Wyoming Law Review

Volume 11 | Number 2 Article 6

January 2011

Recent Developments in the Law Affecting Conservation Easements: Renewed Tax Benefits, Substantiation, Valuation, Stewardship Gifts, Subordination, Trusts, and Sham Transactions

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WYOMING LAW REVIEW

VOLUME 11 *2011* NUMBER 2

RECENT DEVELOPMENTS IN THE LAW AFFECTING CONSERVATION EASEMENTS: RENEWED TAX BENEFITS, SUBSTANTIATION, VALUATION, "STEWARDSHIP GIFTS," SUBORDINATION, TRUSTS, AND SHAM TRANSACTIONS

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I. INTRODUCTION

In Wyoming, conservation easements have become a significant tool for land conservation. Conservation easements are a form of private land restriction voluntarily imposed on property by landowners to preserve agricultural and ranch land, wildlife habitat, and scenic resources. If conservation easements comply with federal tax law requirements, their contribution generates significant federal income and estate tax savings.[1]

In 2010, conservation easements protected over 46,000 acres of Wyoming land.[2] That same year land trusts spent over $20 million purchasing conservation easements in Wyoming.[3] The potential development value extinguished by these conservation easements is easily in the hundreds of millions of dollars.

Funding for the purchase of conservation easements in Wyoming comes from a number of sources including the Farm and Ranch Protection Program of the Natural Resources Conservation Service of the United States Department of Agriculture, the Wyoming Wildlife Natural Resources Trust Fund, the Wyoming Department of Game and Fish, the Jonah Interagency Office, the Rocky Mountain Elk Foundation, and private contributions. These sales are almost always "bargain sales."[4]

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[1] *See* 26 U.S.C. § 170(h) (2006) (defining qualified conservation contributions); 26 C.F.R. § 1.170A-14 (2011) (giving further regulatory definition to qualified conservation contributions).

[2] E-mail from various individuals to author (Jan. 2011) (on file with author).

[3] *Id.*

[4] *See* 26 U.S.C. §§ 170, 1011(b) (defining allowable charitable contributions for federal tax purposes and bargain sales as related to charitable contributions). Bargain sales are those in which the seller and buyer agree to a price that is less than the appraised value of the conservation easement. *See id.* § 1011(b). The difference is intended and recognized as a charitable contribution.

There have been a number of recent developments affecting the tax law governing conservation easements in Wyoming and throughout the United States.[5] This article addresses two of those changes. First, this article discusses changes to federal income tax law affecting conservation easements. Second, this article covers judicial decisions concerning a number of tax law preconditions to the deductibility of conservation easements, including substantiation, subordination, valuation, and denial of deductions for sham transactions.

II. TAX LAW CHANGES

Congress recently enacted the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (2010 Tax Act).[6] This law reinstates significant income tax provisions affecting conservation easements that expired at the end of 2009.[7] Congress made the tax benefits of conservation easements available to landowners with modest incomes by increasing the percentage of income against which a deduction for the contribution of a conservation easement may be claimed and by increasing the period over which that deduction may be used.

A. Faster Write-Off of Conservation Easement Deductions

Suppose Rancher Will contributes a conservation easement over his 1000-acre ranch outside of Cody. The ranch has excellent views of the Absarokas, incredible trout streams, and many spectacular home sites. The conservation easement preserves Will's ability (and that of his successors in title) to ranch, hunt, fish, and engage in other traditional recreational activities. The easement also reserves rights to divide the ranch into three parcels, each of which can be separately conveyed, and each of which can contain one residential compound. Assume that before the easement was in place, the ranch was worth $25 million and that after the easement was in place, the ranch was worth $10 million. The

See id. §§ 170, 1011(b). Due to the requirements of most sources of funding for the purchase of conservation easements, purchase prices are typically less than 50% of the appraised value of the easement. A taxpayer who sells property for less than its fair market value (i.e., makes a "bargain sale") to a charitable organization is entitled to a charitable contribution deduction under § 170(a) that is equal to the difference between the fair market value of the property and the amount realized from its sale. *See id.* § 170(a); Stark v. Comm'r, 86 T.C. 243, 255–56 (1986).

[5] This article covers the principal changes occurring since the author's publication of *Income Tax Aspects of Conservation Easements*, 5 WYO. L. REV. 1 (2005).

[6] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296 (to be codified as amended in scattered sections of 26 U.S.C.).

[7] *Id.* § 723 (delaying the expiration of tax provisions affecting conservation easements contributed after December 31, 2009, namely 26 U.S.C. § 170(b)(1)(E)(vi), (b)(2)(B)(iii) to December 31, 2011).

difference of $15 million is the value of the charitable contribution made by Will in conveying the easement.

Now assume that Will's ranching operations and other investments generate $500,000 in adjusted gross income annually. Under the tax law that existed for most of 2010, Rancher Will could claim, annually, a maximum of $150,000 of the $15 million value of the easement contribution.[8] Moreover, he would be able to carry unused portions of that deduction forward for only five additional years.[9] In other words, the *most* that Will's contribution could save him in income tax would be $315,000.[10] Under this version of the tax law, $14.1 million of the value of the easement contribution would be unusable.[11]

In order to fully utilize a $15 million charitable deduction, Will's income would need to be at least $50 million.[12] Granted there are a few ranch owners in Wyoming whose income probably exceeds $50 million over a six-year period (or even over a one-year period); however, those high-earning ranch owners are probably not earning that from the ranch itself. In other words, the income tax laws in place for most of 2010 and most of the history of the charitable deduction for conservation easement contributions favored those with large incomes and not the average farmer or rancher.[13]

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[8] *See* 26 U.S.C. § 170(b)(1)(C)(i), (b)(1)(G).

[9] *See id*. § 170(b)(1)(C)(ii).

[10] $500,000 (Will's adjusted gross income (AGI) annually) x 30% (the percentage of AGI against which the easement deduction may be taken) x 35% (the maximum tax rate applicable) x 6 (the total number of years over which the deduction may be claimed) = $315,000. *See id.* § 170(b)(1)(C)(i), (b)(1)(C)(ii), (b)(1)(G). Of course, if Will has other contributions, they may reduce the amount allowable for the use of the conservation easement deduction. *See id.* § 170 (allowing the deductibility of charitable contributions generally). Furthermore, not all of the income sheltered by the easement deduction may be taxed at the top rate of 35%, which would lower the actual savings realized. *See id.* §§ 1–15 (specifying a progressive system of tax rates).

[11] *See supra* notes 8–10 and accompanying text. Under this version of the law, one technique frequently used to avoid the loss of major portions of a conservation easement deduction was to phase the contribution over a number of years. Using this technique, Will might contribute a conservation easement over 250 acres at a time, placing each new 250-acre easement when the deduction from the preceding contribution had been used. Whether the "economic substance doctrine" might apply to this approach, resulting in a claim by the IRS that all phases should be "collapsed" into one contribution, is a bit hard to predict. *See* 26 U.S.C.A § 7701(o) (West 2011) (defining how the IRS tests the economic substance of a transaction). Nothing in the tax law requires an individual to contribute more at one time than he chooses, and there are many good reasons, other than tax savings, that a landowner may have for protecting only a portion of his land at a time. *See infra* notes 232–46 and accompanying text (discussing phasing).

[12] $15,000,000/.3 = $50,000,000. *See* 26 U.S.C. § 170(b)(1)(B)(i) (limiting, generally, deductible contributions of individuals to 30% of their income).

[13] Note that the 2010 Tax Act is retroactive to January 1, 2010, thereby superseding the law formerly in place for 2010. *See* Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 723(c), 124 Stat. 3296, 3316.

However, with the enactment of the 2010 Tax Act, the tax rules governing the write-off of conservation easement contributions which had expired at the end of 2009 have been reinstated for 2010 and 2011.[14] These rules allow all taxpayers to claim deductions for the contribution of a conservation easement, up to 50% of their adjusted gross income, and to carry unused portions of those deductions forward for fifteen years.[15]

These rules would allow Rancher Will to realize a maximum of $1.4 million in tax savings.[16] This assumes that Will's annual income for the sixteen-year period in which he can use the deduction remains at $500,000. This tax savings represents an additional $1.085 million in tax savings when compared to the prior law. Nevertheless, $11 million of Will's contribution has been lost.[17]

B. Special Rule for Farmers and Ranchers

Suppose $255,000 of Rancher Will's annual income comes from his ranching operations. If this is the case, Will qualifies as a "rancher" for purposes of writing off his conservation easement deduction.[18] If Will is a qualified rancher then he is

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[14] *See id.* § 723(a)–(c).

[15] 26 U.S.C. § 170(b)(1)(E). The Internal Revenue Code (Code) provides:

> (i) In general. Any qualified conservation contribution (as defined in subsection (h)(1)) shall be allowed to the extent the aggregate of such contributions does not exceed the excess of 50 percent of the taxpayer's contribution base over the amount of all other charitable contributions allowable under this paragraph.
>
> (ii) Carryover. If the aggregate amount of contributions described in clause (i) exceeds the limitation of clause (i), such excess shall be treated (in a manner consistent with the rules of subsection (d)(1)) as a charitable contribution to which clause (i) applies in each of the 15 succeeding years in order of time.

Id.

[16] $500,000 (Will's adjusted gross income annually) x 50% (the percentage of AGI against which the easement deduction may be taken) x 35% (the maximum tax rate applicable) x 16 (the total number of years over which the deduction may be claimed) = $1,400,000. *See id.*

[17] $15,000,000 (the value of the easement contribution) – ($500,000 x 50% x 16) = $11,000,000. *See id.* (limiting the contribution deduction to 50% of gross income over sixteen years).

[18] *Id.* § 170(b)(1)(E)(v). The Code provides the following definition: "For purposes of clause (iv), the term 'qualified farmer or rancher' means a taxpayer whose gross income from the trade or business of farming (within the meaning of section 2032A(e)(5)) is greater than 50 percent of the taxpayer's gross income for the taxable year." *Id.* The Code provides the following definition for the term "farming purposes":

> (A) cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, shearing, feeding, caring for, training, and management of animals) on a farm;
>
> (B) handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity so treated; and

allowed to use his conservation easement contribution deduction against 100% of his adjusted gross income.[19] This increases his potential income tax savings to \$2.8 million.[20] He still loses \$7 million of his potential deduction.[21] However, he can consider phasing the contribution to attempt to utilize more of the potential deduction.[22]

There is one requirement to claim the 100% write-off in addition to the source of income requirement: the contributed conservation easement must provide that the land subject to the easement will "remain available" for agriculture or livestock production.[23] Note this requirement does not state that the land subject to the easement must continue to be farmed or ranched, merely that it "remain available" for such activity.[24] The following example conservation easement provision is intended to ensure compliance with the requirement that the land subject to the easement "remain available" for agriculture or livestock production:

> Example: In accordance with the provisions of §§ 170(b)(1)(E)(iv)(II) and 170(b)(2)(B)(i)(II) of the Internal Revenue Code of 1986, as amended, it is a requirement of this Easement that the Property shall remain available for agricultural and livestock production; however, this provision shall not be deemed to require continued active agricultural or livestock production on the Property.

An important feature of the 100% write-off is that the income requirement only applies in the year of the contribution, not in later years.[25] Therefore, a landowner might earn over 50% of his income in the year of the contribution from the "business of farming or ranching" and thereafter earn all of his income from investments. The 100% write-off will continue to apply in future years, to

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(C) (i) the planting, cultivating, caring for, or cutting of trees, or

(ii) the preparation (other than milling) of trees for market.

Id. § 2032A(e)(5).

[19] *See id.* § 170(b)(1)(E)(v)(I).

[20] \$500,000 (Will's adjusted gross income annually) x 100% (the percentage of AGI against which the easement deduction may be taken) x 35% (the maximum tax rate applicable) x 16 (the total number of years over which the deduction may be claimed) = \$2,800,000. *See id.* § 170(b)(1)(E).

[21] \$15,000,000 (the value of the easement contribution) – (\$500,000 x 100% x 16) = \$7,000,000. *See id.* (limiting the contribution deduction to the aggregate of gross income over sixteen years).

[22] *See infra* notes 232–46 and accompanying text (discussing phasing).

[23] *See* 26 U.S.C. § 170(b)(1)(E)(iv)(II).

[24] *Id.*

[25] *Id.* § 170(b)(1)(E)(iv)(I), (b)(1)(E)(v).

the extent that the deduction was not fully used in the year of the contribution, regardless of the donor's source of income in those future years.

Unfortunately, proceeds from the sale of a conservation easement are not considered "income from the trade or business of farming."[26] This means if the bargain sale of a conservation easement generates enough income from the sale so that the rancher's income from the business of farming or ranching falls below 50% of his total income, he is ineligible for the 100% write-off. [27] This is true even though in future years his income may be entirely from the business of farming or ranching.

In theory, a landowner who intends to bargain sell a conservation easement could structure the sale so he only received a portion of the sale's price in the year in which the easement was conveyed, with the balance due in future years. So long as the contributed portion of the bargain sale occurs in a year when the income from the sale does not reduce the rancher's income from the business of farming or ranching to below 51% of total income, the 100% write-off will be available.[28] Structuring the bargain sale of a conservation easement in this manner, however, risks making the transaction a sham for tax purposes.[29]

C. C Corporations

C corporations are limited in their use of charitable deductions to 10% of their "taxable" income.[30] Because taxable income is a smaller number than adjusted gross income and, of course, 10% is less than 30% or 50%, tax benefits to C corporations for the contribution of conservation easements can be significantly less advantageous than they are for individuals. However, under the 2010 Tax Act the rules that prevailed in 2009 for C corporations making contributions of conservation easements have been reinstated as well, provided that the corporation's stock is not "readily tradable on an established securities market at

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[26] *See id.* §§ 170(b)(1)(E)(v), 2032A(e)(5).

[27] *See infra* notes 223–31 and accompanying text (discussing the use of the installment sales provisions to avoid this result and the probable pitfalls of such an approach).

[28] 26 U.S.C. § 170(b)(1)(E)(v). The income requirement qualifies a farmer or rancher only if the donor's income from the business of farming is "greater than" 50% of his or her total income. *Id.*

[29] *See infra* Part III.E (discussing sham transactions).

