

SJ Quinney College of Law, University of Utah

Utah Law Digital Commons

Utah Law Faculty Scholarship

Utah Law Scholarship

1-2021

Conservation Easements and the Proceeds Regulation

Nancy McLaughlin

Follow this and additional works at: <https://dc.law.utah.edu/scholarship>



Part of the [Land Use Law Commons](#)

**CONSERVATION EASEMENTS
AND THE PROCEEDS REGULATION**

Nancy A. McLaughlin*
56 Real Prop. Tr. & Est. L.J. 1 (2021), Forthcoming

©2021 by Nancy A. McLaughlin, All Rights Reserved

This article provides an in-depth look at Treasury Regulation § 1.170A-14(g)(6)(ii), known as the proceeds regulation. The proceeds regulation is intended to protect the public investment in conservation if a perpetual conservation easement that was the subject of a charitable deduction under Internal Revenue Code § 170(h) is later extinguished. A proper understanding of the proceeds regulation is critical because the public investment in deductible easements is significant—billions of dollars are being invested in such easements annually—and the regulation has recently been subject to challenges regarding its interpretation and validity. This article examines the history and operation of the proceeds regulation as well as possible alternatives. It explains that the proceeds regulation provides a simple and easy-to-implement rule that avoids a host of future valuation difficulties. It demonstrates that the proceeds regulation is neither irrational nor inherently unfair to donors or subsequent property owners, and serves to temper the perverse incentive that property owners may have to seek to extinguish easements. This article concludes that the proceeds regulation provides a reasonable solution to the difficult problem of ensuring that the conservation purpose of a contribution will be protected in perpetuity as required by § 170(h)(5)(A).

I. INTRODUCTION	2
II. THE § 170(H) DEDUCTION	6
A. Partial Interest Donation	6
B. The Special Rules	7
C. History of the Extinguishment Regulation	9
III. THE PROCEEDS REGULATION AND POSSIBLE ALTERNATIVES	14
A. The Proceeds Regulation	14
1. How It Operates.....	14
2. No Subtraction of Improvements	17
a. Unpredictable Variables and Perverse Incentives	19

* Nancy A. McLaughlin is the Robert W. Swenson Professor of Law at the University of Utah S.J. Quinney College of Law.

<i>b. Avoidance of Valuation Difficulties</i>	24
B. Easement Value at Extinguishment	25
1. <i>Possibility of Systematic Underpayment of Donees</i>	26
2. <i>Valuation Difficulties</i>	28
C. The “Greater Of” Formula	29
D. Carve-Outs and Flexibility	30
IV. ADDITIONAL CONSIDERATIONS	31
A. Congress’s Power to Condition Deductions	31
B. Condemnation Awards.....	34
C. Conservation Easements Encumber Improvements.....	36
D. Bright-Line Rule.....	38
E. Enforcement Is Critical	40
V. CONCLUSION	44

I. INTRODUCTION

In the late 1970s, Congress experimented with the idea of authorizing a federal charitable income tax deduction for the donation of conservation easements that were temporary in nature. However, Congress quickly gave up on that experiment as wasteful of taxpayer dollars and ill-advised as a matter of conservation policy. Accordingly, in enacting Internal Revenue Code (IRC) § 170(h) in 1980, Congress limited the deduction to the donation of perpetual conservation easements—those that are intended to permanently protect the conservation attributes of the parcels they encumber. Specifically, Congress required that a deductible easement be “granted in perpetuity,” and that “the conservation purpose [of the contribution be] protected in perpetuity.”¹

Subsidization of perpetual conservation easements through the deduction program raised a number of important questions, not the least of which was how to address the possibility of a state court extinguishment of an easement if the purpose of the easement became impossible or impractical to accomplish due to changed conditions. Congress chose not to address that issue in § 170(h). Instead, it left it to the Treasury to develop a regulation to ensure that, in the event of an extinguishment, the conservation purpose of the contribution would nonetheless be protected in perpetuity. The Treasury, for its part, promulgated Treasury Regulation § 1.170A-14(g)(6)(i)-(ii), referred to as the “extinguishment regulation,” which addresses the limited circumstances under which a deductible perpetual conservation easement can be extinguished and the manner in which the nonprofit or government donee must be compensated for loss of the easement.

¹ I.R.C. § 170(h)(2)(C), (h)(5)(A).

This article focuses on the compensation component of the extinguishment regulation, referred to as the “proceeds regulation,” and the controversy over its interpretation and validity. The proceeds regulation mandates that, if a deductible conservation easement is extinguished—which requires a judicial proceeding and a finding that continued use of the subject property for conservation purposes has become impossible or impractical—the nonprofit or government donee must be entitled to at least a minimum percentage of the proceeds from a subsequent sale, exchange, or involuntary conversion of the property (the “post-extinguishment proceeds”).² The minimum percentage is based on the value of the easement relative to the value of the property as a whole at the time of the easement’s donation.³ The extinguishment regulation provides that the donee must use its percentage of post-extinguishment proceeds in a manner consistent with the conservation purposes of the original contribution.⁴

The foregoing requirements seem sensible. By providing that the donee must receive compensation if an easement is extinguished, and must use that compensation to advance similar conservation purposes elsewhere, the extinguishment regulation protects the investment the public made in conservation through the deduction program. The devil, however, is in the details.

In a number of recent cases, deductions were denied because the conservation easement deeds provided for the value attributable to improvements constructed on the property following the donation to be subtracted from any post-extinguishment proceeds before calculating the donee’s minimum percentage share.⁵ Taxpayers have objected to those holdings, arguing that the proceeds regulation should be interpreted to permit subtraction of the value attributable to

² Treas. Reg. § 1.170A-14(g)(6)(i)-(ii).

³ *Id.*

⁴ Treas. Reg. § 1.170A-14(g)(6)(i).

⁵ See *PBBM-Rose Hill, Ltd. v. Commissioner*, 900 F.3d 193 (5th Cir. 2018); *Coal Prop. Holdings, LLC v. Commissioner*, 153 T.C. 126 (2019); *TOT Prop. Holdings, LLC v. Commissioner*, T.C. Bench Op. (Dec. 13, 2019); *Oakbrook Land Holdings, LLC v. Commissioner*, T.C. Memo. 2020-54; *Hewitt v. Commissioner*, T.C. Memo. 2020-89; *Plateau Holdings, LLC v. Commissioner*, T.C. Memo. 2020-93; *Lumpkin One Five Six, LLC v. Commissioner*, T.C. Memo. 2020-94; *Lumpkin HC, LLC v. Commissioner*, T.C. Memo. 2020-95; *Vill. at Effingham, LLC v. Commissioner*, T.C. Memo. 2020-102; *Riverside Place, LLC v. Commissioner*, T.C. Memo. 2020-103; *Maple Landing, LLC v. Commissioner*, T.C. Memo. 2020-104; *Englewood Place, LLC v. Commissioner*, T.C. Memo. 2020-105; *Smith Lake, LLC, v. Commissioner*, T.C. Memo. 2020-107; *Belair Woods, LLC v. Commissioner*, T.C. Memo. 2020-112; *Cottonwood Place, LLC v. Commissioner*, T.C. Memo. 2020-115; *Red Oak Estates, LLC v. Commissioner*, T.C. Memo. 2020-116; *Glade Creek Partners, LLC v. Commissioner*, T.C. Memo. 2020-148. In some of the cases, the conservation easement deeds also called for the subtraction of any post-donation appreciation in the value of improvements that had existed on the property at the time of the donation. See, e.g., *Coal Prop. Holdings*, 153 T.C. 126; *Plateau Holdings*, T.C. Memo. 2020-93; *Belair Woods, LLC v. Commissioner*, T.C. Memo. 2020-112.

improvements or, alternatively, that the regulation should be deemed procedurally or substantively invalid.⁶ They have argued that it is unfair and irrational for the donee of a conservation easement to be entitled to a percentage of the proceeds attributable to, for example, a million-dollar home that the donor or a subsequent property owner constructed on the property following the donation. They maintain that such a rule amounts to donors and subsequent property owners making unintended charitable contributions for which they receive no deduction.⁷

While those arguments have surface appeal, they are simplistic and ignore important realities. This article provides an in-depth look at the history and operation of the proceeds regulation, as well as possible alternatives. It demonstrates that the proceeds regulation is not inherently unfair to donors or subsequent property owners, nor is it irrational. A variety of unpredictable variables can affect the amount of post-extinguishment proceeds to be divided between the parties and, depending on the facts, the regulation can financially benefit donors and subsequent property owners. There also are a number of rationale bases for the formula in the regulation. For example, not subtracting the value attributable to improvements from post-extinguishment proceeds before calculating the donee's percentage share can temper the perverse incentive property owners may have to seek extinguishment when an easement has appreciated in value relative to the value of the property as a whole. The formula in the proceeds regulation is also simple, easy-to-implement, and avoids significant future valuation difficulties that, as a practical matter, would likely be addressed in a manner that would enrich property owners at the public's expense.

This article also addresses a number of other issues that are important to a full understanding of the proceeds regulation. It explains why a voluntarily donated

⁶ See, e.g., *Oakbrook Land Holdings*, T.C. Memo. 2020-54 (*Oakbrook I*) and *Oakbrook Land Holdings, LLC v. Commissioner*, 154 T.C. No. 10 (2020) (*Oakbrook II*), which are on appeal in the Sixth Circuit, and *Hewitt*, T.C. Memo. 2020-89, which is on appeal in the Eleventh Circuit. In *Oakbrook II*, a majority of the Tax Court, consisting of twelve judges, held that the proceeds regulation was properly promulgated under the Administrative Procedure Act (procedurally valid) and not "arbitrary, capricious, or manifestly contrary to the statute" (substantively valid). *Oakbrook Land Holdings*, 154 T.C. No. 10. In *Mitchell v. Commissioner*, 775 F.3d 1243, 1248 (10th Cir. 2015), the Tenth Circuit held that the mortgage subordination regulation was substantively valid, explaining:

where Congress has delegated to the Commissioner the power to promulgate regulations for the enforcement of the Code, 'we must defer to his regulatory interpretations of the Code so long as they are reasonable'... Here, the relevant regulations [Treasury Regulations § 1.170A-14(g)(1)-(6)], specifically the mortgage subordination provision, represent the Commissioner's reasoned efforts to implement the Code's requirement that '[a] contribution shall not be treated as exclusively for conservation purposes unless the conservation purpose is protected in perpetuity.'

⁷ See, e.g., *Oakbrook Land Holding, LLCs*, T.C. Memo. 2020-54, at *38; *Smith Lake, LLC, v. Commissioner*, T.C. Memo. 2020-107, at *11-12.

conservation easement that satisfies the conditions imposed on the deduction does not infringe on the state law property rights of the donor or a subsequent property owner. It discusses the interaction between the proceeds regulation and laws governing apportionment of condemnation awards, as well as the incorrect notion that a conservation easement encumbers only the underlying land and not the improvements thereon. It explains that the proceeds regulation establishes a bright-line rule and the IRS and the courts should not be required to engage in a case-by-case, fact-specific, and inherently speculative inquiry into whether future improvements would add value to a property. Also addressed is the unfortunate misconception that, in enforcing the requirements of § 170(h) and the Treasury Regulations, the Internal Revenue Service (IRS) is “attacking” conservation easement donations.⁸ The attack on conservation easements is not coming from the IRS; it is coming from those who seek to take advantage of the § 170(h) deduction while avoiding the conditions Congress imposed on the deduction to protect the public interest and prevent abuse.

It is beyond the scope of this article to evaluate the procedural or substantive validity of the proceeds regulation. However, the analysis herein will inform an assessment of whether the regulation is arbitrary, capricious, or manifestly contrary to the statutory requirement that the conservation purpose of a contribution be protected in perpetuity.⁹

The importance of a proper understanding of the proceeds regulation cannot be overstated. The proceeds regulation protects the investment being made by the public in conservation through the § 170(h) deduction program and that investment is significant. The annual revenue loss from the deduction is in the billions of dollars, and the deduction program ranks among the largest federal environmental and land management programs in the U.S. budget.¹⁰ As of 2016, it was estimated that we were spending almost as much on deductible conservation easements as on the entire National Park System.¹¹ Given that level of investment, it is crucial that the rules governing its protection are sound and cannot be subverted by donors or

⁸ See *infra* Part IV.D.

⁹ See I.R.C. § 170(h)(5)(A); *supra* note 6.

¹⁰ Adam Looney, *Estimating the Rising Cost of a Surprising Tax Shelter: The Syndicated Conservation Easement*, Urban-Brookings Tax Policy Center (Dec. 20, 2017), <https://www.brookings.edu/blog/up-front/2017/12/20/estimating-the-rising-cost-of-a-surprising-tax-shelter-the-syndicated-conservation-easement/>. See also *Syndicated Conservation-Easement Transactions*, Committee on Finance, United States Senate, Bipartisan Investigative Report, S. Prt. 116-44, at 2-3 (Aug. 2020), <https://www.finance.senate.gov/imo/media/doc/SFC%20-%20Syndicated%20Conservation-Easement%20Transactions.pdf> [hereinafter, *Senate Finance Committee Bipartisan Investigative Report*]; Roger Colinvaux, *Conservation Easements: Design Flaws, Enforcement Challenges, and Reform*, 2013 UTAH L. REV. 755, 756 (2013), <https://scholarship.law.edu/scholar/107/>.

¹¹ Looney, *supra* note 10.

subsequent property owners. It also is important to minimize the possibility that property owners will have a financial incentive to seek the extinguishment of easements.

This article proceeds as follows. Part II provides some necessary background. It explains the status of the § 170(h) deduction as an exception to the general prohibition on charitable deductions for donations of partial interests in property. It outlines the strict limits that Congress and the Treasury imposed on the deduction to ensure public benefit and prevent abuse. It also provides a brief history of the extinguishment regulation. Part III examines the operation of the proceeds regulation and possible alternatives. It illustrates that the regulation is neither unfair nor irrational. Part IV addresses the additional issues that are important to a full understanding of the proceeds regulation. Part V concludes that, properly understood, the proceeds regulation provides a reasonable solution to the difficult problem of ensuring that the conservation purpose of a contribution will be protected in perpetuity.

II. THE § 170(H) DEDUCTION

A. Partial Interest Donation

In 1969 Congress adopted a general prohibition on charitable income tax deductions for donations of partial interests in property.¹² Partial interest donations are disfavored because they often involve abusive arrangements in which the donors retain extensive control over the property and the public receives little benefit.¹³ Congress made an exception to this general prohibition for conservation easement donations when it enacted section 170(h) in 1980.¹⁴ However, Congress imposed strict limits on the deduction to prevent abuse and ensure that the public benefit provided would be sufficient to justify the public investment.¹⁵ Professor Colinvaux explains:

¹² Pub. L. No. 91-172, § 201; I.R.C. § 170(f)(3)(A).

