Northwestern Journal of Law & Social Policy

Volume 16
Issue 2 *Spring*

Article 1

Spring 4-17-2021

Balancing the Carrot and the Stick: Achieving Social Goals Through Real Property Tax Programs

Ryan F. Bender
rfb251@nyu.edu

Northwestern Journal of Law and Social Policy
Volume 16 (Spring 2021)

Balancing the Carrot and the Stick: Achieving Social Goals Through Real Property Tax Programs

Ryan F. Bender[**]

ABSTRACT

The sharp and growing wealth divide in the United States has elicited significant media and public attention over the past decade, with loud calls for achieving social goals through tax system change. While wealth preservation loopholes in the Internal Revenue Code can contribute to wealth inequalities, tax policies that incentivize socially responsible, tax efficient investment offer an attractive tool for estate planning professionals while also promoting social impact programs. Additionally, while direct government investments into low-income community development, land preservation, and food security are important drivers of change, tax policies that push private capital into these causes are equally important to making a social impact. Through the lens of three widely used estate planning strategies, (i) Qualified Opportunity Zone (QOZ) investments, (ii) conservation easement donations, and (iii) special agricultural appraisals, this Article examines the potential for such strategies to offer wealth-preserving tax breaks while directing private capital toward achieving social goals. There are pitfalls to be considered in the analysis of these programs, including inequality in accessing these tax breaks and potential for taxpayer abuse. Regardless, this Article concludes that well-drafted and properly policed incentive-based programs that offer tax discounts in return for private investments of capital into socially beneficial impact areas can offer an appealing alternative to direct government investment programs.

---

[*] Ryan F. Bender is an Associate in the Tax group of Fried, Frank, Harris, Shriver & Jacobson LLC. He holds a J.D. and LL.M. in Taxation from the New York University School of Law. I owe a debt of gratitude to Bridget J. Crawford, Professor of Law at Pace University School of Law and Adjunct Professor of Law at New York University School of Law, who shepherded my research with invaluable questions and support.
[*] The views and opinions contained in this article are those of the author only and do not reflect the views, opinions, or policies of Fried, Frank, Harris, Shriver & Jacobson LLC, its partners, or its employees.

INTRODUCTION

"With wealth, one is in a position of responsibility. You must try to help others. It is as simple as that."—Arpad Busson, financier and philanthropist

The sharp and growing wealth divide in the United States has elicited significant media and public attention over the past decade, with loud calls for achieving social goals through tax system change. Balancing tax policies with national priorities, including individualism and dead-hand control, property ownership, and social equality, is a daunting government task that has taken on new urgency in an environment shaped by a global pandemic. Growing interest in corporate social responsibility has pushed Wall Street and Main Street players to increasingly embrace socially responsible missions to guide investment strategies. Similarly, academic researchers and public figures have leveled intense criticism at investment funds, university endowments, family offices, and pension plans for investing in "dirty industries," such as arms manufacturing and fossil fuel production, which are destructive from an environmental or societal standpoint.

With myriad instruments for estate planning (e.g. strategies deployed *inter vivos*, at end of life, and post-mortem to minimize lifetime and deathtime taxes) available to tax attorneys to creatively preserve generational wealth, perhaps tax policies incentivizing socially responsible, tax efficient private investment are the best way to promote social programs. It is virtually impossible to effectively police the exploitation of semi-legal loopholes in the Internal Revenue Code (IRC) used to shift generational wealth without significant tax consequence. Though left-leaning members of Congress and their constituents have long called for a heftier tax on the wealthy, recent legislative efforts to raise rates on the highest bracket of taxpayers have not resulted in any action.[1] Additionally, wealthy individuals may generate little ordinary income, instead relying on wealth portfolios that generate only capital gains, adding complexity to thinking about an effective approach to taxing family wealth. Furthermore, because the United States does not utilize a wealth tax, it is difficult to attack the corpus of a family's accumulated assets. In the current legislative atmosphere, the difficulty the Internal Revenue Service (IRS) faces in collecting tax from the wealthy is unlikely to diminish. However, opportunity to expand the monetary and social impact of the IRC without increasing tax revenue through a higher top marginal tax rate clearly resides in encouraging wealthy individuals to shield and transfer their assets in a socially impactful way.

Through the lens of three widely used estate planning strategies, (i) Qualified Opportunity Zone (QOZ) investments, (ii) conservation easement donations, and (iii) special agricultural appraisals, this Article examines the potential for such strategies to offer wealth-preserving tax breaks while directing private capital toward achieving social goals. According to their intended purposes, these strategies can contribute to a range of positive social impacts including low-income community development, natural land and wildlife preservation, and national food security. However, this Article will show that these tax programs have pitfalls that can cause a failure to achieve their intended social goals. This Article will analyze how the IRS has successfully clamped down on tax shelters used to illegally magnify conservation easement donation deductions, and how tax abuse has run unchecked in the QOZ investment and special agricultural appraisal tax program arenas.

Exploring alternatives to the traditional tax system is essential to propelling national social goals. Two questions are critical to the discussion of social goal-focused tax programs. First, can wealth-preserving tax breaks provided by the government and focused on achieving social goals efficiently direct private investment to make a tangible social impact? Second, is the government giving tax breaks to the wealthy through legal wealth planning loopholes while receiving too little in the form of social goal completion? This Article provides three recommendations for achieving social goals more effectively: (1) amend current tax legislation to include ultra-specific legislative requirements for qualifying under economic development and land preservation tax programs; (2) improve IRS funding to expand oversight and enforcement of abusive tax shelters and improve cooperation between the IRS and the DOJ; and (3) create new incentive-based tax programs focused on achieving social goals that can be accessed by lower-income individuals as well as the wealthy. By analyzing existing tax programs and making recommendations for the future, this Article hopes to motivate a conversation about using socially positive tax policy as an alternative to direct government intervention programs.

I. STRATEGY I: QUALIFIED OPPORTUNITY ZONES (QOZ)

A. QOZ Program Background

Opportunity zones are designated, economically underserved census tracts, nominated by state governors and later certified by the United States Department of

[1] For the 99.8 Percent Act, S. 309, 116th Cong. (2019) (proposing to tax estates with a value of over $1 billion at a 77% tax rate).

Treasury (Treasury). Investments in these property zones can enjoy federal capital gain tax incentives (e.g., deferred tax on gains from a stock sale reinvested in a QOZ) if they meet certain requirements. The idea of attracting investment to opportunity zones by offering tax incentives grew in popularity in the mid-2010's, promoted by legal scholars and economists writing about new ways to attract private capital to distressed geographies.[2] However, the concept was not new. Historically, state and local governments have implemented similar programs, such as the 1993 introduction of empowerment zones (EZ) and enterprise communities (EC), and the 2000 addition of renewal communities (RC) and the New Market Tax Credit (NMTC).[3] Unfortunately, Government Accountability Office studies in the 2000s found that the EZ, EC, and RC efforts were largely ineffective at addressing the poverty and unemployment goals attached to the programs.[4] While the NMTC offered incentives for taxpayers to make investments in low-income communities, particularly in real estate, it incentivized relatively small investments. Approximately one third of NMTC projects were less than $500,000 in size, almost 80% were under $20 million, and only 10% were over $25 million.[5] These types of relatively small property investments, while benefiting investors, were not substantial enough to make a traceable impact on the low-income target communities.[6] Also contributing to the lack of impact, the NMTC encouraged individual small- and medium-sized developments in real estate, as opposed to business development and investments through pooled-fund partnerships.[7] This limitation meant a ceiling for business expansion or job creation in the target communities. The partial success of the early place-based tax incentive programs led to calls for a new tax program that allowed investment funds with pooled capital to make large-scale investments.[8]

---

[2] Jared Bernstein and Kevin A. Hassett, *Unlocking Private Capital to Facilitate Economic Growth in Distressed Areas*, ECON. INNOVATION GRP. (Apr. 2015), https://eig.org/wp-content/uploads/2015/04/Unlocking-Private-Capital-to-Facilitate-Growth.pdf (arguing that the complexity, underutilization, misaligned incentives, and restrictive scope of past property tax programs warranted the introduction of a new qualified opportunity zone program).

[3] *Id.* at 5.

[4] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-06-727, EMPOWERMENT ZONE AND ENTERPRISE COMMUNITY PROGRAM: IMPROVEMENTS OCCURRED IN COMMUNITIES, BUT THE EFFECT OF THE PROGRAM IS UNCLEAR (Sep. 22, 2006), https://www.gao.gov/products/GAO-06-727 (exploring the role of empowerment zone and enterprise community programs in revitalizing low-income communities); U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-464R, INFORMATION ON EMPOWERMENT ZONE, ENTERPRISE COMMUNITY, AND RENEWAL COMMUNITY PROGRAMS: BRIEFING FOR CONGRESSIONAL ATTENDEES (Mar. 10, 2010), http://www.gao.gov/new.items/d10464r.pdf.

[5] Bernstein & Hassett, *supra* note 2, at 10; Martin D. Abravanel, Nancy M. Pindus, Brett Theodos, Kassie Bertumen, Rachel Brash & Zach McDade, *New Markets Tax Credit (NMTC) Program Evaluation: Final Report*, URBAN INSTITUTE 75 (April 2013), http://www.taxpolicycenter. org/UploadedPDF/412958-new-markets-tax-final.pdf.

[6] Abravanel, Pindus, Theodos, Bertumen, Brash & McDade, *supra* note 5, at 124.

[7] U.S. DEPARTMENT OF THE TREASURY, NEW MARKETS TAX CREDIT PUBLIC TAX CREDIT PUBLIC DATA R ELEASE: 2003-2011 SUMMARY REPORT (2013), http://www.cdfifund.gov/docs/2013/NMTC/NMTC%20Data%20Release%20July%201%202013.pdf; Katie Codey, *Can the New Markets Tax Credit Program be Transformed Through Leverage of its Real Estate Bias?* FEDERAL RESERVE BANK OF ST. LOUIS (2011), https://www.stlouisfed.org/publications/bridges/summer-2011/canthe-new-markets-tax-credit-program-be-transformed-through-leverage-of-its-realestate-bias.

[8] Bernstein & Hassett, *supra* note 2, at 16-19.

Most recently, on December 22, 2017, President Trump signed into law the 2017 Tax Cuts and Jobs Act (TCJA), and with it the most expansive opportunity zone program to date. The TCJA included a new program for investing in QOZs.[9] The new tax law created IRC Section 1400Z, which promulgates rules for designation of eligible QOZs by the Treasury, treatment of capital gains by investors in QOZs, and creation of Qualified Opportunity Funds (QOF).[10] The IRC defines a QOZ as a "population census tract that is a low-income community that is designated as a qualified opportunity zone."[11] The TCJA also laid out the process for certification.[12] First, the chief executive officer (Governor) of the state in which a tract is located must have nominated the tract for designation as a QOZ and notified the Secretary of the Treasury of such nomination.[13] Next, the Treasury certifies such nominations and finally designates the tracts as certified QOZs.[14]

The TCJA advances strict criteria for the selection of QOZ communities. Under the IRC, designated QOZ communities must fit the "low-income community" definition of IRC Section 45D(e).[15] This section provides that a "low-income community" includes any population census tract that meets two qualifying criteria.[16] First, the poverty rate must be 20% or higher.[17] Second, for non-metropolitan communities, the median family income cannot exceed 80% of statewide median family income; or, for metropolitan communities, the median family income cannot exceed 80% of the greater of statewide median family income or the metropolitan area's median family income.[18] A number of special rules modify this blanket cutoff for communities. Primarily, the total number of tracts in a state that can be designated as QOZs is capped at 25% of the total number of qualifying low-income communities in the state.[19] States with fewer than 100 qualifying communities receive an exception to the 25% cap.[20] Additionally, communities contiguous to low-income communities are deemed eligible for designation if the median family income of that tract did not exceed 125% of the median family income of the contiguous low-income community.[21] The duration period of each QOZ is ten years from the time of designation.[22] At the ten year mark, the period for state determination and Treasury designation ceases.[23]

---

[9] President Donald J. Trump, Remarks by President Trump at Signing of H.R. 1, Tax Cuts and Jobs Bill Act, and H.R. 1370 (Dec. 22, 2017), https://www.whitehouse.gov/briefings-statements/remarks-president-trump-signing-h-r-1-tax-cuts-jobs-bill-act-h-r-1370/.
[10] I.R.C. §§ 1400Z-1, 1400Z-2.
[11] I.R.C. § 1400Z-1(a).
[12] I.R.C. § 1400Z-1(b).
[13] I.R.C. §§ 1400Z-1(b)(1)(A)(i), 1400Z-1(b)(1)(A)(ii).
[14] I.R.C. § 1400Z-1(b)(1)(B).
[15] I.R.C. §§ 1400Z-1(b)(1), 45D(e).
[16] I.R.C. § 45D(e)(1).
[17] I.R.C. § 45D(e)(1)(A).
[18] I.R.C. §§ 45D(e)(1)(B)(i), 45D(e)(1)(B)(ii).
[19] I.R.C. § 1400Z-1(d)(1).
[20] I.R.C. § 1400Z-1(d)(2).
[21] I.R.C. § 1400Z-1(e)(1).
[22] I.R.C. § 1400Z-1(f).
[23] *Id.*

As of 2020, there were over 8,700 QOZs covering every state and territory.[24] IRS Notice 2018-48 and IRS Notice 2019-42 list all QOZs, organized by state, county, census tract number, tract type, and Census Bureau American Community Survey (ACS) data source.[25]

B. Mechanics of the QOZ Program

Determining the place of QOZ investment in any estate planning strategy requires assessing the program requirements and tax benefits of QOZs. The requirements for a taxpayer to invest in a QOZ and reap the tax benefits are relatively streamlined. First, a taxpayer with capital gains from the sale of any property to an unrelated person must make an election on their federal tax return.[26] Second, the taxpayer must reinvest his capital gains into the QOZ within 180 days from the date of the sale or exchange of the original property that created capital gains.[27] If a taxpayer follows these guidelines, there is no further barrier to making a qualifying investment.

However, like many investment areas, the capital needs for a single large investment in a QOZ business or commercial property often go beyond the appetite of a single investor. Therefore, most taxpayers invest in QOZs through a QOF. A QOF is an investment vehicle that is organized either as a partnership or a corporation for the purpose of investing in a QOZ and that holds at least 90% of its assets in QOZ property. QOFs have grown in popularity as a way for investors of all levels to reap the capital gains benefits of the QOZ program.[28] If at any point the qualifying assets fall below the 90% threshold, the QOF must pay a penalty for each month it fails to meet the threshold in an amount equal to the excess of 90% of its aggregate assets, over the aggregate amount of QOZ property held by the fund, multiplied by the underpayment rate.[29] The underpayment rate is the Federal short-term rate plus three percentage points.[30] There is a safe harbor built into the IRC, allowing QOFs a pass on the penalty if the failure to remain above the 90% threshold is due to a "reasonable cause."[31]

C. Tax Benefits of Using a QOZ

The goal of the QOZ program is to attract long-term infrastructure and business investments for the low-income communities selected. There are several major benefits of investing in a QOZ, either directly or indirectly. In particular, the IRC details income tax deferrals and basis step-up provisions which incentivize long-term investors to make QOF investments and to reinvest QOZ gains back into the QOF of which they are a part. The tax benefits provided in the special rules for capital gains invested in QOZs under IRC 1400Z-2 are meant to attract investors and lock in invested capital for a long-term holding period.

