IRS Scrutinizing Conservation Easements

By David van den Berg — dvandenb@tax.org

The IRS's rules regarding conservation easements can be difficult to follow, but the agency is paying close attention to technical details in documents substantiating easement donations.

''It all begins with some regulations that are less than a model of clarity,'' said Larry D. Harvey, a Colorado attorney who works on transactions involving conservation easements. ''There are many, many pages of these easement deeds that are lengthy, and they've got dense language in them, and the IRS just combs through them to try to find something that they could construct an argument that there's some failure or another with the regulations.''

The IRS believes such failures are rampant, according to Stephen J. Small, a tax attorney in the Boston area who also works on conservation easement transactions. ''There are a lot of cases that have — according to the IRS and the Tax Court — fundamentally flawed documents,'' he said. ''And chances are good that the taxpayers might lose those cases, depending on what those flaws are.''

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Harvey said the IRS has been taking aggressive litigation positions, which is having a significant effect on how he advises clients and on pending cases. ''I view the role of the IRS as to try to frame the law and clarify the law,'' he said. ''They're trying to do that, and they've been taking positions that push the boundaries of interpretation.''

Mark Weston, an appraiser near Denver and vice president of Hunsperger & Weston Ltd., said the IRS's approach has had a ''chilling effect'' on well-intentioned landowners. ''Not a month goes by when I don't talk to a landowner who says, 'I did a conservation easement once before — I'm never going to do it again,''' he said.

A series of articles in *The Washington Post* gave the IRS a ''wake-up call'' regarding conservation easements, said Timothy Lindstrom, a conservation easement tax attorney in Virginia. When the IRS started auditing conservation easements, it found ''easy pickings'' because professionals either assumed they had knowledge they didn't or that the details they knew about didn't matter, he said.

''Many folks assume that conservation easements are just standard real estate transactions and [that] if they can handle a closing, they can handle an easement,'' Lindstrom said. ''I believe that failure by professionals to either understand that easement law is much different than general real property law, or to pay attention to the details of the tax requirements, has played very generously into the Service's hands.''

Many easement arrangements ''tempt high-income taxpayers with promises of large tax benefits, with little appreciation of the numerous requirements of an easement transaction to receive any benefits at all,'' said Alan F. Rothschild Jr., an attorney in Columbus, Ga. Taxpayers must meet detailed requirements to deduct conservation easements, including that the easement be granted in perpetuity, the IRS said in a statement to Tax Analysts. Most taxpayers comply with the laws governing charitable contributions, the agency said, but it has found that some taxpayers who donate conservation easements do not meet the legal requirements. In some cases, taxpayers may overvalue the easement, fail to ensure that the conservation purpose is enforceable in perpetuity, or fail to properly substantiate the deduction with the legally required documentation, according to the IRS.

The IRS said that most disputes it has with taxpayers are resolved without litigation, adding that it frequently participates in public outreach events where it discusses relevant issues with people and groups involved in easement donations.

At a District of Columbia Bar Taxation Section luncheon in April, Karin Gross, senior technical reviewer, IRS Office of Assistant Chief Counsel (Income Tax and Accounting), said practitioners often claim that noncompliance with conservation easement rules is technical, or a foot fault.

''We don't call them that,'' Gross said. If the statute requires a contemporaneous written acknowledgement and says there is no deduction if the taxpayer doesn't have one, then that's the end of the matter, she said, adding, ''We don't call it a foot fault — we call it noncompliance with the statute.''

> ***'We don't call it a foot fault — we call it noncompliance with the statute,' Gross said.***

Ultimately, the lesson is to follow the rules, Weston said. ''The rules are murky and sometimes are impossible to understand, but where you can understand a clear dictate from Treasury or even in the statute itself, adhere to it,'' Weston said.

The 2012 Record

So far this year, 12 decisions have been handed down by the Tax Court and federal appellate courts regarding challenges to charitable deductions claimed for conservation easements, said Nancy Assaf McLaughlin, a law professor at the University of Utah. Many of the decisions have dealt with documentation issues, she added.

