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Tax-Deductible Conservation Easements and the Essential Perpetuity Requirements

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TAX-DEDUCTIBLE CONSERVATION EASEMENTS AND THE ESSENTIAL PERPETUITY REQUIREMENTS

Nancy A. McLaughlin[*]

Property owners who make charitable gifts of perpetual conservation easements are eligible to claim federal charitable income tax deductions. Through this tax-incentive program the public is investing billions of dollars in easements encumbering millions of acres nationwide. In response to reports of abuse in the early 2000s, the Internal Revenue Service (Service) began auditing and litigating questionable easement donation transactions, and the resulting case law reveals significant failures to comply with the deduction's requirements. Recently, the Service has come under fire for enforcing the deduction's "perpetuity" requirements, which are intended to ensure that the easements will protect the subject properties' conservation values in perpetuity and that the public's investment in the easements will not be lost. Critics claim that the agency is improperly discouraging easement donations by denying deductions for technical foot faults, and some have called for a change to the law that would allow taxpayers to cure their failures to comply with the perpetuity requirements if they are discovered on audit.

This Article illustrates that noncompliance with the perpetuity requirements should not be viewed as technical foot faults. To the contrary, compliance is essential to the integrity of the tax-incentive program and the easements subsidized through the program. In addition, allowing taxpayers to cure failures to comply with the perpetuity requirements if they are discovered on audit would significantly increase noncompliance and abuse and, given the reliance nationwide on deductible easements to accomplish conservation goals, risk fatally undermining an entire generation of conservation efforts. This Article recommends a more prudent approach: the Treasury's issuance of guidance that would greatly facilitate compliance with the perpetuity requirements, reduce transaction costs for taxpayers, and significantly shore up the integrity of the program.

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INTRODUCTION

Section 170(h) of the Internal Revenue Code (Code) authorizes a deduction for the donation of conservation easements and façade easements provided that, among other things, the easements are "granted in perpetuity" and their conservation purposes are "protected in perpetuity."[1] This deduction has been one of the driving forces behind the dramatic growth in the use of easements as land protection and historic preservation tools over the last several decades.[2] The deduction has also been subject to abuse.

In the early 2000s, the *Washington Post* published a series of articles describing abusive easement donation transactions.[3] These articles described, among other things, transactions involving "wildly exaggerated" easement appraisals, developers who received "shock[ing]" tax deductions for donating easements encumbering golf course fairways or otherwise undevelopable land, and facade easements that merely duplicated restrictions already imposed by local law. These articles raised the ire of Congress and, in 2005, the Senate Finance Committee held a hearing on the federal tax incentives available with respect to easement donations and issued a report recommending numerous reforms.[4] The

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[1] I.R.C. § 170(h)(1), (h)(2)(C), (h)(5)(A). The conservation purposes for which tax-deductible easements may be donated are (1) the protection of habitat, (2) the preservation of open space for the scenic enjoyment of the general public or pursuant to a clearly delineated federal, state, or local governmental conservation policy, (3) historic preservation, and (4) the preservation of land for outdoor recreation by or education of the general public. *Id.* § 170(h)(4).

[2] The National Conservation Easement database (NCED) has thus far gathered data on easements encumbering 24.7 million acres in the U.S., but estimates that approximately 40 million acres are now encumbered by conservation easements. *See What is the NCED?*, NATIONAL CONSERVATION EASEMENT DATABASE, http://www.conservationeasement.us (last visited Nov. 6, 2016). The NCED indicates that the growth in the use of conservation easements began to accelerate soon after 1986, the year in which the Treasury Department issued final regulations interpreting section 170(h). *See* T.D. 8069, 1986-1 C.B. 89; *All States and All Easements, Easements by Acquisition Date*, NATIONAL CONSERVATION EASEMENT DATABASE, http://www.conservationeasement.us/reports/easements (last visited Nov. 6, 2016).

[3] *See, e.g.*, Joe Stephens & David B. Ottaway, *Developers Find Payoff in Preservation*, WASH. POST, Dec. 21, 2003, at A1; Joe Stephens, *For Owners of Upscale Homes, Loophole Pays: Pledging to Retain the Facade Affords a Charitable Deduction*, WASH. POST, Dec. 12, 2004, at A1; Joe Stephens, *Local Laws Already Bar Alterations: Intervention by Trusts Is Rare for Preservation*, WASH. POST, Dec. 12, 2004, at A15; Joe Stephens, *Tax Break Turns Into Big Business*, WASH. POST, Dec. 13, 2004, at A1; *see also* David B. Ottaway & Joe Stephens, *Nonprofit Land Bank Amasses Billions*, 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; Buyers Gain Tax Breaks with Few Curbs on Land Use*, WASH. POST, May 6, 2003, at A1.

[4] *See* STAFF OF S. COMM. ON FIN., 109TH CONG., REPORT OF STAFF INVESTIGATION OF THE NATURE CONSERVANCY (VOLUME 1), at Exec. Summary 10–11 (Comm. Print 2005).

Joint Committee on Taxation also issued a report recommending reforms.[5] In addition, at the behest of Congress, the Service began auditing and litigating questionable easement donation transactions.[6]

Over the past decade, courts have issued more than eighty opinions involving challenges to claimed deductions under section 170(h).[7] This case law reveals various forms of noncompliance and abuse, including persistent and increasing overvaluation of easements,[8] failure to satisfy one or more of the conservation purposes tests set forth in section 170(h),[9] failure to comply with section 170(h)'s perpetuity requirements,[10] and failure to properly substantiate the claimed deductions.[11] In many of the cases, the donations suffered from a number

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[5] *See* STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, at 281 (Comm. Print 2005).

[6] *See Hearing on Tax Code and Land Conservation: Report on Investigations and Proposals for Reform Before the S. Comm. on Fin.*, 110th Cong. (2005) (prepared testimony of Steven T. Miller, Comm'r. Tax-exempt & Gov't Entities Div. I.R.S.). For a history of developments in the easement donation context, see NANCY A. MCLAUGHLIN, TRYING TIMES: IMPORTANT LESSONS TO BE LEARNED FROM FEDERAL TAX CASES INVOLVING CONSERVATION EASEMENT DONATIONS 1–14 (2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2808234 [hereinafter TRYING TIMES].

[7] *See* TRYING TIMES, *supra* note 6 app. C, at 1–6.

[8] *See* Nancy A. McLaughlin, *Conservation Easements and the Valuation Conundrum*, 19 FLA. TAX REV. 225, 249–50, 266–67 (2016) [hereinafter *Valuation Conundrum*].

[9] *See, e.g.*, Atkinson v. Commissioner, 110 T.C.M. (CCH) 550 (2015) (easements taxpayer valued at $7.88 million encumbering noncontiguous portions of land on and adjacent to pesticide-ridden golf courses in a gated and guarded residential community to which public had limited access failed to satisfy either the habitat or open space protection conservation purposes tests); RP Golf, L.L.C. v. Commissioner, 104 T.C.M. (CCH) 413 (2012) (easement taxpayer valued at $16.4 million on two golf courses referenced a state conservation policy that did not apply to the subject properties); Herman v. Commissioner, 98 T.C.M. (CCH) 197 (2009) (easement taxpayer valued at $21.85 million encumbering an unspecified portion of unused development rights above a historic apartment building on Fifth Avenue did not protect the structure or the historic significance of the underlying land); Turner v. Commissioner, 126 T.C. 299 (2006) (easement taxpayer valued at $3.12 million near Mount Vernon did nothing to preserve the open space or historic character of the area); Transcript of Bench Op., PBBM-Rose Hill v. Commissioner, No. 26096-14 (T.C. 2016) (easement taxpayer valued at $15.16 million encumbering a golf course, driving range, and park in a gated and guarded residential community to which public had limited access failed to satisfy the habitat protection, open space protection, or outdoor recreation by the general public conservation purposes tests).

[10] *See infra* Part I.

[11] For example, for cases involving failure to obtain a contemporaneous written acknowledgment of the easement donation from the donee as required by Internal Revenue Code (Code) section 170(f)(8)(A), see *Bruzewicz v. United States*, 604 F. Supp. 2d 1197 (N.D. Ill. 2009); *French v. Commissioner*, 111 T.C.M. (CCH) 1241 (2016); *Didonato v. Commissioner*, 101 T.C.M. (CCH) 1739 (2011); and *Schrimsher v. Commissioner*, 101 T.C.M. (CCH) 1329 (2011). However, for cases in which the court allowed the easement deed or other documentation to serve as the acknowledgment, see *RP Golf, L.L.C. v. Commissioner*, 111 T.C.M. (CCH) 1362 (2016); *Averyt v. Commissioner*, 104 T.C.M. (CCH) 65 (2012); *Irby v. Commissioner*, 139 T.C. 371 (2012); and *Simmons v. Commissioner*, 98 T.C.M. (CCH) 211 (2009).

of these flaws,[12] although the courts sometimes deny deductions on only one ground in the interest of judicial economy.

Some have argued that abuses in the section 170(h) deduction context are confined to syndicated easement donation transactions, in which the donations are made by pass-through entities and the resulting deductions, which are typically based on grossly inflated appraisals, are allocated among multiple investors.[13] However, the case law makes clear that the various forms of noncompliance and abuse noted above are not confined to syndicated transactions.

Federal taxpayers are investing substantial public funds in conservation and facade easements through the deduction program. Professor Roger Colinvaux, former counsel to the Joint Committee on Taxation, estimates that federal taxpayers invested more than $4.2 billion in conservation easements over the eight-year period from 2003 to 2010 through the program.[14] Ruth Madrigal, former Attorney-Advisor with the Office of Tax Policy at the Department of Treasury, indicated that the program is costing federal taxpayers an estimated $600 million annually.[15] In addition, in December of 2015, Congress made permanent certain "enhancements" to the section 170(h) incentive, making conservation easements the most favored form of charitable contribution in the Code.[16] Farmers and ranchers making qualified easement donations can potentially eliminate their federal tax liability for up to sixteen years using the deduction, and other easement donors can potentially reduce their taxable income by half for sixteen years.[17] In making the enhancements to the incentive permanent, which is expected to significantly increase the cost of

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[12] *See, e.g.*, *infra* notes 45–46, 84, 100, and 164–165 and accompanying text. *See also infra* notes 70, 80, 152 and accompanying text.

[13] *See, e.g.*, LAND TRUST ALL., IMPORTANT ADVISORY: TAX SHELTER ABUSE OF CONSERVATION DONATIONS (2016), http://www.landtrustalliance.org/important-advisory-tax-shelter-abuse-conservation-donations. In January 2017, the Internal Revenue Service (Service) issued Notice 2017-10, in which it announced that certain syndicated conservation easement donation transactions are "listed transactions" for purposes of the Code sections 6111 and 6112 and Treasury Regulation section 1.6011-4(b)(2). Listed transaction status means investors in and promoters of the transactions must comply with certain disclosure requirements and failure to comply can result in draconian penalties. *See* Jay Adkisson, *The IRS Leaves A Lump Of Coal For Syndicated Conservation Easements In Notice 2017-10*, FORBES.COM (Dec. 27, 2016), http://www.forbes.com/sites/jayadkisson/2016/12/27/the-irs-leaves-a-lump-of-coal-for-syndicated-conservation-easements-in-notice-2017-10.

[14] Roger Colinvaux, *Conservation Easements: Design Flaws, Enforcement Challenges, and Reform*, 3 UTAH L. REV. 755, 756 (2013). The $4.2 billion figure does not include revenue lost due to corporate contributions, which is likely considerable, or revenue lost due to the estate and gift tax benefits. *Id.* at 756 n.9.

[15] *See Conservation Easements,* EMAIL UPDATE 2014-205 (EO Tax J., Pasadena, Md.), Oct. 16, 2014.

[16] *See* STAFF OF JOINT COMM. ON TAXATION, 114TH CONG., TECHNICAL EXPLANATION OF THE PROTECTING AMERICANS FROM TAX HIKES ACT OF 2015, HOUSE AMENDMENT #2 TO THE SENATE AMENDMENT TO H.R. 2029, at 14–15 (Comm. Print 2015).

[17] *See id.*

the incentive,[18] Congress ignored the abuses revealed by the case law as well as the Treasury's repeated calls for reforms to help curb abuses.[19]

In light of the increasing public investment in tax-deductible easements, it makes sense to ask some pointed questions. Will the easements actually protect the conservation or historic values of the land and structures they encumber in perpetuity as required by section 170(h)? Or will the protections be lost over time as a result of, for example, failures to record the easements, failures to subordinate outstanding mortgages to the easements, or failures to properly document the condition of the properties at the time of the donations? Will the easement restrictions erode over time as a succession of new property owners, who stand to profit from development of the property, press to have the restrictions lifted in whole or in part? And, if continued use of an encumbered property for conservation or historic purposes becomes impossible or impractical due to changed conditions and the easement is extinguished, will the public's investment in the easement be protected?

Section 170(h) and the Treasury Regulations contain requirements that are intended to ensure that tax-deductible easements will not be lost or rendered unenforceable due to failures to record the easements, obtain mortgage subordination agreements, or prepare baseline documentation. The regulations also contain requirements intended to ensure that tax-deductible easements will protect the properties they encumber in perpetuity, or for as long as it remains possible or practicable to do so. The regulations further contain requirements intended to ensure that, in the rare event that use of an encumbered property for conservation or historic preservation purposes becomes impossible or impractical due to changed conditions, a court will oversee extinguishment of the easement and the payment of a share of proceeds to the holder to be used in a manner consistent with the conservation purposes of the original contribution. In other words, the public investment in conservation will not be lost. Case law over the past decade reveals

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[18] *See* STAFF OF JOINT COMM. ON TAXATION, 114TH CONG, ESTIMATED REVENUE BUDGET EFFECTS OF DIVISION Q OF AMENDMENT #2 TO THE SENATE AMENDMENT TO H.R. 2029, at 1 (Comm. Print 2015).

