Tax Court Takes an Ax to Conservation Easement Deductions

by Timothy Lindstrom

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In this report, Lindstrom examines two novel technical objections raised by the IRS and upheld by the Tax Court in recent conservation easement cases.

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I. Introduction

In a recent torrent of decisions, the Tax Court turned decades of common practice regarding conservation easements on its head. As Tax Court Judge Mark V. Holmes recently observed in a dissenting opinion, "Our holding today will likely deny any charitable deduction to hundreds or thousands of taxpayers who donated the conservation easements that protect perhaps millions of acres. . . . This is the second time we've taken an ax to entire forests of these deductions."[1]

The dissent was critical of the Tax Court's decisions on the two matters analyzed in this report: the location of building areas reserved in conservation easements, and the calculation of proceeds due to easement holders if a conservation easement is extinguished.

The location and use of building areas was addressed in *Pine Mountain*[2] and *Carter*.[3] The provisions of so-called proceeds clauses were addressed in *PBBM-Rose Hill*[4] and a series of subsequent Tax Court decisions, most recently concluding with *Lumpkin One Five Six LLC*.[5]

II. Building Areas

"Building areas" and "building envelopes" are terms commonly used in conservation easements to identify specific areas on easement property where improvements may be located. They may enclose existing improvements or future improvements. The intent of building areas is to limit the impact of improvements reserved in conservation easements by mandating that they be located within a confined area to ensure that the improvements are consistent with the conservation purposes of the easement. Typically, easement donors reserve the right to use existing improvements and to develop new improvements such as single-family residences and related structures, including guesthouses, garages, and, for agricultural property, barns, stables, and so forth. Building areas are not excluded from the conservation easement but are included as part of the restricted land. Building areas are subject to

[1] *Oakbrook Land Holdings LLC v. Commissioner*, 154 T.C. No. 10, *82 (2020) (Holmes, J., dissenting).

[2] *Pine Mountain Preserve LLLP v. Commissioner*, 151 T.C. 247 (2018).

[3] *Carter v. Commissioner*, T.C. Memo. 2020-21.

[4] *PBBM-Rose Hill Ltd. v. Commissioner*, No. 26096-14 (T.C. Sept. 9, 2016) (bench opinion), *aff'd*, 900 F.3d 193 (5th Cir. 2018).

[5] *Lumpkin One Five Six LLC v. Commissioner*, T.C. Memo. 2020-94.

express restrictions on future uses within the areas.

Normally, building area restrictions prohibit any improvements other than single-family residences and appurtenances, such as guesthouses, garages, and swimming pools. The building area restrictions often limit the size and height of residential structures and the amount of ground that appurtenances can cover. Multifamily use and commercial and industrial uses within building areas are typically prohibited.

Conservation easements also typically limit the location of building areas to those specified in the easement, often through the use of a map attached to and incorporated into the easement by reference. In many cases, to allow flexibility if a designated building area turns out to be impractical to develop (for example, because of lack of water or lack of soils suitable for septic fields), building areas could be relocated within the easement, subject to prior approval from the easement holder to ensure that new locations are not inconsistent with the easement's conservation purposes. Less typical is the reservation of building areas whose locations were not designated in the easement but can be located by the donor in the future, subject to prior review and approval from the easement holder — again, to ensure compatibility with the conservation purposes.

Allowing building area locations to change or to be located in the future, subject to prior approval from the easement holder, depends on the diligence of the easement holder to ensure that locations are consistent with the conservation purposes. Easement holders, which can only be public charities or governmental agencies, are required by section 170(h)(1)(B) to meet all the criteria of section 170(h)(3) (a "qualified organization"). Reliance on the diligence of qualified organizations is supported by the entire statutory and regulatory scheme that allows deductions for donations of conservation easements. The IRS polices the public charities that are qualified organizations (land trusts) and not infrequently disallows their exempt status — and hence their authority to hold deductible conservation easements — for failure to fulfill their obligations to the public. Moreover, significant financial sanctions apply to actions by land trusts that result in private, rather than public, benefit.[6]

A. A Brief History

The *Pine Mountain* and *Carter* decisions had their genesis in three relatively recent Tax Court opinions beginning with *Belk*.[7] *Belk* involved the conservation of land that included a golf course. The conservation easement permitted the landowner to substitute other property for a portion of the land originally subject to the easement, subject to specific provisos. In other words, the easement reserved the landowner's right to release a portion of the property originally protected by the easement and place other land under easement as a substitute. Such substitution had to be approved by the holder of the easement (a qualified organization); the substituted land had to be greater in size than the land released from the original easement; and the substituted land had to have greater conservation value than the released land.

The purpose of this substitution provision was to allow the landowner flexibility in developing the golf course while ensuring that the original conservation purposes of the easement — protection of habitat and open space — would continue to be met.

Although rare, substitution provisions have been used by land trusts to improve overall conservation. For example, suppose a landowner owns 100 acres and donates a conservation easement over that property, allowing no improvements. Because the landowner anticipates acquiring an adjoining 500 acres of high-quality wildlife habitat, the easement provides that the landowner can substitute the conservation easement over the 100-acre property for a conservation easement containing similar provisions over the 500-acre property. It would be hard to argue that such a substitution does not significantly increase conservation interests and the public benefit.

It was believed that substitutions that improved the overall protection of conservation

[6] *See, e.g.*, section 4958(f)(1) and reg. section 53.4958-3.

[7] *Belk v. Commissioner*, 140 T.C. 1 (2013), reconsideration denied by T.C. Memo. 2013-154, *aff'd*, 774 F.3d 221 (4th Cir. 2014).

values complied with the provisions of section 170(h)(5)(A), which require that the *conservation purposes* of a conservation easement be protected in perpetuity. The fact that a substitution necessarily resulted in the release or termination of a perpetual conservation easement in whole or in part was not considered a violation of the requirements of the code as long as the original conservation purposes were met.

The Tax Court said in *Belk* that it had never before addressed what the code meant by a "qualified real property interest." It held that to be such an interest, not only did the easement have to protect the conservation purposes in perpetuity, as required by section 170(h)(5)(A), but to comply with section 170(h)(2)(C), the land area originally subject to the easement had to be protected in perpetuity. The reserved right to substitute new land for land originally subject to the easement violated this requirement, and the court therefore disallowed the deduction. The opinion was upheld on appeal by the Fourth Circuit.[8]

In other words, the *Belk* courts ruled that the code requires that a deductible conservation easement satisfy two perpetuity requirements: (1) protection of the conservation purposes in perpetuity, and (2) protection of the land originally subject to the donation in perpetuity. *Belk* was the first case to enforce that requirement.