[30] 26 U.S.C. § 170(b)(2)(A). C corporations are those in which corporate income is taxed at corporate rates, as opposed to S corporations, in which corporate income is passed through to and taxed at the shareholder level. *Id.* § 1361(a)–(b).

any time" during the year of the contribution.[31] These rules allow C corporations earning more than 50% of their income from the "business of farming" to write-off conservation easement deductions against 100% of their income and carry unused portions of the deduction forward for fifteen years, just like individuals.[32]

D. Contributions of Fee Interests

The 2010 Tax Act's enhanced write-off and carry-forward provisions for conservation easement contribution deductions also extend to contributions (or bargain sales) of real property in fee where the donor reserves a "qualified mineral interest" in the property.[33] A qualified mineral interest is the donor's interest in subsurface oil, gas, or other minerals and the right to access such minerals.[34] In other words, if a landowner contributes an outright interest in land and retains a qualified mineral interest in that land, he is entitled to the enhanced write-off provisions of the 2010 Tax Act. Ironically, if the landowner contributes his entire interest in the fee without retaining any mineral interest, he does not qualify for the enhanced benefits of the 2010 Tax Act. Instead, such a donor will be limited to writing off the deduction against no more than 30% of his adjusted gross income and carrying forward unused portions of the deduction for no more than five years. In other words, the more limited gift receives the better tax treatment.

This seemingly backward result is because the original 2006 enhanced write-off provisions applied to "qualified conservation contributions" only.[35] The law defines "qualified conservation contributions" as the "contribution of a—(i) qualified real property interest, (ii) to a qualified organization, (iii) exclusively for conservation purposes."[36] For purposes of this definition, a "qualified real property interest" includes both conservation easements *and* the "entire interest of the donor other than a qualified mineral interest."[37] A remainder interest will also qualify as a "qualified real property interest."[38] Thus, if a landowner is planning to contribute an outright fee interest, he or she would be well advised to retain a "qualified mineral interest" when making the contribution in order to be able to claim the benefit of the 2010 Tax Act's enhanced write-off provisions.

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31 *Id.* § 170(b)(2)(B)(i).

32 *Id.* § 170(b)(2)(B).

33 *Id.* § 170(b)(1)(E)(i), (b)(1)(E)(iv), (h)(1).

34 *Id.* § 170(h)(6).

35 *Id.* § 170(b)(1)(E)(i).

36 *Id.* § 170(h)(1).

37 *Id.* § 170(h)(2).

38 *Id.* § 170(h)(2)(B).

E. Enhanced Benefits for S Corporations

S corporations are "small business corporations" that elect to be S corporations as provided for in 26 U.S.C. § 1362.[39] Generally speaking, an S corporation's income is not taxed at the corporate level but is passed through to the shareholders along with losses and deductions.[40] However, deductions, including the deduction for charitable contributions, may only pass through to shareholders to the extent of their basis in their shares.[41]

For example, Ranch Corporation, an S corporation, has two shareholders Sam and Enid. Sam's basis in his 60% ownership of corporate shares is $60,000. Enid's basis in her ownership of the remaining 40% of the corporation is $40,000. Ranch Corporation makes a contribution of a conservation easement valued at $500,000. Under applicable tax law prior to the 2010 Tax Act, Ranch Corporation could only pass $60,000 of that deduction through to Sam and $40,000 of that deduction to Enid. Unless Sam and Enid were able to increase their basis in future years (e.g., by making loans to the corporation or contributing capital assets) the remainder of the deduction would be lost.[42]

The 2010 Tax Act reinstated the prior law allowing S corporations to pass through conservation easement deductions without regard to the shareholders' basis—to a certain extent.[43] The restated rule provides,

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[39] *Id.* § 1361(a).

[40] *Id.* § 1366(a)–(c).

[41] *Id.* § 1366(d)(1).

[42] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 752, 124 Stat. 3296, 3321 (amending the carryover basis for S corporations). Note that unused deductions may be carried forward indefinitely by an S corporation. 26 U.S.C. § 1366(d)(2). However, charitable contributions are subject to the carry-forward limitations of § 170(b)(1). Therefore, to the extent a shareholder's basis prevents him from utilizing his pro-rata share of a charitable contribution deduction passed through from an S corporation, he may expect the unused balance of that deduction to be available in future years without limitation. *Id.* §§ 170(b)(1), 1366(d)(2). However, once the deduction passes through to him as an individual, his ability to carry-forward any portion of the deduction that he cannot use is subject to the limitation of § 170(b)(1).

[43] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, § 752, 124 Stat. at 3321 (amending the carryover basis for S corporations with the title "Basis Adjustment to Stock of S Corps Making Charitable Contributions of Property"). The new law provides:

> (a) In General.—Paragraph (2) of section 1367(a) is amended by striking "December 31, 2009" and inserting "December 31, 2011".
>
> (b) Effective Date.—The amendment made by this section shall apply to contributions made in taxable years beginning after December 31, 2009.

Id.

> (2) Decreases in basis.—The basis of each shareholder's stock in an S corporation shall be decreased for any period (but not below zero) by the sum of the following items determined with respect to the shareholder for such period:
>
> . . . .
>
> (B) the items of loss and deduction described in subparagraph (A) of section 1366(a)(1),
>
> . . . .
>
> The decrease under subparagraph (B) by reason of a charitable contribution (as defined in section 170(c)) of property shall be the amount equal to the shareholder's pro rata share of the adjusted basis of such property. The preceding sentence shall not apply to contributions made in taxable years beginning after December 31, 2009.[44]

This is an unusually obscure provision. There are two potential components of a conservation easement contribution. The first component is the portion of the easement representing gain in the value of the property underlying the easement over the donor's basis in that property. The second component is the donor's adjusted basis in the underlying property. The proportion of the fair market value of the underlying property represented by gain and by basis are represented in equal proportion in the appraised value of a conservation easement over the underlying property. The 2010 Tax Act thus provides that the gain portion of the easement's value passes through to shareholders without regard to their basis in their shares, whereas the basis portion of the easement's value can only pass through to the extent of the shareholders' basis in their shares.[45]

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[44] 26 U.S.C. § 1367(a)(2). The items of "loss and deduction" include charitable contribution deductions. *Id.* § 1367(a)(2)(B).

[45] Note that basis in a conservation easement is different from basis in the land subject to the easement. A conservation easement's basis is a function of the proportionate value of the underlying land represented by the value of the easement, based upon a qualified appraisal of the value of the easement. For example, assume that the donor's basis in the underlying land is $100,000. Assume that a qualified appraisal determines that the value of the land before the easement was $500,000 and after the easement was $250,000. The easement is worth $250,000 ($500,000 – $250,000) and represents 50% of the value of the underlying land. Therefore, the donor's basis in the easement is $125,000 (50% x $250,000). *See* Hughes v. Comm'r, T.C.M. (RIA) 2009-094, 703 (2009) ("[T]he basis of a conservation easement is equal to the adjusted basis of the entire property reduced by the percentage decrease in the entire property's fair market value as a result of the conservation easement.").

Using the example of Sam and Enid, suppose that Ranch Corporation's basis in the conservation easement contribution was $200,000. Thus, $300,000 of the $500,000 easement contribution represents gain over the corporation's basis and can be passed through to Sam and Enid without regard to their basis in their shares. $180,000 of this gain passes through to Sam, and $120,000 passes through to Enid. However, only $100,000 of the corporation's basis in the contribution can be passed through to the shareholders because this amount can only be passed through to the extent of the shareholders' basis in their shares; in this case $60,000 to Sam and $40,000 to Enid. Therefore, the total amount of the deduction Sam can enjoy, at least in the year of the contribution, is $240,000 ($180,000 plus $60,000) and by Enid is $160,000 ($120,000 plus $40,000). Unless Sam and Enid are able to increase their basis (which has been reduced to zero by the easement contribution) to at least $60,000 in Sam's case and $40,000 in Enid's case in the future, they will lose the benefit of the unused $100,000 of the contribution deduction.

III. JUDICIAL DECISIONS

Recent decisions from the United States Tax Court and the United States District Court for the Northern District of Illinois pertain to the tax law applicable to conservation easements and conservation transactions.[46] These decisions underscore the government's increasing focus on technical compliance and the importance of paying close attention to the detail of statutory and regulatory requirements in substantiating conservation easement contributions.

A. *Substantiation*

The substantiation of the contribution of a conservation easement can seem trivial compared to the substance of negotiating a document that permanently dictates the future use of a client's land *and* complies with all of the requirements for deductibility as per the Internal Revenue Code of 1986 (Code), as amended.[47] It would, however, be a serious mistake to consider the attorney's job complete once the easement is put to record.

There are three components to properly substantiating a conservation easement contribution: (1) a contemporaneous, formal, written acknowledgement *in the proper form* from the donee organization; (2) a qualified appraisal of the value of the conservation easement performed by an independent, qualified appraiser; and

[46] This discussion is structured by category of issue, rather than by case decision. Therefore, a case covering several different issues may be discussed more than once.

[47] In order to successfully claim a tax deduction for the contribution of a conservation easement, the donor must substantiate the fact that a contribution was made and the value of the contribution. *See infra* notes 48–119 and accompanying text.

(3) a properly completed and executed *Form 8283 and* the required schedule.[48] Failure to comply with any one of these requirements could cost an easement donor a deduction, as evidenced by several of the cases discussed below.

1. Contemporaneous Acknowledgement

In *Gomez v. Commissioner*, Mr. and Mrs. Gomez made contributions to their church totaling over $6,500 in 2005.[49] There was no issue that the contributions were legitimate or that the recipient was a qualified exempt organization. Furthermore, the recipient provided a written acknowledgement to Mr. and Mrs. Gomez of their contributions.[50] The tax court upheld the Internal Revenue Service's (IRS) disallowance of the charitable deduction for the contributions because the church had not provided the required written acknowledgement in a *timely* manner.[51] In reaching this decision the tax court noted,

> No deduction is allowed pursuant to section 170(a) for all or part of any contribution of $250 or more unless the taxpayer substantiates the contribution with *a contemporaneous written acknowledgment from the donee organization*. Sec. 170(f)(8)(A). Further, a written acknowledgment is contemporaneous if it is obtained by the taxpayer on or before the earlier of (1) the date on which the taxpayer files a return for the taxable year in which the contribution was made, or (2) the due date (including extensions) for filing such return. Sec. 170(f)(8)(C).[52]

Because the church did not provide the acknowledgement until the IRS had already challenged the deduction, the acknowledgement did not conform to the definition of "contemporaneous" provided in the above-cited statute.

In *Bruzewicz v. United States*, Elizabeth Bruzewicz and her husband, Howard Prossnitz (Prossnitzes), contributed a façade easement over their residence in Oak Park, Illinois, in 2002.[53] For the contribution, the Prossnitzes claimed a federal

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[48] 26 C.F.R. § 1.170A-13(c), -13(f) (2011). Note that some experts are now suggesting that easement donors also include in the packet of information substantiating their easement deduction that accompanies their tax return (1) a copy of the recorded easement itself; (2) a copy of the acknowledgement letter; (3) a copy of the subordination of mortgages to the easement (if there were any); and (4) a copy of the documentation of the condition of the property subject to the easement required by 26 C.F.R. § 1.170A-14(g)(5)(i). Stephen J. Small, Remarks at a webinar sponsored by the Land Trust Alliance (Feb. 24, 2011).

[49] T.C. Summ. Op. 2008-93, 2008 WL 2917654, at *1 (July 30, 2008).

[50] *Id.* at *2.

[51] *Id.* at *2–3.

[52] *Id.* at *2 (emphasis added).

[53] 604 F. Supp. 2d 1197, 1200 (N.D. Ill. 2009).

income tax deduction of $216,000.[54] The IRS challenged the deduction on a number of technical grounds including: (1) failure to obtain a contemporaneous written acknowledgement of the contribution from the donee organization; (2) failure to comply with statutory requirements for qualified appraisals by failing to include a description of the appraisers' qualifications and a sufficiently detailed description of the easement property; (3) failure to have both appraisers sign *Form 8283*; (4) failure to include the cost basis of the contributed property in *Form 8283*; and (5) failure to include "a proper basis for the valuation of the easement or use the correct definition of market value."[55] In deciding the case the court said,

> The critical question to be answered is whether the requirements relate "to the substance or essence of the statute." If so, strict adherence to all statutory and regulatory requirements is a precondition to an effective election. On the other hand, if the requirements are procedural or directory in that they are not of the essence of the thing to be done but are given with a view to the orderly conduct of business, they may be fulfilled by substantial, if not strict compliance.[56]

2. *Acknowledgement Letter*

In order to substantiate the deduction, the Prossnitzes were required to provide an acknowledgement letter from the donee organization as was required of Mr. and Mrs. Gomez:

> No deduction shall be allowed under subsection (a) for any contribution of $250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgment of the contribution by the donee organization that meets the requirements of subparagraph (B).
>
> In turn subparagraph (B) states that the acknowledgment must include (1) the amount of cash and a description of any property other than cash contributed, (2) whether the donee

[54] *Id.*

[55] *Id.* at 1204–07. According to the Government, although the appraisal purports to use the before and after method to determine the value of the easement, it really applies an arbitrary percentage to the established "before" value of the property to arrive at the asserted "after" value, rather than independently determining the real "after" value. *Id.* at 1207. Percentages can be used instead of direct comparables to determine the value of a conservation easement. *See infra* notes 86–90 and accompanying text.

[56] *Bruzewicz*, 604 F. Supp. 2d at 1203 (quoting Taylor v. Comm'r, 67 T.C. 1071, 1077–78 (1977)).

