



# WRMarketplace

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**TOPIC: Lifetime Charitable Planning with Conservation Easements: Caution Indicated.**

**MARKET TREND:** The on-going IRS focus on conservation easements requires clients and advisors to carefully consider such planning.

**SYNOPSIS:** Conservation easements are intended to provide real property owners with flexibility in protecting and preserving their land for scenic, historical, recreational, and/or other desirable conservation purposes. To encourage these goals, the Internal Revenue Code (“Code”) allows a charitable income tax deduction for lifetime donations of certain conservation easements to qualifying charitable organizations. However, the increased use of conservation easement planning, combined with the available tax deductions, has garnered significant IRS attention over the years. Recent cases indicate that the IRS continues to scrutinize several areas related to lifetime charitable donations of conservation easements and suggest an on-going need to proceed cautiously when planning for the income tax treatment of such donations.

**TAKE AWAYS:** While lifetime charitable donations of conservation easements have become popular in real estate planning, the requirements for attaining an associated charitable income tax deduction are numerous, very technical, and strictly enforced. Continued IRS scrutiny of this approach means clients contemplating such planning should (1) ensure that conservation of the subject property is their primary goal, (2) understand the potential tax implications, (3) work with advisors and service providers

who are experienced with charitable giving generally and conservation easements specifically, and (4) depending on the case and value of the easement, consider requesting a private letter ruling from the IRS.

Over the past decades, the use of conservation easements in planning with real property has increased significantly. The popularity of this approach, however, combined with the available income tax deductions for such easements, has garnered significant IRS attention. Recent cases indicate that the IRS continues to scrutinize several areas related to lifetime charitable donations of conservation easements and suggest an on-going need to proceed cautiously when planning for the income tax treatment of such donations.

**OVERVIEW**

**Definition.** A conservation easement is a right to, or restriction on, the use or development of real property that is created and recorded by a real property owner (“RPO”) and transferred to a qualified conservation organization, such as a non-profit entity, land trust, or governmental entity. The easement involves a voluntary legal agreement between the RPO and the organization to ensure perpetual enforcement of the conservation restrictions. Under the easement, the RPO may retain current rights in the property, including the right to live on and use the property for its existing purposes.

**Purpose.** Conservation easements allow a RPO to protect and preserve real property over generations for its scenic, ecological, historical, recreational, and/or agricultural values. Conservation easements also include historic preservation easements, which protect properties with historic, architectural, or archaeological significance. So-called “facade easements” fall under this category and are designed to preserve only the exterior of a historic structure.

**Federal Income Tax Deduction.**<sup>1</sup> Generally, a charitable income tax deduction does not apply to contributions of less than an entire interest in property. To encourage donations of conservation property, however, the Code provides an exception for a RPO who donates a conservation easement, if the requirements for a “qualified conservation contribution” under Code §170(h) are met.<sup>2</sup> Some notable requirements include the following:

**Conservation Easement Charitable Income Tax Deduction - Notable Requirements**

Requirement	Overview
<b>Qualified Real Property Interest</b>	<ul style="list-style-type: none"> <li>The contribution must be (1) an entire interest in real property (other than a qualified mineral interest, which the owner may retain), (2) a remainder interest in real property, or (3) a perpetual conservation restriction (the most typical type of conservation easement).</li> </ul>
<b>Qualified Organization (“QO”)<sup>3</sup></b>	<ul style="list-style-type: none"> <li>The contribution may be only to certain U.S. governmental entities, publicly-supported organizations, and their supporting organizations that also (1) have a commitment to protect the property’s conservation purpose<sup>4</sup> and the resources necessary to enforce the restrictions and (2) are restricted in the termination or re-</li> </ul>

