

# Questionable Conservation Easement Donations

By Nancy A. McLaughlin

Since 1980, a landowner who donates a qualifying conservation easement to a government agency or charitable conservation organization has been eligible for a charitable income tax deduction generally equal to the value of the easement under Code § 170(h). A conservation easement is a legally binding agreement between the owner of the land encumbered by the easement and the holder of the easement that restricts the development and use of the land to achieve certain conservation goals, such as the preservation of open space, wildlife habitat, or agricultural land. A landowner who donates a qualifying conservation easement also removes the value of the easement from his or her estate free of transfer tax under Code § 2522(d) and, since 1997, may potentially exclude up to an additional 40% of the value of land encumbered by the easement from the estate for estate tax purposes under Code § 2031(c).

Over the last two decades, there has been a tremendous increase in the number of landowners donating conservation easements and the number of charitable conservation organizations (typically referred to as “land trusts”) accepting such donations. According to the Land Trust Alliance (LTA), the umbrella organization for the nation’s local, state, and regional land trusts, in 1980 only 128,001 acres were protected by conservation easements held by local, state, and regional land trusts, and by 2000 that number had grown to almost 2.6 million acres. In addition, in 1981 local, state, and regional land trusts numbered only 431, and by the end of 2000, that number had grown to 1,263. Riding that wave of success, the land trust community has been aggressively lobbying Congress to increase the federal tax incentives offered to easement donors, and because such incentives generally receive bipartisan support, the increases seemed likely.

---

Nancy A. McLaughlin is Associate Professor of Law at the University of Utah, S.J. Quinney College of Law and serves as Associate Editor for Probate and Trust for the *Real Property, Probate and Trust Journal*.

Slug Signorino

In May 2003, however, the *Washington Post* spoiled the party when it published a three-part series criticizing The Nature Conservancy, one of the nation's largest and most well-funded land trusts, for, among other things, participating in conservation easement transactions that allegedly involved abuse of the tax incentives. See Joe Stephens & David B. Ottaway, *Nonprofit Sells Scenic Acreage to Allies at a Loss*, Wash. Post, May 6, 2003, at A1. In a follow-up article published in December 2003, *Post* reporters described a number of abusive conservation easement donation transactions. Some involved developers who reaped "shocking" tax deductions for donating conservation easements on golf course fairways or otherwise undevelopable land, such as leftover floodplain and steep hillsides. Others involved easement appraisals that appeared "wildly exaggerated." See Joe Stephens & David B. Ottaway, *Developers Find Payoff in Preservation*, Wash. Post, Dec. 21, 2003, at A1.

As a result of the *Post* articles, the Senate Finance Committee launched an investigation of The Nature Conservancy, and proposals to increase the federal tax incentives for conservation easement donations stalled in Congress. On June 30, 2004, the IRS issued a Notice warning that it is aware that some taxpayers are improperly claiming charitable deductions for easement donations under Code § 170(h) and that it intends to disallow such deductions and impose penalties and excise taxes where appropriate. Notice 2004-41. The Notice also warns that the IRS intends to review "promotions" of easement donation transactions involving improper deductions and to impose penalties on the promoters, appraisers, and other persons involved in such transactions. In a News Release accompanying the Notice, IRS Commissioner Mark W. Everson is quoted as stating, "We've uncovered numerous instances where the tax benefits of preserving open spaces . . . 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." See IR-2004-86.

The purpose of this article is to alert practitioners to two aspects of a conservation easement donation transaction that are susceptible to abuse and, thus, most likely to be scrutinized by the IRS: (1) the "conservation purposes test" under Code § 170(h) and (2) easement valuation. Another area of abuse, which is beyond the scope of this short article, is the purported "donation" of conservation easements by developers in connection with an entitlements process or in anticipation of some other economic benefit.

For detailed information on the operation of federal tax incentives, the use of conservation easement donations in income and estate tax planning, and conservation easements and land trusts in general, see the resources listed in the box accompanying this article.

### The "Conservation Purposes Test"

#### The Test

A landowner who donates a conservation easement will be eligible for a charitable income tax deduction under Code § 170(h) only if, *inter alia*, the easement is donated for one or more of the following qualified conservation purposes:

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

Code § 170(h)(4)(A).