> organization provided any goods or services in consideration for any such property and (3) if goods or services were provided in exchange, a description and good faith estimate of the value of such goods or services. And to satisfy the "contemporaneous" requirement, the acknowledgment must be obtained on or before the date on which the taxpayer files a tax return containing the charitable deduction or the deadline date for filing that return (Section 170(f)(8)(C)).[57]

When the Prossnitzes contributed their façade easement, they also made two cash contributions to the donee.[58] The donee provided a contemporaneous written acknowledgement of these contributions characterizing them as an "easement" but did not mention or include a description of the façade easement.[59]

The court found that, in addition to other deficiencies in the acknowledgment letter, there was no description of the easement or its terms. The court concluded, "With no other writing offered by Prossnitzes in purported satisfaction of Section 170(f)(8)(A), they have flat-out violated its requirements."[60]

The court found the statutory requirement of a contemporaneous written acknowledgement was "neither unclear nor confusing."[61] The court then stated,

> Nor can it be said that the statutory requirement is "unimportant." To begin with, its very inclusion in the Code provision itself, rather than in accompanying regulations promulgated by the Treasury Department, signals a negative answer to that inquiry. And that result is underscored by the nature of the statutorily stated consequence: "No deduction shall be allowed . . . unless the taxpayer substantiates the contribution" by the specified contemporaneous written acknowledgment by the donee organization. Lacking that, the IRS is faced with the absence of even a prima facie showing of the existence of a substantial charitable contribution. Even though our tax system is basically one of self-reporting, the statutory establishment of a watershed-$250-beyond which validation is required in addition to a taxpayer's self-declaration cannot be said to be unimportant.
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> . . . .

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57 *Id.* at 1201 (quoting 26 U.S.C. 170(f)(8)(A) (2006)).

58 *Id.* at 1204.

59 *Id.*

60 *Id.*

61 *Id.*

> Prossnitzes' total failure to comply with the just-discussed statutory requirement is alone fatal to their claimed deduction of the preservation façade easement.[62]

3. *Appraisal*

The Treasury Regulations (Regulations) list a number of items that must be included in the appraisal of a conservation easement in order for that appraisal to be considered a "qualified appraisal."[63]

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[62] *Id.* at 1204–05. Note that historic preservation easements limited to the protection of the façade—the front or side of a building facing a public street—are no longer allowed by the Code. *See* 26 U.S.C. § 170(h)(4)(B)(i).

[63] 26 C.F.R. § 1.170A-13(c)(3)(ii) (2011). *Bruzewicz* suggests that failure to comply with any one of the regulatory requirements may be fatal. *See* 604 F. Supp. 2d at 1205. The Regulations require,

> (A) A description of the property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was (or will be) contributed;
>
> (B) In the case of tangible property, the physical condition of the property;
>
> (C) The date (or expected date) of contribution to the donee;
>
> (D) The terms of any agreement or understanding entered into (or expected to be entered into) by or on behalf of the donor or donee that relates to the use, sale, or other disposition of the property contributed, including, for example, the terms of any agreement or understanding that—
>
> > (1) Restricts temporarily or permanently a donee's right to use or dispose of the donated property,
> >
> > (2) Reserves to, or confers upon, anyone (other than a donee organization or an organization participating with a donee organization in cooperative fundraising) any right to the income from the contributed property or to the possession of the property, including the right to vote donated securities, to acquire the property by purchase or otherwise, or to designate the person having such income, possession, or right to acquire, or
> >
> > (3) Earmarks donated property for a particular use;
>
> (E) The name, address and (if a taxpayer identification number is otherwise required by section 6109 and the Regulations thereunder) the identifying number of the qualified appraiser; and, if the qualified appraiser is acting in his or her capacity as a partner in a partnership, an employee of any person (whether an individual, corporation, or partnerships), or an independent contractor engaged by a person other than the donor, the name, address, and taxpayer identification number (if a number is otherwise required by section 6109 and the regulations thereunder) of the partnership or the person who employs or engages the qualified appraiser;
>
> (F) The qualifications of the qualified appraiser who signs the appraisal, including the appraiser's background, experience, education, and membership, if any, in professional appraisal associations;
>
> (G) A statement that the appraisal was prepared for income tax purposes;
>
> (H) The date (or dates) on which the property was appraised;

The Prossnitzes admitted the appraisal failed to include the appraisers' qualifications but argued inclusion of the appraisers' license numbers amounted to substantial compliance.[64] The court ruled the substantial compliance standard requires the Prossnitzes demonstrate either that the requirements were so insignificant or confusing that compliance was excused.[65]

The court found that the Regulation left "no doubt about what was required."[66] In another finding of particular relevance to conservation easement appraisals, the court found:

> [The Regulation] provides the IRS with some basis on which to determine whether the valuation in an appraisal report is competent and credible evidence to support what in some cases may be a very large tax saving. And a statement of an appraiser's background and experience is particularly significant when the subject of the appraisal is as esoteric and specialized as the valuation of a real estate easement. For that reason as well, the regulatory requirements cannot be viewed as unimportant.[67]

With respect to the requirement that the appraisal contain a description of the contributed property, the court held that while the appraisal did contain a detailed description of the residence that was subject to the façade easement, it did not contain a description of the façade actually protected:

> Those substantiation requirements are important, indeed essential, to the review of charitable contribution deductions and the reliability of corresponding appraisals. Absent a description of the facade easement, the appraisal and its valuation of the donated property are meaningless. There is no way for the IRS or any outside party to judge whether the appraisal is reasonable or to understand the basis for the valuation of such undefined

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> (I) The appraised fair market value (within the meaning of § 1.170A-1(c)(2)) of the property on the date (or expected date) of contribution;
>
> (J) The method of valuation used to determine the fair market value, such as the income approach, the market-data approach, and the replacement-cost-less-depreciation approach; and
>
> (K) The specific basis for the valuation, such as specific comparable sales transactions or statistical sampling, including a justification for using sampling and an explanation of the sampling procedure employed.

26 C.F.R. § 1.170A-13(c)(3)(ii).

64 *Bruzewicz*, 604 F. Supp. 2d at 1205.

65 *Id.*

66 *Id.*

67 *Id.*

> contributed property. Neither is the requirement in any way confusing. There is really no excuse for Prossnitzes' failure to comply strictly with its terms.[68]

The court went on to say if the lack of an adequate description of the façade had been the only deficiency in the donors' substantiation, because the easement itself provided a description and had been recorded shortly before the appraisal date, it would have found substantial compliance.[69] Nevertheless, the court finally concluded that the donors had "utterly" failed to comply with important substantiation requirements and upheld the government's denial of their deduction.[70]

Simmons v. Commissioner represents a kinder, gentler approach to substantiation requirements when compared to *Gomez* and *Bruzewicz*.[71] In *Simmons*, the IRS challenges were similar to those in *Bruzewicz*.[72] The court, however, did not entirely disallow the donor's deduction for the contribution of a façade easement, although the deduction was substantially reduced.[73] In rather striking contrast to *Bruzewicz*, the *Simmons* court found that although the donee organization had provided no written acknowledgment of the easement contribution, it had signed and dated the easement itself, which the court considered to be substantial compliance.[74]

The court also noted one of the principal requirements of the Code is that the written acknowledgment include a statement detailing the amount of cash, or a description of other property, received by the donor in exchange for the contribution.[75] However, this information is not available from the mere signature of the donee on the easement. This detailed information would appear substantial because the IRS cannot determine whether the value of the contribution acknowledged in the letter must be offset by any return of value to the donor. Nevertheless, the court made no further comment on the requirement or the lack of compliance therewith.

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[68] *Id.* at 1206.

[69] *Id.*

[70] *Id.* at 1207.

[71] *See* T.C.M. (RIA) 2009-208, 1567–70 (2009) (reducing substantially but not completely eliminating deductions for contributions of a façade easement).

[72] *Compare id.* at 1561–62 (describing the IRS's assertion of a deficiency after the taxpayers had claimed contribution deductions for conservation easements), *with Bruzewicz*, 604 F. Supp. 2d at 1199 (describing a similar assertion by the IRS).

[73] *Simmons*, T.C.M. (RIA) 2009-208 at 1567–70.

[74] *Id.* at 1565–67.

[75] *Id.* at 1567; 26 U.S.C. § 170(f)(8)(B) (2006).

Consolidated Investors Group v. Commissioner is another case in which the donor failed to properly substantiate its deduction.[76] In this case the appraisal of the conservation easement was completed more than three months prior to the contribution.[77] There were other flaws as well, including failure to state the date upon which the partnership contributed the property; failure to state that the appraisal was prepared for income tax purposes; and failure to properly document what the fair market value of the appraised property was on the date of contribution.[78] Nevertheless, the court found that these flaws were "insubstantial," in part because the information lacking from the appraisal had been provided to the IRS in the *Form 8283* and the appraisal had been provided, it just had been prepared earlier than allowed by the Regulations.[79]

In the four cases previously discussed, failure to strictly comply with the Regulations has produced dramatically different results. The outcome of each case depended primarily upon the respective court's application of the "substantial compliance doctrine."[80] Ultimately, the regulatory requirements are clear and there is little excuse for failure to comply.

Complete, timely, and accurate substantiation, including (1) assuring receipt of a contemporaneous written acknowledgment containing a description of goods and services provided to the donor for the contribution; (2) proper completion and execution of *Form 8283* and the required schedule; and (3) an appraisal that meets the extensive requirements of the tax law, are all responsibilities of the donor's attorney. While the substantial compliance doctrine may save some transactions, no one should rely on this rather subjective and unpredictable doctrine as a safety net.

4. *The Use of Percentages in Valuing Conservation Easements*

Based upon the reported cases, the government most frequently uses valuation as grounds to challenge conservation easement deductions. In many cases, conservation easement appraisals are flawed—some fatally, some marginally. But

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[76] T.C.M. (RIA) 2009-290, 2139 (2009).

[77] *Id.* A qualified appraisal is one that was conducted *no earlier than* sixty days prior to the date of the contribution, nor later than the due date for the return upon which the deduction is first claimed, as delayed by any extensions. *See* 26 C.F.R. § 1.170A-13(c)(3)(i)(A) (2011).

[78] *Consol. Investors Grp.*, T.C.M. (RIA) 2009-290 at 2139.

[79] *Id.* at 2138–40.

[80] *See* Hendrix v. United States, No. 2:09-CV-132, 2010 WL 2900391, at *1 (S.D. Ohio July 21, 2010) (dealing with the contribution of a house); Lord v. Comm'r, T.C.M. (RIA) 2010-196, 1164–65 (2010) (dealing with a conservation easement contribution); Ney v. Comm'r, T.C. Summ. Op. 2006-154, 2006 WL 2686850, at *2–10 (Sept. 19, 2006) (involving the bargain sale of development rights on two properties). In each of these cases, failure to comply strictly with the substantiation requirements resulted in the donors' loss of their charitable contribution deduction. *Hendrix*, 2010 WL 2900391, at *6–8; *Lord*, T.C.M. (RIA) 2010-196 at 1165; *Ney*, 2006 WL 2686850, at *5–10.

almost all appraisals need work after they are received from the appraiser and before they go to the IRS. In representing a landowner contributing or bargain selling a conservation easement, a significant part of any lawyer's job is to review the appraisal for compliance with federal tax requirements. One need not be an appraiser to do this; the issues for which legal counsel should take responsibility are purely legal and the rules are clearly set out in the Code and Regulations—and expanded upon in numerous tax court opinions.[81] Further, IRS agents do not always know the law governing conservation easement appraisals.[82]

The need for compliance with technical substantiation requirements has already been covered in preceding sections.[83] The following are recently decided issues dealing with the substance of valuation.

The Regulations state a preference for the use of comparables in valuing conservation easements.[84] However, finding conservation easements that have been sold that are comparable to an easement currently being valued is often not possible because so few conservation easements are sold in arm's length, full-value transactions. Therefore, the Regulations allow the use of the "before and after" method in which the appraiser values property before placement of a conservation easement and then values it after such placement, the difference being the value of the conservation easement.[85]

One way appraisers have dealt with the lack of comparable easement-restricted properties is to apply a percentage reduction to the value of property in its "before" easement condition in order to determine its "after" easement value.[86] The percentage is typically derived from a large number of easement-encumbered property sales, or direct easement sales, obtained by the appraiser

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[81] *See, e.g.*, Hughes v. Comm'r, T.C.M. (RIA) 2009-094 (2009).

[82] In one audit, for example, the IRS challenged a conservation easement contribution deduction because it had been made after the death of the landowner by the landowner's executor. The agent had never heard of the "post-mortem" election allowed by 26 U.S.C. § 2031(c)(8)(A)(iii), (c)(8)(C), and (c)(9), which expressly provide for such deductions. In another example, the IRS review letter criticizing an appraisal failed to understand how to calculate the required limitation to basis applicable to conservation easement contributions made during the first year of the donor's ownership of the underlying property.

[83] *See supra* Part III.A.

[84] 26 C.F.R. § 1.170A-14(h)(3) (2011).

[85] *See id.*

[86] *See, e.g.*, Strasburg v. Comm'r, T.C.M. (RIA) 2000-094, 510–11 (2000). Note in *Strasburg* the appraiser derived a percentage diminution factor from a number of easement sales and sales of property subject to easements. *Id.* The tax court rejected the easement sales data because details allowing evaluation of the comparability of these sales was not included in the appraisal. *Id.* at 511. Of the thirty-one sales of property subject to easements that the appraiser used to determine a percentage reduction, the court accepted only four as being comparable. *Id.*

over time. However, these sales are not necessarily "comparable" to the property being appraised because they may have occurred over a lengthy period of time and may be geographically remote from the property being appraised. The *Instructions to Form 8283* expressly prohibit the use of percentages in appraisals of appreciated property.[87] Nevertheless, appraisers continue to use this method. Several recent cases, discussed below, address this practice.

In *Bruzewicz v. Commissioner* mentioned above, the appraiser used a percentage to determine the after value of the easement property.[88] The court noted finding comparables for determining the value of façade easements is difficult and cited several cases in which the percentage approach was allowed.[89] The court, however, was highly critical of the superficiality of the appraiser's analysis:

> [The appraisal cites] the customary threefold approach to real estate valuation: replacement cost, income capitalization and sales comparison—but then it really applies those only to assert the then present market value of the Prossnitzes' home, *and not to evaluate the easement* that the appraisers purport to be valuing. . . .
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> . . . .
>
> . . . In this Court's view that approach would most likely face real difficulty if this case had to reach trial.[90]

Because the court ruled the donors failed to comply with other substantiation requirements, it upheld the government's disallowance of the easement deduction without examining further the valuation issue.

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87 INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, CAT. NO. 62730, INSTRUCTIONS FOR FORM 8283: NONCASH CHARITABLE CONTRIBUTIONS 3 (2006) [hereinafter IRS FORM 8283 INSTRUCTIONS] ("The FMV of a conservation easement cannot be determined by applying a standard percentage to the FMV of the underlying property.").

