

## **IRS's Miller Speaks on Conservation Easements**

**In a March 28 speech in Washington to the Spring Public Lands Conference, IRS Tax Exempt/Government Entities Commissioner Steven T. Miller discussed some of the abuses his agency has seen involving donations of conservation easements.**

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**Remarks of Steven T. Miller  
Commissioner, Tax Exempt and Government Entities  
Internal Revenue Service  
Before the  
Spring Public Lands Conference**

**March 28, 2006**

**Washington, D. C.**

Thank you. It's a pleasure to be here this morning. I have not had the chance to meet before with either the Western States Land Commissioners Association or the Eastern Lands and Resources Council. I understand that you have never invited anyone from the Service to appear here. It's a special honor to be asked during tax-time, when we often see a modest dip in our popularity.

I am a tax lawyer, and a tax administrator, and I do not know you as individuals, yet, I feel that I am among colleagues. We are all public servants, and we are all charged with marshalling and protecting important public assets. You are in charge of our public lands. You protect them and manage them for the benefit of the people of your states. Throughout the country, public lands offer opportunities for recreation, support the economy and enhance our way of life. You insure that these crucial assets are used for the public good.

I do something similar. My portfolio includes everything from pension plans and charities to governments of every kind. In short, my organization is in charge of tax-exempt entities and governments. Tax exempt entities, like public lands, might well be considered public assets. They are entities upon which Congress has bestowed the privilege of tax-exemption. Each year, the federal government foregoes the collection of some \$280 billion from tax exempts -- what they would owe if taxed. And collectively, the tax exempt entities of this country control assets in excess of \$11 trillion. My job is to see that these assets are used for the public good, in the way Congress intended.

So although I come to you this morning as something of a foreigner -- at least in the sense that I am from the Treasury Department, rather than the more familiar Departments of Agriculture or Interior, I come also as a colleague. We share a common vision of public service and the public good.

You may have read that under my boss, Commissioner Mark Everson, the Internal Revenue

Service has adopted a working equation to help it carry out its mission. That equation is Service + Enforcement = Compliance. Not service or enforcement but both. And I wouldn't doubt that this approach is similar to one many of you use in administering the public lands of your state.

But at this time there is also a darker side to the tax climate in the United States. Several years ago, we began to notice an increase in tax evasion schemes and fraudulent tax avoidance transactions. So throughout the Service, and in the Tax Exempt and Government Entities Division I lead, we have stepped up enforcement, and it is with this in mind that I come to the topic I want to address with you this morning. It is a place where your work and mine intersect, and where we have an opportunity to forge a valuable alliance.

I have come here to talk about conservation easements, problems we are finding in this area and to ask for your help, because if we do not work together on this, the congressionally provided deductibility for gifts of easements may be at risk.

Now I know that land trusts are important partners in your work. You work closely with them to acquire land and easements that advance the important work you do. We, too, are familiar with land trusts. We know them as exempt organizations that we regulate, and we have a good relationship with the Land Trust Alliance, an organization that we view as an ally and a leader in the area of conservation easements.

I understand that Rand Wentworth, the President of the Land Trust Alliance, appeared at this podium last year. And I do not want to spend very much time on this, but let me spend a moment on the rules in this area. It will give context as I discuss the problems we are seeing and explain our reaction.

Our regulation of this area begins, of course, with the Internal Revenue Code. Easements are unusual within the context of philanthropy. Ordinarily, gifts of partial interests in property are not deductible as charitable contributions, and an easement, of course, is only a partial interest in property. However, Code Section 170(h) provides an exception to the partial interest rule for qualified conservation contributions such as conservation easements.

To be deductible, the transfer of a conservation easement must meet the requirements of the Code and the very detailed rules of the income tax regulations. Thus, while there seems to be a popular perception that valuation of the easement is the only issue of concern, there are a myriad of other issues. The recipient must be a qualified organization (governments count) and the easement itself must be for a specific purpose.

I want to turn now to some of the problems and abuses we have been seeing with conservation easements.

Before I start my discussion let me state two things that I know are true. The first is that conservation easements serve a vital role in American society. I ask you to consider everything else I say this morning with that in mind.

When conservation easements are appropriately used, they bring real and enduring benefits to the American public. They can safeguard -- and have safeguarded -- fragile ecosystems, critical watersheds, land bordering state and national parks, and stunning views. We value this use of conservation easements. I want to do nothing at the IRS to hinder the continued and

appropriate donation of conservation easements to provide these gifts to the public.

At the same time there is a second thing I know to be true. It has been expressed best by Commissioner Everson, who has said publicly:

We have uncovered instances where the tax benefits of preserving open space and historic buildings have been twisted for inappropriate individual benefit. Taxpayers who want to game the system and the charities that assist them will be called to account. Pretty tough words, but nothing in them, I think, that should be of concern to stewards of the states' public lands.

As I discuss the problems we are seeing, I would ask to consider whether you have seen problems emerging in your dealings with donors in your state, and what you can do to help insure that the conservation easement program stays within its intended boundaries.