¹³ See, e.g., Daniel Halperin, *Incentives for Conservation Easements: The Charitable Deduction or A Better Way*, 74 DUKE J. L. & CONTEMP. PROBS. 29, 31-33 (2011), <https://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=1644&context=lcp>; Colinvaux, *supra* note 10 at 757-758.

¹⁴ See Colinvaux, *supra* note 10, at 755; I.R.C. § 170(f)(3)(b)(iii), (h). See also *Belk v. Commissioner*, 774 F.3d 221 (4th Cir. 2014) (“The Code generally restricts a taxpayer’s ability to claim a charitable deduction for the donation of ‘an interest in property which consists of less than the taxpayer’s entire interest in such property.’... But it provides an exception to the general rule for ‘a qualified conservation contribution’”).

¹⁵ See S. Rep. 96-1007, at 9, 10-14 (1980) (providing an in-depth explanation of congressional intent regarding § 170(h) and its requirements).

That the easement deduction was born as an exception to the partial interest rule is critical to its design. Congress could simply have waived the partial interest rules and left conservation easements to be treated like any other contribution of real property. . . . A donor could arrange for a conservation easement on property and contribute the easement to any charity for any reason, and a fair market value deduction would be available. This is, after all, how it normally works — with the oversight role of the IRS generally limited to checking value.

But . . . Congress took a different approach and adopted a number of special rules intended to address potential (and anticipated) problems.¹⁶

B. The Special Rules

To be eligible for a federal charitable income tax deduction under section 170(h), the donor of a conservation easement must comply with each of the following requirements: (1) the easement must be a qualified real property interest, defined as “a restriction (granted in perpetuity) on the use which may be made of the real property”;¹⁷ (2) the easement must be contributed to a qualified organization, defined to include a government entity or public-supported charity or a subsidiary thereof;¹⁸ (3) the contribution must satisfy one or more of four conservation purposes tests;¹⁹ and (4) the contribution must be made “exclusively” for one or more of the four conservation purposes, meaning the conservation purpose of the contribution must be protected in perpetuity.²⁰

To satisfy the conservation purposes test, a deductible conservation easement must be contributed for one or more of the following purposes: (1) preservation of land for outdoor recreation by, or education of, the general public; (2) protection of a relatively natural habitat; (3) preservation of open space for the scenic enjoyment of the general public or pursuant to a clearly delineated governmental conservation policy, provided the preservation will yield a significant public benefit; or (4) preservation of a historically important land area or structure.²¹

¹⁶ Colinvaux, *supra* note 10, at 758. *See also* STEPHEN J. SMALL, THE FEDERAL TAX LAW OF CONSERVATION EASEMENTS, 2-2—2-3 (1997) (“A taxpayer who donates an easement continues to use and enjoy the property, and the requirements for taking an income tax deduction simply must be tighter to ensure that there is also a significant long-term public benefit associated with the donation”).

¹⁷ I.R.C. § 170(h)(1)(A), (h)(2)(C).

¹⁸ *Id.* § 170(h)(1)(B), (h)(3).

¹⁹ *Id.* § 170(h)(1)(C), (h)(4).

²⁰ *Id.* § 170(h)(1)(C), (h)(5)(A).

²¹ *Id.* § 170(h)(4)(A); Treas. Reg. § 1.170A-14(d).

For the conservation purpose of a contribution to be protected in perpetuity, the donation must comply with the no-surface-mining requirement in § 170(h)(5)(B) and each of the following regulations:²² the eligible donee regulation;²³ the restriction-on-transfer regulation;²⁴ the no-inconsistent-use regulation;²⁵ the general enforceable-in-perpetuity regulation;²⁶ the mortgage subordination regulation;²⁷ the future defeating events regulation;²⁸ the mining restrictions regulation;²⁹ the baseline documentation regulation;³⁰ the donee notice, donee access, and donee enforcement regulations;³¹ and the extinguishment regulation.³² The no-surface-mining requirement and the foregoing regulations other than the extinguishment regulation are intended to ensure that the conservation purpose of a contribution will be carried out through the conservation easement in perpetuity or forever.³³ The extinguishment regulation specifies the limited circumstances under which an extinguishment can occur.³⁴

To be eligible for the § 170(h) deduction, the donor of a conservation easement also must substantiate the value of the easement by obtaining a qualified appraisal.³⁵ A qualified appraisal must, among other things, be prepared by a qualified appraiser and in accordance with generally accepted appraisal standards.³⁶ The appraisal also must comply with a number of special rules applicable to conservation easements.³⁷

²² See I.R.C. § 170(h)(5)(A); Treas. Reg. § 1.170A-14(e)(1); S. Rep. No. 96-1007, at 13-14. The mortgage subordination regulation applies only if the property is subject to a mortgage on the date of the gift of the easement. See Treas. Reg. § 1.170A-14(g)(2). Although the baseline documentation and donee notice, access, and enforcement regulations are applicable only if the donor “reserves rights the [improper] exercise of which may impair the conservation interests associated with the property,” donors almost always reserve such rights, so those requirements apply to most easements. *Id.* § 1.170A-14(g)(5).

²³ Treas. Reg. § 1.170A-14(c)(1).

²⁴ *Id.* § 1.170A-14(c)(2).

²⁵ *Id.* § 1.170A-14(e)(2)-(3).

²⁶ *Id.* § 1.170A-14(g)(1).

²⁷ *Id.* § 1.170A-14(g)(2).

²⁸ *Id.* § 1.170A-14(g)(3).

²⁹ *Id.* § 1.170A-14(g)(4).

³⁰ *Id.* § 1.170A-14(g)(5)(i).

³¹ *Id.* § 1.170A-14(g)(5)(ii).

³² *Id.* § 1.170A-14(g)(6)(i)-(ii).

³³ See, e.g., *Hoffman Properties II LP v. Commissioner*, 956 F.3d 832, 833 (6th Cir. 2020) (perpetuity means “time without end; eternity” and in perpetuity means “endless duration; forever”).

³⁴ See *infra* Part II.C.

³⁵ Under IRC § 170(f)(11)(C), taxpayers are required to obtain a qualified appraisal for donated property for which a deduction of more than \$5,000 is claimed. See also Treas. Reg. §§ 1.170A-14(i) and (j); -16(d)(1)(ii); -17(a)(1).

³⁶ See Treas. Reg. § 1.170A-17(a)(1). For the definition of a “qualified appraiser”, see Treasury Regulation § 1.170A-17(b)(1).

³⁷ See Treas. Reg. § 1.170A-14(h)(3)(i).

None of the foregoing requirements are optional. Congress and the Treasury considered each of the requirements to be critical to the integrity and effectiveness of the deduction program. Each requirement must be satisfied at the time of a conservation easement's donation, and compliance is indirectly policed by the IRS, through the tax return review and audit process, and the courts, if the issue is litigated.³⁸ In addition, deduction requirements are generally strictly construed.³⁹

C. History of the Extinguishment Regulation

Prior to enacting § 170(h) in 1980, Congress briefly experimented with the idea of allowing deductions for donations of conservation easements that were temporary in nature. The Tax Reform Act of 1976 provided the first statutory authority for charitable deductions for conservation easement donations and it authorized deductions for the donation of both perpetual easements and term easements with a minimum term of 30 years.⁴⁰ However, land conservation groups such as The Nature Conservancy expressed concern that term easements would not effectively promote conservation goals.⁴¹ They believed that term easements would merely allow development pressures to build up over thirty years, at which time the pressure to develop would be irresistible.⁴² They also were concerned that allowing

³⁸ See, e.g., *Palmolive Building Investors LLC v Commissioner*, 149 T.C. 380, 405 (2017) (“The requirements of section 170 must be satisfied at the time of the gift.”); *Oakbrook Land Holdings, LLC v. Commissioner*, 154 T.C. No. 10 (2020) (“Congress specified numerous requirements for a “qualified conservation contribution,” including the requirements that the contribution be made “exclusively for conservation purposes” and that the “conservation purpose [be] protected in perpetuity.”).

³⁹ See *INDOPCO Inc. v. Commissioner*, 503 U.S. 79, 84 (1992) (an income tax deduction is a matter of legislative grace and “deductions are strictly construed”). Several circuit courts have applied *INDOPCO* to § 170(h). See *Minnick v. Commissioner*, 796 F.3d 1156, 1159 (9th Cir. 2015); *Belk v. Commissioner*, 774 F.3d 221, 225 (4th Cir. 2014); *Scheidelman v. Commissioner*, 755 F.3d 148, 154 (2d Cir. 2014); *Esgar Corp. v. Commissioner*, 744 F.3d 648, 653 (10th Cir. 2014). See also *Glass v. Commissioner*, 471 F.3d 698, 706 (6th Cir. 2006); *RP Golf v. Commissioner*, 860 F.3d 1096, 1100 (8th Cir. 2017). *Contra BC Ranch II v. Commissioner*, 867 F.3d 547, 553-554 (5th Cir. 2017). There was a strong and persuasive dissent on this point (and others) in *BC Ranch*. See *id.* at 560-561. For a helpful history of court construction of deduction provisions and support for strictly interpreting § 170(h)'s perpetuity requirements, see Bryan Camp, *Lesson From The Tax Court: Not Stopping The Perpetual Debate About Conservation Easements*, TaxProf Blog, https://taxprof.typepad.com/taxprof_blog/2018/09/lesson-from-the-tax-court-no-stopping-the-perpetual-debate-about-conservatio.html (accessed Dec. 7, 2020).

⁴⁰ Pub. L. No. 94-455, 90 Stat. 1919, § 2124(e) (1976).

⁴¹ See Stephen J. Small, *The Tax Benefits of Donating Easements on Scenic and Historic Property*, 7 REAL EST. L.J. 304, 315-16 (1979).

⁴² *Id.*

deductions for term easements would discourage the donation of perpetual easements.⁴³

Allowing a deduction for term conservation easements was also ill-advised from a tax policy standpoint because it provided an expensive subsidy to taxpayers making long-term investments in land held for eventual development. Under the 1976 legislation, an investor making a 30-year investment in land on the urbanizing fringe of a metropolitan region could receive a deduction for donating an easement that would do little or nothing to advance conservation goals, given that the investor did not intend to develop the land for thirty years in any event. Such a deduction merely reduced the carrying costs of that type of investment.

Accordingly, Congress quickly dropped the idea of temporary easements as wasteful of taxpayer dollars and ill-advised as a matter of conservation policy. In the Tax Reduction and Simplification Act of 1977, Congress limited the deduction to the donation of conservation easements that were granted in perpetuity.⁴⁴ Congress then stuck to this policy when it made the conservation easement deduction provision a permanent part of the Code in 1980 in the form of § 170(h), and it included a new requirement—that the conservation purpose of the contribution must be protected in perpetuity.⁴⁵ Congress thus made a carefully considered judgment not to authorize a deduction for the donation of temporary easements and, instead, to require that deductible easements permanently protect the parcels they encumber.⁴⁶

Congress was aware, however, of the possible extinguishment of perpetual conservation easements by state courts due to changed conditions. In anticipation of a congressional hearing on proposed new § 170(h), the Joint Committee on Taxation prepared a report in which it specifically raised the question of whether § 170(h) ought to include rules to cover the situation “where a transferred partial interest in real property, for which a deduction was allowed because it served a conservation purpose, ceases to be used in furtherance of the conservation

⁴³ *Id.* at 304, 306.

⁴⁴ Pub. L. 95-30, 91 Stat. 154, § 309 (1977).

⁴⁵ Pub. L. No. 96-541, 94 Stat. at 3206, § 6(a).

⁴⁶ In the legislative history of § 170(h), the Senate Finance Committee explained that, to satisfy the new “protected in perpetuity” requirement, among other things, the perpetual restrictions in a deductible conservation easement must be “enforceable by the donee organization (and successors in interest) against all other parties in interest (including successors in interest)” and the easement must “not be transferable by the donee except to other qualified organizations that also will hold the [easement] exclusively for conservation purposes.” S. Rep. No 96-1007, at 14. *See also Graev v. Commissioner*, 140 T.C. 377 (2013) (“In the Tax Treatment Extension Act of 1980 ... Congress amended section 170(f)(3) and added subsection [170](h), which have remained in effect since then and work in tandem to keep the perpetuity requirement for conservation easement donations”).

purpose.”⁴⁷ In response to that question, the president of a prominent land trust, on behalf of nineteen land trusts, advised:

We believe that with a well planned easement program this is most unlikely to occur, but it is not impossible. It is conceivable for example, that a farm, or a natural habitat, might become so closely surrounded by heavy industry at some future time that it would become impossible to continue the original conservation purpose. In such a situation the then owner of the land might, under common law “change of circumstances” doctrine, obtain equitable relief from the burden of the easement in court. Certainly if that were to happen equity would seem to call for a return to the public of the price originally paid for the public benefit provided by the easement, whether that price had been paid directly by purchase or indirectly by a tax deduction. It also seems very difficult, however, to provide for this unlikely occurrence in the Revenue Code itself. We would hope that some Regulation for this purpose could be developed by those most interested, i.e., The Revenue Service and the Treasury Department, which would not interfere with the main operation of the easement program.⁴⁸

Congress did not include standards and procedures governing extinguishment of deductible easements in the event of changed conditions in § 170(h), leaving it to the Treasury to address that issue in regulations. The Treasury did so by crafting the extinguishment regulation, which is part of the final regulations interpreting § 170(h) that were issued in 1986. The extinguishment regulation provides as follows:

In general. If a subsequent unexpected change in the conditions surrounding the property that is the subject of a donation under this paragraph 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 following paragraph] from a subsequent sale or exchange of the property are used by

⁴⁷ Staff of J. Comm. on Taxation, 96th Cong., *Description of Miscellaneous Tax Bills Scheduled for a Hearing Before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means on June 26, 1980*, JCS-33-80, at 27 (Comm. Print 1980) (providing a list of seven issues that were raised by the bill to enact section 170(h)).