88 604 F. Supp. 2d 1197, 1201, 1207 (N.D. Ill. 2009).

89 *Id.* at 1207 ("[C]omparable sales transactions involving real estate with similar facade easements are not always available. In a number of cases percentage reductions have been accepted to determine an easement's value based on qualitative factors that suggest such a value." (citing Griffin v. Comm'r, 56 T.C.M. (CCH) 1560 (1989); Losch v. Comm'r, 55 T.C.M. (CCH) 909 (1988); Nicoladis v. Comm'r, 55 T.C.M. (CCH) 624 (1988))). Note that the cases cited by the court were both decided prior to the date of the current instructions for *Form 8283*. *Compare id.* (citing cases decided in 1988 and 1989), *with* IRS FORM 8283 INSTRUCTIONS, *supra* note 87, at 1 (specifying rules revised in December 2006).

90 *Bruzewicz*, 604 F. Supp. 2d at 1208 (emphasis added).

In *Hughes v. Commissioner*, the appraiser for Hughes, relying on data from six "comparable" properties, determined the reduction in value of Hughes' property due to the conservation easement was 70%.[91] In response, the government appraiser relied on a "matrix."[92] According to the court:

> The matrix incorporated information from 35 easement-encumbered properties and illustrated generally that the amount of diminution caused by an easement is related to the degree to which the easement changes a property's highest and best use. According to Mr. Packard [the IRS's appraiser], the matrix showed that the diminution in value "for those properties that did not experience a change in highest and best use . . . is quite small and was often found to be 0%".[93]

Accordingly, the government's position was the conservation easement had no effect on the value of the property to which it was subject.

Developed by a group of IRS engineers who collected data on all of the land in Colorado sold subject to conservation easements, the matrix extracted the thirty-five sales of easement encumbered property.[94] From those sales the IRS derived a series of percentages representing the reduction in value of property due to conservation easements.[95] The reduction was a function of the number of potential residences removed from the property by the easement.[96]

For example, the matrix asserted where the pre-easement development potential of property was five residences or more, and the post-easement potential was five residences or more, the reduction in the pre-easement value due to the easement was zero.[97] On its face, this seems obvious. However, suppose before an

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[91] T.C.M. (RIA) 2009-094, 711 (2009). This case is a good primer on the dos and don'ts of appraising a conservation easement. However, for purposes of this discussion, the focus will be on the use of percentages by the appraisers for both the government and Hughes to determine the value of the conservation easement in question.

[92] *Id.* at 712.

[93] *Id.*

[94] IRS Engineers Study (on file with author).

[95] *Id.*

[96] *Id.*

[97] *Id.* The matrix also purported to show that if the development potential of easement property before the easement was in place was only one home site and the easement allowed no home sites, the reduction in value would range between 27% and 74%. *Id.* If the pre-easement development potential was three home sites and the easement eliminated all of them, the reduction in value would be 80%, whereas if the easement only eliminated two of the three home sites, the reduction would be between 0% and 20%. *Id.*

easement was in place a property could have been developed into sixty-eight home sites and after the easement it could only be developed into ten.[98] The matrix suggests that the value of such a conservation easement is zero. If there were no demand for residential development of the subject property, this conclusion might be correct. If, on the other hand, demand exists for such development it is hard to understand how the conclusion suggested by the matrix is correct. In other words, one cannot determine the value of a conservation easement using abstract measures. This is essentially what the court found.[99] The court commented on the landowner's appraiser's use of percentages:

> We note as well that Mr. Weston's [the landowner's appraiser] report lacks critical information about the comparable properties he considered; namely the highest and best use of the properties before they were encumbered by conservation easements. Without this information it is impossible to tell how much effect the easements had on the properties' fair market values.[100]

The court similarly commented on the government appraiser's use of the matrix: "We also disagree with Mr. Packard's use of the matrix. Because it included general information that did not have a specific connection to the Bull Mountain and Sylvester parcels, we afforded it little weight in our analysis."[101]

Simmons v. Commissioner is another case involving a façade easement.[102] An important issue in this case revolved around the fact that the two properties subject to the easement were already subject to local historic preservation regulations.[103] The government argued the local regulations already limited the use of the properties in a manner similar to the easement, and therefore, the easement did not affect the value of either property.[104] The court found the additional restrictions imposed on the properties over and above the local regulations did in fact result in a further reduction in the value of the properties, thus allowing the donors about one-third of the deductions they originally claimed.[105]

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[98] *Cf. Hughes*, T.C.M. (RIA) 2009-094 at 711 (acknowledging the significant reduction in the allowed density of home sites).

[99] *See id.* at 712–13.

[100] *Id.* at 712 n.29.

[101] *Id.* at 712 n.30.

[102] T.C.M. (RIA) 2009-208, 1562 (2009); *see supra* Part III.A.3.

[103] *Simmons*, T.C.M. (RIA) 2009-208 at 1568–69.

[104] *Id.*

[105] *Id.* at 1569–70.

In this case, the Simmons' appraiser determined the fair market value of the properties before the easement based upon its highest and best use.[106] The appraiser then applied a percentage to determine the effect of the easement on the value of the two properties: a 13% diminution for one property and 11% for the other.[107] The court, considering the extent to which the properties were already restricted by the local regulations and the relatively minor additional limitations imposed by the easements, concluded a 5% reduction was more appropriate.[108]

The important point here is that both the court and the Simmons' appraiser relied entirely on a percentage reduction in the pre-easement value of the property subject to the easement in determining the value of the easement.[109] There was no evidence as to how either the court or the Simmons' appraiser arrived at these percentages, nor was there any critical discussion of the use of percentages. The court's use of 5% appeared as arbitrary as the landowners' appraiser's use of 11% and 13%. The percentage approach to easement valuation was simply not an issue.

Scheidelman v. Commissioner presented yet another façade easement case in which Ms. Scheidelman's appraiser, Drazner, relied on a percentage reduction in the unrestricted value of the structure to determine the value of the easement.[110] The desirability of the use of percentages in easement appraisals is explained in the Scheidelmans' appraisal:

> [I]t is extremely difficult for appraisers to estimate the probable and possible impact on a property's value by the imposition of a façade conservation easement that is granted in perpetuity. For most attached row properties in New York City, where there are many municipal regulations restricting changes to properties located in historic districts, the façade easement value tends to be about 11–11.5% of the total value of the property. That figure is based on the appraiser's experience as to what the Internal Revenue Service has found acceptable (on prior appraisals).
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> . . . .

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106 *Id.* at 1568.

107 *Id.*

108 *Id.* at 1569–70.

109 *Id.* at 1568–70.

110 T.C.M. (RIA) 2010-151, 910–12 (2010). Façade easements, no longer permitted by the Code, have been heavily targeted by the IRS due to the potential for abuse and the arguably minimal impact on value resulting from the easements. However, while the substance of façade easement is considerably different than that of a conservation easement on land, the principles invoked by the IRS in its numerous challenges to façade easements are the same as those that apply to land easements.

> It is now generally recognized by the Internal Revenue Service that the donation of a façade easement of a property results in a loss of value . . . between 10% and 15%. The donation of a commercial property results in a loss of value of between 10% or 12% or higher if development rights are lost. The inclusive data support at least these ranges, depending on how extensive the façade area is in relation to the land parcel.[111]

The court itself cited an article produced by the IRS supporting the use of percentages in determining the value of historic façade easements.[112] However, while acknowledging courts in the past have accepted the percentage approach to after-easement valuation, the court rejected the use of a set percentage, stating "valuation itself is still a question of facts and circumstances."[113] Specifically, the court found:

> Drazner's report failed to outline and analyze qualitative factors for the Vanderbilt [Scheidelman's residence] property.
>
> Petitioners argue that the Drazner report outlined the methodology set forth to determine the "after" fair market value and assert that Drazner explained at trial that his appraisal was "not mechanical, it was reasoned." *However, the application of a percentage to the fair market value before conveyance of the façade easement, without explanation, cannot constitute a method of valuation as contemplated under section 1.170A-13(c)(3)(ii), Income Tax Regs*. Drazner's report applied *mechanically a percentage with no demonstrated support as to its derivation*, other than acceptance of similar percentages in prior controversies. Further, no meaningful analysis was provided in the Drazner

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[111] *Id.* at 911–12.

[112] *Id.* at 912. The *Scheidelman* court noted,

> An article entitled "Facade Easement Contributions" was prepared by Mark Primoli of the Internal Revenue Service (IRS) sometime before 2002 and was included as a part of the IRS' 1994 Market Segment Specialization Program Audit Technique Guide on the Rehabilitation Tax Credit—used to assist in training IRS personnel. The article stated that
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> > Internal Revenue Service Engineers have concluded that the proper valuation of a facade easement should range from approximately 10% to 15% of the value of the property. Once fair market values have been determined, the same ratios are used to allocate the basis of the building and the underlying land to the facade easement for both rehabilitation tax credit and depreciation purposes. See Treasury Regulation 1.170A14(h).

Id.

[113] *Id.* at 916 (quoting Nicoladis v. Comm'r, 55 T.C.M. (CCH) 624 (1988)).

> report to explain why Drazner applied 11.33 percent to the before fair market value of the property to calculate the façade easement value . . . .[114]

The court concluded the Scheidelman's appraisal was not a "qualified appraisal" and denied the deduction.[115]

It is easy to understand why appraisers want to use percentages derived from a number of different transactions to determine the after value of property subject to easements. Finding real comparable sales of property subject to easements that are in the vicinity of the property being valued and similar in characteristics and timing of the sale can be extremely difficult. There is a dearth of such comparables in virtually every market.

In addition to the foregoing cases critical of utilizing the percentage approach, in 2007 the IRS expressly rejected the use of percentages to determine the value of façade easements:

> The value of each easement is based on the particular facts and circumstances of each property on which the façade is located and the particular restrictions imposed. There was and is no "generally recognized" percentage by which an easement reduces the value of property. *Consequently, unless there is a substantial record of sales of easements comparable to the donated easement (in which case the appraisal would be based on the comparables, see § 1.170A-14(h)(3)(i)), an appraisal that does not value the property both before and after the donation will not be accepted by the Service to substantiate the deduction*.[116]

Notwithstanding the IRS's position and the *Instructions to Form 8283*, the preceding cases demonstrate that the courts have not completely ruled out the use of percentages to determine after-easement values. It is, however, clear that the courts expect the data from which any percentages are derived should be (1) described in the appraisal report and (2) relevant to the property

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[114] *Id.* (emphasis added).

[115] *Id.* at 918–19. Note that the consequence here of failure to comply with the requirements for a qualified appraisal was not a reduction by the court in the amount of the deduction claimed but a disallowance of the entire deduction. *Id.*

[116] I.R.S. Chief Couns. Adv. Mem. 2007-38-013, 2007 WL 2746198 (Aug. 9, 2007) (emphasis added).

being appraised.[117] Failure to thoroughly substantiate percentages used in valuing easements risks not just a reduction in valuation but a denial of the deduction entirely.

The rulings and Chief Counsel Advisory memorandum discussed above (with the exception of *Hughes*) are limited to façade easement appraisals.[118] However, appraisers occasionally attempt to use the percentage approach to valuing conservation easements on land. An appraisal of an easement on land in Sublette County, Wyoming, serves as one example. The appraiser derived a percentage from a "database" of sales of properties subject to conservation easements. The percentage was applied to the value of the land before the easement was in place to determine the reduction in value attributable to the easement. Among the sales contained in the database were sales of easement-restricted land in Teton County, Wyoming.

Elimination of the highly inflated value of the Teton County home sites by conservation easements resulted in very significant reductions in the before value of that land simply because each home site eliminated was so highly valued. Use of this data significantly skewed the percentage indicated by the sales, thus resulting in a reduction in value that did not represent the value of Sublette County home sites. While home site values in Sublette County were certainly above average, they were far from comparable to those in Teton County. A percentage reduction influenced by Teton County sales data simply inaccurately reflected the value of conservation easements in Sublette County. It is this kind of indiscriminate use of widely ranging sales without regard to actual comparability that makes appraisals relying on percentages highly vulnerable and inadvisable. There is no reason why the principles applicable to the use of percentages in determining the value of façade easements cannot be applied to land easements—certainly the skepticism of the court in *Hughes* indicates this.[119]

B. Cash Gifts in Connection with Easement Contributions

As a general practice most land trusts request, or require, that landowners contributing conservation easements also make a cash contribution to cover the

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[117] *See Scheidelman*, T.C.M. (RIA) 2010-151 at 916–18 (noting the use of percentage deductions without an explanation of relevance made the appraisal deficient); Hughes v. Comm'r, T.C.M. (RIA) 2009-094, 712 nn.29–30 (2009) (noting a report lacked critical information with no specific relevance to the parcels in question).

[118] *See supra* notes 83–117 and accompanying text. Note that the proscription on the use of percentages in easement appraisals is not limited to façade easements. IRS FORM 8283 INSTRUCTIONS, *supra* note 87, at 3–4.

[119] *Cf. Hughes*, T.C.M. (RIA) 2009-094 at 712–13 (finding expert opinions using percentage reductions to appraise easement values problematic).

cost of monitoring and enforcing the easement "in perpetuity."[120] While not expressly required by the tax law, the Regulations provide "[t]o be considered an eligible donee under this section, an organization must . . . have the resources to enforce the restrictions . . . . A qualified organization need not set aside funds to enforce the restrictions that are the subject of the contribution."[121]

The Land Trust Alliance, a national umbrella organization for over 1700 land trusts, recommends that,

> The land trust determines the long-term stewardship and enforcement expenses of each easement transaction and secures the dedicated or operating funds to cover current and future expenses. If funds are not secured at or before the completion of the transaction, the land trust has a plan to secure these funds and has a policy committing the funds to this purpose.[122]

In addition, *Form 990*, which requires an annual filing by land trusts and other exempt organizations, expressly requires land trusts to report the amount of staff time and money spent annually monitoring and enforcing conservation easements.[123] One Wyoming land trust has analyzed that the costs of annual monitoring run about $2800 per easement/landowner per year. Endowment of this annual cost, assuming a 2.5% rate of return, would require $112,000.

