

The Inviolability of Real Property Rights Meets the Tax Court

by Vivian D. Hoard



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In this article, Hoard explores how the Tax Court has invalidated conservation easement deeds containing language that specifically protects taxpayers' property rights under state laws.

One simply can't go to a Zoom cocktail party these days without understanding reg. section 1.170A-14(g)(6)(ii) (the proceeds regulation). The Tax Court has made it all the rage with a string of recent cases invalidating conservation easements because of it. The proceeds regulation is complicated, but goes something like this: When a taxpayer donates a conservation easement on a piece of property, for that donation to qualify as a charitable donation under section 170, the donee land trust must receive a property right "with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction at the time of the gift bears to the value of the property as a whole at that time." According to the IRS, if the property is ever part of a condemnation, the land trust must receive that same proportion of proceeds from the condemnation.

But a conservation easement is a donation of a *partial* interest in property allowed by section 170(f) that allows the land trust to protect the conservation values on the property. What if the taxpayer subsequently builds a home on the property and all the property (including the home) is condemned? What happens to the

taxpayer's equity in the home? Presume the ratio of easement value to the property as a whole at the time of donation is 90 percent and the home value/equity is \$500,000. Well, according to the Tax Court, the land trust gets \$450,000 of the proceeds from the home's condemnation, even though the taxpaying homeowner retained the right to the home at the time of donation under state property laws and did not get a deduction for the \$450,000 he is now losing.¹

How can a Treasury regulation give to a donee something the taxpayer never gave to the donee under state real property laws and for which the taxpayer has never been compensated? Quarantining at home provides the leisure to ponder this conundrum.

Ironically, the Supreme Court has already resolved this issue in favor of the taxpayer — but no one seems to have noticed. The proceeds regulation is simply not entitled to deference under either *Chevron* or *Kisor*.² These cases confirm that the IRS cannot by regulation confer a real property interest to a donee greater than what the donor granted under state law. Congress would never have intended that. Real property rights are governed by state laws, not federal agencies.

In addition to *Chevron* and *Kisor*, there is fundamental constitutional law that prohibits the government from either taking or giving away someone's property without paying them for it. The proceeds regulation goes beyond simply

¹ This is how the Tax Court interpreted the proceeds clause in a bench opinion that the Fifth Circuit upheld. *PBBM-Rose Hill Ltd v. Commissioner*, 900 F.3d 193 (5th Cir. 2018). The Tax Court revisited the issue in *Oakbrook Land Holdings LLC*, 154 T.C. No. 10 (May 12, 2020), with the majority concurring with the earlier bench opinion. Judge Holmes, who presided over the case, wrote the dissenting opinion holding that the regulation was invalid. *Oakbrook* is being appealed to the Sixth Circuit. The regulation is also being challenged in the Eleventh Circuit and will likely be challenged in other circuits as well.

² *Kisor v. Wilkie*, 139 S. Ct. 2400 (2019).

valuing the easement to actually reallocating ownership rights.

In section 170, Congress said a conservation easement must be donated in perpetuity. Congress defined the perpetuity requirement as being an issue of duration, not one of valuation of the interests among various stakeholders. Issues regarding proportionate value between ownership interests in real property are governed by state law. Thus, Congress would not have expected the IRS to promulgate regulations purporting to establish the value of ownership rights among individuals with varying ownership interests in property; that value is determined by state law.

To make matters worse, the proceeds regulation purports to grant the donee an interest in the donor's property greater than what the donee received under state law. Congress would not have intended the IRS to promulgate regulations to do so. So while *Chevron* says that if a statute is silent on a point, Congress must then have intended the agency to clarify the statute by regulation, Chief Justice John G. Roberts Jr. has acknowledged that in some cases, that is simply not true. That is known as *Chevron* step zero. And while Roberts did not call it *Chevron* step zero, he emphasized in *King*³ that when an issue is not within the expertise of the agency, the courts should not give deference to the regulation. "It is especially unlikely that Congress would have delegated this decision to the IRS, which has no expertise in crafting health care policy."⁴ In the conservation easement scenario, state law governs real property interests, and according to Roberts, Congress would not have intended the IRS to usurp that authority.