The next case to address the section 170(h)(2)(C) requirement was *Balsam Mountain*,[9] which involved a conservation easement over a 22-acre parcel. The easement allowed the landowner to adjust the boundaries of the easement in the future, subject to conditions intended to ensure that the conservation purposes of the easement were protected in perpetuity, as required by section 170(h)(5)(A).[10]

The taxpayer argued that the boundary adjustment provision allowed in the conservation easement was limited to no more than 5 percent of the original easement area and was therefore distinct from the situation in *Belk*, in which there was no limitation on the amount of the original easement area that could be replaced.

The Tax Court responded:

> This makes the easement different from the one in *Belk*, but the difference does not matter. The easement granted by Balsam Investments in 2003 was not an interest in an identifiable, specific piece of real property. . . . [T]he easement did not constitute a "qualified real property interest" of the type described in section 170(h)(2)(C).[11]

The third case addressing the section 170(h)(2)(C) requirement was *Bosque Canyon* (also known as *BC Ranch*).[12] This case involved two conservation easements covering 3,482 acres within which the donors reserved 47 five-acre "homesites." These homesites were entirely excluded from the easements and were subject to none of their restrictions. The homesites were, as Judge James L. Dennis of the Fifth Circuit characterized them, "holes in the swiss cheese."[13]

The *Bosque Canyon* conservation easements reserved the donors' right to change the boundaries of the five-acre homesites. Because the homesites were not part of the easements, any such adjustment would necessarily change the land area protected by the easement. In effect, this reserved right allowed a "substitution," as in *Belk*, of a portion of land subject to the original easement with other land not originally subject to the easement.

The Tax Court, following the reasoning of *Belk*, disallowed deductions for the easements on the grounds that the land originally subject to the easements had not been protected in perpetuity, as required by section 170(h)(C)(2). The Tax Court was overruled by the Fifth Circuit. The court of appeals found that because the outer boundaries of the conservation easements could not be

[8] *Belk*, 774 F.3d 221.

[9] *Balsam Mountain Investments LLC v. Commissioner*, T.C. Memo. 2015-43.

[10] The conditions were: (1) at least 95 percent of the land originally subject to the easement had to remain subject to the easement; (2) the total acreage subject to easement could not change; (3) any substituted land was required to have equivalent or better conservation values than the land released from the easement; (4) the substituted land had to be contiguous with the easement; and (5) the easement holder could reject the boundary change if it found that it would have a material adverse effect on the conservation purposes. *Id.* at *3.

[11] *Id.* at 8.

[12] *Bosque Canyon Ranch LP v. Commissioner*, T.C. Memo. 2015-130, *vacated sub nom. BC Ranch II LP v. Commissioner*, 867 F.3d 547 (5th Cir. 2017).

[13] *BC Ranch II*, 867 F.3d at 562 (Dennis, J., dissenting).

altered, and because the acreage subject to the original easements could not change, the easements satisfied the requirement of section 170(h)(C)(2) that the land originally subject to the easements had to be protected in perpetuity.

In reaching this conclusion, the Fifth Circuit deviated from the Tax Court's strict interpretation of the code that all the land subject to the original easement must remain subject to that easement in perpetuity. The Fifth Circuit found that the need for flexibility in administering perpetual restrictions on the use of land justified the provisions of the *Bosque Canyon* easements:

> The easements in this case more closely resemble the conservation façade easements in *Commissioner v. Simmons* and *Kaufman v. Shulman* than the easement in *Belk*. In those cases, the circuit courts ruled that conservation easements were perpetual even though the trusts could consent to the partial lifting of the restrictions to allow repairs and changes to the façades of buildings. Both circuits held that, "clauses permitting consent and abandonment . . . have no discrete effect upon the perpetuity of easements. . . ." Even though those cases addressed the perpetuity requirement in section 170(h)(5)(A) rather than the one in section 170(h)(2)(C), the common-sense reasoning that they espoused, i.e., that an easement may be modified to promote the underlying conservation interests, applies equally here. The need for flexibility to address changing or unforeseen conditions on or under property subject to a conservation easement benefits all parties, and ultimately the flora and fauna that are their true beneficiaries.[14] [Citations omitted.]

As we will see, the Tax Court resoundingly rejected the Fifth Circuit's opinion in deciding *Pine Mountain*.[15]

The Tax Court's opinions in *Belk*, *Balsam Mountain*, and *Bosque Canyon* form the foundation for its decisions in *Pine Mountain* and *Carter*. However, the facts of *Pine Mountain* and *Carter* differ from the previous cases in one significant way: In neither *Pine Mountain* nor *Carter* did the easements allow any substitution for, or removal of, land originally subject to the easements. The building areas, which were the Tax Court's focus in both cases, were not excluded from the conservation easement, as was the case in *Bosque Canyon*, but were part of the easement land and subject to easement restrictions. Nevertheless, the Tax Court treated the reserved building areas as though they were excluded from the easement entirely.

B. *Pine Mountain*

1. Facts.

Pine Mountain involved three easements, granted in 2005, 2006, and 2007, respectively. The three easements covered a total of 1,299 acres out of 6,224 contiguous acres of land owned by the grantor. The grantor claimed a total easement value of $33,376,000 on its tax return, and $97,370,000 at trial. The grantor acquired the 6,224 acres over a period of three years for $37,070,435. To put the easement values claimed by the grantor in perspective, the average per-acre price paid for the 6,224 acres was $5,952; the easement value claimed on the return represented an average per-acre value of $25,694; and the easement value claimed at trial represented an average per-acre value of $74,958[16] — a 1,259 percent increase over the purchase price.

The 2005 easement reserved the right to develop 10 building areas of one acre each, allowing one single-family residence and appurtenant structures in each area. Some agricultural structures were also allowed within 1,000 feet of the building areas. An additional 10 acres outside the building areas could be used for equestrian purposes. The location of the building areas was designated by an exhibit to the 2005 easement but could be moved with prior approval from the holder of the easement.

[14] *Id.* at 553.

[15] *Pine Mountain*, 151 T.C. 247.

[16] The dramatic change in value suggests ample grounds for challenging these deductions without resort to a new interpretation of the code.

The 2006 easement reserved the rights to develop six building areas, the uses of which were also limited to one single-family residence each. However, the locations of the building areas were not specified in the 2006 easement; those areas could be located in the future by the grantor anywhere within the easement area, subject to prior approval from the easement holder.

The 2007 easement did not reserve any building areas or rights for residential use, but it did reserve the right to some improvements, such as a water tower, roads, utilities, and pipelines. The Tax Court did not disallow the deduction for the 2007 easement, but disallowed deductions for both the 2005 and 2006 easements in their entirety.

To put the conservation impact of the residential development reserved in the 2005 and 2006 easements in perspective, those easements allowed residential development on 16 of the 1,299 acres subject to the easements — 1.5 percent of the total easement acreage.