Raising the money necessary to fund the monitoring and enforcement of easements in order to comply with tax law and discharge a land trust's "perpetual" obligations under the terms of the conservation easement is a critical and necessary issue for land trusts. Two recent tax court decisions involve government challenges to the deductibility of such cash payments.

In *Kaufman v. Commissioner*, another façade easement case, the government challenged the deductibility of the easement on the grounds the easement was not perpetual.[124] The government also contested the deductibility of a cash payment made by the Kaufmans to assist the donee in monitoring and enforcing the

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[120] *See* LAND TRUST ALLIANCE, LAND TRUST STANDARDS AND PRACTICES 6, 8, 13–16 (2d prtg. 2007) [hereinafter LAND TRUST ALLIANCE], *available at* http://www.landtrustalliance.org/training/sp/lt-standards-practices07.pdf.

[121] 26 C.F.R. § 1.170A-14(c)(1) (2011).

[122] LAND TRUST ALLIANCE, *supra* note 120, at 14.

[123] INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, OMB NO. 1545-0047, SCHEDULE D (FORM 990): SUPPLEMENTAL FINANCIAL STATEMENTS pt. II, l, 7 (2010) [hereinafter IRS FORM 990 SCHEDULE D].

[124] 134 T.C. No. 9, 107 (2010); *see also infra* note 152 and accompanying text.

easement.[125] While the court did not rule on this latter challenge, finding the Kaufmans had raised sufficient factual issues to survive the government's motion for summary judgment, it did describe the issue in some detail.[126]

The Kaufmans entered into an agreement with the National Architectural Trust (NAT) to contribute a façade easement on their property.[127] Included in the agreement was a requirement that the Kaufmans make a cash contribution to NAT equal to a percentage of the estimated value of the easement.[128] The payment was to be made in advance of the contribution of the easement itself.[129] The agreement also provided that in the event the easement was appraised at no value, NAT would refund the payment to the Kaufmans.[130]

The government challenged the deductibility of the payment on two grounds. First, the government argued that because the contribution could be refunded if the easement had no value, it was a conditional gift and thus not deductible.[131] Second, because the contribution was *required* in order for NAT to accept the easement contribution, the cash contribution was a quid pro quo payment and was therefore not deductible.[132]

The Kaufmans responded to the first argument by admitting the contribution was conditional but cited an exception to the rule which states that conditional gifts are not deductible; the exception is for a condition "so remote as to be negligible."[133] The Kaufmans argued there was virtually no chance the façade easement would be found to have no value at all, and therefore the condition was "so remote as to be negligible."[134] The court ruled the resolution of this question was inherently factual and denied the IRS's motion for summary judgment on that issue.[135]

With respect to the government's argument that the cash payment was a quid pro quo payment, the court noted that the government's argument appeared to be that "in return for the cash contribution, NAT accepted the façade

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[125] *Kaufman*, 134 T.C. at 109–10.

[126] *Id.*

[127] *Id.* at 107–08.

[128] *Id.* at 108.

[129] *Id.*

[130] *Id.* at 109.

[131] *Id.* (citing 26 C.F.R. § 1.170A-1(e) (2010)).

[132] *Id.* at 109–10 (citing Hernandez v. Comm'r, 490 U.S. 680, 690 (1989) (emphasis added)).

[133] *Id.* at 109 (discussing the exception set forth in 26 C.F.R. § 1.170A-1(e)).

[134] *Id.*

[135] *Id.*

easement contribution so that petitioners could claim a charitable contribution deduction."[136] The court ruled that even if the Kaufmans were required to make the cash payment, it was not convinced the fact the payment was *required* was sufficient to deny the deduction and denied the motion for summary judgment on that issue as well.[137]

In *Scheidelman v. Commissioner*, Ms. Scheidelman, like the Kaufmans, was required to make a cash contribution in connection with her façade easement contribution to NAT.[138] Again, the government claimed that the payment was not deductible because it was a quid pro quo payment.[139] The court addressed this challenge in detail, summarizing the basic rules governing deductibility of a contribution:

> A payment of cash to a qualified organization may be deductible under section 170 if the payment is a "contribution or gift". A payment of money or transfer of property generally cannot constitute a charitable contribution if the contributor expects a substantial benefit in return. See *United States v. Am. Bar Endowment*, 477 U.S. 105, 116 (1986).
>
>> If a transaction is structured in the form of a quid pro quo, where it is understood that the taxpayer's money will not pass to the charitable organization unless the taxpayer receives a specific benefit in return, and where the taxpayer cannot receive the benefit unless he pays the required price, then the transaction does not qualify for the deduction under section 170.
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> *Graham v. Commissioner*, 822 F.2d 844, 849 (9th Cir.1987), affd. sub nom. *Hernandez v. Commissioner*, 490 U.S. 680 (1989).
>
> A taxpayer who receives or expects to receive a benefit in return for a purported contribution may nonetheless be allowed a deduction if the money or property transferred clearly exceeds the benefit received and the excess is given with the intent to

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[136] *Id.* at 110.

[137] *Id.* Even if the circumstances of the payment indicated that it could have a dual character as partially required and partially charitable, summary judgment would have been improper because such circumstances would have constituted a genuine issue of material fact. *See* Celotex Corp. v. Catrett, 477 U.S. 317, 325 (1986) (acknowledging the impropriety of summary judgment where there is a triable issue of genuine material fact).

[138] T.C.M. (RIA) 2010-151, 910 (2010).

[139] *See id.* at 919. Note that *Scheidelman* was decided in July 2010 and *Kaufman* in April 2010.

> make a gift. See *United States v. Am. Bar Endowment, supra* at 117. A taxpayer claiming a charitable contribution deduction under this "dual character" theory, however, "must at a minimum demonstrate that . . . [she] purposely contributed money or property in excess of the value of any benefit . . . [she] received in return." *Id.* at 117–118.[140]

The court ruled Ms. Scheidelman failed to refute the government's position and denied her claimed deduction for the cash payment.[141] A significant problem for Ms. Scheidelman was that NAT "required" the cash "contribution" as a pre-condition to acceptance of the easement.[142] This immediately jeopardized the deduction. Had NAT "suggested," "recommended," or even "requested" the cash payment rather than making it a mandatory part of acceptance of the easement, the outcome would have been different.

Raising funds for the monitoring and enforcement of conservation easements is of fundamental importance for land trusts. If a land trust can afford to ask for, but not require, a contribution from an easement donor and if the land trust has a record of accepting easements without payment of such a contribution, the contribution should be deductible.[143]

If the land trust requires the contribution directly, or if the land trust has a history indicating it will not accept easement contributions without accompanying cash contributions, then the cash payment is not deductible unless it is treated as a "dual character" contribution.[144] The difference is deductible, provided that both the donee and donor intend that the difference be a charitable contribution.[145]

However, in the case of a cash contribution accompanying the contribution of a conservation easement, the question becomes: What has the donor received from the donee in exchange for the cash contribution? If the donor has received goods and services in the form of baseline report preparation, surveys, or other similar benefits, and the donee quantifies the value of those benefits, and they are less than the contribution, assuming proper substantiation, the donor may deduct

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[140] *Id.*

[141] *Id.*

[142] *Id.* at 910.

[143] United States v. Am. Bar Endowment, 477 U.S. 105, 117–18 (1986) (holding that a purely voluntary payment to a public charity, made with the intention of making a charitable contribution, is deductible as a charitable contribution).

[144] *See id.* at 117 (holding that a dual character contribution is one in which the donor receives something from the donee in exchange for a contribution that is less valuable than the contribution).

[145] *Id.*

the difference between the contribution and the value of the goods and services received in exchange.[146]

On the other hand, if what the donor has received is the donee's agreement to accept the conservation easement, the government may argue that the value of the goods and services received in exchange for that contribution is the value of the tax deduction, in which case the value received would significantly offset the value of the cash contribution.[147] The problem with this argument is that by accepting the conservation easement the donee has caused the donor to give up substantial development value typically far in excess of the value of the tax deduction. It is hard to see how the government could be successful in ignoring what the donor gave up to obtain the deduction by arguing the tax deduction was a *net* benefit to the donor.

If a land trust truly cannot afford to accept easement contributions without an accompanying cash contribution, it should simply require the contribution and make no effort to make that contribution deductible. In most cases the tax deduction from the easement contribution is far more substantial than the deduction from the cash contribution would be, and the deduction more than covers the cost to the donor of making the cash contribution.[148] Furthermore, if the donor is serious about conserving his or her land, it is in the easement donor's interest to ensure that the contributed conservation easement can be enforced long after the donor is gone.

C. Subordinations

In order for the contribution of a conservation easement to be deductible, the easement must be granted in perpetuity.[149] Any mortgage in force at the time of the contribution must be subordinated to the "right of the qualified organization to enforce the conservation purposes of the gift in perpetuity."[150] In the past,

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[146] *Id.* at 113, 117. Written acknowledgment of the contribution from the donee and a statement of the value and nature of goods and services received in exchange is required for the donation to be allowable. 26 C.F.R. § 1.170A-14(g)(5)(i) (2011). Baseline reports, descriptions of the natural resources, and other features of property to be made subject to a conservation easement satisfy this requirement. *See id.*; *see also supra* notes 49–56 and accompanying text.

[147] *See* Kaufman v. Comm'r, 134 T.C. No. 9, 110 (2010) ("Respondent seems to argue that, in return for the cash contribution, NAT [the donee] accepted the facade easement contribution so that petitioners could claim a charitable contribution deduction.").

[148] Note that in *Scheidelman*, the easement donor did not claim a deduction for the cash contribution until her deduction for contribution of the conservation easement was challenged. T.C.M. (RIA) 2010-151, 919 (2010).

[149] 26 C.F.R. § 1.170A-14(b)(2), (g)(1).

[150] *Id.* § 1.170A-14(g)(2).

compliance with this requirement was not typically a problem. However, as land values recently have declined and foreclosures increased, mortgagees are becoming (as they should be) more cautious about subordinating their rights to conservation easements. After all, conservation easements can strip away a considerable part of the value of the mortgagee's security. Of course, so long as there remains sufficient equity in the easement property after the easement is in place to adequately secure the mortgagee's interests, there should be no problem.[151]

The *Kaufman* case, discussed above, provides the first recorded decision dealing with subordination and conservation easements.[152] The Kaufmans lost their façade easement deduction because the subordination of the mortgage on their residence failed to satisfy the requirements of 26 C.F.R. § 1.170A-14(g)(2). Specifically, the subordination gave the mortgagor a first claim to any condemnation awards, or the proceeds of any insurance payments, that might be generated from a condemnation or destruction of all or a portion of the property subject to the façade easement.

The court noted the law requires a deductible easement vest the donee organization with a property right that has a value that is a fixed percentage of the value of the underlying property.[153] That value is equal to the percentage of the unrestricted value of the property represented by the easement.[154] As the court found, the law requires,

> when a change in conditions give rise to the extinguishment of a perpetual conservation restriction . . . , the donee organization, on a subsequent sale, exchange, or involuntary conversion of the subject property, must be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction . . . .[155]

The Kaufmans argued that, in the event of the extinguishment of the easement, the question of whether or not the donee was entitled to its proportionate share of proceeds was a question of fact and that the government's motion for summary judgment should be denied.[156] However, the court ruled the donee's right to its

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[151] However, the author has run into situations where mortgagees balked at subordinations even when it was clear that the remaining security was vastly more valuable than the secured debt and where the easement was granted to obtain approval of an increase in density on a portion of the mortgagee's security that would enhance its value. As is typical with pendulum swings, at either extreme they are rarely sensitive to facts.

[152] *See generally Kaufman*, 134 T.C. No. 9.

[153] *Id.* at 108.

[154] *Id.*

[155] *Id.* (citing 26 C.F.R. § 1.170A-14(g)(6)(ii)).

[156] *Id.* at 109.

proportionate share of the proceeds had to be absolute, not conditional.[157] The court found the mere possibility that the mortgagee might be entitled to the proceeds resulting from condemnation or destruction of the easement property denied the donee its required *absolute* right and, as a matter of law, violated the requirements for deductibility.[158] The court granted the government's motion for summary judgment on this issue, thus effectively disposing of the case and the Kaufman's $220,000 income tax deduction.[159]

One of the fundamental requirements for the deductibility of a conservation easement is that the easement be permanent.[160] If, for any reason, the easement is extinguished in whole, or in part, and the property is subsequently sold, a portion of the sales proceeds represents the easement and must go to the land trust.[161] As *Kaufman* makes clear, failure to guarantee that such proceeds go to the holder of the easement violates the requirement that the conservation easement be perpetual.[162]

The law speaks specifically of mortgages; however, there are other recorded interests that may also preempt an easement holder's right to the required portion of proceeds.[163] While the letter of the law is limited to mortgages, the spirit of the law requires that nothing intervene in the rights of the easement holder to receive proceeds resulting from the extinguishment of a conservation easement.

Given the fact that a failure to comply strictly with the law regarding the deductibility of a conservation easement contribution may result in the permanent restriction of property but no tax deduction for that restriction, it would seem

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157 *Id.*

158 *Id.*

159 *Id.*

160 26 U.S.C. § 170(h)(2)(C) (2006).

161 *Kaufman*, 134 T.C. at 108–09 (citing 26 C.F.R. § 1.170A-14(g)(6) (2011)).

162 *Id.* at 109. The government's opening brief filed in *Kaufman* cited several examples of mortgage subordination clauses of which it approved. One was from the Compact of Cape Cod Conservation Trusts, which reads as follows:

> [Name and address of financial institution] ("Mortgagee"), present holder of a mortgage from, [donors] ("Mortgagor"), recorded on [date] in the [County] Registry of Deeds in Deed Book [ ] Page [ ], for consideration paid, hereby recognizes and assents to the terms and provisions of a Conservation Restriction running to the Conservation Trust, to be recorded herewith, and agrees to subordinate and hold its mortgage subject to the terms and provisions of said Conservation Restriction to the same extent as if said mortgage had been recorded subsequent to the recording of the Conservation Restriction, and the undersigned shall, in the exercise of its rights pursuant to said instrument, recognize the terms and provisions of the aforesaid Conservation Restriction.

Brief of Respondent at n.13, *Kaufman*, 134 T.C. No. 9 (No. 15997-09).