[19] *See* DEPT. OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2017 REVENUE PROPOSALS 216 (2016), https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf; DEPT. OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2016 REVENUE PROPOSALS 188–92 (2015), https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf; DEPT. OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2015 REVENUE PROPOSALS 195 (2014), https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf; DEPT. OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2014 REVENUE PROPOSALS 161 (2013), https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf; DEPT. OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2013 REVENUE PROPOSALS 140 (2012), https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf.

a significant level of noncompliance with these important "perpetuity" requirements.[20]

The Service, never a popular agency, and the subject of much criticism for its treatment of certain organizations applying for tax exemptions,[21] has recently come under fire for enforcing the perpetuity requirements. Critics argue that the agency is improperly discouraging easement donations by denying deductions for what some have called technical foot faults.[22] But a careful review of the perpetuity requirements and the case law illustrates that noncompliance with such requirements should not be viewed as technical foot faults. To the contrary, compliance is essential to ensuring that tax-deductible easements will actually protect the properties they encumber in perpetuity as Congress intended—that easement protections will be durable. Compliance is also essential to ensure that, in the event courts extinguish easements due to impossibility or impracticality, the public's investment in conservation will not be lost. Furthermore, the Treasury could issue some relatively straightforward guidance that would greatly facilitate compliance, reduce transaction costs for taxpayers, and significantly shore up the integrity of the program.[23]

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[20] The requirements described in this paragraph are not the only perpetuity requirements. To be eligible for a deduction for the donation of a conservation easement, the easement must be "granted in perpetuity" to a qualified organization exclusively for one or more of four conservation purposes, and the conservation purposes must be "protected in perpetuity." I.R.C. § 170(h)(1), (h)(2)(C), (h)(5)(A). Satisfying the protected-in-perpetuity requirement requires satisfying each of the following requirements: (1) eligible donee, (2) restriction on transfer, (3) no inconsistent uses, (4) enforceable in perpetuity, (5) mortgage subordination, (6) mineral extraction restrictions, (7) baseline documentation, (8) donee notice, access, and enforcement, and (9) judicial extinguishment, impossibility or impracticality, and division and use of proceeds. *See* I.R.C. § 170(h); S. REP. NO. 96-1007, at 13 (1980); Treas. Reg. § 1.170A-14 (2009).

[21] *See* TREASURY INSPECTOR GEN. FOR TAX ADMIN., INAPPROPRIATE CRITERIA WERE USED TO IDENTIFY TAX-EXEMPT APPLICATIONS FOR REVIEW (2013), https://www.washingtonpost.com/blogs/wonkblog/files/2013/05/201310053fr-revised-redacted-1.pdf.

[22] *See* Anson H. Asbury, *Anyone for Tennis? Technical Foot Faults and the Conservation Easement Deduction*, 32 TAX MGMT. REAL EST. J. 195 (2016); David van den Berg, *Tax Court Signal on Easements: The Rules Are The Rules* 2016 TNT 84-8 (May 2, 2016).

[23] Whether failure to comply with certain of the substantiation requirements, which apply to charitable contributions generally, should be viewed as technical foot faults is beyond the scope of this article. However, in *Mohamed v. Commissioner*, 103 T.C.M. (CCH) 1814, 1818 (2012), the Tax Court denied an $18 million charitable deduction claimed with regard to the donation of real estate because the taxpayers' appraisals were not "qualified appraisals," the statements they attached to their returns were not "appraisal summaries," and the independent appraisals they obtained were untimely. While the court recognized that the result was "harsh—a complete denial of charitable deductions to a couple that did not overvalue, and may well have *undervalued,* their contributions—all reported on forms that even to the Court's eyes seemed likely to mislead someone who didn't read the instructions," the court explained that the problems of misvalued property are so great that Congress was quite specific about what the charitably inclined have to do to defend their deductions, and it could not, in a single sympathetic case, undermine those rules. *Id.* at 1820–1821 (emphasis in original).

The author has discussed each of the perpetuity requirements in detail in a previous article.[24] This Article focuses on recent cases that address four of the perpetuity requirements. These cases highlight the importance of the perpetuity requirements to the long-term effectiveness of the conservation program being conducted through section 170(h).

Part I of this Article discusses the recordation, baseline documentation, mortgage subordination, and extinguishment requirements. Part I illustrates that compliance with these requirements is essential to the integrity of the section 170(h) tax-incentive program and the long-term viability of the easements subsidized through the program. Part II recommends the issuance of guidance that would greatly facilitate compliance with the perpetuity requirements, reduce audits and litigation, and, most importantly, help to ensure that the public's continued and growing investment in tax-deductible easements will prove to be money well spent. Part III explains why a recent proposal to permit taxpayers who fail to comply with the perpetuity requirements to fix their supposed "mistakes" if they are discovered on audit would increase noncompliance and abuse. This Article concludes that, with the growing reliance on conservation easements to accomplish conservation goals, any changes to the law that would increase noncompliance and abuse would have ramifications beyond the waste of public funds. An entire generation of conservation efforts could be fatally undermined.

I. PERPETUITY REQUIREMENTS

Limiting the discussion in this Part to the recordation requirement, the baseline documentation requirement, the mortgage subordination requirement, and the extinguishment requirements is not intended to imply that compliance with the other perpetuity requirements is not also essential.[25] Compliance with all of the perpetuity requirements is necessary to ensure the integrity of the tax-incentive program and the easements subsidized thereunder.

A. Recordation

1. Requirement

Section 170(h) provides that, to be eligible for a deduction for the donation of a conservation easement, the easement must be "a restriction (granted in perpetuity) on the use which may be made of the real property," and the conservation purpose of the easement must be "protected in perpetuity."[26] The Treasury Regulations provide that

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[24] *See* Nancy A. McLaughlin, *Internal Revenue Code Section 170(h): National Perpetuity Standards for Federally Subsidized Conservation Easements Part 1: The Standards*, 45 REAL PROP., TR. & EST. L.J. 473, 505–06 (2010) [hereinafter *National Perpetuity Standards*].
[25] See *supra* note 20, for a complete list of the perpetuity requirements.
[26] *See* I.R.C. § 170(h)(1), (h)(2)(C), (h)(5)(A).

> any interest in the property retained by the donor (and the donor's successors in interest) must be subject to legally enforceable restrictions (for example, by recordation in the land records of the jurisdiction in which the property is located) that will prevent uses of the retained interest inconsistent with the conservation purposes of the donation.[27]

The Service has taken the position, set forth in the Conservation Easement Audit Techniques Guide (the "Guide"), that an easement is not enforceable in perpetuity before it is recorded.[28] Accordingly, a conservation easement must be recorded in the land records of the jurisdiction in which the property is located for the taxpayer to be eligible for a deduction.[29] The Guide provides the following example: "A conservation easement was granted to a qualified organization on December 20, 2007, as evidenced by the dated signatures on the conservation easement deed. However, the easement was not recorded in the public records until March 12, 2008. The year of donation is 2008."[30]

2. Case Law

Zarlengo v. Commissioner involved a donation to the National Architectural Trust (NAT) of a façade easement on a building in a Manhattan historic district.[31] NAT and the taxpayers who donated the easement signed the easement deed in 2004, NAT sent the taxpayers a letter thanking them for the donation in 2004, and the taxpayers claimed deductions for the donation on their 2004 returns. For reasons not explained in the Tax Court's opinion, however, the easement was not recorded until January 26, 2005. The Service argued that the taxpayers were not entitled to deductions in 2004 because the façade easement was not "granted in perpetuity" and its conservation purpose was not "protected in perpetuity" in 2004.

In analyzing these issues, the Tax Court first reiterated the well settled rule that, "[i]n a Federal tax controversy, State law controls the determination of a taxpayer's interest in property while the tax consequences are determined under Federal law."[32] Accordingly, New York law governed when the taxpayers' donation of the façade easement was deemed complete, but federal tax law determined the tax consequences. Because New York law provides that

[27] Treas. Reg. § 1.170A-14(g)(1) (2009).

[28] *See Conservation Easement Audit Techniques Guide*, I.R.S., (Nov. 4, 2016), http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Conservation-Easement-Audit-Techniques-Guide [hereinafter *Audit Techniques Guide*].

[29] *Id.*

[30] *Id.*

[31] Zarlengo v. Commissioner, 108 T.C.M. (CCH) 155, 155–156 (2014).

[32] *Id.* at 159.

conservation easements in the state have no legal effect until they are recorded, the court found that the façade easement was not effective until January 26, 2005.[33]

The Tax Court further explained, however, that even assuming the façade easement had been legally enforceable by NAT against the taxpayers in 2004 because both parties signed the easement that year, the easement still would not have satisfied the perpetuity requirements in 2004 "because neither the use restriction nor the conservation purpose of the conservation easement was protected in perpetuity until January 26, 2005."[34] If a buyer had purchased the subject townhouse and recorded the purchase deed before January 26, 2005, the buyer would have taken the townhouse free and clear of the façade easement.[35]

3. Importance

Recordation is essential to the integrity of a conservation easement. Absent recordation, a purchaser of the subject property who records the purchase deed will generally take the property free of the easement.[36] Federal taxpayers should not be expected to fund the acquisition of conservation easements that are at risk of being rendered unenforceable, with the consequent loss of the public investment, as a result of a failure to record. Accordingly, the Service has properly taken the position that an easement is not "granted in perpetuity" and its conservation purpose is not "protected in perpetuity" absent recordation, and a failure to record should not be treated as an excusable foot fault.

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[33] *Id.* at 160.

[34] *Id.*

[35] *Id.; see also* Mecox v. United States, No. 11 Civ. 8157 (ER), 2016 WL 398216, at *5 n.6 (S.D.N.Y. Feb. 1, 2016) (easement not granted in perpetuity and its conservation purpose not protected in perpetuity until year of recordation); Ten Twenty Six Investors v. Commissioner, T.C. Memo. 2017-115, at *31-*32 (same); *cf.* Gorra v. Commissioner, 106 T.C.M. (CCH) 523, 532 (2013) (under New York law, delivery to the recording office was sufficient to establish the easement's priority in the chain of title and thus satisfy recordation requirement despite a cover sheet error delaying actual recordation until following calendar year). One of the taxpayers in *Zarlengo* was permitted to redetermine her liability for 2005, 2006, and 2007 because the perpetuity and other requirements for the deduction were satisfied as of January 26, 2005. *Zarlengo*, 108 T.C.M. (CCH) at 161.

[36] Recording statutes vary from state to state, but generally impose a harsh result on grantees of real property interests who fail properly to record their deeds. Bona fide purchasers who acquire an interest without notice of a prior claim are protected from the enforcement of the prior claim. *See* 14 RICHARD R. POWELL, POWELL ON REAL PROPERTY § 82.01[3] (Michael Allan Wolf Desk ed., 2009). In addition, as noted in *Zarlengo*, some state conservation easement enabling statutes specifically require recordation for an easement to be legally enforceable. *See, e.g.*, N.Y. ENVTL. LAW § 49-0305(4) (Consol. 2013) ("An instrument for the purpose of creating, conveying, modifying or terminating a conservation easement shall not be effective unless recorded").

B. Baseline Documentation

1. Requirement

Most donors of conservation or facade easements reserve certain development or use rights in the easements, the exercise of which might impair the conservation or historic interests associated with the property. The Treasury Regulations provide that, in such cases, a deduction is allowable only if the donor makes available to the donee, prior to the time the donation is made, documentation sufficient to establish the condition of the property at the time of the gift.[37] This documentation, typically referred to as "baseline documentation," may include:

> (i) survey maps from the United States Geological Survey showing the property line and other contiguous or nearby protected areas;
> (ii) a map of the area drawn to scale showing all existing man-made improvements or incursions (such as roads, buildings, fences, or gravel pits), vegetation, identified flora and fauna (including, for example, rare species locations, animal breeding and roosting areas, and migration routes), land use history (including present uses and recent past disturbances), and distinct natural features (such as large trees or aquatic areas);
> (iii) an aerial photograph of the property at an appropriate scale taken as close as possible to the date of the donation; and
> (iv) on-site photographs taken at appropriate locations on the property.[38]

If the terms of the donation contain restrictions with regard to a particular natural resource to be protected, such as water quality or air quality, the condition of that resource at or near the time of the gift must be specifically established.[39] The baseline documentation must also be accompanied by a statement signed by both the donor and a representative of the donee that clearly references the documentation and in substance states: "This natural resources inventory is an accurate representation of [the protected property] at the time of the transfer."[40]

Baseline documentation is intended to "protect the conservation interests associated with the property, which although protected in perpetuity by the

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[37] Treas. Reg. § 1.170A-14(g)(5)(i) (2009) (this requirement applies to donations made after February 13, 1986). Donations of easements in which the donor does not retain any development or use rights are rare. In the vast majority of cases, an easement donor will retain certain development and use rights, the exercise of which, if done improperly, could impair the conservation or historic interests associated with the property (such as the right to construct additional residences and ancillary structures on the property, which also entails access and utility rights). Accordingly, in the vast majority of cases, baseline documentation is required.
[38] *Id.* § 1.170A-14(g)(5)(i)(A)–(D).
[39] *Id.* § 1.170A-14(g)(5)(i)(D).
[40] *Id.*

easement, could be adversely affected by the exercise of the reserved rights."[41] Such documentation is critical to the ability of the nonprofit or governmental holder of an easement to properly monitor and enforce the easement over its perpetual life. If there is no record of the improvements and incursions on the property at the time the donation was made, it may be impossible for the holder to prove, at some later date, that a violation has occurred.[42] Similarly, if there is no record of the condition of the property's conservation values at the time the donation was made (such as forestland, meadows, wetlands, riparian areas, or specific habitat), it may be impossible for the holder of the easement to prove, at some later date, that the conservation values have been degraded or destroyed or the extent of the damage or destruction. The Conservation Easement Handbook explains, "[m]onitoring and enforcement may be seriously hampered without a record of how the property looked when it was in compliance with the requirements of the easement."[43]

2. Case Law

In *Bosque Canyon Ranch v. Commissioner*, the Tax Court sustained the Service's disallowance of $15.9 million of deductions that limited partnerships claimed for the donation of two conservation easements to the North American Land Trust (NALT).[44] In addition to finding that the easements had not been "granted in perpetuity" because the two parties to the easement could agree to

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[41] *Id.* § 1.170A-14(g)(5)(i).

[42] *See, e.g.*, Ann Taylor Schwing, *Baseline Authentication and Admissibility*, CONSERVATION TAX CTR., http://www.conservationtaxcenter.org/article/Conservation-Easements/Expert-Publications/Baseline-Authentication-and-Admissibility/1041 (last visited Sept. 4, 2016) ("[A]dmission at trial of a well-prepared baseline will provide evidence that there was no second residence on the property, no road or no orchard").

[43] ELIZABETH BYERS & KARIN MARCHETTI PONTE, THE CONSERVATION EASEMENT HANDBOOK 114 (2d ed. 2005); *see also id.* at 100 ("If a conservation organization is to succeed in its most fundamental goal, the permanent protection of open space, it must systematically document baseline and stewardship information for the properties which it protects," quoting Eric Eller, executive director, Capital Land Trust).