2. The decision.

The Tax Court began by rejecting the Fifth Circuit's decision in *Bosque Canyon*. Citing the *Golsen* rule,[17] the Tax Court determined that the Fifth Circuit's opinion was not binding because an appeal of *Pine Mountain* would lie to the Eleventh Circuit rather than the Fifth Circuit. In considering the Fifth Circuit's opinion, the Tax Court found that whether the boundary adjustment of the easement could occur inside the easement (which was the case in *Bosque Canyon*) rather than on the outer boundary of the easement (as in *Belk* and *Balsam*) was a "distinction without a difference,"[18] and it chose to follow the Fourth Circuit's opinion in *Belk*.

Key to the ruling that neither the 2005 nor 2006 easement was deductible was the Tax Court's decision that the building areas in these easements were not subject to the easements:

> But while the homesites are concededly within the outer perimeter of the conservation area, they are not "subject to the easements" in any meaningful sense.
>
> * * *
>
> As sites for standard upscale residential development, the 16 Building Areas are exempt from the conservation easement because they permit uses antithetical to its conservation purposes.[19]

The Tax Court held that the building areas were "holes" in the easement, and it elaborated on the swiss cheese analogy used by Dennis in his *Bosque Canyon/BC Ranch* dissent:

> The cheese represents the real property initially restricted by the conservation easement. The holes represent the zones reserved for commercial or residential development. Section 170(h)(2)(C) requires that the land restricted by the conservation easement be protected from development in perpetuity. The statute thus bars the developer from putting any new holes in the cheese.[20]

The Tax Court found that the retained right to relocate designated building areas (the 2005 easement) or to designate building areas in the future (the 2006 easement) constituted the right to "put new holes in the cheese." In reaching its decision, the court read section 170(h)(2)(C) to require "that the land restricted by the conservation easement be protected *from development* in perpetuity."[21] (Emphasis added.)

The Tax Court held that "the rights reserved to Pine Mountain, considered in their entirety, prevent the 2005 easement from constituting a 'qualified real property interest.'"[22] The court also concluded that the 2006 easement, by allowing six undesignated home sites to be located in the future, allowed land that was initially protected to be "converted to commercial use." As a result, the 2006 easement "did not create a perpetual use restriction on a defined parcel of land, as required by section 170(h)(2)(C)."[23]

[17] *Golsen v. Commissioner*, 54 T.C. 742, 756-757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971).

[18] *Pine Mountain*, 151 T.C. at 273 n.6.

[19] *Id.* at 277-278.

[20] *Id.* at 273.

[21] *Id.*

[22] *Id.* at 276-277.

[23] *Id.* at 275.

3. Analysis.

a. Summary of decision.

The Tax Court held that because restrictions imposed on uses within building areas were "antithetical" to the conservation purposes of the 2005 and 2006 easements, those areas were not part of the easements at all. Because the locations of those building areas were not permanently fixed, the property originally protected by the easements was not protected in perpetuity, and no deduction was allowed. Although the facts, as construed by the Tax Court, are very close to those in *Bosque Canyon*, in which building areas were legally excluded from the easement and could be relocated within the easement, the court chose to disregard the Fifth Circuit decision upholding that easement.

b. Pine Mountain is a break from precedent.

In effect, the *Pine Mountain* decision makes new law, marking a break from precedent,[24] the regulations, and positions taken by the IRS itself in several private letter rulings.[25] To understand the extent to which *Pine Mountain* represents a departure from the past, it is worth taking a look at the legal landscape as it existed before the decision, beginning with the Tax Court's decision in *Butler*,[26] whose facts are strikingly similar to those of *Pine Mountain.*

i. Butler.

In *Butler*, the Tax Court upheld two conservation easements on more than 4,000 acres. Together, the easements reserved the right to develop 12 two-acre building sites with single-family residences. The locations of the building sites were dictated by a map contained in "baseline documents" incorporated into the conservation easements by reference.[27] The easements allowed the landowners to reconfigure (but not expand) the building sites with prior approval from the easement holder. The conservation purposes identified in the easements were protection of habitat, in accordance with section 170(h)(4)(A)(ii), and protection of open space, in accordance with section 170(h)(4)(A)(iii).

The IRS challenged the deductibility of the easements on the grounds that the donors' retained rights to develop the building sites were inconsistent with the conservation purposes, in violation of reg. section 1.170A-14(e)(2), which provides: "Except as provided in paragraph (e)(4) of this section, a deduction will not be allowed if the contribution would accomplish one of the enumerated conservation purposes but would permit destruction of other significant conservation interests."

The Tax Court accepted that a conservation easement might retain development potential and, if it did, deductibility would depend on the consistency of the retained rights with the conservation purposes:

> Sometimes, when landowners preserve their properties using conservation easements, those conservation easements permit no development at all, guaranteeing that the land will continue to exist in its then-current state. In such cases, evidence documenting a contemporaneous conservation purpose served by the land may be sufficient to show that the conservation easements serve the conservation purpose. However, in the instant case, petitioners have reserved rights enabling them to develop portions of their properties and conduct other activities that would noticeably alter the properties' current conditions. *Accordingly, we must decide whether, if the properties were developed to the extent permitted by the rights reserved under the easement deeds, they would still serve the conservation purpose*.[28] [Emphasis added.]

In other words, determining whether development potential that is reserved in a conservation easement is consistent with the conservation purposes depends on evaluating the

[24] *E.g.*, *Butler v. Commissioner*, T.C. Memo. 2012-72; and *BC Ranch*, 867 F.3d 547.

[25] LTR 9603018 and LTR 200403044.

[26] *Butler*, T.C. Memo. 2012-72.

[27] The IRS challenged the effectiveness of the limitation on location, arguing that because the baseline documents were only incorporated by reference and not actually put to record, they were ineffective. The Tax Court, applying Georgia law, held that incorporation by reference was sufficient to make the documents part of the conservation easement, and therefore effective.

[28] *Butler*, T.C. Memo. 2012-72, at *31.

impact of a reserved use on those purposes. Because the taxpayers in *Butler* provided evidence that the development of the reserved building sites was consistent with the conservation purposes, and the IRS presented no evidence to support its position, the Tax Court ruled in favor of the taxpayers.

The development rights reserved in *Butler* were evaluated based on their effect on the easement property as a whole and their consistency with the overall conservation purposes of the easements. The Tax Court did not consider whether the uses reserved within the building sites were consistent with the conservation purposes, nor did it consider whether the reserved right to "reconfigure" (relocate) the building sites was consistent with those purposes. *Butler* stands for the proposition that a conservation easement may reserve development potential if that potential is consistent with the conservation purposes of the easement.[29]

ii. Regulations.