---

[24] U.S. Economic Development Administration, Designated Qualified Opportunity Zones under Internal Revenue Code Sec. 1400Z-2, Notice 2018-48 (July 9, 2018), chrome-extension://oemmndcbldboiebfnladdacbdfmadadm/https://www.irs.gov/pub/irs-drop/n-18-48.pdf.
[25] I.R.S. Notice 2018-48 (July 09, 2018); I.R.S. Notice 2019-42 (July 15, 2019).
[26] I.R.C. § 1400Z-2(a)(1).
[27] *Id.*
[28] I.R.C. § 1400Z-2(d)(1).
[29] I.R.C. §§ 1400Z-2(f)(1)(A)(i)-(ii).
[30] I.R.C. § 6621(a)(2).
[31] I.R.C. § 1400Z-2(f)(3).

Importantly, a taxpayer who makes the QOZ election can defer capital gain from the sale or exchange of property with an unrelated person by investing the gains into a QOZ.[32] This deferral will end at the earlier of December 31, 2026, when the provision sunsets, or when the taxpayer disposes of the QOZ investment.[33] At either of those points, the taxpayer will recognize gain as related to the original sale or exchange of property.[34] Due to the 2026 deadline, to take full advantage of the deferral benefit, investors must have applied their capital gains to the program by December 31, 2019. This way, the capital gains could be deferred for seven full years before being realized.

However, recent political developments have shown attempts to extend the 2026 deadline and loosen the rules on deferring QOZ capital gains. On April 14, 2020, Representative Riggleman and other members of Congress introduced a bill that would defer the year of inclusion for certain capital gains invested in a QOF by four years to December 31, 2030.[35] Additionally, on April 6, 2020, the IRS issued Notice 2020-23 with the goal of providing taxpayers affected by the COVID-19 pandemic of 2019-2020 additional flexibility to invest in QOZs.[36] Under this notice, the IRS allowed taxpayers until July 15, 2020 to elect investment of capital gains into a QOF if the original 180-day decision period expired on or after April 1, 2020.[37] These actions by Congress and the IRS signal appetite for extending the QOZ program into the future, possibly with even more generous capital gain deferral rules and relaxed investment deadlines ahead.

In conjunction with the temporary deferral of taxes on previously earned capital gains, the QOZ program gives taxpayers a step-up in basis for previously earned capital gains invested based on how long the funds are held in the QOF. If the capital gains investment is held in a QOF for at least five years, the taxpayer receives a 10% basis step-up at realization.[38] If the capital gains investment is held in a QOF for at least seven years, the taxpayer receives a 15% basis step-up at realization.[39] The most beneficial treatment of taxpayer investment in a QOF comes at ten years. Under the special rule for investments held in a QOF for at least ten years, the taxpayer receives permanent exclusion of taxable income on any capital gains earned on the initial QOZ investment.[40] The basis of the property is deemed equal to the fair market value of the investment on the date that the investment is sold or exchanged.[41] Therefore, investors receive the most taxable benefit if they plan a ten-year timeline for holding their investment capital in a QOF.

To demonstrate maximized use of the deferral and step-up benefits in action, assume a taxpayer sold property and recognized a capital gain of $100,000 in December 2018. The taxpayer immediately reinvested the full $100,000 of capital gain in QOZ property. The taxpayer sells the property for $225,000 in December 2028. Under the QOZ tax deferral provision, the taxpayer owed no tax when filing taxes in 2019 on the $100,000 of capital

---

[32] I.R.C. § 1400Z-2(b).
[33] I.R.C. §§ 1400Z-2(b)(1)(A)-(B).
[34] I.R.C. § 1400Z-2(b)(2)(B).
[35] To defer the year of inclusion for certain capital gains invested in a qualified opportunity fund, *see* H.R. 6513, 116th Cong. (2020).
[36] I.R.S. Notice 2020-23, 2020-18 C.B. 2020-23.
[37] *Id.*
[38] I.R.C. § 1400Z-2(b)(2)(B)(iii).
[39] I.R.C. § 1400Z-2(b)(2)(B)(iv).
[40] I.R.C. § 1400Z-2(c).
[41] *Id.*

gain recognized in tax year 2018. Because the taxpayer holds the property for at least seven years, the taxpayer's basis increases from $0 to $15,000 on the property sold in 2018, therefore reducing the amount of deferred gain the taxpayer must recognize to $85,000 ($100,000 - $15,000). Assuming a 15% capital gains rate, the taxpayer will pay a total of $12,750 ($85,000 x 15%) on the $100,000 of deferred capital gain initially invested. Additionally, because the taxpayer holds the investment for ten years, he or she will receive a permanent exclusion of the $125,000 in new capital gains ($225,000 - $100,000). In sum, the taxpayer will have received the benefits of deferred tax on the initial $100,000 investment and will have saved $18,750 (15% x $125,000) on the new capital gains that are permanently excluded from taxable income.

In addition to these explicit tax benefits, there are clear intangible benefits to investing in a QOF that are not necessarily explicitly delineated in the IRC. Most prominent is individual access to high-growth investment opportunities in low-income communities. Normally, investors might have trouble finding investment funds willing to look for potential in inner-city commercial real estate, low-income housing, and urban start-up businesses. The creation of QOFs essentially created a new class of investment vehicles for capital holders looking to diversify their portfolios. The investment targets of QOFs are wide-ranging, and might include commercial and industrial real estate, low-income and multiuse housing projects, city and rural infrastructure, and business development.[42] The expansiveness of the investment options for QOF participants combined with the favorable tax benefits make investment in QOZs appealing for wealthy individuals.

Notably, following the TCJA, the IRS expanded the regulations for 100% bonus depreciation to certain kinds of "used property."[43] In addition, the rules for self-constructed property were loosened to include property constructed on behalf of the taxpayer by another builder under contract.[44] Although these rules do not fall under the QOZ Code sections or regulations, the QOF managers can take depreciation deductions under Section 163 to quickly recover the cost of property placed into service during investment of the QOF funds.[45] QOF shareholders can then receive and enjoy these cost recovery savings.

D. Benefits of Estate Planning with QOZs

While investment in a QOF can be a mixed bag for wealthy individuals looking to invest as a piece of their estate planning strategy, if used correctly, a QOF investment can provide all the taxable benefits described accruing to the taxpayer while alive and also exclude assets from the taxable estate at death. In conjunction with an intentionally defective grantor trust (IDGT), a QOF investor can effectively transfer high-growth QOV assets to children and grandchildren while still reaping the benefit of taxable estate exclusion.

The first step in estate planning for QOZ assets is recognizing that Section 1400Z-2(e)(3), and the accompanying regulations, specify that gain required to be recognized on

[42] Investing in Qualified Opportunity Funds, 85 Fed. Reg. 1866 (Jan. 13, 2020).
[43] Additional First Year Depreciation Deduction, 84 Fed. Reg. 50108 (Sept. 24, 2019).
[44] Treas. Reg. § 1.168(k)-1(b)(4)(v) (example 6); *See also* Cost Segregation Audit Techniques Guide - Chapter 6.8 - Bonus Depreciation Considerations, I.R.S. (Dec. 30, 2020), https://www.irs.gov/businesses/cost-segregation-audit-techniques-guide-chapter-6-8-bonus-depreciation-considerations#4.
[45] I.R.C. § 163.

the original property contributed to a QOF is, in the case of a decedent, includible in gross income for the decedent's takers and treated as "income in respect of decedents" (IRD) under Section 691.[46] Therefore, that includible amount of gain will not be eligible for a stepped-up basis at death.[47] The final regulations provide some clarity on this point. The regulations explain that the beneficiary receiving the qualifying investment has the obligation to include the deferred gain in gross income, even in the event of any subsequent inclusion.[48] However, the interest received by transfer at death is still considered a QOZ investment in the hands of the beneficiary under Section 1400Z-2(c).[49]

Understanding the difference between IRD assets and non-IRD assets is critical to structuring an effective QOZ estate plan. Importantly, non-IRD asset treatment and the benefits of nonrecognition of gain on ten-year investments apply to most appreciated property held in a QOF. It is only the original deferred gain that receives IRD treatment. For a wealthy investor with children and grandchildren, the goal is shifting the appreciating, low- or non-taxable QOF assets to beneficiaries, while removing the value of the investment from the taxable estate and also shielding against gift tax on income taxes potentially paid on QOF assets by the beneficiaries. This is best accomplished using an intentionally defective grantor trust (IDGT).

An IDGT is a type of irrevocable grantor trust that allows the grantor to take advantage of the discrepancy in inclusion between the income tax system and the estate tax system. In practice, an IDGT allows the grantor to exclude from his taxable estate the property transferred into the trust, but still retain enough control for income tax purposes. This allows the grantor to pay income tax on the trust assets and avoid having includible gifts in the amount of the taxes normally payable by the beneficiaries. In other words, the lifetime transfer is treated as completed for wealth transfer tax purposes but not for income tax purposes. This treatment allows the taxpayer to transfer even more wealth to younger generations by paying the income tax liability of the trust.

This transfer outcome is achieved using a three-step installment sale process in which QOF assets are shifted into an IDGT in exchange for an interest-bearing promissory note. First, the grantor will establish a trust, appoint an independent trustee, and make a gift to the trust in the amount of 10-15% of the value of the QOF investment to be shifted into the trust. This initial funding provides the trust "seed money" to be used in the next step of the transaction.[50] Second, the grantor will sell the QOF assets to the trust. In return, the trust gives the grantor a promissory note. Under Section 675(2), a grantor is treated as an owner of any portion of a trust in which the grantor has the power to borrow without adequate interest or security.[51] By authorizing the trustee to make an interest-bearing loan to the grantor without regard to interest or security, the grantor develops the "defective power" and is treated as the owner of the trust for income tax purposes. Since the grantor is treated as the owner of the trust, the transaction is not a realization event and there is no gain or loss on the transfers. Third, and finally, the trust makes principal and interest payments to

[46] I.R.C. §§ 1400Z-2(e)(3), 691.
[47] *See id.*
[48] Investing in Qualified Opportunity Funds, 85 Fed. Reg. at 1866.
[49] *Id.*
[50] John B. O'Grady, *Planning for the Next Generation: Installment Sale to an Intentionally Defective Grantor Trust*, WM. & MARY ANN. TAX CONF. 665 (2011).
[51] I.R.C. § 675(2).

the grantor, who will pay income tax on the trust assets. Because the QOF asset taxes are paid by the grantor, the corpus will be excluded from the grantor's taxable estate and the taxes (normally paid by the beneficiary of the trust property) will not be considered taxable gifts.

This estate planning strategy provides the best of both worlds. As long as the QOF assets are held by the beneficiaries through the ten-year holding period for a stepped-up basis, moving QOF assets into an IDGT eliminates the perennial debate between transfer tax and capital gains tax. Normally, the grantor of a trust would benefit by moving assets into trust and removing them from the taxable estate, while still burdening the beneficiaries with capital gains treatment upon the sale of the appreciated assets. However, by combining the power of the irrevocable trust with the tax benefits of QOFs, the grantor gets exclusion from the taxable estate and the beneficiaries receive stepped-up basis and avoidance of capital gains on all but the deferred amount of gain originally contributed to the QOF by the grantor.

To amplify these benefits of the trust, the grantor of an IDGT with QOZ assets can take a valuation discount for lack of marketability and lack of control.[52] This lowers the valuation of the QOF shares and leads to a lower gift tax burden for the grantor on the transfer of the assets to the trust. Despite concerns of abuse, the Tax Court has generally allowed these valuation discounts to stand.[53] The grantor can take a discount for lack of control because they are restricted from making any business decisions related to the QOZ investments. Specifically, the control discount reflects the minority shareholder's inability to compel liquidation and to realize a pro rata share of the net asset value of the QOF.[54] The grantor can take a discount for lack of marketability because of a lack of a ready market for the shares of the QOF. It is objectively more difficult for a QOF investor to dispose of his shares than it would be to otherwise sell shares of a public company on a stock exchange.

Once the IDGT strategy is applied to the QOF context, the grantor has effectively turned his interest in the QOF into a fixed-income bond. The trust pays the grantor a fixed amount of interest on the note that was sold in exchange for the QOF interest moved into the trust.[55] As long as the rate on the note is outpaced by appreciation in the asset, the grantor will have effectively taken advantage of the arbitrage opportunity. This is particularly easy in the current interest rate environment, with the effective federal funds

---

[52] JOYCE BEEBE, THE ESTATE TAX AFTER THE 2017 TAX ACT (2018), https://www.bakerinstitute.org/media/files/files/328b0f06/bi-brief-041718-cpf-estatetax.pdf.

[53] *See* Estate of Tanenblatt v. Comm'r, T.C.M. 2013-263 (2013) (holding that the fair market value of the estate's 16.67% interest in a LLC formed as a real estate holding company was properly subject to discounts of 10% and 26% for lack of control and lack of marketability); *see also* Estate of Newhouse v. Comm'r, 94 T.C. 193 (1990) ("Ignoring discounts for lack of control and lack of marketability is contrary to long-established valuation methods well accepted by the Courts in cases presenting the value of stock in closely held corporations").

[54] Harwood v. Comm'r, 82 T.C. 239, 267 (1984).

[55] *See* John Loew, *Using Opportunity Zone Investments to Super Charge Estate Planning*, BAKER TILLY. (Nov. 21, 2019), https://www.bakertilly.com/insights/using-opportunity-zone-investments-to-super-charge; Stephanie A. Bruno, Patrick M. "Rick" Cox, Forrest David Milder & Kenneth H. Silverberg, *QOZ Final Regulations: New Opportunities for Estate Planning*, NIXON PEABODY. (Jan. 29, 2020), https://www.nixonpeabody.com/en/ideas/articles/2020/01/29/qoz-final-regulations-new-opportunities-for-estate-planning.

rate hovering around .01% as of July 2020.[56] With a near-zero interest rate on the "IDGT bond" the grantor is able to transfer, estate tax free, almost 100% of the appreciation of the QOF assets.

E. Impact of QOZ Investments

The opportunity to invest in QOFs and shift assets in IDGTs gives wealthy individuals a tried and true method to enjoy tax deferral on capital gains, diversification of their investment portfolios, and the ability to transfer appreciating property to children and grandchildren. As shown above, high-net-worth taxpayers have clearly taken advantage of the QOZ program. Regardless, the result is not surprising or unwelcome. Each tax policy undertaken by the TCJA is part of a larger plan for economic development. While the QOZ program gives wealthy taxpayers both tax breaks on appreciated capital and a new tool for avoiding estate and gift taxes, the apparent goal of the QOZ provision is to attract capital to low-income communities and improve economic development in the designated census tracts.

The outcome of low-income investment is usually the heart of any low-income urban or rural development conversation. Sociologists and economists have endlessly debated the pros and cons of community renewal projects. Some argue that profit-focused investments in these communities often lead to inequitable development and subsequent displacement of low-income residents.[57] Others argue that poor implementation of gentrification can lead to displacement of social services for low-income residents.[58] However, there are studies showing that mixed-income communities are positive for education quality and access to government services.[59] Additionally, studies show that more and better quality access to social services and amenities leads to positive outcomes for disadvantaged children.[60] Regardless of the perceived outcome of low-community

---

[56] Federal Reserve, Implementation Note issued July 29, 2020 (July 29, 2020), https://www.federalreserve.gov/newsevents/pressreleases/monetary20200729a1.htm#:~:text=Decisions%20Regarding%20Monetary%20Policy%20Implementation&text=The%20Board%20of%20Governors%20of,%2C%20effective%20July%2030%2C%202020.