163 *E.g.*, provisions in restrictive covenants imposing a lien on property for the payment of dues and assessments.

best to honor the spirit of the law here, not just the letter. In other words, any interest pre-existing recordation of a conservation easement that might preempt the easement holder's right to enforce the easement, or to receive proceeds from extinguishment of the easement, should be unconditionally subordinated to the land trust's right to enforce the conservation purposes of the gift in perpetuity.

In general it is recommended that taxpayers include a copy of any subordination with the packet of information substantiating charitable deductions for conservation easements. It is also recommended that this packet include a completely-filled-out *Form 8283*, the schedule required by the instructions to *Form 8283*, a copy of the "documentation" (typically known as the baseline, or baseline inventory) required by 26 C.F.R § 1.170A-14(g)(5)(i), a copy of the recorded easement and, if the conservation easement exceeds $500,000, a copy of the qualified appraisal.

D. Trusts

Land is often held in trust. Typically these trusts are so-called "grantor" trusts which reserve to the settlor the right to revoke or modify the trust at will.[164] Grantor trusts are ignored for tax purposes, and the contribution of a conservation easement by a grantor trust is treated the same as though the owner of the trust had made the contribution.[165]

In *Goldsby v. Commissioner*, Mr. Goldsby created a trust naming his son the trustee and sole income beneficiary.[166] The court determined that the son was the owner of the income of the trust because he had the right to direct all of the income to himself or for his own benefit.[167] However, the trust provided

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[164] 26 U.S.C. § 674(a). "Grantor trust" is a term used to describe any trust over which the grantor or other owner retains the power to control or direct the trust income or assets. *See id.* §§ 671–679 (defining the characteristics of grantor trusts). If a grantor retains certain powers over or benefits in a trust, the income of the trust will be taxed to the grantor, rather than to the trust. *Id.* §§ 61, 671. These powers include, among others, the power to decide who receives income, the power to vote or to direct the vote of the stock held by the trust or to control the investment of the trust funds, and the power to revoke the trust. *Id.* §§ 673–677. All "revocable trusts" are by definition grantor trusts. *Id.* § 676(a). An "irrevocable trust" can be treated as a grantor trust if any of the definitions contained in Internal Revenue Code §§ 671, 673, 674, 675, 676, or 677 are met. *See id.* §§ 674(b), 677(a) (excepting only some forms of irrevocable trusts from the purview of grantor trusts). If a trust is a grantor trust, then the grantor is treated as the owner of the assets, the trust is disregarded as a separate tax entity, and all income is taxed to the grantor. *Id.* §§ 61, 671; *see Abusive Trust Tax Evasion Schemes—Questions and Answers*, IRS.GOV, http://www.irs.gov/businesses/small/article/0,,id=106551,00.html (last updated Jan. 21, 2011) (anticipating and answering questions about forms of trusts and related evasion schemes).

[165] 26 U.S.C. §§ 61, 671.

[166] T.C.M. (RIA) 2006-274, 1754 (2006).

[167] *Id.* at 1757.

that the corpus of the trust was to be distributed to Mr. Goldsby's grandchildren upon his son's death.[168] Over the years the trust acquired substantial real property which it ultimately protected with conservation easements.[169] The sole income beneficiary, the son, claimed the value of these contributions as deductions on his individual income tax return believing that the deductions passed through to him under grantor trust principles.[170] The government challenged both the easement's valuation and the son's right to take the deductions.[171]

The court ruled that because the son had no right to the land in the trust (the corpus) he did not own the corpus.[172] Contributions of any portion of the trust owned by a beneficiary are deductible by the beneficiary; however, contributions from portions of a trust not owned by a beneficiary are not deductible by the beneficiary.[173] The court found that the conservation easements, having been conveyed over property comprising the corpus of the trust, did not pass through to the beneficiary. Therefore, the court denied the beneficiary's right to a deduction:

> A person is treated as the owner of any portion of a trust with respect to which that person has the power, solely exercisable by himself or herself, to vest the corpus or the income in himself or herself. When a person is treated as the owner of a portion of a trust under section 678, special rules apply to not tax the trust directly. Instead, the person treated as the owner takes into account the trust's items of income, deduction, and credit attributable to that portion of the trust.
>
> If the trust makes a donation to charity from that portion of the trust, the person who is treated as the owner of that portion may cumulate those charitable donations with the person's own charitable donations and deduct them under section 170.[174]

There are other issues implicating contribution of a conservation easement by an irrevocable trust. An important one is the fiduciary obligation of a trustee to protect the corpus and the interest of the beneficiaries.[175] In the absence of express authority in the trust instrument for the contribution of trust assets to

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168 *Id.* at 1754.

169 *Id.* at 1755.

170 *Id.*

171 *Id.* at 1756.

172 *Id.* at 1757.

173 *Id.* at 1756–57.

174 *Id.* at 1756 (citations omitted).

175 *Id.* at 1757 & n.5.

charities, any charitable contribution would seem to violate the trustee's fiduciary obligation. Obtaining judicial authority for such contributions, particularly where there are minor or unborn beneficiaries, is likely to be difficult, if not impossible. *Goldsby* thus underscores the importance of determining the consequences of title to property for the deductibility of contributions made by the title holder.[176]

E. Sham Transactions

The phrase "sham transactions" is intended to be inclusive of the various labels applied to efforts to challenge tax-related transactions for lack of substance, including the economic substance doctrine, the business purpose doctrine, and the step transaction doctrine. The issues discussed in the cases above have been largely technical, and the law governing those issues, while occasionally complex, is fairly clear-cut. On the other hand, the law governing sham transactions is both multi-faceted and subjective.[177] Sham transactions have largely been limited to highly complex business structures intended to take maximum advantage, without real substance, of various features of the Code.[178] Conservation transactions have typically not inhabited such questionable territory.[179] However, the recent case of *Klauer v. Commissioner* demonstrates that the government does not consider conservation transactions immune from sham transaction challenges.[180] In addition to *Klauer*, Congress recently enacted a statutory definition of the "economic substance doctrine," which sets standards for the evaluation of various transactions' substance versus form.[181] The provisions and possible application of this new law to conservation transactions are considered first, followed by a look at *Klauer*.

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[176] *See id.* at 1758–59 (determining that deductions were not available to the petitioner because he did not hold proper title). Not only are trusts problematic, so too are corporations. C. TIMOTHY LINDSTROM, A TAX GUIDE TO CONSERVATION EASEMENTS 133–42 (2008) (discussing the implications for easement contributions of different types of landowner entities).

[177] *See* Robert W. Wood, *Economic Substance: Who and Why?*, 11 M&A TAX REP., May 2003, at 1. A "sham transaction" is one entered into for no business or economic purpose other than the avoidance of tax. *Id.*

[178] *See, e.g.*, Cottage Sav. Ass'n v. Comm'r, 499 U.S. 554, 556–58 (1991) (analyzing the nature of a technical regulatory transaction by a savings and loan association); Gregory v. Helvering, 293 U.S. 465, 467 (1935) (analyzing the nature of a reorganization of a large corporation).

[179] Although, until recently, transactions involving conservation easements were included on the IRS's "Dirty Dozen" listing of questionable tax shelters.

[180] *See* T.C.M. (RIA) 2010-65 (2010); *see also infra* notes 199–221 and accompanying text (discussing *Klauer*).

[181] 26 U.S.C.A § 7701(o) (West 2011); *accord* Health Care and Education Affordability Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409(a), 124 Stat. 1029, 1067 (amending 26 U.S.C. § 7701(o)).

1. *Codification of the "Economic Substance Doctrine"*

The economic substance doctrine is intended to ensure that the tax consequences of a transaction are a result of the substance of the transaction rather than the form of the transaction.[182] "In general, this doctrine denies tax benefits arising from transactions that do not result in a meaningful change to the taxpayer's economic position other than a purported reduction in Federal income tax."[183] A related doctrine, the "business purpose doctrine" "involves an inquiry into the subjective motives of the taxpayer—that is, whether the taxpayer intended the transaction to serve some useful non-tax purpose."[184]

The sham transaction doctrine[185] has been a part of the federal common law since the United States Supreme Court decision of *Gregory v. Helvering*.[186] Since then, the doctrine has been applied by many courts in many different ways.[187] In an effort to "clarify and enhance application of the doctrine"[188] Congress recently amended § 7701 of the Code by adding a new subsection.[189] In addition, Congress increased penalties for transactions found to violate the newly defined economic substance doctrine (or any other similar common law doctrine[190]) by amending §§ 6662 and 6664 of the Code.[191]

To date, the doctrine has not been applied to transactions involving conservation easements in any reported case. However, there is no reason why the doctrine would not apply to certain types of conservation transactions. A brief summary of the provisions of the new federal law and some consideration of how the law might apply to conservation transactions in the future follows.

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[182] King Enters., Inc. v. United States, 418 F.2d 511, 517 (Ct. Cl. 1969).

[183] JOINT COMM. ON TAXATION, JCX-18-10, TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF THE "RECONCILIATION ACT OF 2010," AS AMENDED, IN COMBINATION WITH THE "PATIENT PROTECTION AND AFFORDABLE CARE ACT" 142 (2010) [hereinafter JCT REPORT].

[184] *Id.* at 143.

[185] *See supra* notes 177–81 and accompanying text (noting, for the purposes of this article, "sham transaction" serves as shorthand for related doctrines, including the economic substance doctrine and the step transaction doctrine).

[186] 293 U.S. 465, 470 (1935) (finding that a corporate reorganization had no purpose other than tax avoidance since "[t]he whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization").

[187] JCT REPORT, *supra* note 183, at 143–44.

[188] *Id.* at 152.

[189] Health Care and Education Affordability Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409(a), 124 Stat. 1029, 1067 (amending 26 U.S.C. § 7701(o)).

[190] *Id.* § 1409(b); 26 U.S.C.A. § 6662(b)(6) (West 2011).

[191] Health Care and Education Affordability Reconciliation Act of 2010 § 1409(b)–(d).

New subsection (o) of § 7701 of the Code provides,

> (1) APPLICATION OF DOCTRINE—In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—
>
> > (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and
> >
> > (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.[192]

In adopting this definition, Congress attempted to incorporate both the common law principles of the economic substance doctrine (considered an objective test[193]) in subparagraph (A) and the principles of the "business purpose test" (considered a subjective test[194]) in subparagraph (B). Many commentators have already pointed out that the lack of a statutory definition for "meaningful" or "substantial" renders the new section as ambiguous and uncertain as the plethora of common law principles and applications it is intended to clarify.[195] The new section exempts personal transactions of individuals from its application, provided the transaction is not in connection with (1) a trade or business or (2) an activity engaged in for income production.[196] Yet, this exemption does not mean that personal transactions of individuals are no longer subject to the common law rules governing sham transactions. Those rules, by their various appellations, remain applicable to such personal transactions. In fact, according to the Joint Committee on Taxation, the codification of the economic substance doctrine is "additive" to existing common law, not a replacement for the common law.[197] The

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[192] 26 U.S.C.A. § 7701(o)(1).

[193] JCT REPORT, *supra* note 183, at 143.

[194] *Id.*

[195] *See, e.g.*, Thomas E. Taylor, *Codification of the Economic Substance Doctrine by the Health Care and Education Affordability Reconciliation Act of 2010*, MCGUIREWOODS, 8 (Apr. 9, 2010), http://www.mcguirewoods.com/news-resources/publications/taxation/Economic%20Substance%20Codification.pdf.

[196] 26 U.S.C.A. § 7701(o)(5)(B).

[197] JCT REPORT, *supra* note 183, at 155. The report states,

> No inference is intended as to the proper application of the economic substance doctrine under present law. The provision is not intended to alter or supplant any other rule of law, including any common-law doctrine or provision of the Code or regulations or other guidance thereunder; and it is intended the provision be construed as being additive to any such other rule of law.

Id.

logical inference from this is that *all* of the existing common law remains in place and the new codification becomes an additional basis upon which transactions may be challenged for lack of substance other than tax avoidance.[198]

The new law, as well as the pre-existing common law, will apply to conservation transactions engaged in by corporations, limited liability companies, and partnerships, all of which are increasingly engaging in conservation transactions, often because of ownership structures created to hold family farms and ranches.[199]

2. Klauer v. Commissioner

Klauer v. Commissioner is the first reported case in which the government challenged a conservation transaction using the "step transaction doctrine."[200] The step transaction doctrine is another means of evaluating potential sham transactions.[201] Under the step transaction doctrine, "[s]teps that are transitory, meaningless, or lacking in a nontax, business purpose may be disregarded for purposes of determining the true nature of a transaction."[202]

The step transaction doctrine is closely related to the "economic substance doctrine" but has been differentiated from that doctrine.[203] Codification of the economic substance doctrine "is not intended to alter or supplant any other rule of law, including any common-law doctrine or provision of the Code or Regulations or other guidance thereunder" and is merely "additive."[204] Therefore,

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198 *See id.* (calling new § 7701(o) "additive"). It is hard to understand how adding a new set of rules to the already numerous rules and concepts dealing with sham transactions can be considered a "clarification" as the Committee Report asserts.

199 Placing illiquid assets, such as land, in family limited partnerships, limited liability companies, and S corporations is a technique widely used to facilitate tax-free transfers using the annual gift tax exemption.

200 T.C.M. (RIA) 2010-065, 385 (2010).

201 *Id.* at 386.

202 *Id.*

203 Wood, *supra* note 177, at 1. Wood states,

> While these three concepts are often confused, I think one of them (at least) can be segregated and is truly a horse of a different color. The step transaction doctrine is procedural in nature, something that does not seek to examine whether a transaction makes sense, as the economic substance doctrine does (more about that later). Rather, the step transaction doctrine seeks to determine—regardless of the purpose of the overall series of items—whether ostensibly separate transactions ought to be integrated or stepped together, thus disregarding the overall form of the transaction for its quintessential result.
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> The step transaction doctrine, to a far greater extent than the economic substance doctrine and the sham transaction doctrine, is capable of close definition.

Id.

204 JCT REPORT, *supra* note 183, at 155.

it is presumed that the step transaction doctrine (which is not mentioned at all in the Joint Committee on Taxation Report) continues to apply both to businesses and individuals. In addition, the other common law tools for challenging sham transactions and the recent codification of the economic substance doctrine will also apply.