The misuse of conservation easements is part of a rising concern about the tax-exempt area. The Commissioner has been talking for 2 1/2 years, as I have, about problems in this sector. We are concerned with what can be called lapses in organizational governance. And we are concerned with the misuse of the tax code and the tax-exempt sector to generate hyper-inflated deductions, and other improper tax advantages. Throughout this 2 1/2 year period, the media has pointed out some striking examples of how conservation easements have been abused. Not surprisingly, Congress grew interested in the issue. You may remember the Senate Finance Committee's recent investigation of a well-regarded conservation organization. Over time, Congress' interest in this area has grown and become focused.

Last June, Senate Finance conducted a hearing devoted exclusively to conservation easements, focusing mostly on open space easements. Three weeks later, the Ways and Means Committee conducted a hearing on facade easements. The Joint Committee on Taxation, a Congressional think-tank, has issued proposals that would limit the utility of conservation easements. So it should be no surprise that we at the Service have also been concerned. Let me identify for you some of the things that we have seen that are of particular concern. In this regard, I will start with Notice 2004-41, issued in July 2004. This notice sends a clear message. We refer to it as a "yellow light notice" because it is cautionary in nature.

The notice warns against so called conservation buyer programs. In one type of conservation buyer program, the conservation organization buys property, places an easement on it, and then sells the property to a taxpayer for two payments. The first payment is designated a "purchase price," and the second is characterized by the parties as a "charitable contribution." However, in some cases, the second payment is really part of the negotiated purchase price of the property and therefore is not a contribution. Undervaluation of a property in this fashion can be just as much a problem as overvaluations. The notice tells us that the Service will treat these transactions in accordance with their substance rather than their form. This is one of the abuses we have seen.

Let me speak for a moment about open space easements, since these may be of special interest to you. One type of open space easement is an easement that is pursuant to a "clearly delineated governmental conservation policy." The other type of open space easement is for the scenic enjoyment of the general public. For both types, there must be a "significant public

benefit."

The regulations list eleven factors to be taken into consideration. They also tell us to consider all facts and circumstances, and they say that some of the 11 factors may not be relevant to a particular easement. One of the listed factors is the "opportunity for the general public to use the property or to appreciate its scenic values." If a taxpayer donates a scenic easement on land that is not visible to the public, there is no significant benefit to the public. For example, there have been proposals to place conservation easements on small parcels of land that lie between the holes on a golf course. More recently there have been proposals for easements for the spaces between houses in gated communities.

In addition, we are seeing a number of issues that give us pause in both the open space and the façade areas. Some of these problems impact on whether the gift has been made. For example, has too much authority been vested in the donor? There are cases in which the donor takes an action inconsistent with the easement without adverse consequences. Does the document creating the easement allow a use inconsistent with the ostensible purpose of the easement? And of course, we are seeing real valuation problems. Is the value of the donated easement being reasonably determined? Is the contribution truly forgoing single home developments where there are no water rights? That is, are the development assumptions reasonable? The nature of the issues in façade easements differs somewhat but many still revolve around valuation.

Finally, let me discuss some issues that more closely align to your land management practices and state laws. The first issue is limited duration easements. We have found that some states are accepting easements for a limited period of time -- for example, 25 or 30 years. After the expiration of the term, the interest reverts to the donor. While a state or other entity may be able to accept such an easement, it is not a conservation easement under Code 4 section 170, and we will allow no deduction for it. A valid conservation easement must be granted in perpetuity.

The second issue concerns requests to return easements. We have learned of instances in which taxpayers granted easements to units of government on the expectation that they would be entitled to a state tax credit which they could then sell. However, upon learning that the tax credit was not marketable, as expected, the donors petitioned for the return of the easement. This situation gives us grave concern, because it too violates the requirement that easements be granted in perpetuity. Moreover, this situation seems tailor-made for abuse. We have it under the microscope right now, and are carefully considering its ramifications.

The third issue concerns non-uniform appraisal standards. Appraisals give rise to many problems. We find, for example, that appraisals of conservation easements often:

- are based on unrealistic assumptions about the highest and best use of the land,
- are based on an assumption that the entire assets are already in place,
- are conducted without regard to current zoning law, or
- are conducted pursuant to inadequate professional standards.

The result is generally an appraisal that appears inflated or hyper-inflated.

The fourth issue is the sale of tax credits. We have found situations in which state law grants

tax credits to donors of easements, and permits the donors to sell those credits to other taxpayers. Generally this is accomplished by selling the credit to a broker. The credit often is placed into a limited liability corporation and sold to various investors. The tax credit is the only asset in the LLC. But when the credit is taken -- used up -- some entities are issuing a final K-1 return indicating a complete loss on the investment, allowing the investor to take a loss on his or her tax return. We have serious concerns about this interpretation of the tax law, and are also subjecting these arrangements to close scrutiny.

These are a few of the problems we are finding. Now let me tell you what we are doing about them.

I mentioned Notice 2004-41 a moment ago. In addition to sounding a warning, the notice also outlines the penalties, excise taxes and consequences that will arise if improper deductions are taken.