[57] *See* JAN LIN, TAKING BACK THE BOULEVARD 170 (NYU Press. 2019) (identifying the "class struggle amid the relentless economic violence of capitalism" that has accompanied the urban redevelopment of certain areas of downtown Los Angeles); *see also* L.S. Bourne, *The Myth and Reality of Gentrification: A Commentary on Emerging Urban Forms*, 30 URBAN STUDIES 183, 185 (1993) (noting the reduction in low-rent housing stock and displacement of hundreds of residents that accompanies improved housing quality and social service levels).

[58] Geoffrey DeVerteuil, *Evidence of Gentrification-induced Displacement among Social Services in London and Los Angeles*, 48 URBAN STUDIES 1563 (2011) (examining the role of gentrification in causing displacement and entrapment in social service facilities across gentrifying boroughs in London and areas of Los Angeles).

[59] Joanna Duke, *Mixed Income Housing Policy and Public Housing Residents, Right to the City*, 29 CRITICAL SOC. POL'Y 100 (2009) (identifying higher access to quality schools and more responsive public agencies in mix-income communities).

[60] Mark Joseph & Jessica Feldman, *Creating and Sustaining Successful Mixed-Income Communities: Conceptualizing the Role of Schools*, 41 EDUCATION AND URBAN SOCIETY 623 (2009) (identifying the role of schools in connecting children and parents from different socioeconomic backgrounds to improve social development, economic stability, and quality of life).

investment, most scholars likely agree that the investment is beneficial to low-income communities if paired with an equitable development policy that takes into account both the benefits (e.g., improved public health) and downsides (i.e., displacement) of possible investment programs.[61] The QOZ program attracts unrealized capital gains to low-income communities at the expense of tax revenue losses to the IRS on the unrealized capital gains and estate tax exclusions, with the goal of using private capital to make a social impact on these communities. However, the program lacks strict requirements for qualifying QOF investments and therefore fails to achieve the social goal of revitalizing low-income communities.

Unfortunately, QOF investments are not usually primarily focused on equitable community investment. QOF's are run by experienced, profit-motivated, Wall Street-trained fund managers.[62] By statute, these kinds of fund managers owe duties of care and loyalty to their investors.[63] The combination of these duties is "characterized as requiring the investment adviser to act in the 'best interest' of its client at all times,"[64] which means acting at all times within the investment strategy and best interest of the fund.[65] Unfortunately, the IRC places no social impact requirements on the design or internal strategy of a QOF under Section 1400Z-2(d).[66] The social goal of the program fails because of lax investment requirements for QOFs. Indeed, QOFs are simply investment vehicles for corporations or partnerships with the express and solitary purpose of investing investor funds and returning a profit. The flexibility and tax advantages of QOFs makes these funds attractive to wealthy individuals with a strict focus on profit, creating bad incentives for fund managers to invest in projects that do not actually advance the social goal of revitalizing low-income communities.

The options for property and business investment under a QOF are virtually unrestricted given the relatively lax requirements of Section 1400Z and the accompanying regulations. The focus of QOZ development is the improvement of real estate in low-income tracts.[67] However, there are only two guiding requirements for real property investment in QOZs.[68]

[61] *See, e.g.*, Jana A. Hirsch, Yuzhe Zhao, Kathryn M. Neckerman & Yvonne L. Michael, *Health and Health-Related Resources in Newly Designated Federally Qualified Opportunity Zones: United States, 2012–2016*, 110 AM. J. PUB. HEALTH 407 (2020); Derek Hyra, *Commentary: Causes and Consequences of Gentrification and the Future of Equitable Development Policy,* 18 CITYSCAPE 169 (2016).
[62] TIM STEFFEN, INVESTING IN QUALIFIED OPPORTUNITY FUNDS (2019), http://www.bairdfinancialadvisor.com/pdougherty/mediahandler/media/285015/2019-01-17%20Baird%20on%20Opportunity%20Zone%20Funds.pdf.
[63] SEC Interpretation Regarding Standard of Conduct for Investment Advisers, 17 C.F.R. § 276 (2019), https://www.sec.gov/rules/interp/2019/ia-5248.pdf.
[64] *Id.* at 8.
[65] *See* SEC v. Tambone, 550 F.3d 106, 146 (1st Cir. 2008) ("Section 206 imposes a fiduciary duty on investment advisers to act at all times in the best interest of the fund…"); SEC v. Moran, 944 F. Supp. 286, 297 (S.D.N.Y 1996) ("Investment advisers are entrusted with the responsibility and duty to act in the best interest of their clients.").
[66] I.R.C. § 1400Z-2(d).
[67] Investing in Qualified Opportunity Funds, 85 Fed. Reg. at 1866.
[68] *See* I.R.C. §§ 1400Z-2(d)(2)(D)(i)(II), 1400Z-2(d)(2)(D)(ii).

First, either the original use of QOZ property must commence with the QOF, or the QOF "substantially improves" the property being invested in.[69] Property is treated as substantially improved by the QOF only if, during any thirty-month period beginning after the date of acquisition of the property, additions to basis with respect to the property in the hands of the QOF are at least 100% of the adjusted basis in the property at the beginning of the period.[70] Importantly, the thirty-month period does not have to begin at inception of a property holding, but can take place later in the investment cycle. However, the IRC provides no restrictions on the property type that is eligible for investment. Additionally, the final regulations, released in April 2020, expanded the flexibility of real estate investments by clarifying that there is no requirement that land needs to be "substantially improved" in order to qualify for the QOF requirement of 90% QOZ holdings.[71] Similarly, the value of land is not included when determining if a building on the land has been substantially improved.[72]

Second, during substantially all of the time the QOF holds qualified tangible property, substantially all of the use of the property is in a QOZ.[73] Under the regulations, during at least 90% of the time the QOF holds qualified tangible property, at least 70% of the use of that property by the QOF must be in a QOZ.[74] In combination, this translates to at least 63% usage of tangible property in a QOZ. The relatively lax rules for determining qualifying portfolio investments, substantial improvement, and valuation of improved property means there is little in the way of a guiding principle for development of tangible property in targeted communities.

Similarly, the IRC provides few restrictions on the types of qualified opportunity zone businesses or entities that QOF can form and operate in QOZs. To qualify as a qualified opportunity zone business (QOZB), the business must meet five criteria.[75] First, substantially all (defined as 70%) of owned or leased tangible property must qualify as qualified opportunity zone business property.[76] Second, a substantial portion of intangible property has to be used in the active conduct of business within a QOZ.[77] Third, a QOZB must earn 50% of its gross income from business activities within a QOZ.[78] However, three safe harbors exist for the gross income rule: at least half of the aggregate hours of services received by the business were performed in a QOZ; at least half of the aggregate amounts that the business paid for services were for services performed in a QOZ; or the tangible property and necessary business functions to generate at least half of the gross income of the trade or business were located in a QOZ.[79] Fourth, no more than 5% of the average unadjusted basis in the property may be nonqualified financial property (NFQP).[80] Finally,

[69] I.R.C. § 1400Z-2(d)(2)(D)(i)(II).
[70] *Id.*; I.R.C. § 1400Z-2(d)(2)(D)(ii).
[71] Investing in Qualified Opportunity Funds, 85 Fed. Reg. at 1866.
[72] *Id.*
[73] I.R.C. § 1400Z-2(d)(2).
[74] Investing in Qualified Opportunity Funds, 85 Fed. Reg. at 1866, 1905.
[75] I.R.C. § 1400Z-2(d)(3).
[76] Investing in Qualified Opportunity Funds, 85 Fed. Reg. at 1866, 1899.
[77] *Id.* at 1917.
[78] *Id.*
[79] *Id.*
[80] *Id.* at 1896.

the business cannot be a "sin business" under Section 144(c)(6)(B).[81] A "sin business" includes "any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises."[82]

The "sin business" restriction is important because it shows that, with proper financial manipulation, a QOF could form or fund virtually any kind of business in a QOZ. The QOZB requirements keep investment money focused within the QOZ tracts. However, except for the explicitly restricted "sin businesses" precluded from investment under a QOF, there are no other rules governing the types of business investments that QOF's might make in a QOZ.

As with any field of investing, a group of well-intentioned investors could pool capital in a QOF with a guiding principle of focusing the fund's investments on positive social outcomes. There are numerous social goals that could be accomplished through QOFs. For example, a QOF charter could focus on improving access to capital for minority- and women-owned businesses attempting to expand; developing affordable housing with livable conditions and access to social service offices; constructing medical clinics and community centers; or improving light rail, bus, or metro access through infrastructure projects. All of these projects could produce a significant return on capital and improve the livelihood of low-income residents, all while minimizing the risks of displacement and entrapment.

Unfortunately, development projects undertaken through QOFs after the introduction of the program in the TCJA paint a more discouraging picture of QOF investment goals. For example, there are fifteen National Football League (NFL) stadiums located in QOZs and an additional three stadiums located in qualifying adjacent tracts.[83] With only thirty stadiums in the NFL, this means that 60% of all NFL stadiums can qualify for QOF funding with proper tax structuring. Because the regulations provide flexibility for QOFs to aggregate various properties within a QOZ for the purposes of meeting requirements like the substantial improvement requirement, it is plausible that many of the stadium renovation and improvement projects could receive favorable treatment for QOF holders under the current rules.[84] For example, renovation expenses like the Baltimore Ravens' 2019 season $120 million stadium renewal project might be eligible for QOF investment.[85] Or, even more shocking, QOF money could fund a completely new stadium in Cleveland.[86] Stadium construction in QOZs illustrates the problematic QOF business and real estate investments that have dominated the conversation following the advent of the program.

---

[81] *Id.* at 1929.
[82] 26 U.S.C.A. § 144(c)(6)(B).
[83] Jimmy Atkinson, *These 18 NFL stadium neighborhoods are eligible for the Opportunity Zone tax break*, OPPORTUNITYDB (Feb. 3, 2019), https://opportunitydb.com/2019/02/nfl-stadiums-eligible-for-opportunity-zones-tax-break/.
[84] Investing in Qualified Opportunity Funds, 85 Fed. Reg. at 1866, 1912.
[85] Edward Lee, *Ravens unveil next phases of improvements to M&T Bank Stadium*, BALTIMORE SUN (Jan. 30, 2018), https://www.baltimoresun.com/sports/ravens/bs-sp-ravens-improvements-at-mt-bank-stadium-20180130-story.html.
[86] Zach Spedden, *Cleveland Browns Exploring Development That Could Include New Stadium or Renovation*, FOOTBALL STADIUM DIGEST (May 3, 2018), https://footballstadiumdigest.com/2018/05/cleveland-browns-exploring-development-that-could-include-new-stadium-or-renovation/.

Stadium renovations represent the kinds of QOZ projects that harm, rather than help, low-income communities. These types of investments do not promote economic growth while ensuring the expansion of services and housing opportunities for low-income residents. Quite the opposite, flashy stadium renovation takes potential funding away from small businesses and affordable housing projects and applies it toward services enjoyed almost wholly by wealthy populations who commute into games from affluent suburbs. Additionally, new stadium-like construction projects, as opposed to renovations, occupy scarce QOZ real estate that could otherwise be used for future projects that might benefit low-income residents—for example, the construction of affordable housing, community centers, or social services centers. New builds that attract use by suburban residents but destroy local community gathering places, social venues, and low-income housing development fuel displacement through buyouts and rent increases brought on by rapid gentrification. Though the QOZ program was organized to help revitalize low-income communities, outcomes have instead diverged from this social purpose. Billion-dollar NFL teams, billionaire owners, and individual millionaire property developers have benefited from QOF investment. Accordingly, the QOZ program has failed to achieve its social goal because QOF investments are not actually assisting low-income communities.

F. How Will the Future Judge the Social Impact of QOZs?

It will be difficult to know, until years after the introduction of the QOZ program, whether sufficient capital was directed toward social improvement projects to justify the tax breaks currently offered for QOF investments. Analysis of the current state of the QOZ program suggests that QOF investing is a highly effective estate planning tool with questionable social equality implications. However, while legislators may try to convince themselves that they are efficiently motivating capital gains reinvestment in low-income communities across the United States while providing QOZ tax breaks, there is little evidence to show that this rings true. It is difficult to find any reliable data showing the volume of stadium-type projects versus the volume of low-income community impact projects benefiting from QOZ investment. Additionally, it is clear from the examples above that there has been manipulation of QOZ investment such that wealthy individuals are massively benefiting from tax breaks and tax-deferred capital gains; and the investments are being directed toward projects that improperly divert funding away from low-income community revitalization.

Improving restrictions on QOF investments is the most obvious way to preserve the tax benefits and estate planning possibilities anticipated by proponents of the QOZ legislation, while ensuring the promise of low-income community development. Instead of excluding "sin businesses" from the list of possible QOF investments, the goal might be to create an all-inclusive list of eligible, socially beneficial business types that constitute the only possible investment options for a QOF. An inclusive list does not have to be overly restrictive or unprofitable and could include relatively expansive categories, such as municipal infrastructure, medical facilities, affordable housing, community centers, and mixed-income or mixed-use developments.

The current regulations provide almost no oversight into the amount and types of investments being undertaken by QOF investors. Even at the end of the first phase of QOZ investment, probably around 2030, it will be difficult to know the distribution and depth of low-income community investment. Placing restrictions on the types of projects that QOF investments may produce will ensure equitable, positive economic development. There are no guarantees that restricting QOZ investment options will not lead to gentrification and displacement in the future. However, at least the program can avoid counterproductive, stadium-type projects. Additionally, more restrictive investment options may decrease possible returns on investment from the current QOF model. Yet, this community enrichment is the trade-off legislators should demand from wealthy individuals as the cost of an opportunity to defer capital gains, gain access to QOF vehicles which diversify portfolios, and efficiently transfer rapidly appreciating assets to future generations.

G. The Role of State and Local Government in Determining QOZ Impacts

The question is whether a better tax-funded alternative exists for distributing the high volume of investment that QOFs attract to an entire low-income census tract. If the IRS and state revenue agencies increase collections through increases in the top marginal tax bracket and more powerful restrictions on estate tax exemptions, what could state and local governments do with the funds? The answer might lie in state-funded investment initiatives to rehabilitate low-income neighborhoods by creating integrated, mixed-income communities. The recent development projects undertaken by the District of Columbia government in Southwest D.C. provide a unique model for the way in which state and local governments can build healthy, mixed-income communities.