⁴⁸ *Minor Tax Bills: Hearings Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means*, 96th Cong. 238, 245 (1980) (written statement of Samuel W. Morris, President, French and Pickering Creeks Conservation Trust, Inc., Pottstown, Pa., July 1, 1980, submitted on behalf of nineteen land trusts).

the donee organization in a manner consistent with the conservation purposes of the original contribution.⁴⁹

Proceeds. At the time of the gift the donor must agree that the donation of the [easement]⁵⁰ 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 [easement] 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 [an easement] [as provided in the preceding paragraph], 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 of the [easement], unless state law provides that the donor is entitled to the full proceeds from the conversion without regard to the terms of the prior [easement].⁵¹

The first paragraph of the extinguishment regulation—referred to herein as the judicial proceeding regulation—limits extinguishment to “‘unexpected’ and extraordinary circumstances”; a deductible perpetual conservation easement can be extinguished only when it can be demonstrated to the satisfaction of a court that changed conditions have made continued use of the property for conservation purposes impossible or impractical.⁵² This limitation carries out Congress’s directive in § 170(h)(2)(C) that a deductible conservation easement be “a restriction (granted in perpetuity) on the use which may be made of the real property.”⁵³ That is, a deductible easement must protect the conservation interests associated with the real property it encumbers “in perpetuity” or forever, unless an unexpected change in conditions makes it impossible or impractical to continue to do so.⁵⁴

The second paragraph of the extinguishment regulation—the proceeds regulation—mandates that, in the event of an extinguishment, the donee must be

⁴⁹ Treas. Reg. § 1.170A-14(g)(6)(i).

⁵⁰ The regulations use the term “perpetual conservation restriction” in lieu of conservation easement. To avoid confusion and for brevity purposes, this article uses the terms conservation easement and easement.

⁵¹ Treas. Reg. § 1.170A-14(g)(6)(ii).

⁵² See *Belk v. Commissioner*, 774 F.3d 221, 225 (4th Cir. 2014) (“absent these ‘unexpected’ and extraordinary circumstances, real property placed under easement must remain there in perpetuity in order for the donor of the easement to claim a charitable deduction”).

⁵³ See *id.* at 227 (§ 170(h)(2)(C)’s “granted in perpetuity” requirement “means what it says: a charitable deduction may be claimed for the donation of a conservation easement only when that easement restricts the use of the donated property in perpetuity”).

⁵⁴ See *id.* See also *supra* note 33.

entitled to at least a minimum proportionate share of post-extinguishment proceeds, and the judicial proceeding regulation requires that those proceeds be used in a manner consistent with the conservation purposes of the original contribution. Those provisions are intended to carry out Congress's directive in § 170(h)(5)(A) that "the conservation purpose [of the contribution be] protected in perpetuity" in the event that an easement is extinguished.⁵⁵ That is, if the conservation purpose of a contribution can no longer be carried out through the perpetual easement due to an unexpected change in conditions, the conservation purpose must nonetheless continue to be carried out through the donee's use of proceeds to advance similar conservation purposes elsewhere.⁵⁶

The extinguishment regulation appears to have been modeled on the doctrine of *cy pres*, which applies to perpetual charitable gifts.⁵⁷ Looking to the doctrine of *cy pres* rather than the real property law doctrine of changed conditions in this context makes sense. Deductible conservation easements are, by definition, charitable gifts that are granted for specific purposes in perpetuity,⁵⁸ and both Congress and the Treasury were aware of the rules governing perpetual charitable gifts when § 170(h) was enacted. At the congressional hearings on proposed § 170(h), and in response to the Treasury's concern that charitable conservation organizations might not properly enforce conservation easements, nineteen land trusts submitted an appendix to their testimony in which they acknowledged the status of deductible easements as "charitable grants" and noted the power and duty of courts and state attorneys general to enforce such grants.⁵⁹ Because of their status as charitable grants, the terms of deductible conservation easements, including the

⁵⁵ See *supra* Part II.B, discussing the protected-in-perpetuity requirement.

⁵⁶ See *Coal Property Holdings, LLC v. Commissioner*, 153 T.C. 126, at *136 (2019) ("the [protected in] 'perpetuity' requirement is deemed satisfied because the sale proceeds replace the easement as an asset deployed by the donee 'exclusively for conservation purposes.'"); *Kaufman v. Shulman*, 687 F.3d 21, 26 (1st Cir. 2012) (the extinguishment regulation "appears designed in case of extinguishment both (1) to prevent taxpayers from reaping a windfall if the property is destroyed or condemned and they get the proceeds from insurance or condemnation and (2) to assure that the donee organization can use its proportionate share of the proceeds to advance the cause of historic preservation elsewhere").

⁵⁷ See *Kaufman v. Commissioner*, 136 T.C. No. 13, *9 (2011) (the extinguishment regulation "appears to be a regulatory version of *cy pres*"), vacated and remanded on other grounds, *Kaufman v. Shulman*, 687 F.3d 21 (1st Cir. 2012).

⁵⁸ See I.R.C. § 170(h)(1)(A) (requiring a charitable "contribution" of a qualified real property interest to a qualified organization exclusively for conservation purposes). See also *Carpenter v. Commissioner*, T.C. Memo. 2012-1, at *2 ("A charitable contribution is a gift of property to a charitable organization, made with charitable intent and without the receipt or expectation of receipt of adequate consideration.").

⁵⁹ See *Minor Tax Bills: Hearings Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means*, 96th Cong. 238, 242 (1980) (App. to Testimony of French and Pickering Creeks Conservation Trust, the Brandywine Conservancy, and other Conservation Organizations in re H.R. 7318 on June 26, 1980).

terms specifying the limited circumstances under which the easements can be extinguished, should be binding on both the property owner and the donee under state law.⁶⁰ That is, property owners and donees should not be able to mutually agree to extinguish easements. In addition, under the doctrine of cy pres, in the event of impossibility or impracticality, a court will direct that the charitable asset, or proceeds attributable thereto, be used by the donee to advance similar charitable purposes elsewhere.⁶¹ By contrast, when the real property law doctrine of changed conditions leads to the termination of a servitude, such as in a residential subdivision, there is seldom an entitlement to damages.⁶²

III. THE PROCEEDS REGULATION AND POSSIBLE ALTERNATIVES

A. The Proceeds Regulation

1. How it Operates

The proceeds regulation mandates that, at the time of the gift, the donor must agree that the donation of the easement gives rise to a property right, immediately vested in the donee, with a fair market value that is at least equal to “the proportionate value that the [easement] at the time of the gift, bears to the value of the property as a whole at that time.”⁶³ Both the Tax Court and the Fifth Circuit have determined that the “proportionate value” is a fraction equal to the value of

⁶⁰ See, e.g., *Carpenter v. Commissioner*, T.C. Memo. 2012-1, at *6 (gifts of deductible conservation easements constituted restricted charitable gifts, which are “contributions conditioned on the use of a gift in accordance with the donor’s precise directions and limitations.” Schmidt, ‘Modern Tomb Raiders: Nonprofit Organizations’ Impermissible Use of Restricted Funds’, 31 Colo. Law. 57, 58 (2002)); *Herzog Foundation v. University of Bridgeport*, 699 A.2d 995 (Conn. 1997) (discussing the general rule that charitable gifts are enforceable by state attorneys general and the courts). See also *Oakbrook Land Holdings v. Commissioner*, T.C. Memo. 2020-54, *15-17 (explaining the need to limit the ability of donors and donees of deductible conservation easements to declare “changed circumstances” all by themselves and noting that, “[g]etting a judge involved means there will be a third party to monitor whether conditions really have changed”).

⁶¹ See, e.g., Restatement (Third) of Trusts, § 67. The cy pres doctrine applies to gifts to charitable corporations as well as to charitable trusts. See, e.g., *In re Scott’s Will*, 208 N.Y.S.2d 984, 988 (N.Y. 1960).

⁶² See Restatement (Third) of Prop.: Servitudes § 7.11 cmt. c (2000). See also *Oakbrook*, T.C. Memo. 2020-54, *15-16 (the common-law rule of only implicit compensation for termination of an easement “wouldn’t work with conservation easements” and “could embolden landowners (imagine well-financed developers) to use the threat of protracted changed-conditions litigation to coerce donees (imagine thinly staffed nonprofit organizations) into modifying or terminating their easements.”).

⁶³ Treas. Reg. § 1.170A-14(g)(6)(ii).

the conservation easement at the time of the gift, divided by the value of the property as a whole at that time.⁶⁴

The proceeds regulation further provides that “that proportionate value” (the fraction) “shall remain constant” and, if an easement is extinguished as provided in the judicial proceeding regulation, the donee, “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,” with one exception not relevant here.⁶⁵ By providing that the donee must be entitled, following extinguishment, to “at least” that proportionate value of the proceeds, with that proportionate value established at the time of the gift, the proceeds regulation establishes a floor—the donee’s share can never be less than that minimum proportionate value (or fraction) of the proceeds, although it could be more if the parties were to so agree.⁶⁶

To illustrate the operation of the proceeds regulation, assume the following. A conservation easement that complied with the requirements of § 170(h) and the Treasury Regulations was contributed as a charitable gift to a qualified organization. The fair market value of the subject property before the gift was \$1,000,000 and the fair market value of the subject property after the gift was \$700,000. Under the “before and after” valuation method described in the regulations, the fair market value of the easement at the time of the gift was \$300,000.⁶⁷

To comply with the proceeds regulation, the donor agreed in the easement deed that, at the time of the gift, the donation gave rise to a property right, immediately vested in the donee, with a fair market value that is equal to a fraction, the numerator of which is the value of the conservation easement at the time of the gift (in this example, \$300,000), and the denominator of which is the value of the property as a whole at that time (in this example, \$1,000,000). The donor also

⁶⁴ *Carroll v. Commissioner*, 146 T.C. 196, 216 (2016); *PBBM-Rose Hill, Ltd v. Commissioner*, 900 F.3d 193, 207 (5th Cir. 2018); *Oakbrook Land Holdings v. Commissioner*, T.C. Memo. 2020-54, *8-*11.

⁶⁵ Treas. Reg. § 1.170A-14(g)(6)(ii). An “involuntary conversion” is “[t]he loss or destruction of property through theft, casualty, or condemnation.” BRYAN A. GARNER, ED., BLACK’S LAW DICTIONARY, (11TH ED. 2019), conversion. Accordingly, “the proceeds” in the case of an involuntary conversion could be insurance proceeds or a condemnation award. For discussion of the exception, see *infra* note 127 and accompanying text.

⁶⁶ See, e.g., *Railroad Holdings, LLC v. Commissioner*, T.C. Memo. 2020-22, at *14 (“[t]he [proceeds] regulation sets a minimum for the donee’s participation in extinguishment proceeds and then, using the phrase ‘at least’, makes it explicit that a deed may be more generous to the donee and still comply”).

⁶⁷ See Treas. Reg. § 1.170A-14(h)(3)(i). For a discussion of the rules governing the valuation of conservation easements for purposes of the § 170(h) deduction, see Nancy A. McLaughlin, *Conservation Easements and the Valuation Conundrum*, 19 FLA. TAX. REV. 227, 231-246 (2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2704576.

agreed that this fraction, expressed as a percentage (in this example, 30%), shall remain constant. The easement deed further provided that the easement can be extinguished only in a judicial proceeding, upon a finding by the court that a subsequent unexpected change in the conditions surrounding the property has made impossible or impractical the continued use of the property for conservation purposes, and, in such event, the donee will be entitled to at least that percentage of the proceeds from a subsequent sale, exchange, or involuntary conversion of the subject property, and must use those proceeds in a manner consistent with the conservation purposes of the original contribution.

Some years after the gift of the easement, and after the property had changed hands, the easement was extinguished in whole in a judicial proceeding upon a finding that continued use of the property for conservation purposes had become impossible or impractical and the property, unencumbered by the easement, was sold in an arm's-length transaction for \$5 million. In accordance with the terms of the easement, the donee received 30% of those post-extinguishment proceeds, or \$1.5 million, and used the \$1.5 million in a manner consistent with the conservation purposes of the original contribution. The property owner received the remaining \$3.5 million of post-extinguishment proceeds.

The donee's receipt of \$1.5 million of the post-extinguishment proceeds and use of those proceeds in a manner consistent with the conservation purposes of the original contribution carried out Congress's directive in § 170(h)(5)(A) that "the conservation purpose [of the contribution be] protected in perpetuity." Although the conservation purpose of the contribution could no longer be carried out through the easement, it nonetheless continued to be carried out through the donee's use of its share of the post-extinguishment proceeds to advance similar conservation purposes elsewhere.⁶⁸

In addition, by mandating that the donee be entitled to at least the specified minimum percentage of post-extinguishment proceeds (30% of \$5 million), as opposed to an amount equal to the dollar value of the easement at the time of its donation (\$300,000), the proceeds regulation ensured that the donee received a percentage of the proceeds attributable to the appreciation in the value of the property as a whole following the donation (from \$1 million to \$5 million). If the proceeds regulation limited the donee's share of post-extinguishment proceeds to the dollar value of the easement at the time of its donation, the donee would have watched its proportion of potential post-extinguishment proceeds shrink over the years as the property as a whole appreciated in value.⁶⁹ Moreover, if some of that appreciation were attributable to the easement, the property owner would have had a perverse incentive to seek extinguishment. For example, if the encumbered property and the easement had appreciated in value proportionally, such that, at the

⁶⁸ See *supra* note 56 and accompanying text.

⁶⁹ See *Railroad Holdings, LLC v. Commissioner*, T.C. Memo. 2020-22, at *14.

time of extinguishment, the value of the encumbered property was \$3.5 million and the value of the easement was \$1.5 million, and the donee was entitled to only \$300,000 of the \$5 million of post-extinguishment proceeds, the property owner would have had an incentive to seek extinguishment to benefit from the \$1.2 million of appreciation attributable to the easement.

The proceeds regulation also should apply in the case of partial extinguishments. For example, assume in the example above that, instead of a wholesale extinguishment, a small strip of the encumbered property that adjoined a road was condemned to widen the road for safety purposes.⁷⁰ Assume also that the condemning authority paid just compensation of \$150,000 for the taking of both the strip of the encumbered property and the portion of the conservation easement encumbering that strip. Under the easement deed, the donee would be entitled to 30% of the condemnation award, or \$45,000, and would be required to use the \$45,000 in a manner consistent with the conservation purposes of the original contribution. The property owner would be entitled to the remaining \$105,000.⁷¹

2. No Subtraction of Improvements

In *PBBM-Rose Hill, Ltd. v. Commissioner*, the Fifth Circuit sustained the IRS's disallowance of a deduction claimed for the conveyance of a conservation easement because the easement deed did not comply with the proceeds regulation.⁷² The deed provided that, following extinguishment of the easement, the donee was entitled to the correct percentage of the post-extinguishment proceeds. However, the deed also provided that, before calculating the donee's percentage share, the post-extinguishment proceeds had to be reduced by an amount attributable to improvements constructed on the property pursuant to the property owner's reserved rights.⁷³ The Fifth Circuit held that the easement deed did not comply with the proceeds regulation because of the subtraction provision.⁷⁴

The Fifth Circuit explained that, under the plain language of the proceeds regulation, following extinguishment, the donee of a conservation easement "must" be entitled to at least the mandated minimum percentage of "the proceeds" from a subsequent sale, exchange, or involuntary conversion of the property, and "the

⁷⁰ A condemnation is a "subsequent unexpected change in the conditions surrounding the property." Treas. Reg. § 1.170(g)(6)(i).

