While the Service historically has focused on valuation, revenue agents are now scrutinizing whether the general public in fact benefits from the easement. For example, the Service may assert that the public cannot enjoy recreational space in a gated community or a view from a private golf course. Likewise, façade easements are vulnerable to this challenge if the public cannot enjoy a view of the façade from the road, because it is obscured by a wall.

Defense of a conservation easement donation deduction must be well-planned and organized. The IRS’s trained and coordinated staff should not be dismissed lightly, and each step of either the examination, appeals, or litigation process should be thoroughly thought out in order to avoid traps and a barrage of tax, penalties, and interest.

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