In 2005, the District of Columbia government designed and funded a new initiative to revitalize severely distressed subsidized housing and economically develop low-income communities dealing with high rates of poverty, crime, and economic segregation.[87] The program was organized in an effort to address the holes in economic development spending caused by the elimination of the HOPE VI housing program, a $6 billion initiative created by the United States Department of Housing and Urban Development (HUD) in 1992 and eliminated in the FY2004 and FY2005 administration budgets under President George W. Bush.[88] Unlike gentrification projects that previously targeted inner-city areas for complete overhaul, often leading to displacement of low-income residents, the New Communities Initiative (NCI) focuses on creating integrated, mixed-income neighborhoods with quality affordable housing options and sufficient access to social services.[89] The four guiding principles behind the program include: (1) one for one replacement, ensuring no net loss of affordable housing; (2) opportunity for current residents to return to or stay in the community, giving priority to current residents to allow them to stay in their neighborhoods; (3) mixed-income housing designed to tackle the problems associated with poverty concentration; and (4) build first, which limits displacement by calling for development of affordable housing projects to be started before demolition of existing, dilapidated housing.[90]

Barry Farms, a low-income neighborhood in D.C.'s Southeast, is one of four low-income neighborhoods targeted by the NCI.[91] Since 2006, there have been 346 total units

---

[87] *About the New Communities Initiative*, NEW COMMUNITIES INITIATIVE, http://dcnewcommunities.org/about-nci/ (last visited Nov. 27. 2020).
[88] *Id.*
[89] *Id.*
[90] *Id.*
[91] NEW COMMUNITIES INITIATIVE, BARRY FARMS DEVELOPMENT PROGRESS: NEW COMMUNITIES INITIATIVE (2017), https://dcnewcommunities.org/wp-content/uploads/2014/01/Barry-Farm-Progress.pdf.

planned and completed.[92] This includes 100 replacement units and 246 affordable units.[93] The project was funded by $36.6 million in NCI funding, leveraged with an additional $86.5 million in private capital.[94] In an effort to accomplish the four guiding principles, human capital progress is tracked in the NCI target areas. By teaming up with the Far Southeast Family Strengthening Collaborate, the Barry Farms project has successfully managed cases of residents in the new housing development.[95] The FY2016 human capital progress report shows that 107 residents participated in employment readiness activities, 48 residents gained employment, 18 residents participated in the health program for a 108 pound total weight loss, 16 residents participated in financial literacy classes, and 25 resident youth were involved in mentoring programs.[96] Additionally, in 2016, new partnerships formed with Urban ED, Leadership Training Institute, Capitol Area Asset Builders (CAAB), and Literacy Volunteers and Advocates (LVA), promise to bring additional social services to the Barry Farms community.[97]

The NCI and the Barry Farms revitalization projects provide a model for planned economic development of low-income tracts that considers low-income residents and promotes inclusive investment. However, there are obvious shortcomings of the program, the most prominent being that only a minority share of the total investment cost of the NCI is being shouldered by the District government.[98] The remainder of the funding is private capital hoping to make high returns on the high growth NCI communities.[99] Due to the need for significant private capital in funding community development projects like that at Barry Farms, the NCI-model can sometimes fail.

In contrast, the QOZ program tax and estate planning incentives provide the right carrot attracting private capital. On the other hand, the Treasury should learn from initiatives like the NCI and improve oversight and guardrails on QOF investment. Stricter rules on the eligible investments coupled with required funding for social service offerings or mixed-income housing thresholds might offer the best of both worlds. Wealthy individuals will utilize tax breaks and estate planning tools, and low-income residents will actually reap the benefits of increased investment in their communities.

The IRS offers QOF investing as a social equality-focused estate planning technique, a strategy that might be reproducible and more successful with the correct oversight regarding the types of investments being targeted. Until then, abuse of the QOF system ensures that wealthy individuals are receiving income tax and estate tax breaks without the socially positive economic development outcomes. For social equality-concerned testators with very large estates, it may be worth self-funding a new QOF corporation or partnership instead of investing in an existing fund. Despite increased administrative costs, starting a new QOF will provide the individual with control to minimize the social impact of

[92] *About the New Communities Initiative*, *supra* note 87.
[93] *Id.*
[94] NEW COMMUNITIES INITIATIVE, BARRY FARMS DEVELOPMENT PROGRESS (2017), https://dcnewcommunities.org/wp-content/uploads/2017/08/NCI-Development-Progress-Neighborhoods.pdf.
[95] NEW COMMUNITIES INITIATIVE, *supra* note 91.
[96] *Id.*
[97] *Id.*
[98] *Id.*
[99] *Id.*

displacement effects caused by the QOZ development, regardless of whether the Treasury imposes stricter investing guidelines for QOFs in the future.

The QOZ program is only one of many federal tax programs aimed at incentivizing wealthy individuals to give back to the community through private action. Another significant social goal-focused tax program is the conservation easement donation tax breaks. As discussed below, conservation easement is another tool by which the government gives exemptions and deductions to individuals in return for natural land donations.

II. STRATEGY II: CONSERVATION EASEMENT DONATIONS

The tax benefits of using a conservation easement can be significant for a wealthy testator with expansive natural land holdings. The government offers conservation easement tax exemptions and deductions to encourage social reform in the form of land and wildlife conservation.[100] The wealthiest testators in the country use conservation easements to retain family property rights while also diversifying their wider philanthropic estate plan. However, abuse of the conservation easement provisions in recent years by less philanthropic investors has been cause for concern about the undermining of the underlying tax policy. Specifically, the use of syndicated conservation easements has threatened to deteriorate the amount of natural land being protected, while unfairly providing tax benefits to investors. Fortunately, given recent changes in IRS approaches to dealing with abuse in the conservation easement arena, the tax incentives offered in this area appear to remain a shining light in an effective legislative scheme to achieving tax-driven social goals.

Though there is strong evidence to suggest that land loss leads to undesired consequences, there are generally few government incentives to promote natural land preservation and to disincentivize expansion of real estate and human activity. The tax system, however, offers exclusion and deduction benefits for setting aside natural land under the conservation easement rules.[101] Many uber-wealthy American families have used conservation easements as a socially impactful and media friendly way to set aside, pass down, and sell land assets. In particular, the Rockefeller family has long been in the media spotlight for protecting natural land in Maine, Vermont, and New York, in addition to other states, through the use of conservation easements.[102] Most recently, following the passing of David Rockefeller, the Westchester Land Trust announced that following the sale of his $33 million Hudson Pines estate, located in New York's Hudson Valley, the property would be permanently protected by the anonymous buyer of the estate through use of a conservation easement.[103]

[100] *See* I.R.C. § 2031(c)(8)(A).
[101] *Id.*
[102] *John D. Rockefeller & the Carriage Roads*, VISIT MAINE (2020), https://visitmaine.com/quarterly/acadia/rockefeller.
[103] Karen Croke, *Rockefeller Hudson Pines estate: 60 acres preserved from development*, THE J. NEWS (Mar. 22, 2018), https://www.lohud.com/story/news/local/westchester/2018/03/22/rockefeller-hudson-pines-estate-preservation/447225002/.

A. Conservation Easement Donations as a Social Goal Bargain

Tax breaks for conservation easement donations underpin the social goal bargain struck by the IRS with wealthy landholder families. In return for *inter vivos* and post-mortem donations of natural land to conservation trusts, the IRS provides tax breaks on gross income or the taxable estate.[104] However, this carefully crafted social bargain has been threatened in recent years by syndicated passthroughs used to inflate natural land appraisals and illegally distribute conservation easement deductions to investors. The analysis below evaluates the scope of traditional conservation easement tax breaks, details the risks of the trend towards syndication, and shows how the government has taken steps to ensure that the taxpayers taking conservation tax benefits are holding up their end of this social bargain.

The use and championing of conservation easements by private individuals and government entities developed in tandem with the growth of urban populations in the twentieth century and subsequent concerns that the natural environment would be consumed by sprawling suburban development.[105] In general, conservation easements are used to protect natural resources and stem the loss of natural land.[106] The government's promotion of conservation easements as a tool to drive environmental policy has roots in early 1900's efforts to combat destruction of natural land, including President Franklin Roosevelt's founding of the Civilian Conservation in 1933.[107] As United States environmental policy deepened and became more complex, the IRC became a major tool with which the government could stop the loss of natural land.

B. Harvesting the Fruits of Conservation Easement Donations

There are three conservation tax benefits that wealthy individuals can take advantage of in forming a long-term estate plan. First, under Section 2031(c)(8), there is a capped exclusion from the gross estate for land set aside for conservation.[108] Second, under Section 170(b)(E)(i), individuals can take a charitable deduction for conservation land transferred to charity *inter vivos*.[109] Finally, under 2055(f) there is an estate tax charitable deduction for a conservation easement granted to charity post-mortem.[110] Used jointly, these

[104] I.R.C. § 2031(c)(8)(A).
[105] *Urban Population (% of total population) - United States*, THE WORLD BANK (2020), https://data.worldbank.org/indicator/SP.URB.TOTL.IN.ZS?locations=US/.
[106] *UN Climate Change Conference (UNFCCC COP 26)*, IISD (Nov. 1-12, 2021), https://sdg.iisd.org/events/2020-un-climate-change-conference-unfccc-cop-26/; Brad Plumer, *Humans Are Speeding Extinction and Altering the Natural World at an 'Unprecedented' Pac e*, N. Y. TIMES (May 6, 2019), https://www.nytimes.com/2019/05/06/climate/biodiversity-extinction-united-nations.html.
[107] John F. Organ, Valerius Geist, Shane P. Mahoney, Steven Williams, Paul R. Krausman, Gordon R. Batcheller, Thomas A. Decker, Robert Carmichael, Priya Nanjappa, Ronald Regan, Rodrigo A. Medellin, Ruben Cantu, Richard E. McCabe, Scott Craven, Gary M. Vecellio & Daniel J. Decker, *The North American Model of Wildlife Conservation*, THE WILDLIFE SOC'Y (Dec. 2012), https://wildlife.org/wp-content/uploads/2014/05/North-American-model-of-Wildlife-Conservation.pdf.
[108] *Id.*
[109] I.R.C. § 170(b)(E)(i).
[110] I.R.C. § 2055(f).

provisions can provide huge breaks for aging taxpayers, while maintaining use of, and autonomous management over, family land holdings.

Section 2031(c)(8) allows an exclusion from the gross estate for the value of "land subject to a qualified conservation easement."[111] In order to qualify, the land must (1) be located in the United States or any possession of the United States; (2) have been previously owned by the decedent or a member of the decedent's family at all times during the final three years of the decedent's life; and (3) have been dedicated to a qualified conservation easement by the decedent, or a member of the decedent's family, the executor, or a trustee of the trust that holds the easement.[112] After the election is made, the exclusion will equal the lesser of the "applicable percentage" of the value of the land, reduced by any estate tax deduction taken under the special rule for irrevocable transfers of easements in real property, or $500,000.[113] The "applicable percentage" means 40% reduced by 2% for each percent by which the value of the land is less than 30% of the value of the land.[114] In other words, to get the greatest exemption under the "applicable percentage" test, the testator should set aside at least 30% of the value of the land.

Exceptions further restrict the amount of the exclusion. The exclusion cannot be applied to the extent the land was debt-financed or to the extent the family retains a "development right."[115] However, adding some flexibility to these exceptions, heirs who receive an interest in the qualified land are allowed to terminate, by election post-mortem, a development right that was retained by the decedent until death.[116] Finally, the exclusion applies to a partnership, corporation, or trust interest as long as 30% or more of the entity was owned by the decedent.[117]

There are two types of deductions that can be taken for donated conservation easements, one *inter vivos* and one post-mortem. First, under Section 170(b)(E)(i), any "qualified conservation contribution" is allowed such that the contribution does not exceed the excess of 50% of the taxpayer's "contribution base" over the amount of all other charitable contributions allowable.[118] A "qualified conservation contribution" is any (1) contribution of qualified real property interest, (2) made to a qualified organization, or (3) exclusively for "conservation purposes."[119] The "contribution base" is the adjusted gross income, computed without regard to any net operating loss carryback to the taxable year under Section 172.[120]

There are four types of "conservation purposes" recognized by the IRC:

(i) the preservation of land areas for outdoor recreation by, or the education of, the general public;

[111] I.R.C. § 2031(c)(8)(A).
[112] I.R.C. §§ 2031(c)(8)(A), 2031(c)(8)(C).
[113] I.R.C. §§ 2031(c)(1), 2055(f).
[114] I.R.C. § 2031(c)(2).
[115] I.R.C. § 2031(c)(4).
[116] I.R.C. § 2031(c)(5)(B).
[117] I.R.C. § 2031(c)(10).
[118] I.R.C. § 170(b)(1)(E).
[119] I.R.C. § 170(h)(1).
[120] I.R.C. § 170(b)(1)(H).

(ii) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem;
(iii) the preservation of open space (including farmland and forest land) where such preservation is—
    I. for the scenic enjoyment of the general public, or
    II. pursuant to a clearly delineated Federal, State, or Local governmental conservation policy, and will yield a significant public benefit; or
(iv) the preservation of an historically important land area or a certified historic structure.[121]

As with most property donated to a charity, the taxpayer is eligible for a deduction equal to the fair market value of the conservation easement transferred.[122] The IRS has outlined various examples of reporting deficiencies that might prevent a taxpayer from getting a deduction for a noncash charitable donation.[123] These deficiencies might include a failure to include supporting information, failure to procure confirmation from the donee that complies with Treasury regulations, inadequate conservable value documentation provided to the donee organization by the donor, a failure to show a qualifying conservation purpose, or a failure to convey the conservation easement in perpetuity.[124]

The second mechanism used to receive a charitable deduction for a conservation easement donation is a post-mortem election under 2055(f).[125] This rule, unique from the estate tax conservation exemption rules, allows an estate to take a deduction for qualified conservation easements donated to a qualified charitable organization. The qualifying conservation purposes for a real property interest follow the rules of Section 170(h).[126] In effect, the irrevocable transfer described in 2055 represents the post-mortem alternative to an *inter vivos* donation under Section 170. Interestingly, the allowance of a post-mortem transfer links back to Section 2031(c)(9), which allows a deduction for a qualified conservation easement granted after the decedent's death but before the due date for the tax return filing deadline of 2001.[127] However, the deduction cannot be taken if any charitable deduction is allowed to any person with regard to the conservation real estate being transferred.[128] At first glance, it seems counterintuitive that a testator should be able to "double count" estate tax reductions by taking the 2031(c)(8) exclusion and also the 2055(f) deduction for the same conservation easement transfer. But the IRC does not preclude this double counting, and the IRS has shown a willingness to allow a double-counting estate strategy.[129]

[121] I.R.C. § 170(h)(4)(A).
[122] Treas. Reg. § 1.170A-1(c)(1).
[123] *Conservation Easement Audit Techniques,* INTERNAL REVENUE SERV. (Jan. 3, 2012) (requiring a full appraisal when a charitable deduction is valued at $500,000 or more).
[124] *Id.*
[125] I.R.C. § 170(b)(1)(H).
[126] *See* I.R.C. § 170(h).
[127] I.R.C. § 2031(c)(9).
[128] *Id.*
[129] I.R.S. Priv. Ltr. Rul. 200143011 (July 25, 2001) (Concluding that, "Decedent's estate may claim a deduction under § 2055(f) for the value of the conservation easement attributable to the 68.8% tenancy in

The benefits of the post-mortem donation of a conservation easement are two-fold. First, while the exclusion rule has a relatively low cap on the value of property excluded from the taxable estate, there is no statutory cap on the amount of deduction allowed for the decedent's estate.[130] Due to this unlimited contribution amount, in many ways the post-mortem 2055 deduction offers one of the most powerful estate planning tools for decedents with large land portfolios. Second, conservation easements offer landowners flexibility in allowing beneficiaries to use property even after donation. Especially in more remote locations, easements may see little public foot traffic or recreational use, giving donors semi-private access to the land after donation. Additionally, even after donation, beneficiaries may be able to use the land for personal-use activities such as farming, equestrian, and other non-development activities allowed by the trust holder.