Another part of the legal landscape seemingly disregarded by the *Pine Mountain* decision is reg. section 1.170A-14(e)(2) (cited previously and relied on by the Tax Court in *Butler*). This regulation provides that no deduction will be allowed if a conservation easement donation would accomplish one of the enumerated conservation purposes but would permit the destruction of other significant conservation interests. The regulation tacitly acknowledges that a conservation easement may reserve development potential, because the purpose of the rule is to prohibit the reservation of development potential that could be "destructive" of conservation values. If the areas on which development potential is reserved are not considered part of the easement (as *Pine Mountain* rules) then what happens within those areas cannot be considered development potential reserved by the easement, in which case there is no real purpose for reg. section 1.170A(e)(2).

Reg. section 1.170A-14(d)(4)(v) also anticipates that conservation easements may reserve development potential. This regulation imposes a restriction on the *kind* of development that may be reserved in a conservation easement whose purpose is the protection of open space.[30] It provides: "A deduction will not be allowed for the preservation of open space under section 170(h)(4)(A)(iii), if the terms of the easement permit a degree of intrusion or *future development* that would interfere with the essential scenic quality of the land or with the governmental conservation policy that is being furthered by the donation."[31] (Emphasis added.)

This regulation anticipates that a conservation easement may reserve development potential, some of which may be inconsistent with the preservation of open space and some of which may be consistent with governmental conservation policy. What would be the point of this regulation if the areas reserved for development are not considered to be part of the easement?[32]

Reg. section 1.170A-14(h)(3)(ii) also supports the proposition that deductible conservation easements can retain development rights: "In the case of a conservation restriction that *allows for any development*, however limited, on the property to be protected, the fair market value of the property after contribution of the restriction must take into account the effect of the development." (Emphasis added.)

This regulation assumes that a deductible conservation easement could reserve development potential, and it provides a means for determining the fair market value of a conservation easement that does so. However, if the development areas are not considered part of the easement, this regulation does not have any purpose and only the rules pertaining to

[29] *Butler* is cited for this proposition in *Carter*, T.C. Memo. 2020-21, at *9.

[30] *See* section 170(h)(4)(A)(iii).

[31] Reg. section 1.170A-14(d)(4)(v).

[32] The Tax Court dismisses these examples as irrelevant to whether a conservation easement is in perpetuity as required by section 170(h)(2)(C), because they "illustrate the perpetual protection requirement of section 170(h)(5) rather than the perpetual restriction requirement of section 170(h)(2)." *Carter*, T.C. Memo. 2020-21, at *23. However, it seems questionable that the authors of the regulations would use examples that violate one requirement of the regulations to illustrate compliance with another requirement of the regulations.

contiguous property owned by the donor or members of the donor's family apply.

Reg. section 1.170A-14(h)(3)(ii) is also significant because it prevents an easement donor from realizing any tax benefits from development potential reserved in a conservation easement by requiring that the value of that potential be taken "into account" (that is, subtracted).[33] This leads to the following question: If a conservation easement has a meaningful conservation purpose (for example, protection of 98.5 percent of 1,299 acres, as in the *Pine Mountain* easement), why should it matter if some development is permitted on 1.5 percent of the easement acreage if the donor is allowed no tax benefits for that reserved potential? What is the public purpose of a ruling that says reservation of an insignificant amount of development potential for which the donor enjoys no tax benefits is grounds to deny a deduction?

iii. Private letter rulings.

Finally, although it is well understood that private letter rulings are not precedent and cannot be relied on by anyone other than the taxpayer to whom one is issued,[34] they are relevant as an illustration of the IRS's thinking at the time they were issued.[35]

LTR 9603018 addressed the deductibility of a proposed conservation easement for scenic purposes. The easement reserved the donors' right to develop up to five new single-family residences in designated building envelopes. The locations of the building envelopes could be changed with the prior approval of the easement holder. The IRS, relying on examples 3 and 4 of reg. section 1.170A-14(f), found that the reservation of the right to residential development "comes within the spirit of Example (4)." The letter ruling concluded that the proposed easement met the requirements of the regulations and was "exclusively for conservation purposes."

LTR 200403044 addressed the deductibility of a proposed conservation easement for the purpose of protecting wildlife habitat. The easement reserved the right to develop a limited number of single-family residences and other improvements on the property, the locations of which would be subject to prior review and approval by the easement holder. Relying on the examples provided in reg. section 1.170A-14(f), and the fact that the locations of any development on the property were subject to prior review and approval by the easement holder, the IRS ruled that the easement would be deductible.

Up until at least 2004, the IRS believed that easement deductibility was not precluded by the reservation of building areas, even though their locations were not permanently fixed at the time of the contribution, as long as their location was ultimately approved in advance by the easement holder. It can be assumed that the authors of these rulings were familiar with the provisions of section 170(h)(2)(C) in drafting the rulings and would have referred to them had they been deemed relevant.

4. Interpreting section 170(h)(2)(C).

Butler, the regulations, and the private letter rulings were the legal landscape that existed before *Pine Mountain.* They provided the context within which conservation easements reserving movable building areas, subject to prior approval by the easement holder, have been drafted and contributed for decades. The Tax Court in deciding *Pine Mountain* disregarded that context and took the law in a new direction — at the expense of all those donors that, in making easement donations, relied on what seemed to clearly be the law.

The new direction is a result of the court's reading of section 170(h)(2)(C) as requiring not just a restriction on the use of land in perpetuity, but also a restriction *against development* in perpetuity. The consequence is that the right to relocate building areas, even though they are subject to restrictions in perpetuity, is now considered a right to relocate the boundaries of the easement, as in *Belk*, *Balsam Mountain*, and *Bosque Canyon*.

The Tax Court paraphrased section 170(h)(2)(C) to require "that the land restricted by the conservation easement be protected *from*

[33] One wonders why it matters that a conservation easement allows, say, 1.5 percent of the easement area to be developed, when the easement value must be reduced to reflect that reservation.

[34] *Carter*, T.C. Memo. 2020-21, at *24 (citing section 6110(k)(3)).

[35] *See Smith v. Regional Transit Authority*, 827 F.3d 412, 420 n.3 (5th Cir. 2016); and *Comerica Bank N.A. v. United States*, 93 F.3d 225, 230 (6th Cir. 1996).

development in perpetuity."[36] (Emphasis added.) Unfortunately, this paraphrase is a distortion of both the wording and the purpose of section 170(h)(2)(C), which says a qualified conservation contribution is "a restriction (granted in perpetuity) on the use which may be made of the real property."

This is the context of section 170(h)(2)(C): Section 170(h) requires that a conservation easement meet three criteria to be deductible as a qualified conservation contribution: (1) the contribution must be a qualified real property interest,[37] (2) the contribution must be made to a qualified organization,[38] and (3) the contribution must be exclusively for conservation purposes.[39]

The code then lists three types of qualified real property interests. The third type is "a restriction (granted in perpetuity) on the use which may be made of the real property."[40] Contrary to the court's holding, neither the code nor the regulations say that such a restriction must prohibit development. In fact, nothing in the code or regulations governing conservation easement deductions says that a deductible conservation easement must prohibit development. Section 170(h)(2)(C) requires only that there be "a restriction . . . granted in perpetuity" on the use of the property; it does not dictate the *nature* of the restriction, which is addressed by section 170(h)(5)(A).