[44] Bosque Canyon Ranch v. Commissioner, 110 T.C.M. (CCH) 48 (2015). *Bosque Canyon Ranch* is one of three recent cases in which the Tax Court denied deductions for conservation easements conveyed to the North American Land Trust (NALT). See *Balsam Mountain v. Commissioner*, 109 T.C.M. (CCH) 1214 (2015), involving an easement that authorized the parties to agree to prohibited swaps as discussed *infra* Part I.D, and *Atkinson v. Commissioner*, 110 T.C.M. (CCH) 550 (2015), involving an easement on a pesticide-ridden golf course in a gated and guarded residential community that did not satisfy the conservation purposes test. NALT also was the donee in *Kiva Dunes v. Commissioner*, 97 T.C.M. (CCH) 1818 (2009), in which the Tax Court allowed the taxpayer to claim a $28.6 million deduction for the donation of a conservation easement on a golf course. *Kiva Dunes* inspired the Treasury to recommend eliminating the deduction with regard to golf course easements in each of the Administration's budget proposals for the last five years. *See supra* note 19.

swaps, as discussed below,[45] the court determined that the limited partnerships did not comply with the baseline documentation requirement.[46]

The limited partnerships reserved the right to engage in various activities on the subject properties that had the potential to impair conservation interests, including hunting, trapping, and construction.[47] Accordingly, each partnership was required to make available to NALT, before the donation was made, documentation sufficient to establish the condition of the property at the time of the gift.[48] Although NALT prepared baseline documentation for each of the easements at the partnerships' direction, it was each partnership's responsibility, as the easement donor, to ensure that the baseline documentation requirement was satisfied.[49]

The Tax Court found that the baseline documentation reports prepared by NALT were "unreliable, incomplete, and insufficient to establish the condition of the relevant property on the date the respective easements were granted."[50] Among other things, parts of the reports had been prepared well before and parts had been prepared well after the date of the donations.[51] In addition, in one case, the donor partnership failed to sign the report to certify that the report provided an accurate representation of the protected property at the time of the donation.[52] The court noted that, at trial, "in rambling, incoherent testimony," NALT's president "failed to clarify these glaring inconsistencies."[53] The court also found meritless and rejected the partnerships' argument that they had substantially complied with the baseline documentation requirement.[54]

The Tax Court further found that one of the limited partnerships was not eligible for the reasonable cause exception to the gross valuation misstatement penalty because it did not act reasonably or in good faith with respect to the baseline documentation requirement.[55] The court noted that the partnerships' representative failed to effectively supervise or review NALT's "slipshod" preparation of the baseline documentation reports.[56] Accordingly, the partnership had not made a

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[45] *See infra* note 144 and accompanying text.
[46] *See Bosque Canyon Ranch*, 110 T.C.M. (CCH) 48, at *13–15 (2015). The court also found that the partnerships' sales of movable "homesite parcels" to the limited partners were taxable as disguised sales under the Code section 707, which prevents use of the partnership provisions to render nontaxable what would in substance have been a taxable exchange if it had not been run through the partnership. *See id.* at *15–19.
[47] *See id.* at *12–13.
[48] *See* Treas. Reg. § 1.170A-14(g)(5)(i) (2009).
[49] *Id.*; *Bosque Canyon Ranch*, 110 T.C.M. (CCH) 48, at *12–14 (2015).
[50] *Bosque Canyon Ranch*, 110 T.C.M. (CCH) 48, at *13 (2015).
[51] *Id.* at *13–14.
[52] *Id.* at *14–15.
[53] *Id.* at *14.
[54] *Id.* at *15.
[55] *Id.* at *21–22. The other partnership was not eligible for the reasonable cause exception because the return on which it claimed the deduction for the easement donation was filed after the date on which the gross valuation misstatement penalty became a strict liability penalty. *Id.* at *22.
[56] *Id.* at *21.

reasonable attempt to comply with section 170(h) or the Treasury Regulations, and any reliance on NALT with regard to the report had been unreasonable.[57]

The partnerships' failure to ensure that NALT either prepared or was provided with reliable and complete baseline documentation for each of the properties put the long term enforcement of the easements, which the partnerships valued at $8.4 million and $7.5 million respectively, in serious jeopardy.[58] Without an accurate record of the condition of the properties at the time the donations were made, NALT's ability in the future to prove that violations have occurred or that protected conservation values have been degraded or destroyed (such as the habitat of the endangered golden-cheeked warbler) is seriously hampered.[59] Moreover, the rights to use the properties that were reserved in the easement, coupled with the sale of forty-seven movable "homesite parcels" to limited partners, each of whom can construct a home on the parcel and use the remaining property for various activities, such as swimming, hiking, biking, horseback riding, and hunting, increases the probability of violations and damage to or destruction of conservation values.[60]

3. Importance

The baseline documentation requirement is a key component of the section 170(h) tax-incentive program and noncompliance with the requirement should not be treated as an excusable foot fault. Federal taxpayers should not be expected to fund the acquisition of conservation easements that cannot be appropriately monitored and enforced and, thus, will not protect the conservation values they are intended to protect over the long term. Simply put, as the Treasury recognized when it drafted the regulations interpreting section 170(h), conservation easements that do not include reliable and complete baseline documentation are not good long-term conservation investments.

Existing evidence indicates that noncompliance with the baseline documentation requirement may be common. The Land Trust Accreditation Commission, a self-regulatory body that was formed after publication of the *Washington Post* articles describing abuses,[61] reported in September 2016 that approximately sixty-five percent of all accredited land trusts had been issued an "Expectation for Improvement" regarding baseline documentation for their easements.[62] In other words, roughly two-thirds of the land trusts that had been

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[57] *Id.*
[58] *See id.* at *9–10 (noting the amount of the claimed deductions).
[59] Both easements indicated that the subject properties contained habitat of the golden-cheeked warbler, an endangered species of bird endemic to, and nesting only in, Texas. *See id.* at *4, 8.
[60] *See id.* at *6–7, *8–9 (describing the homesite parcels and accompanying rights).
[61] *See* LAND TRUST ACCREDITATION COMM., http://www.landtrustaccreditation.org (last visited Nov. 6, 2016); *supra* note 3.
[62] *See Practice 11B. Baseline Documentation Report*, LAND TRUST ACCREDITATION COMM., http://www.landtrustaccreditation.org/help-and-resources/expectations-for-improvement/342-

given the Commission's seal of approval did not fully comply with the Commission's baseline documentation requirements (which are modeled on the Treasury Regulation requirements), presumably because they either did not have baseline documentation for some or all of their easements or the documentation did not meet the requirements. The negative effects of this noncompliance are likely to manifest only over time, as easements are violated and holders either institute enforcement actions that are ultimately unsuccessful, or decline to institute enforcement actions, in each case due to lack of appropriate baseline documentation.

C. Mortgage Subordination

1. Requirement

The Treasury Regulations provide that no deduction will be permitted for the donation of a conservation easement after February 13, 1986, if the property to which the easement relates is subject to a mortgage "unless the mortgagee subordinates its rights in the property to the right of the qualified organization to enforce the conservation purposes of the gift in perpetuity" (the "mortgage subordination regulation").[63] Although the Treasury Regulations do not explain this requirement, its purpose seems clear: to ensure that the rights of the donee with regard to the perpetual charitable gift will be superior to the rights of the donor's mortgage lender.

Ensuring that the rights of the donee with regard to the perpetual charitable gift will be superior to the rights of the donor's mortgage lender should accomplish two goals. First, it should prevent extinguishment of the easement (and application of its value to pay off the donor's personal debts) if the donor defaults on the mortgage and the lender forecloses on the subject property. If a lender subordinates its rights to the rights of the donee, the easement should survive foreclosure and the lender should take the property subject to the easement.

Subordination should also protect the public's investment in the gift in the unlikely event of extinguishment of the easement. If a lender subordinates its rights to all of the donee's rights, including the donee's right to receive a share of proceeds

practice-11b-baseline-documentation-report (last visited Sept. 4, 2016); *Expectations for Improvement*, LAND TRUST ACCREDITATION COMM., http://www.landtrustaccreditation.org/help-and-resources/expectations-for-improvement (last visited Sept. 4, 2016) (an Expectation for Improvement is issued to a land trust "when the Commission determines that an organization needs to do additional work to fully comply with one or more elements of an indicator practice.").

[63] Treas. Reg. § 1.170A-14(g)(2) (2009). For donations made prior to February 14, 1986, the "protected in perpetuity" requirement of section 170(h)(5)(A) is satisfied in the case of property with respect to which the mortgagee has not subordinated its rights to the rights of the donee only if the donor can demonstrate that the conservation purpose is protected in perpetuity without such subordination. *Id.*

following extinguishment to be used for similar conservation purposes,[64] the donee will be able to continue to "enforce the conservation purposes of the gift in perpetuity" (as the mortgage subordination regulation contemplates[65]), although the form of the gift will have changed.

An older case involving a facade easement that was purportedly donated before the effective date of the mortgage subordination regulation discusses the first goal of the regulation: elimination of the extinguishment-upon-foreclosure danger. In *Satullo v. Commissioner*, the donee of a facade easement had lost a large percentage of its easements in foreclosure proceedings.[66] The Tax Court explained that

> of the 21 or 22 easements [the donee] has accepted since its incorporation, eight or nine have been lost in foreclosure proceedings to priority lienholders that had not subordinated their security interests in the properties to the right of [the donee] to enforce the easements' terms. Pared down to percentages, . . . [the donee] has lost in foreclosure proceedings between 38 and 45 percent of its accepted easements. [The donee's] high percentage of lost easements underscores the emphasis [that the mortgage subordination regulation] places on subordination agreements as a means of assuring that easements on mortgaged property are protected in perpetuity.[67]

2. Case Law

(a) Subordination at Time of Gift. In three recent cases, U.S. Courts of Appeal have confirmed that, to be eligible for a deduction for the donation of a conservation easement, any lender holding an outstanding mortgage on the subject property must subordinate its rights to the rights of the donee at the time of the gift.[68] In the first case, *Mitchell v. Commissioner*, the Tenth Circuit affirmed the Tax Court's disallowance of a deduction claimed for the donation of a conservation easement encumbering approximately forty percent of a 456-acre ranch in

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[64] With one limited exception, Treasury Regulation section 1.170A-14(g)(6) mandates that, in the event of extinguishment of an easement, the donee must be entitled to at least a minimum proportionate share of the proceeds from a subsequent sale or exchange of the property to be used "in a manner consistent with the conservation purposes of the original contribution."

[65] *See supra* note 63 and accompanying text.

[66] Satullo v. Commissioner, 66 T.C.M. (CCH) 1697, 1701 (1993), *aff'd* 67 F.3d 314 (11th Cir. 1995).

[67] *Id.* The Tax Court upheld the Service's disallowance of the deductions claimed with regard to the facade easement in *Satullo* because the taxpayers did not obtain a mortgage subordination agreement and, under the rule applicable to donations made before February 13, 1986, the taxpayers were unable to show that the possibility that the holder might lose the easement in a foreclosure proceeding was so remote as to be negligible. *Id.* at 1701–02.

[68] *See* Mitchell v. Commissioner, 775 F.3d 1243, 1250–51 (10th Cir. 2015); Minnick v. Commissioner, 796 F.3d 1156, 1160 (9th Cir. 2015); RP Golf, L.L.C., v. Commissioner, 860 F.3d 1096, 1099-00 (8th Cir. 2017).

Colorado.[69] The taxpayer in *Mitchell* donated the easement to a local land trust and claimed a deduction of $504,000. The taxpayer failed, however, to obtain a subordination agreement from the lender holding an outstanding mortgage on the subject property until almost two years after the date of the gift.[70]

The taxpayer argued that the mortgage subordination regulation contains no explicit reference to the time at which subordination must occur and, thus, it should be interpreted to allow subordination to occur at any time. The Tenth Circuit rejected that argument. It explained that the regulation expressly provides that subordination is a prerequisite to allowing a deduction.[71] Accordingly, it held that the plain language of the regulation precludes a deduction unless a subordination agreement is obtained at the time of the gift.[72]

The taxpayer in *Mitchell* argued in the alternative that strict compliance with the mortgage subordination requirement was unnecessary in her particular case because, given her credit history, the risk of foreclosure was negligible. She provided evidence that the family limited partnership that donated the easement paid its debts on time and had sufficient assets at all relevant times to satisfy the amounts due on the mortgage.[73] The Tenth Circuit rejected that argument as well, explaining that it was reasonable for the Commissioner to adopt an easily-applied subordination requirement over a case-by-case, fact-specific inquiry into the financial strength or credit history of each taxpayer. The court further explained:

> The specific requirements in the Code and Treasury Regulations establish bright-line rules that promote efficient and equitable administration of the federal tax incentive program. If individual taxpayers could fail to comply with such requirements and claim that their donations are nonetheless deductible because the possibility of defeasance of the gift is so remote as to be negligible, the Service and the courts would be required to engage in

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[69] *See Mitchell*, 775 F.3d at 1245–46.

[70] *Id.* at 1246. The Service also challenged the claimed deduction on a number of other grounds, including overvaluation. *See* Mitchell v. Commissioner, 138 T.C. 324, 325, n.2 (2012).

[71] *See Mitchell*, 775 F.3d at 1250 ("The provision states 'no deduction *will* be permitted under this section for an interest in property which is subject to a mortgage *unless* the mortgagee subordinates its rights in the property.' ([E]mphasis added).") (citation omitted).

[72] *Id.* The Tenth Circuit further explained that, even if the regulation were ambiguous with respect to timing, the result would be no different because the Commissioner's interpretation is reasonable and consistent with section 170(h)'s requirement that the conservation purpose of the contribution be "protected in perpetuity." *Id.* at 1250–51 ("Because a conservation easement subject to a prior mortgage obligation is at risk of extinguishment upon foreclosure, requiring subordination at the time of the donation is consistent with the Code's requirement that the conservation purpose be protected in perpetuity.").

[73] *See id.* at 1245–46. A family limited partnership of which the taxpayer in *Mitchell* was a partner donated the easement. *See id*.