⁷¹ See *infra* Part IV.B for a further discussion of apportionment of a condemnation award upon the taking of land subject to a conservation easement.

⁷² *PBBM-Rose Hill, Ltd. v. Commissioner*, 900 F.3d 193 (5th Cir. 2018). The *PBBM* easement was conveyed to the North American Land Trust and encumbered a 27-hole golf course in a gated and guarded residential community in South Carolina. *Id.* at 198, 202. The taxpayer overvalued the *PBBM* easement by more than \$15 million. See *infra* note 99.

⁷³ *PBBM-Rose Hill, Ltd. v. Commissioner*, 900 F.3d 193, 199 (5th Cir. 2018).

⁷⁴ *Id.* at 207-209.

proceeds” refers to “the *total* amount brought in from” such sale, exchange, or involuntary conversion.⁷⁵ The regulation, said the court, does not indicate that any amount may be subtracted from “the proceeds” before calculating the donee’s percentage share, including amounts attributable to improvements.⁷⁶ The court also pointed out that the regulation preceding the extinguishment regulation suggests that the Commissioner of Internal Revenue recognized that a donor may reserve rights to construct improvements on the property post-donation, but chose not to carve out an exception for the value attributable to those improvements in the proceeds regulation.⁷⁷

Following the Fifth Circuit’s decision in *PBBM*, the Tax Court denied deductions on similar grounds in a number of cases, many of which involved syndicated conservation easement donation transactions.⁷⁸ In some of the cases, the easements called for the subtraction from post-extinguishment proceeds of not only the value attributable to improvements that a property owner constructed on the property post-donation, but also post-donation appreciation in the value of improvements that had existed on the property at the time of the donation.⁷⁹

Taxpayers have argued that the Fifth Circuit’s interpretation of the proceeds regulation as it relates to improvements is incorrect or, alternatively, that the regulation should be deemed procedurally or substantively invalid.⁸⁰ They have argued that it is unfair and irrational for the donee of a conservation easement to be entitled to post-extinguishment proceeds attributable to the value of improvements that were made and paid for by the donor and for which the donor did not receive a

⁷⁵ *Id.* at 207-208 (emphasis in original).

⁷⁶ *Id.* at 208. The *PBBM* easement also provided for the “actual bona fide expenses” of a sale to be subtracted from the post-extinguishment proceeds before calculating the donee’s share. *Id.* at 199. While the Fifth Circuit did not directly address this subtraction, it did state that the plain language of the proceeds regulation does not indicate that “any” amount can be subtracted from post-extinguishment proceeds before calculating the donee’s percentage share. *Id.* at 208. Accordingly, an easement deed should be drafted to entitle the donee to receive at least its mandated minimum percentage of the total amount of the proceeds, the property owner would be entitled to the remaining proceeds, and then each party could pay its share of the expenses out of the proceeds it received.

⁷⁷ *Id.* The regulation preceding the extinguishment regulation provides that, when an easement donor reserves rights, “the exercise of which may impair the conservation interests associated with the property,” the donor must make available to the donee, prior to the time the donation is made, documentation sufficient to establish the condition of the subject property at the time of the gift. This documentation, generally referred to as “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.” Treas. Reg. § 1.170A-14(g)(5)(i).

⁷⁸ *See supra* note 5.

⁷⁹ *See id.*

⁸⁰ *See supra* note 6.

charitable deduction.⁸¹

Building on the example above, in which the donee is entitled to 30% of any post-extinguishment proceeds, the taxpayers would argue that, if the donor had constructed a residence on the encumbered property post-donation, and the property was sold following extinguishment of the easement for \$6 million rather than \$5 million (with the additional \$1 million attributable to the increase in the property's value as a result of the residence), it would be irrational and unfair for the donee to receive 30% of the proceeds attributable to that \$1 million increase because the donor constructed and paid for the residence and the residence was not the subject of a deductible charitable donation. They also would argue that it would be even more irrational to require a subsequent property owner to forfeit to the donee a portion of the proceeds attributable to improvements constructed and paid for by the subsequent owner given that the subsequent owner did not donate the easement or receive a charitable contribution deduction.

Those arguments are not persuasive when considered in light of the unpredictable variables that can affect the amount of post-extinguishment proceeds to be divided between the parties, as well as the undesirability of creating an incentive on the part of property owners to seek to extinguish deductible perpetual easements. Those arguments also do not take into account the significant challenges that would be associated with determining the value attributable to improvements or appreciation in the value of improvements at the time of an extinguishment.

a. Unpredictable Variables and Perverse Incentives

Conservation easements can appreciate in value relative to the value of the property they encumber following their donation. In addition, many deductible conservation easements are drafted to limit the donee's share of post-extinguishment proceeds to the minimum percentage required by the proceeds regulation—the 30% in our example above. Although it is permissible for a deductible conservation easement to provide that the donee is entitled to more than the minimum percentage of post-extinguishment proceeds,⁸² because it is not required, many easements are drafted to provide that the donee is entitled to only the minimum percentage or to “at least” that percentage, in which case the payment of a higher percentage to the donee would be in the discretion of whoever happens to own the subject property at the time of extinguishment.⁸³

⁸¹ See *supra* note 7.

⁸² See *supra* note 66 and accompanying text.

⁸³ See, e.g., *Railroad Holdings, LLC v. Commissioner*, T.C. Memo. 2020-22, at *14 (the right under an easement deed to receive “at least” a specified share means there is only a hope that there might be more).

If a conservation easement appreciates in value relative to the value of the property it encumbers following its donation, and the donee's percentage of post-extinguishment proceeds is limited to the minimum percentage, then following extinguishment, the property owner would receive the benefit of all of the relative appreciation in the value of the easement. The ability to benefit from the relative appreciation in the value of an easement may create a perverse incentive on the part of property owners to seek extinguishments. Not subtracting the value of improvements from post-extinguishment proceeds before calculating the donee's percentage share may serve to temper that perverse incentive.

Another example is in order. Assume the same easement donation as described above (in which the easement represented 30% of the value of the property as a whole at the time of its donation), but years have passed since the donation, the surrounding area has become urbanized, development pressures have increased, and the fair market value of the property subject to the easement is now \$2 million, the fair market value of the property if the easement were extinguished would be \$5 million, and thus, the value of the easement is now \$3 million, meaning the easement now represents 60% of the value of the property as a whole. Assume also that no improvements were constructed on the property post-donation, and there has been no appreciation in the value of the improvements that existed on the property at the time of the easement's donation. A speculator purchases the property, subject to the easement, in an arm's length transaction for \$2 million and soon thereafter is successful in having the easement extinguished in a judicial proceeding. The speculator then sells the newly unencumbered property for \$5 million.

If the donee and the speculator were to receive post-extinguishment proceeds equal to the value of easement at the time of the extinguishment and the value of the property subject to the easement at that time, respectively, the donee would receive \$3 million and the speculator would receive \$2 million. Under the easement deed, however, the donee would be entitled to only 30% of the \$5 million proceeds, or \$1.5 million, and the speculator would be entitled to the remaining \$3.5 million, even though the speculator purchased the property subject to the easement for only \$2 million. The speculator would benefit from the difference between the percentage that the easement represented of the value of the property as a whole at the time of its extinguishment (60%) and the percentage that the easement represented of the value of the property as a whole at the time of its donation (30%). In other words, the speculator would be entitled to the \$1.5 million of proceeds attributable to the relative appreciation in the value of the easement (30% of \$5 million).

The speculator's ability to benefit from the relative appreciation in the value of the easement could persist, at least in part, even if the donee is entitled to a percentage of the post-extinguishment proceeds attributable to the value of

improvements. To illustrate, assume the same facts as in the preceding example, except that a residence was constructed on the property post-donation, the speculator purchased the property with the residence for \$3 million, and the property is sold following extinguishment of the easement for \$6 million (this assumes the residence increased the value of the property by \$1 million). Under the easement deed, the donee would be entitled to 30% of the \$6 million of post-extinguishment proceeds, or \$1.8 million, and the speculator would be entitled to the remaining \$4.2 million of proceeds. Even though the value attributable to the residence was not subtracted from the post-extinguishment proceeds before calculating the donee's share, the speculator would receive \$1.2 million more than her \$3 million investment in the property and thus would still benefit financially from the extinguishment.

As the Table below illustrates, on the facts of the example, the speculator would receive more proceeds following extinguishment than she invested in the property (that is, the speculator would profit from the extinguishment) provided that the value attributable to the residence was less than \$5 million. Only if the value of the residence exceeded \$5 million would the speculator receive less than her investment upon extinguishment. In addition, the last column in the Table illustrates that, if the value attributable to improvements were subtracted from the post-extinguishment proceeds before calculating the donee's share, the donee would never receive more than \$1.5 million (30% of \$5 million⁸⁴), and the property owner would always benefit from the full \$1.5 million of post-donation relative appreciation in the value of the easement.

⁸⁴ \$5 million is the value of the land unencumbered by the easement at the time of the extinguishment if the increase in the land's value due to the residence is not taken into account.

Donation Values (No Residence)		M = Million		
Before-easement value of the land: \$ 1,000,000		D = Donee		
<u>After-easement value of the land: \$ 700,000</u>		S = Speculator		
Easement value: \$ 300,000 (30%)				
Extinguishment Values (No Residence)				
Value of land unencumbered by easement: \$ 5,000,000				
<u>Value of land encumbered by easement: \$ 2,000,000</u>				
Easement value: \$ 3,000,000 (60%)				
Increase attributable to Residence ⁸⁵	S's Investment	Post-extinguishment proceeds ⁸⁶	Entitlements under easement deed (no subtraction of improvements)	If improvements were subtracted
None	\$2M ⁸⁷	\$5M	D: \$1.5M (30% x \$5M) S: \$3.5M (\$1.5M profit)	D: \$1.5M S: \$3.5M (\$1.5M profit)
\$1M	\$3M ⁸⁸	\$6M	D: \$1.8M (30% x \$6M) S: \$4.2M (\$1.2M profit)	D: \$1.5M S: \$4.5M (\$1.5M profit)
\$2M	\$4M	\$7M	D: \$2.1M (30% x \$7M) S: \$4.9M (\$.9M profit)	D: \$1.5M S: \$5.5M (\$1.5M profit)
\$3M	\$5M	\$8M	D: \$2.4M (30% x \$8M) S: \$5.6M (\$.6M profit)	D: \$1.5M S: \$6.5M (\$1.5M profit)
\$4M	\$6M	\$9M	D: \$2.7M (30% x \$9M) S: \$6.3M (\$.3M profit)	D: \$1.5M S: \$7.5M (\$1.5M profit)
\$5M	\$7M	\$10M	D: \$3M (30% x \$10M) S: \$7M (break even)	D: \$1.5M S: \$8.5M (\$1.5M profit)
\$6M	\$8M	\$11M	D: \$3.3M (30% x \$11M) S: \$7.7M (\$.3M loss)	D: \$1.5M S: \$9.5M (\$1.5M profit)

⁸⁵ The values in this column represent the increase in the value of the land due to the residence at the time of the easement's extinguishment. It is assumed, for example, that if the residence increased the value of the land encumbered by the easement by \$1M at the time of the extinguishment, the residence similarly increased the value of the land unencumbered by the easement by \$1M at that time.

⁸⁶ The values in this column represent the value at extinguishment of the land unencumbered by the easement (\$5M) plus the increase in that value attributable to the residence.

⁸⁷ This is the amount the investor paid for the land encumbered by the easement in an arm's length transaction.

⁸⁸ This, and the remaining values in this column, represent the amount paid by the investor for the land encumbered by the easement (\$2M), as increased by the value attributable to the residence.

The foregoing examples illustrate that, depending on the facts, not subtracting the value attributable to improvements from post-extinguishment proceeds before calculating the donee's percentage share may not, in fact, be unfair to donors or subsequent property owners—they may still receive more on extinguishment than their investment in the property. Not subtracting the value of improvements also enables the donee to recoup some or all of the proceeds attributable to the relative appreciation in the value of the easement and, thus, provides the donee with more proceeds to be used to advance similar conservation purposes elsewhere.⁸⁹ Moreover, not subtracting the value of improvements and thereby reducing the profit to be made from an extinguishment can tamp down the perverse incentive on the part of property owners to seek extinguishment of easements.

Of course, relative appreciation in the value of a conservation easement is only one of the variables that may impact the amount of post-extinguishment proceeds to which the donee and property owner may be entitled at the time of extinguishment. A conservation easement may also depreciate in value relative to the value of the property as a whole following its donation. The value attributable to improvements will also vary from property to property and with regard to the same property over the perpetual life of an easement. Over the perpetual life of an easement, improvements may be constructed and torn down, they may undergo physical, functional, and external obsolescence, and they may require costly demolition and removal. Moreover, it is impossible to predict, at the time of an easement's donation, whether an "unexpected and extraordinary" change in conditions will cause the easement to be extinguished in whole or part, or when that might happen, or the status of the foregoing variables at that uncertain future time.⁹⁰

The goal of this subpart is not to argue that the proceeds regulation would never operate to provide the owner of easement-encumbered property with less than its financial investment in a property at the time of extinguishment. Rather, it is to illustrate that claims that the proceeds regulation is irrational and unfair do not take into account all of the unpredictable variables that may impact the amount of proceeds to which the parties will be entitled, and do not acknowledge that, depending on the facts, the regulation can financially benefit property owners. This subpart also illustrates that the proceeds regulation can protect the public interest when there has been relative appreciation in the value of an easement by both reducing the incentive of property owners to seek extinguishments and allowing donees to recoup some of the proceeds attributable to that relative appreciation to be used to advance similar conservation purposes elsewhere.

⁸⁹ If a conservation easement appreciates in value relative the value of the property it encumbers, the cost of pursuing similar conservation opportunities, whether through the purchase of similar property or a similar easement, could be expected to similarly increase.