Section 170(h)(5)(A) provides: "A contribution shall not be treated as exclusively for conservation purposes unless the *conservation purpose* is protected in perpetuity." (Emphasis added.) Section 170(h)(5) is the only provision in the code that dictates the nature of restrictions required for a conservation easement to be deductible. Notably, the only type of reserved use that the code provides will *automatically* preclude a deduction is surface mining.[41] Presumably, Congress believed that only surface mining was inherently inconsistent with the requirement that the easement be exclusively for conservation purposes. There is no blanket prohibition of development in section 170(h).

By inserting "from development" in its paraphrase of section 170(h)(2)(C), the Tax Court conflated the provisions of section 170(h)(2)(C) with those of section 170(h)(1)(C) (the contribution must be exclusively for conservation purposes) and (h)(5)(A) (the conservation purposes must be protected in perpetuity). In so doing, the court created a new bright-line test (silver bullet?) for deductibility based on reserved development potential, akin to the prohibition on strip mining.[42] This test appears to supersede the test provided in the regulations, which explains the requirements of section 170(h)(5)(A):

> In the case of any donation under this section, any interest in the property retained by the donor (and the donor's successors in interest) must be subject to legally enforceable restrictions (for example, by recordation in the land records of the jurisdiction in which the property is located) that will prevent uses of the retained interest inconsistent with the conservation purposes of the donation.[43]

The building areas in the *Pine Mountain* easements were indisputably subject to restrictions in perpetuity. However, because the restrictions permitted some development within the building areas, even though the nature and extent of that development was strictly controlled by those perpetual restrictions, the Tax Court disregarded them. It was able to do so because it read section 170(h)(2)(C) to require that the perpetual restriction on the use of the real property meet a specific standard: prohibition of *development*.

But for the court's recasting of the text of section 170(h)(2)(C), the *Pine Mountain* easements represented "a restriction (granted in perpetuity) on the use which may be made of the real property."[44] Whether the contribution was

[36] *Pine Mountain*, 151 T.C. at 273.

[37] Section 170(h)(1)(A).

[38] Section 170(h)(1)(B).

[39] Section 170(h)(1)(C).

[40] Section 170(h)(2)(C).

[41] Section 170(h)(5)(B).

[42] *Id.*

[43] Reg. section 1.170A-14(g)(1).

[44] Section 170(h)(2)(C).

"exclusively for conservation purposes"[45] was a different question entirely, the answer to which would appropriately be discovered by a *Butler*-like factual analysis of the effect of the reserved development rights on the easement property as a whole.

By interpreting section 170(h)(2)(C) as it did, the court precludes any flexibility in the location of building envelopes, regardless of the nature and extent of oversight of that location by the easement holder, and regardless of what conditions may be discovered in the future that prevent the use of the initially selected locations.[46] This indicates a lack of confidence in the easement holder's oversight of building area locations. Ironically, in this same decision, the court upheld a provision allowing amendment of the 2007 easement, relying on the easement holder's judgment:

> Respondent contends that article 6.7 could enable the parties to amend the 2007 easement in ways that would clearly violate the statutory "perpetuity" requirements, e.g., by reducing the size of the 2007 Conservation Area or by permitting residential construction within it. *But it is hard to imagine how [the easement holder] could conscientiously find such amendments to be "consistent with the conservation purposes"* set forth in the easement.[47] [Emphasis added.]

If the easement holder can be trusted to make correct judgments about amendments in general, it would seem logical to extend this trust to the easement holder's oversight of building area locations. This is either an inconsistency in the holding or reflects the court's determination that reserved development violates a bright-line prohibition — off limits to the judgment of an easement holder (as with strip mining).

Although the *Pine Mountain* decision is clear about the future location or relocation of designated building areas, it is not clear about development outside building areas, or even about what the court considers development.

Building areas are merely theoretical constructs. By themselves, they are simply a location, not a use. It was the uses reserved in the building areas that lead the court to conclude that the building areas "are not 'subject to the easements' in any meaningful sense,"[48] because the court believed that they allowed the landowner to convert conserved land to commercial development. "As sites for a standard upscale residential development, the Building Areas are exempt from the conservation easement because they permit uses antithetical to its conservation purposes."[49]

In every case, the physical impact of a structure on the ground, and the intensified use of the immediately surrounding area resulting from existence of the structure, is antithetical to the conservation *of that patch of ground*. This is true whether the structure is a chicken coop, a barn, a McMansion, a water tower, or a pipeline. The reservation of the right to locate or construct any of these structures constitutes "development" in its broadest sense, which is how prudence would dictate that the term be applied, given the IRS's increasingly minute application of the law.

The Tax Court faulted the 2005 and 2006 *Pine Mountain* easements for the reservation of residential development in particular. However, the opinion casts a broad net over residences, ponds, equestrian facilities, scenic overlooks, and hunting stands, none of whose locations were either restricted to building areas or fixed in the *Pine Mountain* easements. The Tax Court did not discriminate between these various reserved uses by nature or location, concluding that "the rights reserved to Pine Mountain, considered in their entirety, prevent the 2005 easement from constituting a 'qualified real property interest.'"[50]

Further clouding the issue, the Tax Court did not fault the 2007 Pine Mountain easement for its

[45] Section 170(h)(1)(C).

[46] Typical problems are that land within reserved building areas cannot support septic drain fields or produce potable water, or it possesses other physical characteristics that make its use for the reserved development impractical or impossible.

[47] *Pine Mountain*, 151 T.C. at 280-281. The court went on to find that a conservation easement, being a contract, can always be amended, and that amendment clauses in easements therefore actually narrow the scope of amendments acceptable under the provisions of the easement.

[48] *Id.* at 277.

[49] *Id.* at 277-278.

[50] *Id* at 276-277.

reservation of the right to develop a water tower and related pipelines:

> Unlike the other two easements, the 2007 easement designates no "Building Areas" and permits no residential construction anywhere within the 2007 Conservation Area. It likewise reserves to Pine Mountain no rights to construct scenic overlooks, barns, riding stables, boat storage buildings, piers, or other structures appurtenant to residential development. Apart from hunting blinds, the only structure permitted within the 2007 Conservation Area is a water tower to which may be attached underground pipes to provide water service to other parts of the Pine Mountain property. *Although the water tower, if poorly placed, could conceivably affect whether "the conservation purpose is protected in perpetuity" under section 170(h)(5)(A), we conclude that it has no effect on whether the use restriction attaches in perpetuity "to a defined parcel of real property" as required by section 170(h)(2)(C).*" [Emphasis added.]