> an almost endless series of factual inquiries with regard to each individual conservation easement donation.[74]

In *Minnick v. Commissioner*, the Ninth Circuit similarly disallowed deductions claimed for the donation of a conservation easement because the taxpayers did not obtain a mortgage subordination agreement at the time of the gift.[75] Minnick, a former member of the U.S. House of Representatives from Idaho who was trained as a lawyer, donated the easement to a local land trust in 2006. The easement encumbered eighty percent of a 74-acre parcel in Idaho, the remainder of which Minnick intended to develop.[76] Minnick valued the easement at $941,000 and he and his wife claimed deductions with regard to the donation over a three-year period.[77] Despite warranties in the easement deed to the contrary, Minnick did not obtain a subordination agreement from the lender holding an outstanding mortgage on the property until 2011, as the case was approaching trial in the Tax Court.[78]

In support of its holding disallowing the deductions, the Ninth Circuit cited *Mitchell* and explained that, under the plain meaning of the mortgage subordination regulation, no deduction is permitted unless a subordination agreement is obtained at the time of the donation.[79] The court further explained:

> An easement can hardly be said to be protected "in perpetuity" if it is subject to extinguishment at essentially any time by a mortgage holder who was not

[74] *Id.* at 1254–55 (quoting *National Perpetuity Standards*, *supra* note 24, at 505–06). The taxpayer in *Mitchell* argued that Treasury Regulation section 1.170A-14(g)(3), which provides that a deduction will not be disallowed merely because the interest that passes to the donee organization may be defeated by the happening of some future event "if on the date of the gift it appears that the possibility that such . . . event will occur is so remote as to be negligible," provided an exception to the subordination requirement. The Tenth Circuit disagreed, explaining that, in promulgating the Treasury Regulations, the Commissioner specifically considered the risk of mortgage foreclosure to be neither remote nor negligible, and therefore chose to target the accompanying risk of extinguishment of the conservation easement by strictly requiring mortgage subordination. The court concluded that the remote future event provision could not be reasonably read as modifying the strict mortgage subordination requirement. *See id.* at 1253.
[75] Minnick v. Commissioner, 796 F.3d 1156, 1157 (9th Cir. 2015).
[76] *See id.* at 1157–58; Minnick v. Commissioner, 104 T.C.M. (CCH) 755, 756, 759, 759 n.2 (2012).
[77] *Minnick*, 796 F.3d at 1158.
[78] *Id.* The conservation easement stated: "'Grantor [i.e. Minnick] warrants . . . that there are no outstanding mortgages, tax liens, encumbrances, or other interests in the Property that have not been expressly subordinated to the Easement.'" *Minnick*, 104 T.C.M. (CCH) at 756. Minnick argued that this provision demonstrated that he intended that the mortgage be subordinated when he granted the easement. The Tax Court disagreed, noting that the provision meant only that Minnick falsely—although the court thought unintentionally—represented that the mortgage had been subordinated. *Id.* at 757.
[79] *Minnick*, 796 F.3d at 1159.

a party to, and indeed (as here) may not even have been aware of, the agreement between the Taxpayers and a [land] trust.[80]

In the third case, *RP Golf, L.L.C. v. Commissioner,* the Eighth Circuit sustained the Service's disallowance of a $16.4 million deduction claimed with regard to the donation of a conservation easement on two private golf courses in Kansas City, Missouri.[81] As in *Mitchell* and *Minnick*, the taxpayer in *RP Golf, L.L.C.,* failed to obtain the necessary mortgage subordination agreements at the time of the gift. The Eighth Circuit agreed with the Ninth and Tenth Circuits that mortgage subordination agreements must be obtained at the time of the gift.[82] The taxpayer in *RP Golf* argued that the lenders holding outstanding mortgages on the subject properties had orally agreed to subordinate their interests before the date of the gift.[83] However, the Tax Court found no evidence of binding oral subordination agreements under state law and the Eight Circuit held that this finding was not clearly erroneous.[84]

The taxpayers' failures to obtain mortgage subordination agreements at the time of the donations in *Mitchell*, *Minnick*, and *RP Golf, L.L.C.*, put the conservation easements at issue in those cases at risk of extinguishment in the event of foreclosure. That risk could easily have been avoided by obtaining subordination agreements at the time of the gifts. The taxpayers in each case were able to obtain subordination agreements when they requested them.[85] Their failure to obtain the

[80] *Id.* at 1160. The Service challenged the deduction in *Minnick* on a number of other grounds, including that the conveyance was not a charitable gift because it was part of a *quid pro quo* exchange, the easement did not serve conservation purposes, the easement was not protected in perpetuity because it could be amended by agreement of Minnick and the land trust when they deemed it to be "appropriate," the easement failed to provide for the allocation of proceeds to the land trust upon extinguishment, any allowable deduction would be limited to the amount of basis of the land allocated to the easement, and the easement was overvalued. *Minnick*, 104 T.C.M. (CCH) at 756. The courts did not address these issues because the deduction was denied for failure to comply with the mortgage subordination regulation. *See id.* at *5, *11.

[81] RP Golf, L.L.C., v. Commissioner, 860 F.3d 1096 (8th Cir. 2017).

[82] *Id.* at 1100.

[83] *Id*.

[84] *Id*. at 1100-01. There were additional problems with the easement donation in *RP Golf, L.L.C*. For example, the taxpayer did not own a portion of the property purportedly subject to the easement. RP Golf, L.L.C., v. Commissioner, 111 T.C.M. (CCH) 1362, at *18 (2016). The taxpayer represented that protection of the land was pursuant to a clearly delineated Missouri conservation policy but that policy did not apply to the property. *Id.* at *15–16. And the appraisal estimating that the value of the easement was $16.4 million included a description of property that the taxpayer did not own. *See id.* at *9 n.9, *12 n.11.

[85] Even if a lender refuses to subordinate its rights to the rights of the holder of the easement, which can sometimes happen, the property owner has a number of options. The owner could consider paying down the mortgage to the point at which the lender would be willing to subordinate, paying off the mortgage, or refinancing with a different lender willing to so subordinate before making the donation. Alternatively, the property owner could delay the donation until the lender is willing to subordinate.

agreements at the time of the gifts appears to have been due to sloppiness, inattentiveness, or lack of representation by competent counsel.[86]

(b) Subordination to Holder's Right to Proceeds. Treasury Regulation section 1.170A-14(g)(6)(ii) (the "proceeds regulation") provides that, following judicial extinguishment of a tax-deductible easement,[87] the donee must be entitled to at least a minimum proportionate share of proceeds from the subsequent sale, exchange, or involuntary conversion of the subject property, to be used in a manner consistent with the conservation purposes of the original contribution.[88] In *Kaufman v. Shulman*, the Kaufmans donated a facade easement with regard to their residence (a rowhouse) in Boston's historic South End to a nonprofit.[89] The Kaufmans included a clause in the easement deed that provided for the payment of the required minimum proportionate share of post-extinguishment proceeds to the donee nonprofit.[90] However, the subordination agreement that the Kaufmans obtained from the lender holding an outstanding mortgage on the property provided that, if the easement were extinguished as a result of a casualty event (such as a fire or flood) or condemnation, the lender had first priority to any insurance or condemnation proceeds.[91] Accordingly, despite the clause in the Kaufmans' easement providing for the payment of a share of post-extinguishment proceeds to the donee, the donee might not receive any such proceeds due to the lender's priority rights.

The Service argued that the provision included in the Kaufmans' easement deed regarding the payment of a share of post-extinguishment proceeds to the donee did not satisfy the proceeds regulation because its operation was impermissibly qualified by the terms of the subordination agreement. The First Circuit disagreed, holding that, for purposes of satisfaction of the proceeds regulation, it is sufficient

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[86] Mr. Minnick, for his part, sued the attorney who assisted him with the donation for malpractice. The attorney defended himself by arguing, in part, that he had been hired to provide real estate rather than tax law advice. *See* Keith Miller, *Minnick v. Ennis, No. 41663: Supreme Court of Idaho Remands Dismissal of Legal Malpractice Case*, LEGAL MALPRACTICE LAWYER BLOG (Jan. 22, 2015), http://www.legalmalpracticelawyer.com/2015/01/22/461/.

[87] Pursuant to Treasury Regulation section 1.170A-14(g)(6)(i), a conservation easement can be extinguished in a judicial proceeding upon a finding that continued use of the property for conservation purposes has become impossible or impractical.

[88] There is one minor exception to this requirement—if "state law provides that the donor is entitled to the full proceeds from the conversion without regard to the terms of the prior perpetual conservation restriction." Treasury Regulation § 1.170A-14(g)(6)(ii). A few state codes so provide, presumably to ensure that condemning authorities are required to pay the full unrestricted value of easement-encumbered land upon condemnation. For a critique of these statutes, see *National Perpetuity Standards*, *supra* note 24, at 500 n.103, 510 n.145. Treasury Regulation section 1.170A-14(g)(6) is discussed in more detail *infra* Part I.D.

[89] Kaufman v. Shulman, 687 F.3d 21 (1st Cir. 2012).

[90] In easement deeds, the donee is generally referred to as the "grantee," and that term is generally defined to include the original grantee and all successors in interest.

[91] *Id*. at 24.

that the donee have the right to recover its share of proceeds from the property owner.[92] The First Circuit also noted, however, that the mortgage subordination regulation (as opposed to the proceeds regulation) could be read to require that a lender subordinate its rights to the donee's right to post-extinguishment proceeds.[93] Given the Service's focus on the proceeds regulation in *Kaufman*, the First Circuit specifically declined to address this issue.[94]

Requiring that a lender subordinate its rights to the right of the donee to receive its share of post-extinguishment proceeds is the most sensible reading of the mortgage subordination regulation. The mortgage subordination regulation requires that a lender subordinate its rights in the property to the right of the donee "to enforce the conservation purposes of the gift in perpetuity."[95] The donee of an easement cannot "enforce the conservation purposes of the gift in perpetuity" unless, following extinguishment of the easement, the donee receives a share of proceeds to be used in manner consistent with the conservation purposes of the original contribution (e.g., to acquire a similar easement or other replacement conservation property). In other words, the regulations contemplate that the charitable gift might change form at some point (from the original easement, to post-extinguishment proceeds, to a new easement or replacement conservation property), and they require that a lender subordinate its rights to the rights of the qualified organization to enforce the conservation purposes of the gift, regardless of its form, in perpetuity.

This reading of the mortgage subordination regulation also comports with the substance of a conservation easement donation transaction. When a property owner makes a charitable gift of a conservation easement to a qualified organization, the owner conveys a partial interest in the property to the organization to be held and enforced for the benefit of the public. The owner retains ownership of the remaining interest in the property—the property encumbered by the easement. The property owner's lender should not have a security interest in the

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[92] *Kaufman*, 687 F.3d at 26–27.
[93] In footnote 5 of its opinion, the First Circuit explained:

> The Kaufmans argue that because [the mortgage subordination regulation] deals expressly with subordination and only requires that "the mortgagee subordinate[] its rights in the property to the right of the qualified organization to enforce the conservation purposes of the gift," it is per se improper for the IRS to argue that some other right of the bank—here, to insurance and condemnation proceeds—should have been subordinated. But the Kaufmans' argument could be turned against them by reading "conservation purposes" broadly to include the donee organization's right to post-extinguishment proceeds (which, by regulation, must be used to advance "conservation purposes," . . .).

Id., 687 F.3d at 27 n.5.
[94] *Id.* (stating, without explanation, that "As the IRS disclaimed this broad reading of [the mortgage subordination regulation], we need not pursue this issue."); *see also* Mitchell v. Commissioner, 775 F.3d 1243, 1254, n.6 (10th Cir. 2015) ("The First Circuit . . . specifically declined to address whether the taxpayer had complied with the mortgage subordination provision.").
[95] Treas. Reg. § 1.170A-14(g)(2) (2009).

easement or the post-extinguishment proceeds attributable thereto because, once the gift has been made, the easement is a charitable asset held by the qualified organization for the benefit of the public. The property owner's lender should have a security interest in only what the owner continues to own—the property encumbered by the easement. Allowing the property owner's lender to retain a security interest in the post-extinguishment proceeds attributable to the easement significantly compromises the integrity of the charitable gift. In such a case, if the easement is later extinguished, the proceeds attributable to the easement may be used to satisfy the personal debt of the property owner rather than to acquire a similar easement or other replacement conservation property. And relegating the donee to seeking its share of post-extinguishment proceeds from the property owner may leave the donee and, by extension, the public, with nothing more than an expensive-to-pursue claim against a judgment-proof owner.[96]

The taxpayers' failure in *Kaufman* to obtain a "full" subordination agreement (in which the lender subordinates its rights in the subject property to all of the rights of the donee, including the donee's right to a share of post-extinguishment proceeds) appears to have been due to the donors' lack of representation by competent counsel and reliance on the donee's form or "template" subordination agreement.[97] Donor reliance on a donee's template subordination

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[96] The Tax Court does not appear to agree with the First Circuit's holding regarding the proceeds regulation in *Kaufman* and may not follow that holding in cases appealable to a different Circuit Court of Appeals. In *Irby v. Commissioner*, which was decided after *Kaufman*, the Tax Court noted:

> In cases involving a conservation easement where we determined that the regulation's requirements were not met and thus denied the claimed charitable contribution deduction, the grantee organization had been prevented by the deeds themselves from receiving the full proportionate value of the extinguishment proceeds. *See* T.C. Memo 2012-169, *id.* at *3–4 The funds diverted by the deeds were used to further the donor taxpayer's interests. For example, in *Wall*, the deed of conservation easement provided that if the property was condemned, the grantee conservation organization would be entitled to the easement's proportionate value, but only after any claim of a mortgagee was satisfied. Hence, the first use of the extinguishment proceeds was to further the donor taxpayer's interest in repaying the mortgage on the property, with the grantee conservation organization's receiving only a residual amount of money. *Id.; see also Mitchell v. Commissioner,* 138 T.C. 324, 2012 U.S. Tax Ct. LEXIS 17 (Apr. 3, 2012); *1982 East, L.L.C. v. Commissioner,* T.C. Memo. 2011–84.
>
> Our conclusions in those cases (i.e., denying the deduction) reflect the purpose of the regulation.

Irby v. Commissioner, 139 T.C. 371, 381 (2012). *See also* Nancy A. McLaughlin, *Extinguishing and Amending Tax-Deductible Conservation Easements: Protecting the Federal Investment After* Carpenter, Simmons, *and* Kaufman, 13 FLA. TAX REV. 217, 272–276 (2012) (critiquing the First Circuit's decision in *Kaufman*) [hereinafter *Extinguishing and Amending*].

[97] The donee organization in *Kaufman* apparently supplied facade easement donors with a template "limited" subordination agreement to present to lenders, even though there was disagreement in the

agreement or template conservation easement deed is inappropriate because the donee's legal counsel represents the interests of the donee, not the donor, and, as with any charitable donation, the interests of the donor and the donee are not perfectly aligned.[98] Moreover, most donees are careful to make clear to prospective donors that they cannot provide them with tax or other legal advice.[99]

The First Circuit eventually affirmed the Tax Court's complete disallowance of the Kaufmans' claimed deduction as well as the imposition of penalties. The First Circuit agreed with the Tax Court that the easement was "worthless" (it merely duplicated restrictions already imposed by local law) and that the Kaufmans did not act in good faith in claiming a sizable deduction for an easement that the donee had told them did not reduce the value of their home.[100]

3. Importance

The mortgage subordination requirement is another key component of the section 170(h) tax-incentive program and noncompliance with this requirement also should not be treated as an excusable foot fault. Federal taxpayers should not be expected to fund the acquisition of conservation easements that are at risk of extinguishment, and the consequent loss of the public investment, through foreclosure. Federal taxpayers also should not be expected to fund the acquisition of conservation easements where the public investment may be lost upon judicial extinguishment because the donor's lender was permitted to retain priority rights to post-extinguishment proceeds. As with conservation easements that are not recorded or that lack appropriate baseline documentation, easements that are subject to extinguishment through foreclosure, or the value attributable to which may be used to pay off the property-owner's debts rather than replace lost conservation values following extinguishment, are not good long-term conservation investments.