The cases are legion confirming that property rights are a state law function. The Supreme Court has confirmed this point, noting, "It has long been the rule that in the application of a federal revenue act, state law controls in determining the nature of the legal interest which the taxpayer had in the property sought to be reached by the statute."⁵ Thus, state law determines a taxpayer's property

interest, and the tax consequences are dictated by federal law.⁶ A federal tax statute "itself creates no property rights but merely attaches consequences, federally defined, to rights created under state law."⁷ In other words, "state law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed."⁸ Circuit courts of appeals agree.⁹

At least until recently, the Tax Court also agreed that property interests are determined by state law. "In a Federal tax controversy, state law controls the determination of a taxpayer's interest in property while the tax consequences are determined under Federal law."¹⁰ Questions of property interests are traditionally governed by the law of the state "where the real property is located."¹¹ Thus, the proceeds regulation is improper to the extent it attempts to dictate what would otherwise be governed by state law.

But it is not just *Chevron* step zero that confirms that the IRS has no right to reallocate real property rights between the parties. The proceeds regulation should be afforded no deference for a second reason: It involves issues of common law. The Supreme Court recently confirmed the limitations on agency deference in *Kisor*. In that decision, Justice Elena Kagan noted that deference is not warranted when the subject matter of the dispute falls more naturally to another party —

⁶ *United States v. National Bank of Commerce*, 472 U.S. 713, 722 (1985).

⁷ *United States v. Craft*, 535 U.S. 274, 278 (2002); see also *Drye v. United States*, 528 U.S. 49, 58 (1999) ("We look initially to state law to determine what rights the taxpayer has in the property the Government seeks to reach, then to federal law to determine whether the taxpayer's state-delineated rights qualify as 'property' or 'rights to property' within the compass of the federal tax lien legislation.").

⁸ *Morgan v. Commissioner*, 309 U.S. 78, 80 (1940); see also *United States v. Mitchell*, 403 U.S. 190, 197 (1971) ("In the determination of ownership, state law controls. The state law creates legal interests but the federal statute determines when and how they shall be taxed.").

⁹ See, e.g., *United States v. Smith*, 768 F. App'x 926, 931 (11th Cir. 2019) (per curiam) ("As with a tax lien, state law determines the nature of the legal interest a person has in the property sought to be reached."); *Stuart v. Commissioner*, 841 F.3d 777, 780 (8th Cir. 2016) (remanding for the Tax Court to apply state law); *Krukowski v. Commissioner*, 279 F.3d 547, 550 (7th Cir. 2002) ("Because the lease at issue involves Wisconsin property, we apply Wisconsin law."); and *Warda v. Commissioner*, 15 F.3d 533, 537 (6th Cir. 1994) ("Whether a taxpayer holds an interest in property, and the nature of that interest, is determined by reference to state law.").

¹⁰ *Ten Twenty Six Investors v. Commissioner*, T.C. Memo. 2017-115; see also *Samarasinghe v. Commissioner*, T.C. Memo. 2012-23 ("In the absence of an agreement by the parties to a lease regarding applicable law, we apply the law of the State where the property is located.").

¹¹ *Estate of Holland v. Commissioner*, T.C. Memo. 1997-302.

³ *King v. Burwell*, 135 S. Ct. 2480 (2015).

⁴ *Id.*

⁵ *Aquilino v. United States*, 363 U.S. 509, 512-513 (1960).

such as the various states and their courts.¹² “Some interpretive issues may fall more naturally into a judge’s bailiwick.”¹³ The Court specifically gave the example of “the elucidation of a simple common-law property term” citing a 10th Circuit case in which the court declined deference to the agency because the issues were governed by common law and not within the agency’s expertise.¹⁴

Upon condemnation of property subject to an easement, any proceeds would be distributed based on the value of the particular interests that the parties hold. This distribution is a matter traditionally reserved for state law.¹⁵

In a conservation easement, a taxpayer donates an interest in the property that involves protecting conservation purposes in perpetuity. If the donor donates a conservation easement on property where he lives or plans to build his residence, the easement holder should only receive a property interest to preserve the conservation purposes. No party expects the donee to receive an interest in the donor’s home or any other structure or improvement that the donor personally makes and funds.

Section 170 did not purport to alter state real property rights. It is surprising that the IRS has presumed to do so by regulation and that the Tax Court has agreed. Time will tell whether a majority of the circuit court judges recognize as much. ■

¹² *Kisor*, 139 S. Ct. at 2417.

¹³ *Id.*

¹⁴ *Id.* (citing *Jicarilla Apache Tribe v. FERC*, 578 F.2d 289, 292-293 (10th Cir. 1978)).

¹⁵ See, e.g., *Texas v. Figueroa*, 389 F.2d 251 (5th Cir. 1968) (affirming a 50 percent distribution of proceeds to a surface rights owner under Texas law).

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