Requirement	Overview
<b>Exclusively for Conservation Purposes<sup>6</sup></b>	<p>transfer of the easement as required.<sup>5</sup></p> <ul style="list-style-type: none"> <li>• The contribution must be exclusively and perpetually for a “conservation purpose,” meaning the preservation/protection of: (1) land for public outdoor recreation or education, (2) natural habitats of wildlife, plants, etc., (3) open space for public scenic enjoyment or pursuant to a clearly delineated governmental conservation policy that will yield a significant public benefit, or (4) historically important land or a certified historic structure.<sup>7</sup></li> <li>• The contribution cannot allow for inconsistent uses – i.e., those that accomplish one conservation purpose but permits destruction of other significant conservation interests<sup>8</sup> — unless necessary to protect the conservation interests contributed.<sup>9</sup></li> <li>• A pre-existing use of the property may continue if it does not conflict with the conservation purpose (e.g., continued residence on land over which a scenic easement is contributed).</li> </ul>
<b>Additional Requirements<sup>10</sup></b>	<ul style="list-style-type: none"> <li>• A perpetual conservation restriction must satisfy any state law enforceability requirements.</li> <li>• The RPO must irrevocably release any right to terminate or amend the easement without the QO’s consent.</li> <li>• At the time of the conveyance, any existing mortgages on the subject property must be subordinated to the enforcement of the conservation easement.</li> <li>• The RPO may be required to create a written “natural resource inventory” of any rights to the use of the property that the RPO retains subject to the easement.</li> <li>• The easement must provide the QO with (1) the right to reasonably enter the property for inspection to ensure compliance and (2) legal remedies to enforce compliance.</li> <li>• If the easement is partially or completely terminated, the easement agreement must (1) confirm that the QO has an immediately vested right in the property at a constant value that at least equals the proportionate value that the perpetual conservation restriction at the time of the gift bears to the value of the whole property at that time, and (2) when a change causes the extinguishment of the perpetual restriction, the QO is entitled to a proportionate amount of proceeds from any sale, exchange, etc. unless state law provides otherwise.</li> </ul>
<b>Substantiation<sup>11</sup></b>	<ul style="list-style-type: none"> <li>• The RPO must comply with the substantiation and recordkeeping requirements for charitable deductions under the Code, including (1) a “qualified appraisal” of the conservation easement to the RPO’s tax return, prepared by a “qualified appraiser” and (2) a “contemporaneous written acknowledgment” of the donation from the QO.</li> </ul>

## **AREAS OF SCRUTINY<sup>12</sup>**

The IRS has increasingly scrutinized the use of conservation easements over the past years.<sup>13</sup> Some notable areas of challenge, including in recent cases, have involved the following:

**Exclusively for Conservation.** This requirement for conservation easements often poses a hurdle since there is no definitive guidance regarding what rights an RPO may retain without causing the easement to be non-exclusively for conservation. As the issue is highly fact specific, courts have reached varying decisions depending on a case’s circumstances. Thus, the IRS likely will carefully analyze the characteristics of the property subject to the easement and the rights retained by the RPO.<sup>14</sup>

**Mortgage Subordination.** The IRS has repeatedly disallowed charitable deductions for contributions of conservation easements on mortgaged real property *unless* the mortgage lender subordinates its interest in the property to the easement holder *before the transfer*.<sup>15</sup> Cases have found that a subsequent subordination of the mortgage will **not** correct the issue, since the Treasury Regulations require the protection of a conservation easement in perpetuity from the time of the gift. The ability of a lender to institute foreclosure proceeding between the time of the easement and a subsequent subordination agreement violates this requirement.<sup>16</sup>

**Enforceability under State Law.** The compliance of a conservation easement solely with the federal tax rules will not suffice. State compliance is required, and as state rules can vary significantly, this area is a target for review. The Tax Court has disallowed charitable contribution deductions for conservation easements that were unenforceable under state law, including, for example, because the taxpayer failed to record the easement until several years after the conveyance.<sup>17</sup>

**Valuation.** The valuation of an easement contribution for charitable deduction purposes remains a crucial and particularly complex issue. The IRS has had success in challenging conservation easement valuations,<sup>18</sup> particularly as there is no standard valuation formula or percentage by which an easement reduces a property's value. Further, while valuation of a conservation easement is ideally based on sales prices for comparable easements, such data is rarely, if ever, available. Thus, easement valuation typically relies on a "before and after" method, which determines the property's fair market value both before and after contribution of the easement to determine the estimated loss of value attributable to the easement.<sup>19</sup> As this makes easement valuation complex and costly, it likely will remain a focus of IRS review.

**Proper Substantiation.** Given the number of technicalities required to qualify and substantiate a charitable contribution of a conservation easement, certain items may be missed or overlooked. However the IRS strictly enforces these details, and the Tax Court has agreed, denying charitable deductions for conservation easements due to the lack of a contemporaneous written acknowledgment from the QO<sup>20</sup> and the failure of the RPO to attach a qualified appraisal to his tax return with regard to the donation of a façade easement.<sup>21</sup>

**Accuracy Related Penalties.** Where a charitable deduction is denied for contribution of a conservation easement, the taxpayer also may incur accuracy-related penalties. For example, a 40% penalty may apply to the portion of an underpayment of tax that is attributable to a gross valuation misstatement with regard to conservation easement's value.<sup>22</sup>

**Syndicated Easements - Listed Transaction.** As evidence that the IRS continues to focus on conservation easements, it recently issued Notice 2017-10, stating that it is aware of promoters who use partnerships or other pass-through entities to syndicate conservation easement transactions. In such a transaction, a promoter offers prospective investors in the pass-through entity the possibility of a charitable deduction for the donation of a conservation easement. The deduction significantly exceeds the

amount invested. The IRS has designated these syndicated conservation easements and similar transactions entered into after 2009 as listed transaction for federal tax purposes, imposing additional disclosure and reporting requirement on taxpayers and advisors who may be involved.