⁹⁰ See *supra* note 52 and accompanying text.

b. Avoidance of Valuation Difficulties

Allowing the value attributable to improvements to be subtracted from post-extinguishment proceeds before calculating the donee's percentage share would give rise to a number of difficult valuation issues. For example, should the definition of "improvements" be limited to permanent structures, such as residences, guest houses, and barns? Or should the term be more broadly defined to include, for example, temporary structures, ponds, trails, access roads, driveways, utility lines (including water, septic, and power lines), irrigation systems, fencing, grading, and landscaping?⁹¹ Should post-extinguishment proceeds be reduced by only the value attributable to improvements that a property owner constructed on the property post-donation, or also by post-donation appreciation in the value of improvements that existed on the property at the time of the donation, or both?⁹² Should improvements or appreciation in the value thereof be valued as of the date of the extinguishment or the date on which the unencumbered property is subsequently sold or exchanged?⁹³ Should the value attributable to improvements be determined by an appraisal and, if so, should the appraisal be a "qualified appraisal" or meet other requirements?⁹⁴ Who would police satisfaction of any such requirements? Who should choose the appraiser, define the scope of the assignment, and pay for the appraisal? What valuation methods should be employed?⁹⁵ And what should be done if the property owner and donee did not agree on the values?⁹⁶

⁹¹ See THE DICTIONARY OF REAL ESTATE APPRAISAL (4TH ED., 2002, APPRAISAL INSTITUTE) (Improvements may consist of buildings or other relatively permanent structures (such as residences and agricultural structures), as well as other additions that make a property usable, such as access roads, driveways, utility lines, irrigation systems, fences, and ponds).

⁹² Determining post-donation appreciation in the value of improvements that existed on the property at the time of the donation could be particularly difficult if those improvements were not valued separately in the qualified appraisal that was obtained at the time of the easement's donation. A retrospective appraisal of the value that improvements added to a property years in the past could require an appraiser to attempt to determine values without readily available or reliable data.

⁹³ Some time may pass following an extinguishment before the underlying property or portions thereof are sold and post-extinguishment proceeds distributed.

⁹⁴ See *supra* notes 35-37, referencing the qualified appraisal and conservation-easement specific valuation rules.

⁹⁵ A number of valuation methods might be employed to determine the value of an improvement, such as the property owner's cost in constructing the improvement, the estimated cost to replace the improvement, the estimated cost to reproduce the improvement, or the extent to which the improvement increases the value of the property. These different valuation methods may produce different value estimates.

⁹⁶ The fact that the proceeds regulation does not address any of these issues provides compelling support for the Fifth Circuit's finding that the proceeds regulation was not intended to permit subtraction of the value attributable to improvements from post-extinguishment proceeds.

The difficulties associated with addressing the foregoing issues would be compounded by the fact that property owners and donees would have starkly opposing interests regarding the value attributable to improvements. In addition, donees, which serve as guardians of the public investment in deductible easements, would often be at a disadvantage in arguing their position. Many nonprofit and government donees have limited capacity and resources, and they also have a desire to maintain good relations with property owners and avoid negative publicity in the communities in which they work. Those factors could make it difficult for donees to successfully challenge property owners' overestimates of the value of improvements. As a practical matter, subtracting the value of improvements from post-extinguishment proceeds before calculating the donee's percentage share would likely enrich property owners at the public's expense and leave donees with fewer proceeds with which to advance similar conservation purposes elsewhere.

The proceeds regulation avoids all of the foregoing issues. Under the proceeds regulation, the donee must be entitled to at least a minimum percentage of any post-extinguishment proceeds, and that minimum percentage is generally determined based on the values set forth in the qualified appraisal the donor obtained at the time of the easement's donation. That qualified appraisal must comply with numerous requirements and is subject to indirect policing by the IRS and the courts at the time of the easement's donation as part of the tax return review and audit process.⁹⁷ In addition, if there is a final settlement with the IRS or final determination made by a court with regard to the percentage value of the easement at the time of its donation, that percentage should control for purposes of the proceeds regulation.

B. Easement Value at Extinguishment

One possible alternative to the formula in the proceeds regulation would be to require that the donee of a deductible conservation easement be entitled to an amount of post-extinguishment proceeds equal to the dollar value of the easement at the time of its extinguishment.⁹⁸ This alternative would appear to ensure that the donee would receive the benefit of any post-donation relative appreciation in the value of the easement, and that the property owner would receive only the dollar value of the property subject to the easement at the time of the extinguishment. There would, however, be significant drawbacks to this alternative.

⁹⁷ See *supra* notes 35-37 and accompanying text.

⁹⁸ This alternative could be structured to entitle the donee to a percentage (rather than a dollar amount) of post-extinguishment proceeds, with the percentage based on the value of the easement at the time of its extinguishment relative to the value of the property as a whole at that time, but such a rule would suffer from the same drawbacks discussed in this subpart.

Because of the persistent problem of overvaluation of conservation easements in the § 170(h) deduction context, which has been exacerbated by the rise in the number of abusive syndicated easement donation transactions,⁹⁹ this alternative could lead to systematic underpayment of post-extinguishment proceeds to donees relative to the public investment in the easements. In addition, because easements might not be accurately valued at the time of their extinguishment, this alternative would not guarantee that a donee would receive the benefit of any post-donation relative appreciation in the value of an easement, or that the property owner would receive only the dollar value of the property subject to the easement at the time of the extinguishment. As with valuing improvements at extinguishment, revaluing easements at extinguishment would give rise to a number of difficult valuation issues.

1. Possibility of Systematic Underpayment of Donees

If a conservation easement is overvalued at the time of its donation, and then accurately valued or undervalued at the time of its extinguishment, much of the public investment in the easement through the deduction program could be lost under this alternative. To illustrate, assume the following. A landowner donated a conservation easement and claimed a deduction of \$8 million, based on an abusive

⁹⁹ On overvaluation in the nonsyndicated easement donation context, see, e.g., *PBBM-Rose Hill, Ltd. v. Commissioner*, 900 F.3d 193, 209-213 (5th Cir. 2018) (golf course conservation easement had a value of \$100,000, not the \$15.16 million the taxpayer had claimed); *Johnson v. Commissioner*, T.C. Memo. 2020-79 (ranchland conservation easement had a value of \$372,919, not the \$610,000 the taxpayer had claimed); Nancy A. McLaughlin, *Conservation Easements and the Valuation Conundrum*, 19 FLA. TAX. REV. 227, 249, 266 (2016) (discussing the persistent problem of overvaluation of conservation easements). On overvaluation in the syndicated easement donation transaction context, see, e.g., *Senate Finance Committee Bipartisan Investigative Report*, *supra* note 10, at 105 (“The [syndicated easement donation] transactions discussed in this report involve land valuations that appear so inflated above their original purchase prices that they cannot reasonably be characterized as anything other than abusive tax shelters”). Professor Daniel Halperin, former Deputy Assistant Secretary of the Treasury, explains why conservation easements are “often hard to appraise and easy to overvalue”:

The IRS regulations provide that, in the absence of comparable sales [of conservation easements], a donor must generally look to the difference between the value of the property before the restriction and the value of the property subject to the easement. This is extremely difficult to determine because it is heavily fact specific. For example, it would be necessary to determine what the zoning regulations are, whether they are likely to change, and what sort of development was commercially feasible prior to the restrictions, as well as other issues. That there is no standard form of easement exacerbates these difficulties, as does the IRS’s lack of the resources required to wade through long documents—drafted by hundreds of different attorneys—in order to determine exactly what restrictions are in place....

See Halperin, *supra* note 13, 40-41.

appraisal that indicated that the value of the property before the donation was \$10 million, the value of the property after the donation was \$2 million, and, thus, accordingly to the appraisal, the easement represented 80% of the value of the property as a whole at the time of its donation. Because of the IRS's limited resources, the claimed \$8 million deduction was not challenged and the donor received tax savings from the deduction of \$2.8 million.¹⁰⁰ A number of years later, after the statute of limitations had run on the donor's deduction, and without any change in the actual value of the property or the easement, the easement is extinguished in a judicial proceeding, the unencumbered property is sold in an arm's-length transaction for just \$3 million (its fair market value¹⁰¹), and a nonabusive appraisal indicates the easement has a value of only \$750,000 and, thus, represents only 25% of the value of the property as a whole.

If the donee were entitled to post-extinguishment proceeds equal to the dollar value of the easement at the time of its extinguishment, the donee would receive only \$750,000, even though the donor had claimed that the easement had a value of \$8 million at the time of its donation and the public invested \$2.8 million in the easement through the deduction. This example illustrates that requiring that a donee be entitled to the dollar value of a deductible easement at the time of its extinguishment could lead to underpayment of post-extinguishment proceeds to donees relative to the public investment made in the easements. Given the persistent problem of overvaluation in the § 170(h) deduction context and the limited ability of the IRS to police valuation in our voluntary compliance tax system, this alternative could result in systematic underpayment of post-extinguishment proceeds to donees.¹⁰²

In contrast, under the proceeds regulation, the donee in the example would be entitled to at least 80% of the \$3 million of post-extinguishment proceeds, or \$2.4 million. By requiring that the donee must always receive "at least" the donation (or floor) percentage of post-extinguishment proceeds, the proceeds

¹⁰⁰ This assumes, for simplicity purposes, that \$2.8 million is the amount of income tax the donor otherwise would have paid at an assumed flat rate of 35% absent the \$8 million deduction. This calculation ignores possible limitations, deductions, and other complexities not relevant here. Actual tax savings in individual cases would depend on a variety of factors.

¹⁰¹ In the charitable contribution context, "fair market value" is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. Treas. Reg. § 1.170A-1(c)(2).

¹⁰² See, e.g., *Halperin, supra* note 13, at 40, 44 (the IRS "obviously can audit only a small sample of all transactions"); *Trends in the Internal Revenue Service's Funding and Enforcement*, Congress of the United States, Congressional Budget Office (July 2020), <https://www.cbo.gov/system/files/2020-07/56422-CBO-IRS-enforcement.pdf> (IRS enforcement activities declined over the 2010-2018 period as IRS resources were reduced).

regulation helps to protect the public's investment in deductible easements that were overvalued at the time of their donation and resulted in inflated deductions.

2. Valuation Difficulties

If the donee of a deductible conservation easement were entitled to post-extinguishment proceeds equal to the dollar value of the easement at the time of its extinguishment (or partial extinguishment, such as through condemnation of a strip of property adjacent to a road), a number of valuation difficulties would arise. First, the easement (or the part that is extinguished) would have to be valued as of the date of the extinguishment. That valuation would give rise to many of the same issues that would arise if improvements had to be valued as of the date of an extinguishment; questions would arise regarding how the value would be determined, the property owner and donee would have starkly opposing interests, and it would be similarly difficult for the donee to successfully challenge the property owner's valuation of the easement.¹⁰³

Moreover, additional difficulties would arise. A sale, exchange, or involuntary conversion of the subject property may not occur for some years following extinguishment of an easement, and the value of the easement on the date of its extinguishment may not be determined until that later date, necessitating a retrospective appraisal. Retrospective appraisals performed many years after the effective valuation date can be particularly challenging because the appraiser may be forced to try to ascertain market conditions and trends without readily available or reliable data.

Partial extinguishments could be dealt with in different ways. For example, the dollar value of the portion of the easement that is extinguished could be determined for purposes of providing the donee its share of post-extinguishment proceeds. Alternatively, the value of the entire easement relative to the value of the property as a whole at the time of the extinguishment could be determined and the donee could be entitled to that percentage of the post-extinguishment proceeds. Furthermore, portions of the subject property might be sold or exchanged at different times following extinguishment of an easement, and that would raise additional questions. The donee could be paid first from each allotment of post-extinguishment proceeds until it received the full dollar value of the easement at its extinguishment (\$750,000 from the example immediately above). Alternatively, the donee could be paid only a percentage of each allotment of post-extinguishment proceeds until fully paid, with the percentage equal to the value of the easement at its extinguishment relative to the value of the property as a whole at that time (25% from the example immediately above).

¹⁰³ See *supra* Part III.A.2(b).

The proceeds regulation avoids the foregoing issues. There is no need under the proceeds regulation to value an easement or part thereof as of the date of the extinguishment, or to resolve the other issues outlined above. Rather, implementation is simple—the donee is entitled to the minimum percentage of each allotment of post-extinguishment proceeds.

C. The “Greater Of” Formula

Another possible alternative to the proceeds regulation formula would be to require that the donee of a deductible conservation easement, following extinguishment, be entitled to the greater of (1) the minimum percentage of any post-extinguishment proceeds or (2) the dollar value of the easement at the time of its extinguishment. This greater-of formula would comply with the proceeds regulation because it would ensure that the donee would always receive “at least” the minimum percentage of any post-extinguishment proceeds.¹⁰⁴

As with the proceeds regulation, this alternative would help to protect the public investment in easements that were overvalued at the time of their donation by providing that the donee would always be entitled to at least the minimum percentage of any post-extinguishment proceeds.¹⁰⁵ This alternative would also appear to ensure that the donee would receive the benefit of any post-donation relative appreciation in the value of the easement.¹⁰⁶ However, there are significant drawbacks to this alternative.

¹⁰⁴ See *supra* note 66 and accompanying text.

¹⁰⁵ To illustrate, consider again the example in which the landowner donated a conservation easement, claimed a deduction of \$8 million based on an abusive appraisal that indicated that the easement represented 80% of the value of the property as a whole at the time of its donation, and received tax savings from the deduction of \$2.8 million. See *supra* Part III.B.1. A number of years later, and without any change in the actual value of the property or the easement, the easement is extinguished, the unencumbered property is sold for \$3 million, and a nonabusive appraisal indicates the easement has a value of only \$750,000 and, thus, represents only 25% of the value of the property as a whole. *Id.* Under the greater of alternative, the donee would be entitled to \$2.4 million, which is the greater of (1) the minimum percentage (80%) of the \$3 million of post-extinguishment proceeds, or \$2.4 million, or (2) the dollar value of the easement at the time of its extinguishment (\$750,000).

¹⁰⁶ To illustrate, consider again the example in which the landowner donated a conservation easement that represented 30% of the value of the property as a whole at the time of its donation, and years later when the easement is extinguished it has a value of \$3 million and represents 60% of the value of the property as a whole. See *supra* Part III.A.2(a). The property is sold following extinguishment for \$5 million. *Id.* Under this alternative, the donee would be entitled to \$3 million, which is the greater of (1) the minimum percentage (30%) of the \$5 million of post-extinguishment proceeds, or \$1.5 million, or (2) the \$3 million dollar value of the easement at the time of its extinguishment. This example assumes that the easement is correctly valued at the time of its extinguishment.

Donees would not necessarily receive the benefit of any post-donation relative appreciation in the value of easements under this alternative because the easements might not be accurately valued as of the date of their extinguishment. All of the difficulties associated with valuing easements as of the date of their extinguishment and the apportionment of proceeds would be present.¹⁰⁷ In addition, if the greater of formula permitted the value attributable to improvements to be subtracted from post-extinguishment proceeds before calculating the donee's minimum percentage share, all of the difficulties associated with valuing improvements as of the date of an extinguishment would also be present.¹⁰⁸ Moreover, the likelihood that the various valuation issues would be resolved in a manner that enriches property owners at the public's expense would be high. The proceeds regulation, with its simple and easy-to-implement formula, avoids all of those issues.