Congress carefully crafted the "conservation purposes test" to limit the deduction to donated easements that will provide significant benefits to the public. Congress provided substantial guidance regarding the types of easements that will satisfy the conservation purposes test in the legislative history to Code § 170(h) (S. Rep. No. 96-1007, 602-607), and the Treasury provided significant additional guidance in the regulations interpreting that section (Treas. Reg. § 1.170A-14) (the "Regulations"). Because of the breadth of the land protection objectives of Code § 170(h), the tremendous diversity of land in the United States, and the inherently subjective nature of the concept of "public benefit," however, the conservation purposes test necessarily contains subjective standards that are susceptible to abuse. The two standards most susceptible to abuse are the "open space retained rights" and the "inconsistent use" standards, which permit a landowner donating a conservation easement to retain certain development and use rights with respect to the encumbered land.

#### The Open Space Retained Rights and Inconsistent Use Standards

The Regulations ambiguously provide that the deduction for the donation of an easement intended to satisfy the "open space" conservation purposes test will be denied if the donor retains rights to develop and use the land subject to the easement that could interfere with the essential scenic quality of the land or the governmental conservation policy being furthered by the donation (the "open space retained rights" standard). Treas. Reg. § 1.170A-14(d)(4)(v). The Regulations contain an equally ambiguous "inconsistent use" standard that applies to all donated easements regardless of the conservation purpose of the easement. Under the inconsistent use standard, a deduction for the donation of an easement will be denied if the donation would accomplish one of the four conservation purposes enumerated in Code § 170(h) but would permit the destruction of other significant conservation interests. Treas. Reg. § 1.170A-14(e)(2).

## Resources for Attorneys Representing Conservation Easement Donors

- Land Trust Alliance (LTA) web site: [www.lta.org](http://www.lta.org).
- Stephen J. Small, *Federal Tax Law of Conservation Easements* (1997), with supplements (available from the LTA).
- Janet Diehl & Thomas S. Barrett, *The Conservation Easement Handbook: Managing Land Conservation and Historic Preservation Easement Programs* (1988); Thomas S. Barrett & Stefan Nagel, *Model Conservation Easement and Historic Preservation Easement, 1996: Revised Easements and Commentary from The Conservation Easement Handbook* (1996) (available from the LTA; a revised edition of the handbook is due to be published by the LTA in 2004).
- C. Timothy Lindstrom & Stephen J. Small, *New Estate Tax Relief for Land Under Conservation Easement*, 78 Tax Notes 1171 (1998).
- Nancy A. McLaughlin, *Tax Benefits of Conservation Easements*, 23 Tax Mgmt. Est., Gifts & Tr. J. 253 (1998).
- Stephen J. Small, *Understanding the Conservation Easement Estate Tax Provisions*, 87 Tax Notes 435 (2000).
- David Braun, *Strategies for Using Conservation Easements in Tax and Estate Planning*, Prob. & Prop. 15 (Nov./Dec. 2002).
- Myra Lenburg & Norman Rogers Jr., *Farmland Preservation: Combining Land Conservation and Planned Giving*, Prob. & Prop. 16 (Sept./Oct. 2003).
- Stephen J. Small, *Conservation Easements Today: The Good and the Not-So-Good*, 22 Exchange, The Journal of the Land Trust Alliance No. 2, 32 (Spring 2003) (available from the LTA).
- Stephen J. Small, *Local Land Trust Signed a Fraudulent Tax Form!*, 22 Exchange, The Journal of the Land Trust Alliance No. 3, 5 (Fall 2003) (available from the LTA).
- Nancy A. McLaughlin, *Increasing the Tax Incentives for Conservation Easement Donations—A Responsible Approach*, 31 Ecology L. Q. 1 (2004).

The Regulations provide two examples of the application of those standards to the retention of development rights in an easement. Both examples involve the donation of a “scenic open space” easement on a 900-acre parcel located on the crest of a mountain. In the first example, the entire parcel is clearly visible from a nearby national park, and the donor wishes to reserve the right to subdivide the parcel into ten 90-acre parcels and to construct one single-family home on each parcel. The example provides that no deduction would be allowable because such “random” building on the property, even as little as one home every 90 acres, would “destroy the scenic character of the view.” Treas. Reg. § 1.170A-14(f), Example (3). In the second example, not all of the parcel is visible from the national park, the easement allows for limited cluster development of no more than five 9-acre clusters (with four houses on each cluster) located in areas generally not visible from the park, and the development is subject to site and building approval by the donee organization. The second example provides that the deduction would be allowed. Treas. Reg. § 1.170A-14(f), Example (4).