C. Abuses Abound

A consistent pattern of tax evasion is clearly discernible in the use of syndicated conservation easement structures. The complicated structure of the syndicated conservation easement transaction is the basis for passing off the transaction as permissible. In a syndicated conservation easement, a promoter offers investors the opportunity to take a charitable contribution deduction from donation of a conservation easement by investing in a pass-through entity, often a partnership.[131] A promoter will first flag a pass-through entity that has real property holdings or, alternatively, form a new pass-through entity that will purchase real property.[132] Next, the promoter will syndicate ownership in the passthrough holding company, soliciting investors by promising a pro rata charitable deduction equal to or exceeding the initial seed money invested.[133] Following the fundraising stage, the promoter will contract for an appraisal that simultaneously succeeds as a qualified appraisal under Section 170(f)(11)(E)(i) and inflates the value of the qualifying conservation property by relying on irrational assumptions about the property's development potential.[134] After the investment and appraisal stages, the pass-through entity will donate a conservation easement attached to the property to a tax-exempt entity.[135] Under Section 170(e)(1)(A), investors who held an interest in the passthrough prior to the transfer, even if held for under one year, will be able to rely on the passthrough entity's holding period in the property and treat the conservation easement donation as long-term capital gain property.[136] The investors emerge from the transaction with a long-term capital deduction under Section 170(b)(E)(i), and the promoter is compensated through either a fee or ownership structure.[137]

---

common interest includible in Decedent's gross estate, notwithstanding that A and B will claim a deduction under § 170(h) for the conservation easement granted with respect to the interests in Property they owned.").

[130] I.R.C. § 2055(d).

[131] I.R.S. Notice 2017-10 (Jan. 1, 2017).

[132] *Id.*

[133] *Id.*

[134] *Id.*

[135] *Id.*

[136] I.R.C. § 170(e)(1)(A).

[137] I.R.C. § 170(b)(E)(i).

Increasing use of syndicated conservation easements has exposed serious cracks in the administration of conservation donation deductions. First, the use of passthrough interests to manipulate and inflate the value of deductions taken for a single piece of donated real property undermines the spirit of the conservation easement laws. Instead of setting aside valuable natural land in return for a fair deduction, promoters are turning water into wine by "saving" targeted natural land from property development. Investors in the syndicated passthrough entities also expose an inconsistency in the IRC. If a syndicated interest is respected, the investors are not only getting a deduction, but are also getting long-term capital treatment under Section 170 despite failing to hold the investment for greater than one year. On the other hand, a decedent, or family member of a decedent, who fails to hold land for at least the three-year period ending with the decedent's death cannot qualify for a deduction under the 2055(f) conservation easement donation rules.[138] In effect, because only living investors are able to take action to skirt the three-year holding requirement, there is little incentive to die with natural land and donate post-mortem. The inconsistency in the IRC will only continue to deteriorate the system envisioned by the IRC drafters.

Fortunately, the IRS has taken increasingly serious steps to monitor abuse of the conservation easement donation system and weed out future manipulation. In 2004, the IRS issued a memorandum alerting taxpayers that syndicated conservation easements were being scrutinized for potential improper claims of charitable deductions.[139] The notice also cited possible imposition of penalties for both investors and promoters.[140] On the investor side, the IRS threatened penalties for accuracy-related underpayment and excess benefit under Section 6662 and Section 4958.[141] On the promoter side, the IRS threatened penalties for promotion of tax shelters, aiding and abetting underpayment of taxes, and understatement of a taxpayer's liability by a tax return preparer under Sections 6700, 6701, and 6694.[142] Unfortunately, the threat of penalty did little to stem the wave of improper charitable deductions being taken by investors in syndicated arrangements.[143] In the years following identification of the problem, the use of syndicated conservation easements expanded, and the IRS took more concrete steps to attack these transactions.[144]

In 2017, the IRS issued Notice 2017-10, which targeted syndicated conservation easements as reportable, listed tax avoidance transactions for purposes of Treas. Reg. 1.6011-4(b)(2) and Sections 6111 and 6112.[145] By making syndicated conservation easement transactions a listed transaction, the IRS also made these transactions reportable within 180 days and also subject to list maintenance obligations.[146] Most importantly, following Notice 2017-10, participants of syndicated conservation easement transactions who were required, and failed, to disclose these transactions were now subject to penalty

[138] I.R.C. § 2031(c)(8)(A)(ii).
[139] I.R.S. Notice 2004-41(July 7, 2004).
[140] *Id.*
[141] *Id.* at 32.
[142] *Id.*
[143] I.R.S. Notice 2017-10 (Jan. 1, 2017).
[144] *Id.*
[145] *Id.*
[146] I.R.C. §§ 6111, 6112.

under IRC 6707A.[147] The crackdown on these transactions continued to expand in the following two years through joint IRS and Department of Justice (DOJ) actions. In December 2018, the DOJ filed a complaint to prevent promoters from organizing, promoting, or selling abusive syndicated conservation easement transactions.[148] In 2019, the IRS announced an increase in enforcement actions for syndicated conservation easement transactions and a shift to make this type of transaction a priority compliance area for the agency.[149]

Following the crackdown on syndicated conservation easement transactions from 2017 to 2020, taxpayers have sought relief from IRS penalties through Tax Court hearings.[150] And although the cases are ongoing, the Tax Court has shown a preference for IRS enforcement and imposition of penalties in the syndicated conservation easement transaction cases.[151] The IRS enforcement measures and subsequent litigation culminated in a time-limited settlement offer by the IRS for taxpayers involved in syndicated conservation easement transactions.[152] The settlement letter mailed to taxpayers confirmed the IRS's commitment to the important role that conservation easement deductions play in motivating conservation of natural land. Addressing the settlement offer, Commissioner Chuck Rettig noted,

> The IRS will continue to actively identify, audit and litigate these syndicated conservation easement deals as part of its vigorous and relentless effort to combat abusive transactions. These abusive transactions undermine the public's trust in private land conservation and defraud the government of revenue. Ending these abusive schemes remains a top priority for the IRS.[153]

The syndicated conservation easement settlement offer contained four key terms for taxpayers.[154] First, any deduction for the involved contributed easement will be denied in full.[155] Second, all passthrough partners must agree to settle, and the partnership must pay the full amount of tax, penalties, and interest prior to settlement.[156] Third, investors in the promoted passthrough are allowed to deduct the cost of acquiring the partnership interest and would pay a reduced 10-20% penalty depending on the ratio of deduction claimed to investment buy-in cost.[157] Finally, the partners who provided services in connection with any syndicated conservation easement transaction must pay the maximum penalty, which

---

[147] I.R.C. § 6707A.
[148] I.R.S. News Release IR-2019-182 (Nov. 12, 2019).
[149] *Id*.
[150] *See TOT Property Holdings, LLC v. Comm'r*, 2020 WL 3576874 (C.A.11) (Appellate Brief) (citing the Tax Court's holding sustaining in its entirety the IRS's determination that all tax benefits from a syndicated conservation easement transaction should be denied and that the 40% gross valuation misstatement and negligence penalties were applicable).
[151] *Id*.
[152] I.R.S. News Release IR-2020-130 (Jun. 25, 2020).
[153] *Id.*
[154] *Id.*
[155] *Id.*
[156] *Id.*
[157] *Id.*

is currently 40%, with no deduction for costs.[158] The IRS's 2020 settlement offer and news release notes that taxpayers should not expect a more favorable settlement from their individual Tax Court cases than the 2020 blanket settlement offers.[159] The IRS has used the 2020 settlement offer to quash any remaining hope of using syndicated conservation easement deductions or receiving favorable outcomes in ongoing litigation. Chief Counsel Michael J. Desmond stated,

> With this announcement, we encourage taxpayers and their advisors to take a hard, realistic look at their cases. They should carefully review this settlement offer. We believe this is clearly the best option for them to pursue given all of these factors. Those who choose not to accept the offer should keep in mind the Office of Chief Counsel will continue to vigorously litigate their cases to the fullest extent possible.[160]

The strong stance taken by the Commissioner and the Chief Counsel has swiftly swayed investors into cooperation with the IRS. On August 31, 2020, the IRS announced the first syndicated conservation easement settlement under the 2020 blanket settlement offer.[161] According to the IRS announcement, "Coal Property Holdings, LLC and its partners agreed to a disallowance of the entire $155 million charitable contribution deduction claimed for an easement placed on a 3,700-acre tract of land in Tennessee."[162] Under the settlement terms, the investing partners were allowed to deduct the cost of investing in the easement transactions and paid a 10% penalty, while the promoting partner was denied a deduction and paid a larger 40% penalty.[163] The Coal Property settlement shows that the IRS 2020 blanket settlement offer is likely to yield strong results in moving investor tax compliance and penalties forward. Given this progress, it is clear that conservation is an area in which the government has been unwilling to yield the social goal-focused tax policy in favor of tax breaks.

While slow, the IRS response to abuse in the conservation donation space has been targeted and relentless. The slow progression of enforcement, from identification of the tax abuse, to taxpayer warnings, to development of a penalty regime, and finally to the offer of settlements with taxpayers, has set an example for enforcement of socially beneficial tax policies. In this author's view, targeted IRS efforts to police syndicated conservation easement transactions shows that when there is agency will to attack certain transaction types, the IRS can and will impose compliance on taxpayers. Unlike in the case of QOZs, with conservation easements, the IRC laid out strict guidelines for compliance that the IRS was able to leverage in enforcement processes.[164] Moreover, cooperation between the IRS and the DOJ allowed for a two-front war, with the IRS pursuing abusive taxpayers and the

---

158 *Id.*
159 *Id.*
160 *Id.*
161 I.R.S. News release IR-2020-196 (Aug. 31, 2020), https://www.irs.gov/newsroom/settlements-begin-in-syndicated-conservation-easement-transaction-initiative#:~:text=On%20June%2025%2C%202020%2C%20the,abusive%20syndicated%20conservation%20easement%20transactions.&text=These%20transactions%20undermine%20the%20public's,in%20tax%20compliance%20in%20general.
162 *Id.*
163 *Id.*
164 I.R.S. Notice 2007-50 (Dec. 10, 2007), https://www.irs.gov/irb/2007-50_IRB.

DOJ prosecuting opportunistic promoters and investment professionals. Due to these efforts, the tax exemptions and deductions allowed for natural land set aside through the use of conservation easements will accomplish conservation and wildlife preservation goals they were intended to promote. In other words, a combination of effective tax policy planning and enforcement accomplished an important social goal.

Efforts to protect the natural environment through tax incentives do not end with conservation easement tax breaks. Another powerful policymaking tool in the conservation space is the special agricultural appraisal. Adding to the umbrella of environmental protection programs, special agricultural appraisals work to improve food security and wildlife conservation at the state level.

III. STRATEGY III: SPECIAL AGRICULTURAL APPRAISALS

Maintaining high levels of domestic food production addresses national security concerns of food scarcity in situations of a breakdown in global supply chains due to war, pandemic, or other natural disaster. A complex legislative framework has been created to support and incentivize food security initiatives and boost agricultural production.[165] Domestic and global food security are top priorities for the United States federal government.[166] Promoting food security at home and abroad ensures a steady food supply for Americans and helps to push forward foreign policy goals. The United States has long used global food security programs as a foreign policy tool.[167] Through Foreign Agricultural Service programs like the Food for Progress initiative, the Emerging Markets Program, and the McGovern-Dole Food for Education Program, the United States government addresses international food needs while also building international relations.[168] Similarly, the Global Food Security Act of 2016 makes agricultural-led economic growth, nutritional health, and food production capacity a national policy priority by directing the President "to develop and implement a Global Food Security Strategy to promote global food security, resilience, and nutrition."[169] Most recently, in 2020, the COVID-19 pandemic exposed vulnerabilities of the United States food supply, with labor shortages and supply chain disruptions impacting local food markets.[170]

Many government incentive programs keep human capital and investment capital flowing into agricultural resources. These incentive programs include crop insurance, cost sharing, agricultural management assistance, disaster relief, excess food purchase programs, and emergency watershed protection.[171] All of these programs are meant to keep

[165] *See* Kimberly Flowers, *U.S. Policy Roadmap: A Drive to Transform Global Food and Nutrition Security*, CTR. FOR STRATEGIC & INT'L STUD. (Jan. 4, 2019), https://www.csis.org/analysis/us-policy-roadmap-drive-transform-global-food-and-nutrition-security.
[166] *Id.*
[167] *A Short History of U.S. International Food Assistance*, U.S. DEP'T OF STATE (2020), https://2009-2017.state.gov/p/eur/ci/it/milanexpo2015/c67068.htm.
[168] *Programs*, U.S. DEP'T OF AGRICULTURE FOREIGN AGRICULTURAL SERV. (2020), https://www.fas.usda.gov/programs.
[169] H.R. 1567, 114th Cong. § 2 (2016).
[170] Chris J. Macias, *Is the Food Supply Strong Enough to Weather COVID-19*, U.C. Davis (June 25, 2020), https://www.ucdavis.edu/food/news/is-food-supply-strong-enough-to-weather-covid-19-pandemic.
[171] *Small and Mid-Sized Farmer Resources*, U.S. DEP'T OF AGRICULTURE (2020), https://www.usda.gov/topics/farming/resources-small-and-mid-sized-farmers.

farmers farming and attract investment money to farm and ranch food production. Both the federal government and state governments have used their respective tax codes to provide special business tax breaks to farms.[172] For example, agricultural companies can postpone gains on the sale of excess production of livestock under agricultural-specific involuntary converted property rules.[173]

Similarly, a number of agriculture-related tax breaks benefit wealthy individuals in crafting a long-term estate or wealth planning strategy. One tool available for ultra-high-net-worth estate planning is the special agricultural appraisal. As noted, one goal of agricultural tax breaks is to increase domestic agricultural production and to improve investment interest in the agriculture industry. However, the special agricultural appraisal, like many social goal-focused tax programs, has been a hotspot for abuse when used in estate planning. The below analysis of the Texas special appraisal shows that the special agricultural appraisal tax breaks for farmland and ranchland does not necessarily achieve the food security social goal which underlies this tax policy. It is important to note that the special agricultural appraisal is a program administered at the state level.[174] Therefore, while the analysis of the QOZ program and conservation easement tax program focused on federal tax law, the following discussion centers around Texas state law.

A. The Role of the Special Agricultural Appraisal

An analysis of special agricultural appraisals centers on the question of whether the estate planning exemption adds value to the government's arsenal of strategies to ensure national food security. Historically, estate tax scholars studying agriculture mainly focused on how to effectively use farm corporations for wealth transfer.[175] Today, one of the most controversial topics in agricultural estate planning is the exploitation of the special agricultural appraisal by non-farmer, non-rancher, hobby farmers. These hobby farmers, wealthy individuals who exploit agriculture tax provisions in their estate plans, frequently provide no reciprocal return to the society at large through meaningful agricultural production and thus unfairly cheat the state out of property tax.