In addition to this notice, we have taken steps to improve reporting. We modified Form 1023, the application for tax-exempt status, to identify organizations with conservation easement donation programs. We added a checkbox to the Form 990, the annual information return for exempt organizations, to identify organizations that receive conservation easement donations during the year. We are considering changes to the Form 8283, on which donors list donated property, to better identify donors of such easements, and we amended the instructions of that form to better describe what is permissible.

That is guidance and reporting. I want next to discuss our development of a comprehensive examination program. To do this, we created a Service-wide team to attack all aspects of conservation easement misuse. This team has initiated a robust examination program, investigating promoters, appraisers, contributors and, yes, the recipients. It has also reached out to several states to work cooperatively in this effort.

In our examinations, we have looked at more than 25 promoters, and so far have referred 9 for further investigation. We are examining more than 15 recipient charities for involvement in particular abuses, and several charity officials for unduly profiting from their positions with the charity. We are examining over 500 easement donors, approximately 75 of these involve façade donations, and the rest involve open space easements.

We have many more cases under review, and the level of our activity in this area is unprecedented. As we proceed, we are prepared to use every civil and criminal tool at our disposal.

We are also litigating cases. Some of you may be familiar with the Glass case that was tried in tax court. It had nothing to do with valuation. It is a case we are pursuing to help get a uniform and workable definition of "natural habitat" in the context of conservation easements. While we lost at the trial level, we have filed for appeal.

So we have worked on guidance, we have a robust examination program, and we are litigating to establish definitions and boundaries.

The last area I want to touch on involves the regulation of appraisers. There are those who see this as key to curtailing some of the problems in the area of conservation easements.

The IRS issues a document called Circular 230 that regulates the practice of appraisers -- and other professionals -- before the Service, and it provides that we may disqualify any appraiser against whom a penalty has been assessed under Section 6701 of the Code. Section 6701 imposes a penalty for aiding and abetting an understatement of tax liability.

A disqualified appraiser is barred from presenting evidence or testimony in any administrative proceeding before the IRS, and any appraisal made by such an appraiser has no probative effect in administrative proceedings. One of Commissioner Everson's strategic goals is to increase our review of professional standards -- and this area is directly impacted. So we are looking at appraisals and appraisers very carefully. As appropriate, we are referring appraisers as appropriate to the office of professional responsibility for possible disbarment.

Moreover, the Senate has passed legislation that would add a new section, 6695A, to the Code. It would revise penalties on appraisers for substantial and gross overstatements of valuation.

Let me close. What we see today is a real concern -- across the Service and Congress, and throughout the great majority of the tax and tax-exempt community -- about the misuse, by some, of important provisions of the code intended to foster and promote the philanthropic and charitable impulses of the American people.

Conservation easements have not escaped this concern, and no one should expect them to escape increased scrutiny in the future. In this new environment, I think each of you can play an important role in ensuring that conservation easements are appropriately used and thereby preserved.

You have heard me talk about valuation being an issue. I hear all the time that I should not hold charities and the recipients of easements accountable for the misconduct of their donors, but I must. Charities and recipients cannot sit idly by while donors poison the charitable environment. A donor's aggressive acts bring discredit to all involved, and the IRS and the Congress to the door. Here is where I will ask for your help. Please exercise prudence. If you perceive that there is something out of whack with a transaction, if it does not pass the smell test, if it is not fairly valued, walk away. Do not accept it, and let us know about it.

I sincerely invite any of you, or your staffs, to contact us with concerns and questions you have. We are eager to form a productive working relationship with you on this issue. Let me give you a contact. She is Nancy Todd, who can be reached at (616) 235- 1677, or at [nancy.m.todd@irs.gov](mailto:nancy.m.todd@irs.gov). Nancy serves on the Service's issue management team that is focusing on conservation easements, or feel free to contact me and I will get the information to the right folks.

And as an example of positive work between states and the Service, allow me to take a moment to express my admiration for Burnie Maybank, the former director of Revenue of South Carolina. He has been very involved in the issue of abuse of easements in his state. He sent out teams of examiners to look at easements created in South Carolina, and then invited us to see what they found. At the state level, South Carolina no longer recognizes golf-course easements. This is a case where a state recognized an abuse and put a stop to it. In my view, it is a very positive development.

A vibrant tax-exempt sector is key to our way of life. Media reports of greed and misuse

damage that vibrancy. You and I share an interest, both as government officials and as citizens, to see that that does not happen. We can do that by establishing for the public that the nonprofit sector is tax compliant. The prudence I just mentioned is the first step in that direction.

Ultimately there is no inconsistency between appreciating conservation easements, while also being aware that they can be misused. What we have to recognize is that if we are to preserve the benefit of conservation easements for the public into the future, we all have a solemn and continuing obligation to see that the conservation easement program stays within its lawful and intended boundaries.

I therefore, solicit your cooperation to help preserve a viable, appropriately disciplined program. Thank you.

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### Tax Analysts Information

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