### ***HOW TO PROCEED? WITH CAUTION***

The requirements for donation of qualified conservation contributions are complex, highly technical, and strictly interpreted by the IRS and the courts. Clients contemplating a lifetime donation of a conservation easement should fully understand the potential issues and consider the following in relation to federal charitable deduction planning with regard to the easement:

**Focus on Conservation.** The transaction should be primarily driven by the client's desire to ensure preservation and conservation of the property subject to the easement. As with other planning, tax considerations should not be the sole or main drivers for the client's actions.

**Work with Experienced Advisors and Service Providers.** Clients should work with legal counsel and other advisors who have specific experience in structuring and negotiating conservation easements. Further, the selection of a qualified and experienced appraiser to value the easement is crucial. Appraisers not only should have experience in valuing contributions (and particularly conservation easements) for charitable purposes so that they are familiar with the qualified appraiser and qualified appraisal requirements under the Code, but they also should have significant knowledge of the geographic area and real estate market being appraised.<sup>23</sup>

**Consider a Private Letter Ruling.** In the right cases, such as where the client is irrevocably relinquishing a substantial value with regard to the proposed conservation easement, a private letter ruling request to the IRS may be recommended to address the tax treatment of the contribution.<sup>24</sup> The request should show how the proposed transaction will comply with all applicable federal and state law requirements for a qualified conservation contribution, since state law governs easement validity and enforceability. Clients will need to weigh the time and costs associated with such requests against any potential certainty offered by a ruling.

### ***TAKE AWAYS***

While lifetime charitable donations of conservation easements have become popular in real estate planning, the requirements for attaining an associated charitable income tax deduction are numerous, very technical, and strictly enforced. Continued IRS scrutiny of this approach means clients contemplating such planning should (1) ensure that conservation of the subject property is their primary goal, (2) understand the potential tax implications, (3) work with advisors and service providers who are experienced with charitable giving generally and conservation easements specifically, and (4) depending on the case and value of the easement, consider requesting a private letter ruling from the IRS.

## DISCLAIMER

**This information is intended solely for information and education and is not intended for use as legal or tax advice. Reference herein to any specific tax or other planning strategy, process, product or service does not constitute promotion, endorsement or recommendation by AALU. Persons should consult with their own legal or tax advisors for specific legal or tax advice.**

## NOTES

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<sup>1</sup> In addition, lifetime donations of qualified conservation contributions may qualify for (1) the lifetime charitable gift deduction under Code §2522(d) and (2) for estate tax purposes, and estate tax exclusion under Code §2031(c), which allows an executor to elect to exclude from the gross estate of a RPO the lesser of: (a) up to 40% of the value of land subject to a qualified conservation easement; or (b) \$500,000, assuming all exclusion requirements under the Code and applicable Treasury Regulations are met. A full discussion of the application of, and requirements for, this exclusion are beyond the scope of this report.

<sup>2</sup> Code §170(h); Treas. Reg. 1.170A-14;

<sup>3</sup> Code §170(h)(3); Treas. Reg. §1.170A-14(c). The U.S., Washington D.C., U.S. states and their political subdivisions qualify. Charitable organizations that qualify are publicly supported charities under Code §§509(a)(1) or 509(a)(2) or their supporting organizations under Code §509(a)(3).

<sup>4</sup> An organization created or operated mainly for a conservation purpose listed in the Code or regulations will be deemed to have such a commitment.

<sup>5</sup> The easement agreement must provide that (i) the easement can only be re-transferred to another “qualified organization” who agrees in writing to carry out the original conservation purpose (and any subsequent re-transfers by the new qualified organization also must be subject to the same conditions) and (ii) if an unexpected change makes the conservation purpose impossible, and the property is sold or exchanged, the organization must use any proceeds to support the original conservation purpose.

<sup>6</sup> Code §§170(h)(4) and (h)(5); Treas. Regs. §§1.170A-14(d) and (e).

<sup>7</sup> With regard to historic structures, special rules apply for contributions of restrictions with respect to exteriors of buildings in registered historic districts (façade easements).

<sup>8</sup> For example, preservation of farmland under a state flood prevention programs that would result in destruction of a significant, naturally occurring ecosystem due to farming pesticides.

<sup>9</sup> For example, donation of an easement to preserve an archaeological site may be allowed even if archaeological excavation may impair a scenic view of which the land is a part.