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land trust community as to whether such a limited agreement complied with federal tax law requirements. *See Extinguishing and Amending*, *supra* note 96, at 273–75. It is possible that the Kaufmans would have been able to obtain a full subordination agreement from their lender had they asked. *See id.* at 273 n.177.

[98] Most notably, it is the donor, not the donee, who will suffer the economic setback of having a deduction denied and perhaps the payment of penalties as the result of a noncompliant donation. Accordingly, savvy charitable donors employ their own legal counsel to represent their interests, and conservation easement donors should be no exception.

[99] The Land Trust Standards and Practices caution land trusts to advise easement donors to obtain independent legal advice because the donor and the land trust have "independent interests to protect." *See* LAND TRUST ALLIANCE, BACKGROUND TO THE 2004 REVISIONS OF LAND TRUST STANDARDS AND PRACTICES § 9B (2004).

[100] *See* Kaufman v. Commissioner, 784 F.3d 56, 58, 66–69 (1st Cir. 2015).

D. Extinguishment

1. Requirements

Tax-deductible conservation easements are intended to protect the conservation values of the properties they encumber in perpetuity or forever.[101] However, forever is a long time, and the Treasury recognized that, in rare circumstances, changed conditions might make continuing to use some of the encumbered properties for conservation purposes impossible or impractical. To ensure that the easements subsidized through the deduction program will be permanent and, at the same time, protect the federal investment in the event of extinguishment of some easements due to impossibility or impracticality, the Treasury crafted the "judicial proceeding" and "proceeds" regulations (together, the "extinguishment" regulation), which provide as follows:

> <u>Judicial Proceeding Regulation</u>
>
> If a subsequent unexpected change in the conditions surrounding the property . . . can make impossible or impractical the continued use of the property for conservation purposes, the conservation purpose can nonetheless be treated as protected in perpetuity if the restrictions are extinguished by judicial proceeding and all of the donee's proceeds [determined as provided in the proceeds regulation] from a subsequent sale or exchange of the property are used by the donee organization in a manner consistent with the conservation purposes of the original contribution.[102]
>
> <u>Proceeds Regulation</u>
>
> [A]t the time of the gift the donor must agree that the donation of the perpetual conservation restriction gives rise to a property right, immediately vested in the donee organization, with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction at the time of the gift, bears to the value of the property as a whole at that time. . . . [T]hat proportionate value of the donee's property rights shall remain constant. Accordingly, when a change in conditions give rise to the extinguishment of a perpetual conservation restriction [as provided in the extinguishment regulation], 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

[101] *See, e.g.*, *In Perpetuity*, BLACK'S LAW DICTIONARY (10th ed. 2014) (defining "in perpetuity" as "Forever; without end.").
[102] Treas. Reg. § 1.170A-14(g)(6)(i) (2009).

> of the perpetual conservation restriction, unless state law provides that the donor is entitled to the full proceeds from the conversion without regard to the terms of the prior perpetual conservation restriction.[103]

The extinguishment regulation has two purposes. First, it is intended to limit the extinguishment of tax-deductible conservation easements to exceptional circumstances; extinguishments can occur only when it can be demonstrated to the satisfaction of a court that continuing to use the encumbered property for conservation purposes has become impossible or impractical due to changed conditions. This is consistent with section 170(h)'s requirements that tax-deductible easements be "granted in perpetuity" and their conservation purposes be "protected in perpetuity."[104] It also is consistent with Congress's intent that the deduction be directed at the permanent preservation of "unique or otherwise significant land areas or structures."[105]

The extinguishment regulation is also intended to protect the federal investment in conservation in the rare event of an extinguishment. The regulation accomplishes this second goal by mandating that, in the event of an extinguishment, the holder must be entitled to at least a minimum proportionate share of proceeds and be required to use those proceeds in a manner consistent with the conservation purposes of the original contribution.

Those familiar with the laws governing restricted charitable gifts (which tax-deductible conservation easements, by definition, are[106]) will recognize that the extinguishment regulation is a regulatory version of the state law doctrine of cy pres.[107]

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[103] *Id.* § 1.170A-14(g)(6)(ii) (2009).

[104] I.R.C. §§ 170(h)(1), (h)(2)(C), (h)(5)(A).

[105] S. REP. NO. 96-1007, at 20–21 (1980). Congress also explained in the legislative history of section 170(h) that it intended, among other things, that tax-deductible easements must be enforceable by the donee organizations and their successors against all other parties in interest, that contributions of easements would be made only to donees that have the commitment and resources to enforce the perpetual restrictions, and that the easements would be transferable by the donees and their successors only to other qualified organizations that will also hold the easements exclusively for conservation purposes. *Id.* at 32–33.

[106] A restricted charitable gift is a gift made to a charitable organization to be used for a specific charitable purpose rather than for the organization's general purposes. *See* Carpenter v. Commissioner, 103 T.C.M. (CCH) 1001, 1004 (2012) (holding that the tax-deductible conservation easements at issue were restricted charitable gifts, or "contributions conditioned on the use of a gift in accordance with the donor's precise directions and limitations," quoting Michael M. Schmidt & Taylor T. Pollock, *Modern Tomb Raiders: Nonprofit Organizations' Impermissible Use of Restricted Funds*, 31 COLO. LAW. 57, 58 (2002)).

[107] *See* RONALD CHESTER ET AL., THE LAW OF TRUSTS AND TRUSTEES § 431 (2016) (Origin and general meaning of cy pres). *See also generally* Carl J. Herzog Found. v. Univ. of Bridgeport, 699 A.2d 995, 997 n.2 (Conn. 1997) ("The law governing the enforcement of charitable gifts is derived from the law of charitable trusts.").

2. Case Law

The extinguishment regulation contains four separate requirements: the judicial extinguishment requirement, the impossibility or impracticality requirement, the division of proceeds requirement, and the donee's use of proceeds requirement. The courts have tended to address the judicial proceeding and impossibility or impracticality requirements and the division and use of proceeds requirements separately. Accordingly, these two sets of requirements are discussed separately below, along with two other issues relating to the extinguishment regulation that are addressed by the case law (incompatible state law and prohibited swaps).

(a) Judicial Proceeding and Impossibility or Impracticality. In *Carpenter v. Commissioner*, the Tax Court sustained the Service's disallowance of more than $2.7 million of deductions claimed with regard to a number of conservation easements conveyed to a Colorado land trust.[108] The easements at issue were virtually identical. Each provided that, if circumstances arose in the future that rendered the purpose of the easement impossible to accomplish, the easement could be extinguished, whether in whole or in part, by judicial proceedings *or* by mutual written agreement of both parties. The Tax Court held that such easements failed as a matter of law to satisfy the extinguishment regulation. The court also explained:

> Extinguishment by mutual consent of the parties does not guarantee that the conservation purpose of the donated property will continue to be protected in perpetuity.... [T]he "restrictions [in an easement] are supposed to be perpetual..., and the decision to terminate them should not be [made] solely by interested parties. With the decision-making process pushed into a court of law, the legal tension created by such judicial review will generally tend to create a fair result."[109]

The "interested parties" the Tax Court referred to are the owner of the land and the holder of the easement, both of which stand to benefit financially and in other ways from the extinguishment of easements. With regard to the owners of the land, Professors John Echeverria and Janet Milne caution:

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[108] Carpenter v. Commissioner, 103 T.C.M. (CCH) 1001 (2012), *reconsideration denied and opinion supplemented*, Carpenter v. Commissioner, 106 T.C.M. (CCH) 62 (2013).

[109] *Id.* at *1005 (quoting STEPHEN J. SMALL, FEDERAL TAX LAW OF CONSERVATION EASEMENTS 16–4 (1986)). The Tax Court also held that the so-remote-as-to-be-negligible standard does not modify the extinguishment regulation. *See id.* at 1003; *see also* Kaufman v. Commissioner, 687 F.3d 21, 27 (1st Cir. 2012) (holding that the so-remote-as-to-be-negligible standard does not modify the proceeds regulation).

> Absent rigorous safeguards . . . easement protections are at serious risk of erosion over time. Ownership of lands protected by easements will eventually pass from the original easement grantor to new owners. Legally, the easement restrictions will remain in place despite the changes in land ownership. But the new owners may lack the same level of commitment to conservation as the original land owner. Moreover, the new owners could profit from developing the land if the easements restrictions could be lifted. Inevitably, some future owners of lands subject to easements will press for modification or even termination of easement restrictions.[110]

Holders, which include both government entities and nonprofits, also stand to benefit from extinguishments. Upon extinguishment of an easement, the holder generally will be entitled to a share of proceeds based on the value of the easement, and that share could be hundreds of thousands or multiple millions of dollars. Holders also have an interest in maintaining good relations with the owners of easement-encumbered properties, some of whom may be donors to the organization, influential members of the local community, or former, current, or future board members. Holders further have an interest in avoiding unpleasant interactions and potential litigation over their refusals to acquiesce to the lifting of restrictions from protected properties. Requiring a judicial proceeding and a finding of impossibility or impracticality to extinguish an easement helps to insulate holders from these pressures.[111] It also ensures that the easements subsidized through the deduction program will actually protect the subject properties' unique or otherwise significant conservation values for as long as continuing to do so remains possible or practical.

Unhappy with the Tax Court's holding that their easements failed to comply with the extinguishment regulation, the taxpayers in *Carpenter* filed a motion for reconsideration. They argued, among other things, that the extinguishment regulation should be interpreted as merely a safe harbor, and that it should be permissible for the parties to determine when to extinguish an easement so long as the donee organization is entitled to a share of the post-extinguishment proceeds. As to the latter point, they argued that ensuring the federal investment stays in the charitable conservation sector is all that is required, rather than perpetuation of the easement.

The Tax Court summarily dismissed those arguments. It reiterated that the decision to extinguish an easement should not be made solely by the interested

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[110] *See* Nancy A. Mclaughlin, *Keeping the Perpetual in Perpetual Conservation Easements*, LAW PROFESSOR BLOGS NETWORK (Dec. 13, 2015), http://lawprofessors.typepad.com/nonprofit/2015/12/keeping-the-perpetual-in-perpetual-conservation-easements.html.

[111] *See also* Jon Margolis, *Conservation Groups Backtrack in the Wake of Public Outcry*, VERMONT DIGGER (Mar. 17, 2014), https://vtdigger.org/2014/03/17/margolis-7/ (warning of the dangers of giving power to holders to substantially modify or extinguish perpetual conservation easements).

parties.[112] And it held: “To make our position clear, extinguishment by judicial proceedings is mandatory. Therefore, we reject petitioners' argument that [the extinguishment regulation] contemplates any alternative to judicial extinguishment.”[113] The Tax Court understood that Congress did not intend for tax-deductible conservation easements to be fungible conservation assets in the hands of the donee organizations.[114]

In *Mitchell v. Commissioner*,[115] the Tax Court again held that the extinguishment regulation is not merely a safe harbor and the perpetuity requirements “are mandatory and may not be ignored.”[116] The court also again rejected the argument that the extinguishment regulation requires only that the holder receive a share of proceeds following extinguishment, rather than perpetuation of the easement.[117] *Carpenter* and *Mitchell* thus confirmed that the extinguishment regulation has two purposes. It is intended not only to protect the federal investment in conservation in the event of an extinguishment, but also to limit the extinguishment of tax-deductible easements to exceptional circumstances—when it can be demonstrated to the satisfaction of a court that continuing to use the subject property for conservation purposes has become impossible or impractical.[118]

(b) Incompatible State Law. In *Wachter v. Commissioner*, the Tax Court held that North Dakota law, which limits the duration of easements created after July 1, 1977, to a maximum of ninety-nine years, precludes conservation easement

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[112] Carpenter v. Commissioner, 106 T.C.M. (CCH) 62 (2013) (denying reconsideration and supplementing Carpenter v. Commissioner, 103 T.C.M. (CCH) 1001 (2012)).
[113] *Id.* at 67.
[114] *See supra* notes 101104–07 and accompanying text.
[115] *Mitchell* was discussed in *supra* Part I.C. (the taxpayer’s deduction was denied for failure to obtain a timely mortgage subordination agreement).
[116] *See* Mitchell v. Commissioner, 106 T.C.M. (CCH) 215, 220 (2013).
[117] *Id.*
[118] The holdings in *Carpenter* and *Mitchell* are consistent with the Land Trust Alliance’s 2007 amendment report, which instructs:

> If the conservation easement was the subject of a federal income tax deduction, then Internal Revenue Code Section 170(h) and the Treasury Regulations Section 1.170A-14 apply. . . . The easement can only be extinguished by the holder through a judicial proceeding, upon a finding that continued use of the encumbered land for conservation purposes has become “impossible or impractical,” and with the payment to the holder of a share of proceeds from a subsequent sale or development of the land to be used for similar conservation purposes.

LAND TRUST ALLIANCE, *Amending Conservation Easements: Evolving Practices and Legal Principles* 24 (2007). The holdings are also consistent with an IRS General Information Letter on extinguishment. *See* I.R.S. Gen. Info. Ltr. 2013-0014 (Sept. 18, 2012).

donations in the state from qualifying for a deduction under section 170(h) because easements in North Dakota cannot be "granted in perpetuity."[119]

The court based its holding on the commonsense understanding that ninety-nine years is not "perpetuity" and did not go on to discuss the judicial proceeding regulation.[120] It is clear, however, that the easements in *Wachter* failed to satisfy that regulation: they were not subject to extinguishment only in a judicial proceeding upon a finding of impossibility or impracticality. Rather, they will be extinguished automatically by operation of law after the specified term of years.