The special agricultural appraisal is a product of the state property tax system. Generally, a real estate appraisal is an expert opinion on the market value of a piece of land or developed property.[176] Accurate appraisals are critical to revenue collection at the state level, as state or local property taxes are levied based on the fair market value of

---

172 *See Publication 225 (2020), Farmer's Tax Guide*, INTERNAL REVENUE SERV., https://www.irs.gov/publications/p225#en_US_2019_publink1000218664; *Sale & Use Tax Exemptions*, CAL. DEP'T OF TAX AND FEE ADMIN., https://www.cdtfa.ca.gov/taxes-and-fees/sales-and-use-tax-exemptions.htm.

173 *Id*.

174 *See* TEX. TAX CODE § 23.51(1).

175 *See* Donald H. Kelley, *The Farm Corporation as an Estate Planning Device*, 54 NEB. L. REV. 217, 221 (1975) (examining the ways in which incorporation of farm estates can help to achieve basic estate planning objectives); James K. Logan, *Estate Planning: The Special Problems of the Farmer in Dispositions by Will*, 32 ROCKY MNTN. L. REV. 329, 329-30 (1960) (concentrating on the estate planning problems, for example liquidity concerns, inherent to disposition by will of farm or ranch businesses).

176 *Understanding the Appraisal*, APPRAISAL INST. (2013), https://www.appraisalinstitute.org/assets/1/7/understand_appraisal_1109_(1).pdf.

property.[177] In many states, the state government directs local appraisal districts to appraise the value of property in that geographic region.[178] For example, in Texas, each county has appraisal districts containing professional appraisers under the direction of a chief appraiser.[179] Disputed appraisals are subject to review by local appraisal review boards, comprised of a board of local citizens who hear disagreements.[180] A statewide government agency, the Comptroller's Property Tax Assistance Division (PTAD), monitors all local appraisals.[181] The agency also conducts annual tax collection predictions and performs oversight.[182] Some states, including Texas, offer special agricultural appraisals to landowners that use the land for socially positive agricultural activity.[183] By issuing a lower appraisal on a farmer's land, the state is giving the farmer a break on their annual property tax bill.

It is important to recognize that there are safeguards in the IRC that serve to protect against abuse by pseudo-farmers and wealthy individuals who approach farming as a hobby and unfairly reap farming tax breaks. For example, returning to the use of conservation easement deductions, qualified farmers and ranchers are eligible for a significantly higher deduction than the general public when contributing property used in agriculture or livestock production.[184] Under Section 170(b)(1)(E), a qualified farmer or rancher is allowed a qualified conservation contribution to the extent the aggregate of the contributions does not exceed 100%, as opposed to 50% for non-farmer taxpayers, of the taxpayer's contribution base over all other charitable contributions allowed under that section.[185] However, the IRC also lays out specific criteria for persons who qualify as farmers or ranchers, providing a safeguard against wealthy individuals looking to increase their conservation easement deductions.[186] To be considered a "qualified farmer or rancher" for the purposes of Section 170, the taxpayer's gross income from farming must exceed 50% of total annual gross income.[187] Using a gross income check, the government can bypass individuals who derive the majority of their gross income from other means besides farming and protect the integrity of the conservation easement benefits for genuine career farmers and ranchers.

B. The Failure of the Special Agricultural Appraisal

Loopholes abound in the world of special agricultural appraisals, creating a mismatch between tax breaks taken and social goals achieved. Given the breadth of eligible

---

[177] *Property Tax System Basics*, TEX. COMPTROLLER OF PUB. ACCOUNTS (2020), https://comptroller.texas.gov/taxes/property-tax/basics.php.
[178] *Id.*
[179] Glenn Hegar, *Property Tax System Basics*, TEX. COMPTROLLER OF PUB. ACCOUNTS (2020), https://comptroller.texas.gov/taxes/property-tax/basics.php.
[180] *Id.*
[181] *Id.*
[182] *Id.*
[183] *Agricultural and Timber Exemptions*, TEX. COMPTROLLER OF PUB. ACCOUNTS (2020), https://comptroller.texas.gov/taxes/ag-timber/#:~:text=All%20purchasers%2C%20including%20non%2DTexas,to%20retailers%20on%20your%20purchases.
[184] I.R.C. § 170(b)(1)(E)(iv).
[185] I.R.C. §§ 170(b)(1)(E)(i), 170(b)(1)(E)(iv).
[186] I.R.C. § 170(b)(1)(E)(v).
[187] *Id.*

agriculture activities that qualify land for special agriculture appraisal, as well as the subjective and pliable nature of the use and intensity tests, special appraisal is an area ripe for estate planning manipulation.

For wealthy individuals with sound state and local tax (SALT) advice, agricultural land presents a unique holding vessel for wealth transfer. For a traditional farmer or rancher, the income from agricultural operations is traditionally the only business case for operating, especially if the land is leased. Quite the opposite for an individual with a large estate portfolio, the income from agricultural operations is often an afterthought. Crop production and husbandry are fickle businesses subject to risks like poor weather conditions, health pandemics, and wildfire.[188] On the other hand, land appreciation, especially near major cities, is much more dependable.[189] For example, Iowa State researchers found that land values increased a healthy 6.7% annually from 1970 to 2009.[190] For the same period, the S&P 500 returned 9.3% with dividends reinvested.[191] At first glance, a wealth manager might frown on the 2.6% discrepancy in return on investment between these investment vehicles. However, agricultural land appreciation is just one piece of the complicated estate planning puzzle. Apart from agricultural operations income and the benefits of portfolio diversification that individuals receive from agricultural land, the special appraisal provides a huge boon to return on investment by dramatically reducing the property tax burden that usually diminishes the value of real property ownership. Additionally, through the use of various types of trusts, agricultural land can be passed to future generations outside of probate.[192] Similar to the use of an IDGT with QOF property, wealthy individuals can shoulder the tax burden of farmland or ranchland while still passing enjoyment of the corpus to future generations outside of the probate process.

The special appraisal has historically enraged the media, with examples of celebrity property owners accessing the special appraisal, which have illustrated the huge tax windfalls that wealthy individuals can receive by investing in agricultural property. For instance, in the late-2000s, Michael Dell, billionaire founder of Dell Technologies, was scrutinized for receiving tax breaks on his suburban ranchland outside of Austin, Texas.[193] By periodically hunting and managing a deer herd on his ranch, Dell reportedly reduced the 2005 fair market value of his ranch to an agricultural value of $290,000.[194] This saved Dell an estimated $1.2 million a year in Texas state property taxes.[195] Similarly, in the 1980s, the Washington Post highlighted President Ronald Reagan for receiving a special

---

[188] Joy R. Harwood, Richard Heifner, Keith H. Coble, Janet Perry & Agapi Somwaru, *Managing Risk in Farming: Concepts, Research and Analysis*, U.S. DEP'T OF AGRICULTURE (March 1999), https://www.ers.usda.gov/publications/pub-details/?pubid=40971.

[189] Morris A. Davis & Michael G. Palumbo, *The Price of Residential Land in Large U.S. Cities* (Fed. Rsrv. Bd., Working Paper), https://www.federalreserve.gov/pubs/feds/2006/200625/200625pap.pdf.

[190] *Returns to Farmland Ownership*, Iowa State U. Extension and Outreach (May 2010), https://www.extension.iastate.edu/agdm/articles/edwards/EdwJune18.html.

[191] *S&P 500 Return Calculator, With Dividend Reinvestment*, DQYDJ (June 16, 2020), https://dqydj.com/sp-500-return-calculator/.

[192] *The Probate Process*, AM. BAR ASS'N (2020), https://www.americanbar.org/groups/real_property_trust_estate/resources/estate_planning/the_probate_process/.

[193] Yasha Levine, *This Tax Day, 'Farms' Owned by the Rich Provide Massive Tax Shelter* (Apr. 14, 2011), https://www.thenation.com/article/archive/tax-day-farms-owned-rich-provide-massive-tax-shelter/.

[194] *Id.*

[195] *Id.*

appraisal on his ranchland near Santa Barbara, California.[196] Reportedly, President Reagan received the special appraisal due to his grazing 22 head of cattle on the approximately 688-acre ranch.[197] With a 1980 fair market value between $1 million and $2 million, the property tax on the property should have been about $42,000 per year.[198] Instead, in 1980, President Regan paid $862 in California state property tax.[199]

Despite public uproar at some of the special appraisals taken by celebrities, the only consideration for tax legislators should be whether the tax breaks made progress toward the policy and social goals underlying the program. Unfortunately, it seems that the lax rules for qualifying land as farmland, ranchland, or wildlife conservation land have given huge tax breaks to wealthy individuals without improving social goals like national food security, wildlife conservation, or preservation of farmland and timberland. While the "principal or primary use" requirement aims to prevent property from being used for a non-agricultural use, it does not guard against investment as the primary function. Michael Dell is not keeping a small herd of deer on his ranch to preserve the land or save the animals; rather, he is using the ranch as a special purpose vehicle for a small fortune worth $71 million. In fact, white-tailed deer are considered a nuisance that requires population control in Texas.[200] Additionally, a "degree of intensity test" is meant to hold property owners to operational standards of the region in which they reside. However, that system is clearly flawed when landowners, like President Reagan or Michael Dell, can hold twenty-two head of cattle or a small herd of deer on an enormous ranch and still qualify for special appraisal. While difficult to quantify, it seems that individuals are getting an outsized tax break that could better be used by state governments for direct investment. In Dell's case, the government's lost tax revenue of roughly $1 million per year would allow the government to purchase Dell's entire ranch within 70 years.[201] Instead, the Dell family will hold the appreciating ranch property for generations with minimal tax burden.

The only way to remedy the imbalance between tax breaks taken and social goal-focused tax policy is to impose tighter qualifications on land eligible for special appraisal. In Texas, and among other state special appraisal programs, the principal use and intensity requirements are vague and subject to political dealing.[202] The near impossibility of objective review of applications received by each county's chief appraiser[203] under these tests has the potential to lead to manipulation of the special appraisal rules by local government officials and wealthy landowners.

To illustrate, it is helpful to look at a case where not only individuals, but also closely held companies, have successfully received special appraisals to lower their tax burdens.

---

[196] Lou Cannon, *Reagan's Ranch a Retreat, Tax Shelter -- and Security Risk*, THE WASH. POST (July 5, 1980), https://www.washingtonpost.com/archive/politics/1980/07/05/reagans-ranch-a-retreat-tax-shelter-and-security-risk/21a64428-60f7-4dac-8603-6b297ab0ad44/.
[197] *Id.*
[198] *Id.*
[199] *Id.*
[200] *Overabundant Deer*, TEX. PARKS & WILDLIFE (2020), https://tpwd.texas.gov/huntwild/wild/game_management/overabundant_deer/.
[201] *Id.*
[202] TEX. TAX CODE § 23.51(1); Tax § 23.51(1) (West).
[203] *A Message from the Chief Appraiser*, Harris Cnty. Appraisal Dist. (2020), https://hcad.org/about/message-from-hcad-chief-appraiser/.

For example, from 2007-2009, SA Real Estate, owner of a PGA Tour golf resort in San Antonio, Texas, received a wildlife management valuation worth $17 million in past and future tax savings after claiming the golf course provided a wildlife refuge for indigenous birds and deer in the region.[204] Later, in 2009, the Bexar Appraisal District attempted to impose a "rollback tax" on the golf course owner, saying the land did not meet the statutory requirements of a wildlife refuge.[205] The dispute was seemingly fueled, at least in part, by anger among local government officials at "double dipping" by SA Real Estate, which also received a tax break in 2005 through the PGA Tour's tax deal with the city of San Antonio.[206] The SA Real Estate dispute has shown how special appraisal approvals for individuals or companies can become embroiled in local politics. States that are genuinely interested in providing efficient tax breaks that improve land preservation and wildlife conservation should tighten their regulations and improve oversight.

C. State-Based Agricultural Code: Texas as a Model

Texas provides one of the most well-known and expansive programs for special agricultural appraisal. The valuation of farmland and ranchland in Texas demonstrates the ease of accessing agricultural tax breaks that can be used in an ultra-high-net-worth estate planning strategy and the pitfalls of these incentive programs in the scope of long-term social goals.

Texas legislators created the first state agricultural appraisal law in response to an expansion of urban development and a decrease in the amount of farm and ranch land in the 1960s.[207] Prior to 1966, Texas farms and ranches were appraised at their fair market value.[208] However, as land became relatively more scarce given urbanization, farmers and ranchers were subject to increased tax burdens because even if their land was never intended for development, the mere fact that it could be developed made it more valuable in the eyes of the state.[209] In 1966, legislators amended the Texas Constitution to include Section 1-d, Article VIII, which provides that farmland should be "appraised at its value based on the land's capacity to produce agricultural products," rather than at fair market value.[210] This provision was later expanded to provide more comprehensive coverage for farmland and ranchland.[211] In 1978, the addition of Section 1-d-1 created an avenue for open-space land and timberland to receive special productivity valuations.[212] Importantly,

---

[204] Karisa King, *PGA resort fights for another tax break*, SAN ANTONIO EXPRESS-NEWS (Sept. 12, 2009), https://www.mysanantonio.com/business/local/article/PGA-resort-fights-for-another-tax-break-847801.php.
[205] *Id.*
[206] John W. Gonzalez, *San Antonio Proceeds with PGA resort talks*, HOUS. CHRON. (Jan. 22, 2002), https://www.chron.com/news/houston-texas/article/San-Antonio-proceeds-with-PGA-resort-talks-2065806.php; King, *supra* note 204.
[207] GLENN HEGAR, TEX. COMPTROLLER OF PUB. ACCOUNTS, MANUAL FOR THE APPRAISAL OF AGRICULTURAL LAND, 1 (Nov. 2018; adopted May 2019).
[208] *Id.*
[209] *Id.*
[210] Tex. H.J.R. 79, 59th Reg. Sess. (1965); TEX. TAX CODE § 23.41(a).
[211] Tex. H.J.R. 1, 65th 2nd Called Sess. (1978).
[212] *Id.*

the 1978 amendment also allowed productivity valuations for corporations in addition to non-corporate persons.[213] This expansion of the Texas special appraisal regime peaked in 1995, when legislators amended the Texas Constitution to allow agricultural appraisal for land used in the management and conservation of wildlife.[214] The dramatic expansion of land eligible for special appraisal has been accompanied by statutorily mandated oversight, including development of procedures and requirements, by the Texas Comptroller of Public Accounts (Comptroller).

Under the Texas Tax Code (TTC), the Comptroller is directed to "promulgate rules specifying the methods to apply and the procedures to use in appraising land designated for agricultural use."[215] To carry out this mission, the Comptroller is required to create and update a "Manual for the Appraisal of Agricultural Land" (Manual) for the evaluation of 1-d-1 eligible property.[216] The special appraisal rules laid out by the Comptroller for farmland, timberland, and wildlife conservation land have, in general, received highly deferential treatment in Texas state court decisions.[217] Because of the hands-off approach taken by Texas state courts, it is relatively easy to qualify land for special agricultural appraisal under the five broad eligibility requirements provided by the TTC under 1-d-1.