Harvey said the 2012 decisions largely address perpetuity, subordination, the contemporaneous written acknowledgement, and whether an appraisal or the appraiser performing it is qualified. The perpetuity standard is the least clear of the four, he said, adding that more appeals may be needed before those four issues are ''gelled.''

Speaking at an Exempt Organizations session of the American Bar Association Section of Taxation meeting in Boston on September 14, Janine Cook, deputy division counsel/associate chief counsel, IRS Office of Associate Chief Counsel (Tax-Exempt and Government Entities), said she believes that the outcome of easement litigation has generally been favorable to the government. When asked whether the outcome of litigation has led to policies in Appeals regarding the settlement of conservation easement cases, she said, ''If we're generally prevailing in litigation, I'm not sure how much that would cause the government to rethink its approach.''

The IRS hasn't won every case. Harvey highlighted a recent loss for the IRS at the appellate level. In *Kaufman*, the First Circuit held that a charitable contribution deduction could not be withheld based on an overly restrictive reading of perpetuity language in reg. section 1.170A-14(g)(1). Judge Michael Boudin, writing for the court, found the IRS's ''reading of its regulation would appear to doom practically all donations of easements, which is surely contrary to the purpose of Congress.'' (*Kaufman v. Commissioner*, 687 F.3d 21 (1st Cir. 2012), *Doc 2012-15409*, *2012 TNT 140-8*, *vacating in part and remanding* 136 T.C. 294 (2011), *Doc 2011-7123*, *2011 TNT 65-17*.)

However, McLaughlin said *Kaufman* may end up a hollow victory for the taxpayers because the First Circuit remanded the case to the Tax Court on the issue of valuation. The circuit court intimated that the easement may be found to have had no value and that the Kaufmans are liable for penalties, she said.

Kaufman is one of two cases the IRS has lost at the appellate level in 2012. In *Scheidelman*, the Second Circuit reversed and remanded a Tax Court decision, holding that a facade easement appraisal met regulatory requirements. The circuit court remanded the case to the Tax Court for a decision on whether the methods and bases for the appraisal were reasonable. (*Scheidelman v. Commissioner*, 682 F.3d 189 (2d Cir. 2012), *Doc 2012-12913*, *2012 TNT 117-29*, *vacating and remanding* T.C. Memo. 2010-151, *Doc 2010-15685*, *2010 TNT 135-19*.)

Roger Colinvaux, an associate professor at the Catholic University of America's Columbus School of Law, called *Scheidelman* unfortunate but not a total loss for the IRS. He said the easement was donated when it was fairly common practice to base a facade easement's value on a discount rate in accordance with informal IRS guidance. The IRS has since revoked the informal guidance, he said.

Scheidelman ''takes a somewhat formalistic view'' of reg. section 1.170A-13(c)(3), Colinvaux said. The IRS lost not on the merits of valuation, but on the question whether the appraisal adequately demonstrated a method of valuation and the basis for it, he said. ''So this is just a loss about the standards an appraisal must meet to be qualified,'' he added.

Lindstrom said the circuit courts in *Scheidelman* and *Kaufman* went out of their way to find for the taxpayer. He said the circuits might be sending a message to the IRS to ''lighten up'' when contributions are otherwise substantive and legitimate.

''Of course, in both of these cases, the Tax Court gets another chance to determine valuation, and my guess is that the taxpayers will suffer in that department,'' Lindstrom said.

Harvey, who represented the taxpayers in *Carpenter* and *Mitchell*, said he plans to file a motion for reconsideration in the first ''because *Kaufman*'s almost right on point.'' (For *Carpenter v. Commissioner*, T.C. Memo. 2012-1, see *Doc 2012-56* or *2012 TNT 2-7*. For *Mitchell v. Commissioner*, 138 T.C. No. 16 (2012), see *Doc 2012-7077* or *2012 TNT 65-6*.)

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Lindstrom, who has no involvement in *Carpenter*, said he would also ask for reconsideration. ''While few conservation easements expressly provide for termination in the manner of *Carpenter*, state-enabling legislation for conservation easements in most states says that they can be terminated in the same manner as other easements — i.e., by agreement of the parties,'' he said. ''Therefore, *Carpenter* has some alarming implications.''