D. Carve-Outs and Flexibility

A prospective conservation easement donor may prevent the donee from receiving post-extinguishment proceeds attributable to improvements by excluding or "carving out" from the easement the portions of the property on which improvements are or in the future may be located (the improvement areas).¹⁰⁹ There are potential drawbacks to such carve-outs. From a conservation perspective, the donee would not be able to limit intensive uses in the excluded areas, and in some cases those intensive uses could negatively impact the conservation interests on the property encumbered by the easement. For example, a busy gas station on an excluded area could have significant negative effects on the conservation interests on the adjacent property. In addition, from a deduction perspective, excluding the improvement areas from an easement could reduce the donor's deduction because less acreage would be encumbered by the easement and the Treasury Regulations require that an easement donor's deduction be reduced to the extent that the donation increases the value of other property owned by the donor or a related person.¹¹⁰ The donation of a conservation easement might increase the value of the excluded improvement areas because prospective purchasers are often willing to

¹⁰⁷ See *supra* Part III.B.2.

¹⁰⁸ See *supra* Part III.A.2(b).

¹⁰⁹ A donee must be entitled to a share of the proceeds from a subsequent sale, exchange, or involuntary conversion of the property that is subject to the easement. See Treas. Reg. § 1.170A-14(g)(6)(i). By excluding improvement areas from an easement, the donor ensures that the property that is subject to the easement will not include improvements.

¹¹⁰ See Treas. Reg. § 1.170A-14(h)(3)(i). "Related person" is defined to include various familial, entity, and trust relationships. See I.R.C. §§ 267(b), 707(b). For a discussion of these rules, see McLaughlin, *supra* note 67, at 245-246.

pay more for property that is adjacent to or otherwise benefits from permanently protected undeveloped land.

The drawbacks to carve-outs could be addressed, at least in part, by having the donor convey two easements: one nondeductible easement that restricts uses in the excluded areas and a second deductible conservation easement encumbering the remaining property. Alternatively, restrictions in the conservation easement limiting access to the excluded areas may be sufficient to limit uses in those areas.

Some easement donors may consider the advantage associated with carve-outs—preventing the donee from receiving post-extinguishment proceeds attributable to improvements—to be worth the added cost and complexity. Others may be comfortable proceeding with the donation of an easement that encumbers areas in which improvements are or may be located given the improbability of an extinguishment, particularly during the donor’s limited ownership period, and the ability of the donor or subsequent property owner to benefit from any post-donation relative appreciation in the value of the easement in the event of an extinguishment.

A donee working with a donor who wishes to exclude improvement areas from a conservation easement could insist on the two-easement option to protect the conservation interests on the property that will be encumbered by the easement. The donee also could insist that the easement be drafted to include the “greater of” formula discussed in Part III.C. to ensure that the donee would receive the full benefit of any post-donation relative appreciation in the value of easement, given that the donee would not be entitled to any proceeds attributable to improvements. The donee could further negotiate to include provisions in the easement addressing the various valuation issues that would arise.¹¹¹ The proceeds regulation, with its “at least” formulation, permits this flexibility and encourages donees to consider the consequences of carve-outs and how best to protect the public interest and investment in easements.

IV. ADDITIONAL CONSIDERATIONS

A. Congress’s Power to Condition Deductions

It is well-settled that Congress has the power to condition eligibility for a federal deduction upon satisfaction of requirements Congress sees fit to impose—including, in the case of a conservation easement donation, that the conservation

¹¹¹ For example, the easement could authorize the donee to obtain the appraisal of the easement at the time of extinguishment, mandate that each party pay half of the cost of the appraisal from that party’s share of proceeds, and allow the donee to forego obtaining the appraisal if the donee deems that the anticipated benefit would not justify the cost (that is, if property values in the area indicate that there has not been any relative appreciation in the value of the easement).

purpose of the contribution must be protected in perpetuity.¹¹² Congress also has the power to delegate to the Treasury the task of promulgating regulations interpreting federal tax code requirements.¹¹³ A prospective conservation easement donor who seeks to benefit from the § 170(h) deduction must meet the terms on which the offer was held out.¹¹⁴ That is, the donor must draft the easement to comply with the requirements of § 170(h) and, assuming they are procedurally and substantively valid, the Treasury Regulations interpreting those requirements.

Whether a Treasury Regulation is valid is a separate issue from whether Congress has the power to condition eligibility for a federal deduction. Congress unquestionably has that power, even if qualifying for the deduction requires a taxpayer to structure a charitable gift in a particular way.¹¹⁵ For example, in *Gillespie v. Commissioner*, the Tax Court sustained the IRS's disallowance of an estate tax charitable deduction claimed with regard to the donation to a charity of a remainder interest in a split-interest trust.¹¹⁶ The deduction was denied because the trust did not meet the requirements of IRC § 2055(e)(2).¹¹⁷ Section 2055(e)(2) authorizes a deduction for the donation to a charity of a remainder interest in a split-interest trust only if the donation is made in the form of a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund, each of

¹¹² I.R.C. § 170(h)(5)(A). *See, e.g.,* *Feinberg v. Commissioner*, 916 F.3d 1330, 1333 (10th Cir. 2019) (“deductions ‘are matters of legislative grace specifically authorized by statute, and Congress has unquestioned power to condition, limit, or deny deductions’”); *Wisely v. United States*, 893 F.2d 660, 666 (4th Cir. 1990) (“Deductions are a matter of legislative grace, and the taxpayer seeking the benefit of a deduction must show that every condition which Congress has seen fit to impose has been fully satisfied”); *J.E. Riley Inv. Co. v. Commissioner*, 110 F.2d 655, 658 (9th Cir. 1940) (“Congress may condition deductions from gross income in any manner it sees fit”); *Barbour Coal Co. v. Commissioner*, 74 F.2d 163 (10th Cir. 1934) (“Congress has power to grant, restrict, or deny deductions”); *Helvering v. Independent Life Ins. Co.*, 292 U.S. 371 (1934) (“Unquestionably Congress has power to condition, limit, or deny deductions from gross income in order to arrive at the net that it chooses to tax”).

¹¹³ *See, e.g.,* *Mitchell v. Commissioner*, 775 F.3d 1243, 1247 (10th Cir. 2015) (“Congress ... tasked the Commissioner with promulgating rules to ensure that a conservation purpose [will] be protected in perpetuity.... Acting pursuant to this authority, the Commissioner promulgated [Treasury Regulation § 1.170A-14(g)(1)-(6)]” (citations omitted)).

¹¹⁴ *See, e.g.,* *Wisely*, 893 F.2d at 666 (“The taxpayer may not haggle with Congress; he either fits squarely within the statute in every particular or the deduction is unavailable”); *J.E. Riley Inv. Co.*, 110 F.2d at 655 (“The taking of the deduction was a privilege granted the taxpayer; and in order to avail himself of it he must meet the terms on which the offer was held out”); *Barbour Coal Co.*, 74 F.2d at 163 (“the right to an asserted deduction must come within an applicable provision of the statute, else it does not exist”).

¹¹⁵ *See supra* note 112 and accompanying text.

¹¹⁶ A split-interest trust is a trust that has both charitable and noncharitable beneficiaries. *See, e.g.,* Wendy C. Gerzog, *The Times They Are Not A-Changin’: Reforming the Charitable Split-Interest Rules (Again)*, 85 CHI.-KENT L. REV. 849, 862-863 (2010), <https://scholarship.kentlaw.iit.edu/cklawreview/vol85/iss3/2/>.

¹¹⁷ *Gillespie v. Commissioner*, 75 T.C. 374 (1980).

which must meet specific requirements set forth in the IRC. As with § 170(h), Congress imposed the conditions in § 2055(e)(2) to protect against potential abuse.¹¹⁸

In *Gillespie*, the estate that claimed the deduction argued that § 2055(e)(2) abrogated a decedent's right under state law to provide for the needs of an income beneficiary and then pass any property remaining upon the beneficiary's death to a charity.¹¹⁹ The Tax Court rejected that argument, explaining that § 2055(e)(2) did not have that effect.¹²⁰ The court acknowledged that the creation and validity of testamentary trusts is governed by State law, not the IRC.¹²¹ However, the court explained that whether a particular transfer qualifies for a federal deduction is a matter of federal concern, and § 2055(e)(2) merely prescribes the requirements that must be met if a decedent wishes to obtain the benefit of a federal deduction for the donation of a remainder interest to charity.¹²² In other words, the decedent was free to structure the trust in any manner permissible under state law, but for his estate to be eligible for a federal deduction, the trust had to meet the requirements Congress saw fit to impose in § 2055(e)(2).

The same is true for a conservation easement donation. The donor is free to draft the conservation easement in any manner permissible under applicable state law. However, to be eligible for a federal charitable deduction, the easement must meet the conditions Congress saw fit to impose in § 170(h), as interpreted by the Treasury in regulations. One of those conditions requires the donor to agree in the easement deed that the donee will be entitled to at least a minimum percentage of the total amount of any post-extinguishment proceeds.

Mandating that the donee be entitled to at least a minimum percentage of any post-extinguishment proceeds, including any proceeds attributable to improvements, does not infringe upon the donor's property rights under state law. To be eligible for the § 170(h) deduction, part of the charitable gift that must be made is the transfer to the donee of a right to a minimum percentage of the total amount of any post-extinguishment proceeds. Moreover, a conservation easement

¹¹⁸ See *id.* at 377, 379 (“Congress found that charitable deductions were being allowed for transfers which resulted in little or no benefit to charity”). Remainder interests in trusts, like conservation easements, are partial interests in property and their donation similarly raises the possibility of abuse.

¹¹⁹ *Id.* at 378.

¹²⁰ *Id.*

¹²¹ *Id.* at 378-379.

¹²² *Id.* at 379. See also, e.g., *Carpenter v. Commissioner*, T.C. Memo. 2012-1, at *5 (“State law determines the nature of the property rights, and Federal law determines the appropriate tax treatment of those rights”); *Patel v. Comm’r*, 138 T.C. 395, 404 (2012) (“State law determines only which sticks are in a person’s bundle. . . . Once property rights are determined under State law, as announced by the highest court of the State, the tax consequences are decided under Federal law” (citations omitted)).

donation is a voluntary act. A prospective easement donor who does not wish to comply with the proceeds regulation need not make the donation or need not claim a federal deduction for the donation. Alternatively, a prospective donor may negotiate with the donee to exclude from the easement's coverage the areas in which improvements are or may be constructed, in which case the donee may insist on drafting the easement to entitle it to benefit from any post-donation relative appreciation in the value of the easement.¹²³

The proceeds regulation also does not infringe upon a subsequent owner's property rights under state law. The purchase of property subject to a conservation easement is also a voluntary act, and a prospective purchaser of such property will have at least constructive notice of the terms of the easement. A prospective purchaser concerned about the division of post-extinguishment proceeds as provided in the easement deed need not purchase the property. Alternatively, the prospective purchaser could offer to pay a slightly reduced purchase price to address any perceived risk associated with that provision.

B. Condemnation Awards

While private property may not be taken for public use without the payment of just compensation,¹²⁴ owners of interests in property are generally free to enter into enforceable agreements regarding the apportionment of condemnation awards.¹²⁵ Thus, upon the condemnation of property subject to a conservation

¹²³ See *supra* note 111 and accompanying text.

¹²⁴ See Nancy A. McLaughlin, *Condemning Conservation Easements: Protecting the Public Interest and Investment in Conservation*, 41 U.C. DAVIS L. REV. 1897, 1904 (2008) (“The Taking Clause of the Fifth Amendment to the Federal Constitution provides, in part, that private property shall not be taken for public use without just compensation, and the Fourteenth Amendment makes the Fifth Amendment applicable to the states and their political subdivisions.”), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1136963 [hereinafter, *Condemning Conservation Easements*].

¹²⁵ See, e.g., *United States v. 1.377 Acres of Land*, 352 F.3d 1259, 1269 (9th Cir. 2003) (interpreting a lease to determine whether lessee was entitled to share in condemnation award and explaining that “parties are free to contract around the eminent domain rules”); *City of Roeland Park v. Jasan Trust*, 132 P.3d 943, 948 (Kan. 2006) (“[T]he right of the lessee to compensation, as any other right, may be waived or contracted away by the terms of the lease”); *State by Humphrey v. Kouri*, 415 N.W.2d 412, 414 (Minn. Ct. App. 1987) (owner of billboards on condemned land not entitled to eminent domain proceeding to determine their value; lease with landowner treated billboards as personal property, which was not compensable, and “[p]arties may contract away their right to compensation in an eminent domain proceeding”); *State Highway Dep't of Ga. v. Ivey*, 120 S.E.2d 618, 620 (Ga. 1961) (property owner's agreement with highway department precluded a claim for damages to his other property by reason of construction work on the land that had been conveyed to the Highway Department); *Honey Properties, Inc. v. City of Gastonia*, 114 S.E.2d 344 (N.C. 1960) (contract between restaurant owner and city precluded compensation to restaurant owner for sewer lines when territory containing lines was annexed to the city).

easement, the terms of the easement will generally control apportionment of the condemnation award. The donee's entitlement under the easement to at least the mandated minimum percentage of the total condemnation award, including the portion of the award attributable to improvements, would not constitute an unconstitutional taking of private property without just compensation because the donor voluntarily entered into the apportionment agreement by donating a § 170(h)-compliant conservation easement. In addition, any subsequent property owner would also have voluntarily entered into the apportionment agreement by purchasing the property subject to, and with at least constructive notice of, the easement.

Some states have statutes that specifically address the apportionment of a condemnation award upon the taking of property subject to a conservation easement. In a few states, those statutes provide for payment of the full condemnation award to the property owner, meaning the donee would receive nothing.¹²⁶ The proceeds regulation addresses this possibility by providing that the donee need not be entitled to a percentage of the post-extinguishment proceeds from an involuntary conversion "if state law provides that the donor is entitled to the full proceeds from the conversion without regard to the terms of the prior [easement]."¹²⁷ An "involuntary conversion" includes the loss of property through condemnation.¹²⁸

In some states, a statute may provide that, upon the taking of property subject to a conservation easement, the donee shall receive a specified share of the condemnation award and that share might be smaller than the share the donee is required to receive under the proceeds regulation. For example, Virginia's version of the Uniform Conservation Easement Act provides that, in an eminent domain proceeding, "the holder of the conservation easement shall be compensated for the value of the easement."¹²⁹ It is possible that the value of an easement at the time of its condemnation may be a smaller dollar amount than the minimum percentage of the total condemnation award. However, a donor might be able to nonetheless comply with the proceeds regulation in such a state by agreeing in the easement deed to transfer to the holder whatever portion of the donor's share of a condemnation award is necessary to ensure that the holder receives the required minimum percentage of the total condemnation award.