The court did not find that the rights to develop (in a generic sense) a water tower and related structures anywhere on the 2007 easement property violated its new bright-line interpretation of section 170(h)(2)(C). However, the court did find that those structures, "if poorly placed," might violate section 170(h)(5)(A), which would require an evaluation of the impact of the reserved rights on the property as a whole, as in *Butler*. Were the water tower and related structures OK because they didn't constitute "upscale residential development"? All practitioners, landowners, and land trusts can do is wonder — and wait.

The relationship of sections 170(h)(2)(C) and 170(h)(5) is elaborated on in *Carter*.

C. *Carter*

Carter[51] is the first Tax Court case dealing with building area locations since *Pine Mountain*. Not surprisingly, it follows the *Pine Mountain* precedent exactly, although articulating the principles of the decision more clearly. *Carter* underscores the Tax Court's concern about the reservation of development potential in conservation easements.

1. Facts.

In 2005 the easement donor acquired 5,245 acres in Glynn County, Georgia. In 2011 it donated a conservation easement over 500 acres of that land. The stated conservation purposes of the easement were preservation of habitat,[52] preservation of open space for scenic purposes,[53] and preservation of open space in accordance with a governmental conservation policy.[54] The conservation easement prohibited any development or improvements on the 500 acres, with the exception of the reserved right to designate and develop up to 11 two-acre building areas for single-family residential use. The locations of those building areas were not fixed by the easement, but it required prior approval from the easement holder before they could be used. Excluding penalties, the IRS sought to recover $4,644,297 in underpaid taxes.

2. The decision.

The Tax Court held:

> Because the allowed use within the building areas would be antithetical to the easement's conservation purposes, the residual restrictions applicable within the building areas would not be sufficiently meaningful to be taken into account in applying section 170(h)(2). See *Pine Mountain Pres., LLLP v. Commissioner*, 151 T.C. at 277-278. Consequently, the easement in issue is not described in section 170(h)(2)(C), it is not a "qualified real property interest," and the conveyance of the easement to [the donee] was not a qualified conservation contribution, within the meaning of section 170(h)(1).[55]

[51] *Carter*, T.C. Memo. 2020-21.

[52] In accordance with section 170(h)(4)(A)(ii).

[53] In accordance with section 170(h)(4)(A)(iii)(I).

[54] In accordance with section 170(h)(4)(A)(iii)(II).

[55] *Carter*, T.C. Memo. 2020-21, at *25.

The Tax Court characterized the *Pine Mountain* decision as focused on what was allowed within the building areas, not the effect of the reserved building areas on the conservation purposes of the easement as a whole. The court interpreted *Pine Mountain* to conclude that it didn't matter whether the impact of the reserved building areas was consistent with the conservation of the property as a whole if the impact of the reserved rights within the building areas was inconsistent with the conservation purposes:

> Our analysis in *Pine Mountain* also implicates an important framing issue. When we concluded that the uses permitted within the building areas were antithetical to the easement's conservation purposes, *we implicitly focused on the achievement of conservation purposes within the building areas themselves*. If the uses permitted within the building areas prevented the achievement of conservation purposes in the easement as a whole, the easement would have failed section 170(h)(5)'s perpetual protection requirement; the question of whether the easement also failed section 170(h)(2)'s perpetual restriction requirement would have been irrelevant.[56] [Emphasis added.]

3. Analysis.

Carter underscores the Tax Court's change of focus from the impact of reserved development on the conservation of an easement property as a whole — the focus of the Tax Court in *Butler* — to the impact of reserved development on that small portion of land located within reserved building envelopes.

> *Regardless of whether building houses on each of 11 two-acre lots would impair conservation purposes in the easement area as a whole*, it would impede the achievement of those purposes *within each building area*. Pine Mountain establishes that the building of a single family home on a given site does not preserve the site itself as an open space or protect natural habitats or similar ecosystems within the site.[57] [Emphasis added.]

The court acknowledged that the restrictions imposed on uses within the building areas were meaningful to a degree, but that that missed the point:

> Had those areas not been covered by the easement, the donor could have built homes in them in greater density, limited only by applicable zoning law. While that restriction might well be viewed as meaningful in some senses, we concluded [in *Pine Mountain*] that it and any other applicable restrictions were not meaningful for purposes of section 170(h)(2)'s perpetual restriction requirement because they allowed a use of the property that was antithetical to the easement's conservation purposes.[58] [Emphasis added.]

This is a confusing formulation. The court accepts that the building areas are covered by the easement; however, if they are covered by the easement, they cannot be "holes" in the easement as they are described by the court. This conundrum is the result of the court's expansion of the plain meaning of section 170(h)(2)(C) to include a requirement that the perpetual restriction required by this section be a prohibition *on development*. The fact is that the restrictions imposed on the use of the building areas reserved by Pine Mountain included prohibition of development of many different kinds. One can only conclude that the only restriction on development that will satisfy the court's reading of section 170(h)(2)(C) is a restriction prohibiting *all* development. This, of course, eliminates any need for section 170(h)(5)(A).

The fact that the Tax Court's interpretation of section 170(h)(2)(C) supersedes section 170(h)(5) is underscored by the court's reference to *Butler* previously cited:

[56] *Id.* at *19.

[57] *Id.* at *21.

[58] *Id.* at *19.

> A donor's retention of limited development rights in specified portions of property covered by a conservation easement granted to a qualified organization need not preclude the donor from claiming a deduction for the contribution under section 170. E.g., *Butler v. Commissioner*, T.C. Memo. 2012-72; see also sec. 1.170A-14(f), Example (4), Income Tax Regs. The requirement that the donee approve the donor's exercise of those development rights, for example, may provide assurance that any structures erected will not materially prejudice the achievement of the easement's conservation purposes. But, as *Belk* and its progeny establish, if the boundaries of the areas in which the easement allows development are not fixed at the outset, *the donor's retention of development rights can violate section 170(h)(2)'s perpetual restriction requirement even if they do not violate section 170(h)(5)'s perpetual protection requirement*. When the boundaries of the building areas are indeterminate, there may be no defined parcel of property that is subject to a perpetual use restriction.[59] [Emphasis added.]

It may be that reserving flexibility in the location of building areas could conflict with the conservation purposes, in violation of code section 170(h)(5)(A), but *not* because the use of the building areas is unrestricted. The logical consequence of this rule is that the reservation of one undesignated two-acre building area could undermine the deductibility of a conservation covering 500 acres, which makes little sense. This is particularly true if the location of the building area must be approved in advance by the easement holder to ensure consistency with the conservation purposes and the donor gets no tax benefits for reservation of the building area.