Because the two examples involve a scenic open space easement and are very fact specific, they offer only limited guidance to the type of retained development rights the IRS considers permissible in an easement. The first example indicates that retaining rights to randomly build on a parcel protected for scenic purposes, even at low density, is not acceptable. On the other hand, the second example appears to bless the retention of cluster development rights on a scenic parcel, provided the development is limited (in the example, only 45 acres, or 5% of the total acreage, is subject to development) and is not generally visible to the public from a nearby viewing area, such as a national

park. Because the cluster developments are subject to site and building approval by the donee, however, the second example also implicitly acknowledges that the IRS is relying, in large part, on the government agencies and land trusts accepting tax-deductible easement donations to ensure that any retained development rights do not “interfere” with the conservation purposes of the easement or “permit the destruction” of “significant conservation interests.”

The Regulations also provide a number of examples illustrating the application of the inconsistent use standard to the retention of certain use rights in an easement. For example, the Regulations provide that an “open space” easement preserving farmland under a state program for flood prevention and control would not qualify for the deduction under Code § 170(h) if, under the terms of the easement, a significant naturally occurring ecosystem could be injured or destroyed by the use of pesticides in the operation of the farm. Treas. Reg. § 1.170A-14(e)(2). On the other hand, the Regulations also provide that the inconsistent use standard is not intended to prohibit uses of the property that do not impair significant conservation interests, such as selective timber harvesting or selective farming. *Id.* As with retained development rights, the examples in the Regulations offer only limited guidance to the type of retained use rights the IRS considers permissible in an easement.

The IRS has provided some additional guidance as to the type of retained development and use rights it considers permissible in an easement in a series of private letter rulings. See, e.g., PLR 200208019; PLR 200403044. Again, however, the fact-specific nature of those rulings limits their usefulness.

Stephen J. Small, an attorney who worked in the Office of Chief Counsel of the IRS from 1978 to 1982 and was the principal author of the Regulations, stresses that the deduction under Code § 170(h) is intended to encourage the protection of significant conservation values and open space—not the creation of upscale, large-lot subdivisions. In an article published in the spring

2003 issue of *Exchange, The Journal of the Land Trust Alliance*, Small, who now is in private practice and specializes in conservation easement transactions, explains:

I know of many landowners and real estate developers who believe that if they own 100 acres in an area of one-acre zoning, they can “get a conservation easement” and a big tax deduction by limiting their development to two-acre house lots. They need to understand that the starting point for federal tax benefits is the protection of *significant conservation values . . .*, often meaning protection of some significant, contiguous tract of open space, uninterrupted by roads, driveways, cul-de-sacs, swing sets, three-car garages. The federal tax rules do not give you an income tax deduction for building fewer houses on your property than you otherwise could have under local zoning.

In the same article, Small describes two additional types of easements that do not satisfy the conservation purposes test of Code § 170(h):

the conservation easement on a little bit of open space in the middle of a bigger development [where] the conservation benefits either are minimal or their “protection” only benefits those who have homes in the development . . . [and] . . . a conservation easement on a private golf course that is an intensively altered landscape.

The IRS historically has not targeted easement donors for audit, and, even when it has audited such donors, it has focused on the issue of easement valuation rather than satisfaction of the conservation purposes test. To date, the IRS has largely relied on the government agencies and land trusts accepting tax-deductible easement donations to ensure that the retained development and use rights in an easement do not “interfere” with the conservation purposes of the easement or “permit the destruction” of “significant conservation interests.” The IRS, however, is

not bound by its past pattern of non-enforcement of the conservation purposes test. Indeed, although the open space retained rights and inconsistent use standards leave considerable room for subjective judgment and abuse, they also reserve to the IRS the right to audit and litigate such matters if it determines that donors are proposing, and donees are accepting, abusive easements. Reports of “rogue” land trusts willing to accept conservation easements that do not comply with the spirit of Code § 170(h) may well provide the impetus for greater IRS scrutiny of the conservation purposes of easement donations. See Stephens & Ottaway, *Developers Find Payoff in Preservation*, supra, at A1; Notice 2004-41.