What Should the IRS Do?

When the IRS uses non-substantive procedural compliance to deny otherwise legitimate deductions, it thwarts Congress's intent to encourage conservation and historic preservation easements, said Leslie Ratley-Beach, conservation defense director with the Land Trust Alliance. The IRS should narrow its focus in audits and prosecutions to the relatively few transactions that are suspect, she said, adding, ''The conservation sector is regulating itself successfully, which should encourage the IRS to focus resources on truly abusive appraisals.''

Lindstrom said there should be some way to evaluate audits to determine when there are abuses as opposed to innocent mistakes or minor valuation discrepancies. ''I do think that we may see the courts begin to allow more reliance on the substantial compliance doctrine if the Service continues to be aggressive on technical compliance with relatively minor requirements,'' he said.

McLaughlin said it may be difficult for the IRS to continue its aggressive approach without issuing guidance because of judicial implications that taxpayers need a roadmap.

The IRS's aggressive litigation strategy has succeeded on several fronts, including in curbing abuses and setting forth basic rules, especially regarding substantiation, McLaughlin said. However, she said it may be difficult for the IRS to continue its aggressive approach without issuing guidance because of the First Circuit's recommendation in *Kaufman* that Treasury issue regulations giving taxpayers ''fair warning'' regarding the rules, and the Second Circuit's suggestion in *Scheidelman* that Treasury use its broad regulatory authority to set stricter requirements.

McLaughlin said the IRS should issue guidance or regulations with provisions to be included in easement deeds to satisfy federal tax law requirements, including those addressing transfers, extinguishment, and the payment of proceeds to the holder following extinguishment to replace lost conservation values. Standardization of those provisions would aid taxpayer compliance and IRS and court review of deductions, as well as the interpretation and enforcement of easements over the long term, which is necessary to protect the federal investment, she said. Federal rules are also needed to govern amendments, she said. ■

Romney Paid Almost $2 Million In Taxes for 2011

By Meg Shreve — mshreve@tax.org

Republican presidential nominee Mitt Romney and his wife, Ann, paid $1.94 million in federal income taxes for 2011 on $13.7 million in adjusted gross income, for a 14.1 percent effective tax rate, according to federal income tax filings his campaign released September 21.

The Romneys released their 2011 federal income tax returns along with a notarized summary of their returns for the last 20 years, which was drafted by their tax return preparer, PricewaterhouseCoopers LLP. The summary says that during the last 20 years, Romney paid an average federal tax rate of 20.2 percent, with a lowest tax rate of 13.66 percent. (For the summary, see *Doc 2012-19814* or *2012 TNT 185-73*. For related coverage, see p. 23.)

The Romneys' 2011 return reports that they also donated $4 million to charity but deducted only $2.25 million of that sum. According to a statement by the trustee of Romney's blind trust, R. Bradford Malt of Ropes & Gray LLP, the Romneys could have deducted more but ''limited their deduction of charitable contributions to conform'' to previous assertions by Romney that he paid at least 13 percent in income taxes in each of the last 20 years. By forgoing the full deduction, Romney essentially gave an extra $270,000 to the federal government. (For Malt's statement, see *Doc 2012-19828* or *2012 TNT 185-68*.)

The Romneys 'limited their deduction of charitable contributions to conform' to previous assertions by Romney that he paid at least 13 percent in income taxes in each of the last 20 years, Malt said.

Martin R. Press of Gunster, Yoakley & Stewart PA noted that the Romneys paid $3.4 million in taxes, overpaying by $1.5 million. ''Normally, one would ask for a refund, but the Romneys have applied the money to their 2012 liability,'' Press told Tax Analysts.

The Romneys also did not claim a passive loss deduction for expenses related to Ann's show horse, Rafalca, which recently competed in the 2012 Olympics in London. The campaign said in a set of frequently asked questions that the horse expenses in 2011 were considered personal. (For the FAQs, see *Doc 2012-19830* or *2012 TNT 185-69*. For prior