As in *Pine Mountain*, the Tax Court concluded that because the uses allowed within the reserved building areas were "antithetical to the easement's conservation purposes," they weren't part of the easement at all. Thus, the court reasoned, if the boundaries of the building areas aren't fixed at the outset, the boundaries of the easement itself aren't permanent and thereby violate section 170(h)(2)(C). If the court had instead concluded that the building areas were in fact part of the easement, would that have led it to find that the reservation of even a fixed building area violated section 170(2)(C) because the easement allowed development?

Further, if, as the court stated, "the building of a single family home *on a given site does not preserve the site itself* as an open space or protect natural habitats or similar ecosystems within the site,"[60] do building areas really matter? As noted earlier, it is the development allowed within the building area that has an effect on the property, not the building envelope itself. Does the reservation of any structure, whether or not confined to a building area, create a hole in the easement, the relocation of which violates section 170(h)(2)? Taken to its logical extreme, this would seem to be where the IRS, if not the Tax Court, is headed.

D. Conclusion

Before *Pine Mountain*, the accepted rule was that the reservation and use of structures ("development") within a conservation easement was evaluated for its consistency with the overall conservation purposes of the easement. Generally speaking, major improvements such as residences and related amenities were not inconsistent with conservation purposes as long as they were confined to defined locations and as long as those locations could be changed only with the prior approval of the easement holder, taking into account the effect of the relocated structures on the conservation purposes of the easement.

Barns, fencing, and other agricultural improvements, as well as roads and utilities, could be located outside building areas if they had only an insignificant impact on the conservation purposes. Protection of particularly sensitive conservation values, such as streams, wetlands, and scenic views over the property, was accomplished through "no-build" buffers.

That approach was consistent with the scheme provided in reg. section 1.170A-14(h) and (f) and

[59] *Id.* at *9-*10.

[60] *Id.* at *21 (emphasis added).

implemented in *Butler*. Further, easement donors had a reason to limit the amount of development potential reserved in conservation easements because such reserved potential reduced the deductible value of the easement.

The Tax Court's decisions in *Pine Mountain* and *Carter* make such provisions in conservation easements generally untenable. Reasonable flexibility, allowed by the consistency rules of the code and regulations, has been replaced by a new and draconian interpretation of the code that reservation of development potential violates the perpetuity requirement. The Tax Court's failure to define development opens the door to potential IRS challenges to even the most commonplace agricultural structures if their locations are not fixed at the outset.

How should practitioners, landowners, and land trusts proceed? Arguably, the safest practice is to limit all reserved structures to irrevocably designated building areas — either a residential building area or an agricultural building area. Small-scale structures, if supportive of the conservation purposes of the easement, such as run-in sheds for livestock, fencing, feeding and watering stations for livestock, cattle guards, and storage sheds, might be allowed outside designated building areas on the grounds that they are necessary for agricultural preservation (which is among the open-space conservation purposes) and cannot feasibly be confined to fixed building areas. The location of such minor uses might pass the new perpetuity test established by the Tax Court's interpretation of section 170(h)(2)(C) and be afforded case-by-case evaluation under section 170(h)(5)(A) for consistency with the conservation purposes.

None of the foregoing suggestions are proof against a creative and aggressive IRS, as aided and abetted by the Tax Court. Hopefully, a more reasoned interpretation of the code will be applied in the future.[61]

Most discouraging of all, although there may be ways to avoid violating the court's new perpetuity rule in the future, hundreds, if not thousands, of easements that have already been irrevocably contributed in good faith, resulting in meaningful conservation, and drafted based on what seemed to be established law at the time, have suddenly become vulnerable to IRS challenge. This is an unreasonable and unnecessary injustice.

III. Proceeds Clauses

The regulations require that in the event a conservation easement is extinguished for any reason, proceeds resulting from a subsequent sale of the underlying property must be shared between the landowner and the easement holder.[62] This requirement (the proceeds clause) is intended to ensure that the easement donation is in fact perpetual even if the easement itself is extinguished for some reason. This would not be the case if there was any possibility that the economic value extinguished by the easement could be recovered by the donor if the easement was extinguished. As the Fifth Circuit described it:

> The purpose of this regulation is (1) to prevent a taxpayer (or his successor) "from reaping a windfall if the property is destroyed or condemned" such that the easement cannot remain in place and (2) to assure that the donee can use its portion of any proceeds to advance the conservation purpose elsewhere. In other words, the Commissioner recognized that the conservation interest that is the subject of a donation could be destroyed in the future and set forth a regulation to guarantee that such an interest is still protected in such an event.[63] [Internal citations omitted.]

The proceeds clause provides:

> *Proceeds.* In case of a donation made after February 13, 1986, for a deduction to be allowed under this section, at the time of the gift the donor must agree that the donation of the perpetual conservation restriction gives rise to a property right, immediately vested in the donee

[61] *Pine Mountain* is on appeal to the Eleventh Circuit, with oral argument scheduled for August 28.

[62] Reg. section 1.170A-14(g)(6).

[63] *PBBM-Rose Hill*, 900 F.3d at 205.

> organization, with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction at the time of the gift, bears to the value of the property as a whole at that time. . . . For purposes of this paragraph (g)(6)(ii), that proportionate value of the donee's property rights shall remain constant.

A. Proceeds Clause Cases

The Tax Court has, over the years, reviewed various conservation easement provisions intended to comply with the proceeds clause, and it has required strict compliance with the regulations.[64] In most of these cases, the court has rejected provisions that could have deprived the easement holder of any proceeds or prevented the holder from sharing in any increase in property value after the donation of the easement. Those cases are understandable and seem in line with the purposes of the proceeds clause.

However, in a recent series of cases, the Tax Court has held that the value of *improvements* located on the easement land, both existing and future, must be included in an easement donee's proportionate share of extinguishment proceeds. These rulings are contrary to common and long-standing practice and seem to address an issue that is nearly nonexistent in the real world, while putting hundreds, if not thousands, of existing deductions at risk.[65]

In *PBBM-Rose Hill*,[66] the Tax Court addressed a proceeds clause that subtracted expenses of sale and the value of improvements from the amount of proceeds due to the easement holder if an extinguishment of the easement resulted in a sale of the underlying land. The Tax Court paraphrased the proceeds clause as follows:

> At the time of the gift the donor must give the donee the right, in the event the conservation restriction is extinguished by a judicial proceeding, to a portion of the proceeds received for the whole property that is at least equal to the proceeds received for the whole property multiplied by the value of the restrictions at the time of the gift, and divided by the value of the property as a whole at the time of the gift.[67]

The Tax Court held that subtracting the value of expenses of sale and the value of improvements violated the regulation, and it denied the deduction. The decision was upheld on appeal by the Fifth Circuit. The Fifth Circuit held that the term "proceeds" as used in the regulation meant the "total amount brought in" from a sale after an extinguishment.[68] Thus, if a sale resulting from an extinguishment included an amount realized from improvements, the improvements had to be included in the proceeds, a portion of which is due to the easement donee under the proceeds clause.