Although the government lost, *Klauer* underscores the importance of ensuring conservation transactions generating tax benefits have substance other than mere tax avoidance. *Klauer* did not involve a conservation easement; however, the issues raised in the case are directly applicable to many conservation easement transactions. In *Klauer*, an S corporation, Klauer Manufacturing (Klauer), entered into three options to bargain sell approximately 2581 acres (Property) located in Taos County, New Mexico, to The Trust for Public Land (TPL) for a price of $14.5 million.[205] At the time Klauer estimated the value of the land to be between $20 million and $21 million.[206] TPL anticipated receiving funds from the United States Land and Water Conservation Fund (Fund) for the purchase.[207] However, because appropriations to the Fund were limited annually, TPL could not raise sufficient amounts to purchase all of the Property in one transaction.[208] Furthermore, TPL could not be sure of obtaining funds in the future.[209]

Because of the uncertainty over obtaining funds to pay the entire $14.5 million purchase price, TPL structured the transaction as three options, with each option covering a portion of the Property and exercisable solely in TPL's discretion.[210] Due to funding and appraisal issues, the three options were modified by TPL and Klauer into six options, and the total purchase price was increased to $15 million. TPL successfully raised the necessary $15 million, and all of the options were exercised by the end of 2003.[211] Klauer claimed charitable deductions in 2001, 2002, and 2003 totaling approximately $5.8 million.[212]

The government argued that the series of sales constituted "steps" of a transaction, the sole purpose of which was tax avoidance.[213] The government asserted that these steps should be "collapsed" so that the entire series of sales

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[205] *Klauer*, T.C.M. (RIA) 2010-065 at 370–71. See also *Historic Boardwalk Hall, LLC v. Commissioner*, 136 T.C. 1 (2011), for an even more recent (and failed) attempt by the IRS to apply the step transaction doctrine, in this case to the allocation of historic rehabilitation credits.

[206] *Klauer*, T.C.M. (RIA) 2010-065 at 372.

[207] *Id.*

[208] *Id.*

[209] *Id.*

[210] *Id.* at 372–75.

[211] *Id.* at 375–83.

[212] *Id.* at 383–84.

[213] *Id.* at 385.

would be treated as one sale for $15 million in 2001. The court noted that the parties had agreed that if the steps were collapsed, there would be no deduction.[214] The government sought an additional $1,336,629 in taxes from Klauer's shareholders.[215]

The court examined three alternative tests for application of the doctrine:

> The step transaction doctrine is in effect another rule of substance over form; it treats a series of formally separate "steps" as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result. . . . There is no universally accepted test as to when and how the step transaction doctrine should be applied to a given set of facts. Courts have applied three alternative tests in deciding whether to invoke the step transaction doctrine in a particular situation.
>
> The narrowest alternative is the "binding commitment" test, under which a series of transactions are collapsed if, at the time the first step is entered into, there was a binding commitment to undertake the later step.
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> . . . .
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> . . . That test "requires telescoping several steps into one transaction only if a binding commitment existed as to the second step at the time the first step was taken."[216]

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[214] *Id.* at 385 n.38 ("The parties agree that if the Court were to find that the step transaction doctrine applies, petitioners would not be entitled to the charitable contribution deductions at issue and that if the Court were to find that the step transaction doctrine does not apply, petitioners would be entitled to those deductions."). This seemingly strange agreement resulted in a waiver of Klauer's right to claim a bargain sale deduction for the transaction, even if it were collapsed. Presuming that Klauer's appraisal supported the fact that the $15 million sale price was below the fair market value of the Property (and the appraisals used by TPL to support the purchase showed that the value of the Property was approximately $20.45 million) even if the six different sales were collapsed into one sale, there would still have been a charitable contribution of $5.45 million. The sole consequence of "collapsing" the steps in the transaction should have been that the charitable deduction for the bargain sale would be limited to the year 2001 (plus the five-year carry-forward for unused charitable deductions).

[215] *Id.* at 370.

[216] *Id.* at 386–87 (citations omitted) (quoting Penrod v. Comm'r, 88 T.C. 1415, 1428–30 (1987) and Sec. Indus. Ins. Co. v. United States, 702 F.2d 1234, 1245 (5th Cir. 1983)).

The court found that the "binding commitment" test did not apply because there were no guarantees TPL would receive the funding necessary to exercise the options and TPL had no obligation to exercise any or all of the options.[217]

> At the other extreme, the most far-reaching alternative is the "end result" test. Under this test, the step transaction doctrine will be invoked if it appears that a series of formally separate steps are really prearranged parts of a single transaction intended from the outset to reach the ultimate result.
>
> . . . .
>
> . . . Under that test, "purportedly separate transactions are to be amalgamated when the successive steps were designed and executed as part of a plan to achieve an intended result."[218]

The court found the "end result" test did not apply because

> the Trust's exercise of each of various options that it had under the Option Agreement as amended and its purchase of each of specified portions of the Taos Overlook pursuant to the exercise of each of those options were not component parts of a single transaction that Klauer Manufacturing intended and prearranged from the outset be taken in order to sell to the Trust the approximately 2,581 acres of the Taos Overlook.[219]

The court next turned to the third test:

> The third test is the "interdependence" test, which focuses on whether "the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series."
>
> . . . .
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> . . . That test focuses on "whether the individual steps in a series had independent significance or whether they had meaning only as part of the larger transaction. This test concentrates on the relationship between the steps, rather than on their "end result."[220]

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[217] *Id.* at 387–88.

[218] *Id.* at 386, 388 (citations omitted) (quoting *Penrod*, 88 T.C. at 1429, and *Sec. Indus. Ins. Co.*, 702 F.2d at 1246).

[219] *Id.* at 391.

[220] *Id.* at 386, 391–92 (citations omitted) (quoting *Penrod*, 88 T.C. at 1430, and *Sec. Indus. Ins. Co.*, 702 F.2d at 1246).

The court rejected application of this test as well, finding that each of the options in the transaction had independent meaning and that TPL's purchase of a portion of the property under any single option would not have been "fruitless."[221]

The facts of *Klauer* so overwhelmingly support the court's conclusions that it is hard, at least based on the facts recited in the opinion, to understand why the government challenged the transaction in the first place.

3. Examples and Discussion

Neither the economic substance doctrine nor the step transaction doctrine is likely to apply to most conservation transactions. In many complex transactions, particularly those where there is an attempt to syndicate a conservation easement deduction, other issues are likely to arise defeating the transaction without resorting to these doctrines.[222] However, one type of transaction, intended to qualify for the 100% write-off available under revived 26 U.S.C. § 170(b)(1)(E)(v)(I), provides an illustration of how the newly codified economic substance doctrine might be applied.

Example 1:

Suppose Jones Inc., a family-owned C corporation, has been approached by the XYZ Land Trust which wants to bargain purchase a conservation easement over the Jones Inc. ranch for 50% of the value of the easement. Jones Inc.'s income is entirely from the "business of farming" so the tax deduction available to Jones Inc. for the contribution portion of the bargain sale may be taken against 100% of Jones Inc.'s income.[223] However, income from the sale of a conservation easement is not considered income "from the business of farming."[224] Therefore, the bargain sale will disqualify Jones Inc. from enjoying the 100% write-off. To avoid this consequence, Jones Inc. and XYZ (which has all of the funding necessary for the purchase) agree to structure the sale as an installment sale. The conveyance of the easement is to be made at closing in exchange for a payment equal to an amount just under Jones Inc.'s anticipated income for that year. In addition, Jones Inc. will receive, at closing, a note from XYZ providing for the payment of the balance of the purchase price over the next five years.

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221 *Id.* at 393.

222 *See* LINDSTROM, *supra* note 176, at 115–28 (discussing donative intent and its application to various types of conservation transactions).

223 26 U.S.C. § 170(b)(2)(B) (2006); *see supra* Part II.B.

224 26 U.S.C. § 2032A(e)(5) (defining farming to include cultivating the soil, raising or harvesting agricultural products, and handling such products).

Let us examine this transaction from the perspective of the government under the new statutory definition of "economic substance."[225] First, does the transaction change in a meaningful way the taxpayer's economic position (apart from federal income tax effects)? The government could argue that at the beginning of the transaction Jones Inc. had an offer to purchase a conservation easement for a stated bargain sale price and afterwards it received that price. The only effect of the installment sale was to qualify Jones Inc. for the 100% write-off. There was no reason why the entire purchase price could not have been paid at closing. The only effect of the transaction was to change the income tax effects of the sale. As a result, the government could argue (1) that there was no economic substance to the transaction; (2) that Jones Inc. should be treated as having received the entire purchase price at closing; (3) that Jones Inc. should be required to report gain on that basis; and (4) that Jones Inc. also be prevented from writing off the charitable contribution portion of the bargain sale against 100% of its income.[226]

Second, did Jones Inc. have a substantial purpose (apart from federal income tax effects) for entering into such transaction? Here again, the government would seem to have a strong argument that the only possible motivation for the installment structure was tax avoidance—ensuring that more than 50% of Jones Inc.'s income came from the "business of farming" so that it could qualify for the 100% write-off.[227]

Jones Inc.'s best response is that the Code expressly sanctions installment sales so long as there is some risk future installments will not be paid.[228] In the first United States Supreme Court decision to deal with sham transactions, the Court stated that a motivation to avoid tax is not fatal to a transaction so long as the transaction is not outside the boundaries of the intent of the Code.[229] In other

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[225] 26 U.S.C.A. § 7701(o) (West 2011); *accord* Health Care and Education Affordability Reconciliation Act of 2010, Pub. L. No. 111-152, § 1409(a), 124 Stat. 1029, 1068 (amending 26 U.S.C. § 7701(o)).

[226] *See* 26 U.S.C.A. § 7701(o) (defining economic substance). The consequence would be to limit the write-off to 10% of Jones Inc.'s taxable income as it is a C corporation. 26 U.S.C. § 170(b)(2)(A).

[227] *See* 26 U.S.C. § 170(b)(1)(E)(v)(I) (allowing the 100% write-off for qualified farmers and ranchers).

[228] *Id.* § 453. The requirement of risk is met by the seller's acceptance of a promissory note, even if the note is secured. However, escrowing funds to cover future payments would lack the element of risk and disqualify the sale for installment treatment.

[229] Gregory v. Helvering, 293 U.S. 465, 469 (1935). The Court stated,

> The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.

Id. (citations omitted).

words, Jones Inc. may rely on provisions of the Code to avoid tax, provided that the provision relied on was intended to allow installment sales to defer income. In this hypothetical, the income deferral was expressly for the purpose of qualifying Jones Inc. for the 100% write-off.

However, the intent behind the installment sales provision was to provide a method of accounting that allows a taxpayer to defer realization of gain, where a sale was made in installments, to give the taxpayer sufficient liquidity to pay taxes when due.[230] In this hypothetical, Jones Inc. is not confronted with a sale that can only be made in installments because XYZ has all the funds necessary to complete the purchase in hand. Therefore, Jones Inc. does not need to rely on the installment sales provisions in order to match its tax liability with income from the sale. Instead, Jones Inc. is deliberately seeking installment sales treatment to qualify for other tax benefits.[231]

The result of the installment structure in this example would be quite different if XYZ did not have the funds in hand to pay the entire purchase price up front. In that hypothetical, the facts would be more like those of *Klauer*.

Example 2:

Another situation in which the government might attempt to apply the step transaction doctrine or the economic substance doctrine is that in which a landowner "phases" a series of conservation easement contributions over time.[232] Assume the year is 2012 and Congress has not renewed the fifteen-year carry-forward provisions which currently expire at the end of 2011.[233] Rancher Will wants to contribute a conservation easement on his 500-acre ranch. The proposed

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[230] Fred C. Chandler, *The Installment Sales Provisions of Internal Revenue Code Section 453*, 7 RUTGERS-CAMDEN L.J. 428, 428 (1976).

[231] *See supra* notes 223–30 and accompanying text. The arguments supporting Jones Inc. could be further extrapolated and might even become convincing; however, it is beyond the scope of this article.

[232] Phasing conservation easements was particularly useful when the carry-forward period for unused deductions was limited to five years. The strategy was this: when the value of a conservation easement over an entire tract of land would generate a deduction greater than the landowner could use within the statutory period, the landowner would only place a conservation easement on so much of the land as would generate a deduction that could be completely used within the statutory period.

[233] *See* Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 723, 124 Stat. 3296, 3316 (extending the expiration of applicable provisions to December 31, 2011). After 2011, the carry-forward period would presumably revert to five years. *Compare* 26 U.S.C. § 170(b)(1)(B) (establishing a five-year carry-forward generally), *with* 26 U.S.C.A. § 170(b)(1)(E) (West 2011) (establishing a fifteen-year carry-forward, which will expire on December 31, 2011).

easement is appraised at a value of $3 million, generating a federal income tax deduction of an equal amount. However, Will's annual income will only allow him to use $1 million of the deduction within the six years allowed by the law.[234] Will decides to grant the easement over only 167 acres of the ranch, which will generate a deduction of about $1 million.[235] By 2017, Will has used up all of his deduction for this easement and grants a second easement over 166 acres of the ranch, which again generates a deduction of about $1 million. Will's income increases after 2017 and he writes the deduction for the second easement off by 2020, at which time he grants an easement over the remainder of the ranch, generating a deduction of around $1.2 million.

In 2021, the IRS sends a deficiency notice to Will notifying him that he owes $700,000 in additional income tax because it is disallowing the deductions for the contributions made in 2017 and 2020. Using the step transaction doctrine, the government argues that (1) the three easements constitute three steps in a transaction whose only purpose was tax avoidance; (2) these steps should be collapsed into one step; and (3) Will should be treated as having contributed only one conservation easement over the entire 500 acres in 2012.[236]

Let us examine the government's challenge using the three tests found in *Klauer.* First, the "binding commitment" test.[237] As noted, this test "requires telescoping several steps into one transaction only if a binding commitment existed as to the second step at the time the first step was taken."[238] Clearly, there was no obligation for Will to contribute any of these conservation easements, let alone all of them. Therefore, the binding commitment test does not apply.

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[234] *See* 26 U.S.C. § 170(b)(1)(B) (providing for a five-year expiration). Again, remember that this assumes that the fifteen-year carry-forward period has expired. *See* sources cited *supra* note 233.