Even if a state eminent domain statute were deemed to preclude compliance with the proceeds regulation, that should not render the proceeds regulation unenforceable or unconstitutional. Rather, it should mean that a conservation

¹²⁶ For a discussion of those statutes, see *Condemning Conservation Easements*, *supra* note 124, at 1961-1964.

¹²⁷ Treas. Reg. § 1.170A-14(g)(6)(ii).

¹²⁸ See *supra* note 65.

¹²⁹ Va. Code Ann. § 10.1-1010(F).

easement governed by the statute would not be eligible for the federal deduction. *Wachter v. Commissioner* is illustrative.¹³⁰ In *Wachter*, the Tax Court held that a North Dakota statute, which limits the duration of any easement created in the state after July 1, 1977, to a maximum of 99 years, prevents conservation easements in the state from being granted in perpetuity.¹³¹ Accordingly, donors of conservation easements in North Dakota cannot qualify for the § 170(h) deduction.¹³²

In *Wachter*, the Tax Court reiterated the fundamental principle that, while state law determines the nature of property rights, it is federal law that determines the federal tax treatment of those rights.¹³³ *Wachter* also confirmed that a state statute can render all conservation easement donations in the state ineligible for the federal deduction. State legislatures are, of course, free to change their laws to allow for the creation of conservation easements that satisfy § 170(h) requirements and, thus, enable their citizens to benefit from the federal deduction.

C. Conservation Easements Encumber Improvements

Taxpayers have argued that the proceeds regulation should not be interpreted to require that the donee receive a percentage of post-extinguishment proceeds attributable to improvements because conservation easements apply only to the land they encumber and not to any improvements thereon.¹³⁴ As a result, taxpayers have argued, the reference in the proceeds regulation to the proceeds from a sale, exchange, or involuntary conversion of “the subject property” refers to the proceeds from the sale, exchange, or involuntary conversion of the underlying land only, and not the improvements thereon.¹³⁵

The Tax Court rejected that argument in *Belair Woods, LLC v. Commissioner* on statutory and regulatory as well as commonsense grounds. The court explained that the use restrictions in a conservation easement deed apply, not only to the subject land, but also to any existing and future improvements on that

¹³⁰ *Wachter v. Commissioner*, 142 T.C. 140 (2014).

¹³¹ *Id.* See N.D. Cent. Code § 47-05-02.1(2) (“Real property easements, servitudes, or any nonappurtenant restrictions on the use of real property, which become binding after July 1, 1977, shall be subject to the requirements of this section. These requirements are deemed a part of any agreement for such interests in real property whether or not printed in a document of agreement.... The duration of the easement, servitude, or nonappurtenant restriction on the use of real property must be specifically set out, and in no case may the duration of any interest in real property regulated by this section exceed ninety-nine years.”).

¹³² The Tax Court noted that “[b]oth parties allege that the State law at issue here is unique because this is the only State that has a law that provides for a maximum duration that may not be overcome by agreement.” *Wachter*, 142 T.C. at 147.

¹³³ *Id.*, citing *United States v. Nat'l Bank of Commerce*, 472 U.S. 713, 722, 105 S.Ct. 2919, 86 L.Ed.2d 565 (1985).

¹³⁴ See *Belair Woods, LLC v. Commissioner*, T.C. Memo. 2020-112.

¹³⁵ See *id.*, at *14.

land.¹³⁶ As examples, the court noted that the easement deed in *Belair* imposed a variety of restrictions on the improvements permitted under the deed, such as specifying the location of residential driveways and utility lines, including water, septic, and power lines.¹³⁷

The Tax Court was clearly correct. Unless the land on which improvements are or will be located is excluded from a deductible conservation easement, the easement deed will impose restrictions on the improvements. A conservation easement deed generally will include an overarching restriction that requires any use of the land—including the maintenance or construction of improvements on the land—to be consistent with the conservation purposes of the donation and not harmful to the specific conservation interests associated with the land.¹³⁸ The deed also generally will impose additional restrictions on individual improvements, as in *Belair*. To provide additional examples, permitted permanent structures, such as single-family residences, guest houses, and agricultural structures, are generally subject to number, location, size, and height restrictions, as well as restrictions on their replacement or expansion; there may be limits or prohibitions on paving access roads or driveways and square footage limitations on other impermeable surfaces; and fencing may be restricted in numerous ways, including its location and type, such as requiring that it be wildlife-friendly.¹³⁹ Restrictions on improvements are integral to a conservation easement; they are key to protecting the specific conservation interests associated with the land and accomplishing the conservation purpose of the easement.

The Tax Court in *Belair* also explained that including the value attributable to improvements in the post-extinguishment proceeds to be shared by the donee is consistent with a commonsense understanding of the language in the proceeds regulation, which refers to the proceeds from the sale, exchange, or involuntary conversion “of the subject property.”¹⁴⁰ The court explained that owners of real estate do not typically sell roads, driveways, ponds, or buried utility lines separately from the real estate on which those improvements are situated.¹⁴¹ If the property is sold, the sales proceeds are necessarily attributable both to the land and any

¹³⁶ *Id.*

¹³⁷ *Id.* at *16.

¹³⁸ See Treas. Reg. § 1.170A-14(g)(1) (the “interest in the property retained by the donor (and the donor’s successors in interest) must be subject to legally enforceable restrictions . . . that will prevent uses of the retained interest inconsistent with the conservation purposes of the donation”); *id.* § 1.170A-14(e)(2)-(3) (the terms of the easement must not permit uses that are destructive of conservation interests, subject to one limited exception).

¹³⁹ See, e.g., *Fencing With Wildlife in Mind*, Colorado Division of Wildlife (Dec. 2009), available at https://wildlifefriendly.org/wp-content/uploads/2015/09/fencingwithwildlifeinmind_coloradodow.pdf.

¹⁴⁰ *Belair Woods, LLC v. Commissioner*, T.C. Memo. 2020-112, at *16, n. 6.

¹⁴¹ *Id.*

attached improvements.¹⁴² The same is true for structures, such as residences, guest houses, barns, and fencing. That is, owners of real estate do not typically sell such structures separately from the real estate on which they are situated.

D. Bright-Line Rule

In a few cases involving conservation easement deeds that provide for subtraction of the value attributable to improvements before calculating the donee's percentage of post-extinguishment proceeds, taxpayers have argued that the subtraction language is "effectively a nullity" or "empty verbiage" because the easements permit only limited future improvements and those improvements would either not increase the value of the subject property or any such increase would be "truly de minimis."¹⁴³ The Tax Court, in Orders, ruled that those assertions are plausible and denied the IRS's motions for summary judgment on the issue.¹⁴⁴ The improvements permitted by the easements involved in these cases include, for example, a trail for use by hikers and bicyclists on 42-acres, small recreational-only structures, fire breaks, drainage ditches, and gravel and other permeable-surfaced roads.¹⁴⁵

There are a number of problems with the approach to the proceeds regulation adopted in these Orders. First, as the Tax Court stated in *Belair Woods, LLC v. Commissioner* in response to the supposed-worthlessness-of-improvements argument, "[i]t is hard to understand why the draftsman would have included this language if [the taxpayer] had believed that its anticipated improvements would not enhance the property's value."¹⁴⁶ In the case of the easements at issue in the Orders, as just one example, "forestry" is permitted and forest roads can be particularly valuable improvements.¹⁴⁷ Second, it is not clear what would constitute a "truly de

¹⁴² *Id.*

¹⁴³ *St. Andrews Plantation, LLC v. Commissioner*, Tax Court Order, Docket No. 20849-17, at 13, 14 (Nov. 16, 2020); *Oconee Landing Property, LLC v. Commissioner*, Tax Court Order, Docket No. 11814-19, at 6 (Aug. 18, 2020).

¹⁴⁴ *St. Andrews Plantation*, Tax Court Order, Docket No. 20849-17, at 14; *Oconee Landing Property*, Tax Court Order, Docket No. 11814-19, at 6.

¹⁴⁵ *St. Andrews Plantation*, Tax Court Order, Docket No. 20849-17, at 6-7; *Oconee Landing Property*, Tax Court Order, Docket No. 11814-19, at 3.

¹⁴⁶ *Belair Woods, LLC v. Commissioner*, T.C. Memo. 2020-112 *17. The court in *Belair* explained: It is true that money spent to improve property does not necessarily produce a dollar-for-dollar increase in the FMV of the property. But it does not follow that a combination of roads, driveways, irrigation systems, water pipes, electric cables, and septic systems would have no effect on the FMV of the conserved area. *Id.* at *18, n.7.

¹⁴⁷ *St. Andrews Plantation*, Tax Court Order, Docket No. 20849-17, at 6; *Oconee Landing Property*, Tax Court Order, Docket No. 11814-19, at 3. See, e.g., Deborah A. Layton, et al., *Cost Estimators for Construction of Forest Roads in Central Appalachians*, USDA, Forest Service Research Paper

minimis” increase in value. Different revenue agents and courts might come to different conclusions on the matter, leading to inconsistent and inequitable enforcement of the proceeds regulation.

Third, as Tax Court explained in *Red Oak Estates, LLC v. Commissioner*:

The U.S. Court of Appeals for the Fifth Circuit explicitly held that the proceeds regulation’s meaning is unambiguous as to improvements: Their value cannot be subtracted.... Here, the deed explicitly allows for improvements to be made to the property and allows any value derived from those improvements to be subtracted from the proceeds of a judicial extinguishment before the donee receives its share.... Whether those improvements will add value to the property at some point “in perpetuity” is an unknowable speculation and not a question of fact for this Court to address.¹⁴⁸

Given the perpetual life of a conservation easement and that an extinguishment might occur 75, 100, or 200 years following a donation, the potential value of future improvements is “unknowable speculation.” Revenue agents and the courts should not be required to speculate as to the value, at some remote and unknowable date in the future, of, for example, roads, trails, firebreaks, or recreational structures, or improvements that might be permitted via amendment.¹⁴⁹

The supposed-worthlessness-of-improvements argument is similar to the argument addressed in *Mitchell v Commissioner*, in which the Tenth Circuit held that failure to obtain a mortgage subordination agreement at the time of an easement’s donation was fatal to the deduction, despite the taxpayer’s argument that the risk of her defaulting on the mortgage (and the easement being extinguished) was so remote as to be negligible given her financial circumstances and credit history.¹⁵⁰ The Tenth Circuit explained: “it is 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

NE-665, 1 (“The construction of forest roads is the most expensive and time-consuming task involved in forest operations”).

¹⁴⁸ *Red Oak Estates, LLC v. Commissioner*, T.C. Memo. 2020-116, at *14-*15. See also *Belair Woods, LLC v. Commissioner*, T.C. Memo. 2020-112 *17, n. 7 (“[the taxpayer] can only speculate about the future value of the specific improvements it has retained the right to make but has not yet made”).

¹⁴⁹ On amendments to conservation easements, see, e.g., *Pine Mountain Preserve, LLLP v. Commissioner*, 978 F.3d 1200 (11th Cir. 2020); Chief Counsel Advisory AM 2020-001 (March 27, 2020); Nancy A. McLaughlin, *Amendment Clauses in Easements: Ensuring Protection in Perpetuity*, 168 TAX NOTES FEDERAL 819 (August 3, 2020). *Pine Mountain Preserve* is controlling in the Eleventh Circuit, which encompasses Alabama, Florida, and Georgia.

¹⁵⁰ *Mitchell v. Commissioner*, 775 F.3d 1243 (10th Cir. 2015).

taxpayer.”¹⁵¹ It was similarly reasonable for the Commissioner to adopt an easily-applied proceeds requirement over a case-by-case, fact-specific and inherently speculative inquiry into the nature and value of possible future improvements. The IRS reviews millions of tax returns each year for audit potential, and bright-line rules, like the mortgage subordination and proceeds requirements, help to make that process manageable. Accordingly, a conservation easement deed that provides for the subtraction of the value attributable to improvements before calculating the donee’s share of post-extinguishment proceeds should not be eligible for a deduction. Taxpayers who are denied deductions on this ground can seek redress from the easement’s draftsman.

E. Enforcement is Critical

In a recent case involving the denial of a § 170(h) deduction for failure to comply with the proceeds regulation, Tax Court Judge Holmes made some statements regarding § 170(h) and the Treasury Regulations that are concerning and warrant comment.¹⁵² He stated that, in recent years, the Commissioner has “attacked” a popular form of charitable contribution—the donation of conservation easements.¹⁵³ He suggested that cases involving challenges to deductions claimed under § 170(h) should be resolved “case-by-case in contests of valuation.”¹⁵⁴ He also stated that the Tax Court majority’s holding that the proceeds regulation is valid “will likely deny any charitable deduction to hundreds or thousands of taxpayers who donated the conservation easements that protect perhaps millions of acres.”¹⁵⁵ Those statements are concerning for a number of reasons.

At two separate points in the past two decades, Congress has called upon the IRS to increase enforcement of the requirements of § 170(h) and the Treasury Regulations. The first call for stepped-up enforcement came after the Washington Post published a series of articles in 2003 and 2004 describing a variety of abuses in the nonsyndicated easement donation context.¹⁵⁶ The second call for stepped-up

¹⁵¹ *Id.* at 9.

¹⁵² See *Oakbrook Land Holdings, LLC v. Commissioner*, T.C. Memo. 2020-54 (*Oakbrook I*); *Oakbrook Land Holdings, LLC v. Commissioner*, 154 T.C. No. 10 (2020) (*Oakbrook II*). In *Oakbrook I*, which was authored by Judge Holmes, the tax court sustained the IRS’s complete disallowance of a \$9,545,000 deduction claimed for a conservation easement donation because the easement did not comply with the proceeds regulation. In *Oakbrook II*, in which Judge Homes dissented, the majority, consisting of twelve judges, held that the proceeds regulation was both procedurally and substantively valid.

¹⁵³ *Oakbrook*, T.C. Memo. 2020-54, at *1.

¹⁵⁴ *Oakbrook*, 154 T.C. at 126.

¹⁵⁵ *Id.* at 82.