The taxpayers in *Wachter* argued that North Dakota's ninety-nine year limitation should be considered the equivalent of a remote future event that does not prevent an easement from being considered perpetual. They cited Treasury Regulation section 1.170A–14(g)(3), which provides, in part, that a

> deduction shall not be disallowed ... merely because the interest which passes to, or is vested in, the donee organization may be defeated by the performance of some act or the happening of some event, if on the date of the gift it appears that the possibility that such act or event will occur is so remote as to be negligible.[121]

The Tax Court explained that the term "remote" as used in this regulation refers to the likelihood of the event that could defeat the donee's interest in the gift.[122] It then explained that the likelihood of the event in *Wachter* that could defeat the donee's interest in the easements—expiration of the easements after ninety-nine years—was not "remote." On the date of the donation of the easements, the court explained, it was not only possible, it was inevitable that the donee would be divested of its interests in the easements by operation of North Dakota law. Accordingly, the easements were not restrictions "granted in perpetuity" and, thus, were not deductible under section 170(h).[123]

(c) Prohibited Swaps. In *Belk v Commissioner*, the Fourth Circuit affirmed the Tax Court's holding that a conservation easement that authorizes the parties to agree to "substitutions" or "swaps" (i.e., to extinguish an easement with regard to some or all of the original protected land in exchange for the protection of other

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[119] Wachter v. Commissioner, 142 T.C. 140 (2014).
[120] *Id.* at 148–49.
[121] *Id.* at 148 (explaining that the courts have construed the so-remote-as-to-be-negligible standard to mean "'a chance which persons generally would disregard as so highly improbable that it might be ignored with reasonable safety in undertaking a serious business transaction' . . . [or] 'a chance which every dictate of reason would justify an intelligent person in disregarding as so highly improbable and remote as to be lacking in reason and substance'") (citations omitted).
[122] *Id.* at 148–49.
[123] *Id.*

land) is not eligible for a deduction.[124] The Fourth Circuit explained that such an easement is not "a restriction (granted in perpetuity) on the use which may be made of the real property" as required under section 170(h)(2)(C).

The easement at issue in *Belk* encumbered a 184-acre noncontiguous semi-private golf course located within a high-end residential development near Charlotte, North Carolina.[125] The Belks donated the easement to a local land trust and claimed a $10.5 million deduction. The easement deed authorizes the landowner to remove land from the easement in exchange for adding an equal or greater amount of contiguous land, provided that, in the opinion of the grantee (1) the substitute property is of the same or better ecological stability, (2) the substitution will have no adverse effect on the conservation purposes of the easement, and (3) the fair market value of the "easement interest" placed on the substitute land will be at least equal to or greater than the fair market value of the "easement interest" extinguished with regard to the land removed from the easement. The Belks argued that, as long as they agreed not to develop 184 acres, neither the court nor the Service should be concerned with what land actually comprises those 184 acres. In other words, they argued that it should be permissible to allow an easement to "float" across the landscape in the parties' discretion. [126]

In affirming the Tax Court's holding that the Belks were not eligible for a deduction, the Fourth Circuit explained that the "Treasury Regulations offer a single—and exceedingly narrow—exception to the requirement that a conservation easement impose a perpetual use restriction"—that is:

> [if a] subsequent unexpected change in the conditions surrounding the property … make[s] impossible or impractical the continued use of the property for conservation purposes, the conservation purpose can nonetheless be treated as protected in perpetuity if the restrictions are extinguished by judicial proceeding and all of the donee's proceeds … from a subsequent sale or exchange of the property are used by the donee organization in a manner consistent with the conservation purposes of the original contribution.[127]

"[A]bsent these 'unexpected' and extraordinary circumstances," explained the Fourth Circuit, "real property placed under easement must remain there in perpetuity in order for the donor of the easement to claim a charitable deduction."[128]

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[124] Belk v. Commissioner, 774 F.3d 221 (4th Cir. 2014).

[125] The entire golf course is not contiguous but lies in clusters throughout the residential development (e.g., holes 2, 3, and 4 are grouped together, while hole 11 is by itself). *See* Belk v. Commissioner, 140 T.C. 1, at 3 (2013).

[126] Belk v. Commissioner, 105 T.C.M. (CCH) 1878, 1879 (2013).

[127] *Belk*, 774 F.3d at 225 (emphasis added by the court) (quoting Treas. Reg. § 1.170A-14(g)(6)(i) (2009)).

[128] *Id.*

The Fourth Circuit further explained that permitting a deduction for the donation of an easement that authorized swaps would enable taxpayers to bypass several requirements critical to the statutory and regulatory schemes governing deductions for charitable contributions. For example, permitting swaps would render "meaningless" the requirement that an easement donor obtain a qualified appraisal to substantiate the deduction because the appraisal would no longer be an accurate reflection of the value of the gift, parts of which could be clawed back by the donor.[129] In addition, the court noted that it did not matter that the *Belk* easement requires that the removed property be "replaced with property of 'equal or greater value,' because the purpose of the appraisal requirement is to enable the Commissioner, *not* the donee or donor, to verify the value of a donation."[130]

The Fourth Circuit similarly determined that the baseline documentation requirement would be "skirted" if the borders of an easement could shift.[131] The court explained that requiring the donor to furnish the donee with documentation sufficient to establish the condition of the subject property at the time of the gift confirms that a conservation easement must govern a defined and static parcel.[132] The court further noted that allowing deductions for the donation of easements that authorize swaps would deprive donees of the ability to ensure protection of conservation interests by, for instance, examination of maps and photographs of "the protected property," because that property would change over time.[133]

The Belks argued that, because North Carolina law permits parties to amend or swap easements, such as a right-of-way easement between neighbors, not permitting swaps would render all conservation easements in North Carolina ineligible for a deduction under section 170(h). The Fourth Circuit found that argument unpersuasive, explaining that:

> whether state property and contract law permits a substitution in an easement is irrelevant to the question of whether federal tax law permits a charitable deduction for the donation of such an easement . . . § 170(h)(2)(C) requires that the gift of a conservation easement on a specific parcel of land be granted in perpetuity to qualify for a federal charitable deduction, notwithstanding the fact that state law may permit an easement to govern for some shorter period of time. Thus, an easement that, like the one at hand, grants a restriction for less than a perpetual term, may be a valid conveyance under state

[129] *Id.* at 226.
[130] *Id.* (emphasis in original).
[131] *Id.* at 226–27.
[132] *Id.* at 227; *see* Treas. Reg. § 1.170A-14(g)(5)(i) (2009) ("[The baseline documentation] is designed to protect the conservation interests associated with *the property*, which although protected in perpetuity by the easement, could be adversely affected by the exercise of the reserved rights." (emphasis added)).
[133] *Belk*, 774 F.3d at 227.

law, but is still ineligible for a charitable deduction under federal law.[134]

Other than in North Dakota, where the duration of any easement is limited by statute to ninety-nine years,[135] it appears that the parties to a conservation easement can include provisions in the deed that will comply with the federal tax law judicial proceeding, impossibility or impracticality, and proceeds requirements. If the easement is drafted appropriately, those provisions should be legally binding on both the property owner and the holder, even though they impose conditions on the transfer or extinguishment of the easement that may be different or more restrictive than those imposed by state law.[136] As the Tax Court noted in *Wachter*, "[b]oth parties allege that the State law at issue here is unique because [North Dakota] is the only State that has a law that provides for a maximum duration that may not be overcome by agreement."[137]

The Belks also argued that the amendment clause included in the easement deed "saved" their deduction. The substitution provision in the deed provided that substitutions would become final when they were reflected in a formal recorded amendment. The amendment provision provided that the land trust could not agree to an amendment that would result in the easement failing to qualify for a deduction under section 170(h). The Belks argued that, if the Fourth Circuit found that the substitution provision violated the requirements of section 170(h), the amendment clause (which they referred to as a "savings clause") would render the substitution provision inoperable, thus making the easement eligible for the deduction. In other words, they argued that the savings clause would operate to negate a right clearly articulated in the easement (the right to substitute property), but only if triggered by an adverse determination by the court.

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[134] *Id.* at 228. *See also, e.g.*, Carpenter v. Commissioner, 103 T.C.M. (CCH) 1001, 1004 (2012) ("To determine whether the conservation easement deeds comply with requirements for the . . . deduction under Federal tax law, we must look to State law to determine the effect of the deeds. State law determines the nature of the property rights, and Federal law determines the appropriate tax treatment of those rights.").

[135] *See supra* note 119 and accompanying text.

[136] *See, e.g.*, Bjork v. Draper, 886 N.E.2d 563 (Ill. App. Ct. 2008), *appeal denied*, 897 N.E.2d 249 (Ill. 2008) (holding that the terms of a conservation easement deed requiring a judicial proceeding to extinguish the easement had to be complied with, despite the more permissive language in the Illinois conservation easement enabling statute providing that holders could "release" easements). In *Carpenter v. Commissioner*, the Tax Court held that the conservation easements at issue were restricted charitable gifts, or "contributions conditioned on the use of the gift in accordance with the donor's precise directions and limitations." *Carpenter*, 103 T.C.M. (CCH) at 1004. Restricted gift status means that the property owner and the holder of the easement (and their successors) will be bound by the terms of the deed under state law, including the restriction on transfer, extinguishment, division of proceeds, and other provisions included in the deed to satisfy federal tax law requirements. For a discussion of the interaction of federal and state law, see *Extinguishing and Amending*, *supra* note 96, at 269; *National Perpetuity Standards*, *supra* note 24, at 20–26.

[137] Wachter v. Commissioner, 142 T.C. 140, 147 (2014).

The Fourth Circuit rejected the savings clause argument, noting that the Belks were asking the court to employ the savings clause to rewrite the easement in response to the court's holding, something the court was unwilling to do.[138] The court refused to condone such "'trifling with the judicial process'" and explained that holding for the Belks "would dramatically hamper the Commissioner's enforcement power."[139] If every taxpayer could rely on a savings clause to void, after the fact, a disqualifying power included in a conservation easement deed, "enforcement of the Internal Revenue Code would grind to a halt."[140]

The Fourth Circuit also rejected the Belks' "last-ditch" argument—that the savings clause was designed to accommodate an evolving interpretation of section 170(h).[141] The court explained that the statutory language of section 170(h)(2)(C) has not evolved since the provision was enacted in 1980. "The simple truth," said the court, is "the Easement was never consistent with § 170(h), a fact that brings with it adverse tax consequences. The Belks cannot now simply reform the Easement because they do not wish to suffer those consequences."[142]

Soon after *Belk* was decided, the Tax Court issued two additional decisions denying deductions claimed with respect to easements that authorized the parties to agree to partial extinguishments in the form of swaps: *Balsam Mountain v. Commissioner*[143] and *Bosque Canyon Ranch v. Commissioner*,[144] the latter of which also involved "slipshod" baseline documentation, as discussed above.[145] Citing the Fourth Circuit's opinion in *Belk*, the Tax Court held that the easements in both cases were not "restrictions (granted in perpetuity) on the use which may be made of the real property" as required under section 170(h)(2)(C).[146]

Conservation easements that authorize the parties to swap land in and out of the easement are antithetical to the purpose of section 170(h), which is to

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[138] *Belk*, 774 F.3d at 230.
[139] *Id.*
[140] *Id.*
[141] *Id.* at 230 n.3.
[142] *Id.*
[143] Balsam Mountain v. Commissioner, 109 T.C.M. (CCH) 1214, at *1 (2015). The Balsam Mountain easement reportedly encumbered a small part of the Balsam Mountain Preserve in North Carolina, and the Service had previously settled with a different entity that had donated another easement on 3,400 acres of the preserve, allowing only $8 million of the entity's claimed $55.49 million deduction. *See* Peter J. Reilly, *Did Andie MacDowell's Mountain Hideaway Require Tax Incentives?*, FORBES.COM (Mar. 25, 2015), http://www.forbes.com/sites/peterjreilly/2015/03/25/did-andie-macdowells-mountain-hideaway-require-tax-incentives/.
[144] Bosque Canyon Ranch v. Commissioner, 110 T.C.M. (CCH) 48 (2015).
[145] *See supra* Part I.B.
[146] The donee in both *Balsam Mountain* and *Bosque Canyon Ranch* was NALT. *See supra* note 44 and accompanying text. The holdings in *Belk, Balsam Mountain*, and *Bosque Canyon Ranch* on the swap issue are consistent with an IRS General Information Letter regarding swaps. *See* I.R.S. Gen. Info. Ltr. 2012-0017 (Mar. 5, 2012), http://www.irs.gov/pub/irs-wd/12-0017.pdf. *Bosque Canyon Ranch* has been appealed to the Fifth Circuit.

encourage the donation of easements that will permanently protect properties that are identified, at the time of the donation, as having unique or otherwise significant conservation values. Section 170(h) was neither intended nor designed to subsidize the conveyance of easements that would be fungible conservation assets in the hands of the donee nonprofit or governmental entities.

(d) Holder's Share of Post-Extinguishment Proceeds. In *Carroll v. Commissioner*, the Tax Court sustained the Service's disallowance of $650,000 of carryover deductions claimed with regard to the donation of a conservation easement because the easement deed contained a proceeds clause that did not comply with the proceeds regulation.[147] The court explained that the proceeds regulation requires that, following extinguishment, the holder must be entitled to at least a minimum proportionate share of proceeds (expressed as a percentage) determined by (1) the fair market value of the conservation easement on the date of the gift (the numerator) over (2) the fair market value of the property as a whole on the date of the gift (the denominator).[148] For example, if the fair market value of an easement on the date of the gift was $300,000, and the fair market value of the property as a whole on the date of the gift was $1,000,000, the easement represented 30% of the value of the property on the date of the gift, and the holder must be entitled to at least 30% of the proceeds following the easement's extinguishment.

In *Carroll*, the conservation easement deed limited the numerator of the formula noted above to "the deduction for federal income tax purposes allowable" by reason of the donation.[149] Thus, if the Service were to disallow the deduction for reasons other than valuation and the easement were later extinguished in a judicial proceeding, the numerator would be zero and the holder of the easement would not receive the minimum proportionate share of proceeds as is required (the holder would receive nothing). This, said the Tax Court, would provide the donors or their heirs with a windfall and deprive the donee of its ability to use a share of post-extinguishment proceeds for similar conservation purposes.[150] The court explained that deductions are denied for many reasons unrelated to valuation,[151] and, in fact,

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[147] Carroll v. Commissioner, 146 T.C. 196 (2016). The taxpayer asserted that the easement had a value of $1.2 million and claimed deductions in that amount over a series of years. Due to the statute of limitations, the Service challenged only $650,000 of carryover deductions.

[148] *Id.* at 216. See *supra* note 103 and accompanying text for the text of the proceeds regulation.

[149] *Carroll*, 146 T.C. at 216.

[150] *Id.* at 217. If the fair market value of an easement on the date of the gift is zero, as in *Kaufman*, the numerator should be zero. In such a case there should be no deduction because no charitable gift has been made.