<sup>10</sup> Treas. Reg. §1.170A-14(g).

<sup>11</sup> See Code §§170(a)(1), 170(f)(8), 170(f)(11), 170(f)(13), and 170(f)(17), and Treas. Regs. §§1.170A-13 and 1.170A-14. A full discussion of all charitable substation requirements is beyond the scope of this report.

<sup>12</sup> This report provides only an overview of certain potential areas for IRS review with regard to conservation easement charitable donations and is not meant as a full discussion of the specifics of all possible issues. For a more detailed discussion of these and other related issues and case, see IRS Conservation Easement Audit Techniques Guide, Rev. Nov. 4, 2016; James L. Wittenback, “Conservation Easements: Recent Cases Deny Contribution Deductions,” *Practical Tax Strategies* (WG&L) June 2017 Vol. 98, No. 06; H. Zaritsky, ¶8.08. Charitable Conservation Easements, *Tax Planning for Family Wealth Transfers During Life: Analysis With Forms*, (Thomson Reuters/Tax & Accounting, 5th ed. 2013, with updates through June 2017) (online version accessed on Checkpoint ([www.checkpoint.riag.com](http://www.checkpoint.riag.com))); Laura Jean Kreissl and Karyn Bybee Friske, “IRS Takes a Hard Stance on Deductions for Conservation Easements,” *Practical Tax Strategies*, Vol. 84, No. 02 (Feb. 2010) Suzanne Thau and Jonathan G. Blattmacr, “Introduction to Tax Effects of Conservation Easements- Part I”, *Estate Planning Journal*, Vol. 38, No. 12 (Dec. 2011);

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<sup>13</sup> See e.g., Notice 2004-41.

<sup>14</sup> See e.g., cases disallowing deduction for lack of exclusive conservation purpose: *Atkinson v. Commissioner*, T.C. Memo 2015-236; *Herman v. Commissioner*, T.C. Memo 2009-205; *R.P. Golf, LLC v. Commissioner*, T.C. Memo. 2012-282. *But see*, e.g., cases allowing deduction: *Irby v. Commissioner*, 139 T.C. No. 14 (2012); *Glass v. Commissioner*, 471 F.3d 698 (6th Cir. 2006), *aff'd* 124 TC 258 (2005).

<sup>15</sup> *R.P. Golf v. Commissioner*, 860 F.3d 1096 (2017); *Minnick v. Commissioner*, T.C. Memo. 2012-345, *aff'd*, 796 F.3d 1156 (9th Cir. 2015).

<sup>16</sup> *Mitchell v. Commissioner*, 138 T.C. 324 (2012), reconsidered denied, TC Memo. 2013-204, *aff'd*, 775 F.3d 1243 (10th Cir. 2015) (mortgage on property must be subordinated at the time of donation for easement to be deductible).

<sup>17</sup> *Ten Twenty Six Investors v. Commissioner*, T.C. Memo 2017-115 (2017).

<sup>18</sup> See e.g., *Mountanos v. Commissioner*, TC Memo. 2013-138, reconsideration rejected, T.C. Memo. 2014-38, *aff'd* by unpublished op., 651 Fed. Appx. 59 (9th Cir. 2016).

<sup>19</sup> See Treas. Reg. §1.170A-14(h)(3)(i); CCA 200738013; Rev. Rul. 73-339, clarified in Rev. Rul. 76-376; *Mountanos* at note 20 (disallowing entire amount of charitable deduction for conservation easement contribution based on “before-and-after” approach because the Tax Court determined the taxpayer did not show that the value of the property declined after the easement’s contribution).

<sup>20</sup> See *French v. Commissioner*, T.C. Memo 2016-53 (2016) (the deed of easement could not serve as a contemporaneous written acknowledgment (“CWA”) because the provisions did not contain all the required elements of a CWA); *15 West 17th Street LLC, et al. v. Commissioner*, 147 T.C. No. 19.

<sup>21</sup> See e.g., *Gemperle v. Commissioner*, T.C. Memo 2016-1.

<sup>22</sup> See e.g., *Mountanos* at note 20.

<sup>23</sup> Ronald A. Levitt, David M. Wooldridge, Gregory P. Rhodes, and Nathan Vinson, “Tax Court Analysis of Land Conservation Easement Values – Developments since Kiva Dunes,” *Taxation of Exempts* (May/Jun 2011).

<sup>24</sup> For further discussion, see Timothy Lindstrom, “The Role of Letter Rulings in Conservation Easement Contributions,” *Estate Planning Journal* (Feb 2013); “Introduction to Tax Effects of Conservation Easements-Part I” at note 12.