¹⁵⁶ For some of the articles describing abuses, see, e.g., Joe Stephens & David B. Ottaway, *Developers Find Payoff in Preservation*, WASH. POST, Dec. 21, 2003, at A1, <https://www.washingtonpost.com/archive/politics/2003/12/21/developers-find-payoff-in->

enforcement was made more recently in response to the increase in abusive syndicated easement donation transactions.¹⁵⁷ Accordingly, IRS enforcement efforts are not an “attack” on conservation easement donations. Rather, they are congressionally-encouraged attempts to curb abuses and ensure public benefit in this partial interest donation context. The attack on conservation easements is more

[preservation/8add5325-7f4a-41ad-88ad-55aa1ca8bdf0/](https://www.washingtonpost.com/archive/politics/2004/12/12/for-owners-of-upscale-homes-loophole-pays/1957fc0f-44ad-45c1-8ac6-0b6fe85dc17d/); 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, <https://www.washingtonpost.com/archive/politics/2004/12/12/for-owners-of-upscale-homes-loophole-pays/1957fc0f-44ad-45c1-8ac6-0b6fe85dc17d/>; Joe Stephens, *Local Laws Already Bar Alterations*, WASH. POST, Dec. 12, 2004, at A15, <https://www.washingtonpost.com/archive/politics/2004/12/12/local-laws-already-bar-alterations/aacd9e52-9757-47eb-92e2-0657bd219d42/>; Joe Stephens, *Tax Break Turns Into Big Business*, WASH. POST, Dec. 13, 2004, at A1, <https://www.washingtonpost.com/archive/politics/2004/12/13/tax-break-turns-into-big-business/1097faeb-e789-4a22-b22c-e74ba9a48844/>. On Congress’s response, see, e.g., Joe Stephens & David B. Ottaway, *IRS Toughens Scrutiny of Land Gifts*, WASH. POST, July 1, 2004, at A1 (the Senate Finance Committee began investigating easement transactions in 2003 and Committee Chairman Charles E. Grassley stated “the investigation’s findings so far demand ... stronger enforcement by the IRS”), <https://www.washingtonpost.com/archive/politics/2004/07/01/irs-toughens-scrutiny-of-land-gifts/04677e57-810f-443d-9ef4-493544136b45/>; Joe Stephens, *Senators Vow to End Tax Break on Easements*, WASH. POST, Dec. 18, 2004, at A3, (Senators Grassley and Baucus “called for the IRS to make audits of easement deductions a priority”), <https://www.washingtonpost.com/wp-dyn/articles/A8794-2004Dec17.html>; Joe Stephens, *IRS Starts Team on Easement Abuses*, WASH. POST, June 9, 2005 (reporting on a Senate Finance Committee hearing on conservation easement abuses), <https://www.washingtonpost.com/archive/politics/2005/06/09/irs-starts-team-on-easement-abuses/bce00d7f-5d12-40be-86c4-9876b58c85a7/>; *Options to Improve Tax Compliance and Reform Tax Expenditures*, prepared by the Joint Committee on Taxation, JCS-2-05, 281 (Jan. 27, 2005) (recommending a variety of reforms to Congress), <https://www.jct.gov/publications/2005/jcs-2-05/>; *Report of Staff Investigation of The Nature Conservancy (Volume I), Executive Summary, U.S. Senate Committee on Finance (June 2005)* (recommending that the IRS take a number of actions to address abuses), <https://www.finance.senate.gov/imo/media/doc/Prt109-27.pdf>.

¹⁵⁷ In a recent bipartisan investigative report, the Chairman and the Ranking Member of the Senate Finance Committee concluded “the IRS has strong reason for taking enforcement action against syndicated conservation-easement transactions as it has to date ... [and] ... Congress, the IRS, and Department of the Treasury should take further action to preserve the integrity of the conservation-easement tax deduction.” *Senate Finance Committee Bipartisan Investigative Report*, *supra* note 10, at 4. See also, e.g., Richard Rubin & Brody Mullins, *Land-Tax Deal Promoters Lobby Congress After IRS Crackdown*, WALL ST. J. (March 28, 2017) (quoting Senator Ron Wyden: “the IRS must continue to work to ensure that this critical program does not fall victim to tax cheats whose only goal is to sell tax shelters to the highest bidder”), <https://www.wsj.com/articles/land-tax-deal-promoters-lobby-congress-after-irs-crackdown-1490717906>; *Finance Committee Releases Report on Syndicated Conservation-Easement Transactions*, U.S. Senate Committee on Finance (Aug. 25, 2020), at <https://bit.ly/3m69N6T> (quoting Senator Ron Wyden: “cracking down on abusive syndicated conservation easements requires ensuring IRS has the resources and legal tools to do its job”).

properly viewed as coming from taxpayers, land trusts, and attorneys who represent them that seek to take advantage of the § 170(h) deduction while avoiding the conditions Congress imposed on the deduction to protect the public interest.

Judge Holmes also appeared to suggest that the role of the IRS and the courts in the § 170(h) context should be limited to ensuring that a deductible easement is conveyed to a qualified organization and to checking value. However, as explained in Part II, that is precisely what Congress chose not to do when it enacted § 170(h). Congress deliberately did not rely on the status of the donee as a qualified organization to ensure that a deductible easement would be a restriction (granted in perpetuity) on the use that may be made of the real property, or that the easement would satisfy the conservation purposes test, or that the conservation purpose of the contribution would be protected in perpetuity. Rather, each of those requirements is separate and distinct and each must be satisfied independently of the qualified organization requirement.

In addition, neither the status of donees as qualified organizations nor the accurate valuation of conservation easements would ensure that easements actually “protect” millions of acres. The level of protection that a conservation easement provides is largely dependent upon whether the easement is drafted to comply with the granted-in-perpetuity, conservation purpose, and protected-in-perpetuity requirements. For example, to comply with those requirements, the easement must not authorize uses that are inconsistent with the conservation purpose of the donation;¹⁵⁸ the easement must not authorize uses that could injure or destroy the property’s specific conservation interests, with one limited exception;¹⁵⁹ the easement, if it is an open space easement, must not permit a degree of intrusion or future development that would interfere with the essential scenic quality of the land or with the governmental conservation policy being furthered by the donation;¹⁶⁰ the easement must prohibit surface mining and any other method of mining that could harm conservation interests;¹⁶¹ the easement must prohibit its transfer except to other eligible donees that agree to continue to carry out the conservation purpose of the contribution;¹⁶² the easement must grant the donee the requisite notice, access, and enforcement rights;¹⁶³ and the easement can be extinguishable only in a judicial proceeding upon a finding by the court of impossibility or impracticality, and the donee must be entitled to at least the specified minimum percentage of any post-extinguishment proceeds and must be required to use those proceeds in a

¹⁵⁸ Treas. Reg. § 1.170A-14(g)(1).

¹⁵⁹ *Id.* § 1.170A-14(e)(2)-(3).

¹⁶⁰ *Id.* § 1.170A-14(d)(4)(v).

¹⁶¹ I.R.C. § 170(h)(5)(B); Treas. Reg. § 1.170A-14(g)(4).

¹⁶² Treas. Reg. § 1.170A-14(c)(1)-(2).

¹⁶³ *Id.* § 1.170A-14(g)(5)(ii).

manner consistent with the conservation purposes of the original contribution.¹⁶⁴ Reducing compliance with § 170(h) to checking the status of the donee as a qualified organization and checking value would strip the section of these and other requirements, each of which was considered essential to the integrity and effectiveness of the deduction program.¹⁶⁵ Moreover, valuation disputes present their own set of challenges.¹⁶⁶

Taxpayers also are not without tools to ensure compliance with § 170(h) requirements. In addition to the plain language of the proceeds regulation, before a donation is made, a taxpayer can obtain a private letter ruling from the IRS that the terms of the conservation easement deed comply with all requirements.¹⁶⁷ In the reported cases to date in which deductions have been denied due to a noncompliant proceeds clause, the claimed deductions ranged from \$1.2 million to \$155.5 million, with an average deduction of approximately \$15.5 million.¹⁶⁸ Ordinary

¹⁶⁴ *Id.* § 1.170A-14(g)(6)(i)-(ii).

¹⁶⁵ A deductible easement must also comply with the mortgage subordination and baseline documentation requirements. *See id.* § 1.170A-14(g)(2) and (5).

¹⁶⁶ *See, e.g., Boltar v. Commissioner*, 136 T.C. 326, 335 (2011) (“The problem is created by [the] willingness [of appraisers] to use their resumes and their skills to advocate the position of the party who employs them without regard to objective and relevant facts, contrary to their professional obligations”); Michael R. Devitt *A Dip in the Hot Tub: Concurrent Evidence Techniques for Expert Witnesses in Tax Court Cases*, 117 J. TAX’N 213 (2012) (“appearance of separately testifying government- and taxpayer-retained expert witnesses only perpetuates the enduring concerns of trustworthiness, partiality, and litigation lethargy while exacerbating the challenge of reaching the right results”). *See also* Lee A. Sheppard, *Clamping Down on Conservation Easement Shelters*, TAX NOTES FEDERAL, 1753, 1761 (“Valuation cases are a crapshoot, because a court could be enchanted by photos of a scenic plot of land”).

¹⁶⁷ A private letter ruling (PLR) is a written statement issued to a taxpayer that interprets and applies tax laws to the taxpayer’s specific set of facts. A PLR may not be relied on as precedent by other taxpayers or IRS personnel. PLRs are generally made public after all information has been removed that could identify the taxpayer to whom it was issued. *See* IRS, *Understanding IRS Guidance – A Brief Primer*, available at <http://www.irs.gov/uac/Understanding-IRS-Guidance-A-Brief-Primer>.

¹⁶⁸ The claimed deduction amounts, largest to smallest, were as follows: *Coal Prop. Holdings, LLC v. Commissioner*, 153 T.C. 126 (2019) (\$155,500,000); *Plateau Holdings, LLC v. Commissioner*, T.C. Memo. 2020-93 (\$25,449,000); *Glade Creek Partners, LLC v. Commissioner*, T.C. Memo. 2020-148 (\$17,504,000); *R.R. Holdings, LLC v. Commissioner*, T.C. Memo. 2020-22 (\$16,000,000); *PBBM-Rose Hill, Ltd. v. Commissioner*, 900 F.3d 193 (5th Cir. 2018) (\$15,160,000); *Oakbrook Land Holdings, LLC v. Commissioner*, T.C. Memo. 2020-54 (\$9,545,000); *Woodland Prop. Holdings, LLC v. Commissioner*, T.C. Memo. 2020-55 (\$8,703,000); *Lumpkin HC, LLC v. Commissioner*, T.C. Memo. 2020-95 (\$8,242,000); *TOT Prop. Holdings, LLC v. Commissioner*, T.C. Bench Op. (Dec. 13, 2019) (\$6,900,000); *Maple Landing, LLC v. Commissioner*, T.C. Memo. 2020-104 (\$6,791,000); *Smith Lake, LLC v. Commissioner*, T.C. Memo. 2020-107 (\$6,524,000); *Vill. at Effingham, LLC v. Commissioner*, T.C. Memo. 2020-102 (\$5,237,000); *Belair Woods, LLC v. Commissioner*, T.C. Memo. 2020-112 (\$4,778,000); *Englewood Place, LLC v. Commissioner*, T.C. Memo. 2020-105 (\$4,773,000); *Cottonwood Place, LLC v. Commissioner*, T.C. Memo. 2020-115 (\$4,592,000); *Red Oak Estates, LLC v. Commissioner*, T.C. Memo. 2020-116 (\$4,343,000); *Riverside Place, LLC v. Commissioner*, T.C. Memo. 2020-103 (\$4,071,000); *Hewitt v.*

prudence suggests that taxpayers planning to claim such sizable deductions should have sought rulings from the IRS approving the conservation easement deeds before the donations were made. Seeking a private letter ruling would seem particularly appropriate in syndicated easement donation transactions, where interests are sold to investors and representations presumably are made regarding compliance with § 170(h) requirements.

V. CONCLUSION

After § 170(h) was enacted in 1980, the Treasury faced a difficult problem—how to ensure, following extinguishment of a deductible perpetual conservation easement, that the conservation purpose of the contribution would be protected in perpetuity. Requiring that the donee receive proceeds equal to the value of the easement at the time of its extinguishment and use those proceeds for similar conservation purposes elsewhere would, at first glance, appear to be the most sensible solution. However, due to the persistent problem of overvaluation of easements at the time of their donation, that rule could lead to systematic underpayment of post-extinguishment proceeds to donees relative to the public investment made in the easements. It also would entail significant future valuation difficulties that would likely be resolved in a manner disadvantageous to donees and, by extension, the public. The proceeds regulation avoids those problems and provides additional benefits.

By providing that the donee must be entitled to a percentage of any post-extinguishment proceeds, rather than the dollar value of an easement at its donation, the proceeds regulation ensures that the donee will benefit from appreciation in the value of the property as a whole following the donation. In addition, an easement may appreciate in value relative to the property as a whole following its donation, and not subtracting the value attributable to improvements before calculating the donee's percentage share of post-extinguishment proceeds can temper the perverse incentive property owners may have to seek extinguishment to benefit from that relative appreciation. Not subtracting the value attributable to improvements also avoids the future difficulties associated with valuing improvements or appreciation in the value thereof.

The proceeds regulation also is not inherently unfair to donors or subsequent property owners. A variety of unpredictable variables can affect the amount of post-extinguishment proceeds and, depending on the facts, the regulation can financially benefit donors and subsequent property owners. Furthermore, a conservation easement donation is a voluntary act, and a prospective easement donor who does not wish to comply with the proceeds regulation or any of the other conditions that

Commissioner, T.C. Memo. 2020-89 (\$2,788,000); *Lumpkin One Five Six, LLC v. Commissioner*, T.C. Memo. 2020-94 (\$2,483,000); *Carroll v. Commissioner*, 146 T.C. 196 (2016) (\$1,200,000).

Congress and the Treasury imposed on the deduction to safeguard the public interest need not make the donation or need not claim the deduction. The purchase of property subject to a deductible conservation easement also is a voluntary act, and a prospective purchaser concerned about the division of post-extinguishment proceeds or other of the easement's terms need not purchase the property, or could offer to pay a reduced purchase price to address any perceived risks or inconveniences.

In sum, the proceeds regulation contains a simple and easy-to-implement rule: whenever a deductible easement is extinguished in whole or in part, the donee must be entitled to at least the specified minimum percentage of any post-extinguishment proceeds and must use those proceeds to advance similar conservation purposes elsewhere. There is no need to grapple with appraisals, opposing interests, or other difficult valuation issues. The rule also is neither irrational nor inherently unfair. Considered in light of the unpredictable variables, the alternatives, the potential incentive on the part of property owners to seek extinguishments, and the goal of protecting the public investment in conservation, the proceeds regulation provides a reasonable solution to the difficult problem of ensuring that the conservation purpose of a contribution will be protected in perpetuity.