[151] The court explained that there are multiple requirements in section 170 and the corresponding regulations that, if not followed, may lead to disallowance of the deduction, and overvaluation is only one of them. *Id.* at 218 n.13. For example, a deduction may be disallowed where (1) the donee is not a qualified organization, (2) the property subject to the easement is not a historically important land area or a certified historic structure, (3) the easement is not a qualified real property interest, (4) the easement does not preserve conservation purposes in perpetuity, (5) the taxpayer fails to

the Service challenged the claimed deductions in *Carroll* on a number of grounds. For example, the Service argued that the gift of the easement was not complete at the time of the donation because Dr. Carroll's minor children owned part of the subject property and, under state law, minors generally can disavow gifts made of their property before they reach the age of majority. The Service further argued that, even if the gift were deemed complete at the time of the donation, Dr. Carroll and his wife were entitled to only the portion of the deduction attributable to their percentage ownership interest in the property at the time of the donation. Dr. Carroll and his wife claimed 100% of the deduction, despite having transferred a 60% ownership interest in the property to their minor children prior to the donation.[152]

The Tax Court distinguished its holding in *Carroll* from the First Circuit's holding in *Kaufman*. In *Kaufman*, the First Circuit held that the donors had satisfied the proceeds requirement because the easement deed correctly stated the proceeds formula and the donee had a right to recover its share of post-extinguishment proceeds from the owner of the subject property. In *Carroll*, in contrast, the donee would not be entitled to any proceeds in certain circumstances based on the formula included in the easement deed. Consistent with the First Circuit's reasoning in *Kaufman*, failing to guarantee that the donee would be entitled to at least the required minimum proportionate share of proceeds upon extinguishment, and providing a potential windfall to the donor or the donor's successors as a result, was fatal to the deduction.[153] The Tax Court explained that the taxpayers "could have avoided this adverse outcome by strictly following the proportionality formula set forth in the regulation."[154]

Although not mentioned by the court, mandating that the donee receive at least a minimum proportionate share of proceeds, even if the donor's deduction is disallowed, is appropriate from a policy perspective. Regardless of whether a donor's deduction is allowed or disallowed, a charitable gift of the easement will have been made, and the holder will have an ongoing obligation to monitor and enforce the easement on behalf of the public. Given that an easement, once donated, constitutes a charitable asset held for the benefit of the public, and the public will make a significant investment in the monitoring and enforcement of the easement over its perpetual life, the value attributable to the easement should not be permitted to revert to the donor (or the donor's successors in interest) in the event of

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obtain a required mortgage subordination agreement, (6) the taxpayer fails to attach a fully complete appraisal summary to the tax return, (7) the appraisal is not a qualified appraisal, (8) the appraiser is not a qualified appraiser, (9) the parties fail to record the easement or otherwise effect legally enforceable restrictions, or (10) the taxpayer fails to maintain records necessary to substantiate the charitable contribution. *Id.*

[152] *Id.* at 221–22.

[153] *Id.* at 217.

[154] *Id.* at 220.

extinguishment.[155] Rather, such value should remain in the charitable sector, as the extinguishment regulation requires. This is no different than the rule applied to charitable donations generally (for example, to donations of artwork, land, or stocks and securities); donors are not entitled to return of their gifts should their deductions be denied.[156]

Dr. Carroll hired a general practice attorney who focused on real property transfers (and did not provide tax advice) to draft the gift deed by which Dr. Carroll, prior to the donation of the easement, transferred ownership of the subject property from himself to himself, his wife, and his three minor children. However, at trial, Dr. Carroll, who is not an attorney, testified that he personally handled the conservation easement donation and did not consult with an attorney or other adviser.[157] To the extent Dr. Carroll relied on the donee's template conservation easement deed, that reliance was inappropriate. As noted above, the interests of the donor and the donee in an easement donation transaction are not perfectly aligned, and most donees are careful to make clear to donors that they cannot provide them with tax or other legal advice.[158]

In finding that Dr. Carroll and his wife were not eligible for the reasonable cause defense to accuracy-related penalties and, thus were liable for such penalties, the Tax Court explained:

> [The taxpayers] offered no evidence which would explain why the terms of the conservation easement varied from the requirements of [the proceeds regulation], nor do they clarify why Dr. Carroll failed to seek competent advice from a tax attorney or other adviser to ensure the conservation easement's compliance with pertinent regulations. In the light of Dr. Carroll's high level of sophistication and experience with conservation easements, we conclude that [the taxpayers] have not demonstrated that they acted with reasonable cause and in good faith in not seeking competent tax advice regarding the conservation easement.[159]

Conservation easement donations generally involve large deductions, with a correspondingly large public investment in the easements, and the requirements of section 170(h) and the regulations are numerous. Accordingly, as the Tax Court

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[155] The public's investment in an easement over its perpetual life may include public support of the donee through the donee's tax-exempt status and receipt of tax-deductible donations; lost property tax revenues in jurisdictions where easements are taken into account for property tax assessment purposes; and enforcement of easements by state attorneys general and the courts.
[156] *See, e.g.*, Mohamed v. Commissioner, 103 T.C.M. (CCH) 1814, 1820–21 (2012) (denying deductions for the donation of valuable real estate to charity for lack of proper substantiation of the deductions).
[157] *Carroll*, 146 T.C. at 199, 199 n.5, 224.
[158] *See supra* notes 98–99 and accompanying text.
[159] *Carroll*, 146 T.C. at 224.

intimated in *Carroll*, it is reasonable to expect that prospective easement donors will hire competent tax counsel to assist them with their donations, and that the Service and the courts will deny deductions when donors fail to comply with section 170(h)'s perpetuity requirements. The public should not be expected to subsidize the acquisition of conservation easements that do not comply with the requirements necessary to ensure the perpetual nature of the easements or the protection of the public's investment.

Some have argued that the deduction in *Carroll* should not have been denied because the easement clearly satisfied the conservation purposes test—that it was a "good" easement in terms of conservation value. However, the conservation purposes test is but one of a number of requirements that must be satisfied to ensure that conservation easements will provide benefits to the public sufficient to justify their deduction. Satisfaction of the conservation purposes test means only that the subject property has important conservation or historic values. It is the perpetuity requirements that ensure that those values will be permanently protected and that, in the rare event of extinguishment due to impossibility or impracticality, the public investment in conservation will not be lost. Moreover, as noted above, there were potential problems with the *Carroll* donation in addition to the noncompliant proceeds clause.[160] The Tax Court likely chose to deny the deduction on noncompliant proceeds clause grounds because that was the most expedient way to dispose of the case. It was not because the courts and the Service unfairly focus on supposed technical foot faults.[161]

In *PBBM-Rose Hill v. Commissioner*, the Tax Court issued a bench opinion sustaining the Service's disallowance of a $15.1 million deduction that a partnership claimed with regard to the donation of a conservation easement encumbering a golf course, driving range, and park in a gated and guarded residential community.[162] As in *Carroll*, the clause included in the partnership's easement to comply with the proceeds regulation was written such that the holder would not receive a minimum proportionate share of post-extinguishment proceeds in some circumstances.[163] Accordingly, the court found that the easement did not meet the requirements of the proceeds regulation, which the court explained "elaborates on the protected-in-perpetuity requirement of section 170(h)(5)(A) by setting forth substantive rules to safeguard the conservation purpose of a contribution."[164]

The easement in *PBBM-Rose Hill* also had additional flaws. It failed to satisfy section 170(h)'s conservation purposes test (it did not preserve open space, protect habitat, or provide for outdoor recreation by the general public). And the court agreed with the Service that the easement was worth only $100,000, rather

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[160] *See supra* note 152 and accompanying text.
[161] *Carroll* has been appealed to the Fourth Circuit.
[162] Transcript of Bench Op. at 5–6, PBBM-Rose Hill v. Commissioner, No. 26096-14 (T.C. 2016).
[163] The bench opinion does not include the clause itself or describe it in any more detail.
[164] *Id.* at 9.

than the claimed $15.1 million and, as a result, the partnership was subject to a 40% strict liability gross valuation misstatement penalty.[165]

3. Importance

The judicial proceeding, impossibility or impracticality, and division and use of proceeds requirements are at the heart of the section 170(h) deduction program. They are intended to ensure that the easements subsidized through the program will actually protect the subject properties' conservation values in perpetuity, or for as long as continuing to do so remains possible or practical. They are intended to ensure that the decision to terminate easements will not be made solely by the two parties who have a financial interest in the termination and are likely to be subject to other significant pressures to terminate. They are intended to ensure protection of the public's investment in conservation in the rare event of a judicial extinguishment. And they are intended to ensure that all taxpayers who donate conservation easements and receive federal tax benefits will be subject to the same rules—that is, taxpayers in Montana and Minnesota will not be able to more easily have the perpetual restrictions lifted off their properties than taxpayers in Maine or Maryland.[166]

II. RECOMMENDED GUIDANCE

As discussed in the Introduction, the public is investing billions of dollars in conservation easements through the section 170(h) deduction program, and this investment is likely to only increase now that Congress has made the enhancements to the incentive a permanent part of the Code. In addition, as explained in Part I, failure to satisfy the recordation, baseline documentation, mortgage subordination, and extinguishment requirements should not be viewed as excusable foot faults. Rather, satisfaction of these requirements is essential to both the integrity of the tax-incentive program and the long-term viability of the easements subsidized through the program. Equally important, but generally overlooked, is that compliance with these perpetuity requirements could easily be facilitated through the issuance of guidance.

While Service audits and litigation remain an indispensable enforcement backstop, they should not be relied upon as the primary approach to increasing compliance. Audits and litigation are an ad hoc and inefficient means of increasing

[165] *Id.* at 23–30.

[166] Section 170(h) and the Treasury Regulations impose minimum federal requirements for the extinguishment of tax-deductible easements. These requirements must be complied with regardless of seemingly permissive language in a state conservation easement enabling statute regarding extinguishment. In the few states that impose their own requirements on extinguishment (for example, Massachusetts requires approval of certain public officials, see Mass. Gen. Laws Ann. ch. 184, § 32 (West 2009)), the state requirements must be complied with in addition to the federal requirements.

compliance. The Service has the resources to audit only a small percentage of donations, allowing many noncompliant easements to slip through the system. And litigation is expensive and time consuming, and leads to unpredictable decisions based on the facts of particular cases rather than a comprehensive assessment of tax policy and compliance concerns.

It is time for a new approach.

A. Template Baseline Documentation Report

To facilitate taxpayer compliance with the baseline documentation requirement, as well as Service review of donation transactions, the Treasury should develop a section 170(h)-compliant template baseline documentation report and accompanying instructions. The template could specify the materials to be included in the report (various maps, photographs, GPS coordinates, etc.), the order in which such materials should appear, the date on which the report must be completed, how and when the report should updated over time, and the certifications to be made by the donor and donee.[167] The template could also be structured to help ensure "authentication" of the report sufficient to support its admissibility into evidence in future litigation, thereby facilitating positive conservation outcomes in enforcement actions.[168]

Donees should be free to include more content in their baseline documentation reports than the template requires. However, by specifying clear minimum requirements, the template would significantly increase the comprehensiveness and usefulness of such reports for monitoring and enforcement purposes. An added benefit could be more accurate valuation of conservation easements because appraisers would be provided with substantial information regarding existing topography, land use history, distinct natural features, and improvements and incursions on the subject properties.

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[167] Examples of instructions for baseline documentation include the Natural Resources Conservation Program's Agricultural Conservation Easement Program Baseline Documentation Report Items, see *Part 528 – Agricultural Conservation Easement Program (ACEP)*, USDA NATURAL RESOURCES CONSERVATION SERVICE, https://directives.sc.egov.usda.gov/viewerFS.aspx?hid=36843 (last visited Jan. 10, 2017), and the VIRGINIA OUTDOORS FOUNDATION, VIRGINIA OUTDOORS FOUNDATION'S BASELINE DOCUMENTATION REPORT: GUIDELINES FOR PREPARATION BY THIRD-PARTY 1 (2016).

[168] *See, e.g.*, Ann Taylor Schwing, *Baseline Authentication and Admissibility*, CONSERVATION TAX CENTER, http://www.conservationtaxcenter.org/article/Conservation-Easements/Expert-Publications/Baseline-Authentication-and-Admissibility/1041 (last visited Sept. 9, 2016) (noting, with regard to multiple examples of existing baseline documentation, that "[v]irtually none begin to satisfy the requirements for admissibility under the business records exception to the hearsay rule").

B. Template Mortgage Subordination Agreement

The Treasury should also develop a template mortgage subordination agreement. The template should be drafted to ensure that outstanding mortgages are subordinated to the rights of the donee "to enforce the conservation purposes of the gift in perpetuity."[169] Thus, outstanding mortgages should be subordinated to both (1) the rights of the donee to enforce the conservation easement in perpetuity, thereby preventing extinguishment of the easement in the event of foreclosure, and (2) the rights of the donee to receive a share of post-extinguishment proceeds, thereby ensuring the donee can acquire a similar easement or other replacement conservation property upon extinguishment. Template subordination agreement language would also provide an important signal to lenders; that the easement is being conveyed to the donee as a charitable gift and the lender is being asked to give up all rights with respect to that gift, including the right to proceeds attributable to the easement upon an extinguishment.

C. Safe Harbor Conservation Easement Clauses

Although federally-deductible conservation easements obviously could not be standardized in full, certain terms generally should not vary from easement to easement. For example, the Treasury Regulations specify the limited circumstances under which tax-deductible easements can be extinguished, the minimum proceeds that must be payable to the holder upon extinguishment, and the manner in which the holder must use such proceeds.[170]

Taxpayers currently draft easements that address these extinguishment requirements in countless different ways, and sometimes in ways purposefully designed to circumvent the requirements.[171] The result is that some (perhaps not insignificant percentage of) easements that do not satisfy these important requirements slip through the current system and are valued—and subsidized by federal taxpayers—as if they were perpetual when they are not.

To facilitate taxpayer compliance with the extinguishment requirements, as well as Service review of donation transactions, the Treasury should develop sample or safe harbor clauses that comply with these requirements.[172] Developing

[169] Treas. Reg. § 1.170A-14(g)(2) (2009).
[170] *See Id.* § 1.170A–14(g)(6) (2009).
[171] See, for example, *Carpenter v. Commissioner*, *supra* notes 108–114 and accompanying text, and *Belk v. Commissioner*, *supra* notes 124–33 and accompanying text.
[172] Compliance with some of the other perpetuity requirements could similarly be facilitated through the development of safe harbor clauses, including the restriction on transfer requirement, the mineral extraction restrictions requirement, and the donee notice, access, and enforcement requirements. *See supra* note 20 (listing the perpetuity requirements). Modifications to the safe harbor clauses could be permitted in appropriate circumstances (such as where a government entity funded the acquisition of the easement in part and needs to be reimbursed following extinguishment), provided the clauses still satisfy the regulatory requirements. *See* Irby v. Commissioner, 139 T.C. 371, 374–377 (2012).

sample provisions would not be a novel approach to facilitating compliance and curbing abuse in the charitable deduction context. The Treasury developed sample trust provisions with annotations in the charitable remainder trust and charitable lead trust contexts and those provisions, which are now widely used, have greatly facilitated compliance and reduced abuses.[173]

D. IRS Form 8283 Certifications

The Instructions for IRS Form 8283 could be revised to require that conservation easement donors make a series of certifications regarding satisfaction of the perpetuity requirements. These certifications would signal to donors and their advisors the importance of compliance with the perpetuity requirements and the existence of the templates and safe harbor clauses. For example, donors could be required to certify the following in a Supplemental Statement to the Form 8283:

1) The easement was properly recorded in the land records of the jurisdiction in which the subject property is located in the year in which the donor intends to first claim the deduction.

