

RECENT DEVELOPMENT

INCREASED SCRUTINY ON CONSERVATION EASEMENT DONATIONS: HOW A CRACKDOWN ON TAX FRAUD BY THE IRS COULD IMPACT ENVIRONMENTAL PROTECTION

I. SUMMARY

For almost twenty-five years, federal tax policy has encouraged private property owners to forego land development by granting tax deductions to reward conveyance of “conservation easements” to charitable land trusts such as the Nature Conservancy. Unfortunately, this deduction has been subject to abuse by those engaging in unethical land transactions. In order to close the loophole that allowed for this tax fraud the Internal Revenue Service (the Service) has increased its scrutiny of claims for these deductions. Taxpayers must now take extra care to meet the heightened standards which govern their easement donation transactions. The stakes are high, as failure to comply with the requirements in the tax code jeopardizes the value of the taxpayer’s property.

II. BACKGROUND

A conservation easement has been defined as “a restriction that limits the future use of a property to preservation, conservation, or wildlife habitat.”¹ The Uniform Conservation Easement Act, enacted in twenty-two states, defines a conservation easement as:

a nonpossessory interest of a holder in real property

1. Bill Garber, *Conservation Easements: Growth, Abuses, and Regulation*, 72 APPRAISAL J. 175 (2004).

imposing limitations or affirmative obligations the purpose [sic] of which include retaining or protecting natural, scenic, or open-space values of real property, assuring its availability for agricultural, forest, recreational, or open-space use, protecting natural resources, maintaining or enhancing air or water quality, or preserving the historical, architectural, archaeological, or cultural aspects of real property.²

Conservation easements are an economically efficient way to further environmental protection, serving taxpayers as a relatively inexpensive alternative to government regulation or eminent domain. The transaction conveying a conservation easement is fairly straightforward. The private property owner typically enters into a legally binding agreement with a nonprofit organization called a "land trust," such as the Nature Conservancy. In the terms of the agreement, the owner retains ownership of his or her property and covenants to restrict future development. The land trust receives the right to enjoin the property owner from developing the property as long as the property is encumbered by the easement. The owner is normally left with some economically viable use of the land and may be able to operate a profitable farm or ranch or use the land as security for borrowed capital.

Property encumbered by a conservation easement experiences a dramatic decrease in value. In order to encourage property owners to voluntarily convey conservation easements, Congress passed Internal Revenue Code section 170, which allows taxpayers to qualify for a charitable income tax deduction equal to the value of the easement.³ Section 170 has been very effective in encouraging the use of the conservation easement. Over 2.4 million acres have become protected by these easements in the last twenty years, and the number of land trusts has almost tripled.⁴

III. ABUSE OF THE DEDUCTION

The extent to which the conservation easement tax deduction has been abused is uncertain, but the consensus of reports and experts indicates that abusive transactions represent

2. *Id.* (citing "Uniform Conservation Easement Act," (National Conference of Commissioners on Uniform State Laws, 1981), approved by the American Bar Association January 26, 1982).

3. I.R.C. § 170 (West 2004).

4. Nancy A. McLaughlin, *Questionable Conservation Easement Donations*, PROB. & PROP., Oct. 18, 2004, at 40 (hereinafter McLaughlin I).

a small minority of deduction claims.⁵ While few in number, reported abuses have been highly publicized and have caused Congress to take action to curb abuse of the tax deduction.

The *Augusta Chronicle* reported that developers in the Charleston, South Carolina area were abusing the practice by “protecting golf courses or parts of residential developments that didn’t satisfy conservation guidelines.”⁶ The developers also “erroneously claimed tax credits by agreeing to conserve land if a local government would allow them to build in a restricted area, which is considered a ‘quid pro quo’ and no longer qualifies as a charity.”⁷ Such abuse of the tax system allowed a piece of property valued at \$17 million to be purchased for a fraction of that price.⁸

In Denver, Colorado, the Colorado Coalition of Land Trusts issued a press release warning that the incidents of abuse of conservation easements might jeopardize state funding for conservation easement programs.⁹ The Colorado Department of Revenue attributed the problem to “outrageous” appraisal methods which radically overstated the value of the easement.