Attorneys assisting landowners who donate conservation easements should take pains to ensure that the easements satisfy the conservation purposes test under Code § 170(h) because the stakes involved in an easement donation are quite high. An easement donation generally (1) reduces the fair market value

of the encumbered land by multiple thousands, if not hundreds of thousands or even millions of dollars, (2) involves a permanent loss of some autonomy in the owner’s use and management of the encumbered land, and (3) involves not insignificant legal, appraisal, and tax accounting costs. Moreover, the donation is not reversible if the IRS later determines that the easement did not satisfy the requirements of Code § 170(h) and the Regulations and denies the donor the anticipated tax benefits.

Given the stakes involved in an easement donation and the increased scrutiny such transactions are receiving from the media, policymakers, and the IRS, easement donors and their attorneys are advised to be conservative in their interpretation of the conservation purposes test of Code § 170(h) and, in particular, the open space retained rights and inconsistent use standards. If the donor is audited, the donor must be able to make a compelling case that, assuming full exercise of the development and use rights retained in the

easement, the easement nonetheless protects significant conservation interests, provides significant benefits to the public, and, thus, is deserving of the deduction under Code § 170(h).

## **Easement Valuation**

### **Regulatory Requirements**

The Regulations dictate the manner in which a conservation easement must be valued for purposes of the charitable income tax deduction under Code § 170(h). In virtually all cases, the Regulations require that an easement be valued using the "before and after" method, pursuant to which the value of an easement is equal to the difference between (1) the fair market value of the land immediately before the donation of the easement (the "before-easement value") and (2) the fair market value of the land immediately after the donation of the easement (the "after-easement value"). Treas. Reg. § 1.170A-14(h)(3). "Fair market value" is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of relevant facts." Treas. Reg. § 1.170A-1(c)(2).

An easement donor employing the "before and after" method can inflate the value of his easement by (1) exaggerating the fair market value of the land immediately before the donation of the easement, which would produce an unreasonably high before-easement value, (2) exaggerating the extent to which the easement restrictions reduce the fair market value of the land, which would produce an unreasonably low after-easement value, or (3) employing some combination of the two foregoing techniques.

Determining the after-easement value of land can be a difficult undertaking because few real estate markets exist in which a substantial number of easement-encumbered properties have been bought and sold. Thus, appraisers often are required to be creative in their search for appropriate sales comparison data. Such data might include sales of properties encumbered by similar conservation easement restrictions in other real estate markets, or sales of

properties whose development and use are limited by restrictions analogous to those in the easement (such as restrictive zoning, steep slopes or floodplains, restricted access, and remoteness). An appraiser's ability to exaggerate the extent to which an easement reduces the fair market value of the subject land necessarily is limited, however, because even the most restrictive easement is not likely to reduce the value of the land to zero. Accordingly, appraisers increasingly are employing a complex land appraisal method, generally referred to as the "subdivision development analysis," to exaggerate the before-easement value of land.

### **Inappropriate Use of the Subdivision Development Analysis**

Determining the fair market value of land immediately before the donation of an easement should be no different from any run-of-the-mill appraisal of land. Although the appraisal should take into account the land's "highest and best use," which, in many cases, will be residential subdivision (rather than, for example, agricultural use), the

appraiser nevertheless should be estimating the price at which the land would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of relevant facts. In other words, the appraiser should be estimating the price at which the donor realistically could sell the land in its current state in the open market. In most cases, the appraiser should determine that price by comparing the subject property to similar properties that recently have sold in the market (typically referred to as the "sales comparison approach"). Unfortunately, appraisers increasingly are eschewing the sales comparison approach in favor of the subdivision development analysis and are thereby obtaining grossly exaggerated before-easement values for land that have no rational relation to the price at which the easement donors realistically could sell their land in the open market.