1. Land and Appurtenances

First, the agricultural appraisal may only apply to land and appurtenances.[218] Property owners may not receive a special appraisal for land improvements, minerals underlying the property, or agricultural products of the land.[219] While the exclusionary rule seems comprehensive at first glance, the definition of "appurtenances" given by the Comptroller is highly inclusive of man-made and natural non-land components that can receive favorable appraisal. According to the Manual, appurtenances that qualify for special appraisal include, "private roads, dams, reservoirs, water wells, canals, ditches, terraces and other similar reshapings of the soil (such as stock tanks); fences; riparian water rights; and decorative trees, windbreaks, fruit trees or nut trees."[220] Additionally, while water well pumps and windmills are separately valued, "The landowner's right to use natural bodies of water adjoining the land are appurtenances and included in the special

---

[213] *Id.*

[214] Tex. H.J.R. 72, 74th Reg. Sess. (1995).

[215] TEX. TAX CODE § 23.41(b).

[216] TEX. TAX CODE § 23.52(d); HEGAR, *supra* note 207.

[217] *See* Tarrant Appraisal Dist. v. Moore, 845 S.W.2d 820, 821, 823 (Tex. 1993) (noting that the Texas Constitution allows the legislature to place limitations on open-space land and that the special appraisal guide has been used in creating Texas case law); Kerr Cent. Appraisal Dist. v. Stacy, 775 S.W.2d 739, 741–42 (Tex. App.-San Antonio 1989, writ denied) (upholding trial court's decision granting open-space exemption based on the1988 Agricultural Land Appraisal Manual); Bower v. Edwards Cty. Appraisal Dist., 697 S.W.2d 528, 530 (Tex. App.-San Antonio 1985, no writ) (using definitions from the State Property Tax Board Guidelines for the Valuation of Agricultural Land is a proper basis for jury charge). *But see* Riess v. Appraisal Dist. Of Williamson Cty., 735 S.W.2d 633, 637–38 (Tex. App.-Austin 1987, writ denied) (determining the State Property Tax Board rule is invalid when it is inconsistent with Section 23.51, which defines "qualified open-space land").

[218] TEX. TAX CODE § 23.51(1).

[219] TEX. TAX CODE §§ 11.16, 11.161, 23.51 and 23.52.

[220] HEGAR, *supra* note 207, at 6; TEX. TAX CODE § 23.51(1).

appraisal of the land."[221] In other words, almost any man-made or natural structure, other than building improvements, minerals, and agricultural products, will qualify for special agricultural appraisal along with the farmland, timberland, or wildlife conservation land.

2. Current and Principal Use

The second eligibility requirement mandates the property to pass the "current and principal agricultural use" test.[222] This test ensures that the land is currently devoted principally to a qualified use to a degree generally accepted in the area.[223] Under Section 1-d-1, agricultural uses included cultivating soil and producing crops for human or animal consumption, floriculture, viticulture, horticulture, raising or keeping livestock, raising or keeping exotic animals for product production, planting cover crops or leaving land open for crop rotation, producing or harvesting timber, wildlife management, and raising or keeping bees for production of human-consumed products.[224] Importantly, this is a non-exhaustive list, as the TTC provides that an agricultural use "includes but is not limited to" these activities.[225]

The significant breadth of activities allowed under the "current and principal agricultural use" requirement today is built upon a history of broad interpretation of agriculture activity in Texas. The Supreme Court of Texas broadly interpreted the term "agriculture" many years before the drafters used the term for the purposes of special agricultural appraisals.[226] In the years following the 1966 codification of the special agricultural appraisal, the Texas Attorney General (TAG) confirmed this broad interpretation of "agriculture" in a series of relevant holdings.[227] In 1974, the TAG confirmed that the threshold question for agricultural activity is whether the activity included any form of "production."[228] In 1983, the TAG ruled that mariculture, a specialized branch of aquaculture that includes farming marine organisms in the open ocean, and the land used for aquatic organism production, qualify for special agricultural appraisal because of the role of production in these activities.[229] Production of aquatic organisms, as opposed to capture of aquatic organisms, was the key to this holding.[230] A highly inclusive definition of agricultural activity results from these court cases and TAG holdings.

---

[221] HEGAR, *supra* note 207, at 6; TEX. TAX CODE § 23.51(1).
[222] TEX. TAX CODE § 23.51(1).
[223] *Id.*
[224] TEX. TAX CODE § 23.51(2).
[225] *Id.*
[226] Gordon v. Buster, 257 S.W. 220, 221 (Tex. 1923) ("The art or science of cultivating the ground, including harvesting of crops and rearing and management of livestock; husbandry; farming; in a broader sense, the science and art of the production of plants and animals useful to man.").
[227] Op. Tex. Att'y Gen. JH-0272 (1974) ("'agriculture' was intended to mean, in addition to the cultivation and harvesting of crops (its narrow definition), the science and art of production of plants and animals useful to man").
[228] *Id.*
[229] Op. Tex. Att'y Gen. JM-087 (1983) ("To the extent that 'mariculture' consists of cultivation or production, we believe that it is included within the meaning of 'agriculture' for purposes of section 23.42. To the extent that 'harvesting' consists of the mere capture of animal life. we believe it is not within the meaning of 'agriculture.'").
[230] *Id.* at 369.

The expansion of Section 1-d-1 to include wildlife management land created an even wider net for getting property qualified for special agricultural appraisal.[231] Landowners can qualify for special agriculture appraisal for land used for wildlife management if the property is actively used for one of three conservation activities.[232] First, landowners may qualify if their property is qualified open-space land or timberland under TTC Chapter 24, Subchapter E, and has received special appraisal under that section at the time that wildlife management started to support breeding or migrating indigenous wild animals for human use as food, medicine, or recreation in at least three statutory methods. The statute provides a list of activities that qualify for support of wild animals: habitat control, erosion control, predator control, supplemental water supply storage, supplemental food supply storage, shelter creation, or wild animal population monitoring.[233] Second, the land may qualify if it is being actively used to protect endangered species listed under federal law, and is either (1) located within a habitat preserve and subject to a conservation easement under the Texas Natural Resources Code Chapter 183 or (2) part of a federally-approved conservation plan.[234] Finally, the property may qualify for special appraisal if the land is actively used for conservation and restoration projects that compensate for natural resource damage under federal environmental laws.[235] The wildlife conservation provisions in the TTC dramatically expand the opportunities for a landowner to qualify for a special agricultural appraisal.

3. Devoted to Agricultural Use

The third eligibility requirement focuses on the use of the property. In order to qualify for agricultural appraisal, the land must be "devoted principally to agricultural use."[236] A property may be multi-use, but the primary use has to be agricultural in nature.[237] The Supreme Court of Texas addressed the "principal or primary use" requirement in reversing a state court of appeals decision that allowed a special appraisal for a landowner using their property for recreational horseback riding.[238] Landowners brought suit challenging the appraisal district's and appraisal review board's denial of the "open-space land" designation for the landowner's property. The court held that use of land "principally for recreational purposes, or as a hobby" does not qualify as agricultural use, and therefore the landowner should not receive a special appraisal.[239] In the opinion, the court indicates that land used principally for "raising, breeding, and/or grazing horses" and for other uses primarily for

[231] TEX. TAX CODE §§ 23.51(1), (2), (7), 23.521; 34 TEX. ADMIN. CODE 9.2001-9.2005.
[232] TEX. NAT. RES. CODE § 183.001.
[233] HEGAR, *supra* note 207, at 6–7.
[234] *Id.*; TEX. NAT. RES. CODE § 183.001.
[235] Conservation and restoration programs may qualify under federal and state laws including the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (42 U.S.C. §§ 9601-9675), the Oil Pollution Act of 1990 (33 U.S.C. §§ 2701-2762.), the Federal Water Pollution Control Act (33 U.S.C. §§ 1251-1370), and TEX. NAT. RES. CODE, Chapter 40; Hegar, *supra* note 179, at 6.
[236] Tax § 23.51(1) (West).
[237] The Comptroller's Manual cites to popular dictionary definitions of "principal" as meaning "most important, consequential or influential." *See* Hegar, *supra* note 179, at 8.
[238] *Tarrant*, 845 S.W.2d at 820 (holding that land used primarily for recreation or hobby does not qualify for special agricultural appraisal).
[239] *Id.*

"farm or ranch purposes" will qualify for special agricultural appraisal.[240] The *Moore* case addressed only one very narrow example of a non-qualifying primary use. In this vein, the Comptroller's Manual notes that "in reviewing each application for special agricultural appraisal, the chief appraiser is to consider all of the facts surrounding the property owner's use of the land—the totality of the circumstances—to determine whether, in the exercise of his or her professional judgment, 1-d-1 appraisal should be granted."[241] Due to the subjective nature of special appraisal approval under the "principal or primary use" requirement, there is significant room for taxpayers to manipulate use of a property to comply with use requirements. For example, leasing land for hunting is not a qualifying agricultural primary use and would disqualify a property from receiving a special appraisal.[242] However, if the landowner uses their land "primarily" for grazing cattle, and concurrently leases the land for hunting, he or she would then satisfy the "principal or primary use" requirement.[243]

4. Principal or Primary Use

Related to the "principal or primary use" requirement, county appraisers use the "degree of intensity test" to evaluate the extent to which the primary agricultural activity pursued reaches a threshold based on the geographic area in which the land is located.[244] Under Texas law, the threshold requires the land to be "currently devoted principally to agricultural use to the degree of intensity generally accepted in the area."[245] Texas legislators established this test as a safeguard against "hobby farms" that are only nominally used for agriculture purposes to secure a favorable tax break for the landowner.[246] In other words, the chief appraiser uses the test to ensure that land is farmed or ranched to a level typical of farm or ranch operations in Texas. Like the "principal or primary use" requirement, the "degree of intensity test" is not specifically defined by Texas statute. Instead, the State Property Tax Board has used a "prudent manager" test for intensity, which was confirmed by the Court of Appeals of Texas.[247] The chief appraiser in each Texas county determines the typical level of intensity for each step of an agriculture activity.[248] The chief appraiser will then compare the intensity of current agriculture activity being undertaken on the property in question with the determined standard.[249] The Manual uses the example of farming dryland cotton.[250] This agricultural activity requires

[240] *Id.* at 821.
[241] HEGAR, *supra* note 207, at 8.
[242] HEGAR, *supra* note 207, at 7.
[243] *Id.*
[244] HEGAR, *supra* note 207, at 8.
[245] Tax § 23.51(1) (West).
[246] HEGAR, *supra* note 207, at 17.
[247] Riess v. Appraisal District of Williamson County, 735 S.W.2d 633, 637 (Tex. App. 1987) ("The State Property Tax Board in its regulations has defined 'agricultural use to the degree of intensity generally accepted in the area' to mean 'farming or ranching to the extent that the typically prudent manager of the area of the taxing unit would farm or ranch on an identifiable and substantial tract of land when the tract is devoted principally to agricultural use.'").
[248] Tex. Tax Code §23.52(d); 34 Tex. Admin. Code §9.4001
[249] HEGAR, *supra* note 207, at 9.
[250] *Id.*

tilling soil, planning, use of herbicides, and harvesting.[251] In an intensity test, the chief appraiser would determine the level of labor and equipment normally needed to accomplish each step, and then compare this against the amount of labor and equipment used on the property under review.[252]

5. Time Period Test

The final requirement for receiving a special agricultural appraisal is the "time period test." This test is relatively objective compared to the use or intensity tests. To satisfy the time period requirement, property must be "devoted principally to agricultural use or to production of timber or forest products" for five out of seven years preceding the landowner's special appraisal application.[253] Importantly, only the use requirement applies to all five years; the intensity test applies solely to the tax year that the special appraisal application is processed.[254]

These five requirements are the threshold questions in any determination of a special agricultural appraisal application. The special appraisal regime also relies on the location of the agricultural land and who may apply for a special appraisal. Generally, land within a city or town will not qualify for special appraisal.[255] However, farmland or ranchland may be located in an incorporated city if it meets the following criteria: (1) the city does not provide services to the land comparable to services provided to other areas of the city with similar geography and density; (2) the land was principally used for agriculture continually for five years preceding application; and (3) the land was devoted principally to a qualified agricultural activity.[256] Additionally, TTC Sections 23.56(2) and (3) make land ineligible for special appraisal in some cases if foreign owned by a nonresident alien.[257] However, there is debate as to whether this is constitutional.[258] The Supreme Court of Texas has held that Section 23.56(3), barring foreign corporate and governmental organizations from qualifying land for special appraisal, is unconstitutional under the Texas constitution's Equal Protection Clause.[259] However, it is currently unclear whether non-resident aliens are still ineligible to apply for special appraisal.

The requirements for a successful application for special agricultural appraisal are overbroad and ripe for abuse. The expansiveness of qualifying activities means that hobby farms have too many options for skirting serious agricultural production. Likewise, the subjectiveness and lack of oversight in the intensity review equates to a failure of quality control in reviewing special appraisal applications. While the special agricultural appraisal offers states the chance to make a serious impact on food security and wildlife conservation, the program is overly generous with hobby farmers who return little to advance social goal initiatives.

---

251 *Id.*
252 *Id.*
253 Tax § 23.51(1) (West).
254 *Riess*, 735 S.W.2d 633 at 637-38.
255 HEGAR, *supra* note 207, at 11.
256 Tax § 23.56(1) (West).
257 Tax § 23.56(2), (3).
258 HL Farm Corp. v. Self, 877 S.W.2d 288 (Tex. 1994).
259 *Id.*

IV. Recommendations for Future Social Goal-Focused Tax Initiatives

QOF investments, conservation easement donations, and special agricultural appraisals are government-sponsored estate planning tools designed to offer wealthy individuals advantages of deferring capital gains, receiving charitable deductions, or lowering the state property tax burden in return for national assistance to provide a secure food supply. In theory, the government and taxpayers expect this two-sided equation to accomplish the social goals that shaped these tax programs. These social goals include low-income community economic development, natural land conservation, wildlife preservation, and food security. The preceding analysis of these real property-focused programs exposed cracks in the tax system and offers doubt that implementation of these incentive-based, social goal-focused tax policies has been as successful as hoped to date. In response, the three proposed policy recommendations below aim to guide future social goal-focused tax policymaking.

A. Amend current economic development and land preservation tax programs to include ultra-specific legislative requirements and more vigilant oversight.

1. Limiting QOF Investment Options

Overbroad language and lack of oversight are at the heart of the QOZ program's failure to focus investment into low-income community revitalization and the Texas special agricultural appraisal's failure to effectively weed out the use of agricultural land as a tax shelter. Both programs have insufficient guidelines for investment that do not effectively usher the flow of investment to low-income communities and productive agriculture.

The most prominent guardrail associated with QOF investment is the restriction on "sin business" investments in QOZs.[260] However, as noted previously, this requirement only protects against businesses that are morally questionable in the eyes of the federal government. The rule has no effect on investment of QOF funds into projects that provide economic development to low-income tracts at the expense of population displacement and other negative effects associated with gentrification. Using an exclusionary rule that simply puts restrictions on immoral business activity does nothing to help the members of the low-income communities being targeted.