The reporting that blew the door open for Congressional involvement was published in May 2003 by the *Washington Post*, which ran a series of articles exposing flagrant abuse of the tax incentives made possible by section 170.¹⁰ The articles examined transactions involving the Nature Conservancy and revealed that land developers were reaping extraordinarily large tax deductions for donating conservation easements covering golf course fairways and economically undevelopable land, including steep slopes, side-hills, and floodplains.¹¹ Other unscrupulous developers were grossly exaggerating the appraised value of the encumbered property.¹² This series of articles led ranking

5. Nancy A. McLaughlin, *Increasing The Tax Incentives For Conservation Easement Donations—A Responsible Approach*, 31 *ECOLOGY L.Q.* 1, at 73 (2004) (hereinafter *McLaughlin II*).

6. Josh Gelinas, *Group Tries to Make Changes in Land Trusts so Tax Breaks Can't Be Abused*, *AUGUSTA CHRON.*, Mar. 16, 2005, at O3.

7. *Id.*

8. *Id.*

9. Kevin Simpson, *Conservation Efforts Might Lose Ground in Appraisal Flap*, *DENV. POST*, Feb. 22, 2004, at A01.

10. McLaughlin I, *supra* note 4, at 41 (making reference to the following series of articles: David B. Ottaway & Joe Stephens, *Nonprofit Sells Scenic Acreage to Allies at a Loss*, *WASH. POST*, May 4, 2003, at A1; Joe Stephens & David B. Ottaway, *How a Bid to Save a Species Came to Grief*, *WASH. POST*, May 5, 2003, at A1; Joe Stephens & David B. Ottaway, *Nonprofit Sells Scenic Acreage to Allies at a Loss*, *WASH. POST*, May 6, 2003, at A1).

11. *Id.*

12. *Id.*

members of the Senate Finance Committee to undertake an independent review of the Nature Conservancy's practices, and caused the Conservancy to ban a range of practices in conducting easement transactions.¹³ The Land Trust Alliance has responded to these scandals by implementing training and accreditation programs to improve ethics and fiscal accountability by land trusts across the country.¹⁴

The IRS reacted to these reports and allegations in July 2004, publishing a notice entitled "Charitable Contributions and Conservation Easements."¹⁵ The notice contained a warning that the IRS will investigate claims for charitable donation deductions filed under section 170 and will impose penalties and excise taxes to punish abuse of the system.¹⁶ The notice also warned that promotion of easement donation transactions involving improper deductions would be met with serious consequences.¹⁷

Increased scrutiny of these transactions could have a chilling effect on future legitimate conservation easement donations. Compliance with the heightened standards may increase the amount of costly legal work necessary to complete the transaction, and land owners may become unwilling to risk invasive IRS investigations. It has been suggested that the best guarantee of success in defending conservation easements in court is through attorney due diligence in preparing a thorough analysis of easement valuation, and through retaining convincing appraisers who can sound more credible than those obtained by the IRS.¹⁸ While many landowners may be able to absorb these increased fees as a cost of doing business, some land owners may be shut out of the process if the costs cannot be justified because of low property values.

In order to alert practicing attorneys to the importance of the new development, Nancy A. McLaughlin, associate law professor at the University of Utah, has published an article to educate those who represent clients with legitimate conservation easement transactions.¹⁹ Her article explains the two aspects of

13. Garber, *supra* note 1, at 179.

14. See Eryn Gable, *Conservation: Land Trust Alliance Advances Training and Accreditation Program*, LAND LETTER, Apr. 21, 2005, available at <http://www.eenews.net/Landletter/Backissues/042105/042105ll.htm#7> ("Accreditation can meet two important goals—to build strong and enduring land trusts and to create a seal of approval that publicly recognizes their good work.").

15. I.R.S. Notice 2004-41, 2004-28 I.R.B. 31.

16. *Id.*

17. *Id.*

18. McLaughlin II, *supra* note 5, at 76–77.

19. McLaughlin I, *supra* note 4.

the transaction that are most likely to be abused and therefore scrutinized by the IRS: (1) the 'conservation purposes test' and (2) easement valuation.²⁰

IV. THE "CONSERVATION PURPOSES TEST"

The July 2004 IRS notice made clear that the Service will thoroughly scrutinize the purpose of the conservation easement.²¹ To qualify for the charitable income tax deduction under section 170, the easement must be donated for at least one of the following qualified conservation purposes:

- (i) the preservation of land areas for outdoor recreation by, or the education of, the general public,
- (ii) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem,
- (iii) the preservation of open space (including farmland and forest land) where such preservation is—
 - (I) for the scenic enjoyment of the general public, or
 - (II) pursuant to a clearly delineated Federal, State, or local governmental conservation policy, and will yield a significant public benefit, or
- (iv) the preservation of an historically important land area or a certified historic structure.²²

The premise of these limitations is that the deductions should be limited to reward donation of easements that will provide a significant benefit to the public. The benefit must be to the public in general, and not to a limited group of private citizens.²³ Thus a conservation easement over a golf course fairway or in the middle of an exclusive subdivision will not satisfy the "public benefit" requirement, because the benefit actually derived from the easement is either inconsequential or too limited in scope to justify granting the deduction.²⁴

The July 2004 IRS notice emphasized that the Service will place the focus of its examination of future deduction claims on satisfaction of the "open space retained rights" and the

20. *Id.* at 41.