[235] *See* 26 U.S.C. § 170(b)(1)(E)(v)(I) (limiting the deduction to 100% of income). Actually slightly less because the easement will increase the value of the remaining unprotected portion of the ranch reducing the value of the easement on the 167 acres by an equivalent amount.

[236] The newly codified "economic substance doctrine" cannot be applied in this case because Will is an individual and the transaction was not one for the purpose of generating income. *See* 26 U.S.C.A. § 7701(o)(5)(B) (limiting the applicability of the economic substance doctrine to individuals engaged in an activity for the production of income). Note also by making its challenge in 2021, the IRS has preserved its claim against the easement contributed in 2017 as well as that contributed in 2020 because the three-year statute of limitations did not cease to run on the 2017 contribution until the last deduction from that contribution was claimed in 2019. *See* 26 U.S.C. § 6501(a) (requiring the IRS to assess tax within three years after the tax return is filed); 26 C.F.R. § 301.6501(a)-1 (2011) (barring the IRS from initiating a judicial proceeding after three years after the date of filing).

[237] Klauer v. Comm'r, T.C.M. (RIA) 2010-065, 386–87 (2010).

[238] *Id.* at 386 (quoting Sec. Indus. Ins. Co. v. United States, 702 F.2d 1234, 1245 (5th Cir. 1983)).

Second, the "end result" test.[239] As noted, under this test "purportedly separate transactions are to be amalgamated when the successive steps were designed and executed as part of a plan to achieve an intended result."[240] The quote begs the question: what kind of intended result? Clearly, every transaction has some intended result. It must be assumed that if the intended result was entirely, or almost entirely, to avoid taxes, the transaction violates this test. This test requires us to look at Will's motivation in granting three easements rather than just one. "The taxpayer's subjective intent is especially relevant . . . because it allows us to determine whether the taxpayer directed a series of transactions to an intended purpose."[241] Obviously a significant part of contributing three easements rather than one was to maximize enjoyment of the charitable deduction associated with protecting the ranch, which is another way of saying "tax avoidance."

However, proving, and even understanding, motivation is extremely difficult. It would seem logical that unless there is no valid explanation other than tax avoidance for why Will structured the protection of the ranch, and particularly because a tax motivation is not by itself fatal, the protection of the ranch by three contributions rather than one should pass the end result test. At least one meaningful non-tax motivation for protecting the ranch in phases is the desire by the landowner to retain flexibility regarding future use of the ranch in the face of economic uncertainty.

This leads us to the third step transaction test, the "interdependence test."[242] This test looks at "whether the individual steps in a series had independent significance or whether they had meaning only as part of the larger transaction."[243] The protection of Will's ranch would appear to easily pass this test. This is because each contribution resulted in the meaningful protection of a portion of the ranch independently of whether additional protection occurred. In this regard, the result is much the same as in *Klauer* where the court found that failure by TPL to exercise any one option did not render "fruitless" those options it had exercised.[244] In other words, each of the series of steps leading to the complete protection of Will's ranch were independent of the others, not "interdependent."

While the newly codified economic substance doctrine should not apply to Will because he fits the exception to the law, had he owned his ranch in a corporate form or as a limited liability company, the law could have been applied.[245]

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[239] *Id.* at 386, 388–90.

[240] *Id.* at 388 (quoting *Sec. Indus. Ins. Co.*, 702 F.2d at 1246).

[241] *Id.* (quoting True v. United States, 190 F.3d 1165, 1175 (10th Cir. 1999)).

[242] *Id.* at 391.

[243] *Id.* (quoting *Sec. Indus. Ins. Co.*, 702 F.2d at 1246–47).

[244] *Id.* at 393.

[245] *See supra* note 196 and accompanying text (regarding this exception).

Therefore, an evaluation of the phased protection of Will's ranch under this new law is appropriate.

As noted earlier, the new law requires two inquiries.[246] First, whether protecting the ranch by three contributions rather than one changes in a meaningful way (apart from federal tax effects) Will's economic position. Because the three contributions preserved significant economic flexibility and value for Will over a number of years, the answer to this question is yes.

The second question is whether Will had a substantial purpose (other than tax avoidance) for structuring the transaction as he did. The analysis required to answer this question is very much like the analysis required to answer the "end result" test found in the step transaction doctrine. Arguably, so long as Will had a meaningful purpose for protecting the ranch in three phases other than tax avoidance, his purpose satisfies this test. As noted earlier, at least one meaningful non-tax purpose for Will's approach would be his desire to retain as much economic flexibility over time as possible while still ultimately protecting the ranch. Therefore, the likely answer to the second question posed by the codified economic substance test is also affirmative.

Example 3:

Finally, let us examine a relatively complex structure which has the effect of syndicating a conservation easement deduction. Suppose a development company has just completed a major "conservation development" in which ten residential lots are surrounded by 500 acres of open space. The company wants to be able to assure lot purchasers that the open space is permanently protected. It also wants to provide a tax incentive to interested lot buyers. It conveys the open space land to Open Land, LLC (Open Land) of which the development company is the sole member.

Open Land then enters into an option agreement with ABC Land Trust (ABC) in which Open Land agrees to bargain sell a conservation easement over the 500 acres for $5000. The option period does not begin until two years after the date upon which the option was exercised. During the two years before the option can be exercised, Open Land successfully sells all ten lots and also sells ten memberships in Open Land (representing the entire ownership of Open Land) to the lot purchasers for $10,000 each. At the end of this period ABC exercises the option and purchases the easement, paying the $5000 purchase price. Open Land

[246] 26 U.S.C.A. § 7701(o)(1) (West 2011).

obtains a qualified independent appraisal of the value of the easement, which shows that the value of the easement is $500,000. Each of Open Land's members claims their pro-rata share of the $495,000 deduction.[247]

The IRS several years later sends deficiency notices to all of Open Land's members disallowing their charitable deduction for Open Land's bargain sale of the conservation easement to ABC. It claims the transaction generating the conveyance of the easement violated the requirements of the newly codified "economic substance doctrine."[248]

First it is necessary to figure out exactly what aspect of the transaction is subject to challenge. This is best done by comparing the transaction that actually took place with an alternative transaction that could have taken place and eliminating the various steps of the transaction that were, arguably, not needed to achieve the end result.

Here the actual transaction involved the following steps: (1) conveyance of open space land by developer to wholly-owned Open Land; (2) grant of enforceable pledge by Open Land to land trust; (3) pledge conditioned on not being called for at least two years; (4) sale of memberships in Open Land to lot purchasers; (5) call of pledge by land trust; and (6) deduction claimed by members of Open Land.

An alternative approach with the same end result (i.e., bargain sale of a conservation easement on the 500 acres) would have been one in which the developer itself bargain sold the conservation easement to ABC, then conveyed the land to Open Land subject to the easement, and sold memberships in Open Land to the lot buyers. The result is the same as in the actual transaction: the 500 acres are protected and the lot buyers end up owning the 500 acres through memberships in Open Land.

Comparing these two approaches, the first question is: whether the actual transaction changes in a meaningful way (apart from federal tax effects) Open Land's members' (the relevant taxpayers in this situation) economic position over what would have resulted from the theoretical transaction. Under either alternative the members ended up with a one-tenth membership in Open Land; under either alternative Open Land ended up owning the 500 acres subject to a conservation easement. However, under the actual transaction the $5000 purchase price flowed

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[247] Note, for this to work the 500 acres must have been legally, physically, and financially developable. LINDSTROM, *supra* note 176, at 19–20. It could not have been required open space under any governmental approval of the development, or the bargain sale of the easement would have been a quid pro quo transaction in which the necessary donative intent to claim a charitable deduction was lacking. *Id.*

[248] *See* 26 U.S.C.A § 7701(o)(1) (codifying the economic substance doctrine).

through to the members of Open Land whereas in the theoretical transaction the purchase price of the easement went to the developer. Is this a "meaningful" change? Suppose that the bargain price of the easement had been $250,000 rather than merely $5000? We begin to see the problem with the undefined terms in the new law.

Again, using the comparison of the actual transaction with the theoretical transaction the second question required under the 2010 Tax Act is whether the members of Open Land had a substantial purpose (other than tax avoidance) for structuring the transaction as it was.[249] Of course, the first problem in answering this question is that, presumably, the members of Open Land, the lot buyers, had no hand in structuring the transaction. They merely wanted to purchase lots in the development and the structure was dictated by the developer. If the developer's motivation is examined, it certainly was not tax avoidance, at least for itself. It was marketing residential lots in a manner that included a tax incentive to purchasers.

However, overall we can analyze whether the transaction was structured with a substantial purpose other than tax avoidance. Clearly the developer intended to provide tax benefits to lot purchasers. While the tax benefits were not for the developer's benefit, the purpose was still tax avoidance. Also, the developer, as a developer, might have had a difficult time claiming the tax benefits for itself.[250] By transferring the tax benefits that the developer could not enjoy to the lot purchasers who could, the developer was making possible tax deductions that could not otherwise have been used. It is difficult to impute these motivations to the lot buyers, unless they were given a choice to purchase under the actual transaction or the theoretical transaction. The lot buyers had no choice regarding the structure of the transactions. Therefore, it is hard to argue that they, as the taxpayers whose deductions were challenged, had any motivation other than purchasing lots in this particular development. Such a motivation would not appear to violate the economic substance doctrine.

The government might have an easier time challenging this transaction under the step transaction doctrine than under the 2010 Tax Act, for reasons I will leave to the reader to analyze. However, the increased penalties provided by the new law would not be available in that case.

IV. CONCLUSION

The tax rewards of the contribution or bargain sale of a conservation easement have never been greater. However, the risks involved in permanently protecting one's land in the expectation of receiving these benefits have also never been

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[249] *Id.* § 7701(o)(1)(b).

[250] *See* LINDSTROM, *supra* note 176, at 129–33 (discussing issues faced by developers claiming charitable contributions for conservation easements related to development projects).

greater. After years of neglect, the IRS is bearing down on conservation easements and conservation transactions. As the cases discussed in this article demonstrate, the focus has become minute, making it even more imperative that one "read the Regulations, read the Regulations, and read the Regulations."[251]

Traditionally the focus of the IRS has been on the valuation of conservation easements, and that still remains true today.[252] However, the IRS has increasingly been successful in challenging easement deductions for technical failures to comply with the Code and Regulations. When the government wins this latter type of case, the consequence is the loss of the entire deduction, not just a reduction.

Conservation easement law has become highly specialized. Except for sham transaction issues, the rules are pretty clear—there are just a lot of them. No one should be deterred from contributing a conservation easement and claiming a reasonable deduction for that contribution, so long as the transaction is guided from beginning to end (including review of the appraisal and the filing of the *Form 8283*) by knowledgeable tax counsel. The days when a land trust and a landowner could expect to sit down on their own, negotiate a conservation easement, draft it, sign it, and be done with it, are definitely over.

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[251] *See supra* notes 46–248 and accompanying text. As my friend Stephen J. Small, one of the authors of the original conservation easement regulations, likes to say, "And *comply* with the Regulations."

[252] Since 1985 there have been approximately thirty reported cases in which the issue was the valuation of a conservation easement. This excludes cases in which a deduction was entirely disallowed for technical reasons. Of those cases, five were ones in which the taxpayer was able to salvage 100% of the original deduction. The closest to a zero valuation was a case in which the taxpayer could only salvage 0.8% of the original deduction. The average amount of the original deduction retained by taxpayers in all thirty cases was 62.04% and the median was 62.1%. *See* McLennan v. United States, 24 Cl. Ct. 102 (1991), *aff'd*, 994 F.2d 839 (Fed. Cir. 1993); Richmond v. United States, 699 F. Supp. 578 (E.D. La.1988); Todd v. United States, 617 F. Supp. 253 (W.D. Pa. 1985); Trout Ranch v. Comm'r, T.C.M. (RIA) 2010-283 (2010); Hughes v. Comm'r, T.C.M. (RIA) 2009-094 (2009); Kiva Dunes Conservation v. Comm'r, T.C.M. (RIA) 2009-145 (2009); Simmons v. Comm'r, T.C.M. (RIA) 2009-208 (2009); Whitehouse Hotel v. Comm'r, 131 T.C. 112 (2008); Strasburg v. Comm'r, T.C.M. (RIA) 2000-094, 513–14 (2000) (pertaining to the original easement); *id.* (pertaining to the amendment); Browning v. Comm'r, 109 T.C. 303 (1997); Johnston v. Comm'r, T.C.M. (RIA) 1997-475 (1997); Schwab v. Comm'r, T.C.M. (RIA) 1994-232 (1994); Clemens v. Comm'r, T.C.M. (RIA) 1992-436 (1992); Forte v. Comm'r, 61 T.C.M. (CCH) 1754 (1991); Schapiro v. Comm'r, 61 T.C.M (CCH) 2215 (1991) (Easement #1); *id.* (Easement #2); Higgins v. Comm'r, 58 T.C.M. (CCH) 1536 (1990); Dorsey v. Comm'r, 59 T.C.M. (CCH) 592 (1990); Fannon v. Comm'r, 56 T.C.M. (CCH) 1587 (1989); Griffin v. Comm'r, 56 T.C.M. (CCH) 1560 (1989), *aff'd*, 911 F.2d 1124 (5th Cir. 1990); Nicoladis v. Comm'r, 55 T.C.M. (CCH) 624 (1988); Losch v. Comm'r, 55 T.C.M. (CCH) 909 (1988); Stotler v. Comm'r, 53 T.C.M. (CCH) 973 (1987); Stanley Works & Subsidiaries v. Comm'r, 87 T.C. 389 (1986); Fannon v. Comm'r, 52 T.C.M. (CCH) 1113 (1986), *modified in unpublished opinion*, 842 F.2d 1290 (4th Cir. 1988); Symington v. Comm'r, 87 T.C. 892 (1986); Hilborn v. Comm'r, 85 T.C. 677 (1985); Akers v. Comm'r, 48 T.C.M. (CCH) 1113 (1984), *aff'd*, 799 F.2d 243 (6th Cir. 1986), *cert. denied*, 479 U.S. 1086 (1987); Thayer v. Comm'r, 36 T.C.M. (CCH) 1504 (1977).