Instead, legislators should amend Section 1400Z to include an enumerated list of businesses that are eligible for QOF investment. Each business on the list should provide positive economic revitalization for low-income communities. For example, the enumerated list might include mixed-use affordable housing as an option for real estate investment, perhaps mirroring the properties developed by the NCI in Barry Farms, D.C. Alternatively, the list might include minority-owned businesses as a possibility for non-property investment. Regardless of the types of enterprises included in the enumerated list, each option should have specific guidelines to ensure community access. Qualifying language for mixed-use affordable housing might include a minimum ratio of rent-controlled to market-rate apartment units and a required percentage of total commercial space dedicated to low-income social service providers. This would ensure that new housing projects do not displace current low-income residents. Similarly, the minority-owned business investment option should contain language requiring a minimum

[260] I.R.C. § 144(c)(6)(B).

percentage of the business be minority-owned and a limit on enterprise value. These requirements would keep investment focused on genuinely minority-owned, small-and medium-sized businesses connected to the local community. A combination of an enumerated investments list and ultra-specific legislative requirements for each category of investment will ensure that QOF funds are used for low-income community revitalization rather than football stadiums and other forms of negative gentrification.

2. Applying Strict Agricultural Appraisal Requirements

State special agricultural appraisal programs have lenient requirements for qualifying land as principally used for agriculture at an acceptable intensity level. Using Texas as the model, the legislation and the accompanying Comptroller's Manual are simply too inclusive of all types of agricultural activities. Texas courts have had no choice but to continuously approve new agricultural uses for land because the language for qualifying activities is so broad. Likewise, intensity is a subjective measure that will vary from district to district. And, as seen above in the San Antonio case, intensity reviews are often embroiled in local political conflicts.[261] Texas should scrap the current legislation and provide ultra-specific requirements for each type of qualifying agricultural activity based on scientific data.

For example, keeping in mind the Michael Dell ranchland case, if management of deer was an enumerated qualifying agricultural activity for ranchland, the state could use the ratio of deer per acre and percentage of land in service as qualifying requirements. According to experts at Stephen F. Austin University, whitetail deer need approximately twenty-five acres of native woods or five acres of openings to support a single deer in good health.[262] Using this information, the Texas government might require a ranch focused on management of deer to place at least 75% of available property into service, with at least one deer per every five acres. The Dell ranch is approximately 119 acres.[263] Assuming that Dell wanted a special appraisal for 100 acres of wooded ranchland on which he manages deer, he would need at least fifteen deer ((75% x 100) / 5 = 15). In essence, an amendment with strict guidelines would create a more objective system for assessing the use and intensity of production on agricultural property. The chief appraiser would become a more objective judge of special appraisal applications, and the system would leave less room for abuse. Critics of this system might argue the burden of legislating for all approved agricultural activities is tedious and inefficient. However, a list of approved agricultural activities would not be out of the ordinary, as tax codes are filled with minutiae explaining each tax provision. Additionally, creating a list of approved agricultural activities would allow the Texas legislature to promote favorable, coordinated agricultural land development.

A key component to the successful administration of future QOZ programs or special agricultural appraisals is better government oversight. In 2019, at the outset of the QOZ

[261] King, *supra* note 204.

[262] James C. Kroll, *Analyzing Whitetail Habitat*, NORTH AM. WHITETAIL (Sep. 22, 2010), https://www.northamericanwhitetail.com/editorial/deermanagement_naw_aa902landscaping/264195#:~:text=What%20this%20leads%20to%20is,supporting%20several%20deer%20per%20acre.

[263] Katherine Clarke, *Inside Michael Dell's Sprawling Property Empire*, MANSION GLOB., (Mar. 22, 2018), https://www.mansionglobal.com/articles/inside-michael-dell-s-sprawling-property-empire-92091.

program, Democratic Party critics of the program raised concerns that there were too few reporting requirements for QOFs and their investors.[264] Without better oversight, insufficient data collection will continue to lead to a failure to track the geographies, industries, and populations affected by QOF investments. Likewise, with Texas special agricultural appraisals, once land is approved for special appraisal, there is insufficient continuing oversight as to the agricultural operations on the land. In effect, there is no way to track the agricultural productivity return on each dollar lost by the state government in tax breaks given to the taxpayer.

To remedy these two oversight disasters, legislators must amend both the QOZ and special appraisal programs to include yearly reporting requirements. The Government Accountability Office (GAO) should require QOFs to report the geographic location, industries, and types of assets invested in each year. In addition, the GAO should require QOFs to submit an updated list of investors in the fund. Similarly, Texas should require landowners that receive a special appraisal to submit yearly reports on the productivity of their approved agricultural activity. This might take the form of crops grown, animals raised, wildlife programs established, or other productivity metrics. Developing more comprehensive reporting programs will increase transparency, improve government oversight and enforcement of program guidelines, and provide better social goal returns for tax breaks given.

B. Improve funding to expand IRS oversight and enforcement of abusive tax shelter utilization while further developing cooperative civil and criminal enforcement between the IRS and the DOJ.

The gradual and coordinated crackdown on syndicated conservation easement transactions by the IRS and DOJ Tax Division models the type of enforcement and prosecution that preserves the integrity of incentive-based tax programs focused on achieving social goals. In 2004, the IRS successfully identified the potential tax abuse of using syndicated conservation easement transactions.[265] IRS enforcement regarding these transactions followed a steady increase in warnings and imposition of penalties, eventually leading up to the 2020 settlement offer for taxpayers invested in these abusive tax schemes.[266] Simultaneously, the DOJ Tax Division increasingly prosecuted promoters of syndicated conservation easement transactions for civil and criminal offenses related to fraud and tax evasion.[267] This coordinated effort to quash an abusive tax structure upheld the integrity of conservation easement donations under Sections 2031(c)(8), 170(b)(E)(i), and 2055(f).[268] The goal of such tax policies is to entice taxpayers with targeted assets to assist in promoting a national social goal (in this case natural land conservation) in return for a tax break deemed appropriate by the IRS. When the taxpayer abuses the program to

[264] Letter from Congressman Richard E. Neal, Senator Ron Wyden, Congressman John Lewis & Senator Cory A. Booker, to the Honorable Gene L. Dodar, Comptroller General of the United States (Nov. 4, 2019), https://www.finance.senate.gov/imo/media/doc/110419%20Letter%20from%20Neal,%20Wyden,%20Lewis,%20Booker%20Opportunity%20Zone%20Request.pdf.

[265] I.R.S Notice 2004-41 (July 7, 2004).

[266] I.R.S. Notice 2020-23, 2020-18 C.B. 2020-23.

[267] I.R.S. News Release IR-2019-182 (Nov. 12, 2019).

[268] I.R.C. §§ 170(b)(E)(i), 2031(c)(8), 2055(f).

receive a tax break disproportionate to their policy-incentivized commitment, the tax law should enable the IRS to enforce the law and penalize the taxpayer.

However, the IRS cannot effectively identify or penalize even the most basic tax shelters without scrutiny by lawyers and accountants at the agency. Enforcement of tax rules is complicated, and tax reasoning is often illogical due to the political process behind tax legislation. Taxable and non-taxable transactions require meticulous oversight. Unfortunately, identification of tax abuse often takes more human scrutiny than legal transactions because the development of tax shelters intentionally exploits tax policy failures and gaps. Computers do not yet have the capability of identifying gaps and making judgement calls on tax structures that fall in the "grey area." Congress should promote IRS oversight of estate planning tools by better funding IRS hiring programs for tax attorneys, forensic accountants, and support staff. The IRS will see increased success in program enforcement by offering higher salaries and remaining a competitive hiring party versus private companies, such as law firms and accounting firms, which have similar human capital needs.

Additionally, the IRS was successful in stomping out syndicated conservation easements because of its cooperation with the DOJ. Having the prosecutorial support to pursue non-taxpayer criminal organizations and individuals allows the IRS to wage a two-front war. Congress should allocate funding for a joint IRS-DOJ Tax Section task force. To some extent, this type of program has already been tested with the Organized Crime and Drug Enforcement Task Force, which brings together agents from the IRS's Criminal Investigation (CI) arm and the DOJ.[269] The IRS could leverage its own technical expertise and the DOJ's prosecutorial reach by creating smaller joint task forces dedicated to one area, such as tax abuse in social goal-focused tax programs. Not only would this give the IRS improved capability for overseeing programs like QOF investments and conservation easement donations, it would give tax legislators the comfort of knowing that future social goal-focused, incentive-based tax policies would have adequate federal supervision and enforcement.

C. Create new incentive-based tax programs focused on achieving social goals and improving accessibility for middle-income individuals who do not have untapped capital gains or excess property holdings.

The focus of this analysis has been on the effectiveness of social goal-focused, incentive-based tax programs that can be used as tools for socially conscious estate planning. Unfortunately, two of the three tax breaks explored above require an individual to have accumulated household wealth before reaping significant tax benefits.

For instance, to take advantage of the tax deferral regime under QOZ investing, an individual must already have unrealized capital gain built up in their investment portfolio.[270] According to the Federal Reserve, in 2016, the average American family had only $40,200 in mean holdings.[271] Additionally, excluding retirement account savings that

[269] I.R.S. IRM Part 9, 9.4.13 (Aug. 17, 2015), https://www.irs.gov/irm/part9/irm_09-004-013.
[270] *See* I.R.C. § 1400Z-2(a)(1).
[271] Jesse Bricker, Lisa J. Dettling, Alice Henriques, Joanne W. Hsu, Lindsay Jacobs, Kevin B. Moore, Sarah Pack, John Sabelhaus, Jeffrey Thompson & Richard A. Windle, *Changes in U.S. Family Finances*

wouldn't qualify for reinvestment in the QOZ program, American household ownership of certificates of deposits, directly held stocks, and pooled investment funds was 6.5%, 13.9%, and 10% respectively.[272] The fact that less than 15% of all American households hold any kind of liquid capital asset means that only the wealthiest individuals have unrealized capital gains that can be directed toward QOZ investment.

Similarly, to receive an exemption or deduction for a conservation easement donation, a taxpayer would have to own enough natural and undeveloped land to make donation an appealing prospect. Simultaneously, at least for the post-mortem donation, the conservation easement deduction only makes sense for testators who exceed the $11.58 million individual estate tax exemption for 2020.[273] Only the wealthiest households will either own natural land or reach the household wealth that would force them outside of the $11.58 million estate tax exemption. Even among households that both own natural land and hold wealth exceeding the exemption, the administrative cost of placing a conservation easement on property and applying to the IRS for an exemption or deduction is cost prohibitive. Less wealthy professionals who have medium-sized estates likely would not have interest in conservation easement donations given the hassle and expense of hiring tax attorneys and land appraisers. In practice, only ultra-wealthy families, such as the Rockefellers, have the property holdings and accumulated wealth necessary to make the conservation easement donation feasible.

Finally, in theory, the special agricultural appraisal is the most accessible tool because any landowner who owns farmland or ranchland can apply for it. There are no size limits on qualified property, and the current requirements for an agricultural activity performed on the property are broad.[274] Additionally, if approved for special appraisal, the lower state property tax burden is immediately felt by the landowner, regardless of the landowner's financial position. Still, ultra-wealthy individuals receive both the immediate advantage of lower state property taxes and the long-term wealth transfer and portfolio diversification benefits of owning farmland. In other words, farmland is only useful as a diversifying investment if the farmer owns an investment portfolio of non-real property holdings.

Part of the problem with creating wealth planning tools that are available to low- and middle-income individuals is that deductions that such individuals can generate rarely exceed the standard deduction of $12,400 for individual taxpayers or $24,800 for taxpayers married filing jointly.[275] There are many programs that reward taxpayers for making positive life choices in the eyes of the government, including child-bearing, pursuing education, and saving for retirement.[276] Some of these programs, such as the Earned Income Tax Credit, the American Opportunity Tax Credit, and the Lifetime Learning

from 2013 to 2016: Evidence from the Survey of Consumer Finances, 103 Fed. Res. Bulletin 1, 19 (Sep. 2017), https://www.federalreserve.gov/publications/files/scf17.pdf.

[272] *Id.*

[273] *Estate Tax*, INTERNAL REVENUE SERV. (July 2020), https://www.irs.gov/businesses/small-businesses-self-employed/estate-tax.

[274] HEGAR, *supra* note 207, at 40.

[275] I.R.S. IR-2019-280 (Nov. 06, 2019), https://www.irs.gov/newsroom/irs-provides-tax-inflation-adjustments-for-tax-year-2020.

[276] I.R.C. §§ 24, 25A, 401.

Credit, focus on giving taxpayers credit for socially positive acts taken in the past.[277] The question is whether there is a way to entice lower income taxpayers to take actions that are social goal-focused and outside of personal-growth activities such as seeking education, working a steady job, and growing the family.

For example, if the federal government is concerned with wildlife preservation, the tax code could include an hourly rate deduction for hours worked in local, state, or national parks. This "wildlife preservation labor deduction" would be separate and untied from the standard deduction, so even a taxpayer who took the standard deduction could qualify. In terms of oversight and abuse prevention, the IRS would coordinate with national, state, and local agencies to log community service hours and report on taxpayer progress. For example, for Illinois taxpayers, the IRS might partner with the National Park Service for community service completed in national parks, with the Illinois Department of Natural Resources for community service performed in state parks, and with the Chicago Park District for local community service performed in Chicago parks.

The wildlife preservation labor deduction would be administratively taxing to set up and would be subject to taxpayer abuse. However, with proper oversight, the program would allow individuals at all income levels to receive a deduction for hours worked. Additionally, there are ways to make the deduction progressive. The government could offer the largest hourly deduction for taxpayers with the lowest yearly gross income. This would effectively create a reverse progression as compared to the income tax. By making the wildlife preservation labor deduction progressive, the government transfers deductions in a way that motivates productivity among high-income workers and provides support for the lowest wage earners.

A program that targets social goals and offers lower income workers a way to lower their tax burden outside of the normal course of professional and family life is obviously difficult to develop and monitor. However, without a goal of creating these types of programs in the future, tax legislators will likely continue to serve only the wealthiest individuals when trying to accomplish social goals through use of the IRC.

CONCLUSION

The IRS headquarters building displays a powerful inscription: "Taxes are what we pay for civilized society."[278] While this quote may stand as a battle anthem for the IRS, it is clear that promoting social advancement (an indicator of advanced civilization) through taxation requires a careful political dance between two important partners—the government and the taxpayer. Driven by market dynamics, taxpayers are always looking for a bargain and to receive a quid pro quo for profit margins relinquished. Consequently, for taxpayers, social goal-focused, incentive-based tax programs are a perfect fit and advance low-income community development, land and wildlife conservation, and food security. Government programs that efficiently advance social goals are always accompanied by a cost to taxpayers. However, incentive-based programs that offer estate

[277] *Earned Income Tax Credit (EITC)*, INTERNAL REVENUE SERV. (2020), https://www.irs.gov/credits-deductions/individuals/earned-income-tax-credit; *American Opportunity Tax Credit*, INTERNAL REVENUE SERV. (2020), https://www.irs.gov/credits-deductions/individuals/aotc; *Lifetime Learning Credit*, INTERNAL REVENUE SERV. (2020), https://www.irs.gov/credits-deductions/individuals/llc.

[278] Compania Gen. de Tabacos de Filipinas v. Collector of Internal Revenue, 275 U.S. 87, 100 (1927).

planning discounts in return for private investments of capital or labor into socially beneficial areas seem to be a welcome alternative to direct government investment programs. Tightening of legislative language, improved IRS funding, and creation of more accessible incentive-based programs will help to ensure that programs like the QOZ, conservation easement donation deduction, and special agricultural appraisal work effectively to push American society in a positive direction.