21. I.R.S. Notice 2004-41, 2004-28 I.R.B. 31.

22. I.R.C. § 170(h)(4)(a) (West 2004).

23. *Id.*

24. McLaughlin I, *supra* note 4, at 43 (citing Stephen J. Small, *Conservation Easements Today: The Good and the Not-So-Good*, 22 EXCHANGE J. LAND TRUST ALLIANCE 32, 33 (2003)).

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“inconsistent use” standards of the conservative purposes test.²⁵ The property owner satisfies the “open space” test if the easement proscribes development or use of the property in a manner that tends to diminish significantly its scenic quality or the benefit to the public. The “inconsistent use” standard is satisfied if the owner can demonstrate that the permitted uses of the property would not lead to the destruction of other conservation interests, such as injury to a naturally occurring ecosystem by the use of pesticides in the operation of a farm.²⁶

V. EASEMENT VALUATION

The Treasury Regulations set a standard for determining a conservation easement’s value, calling for the use of the “before-and-after” method.²⁷ Under this method, the value is calculated by finding the difference between (1) the fair market value of the property before it is encumbered by the easement, and (2) the fair market value of the property after the easement is conveyed.²⁸ This method of valuation is subject to abuse by either exaggerating the before-easement value of the property or exaggerating the extent to which the easement negatively impacts the property value. Taxpayers should ensure that the appraisal of the property is not too speculative, so that the reported value can be properly supported in light of enhanced scrutiny by the IRS.

VI. CONSEQUENCES OF FAILURE TO COMPLY

If the IRS rejects the claim for the deduction, the consequences can be very costly to the landowner. Because the easement is written to be irreversible in order to qualify for the tax deduction, the property will suffer a permanent loss in value (perhaps in the millions of dollars). The donor will not only lose the anticipated tax benefits, but will also be precluded from using the property in profitable and otherwise legal uses, and be forced to absorb the futile but significant legal, appraisal and accounting costs.

Specifically, the IRS intends to deter future fraud by implementing the following practices: (1) disallow deductions for easements that are not substantiated, (2) hit donors with penalties of twenty or forty percent of the claimed deduction for

25. I.R.S. Notice 2004-41, 2004-28 I.R.B. 31.

26. See Treas. Reg. § 1.170A-14(e)(2).

27. Treas. Reg. § 1.170A-14(h)(3).

28. *Id.*

substantially overstating the value of an easement, (3) impose intermediate sanctions on disqualified persons who purchase property from a charity and improperly claim an easement, (4) impose intermediate sanctions on organization managers participating in the purchase, and (5) bring penalties against promoters, appraisers, and others involved in abusive transactions.²⁹

Additionally, the IRS has “threatened to challenge the charity’s tax-exempt status if it is operating for a substantial nonexempt purpose or providing impermissible private benefits.”³⁰ The high stakes of the transaction should lead taxpayers to be conservative in their interpretation of the “conservation purposes” test and in appraising the value of the property.

VI. CONCLUSION

Given the increased scrutiny with which the IRS is now examining the deductions claimed for conveyance of conservation easements, attorneys face a new challenge serving the needs of their clients. It is important that the use of conservation easements not be discouraged, as they can be an economically efficient and successful method for achieving improved environmental protection. Therefore, attorneys must ensure that the transaction actually provides a benefit to the general public, pay particular attention to satisfaction of the “conservation purposes” test, and be conservative in appraising the value of the encumbered property. This diligence will aid in justifying the client’s claim for the charitable donation tax deduction, decrease the probability of a costly audit by the IRS, and safeguard the value of the client’s property.

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29. *IRS Takes Aim At Charitable Deductions Involving Conservation Easements*, 91 Stand. Fed. Tax Rep. 2 (CCH), (July 8, 2004) (citing IR-2004-86, Notice 2004-41).

30. *Id.*