2) A copy of the recorded conservation easement deed is attached to Form 8283.

3) Prior to the date of the donation, the donee was provided with baseline documentation in a form that complies with the Treasury's template baseline documentation report and instructions.

4) The donor understands that compliance with the baseline documentation requirement is the donor's responsibility.

5) If there was an outstanding mortgage on the subject property at the time of the donation, the donor obtained from the lender on or before the date of the gift a subordination agreement in the form of the Treasury's template subordination agreement.

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[173] *See, e.g.*, Rev. Proc. 2005-52, 2005-34 I.R.B. 326; Rev. Proc. 2005-53, 2005-34 I.R.B. 339; Rev. Proc. 2005-54, 2005-34 I.R.B. 353; Rev. Proc. 2005-55, 2005-34 I.R.B. 367; Rev. Proc. 2005-56, 2005-34 I.R.B. 383; Rev. Proc. 2005-57, 2005-34 I.R.B. 392; Rev. Proc. 2005-58, 2005-34 I.R.B. 402; Rev. Proc. 2005-59, 2005-34 I.R.B. 412. *See also* Rev. Proc. 92-64, 1992-33 I.R.B. 11 (containing a model grantor trust for use in executive compensation arrangements that are popularly referred to as "rabbi trusts"). Annotations in a conservation easement safe harbor clause revenue procedure could also provide helpful guidance on numerous issues, such as a holder's acceptable use of the proceeds received upon extinguishment (for example, to acquire additional conservation interests, whether easements or fee title, and establish restricted stewardship endowments for such interests).

6) The conservation easement deed contains the Treasury's safe harbor extinguishment and division and use of proceeds clauses and they are not qualified by other provisions in the deed or outside agreements.

7) If the donor is unable to certify any of the foregoing, please explain.

Although a Form 8283 generally is not completed until after a donation has been made, its requirements and instructions are familiar to competent tax counsel and discussed in conservation easement donation educational programs and materials. Also, the new certifications and other provisions in the Form 8283 relating to conservation easements could be discussed in the new Service publication recommended below.

E. IRS Conservation Easement Contributions Publication

The Treasury should develop a new publication that is devoted solely to charitable conservation easement contributions under section 170(h).[174] The publication, which could be made available to taxpayers and their advisors online, could contain instructions regarding compliance with the section 170(h) and the Treasury Regulation requirements, as well as the relevant appraisal and substantiation requirements. The publication could also serve as a central repository for all guidance relating to conservation easement contributions, including existing guidance, the new forms of guidance recommended above, case law, and future developments. As with all Service publications, the publication could be updated periodically.[175]

Development of this and similar guidance[176] would help to ensure that almost all of the perpetuity requirements would be satisfied for most donations, thus reducing litigation and significantly shoring up the integrity of the program. It also would enable the Service to focus its enforcement efforts on other forms of noncompliance that are not as easily resolved, namely overvaluation, failure to satisfy the conservation purposes test, and the retention of too many development and use rights in conservation easement deeds.[177]

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[174] For a list of IRS Publications, see *Publications Online*, I.R.S., https://www.irs.gov/publications/ (last visited July 9, 2017).

[175] Although the IRS has published a Conservation Easement Audit Techniques Guide, its purpose is to provide Service personnel with guidance for the examination of charitable contributions of conservation easements. Taxpayers donating conservation easements and their advisors are not its intended audience. *See Audit Techniques Guide*, *supra* note 28.

[176] *See supra* note 172 and accompanying text (noting the various perpetuity requirements that could be satisfied through safe harbor clauses).

[177] *See generally* I.R.C. § 170(h)(4); Treas. Reg. § 1.170A-14(d), (e)(2)–(3) (2009); *Valuation Conundrum*, *supra* note 8.

III. "CURE ON AUDIT" PROVISION WOULD BE BAD TAX POLICY

The Land Trust Alliance, which is the umbrella organization for the nation's approximately 1,300 land trusts, has proposed that section 170(h) be modified to permit taxpayers who fail to comply with the perpetuity requirements to fix their supposed "mistakes" on audit, and thereby avoid disallowance of the deduction, unless the Service can demonstrate that the failure to comply was intentional.[178] Thus, for example, if a taxpayer failed to ensure that the easement was recorded or the donee was provided with appropriate baseline documentation, or failed to obtain a mortgage subordination agreement, or failed to include provisions in the easement deed to comply with the extinguishment requirements and the failures were discovered on audit, the taxpayer would be permitted to fix these supposed mistakes.

Such a "cure on audit" provision would constitute singularly bad tax policy. First, while some instances of noncompliance may truly be innocent mistakes, many are not. Taxpayers fail to comply with section 170(h) and the Treasury Regulations for a host of reasons. For example, some treat the donation of an easement casually, despite the large dollar value of the deduction, and fail to engage competent tax counsel, relying instead and inappropriately on the donee and the donee's legal counsel.[179] Some engage legal counsel who specialize only in real estate law and know little or nothing about tax law. Some are reluctant to invest the time and money needed to prepare appropriate baseline documentation, obtain the necessary mortgage subordination agreements, or carefully draft easements that comply with section 170(h). And some intentionally do not comply with the requirements because they want to retain significant development and use rights and the flexibility to eliminate restrictions or terminate the easements in the future, all of which can be very lucrative for the taxpayer.

Second, in implementing the proposed cure on audit provision, it would be impossible in most cases for the Service to distinguish among innocent mistakes, negligence, and "intentional" abuse because it is difficult to discern with certainty the subjective motivations of taxpayers. It also is reasonable, as the Tenth Circuit

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[178] The Land Trust Alliance's proposals, misleadingly labeled, "Proposed amendments to protect the integrity of the law governing conservation donations and its administration" dated October 17, 2016, propose, among other things, that section 170(h)(5)(A) be amended by adding the following new subsection: "(ii) If a donor is found to have failed to meet the requirement that a contribution shall be granted and protected in perpetuity, the deduction will be allowed if the donor meets those requirements within 120 days of written notice by the Commissioner and can show that no harm has been done to the conservation purposes of the donation before the requirements are met, unless Service can demonstrate that the failure to meet those requirements was intentional." LAND TRUST ALLIANCE, PROPOSED AMENDMENTS TO PROTECT THE INTEGRITY OF THE LAW GOVERNING CONSERVATION DONATIONS AND ITS ADMINISTRATION 3 (2016).

[179] *See supra* notes 98–99 and accompanying text (explaining that the interests of the donor and the donee in an easement donation transaction are not perfectly aligned, and most donees are careful to make clear to donors that they cannot provide them with tax or other legal advice).

explained in *Mitchell*, for the Treasury to impose a bright-line, easy to administer requirements, rather than to require the Service to engage in a case-by-case, fact-specific inquiry into the subjective motivations every easement donor—an impossible task in a tax system that depends on voluntary compliance and has a very low audit rate.[180]

Third, the Service has limited resources and can audit only a small percentage of returns on which taxpayers have claimed deductions for easement donations. Accordingly, even in the current system, where the penalty for noncompliance is complete disallowance of the deduction, the deterrent effect of that penalty is weak and there is significant noncompliance, as evidenced by the case law. If there were no sanction for noncompliance—if taxpayers were required only to fix noncompliance if it is discovered on audit—the incidence of noncompliance could be expected to increase significantly, particularly given the incentives for taxpayers not to comply. And because the audit rate would continue to be low, only a small percentage of noncompliant easements would be "fixed," and more noncompliant easements would slip through the system and be subsidized by federal taxpayers as if they protected important conservation values and the public's investment in perpetuity when they do not.

It has been suggested that the ability to fix noncompliance on audit be paired with a modest penalty, and that the threat of a modest penalty would ensure that taxpayers comply with the perpetuity requirements. But if the current threat of *complete* disallowance of the deduction does not ensure compliance, reducing that penalty can hardly be expected to do so. Instead, it can be expected to increase the level of noncompliance. And, again, because the audit rate would continue to be low, only a small percentage of the noncompliant easements would be fixed, and more noncompliant easements would slip through the system.

A cure on audit provision would be acceptable policy only if the Service were able to audit every return on which a deduction for a conservation easement donation was first claimed, and then supervise the "fixing" of all of the noncompliant donations. It is unrealistic, however, to think that the Service would ever have the mandate or resources to do so.[181] In a system that relies on voluntary compliance, the audit rate will always be low. Moreover, the mission of the Service is primarily to raise revenue. If easement donors were permitted to cure non-compliance after being caught on audit, then, as the Fourth Circuit noted in *Belk*

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[180] *See* Mitchell v. Commissioner, 775 F.3d 1243, 1254–55 (10th Cir. 2015).

[181] Chuck Marr & Cecile Murray, *IRS Funding Cuts Compromise Taxpayer Service and Weaken Enforcement*, CENTER ON BUDGET AND POLICY PRIORITIES (Apr. 4, 2016), http://www.cbpp.org/sites/default/files/atoms/files/6-25-14tax.pdf ("The Internal Revenue Service . . . budget has been cut by 17 percent since 2010, after adjusting for inflation, forcing the IRS to reduce its workforce, severely scale back employee training, and delay much-needed upgrades to information technology systems. These steps, in turn, have weakened the IRS's ability to enforce the nation's tax laws . . . .").

with regard to alleged saving clauses, Service enforcement in this context "would grind to a halt."[182]

The Land Trust Alliance, which purports to be the standard bearer for the industry, should not be seeking changes to the law that would increase the level of noncompliance and abuse in the section 170(h) deduction context.[183] Rather, it should seek reforms, such as those proposed in this article, that would facilitate taxpayer compliance and Service review, and result in the granting of more high-quality and durable easements.

With the enhancement of the section 170(h) tax incentive at the end of 2015, conservation easements became the most favored type of charitable contribution in the Code. It is not too much to ask that the taxpayers benefiting from this exceptionally generous tax incentive comply with its requirements.

CONCLUSION

Compliance with section 170(h)'s perpetuity requirements is essential to the integrity of the tax-incentive program and the long-term viability of the easements subsidized through the program. The public should not be expected to subsidize the acquisition of conservation easements that do not comply with the requirements necessary to ensure the durability of the easements and the protection of the public's investment. The Service should thus be encouraged, rather than criticized, for enforcing these crucial requirements.

The Service, however, is not completely without fault. It has spent considerable resources on audits and litigation in the section 170(h) context, and far less on issuing guidance to facilitate taxpayer compliance.[184] Fortunately, the Treasury has now made issuing guidance in this context one of its priorities.[185] As

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[182] *See* Belk v. Commissioner, 774 F.3d 221, 230 (4th Cir. 2014).

[183] The Land Trust Alliance has proposed additional changes to section 170(h), most of which are equally ill-advised. *See supra* note 178. A critique of those proposals is beyond the scope of this article, but granting holders broad discretion to agree to "amend" tax-deductible easements would be particularly ill-advised given the enormous value inherent in conservation easement restrictions and the significant pressures on holders to agree to amendments that are contrary to the public interest. *See supra* note 110–11 and accompanying text. A much more considered and nuanced approach to amendments is required to avoid compromising the integrity of program and the easements acquired thereunder.

[184] *But see, e.g.*, I.R.S. Notice 2017-10, 2017-4 C.B. 544 (providing that certain syndicated easement donation transactions are listed transactions); I.R.S. Notice 2006-96, 2006-2 C.B. 902 (providing transitional guidance regarding statutory definitions of qualified appraisal and qualified appraiser); I.R.S. Notice 2004-41, 2003-2 C.B. 31 (warning that the IRS is aware of abuses in the easement donation context); I.R.S. Gen. Info. Ltr. 2013-0014 (Sept. 18, 2012) (discussing extinguishment); I.R.S. Gen. Info. Ltr. 2012-0017 (Mar. 5, 2012) (discussing prohibited swaps); I.R.S. Chief Couns. Adv. Mem. 201334039 (Aug. 23, 2012) (providing guidance on easement-specific valuation rules); *Audit Techniques Guide*, *supra* note 28.

[185] *See* DEP'T OF TREASURY, 2016-2017 PRIORITY GUIDANCE PLAN 12 (Aug. 15, 2016), https://www.irs.gov/pub/irs-utl/2016-2017_pgp_initial.pdf.

described in this Article, it would not be difficult to issue guidance that would help to ensure that almost all of the perpetuity requirements would be satisfied for most donations, thereby reducing transaction costs for donors and significantly shoring up the integrity of the program and the easements acquired thereunder.

Finally, any changes to section 170(h) that would increase noncompliance and abuse would have ramifications beyond the waste of public funds. The government at all levels is increasingly relying on conservation easements to accomplish conservation goals, and many government programs have either adopted or rely in part on the perpetuity requirements of section 170(h) for their easement purchase or tax-incentive programs.[186] In addition, in the current political environment, regulatory approaches are likely to be less popular, and reliance on voluntary incentives, such as the deduction under section 170(h), is likely to become even more prevalent. If conservation easements acquired under the auspices of section 170(h) do not actually provide the anticipated conservation benefits to the public over the long term because they fail to comply with the essential perpetuity requirements, an entire generation of conservation efforts could be fatally undermined.

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[186] *See, e.g.*, VA. CODE ANN. §§ 58.1-511, 58.1-512(C)(2) (2015)(to qualify for a state income tax credit for the donation of a conservation easements, the easement must comply with the requirements of and qualify as a charitable contribution under section 170(h)). And, for example, pursuant to the Forest Legacy Program, the federal government will often acquire conservation easements in "bargain-sale" transactions, in which the government pays up to seventy-five percent of the project costs associated with an easement acquisition, and the landowner makes a charitable donation of a portion of the value of the easement and claims a deduction under section 170(h) for the donation. *See Forest Legacy Program*, U.S. FOREST SERVICE (Dec. 16, 2013), https://www.fs.fed.us/cooperativeforestry/programs/loa/aboutflp.shtml.