The subdivision development analysis is well-suited to the task of exaggerating the before-easement value of land because it is highly speculative and

subject to manipulation. The analysis is intended to mimic the valuation process that would be employed by a prospective purchaser interested in acquiring the subject land for development. The appraiser first determines the total gross proceeds that would be realizable if the land were developed to its fullest extent. The gross proceeds figure is then discounted for the various factors that a prospective developer would consider, such as the risk and delay associated with obtaining any necessary approvals or zoning changes, the time it would take to sell the lots, the various costs associated with developing the property such as marketing, engineering, and infrastructure costs, and, importantly, the profit that the developer expects to make on the development. That discounted figure is then presented as the "fair market value" of the property.

The subdivision development analysis can produce unrealistically high values if the appraiser overestimates the gross proceeds realizable from the imagined development or fails to account for all of the costs and risks associated with the development in a detailed and realistic manner. Even minor errors in the discount rate applied to the estimated gross proceeds can create large variances in the ultimate value determined. In addition, no matter how much care and skill is employed in preparing a subdivision development analysis, its prediction of fair market value will almost always be highly speculative in comparison to the value that would be obtained using a more traditional appraisal method, such as the sales comparison approach.

Because of the highly speculative nature of the subdivision development analysis, established appraisal rules dictate that the analysis should be used as the sole or primary appraisal method only in relatively rare circumstances. In general, two conditions must be present before the subdivision development analysis can be used to establish the value of land: (1) the "highest and best use" of the land must be for subdivision purposes and (2) the sales comparison approach must not be available because comparable sales either do not exist or are so few and

dissimilar to the subject property that a sales comparison approach would involve unacceptably speculative adjustments and assumptions. Nancy A. McLaughlin, *Increasing the Tax Incentives for Conservation Easement Donations—A Responsible Approach*, 31 Ecology L.Q. 1, at 78-80 (2004). See also *The Appraisal of Real Estate* 346 (12th ed., 2001); U.S. Dep't of Justice, *Uniform Appraisal Standards for Federal Land Acquisitions* 45 (2000); and The Appraisal Foundation, *The Uniform Standards of Professional Appraisal Practice* SMT-2 (2003).

Appraisers who employ the subdivision development analysis as the sole means of estimating the before-easement value of land often are doing so in contravention of established appraisal rules because comparable sales are available. See, e.g., *Akers v. Commissioner*, T.C. Memo 1984-490, aff'd, 799 F.2d 243 (6th Cir. 1986). In addition, such appraisers often overestimate the gross proceeds realizable from the imagined development and/or fail to properly account for all of the costs and risks associated with the development. See AOD 1991-023 (1991). Although the attorney representing an easement donor is not qualified to assess the accuracy of the values asserted by the donor's appraiser, the attorney should be alert to the possibility that the appraiser may be making indefensible claims for value in the appraisal. Given the increased scrutiny easement donation transactions are receiving, and the fact that the IRS historically has focused its enforcement efforts on the issue of easement valuation, easement donors and their attorneys are advised to be cautious regarding the use of the subdivision development analysis.

If the appraiser employs the subdivision development analysis to determine the before-easement value of the donor's land, the attorney should ensure that either (1) the appraiser also has employed a less speculative method, such as the sales comparison approach, to determine the before-easement value of the land, and the subdivision development analysis is employed merely to confirm the value obtained under the less-speculative method, or (2) the appraiser makes a

fully supported and compelling case in the appraisal report as to why the subdivision development analysis is the appropriate appraisal method. Furthermore, the attorney should object if the appraised value of the easement appears patently abusive (for example, if the property was purchased for \$1 million and one year later an easement is donated with a purported value of \$10 million).

## Conclusion

Given the increased scrutiny that conservation easement donation transactions are receiving from the media, policymakers, and the IRS, easement donors and their attorneys can no longer afford to be cavalier about the requirements for the charitable income tax deduction set forth in Code § 170(h) and the Regulations. Increased IRS enforcement efforts are likely to focus on satisfaction of the conservation purposes test and, in particular, easement valuation abuse. Attorneys who do not wish to have to answer to an irate client who is denied anticipated tax benefits for an irreversible conservation easement donation should take care to ensure that (1) the client can make a compelling case that the easement protects significant conservation interests and provides significant benefits to the public, even assuming full exercise of the development and use rights retained in the easement, and (2) the value asserted for the easement (and, thus, the value of the client's charitable income tax deduction) is based on a fully supported appraisal that does not involve the inappropriate use of the subdivision development analysis to inflate the before-easement value of the land. ■