The *PBBM-Rose Hill* holding provided the template for the spate of proceeds clause decisions that followed,[69] all of which disallowed deductions because the easement proceeds provisions subtracted the value of improvements. The only variation in this string of decisions was an extensive analysis of the validity of the regulation itself in one case, which generated an even more extensive dissent.[70]

B. Analysis

1. Preface.

This analysis focuses on the Tax Court's holdings that the value of existing and future improvements must be included in determining

[64] *Kaufman v. Commissioner*, 134 T.C. 182 (2010) (finding that a subordination agreement preserving a lender's right to any insurance or condemnation proceeds violated reg. section 1.170A-14(g)(6)), *rev'd*, 687 F.3d 21 (1st Cir. 2012); *Carroll v. Commissioner*, 146 T.C. 196 (2016) (finding that a proceeds clause that established the amount of deduction allowed as the basis for determining the easement holder's "proportionate share" violated reg. section 1.170A-14(g)(6)); and *Railroad Holdings LLC v. Commissioner*, T.C. Memo. 2020-22, and *Woodland Property Holdings*, T.C. Memo. 2020-55 (both rejecting proceeds clauses that tied values to those existing on the date of the donation).

[65] A risk for which there is no protection, because the contributions are irrevocable and there is no provision in relevant tax law allowing a correction by amendment to have retroactive effect.

[66] *PBBM-Rose Hill*, No. 26096-14 (T.C. bench opinion), *aff'd*, 900 F.3d 193.

[67] *Id.*, bench opinion at 9.

[68] *Id.*, 900 F.3d at 205.

[69] *Coal Property Holdings LLC v. Commissioner*, 153 T.C. 126 (2019); *Oakbrook Land Holdings LLC v. Commissioner*, T.C. Memo. 2020-54; *Hewitt v. Commissioner*, T.C. Memo. 2020-89; and *Lumpkin One Five Six*, T.C. Memo. 2020-94.

[70] *Oakbrook Land Holdings*, 154 T.C. No. 10.

an easement donee's proportionate share of extinguishment proceeds.[71] Given the five Tax Court opinions and the Fifth Circuit's concurrence, it seems clear that this interpretation is by now carved in stone.[72] However, that doesn't necessarily mean it is correct.

By requiring that the value of existing and future improvements be included in the donee's proportionate share of extinguishment proceeds, the courts have gone beyond ensuring the perpetuity of *the contribution*, which is the purpose of the proceeds clause, to include the value of property rights that were neither part of the original donation, nor the basis for any tax benefit to the donor. Ironically, in many cases the interpretation mandated by the court *will reduce* the proceeds due to the easement donee and may expose donors and their successors in title to significant financial risk.

2. Improvements are not part of easement donations.

It is a basic principle of real property law in the United States that the fee simple ownership of real property consists of a "bundle of twigs," each twig representing a different right to the use of the property, and all the twigs together representing the fee simple.[73] Recalling this basic principle helps illustrate the problem with the recent Tax Court decisions interpreting the proceeds clause.

When someone donates a conservation easement, the donation includes some of the twigs in the donor's bundle — for example, the right to subdivide the property or the right to undertake commercial or industrial uses. The donor also keeps some of the twigs, which are not part of the donation and are not among those donated to the easement donee[74] — for example, the right to continue to use existing improvements; the right to conduct agricultural activities; and the right to construct new improvements, which may include agricultural or residential structures. These retained rights are clearly distinct from the rights granted to the easement donee. They are also rights for which the donor receives no tax benefits, because they are not part of the donation.

Failure to respect this basic fact of conservation easements has led the IRS and courts to treat easement donations as though the donor included some twigs in its donation that it did not. Specifically, the courts' interpretation of the proceeds clause requires that the value of rights that are retained by the donor and not part of the easement be included in proceeds payable to the holder in the event of extinguishment.

This interpretation of the proceeds clause not only disregards the actual facts of easement donations, but it is also inconsistent with the rules of easement valuation in the regulations. These rules demonstrate that the donation of a conservation easement (other than an easement protecting an historic structure) does not include the value of improvements, existing or future. The regulations provide:

> The value of the contribution under section 170 in the case of a charitable contribution of a perpetual conservation restriction is the fair market value *of the perpetual conservation restriction* at the time of the contribution. . . . If no substantial record of market-place sales is available to use as a meaningful or valid comparison, as a general rule (but not necessarily in all cases) the fair market value of a perpetual conservation restriction *is equal to the difference between the fair market value of the property it encumbers before the granting of the restriction and the fair market value of the encumbered property after the granting of the restriction*.[75] [Emphasis added.]

"Perpetual conservation restriction" is the label for the particular set of twigs donated by the easement donor. As noted, these twigs do not

[71] The Tax Court's position that expenses of sale and other charges against the extinguishment proceeds cannot be subtracted before their allocation is logical and consistent with the rest of the regulations governing conservation easement deductions. The same does not hold true for its position that the value of existing and future structural improvements must be included in that allocation.

[72] The Tax Court's decision in *Oakbrook Land Holdings* regarding the validity of the proceeds clause regulation may be appealed.

[73] Jane B. Baron, "Rescuing the Bundle-of-Rights Metaphor in Property Law," 82 *U. Cin. L. Rev.* 57 (2014).

[74] Conservation easements sometimes emphasize this with a provision that states: "Except for the rights expressly granted to the grantee herein, the grantor retains all of the rights to the Property that are consistent with the conservation purposes hereof," or other words to that effect.

[75] Reg. section 1.170A-14(h)(3)(i).

normally include the value of existing or future improvements.

The regulatory directions for easement valuation illustrate this. These directions require an easement appraiser to determine the value of the bundle of twigs owned by the donor before the donation and the value of the bundle of twigs it owns after the donation. Before the donation, the bundle included development rights; after the donation, the bundle no longer includes the development rights eliminated by the easement's restrictions, but it includes the right to own and use the restricted land and the right to own and use existing and future improvements not prohibited by the easement. The difference in these two values represents the value of the twigs donated to the easement donee for which a charitable deduction is allowed. The donor gets no tax benefit for the value of the retained rights because they were not part of the donation.

In other words, unless the easement imposes restrictions on the value of improvements that reduce the value of the improvements, the value of improvements is not included in the value of the donation.

As for the future improvements, they have no value until the landowner at some point creates them, typically at considerable expense to the landowner. The right to construct improvements in the future is a twig retained by the original easement donor, but that right has a value distinct from the value of the improvements themselves. The value of the improvements is the result of some future investment by the landowner or a successor in title.

Here is an example of what can happen under the Tax Court's interpretation: A landowner donates a conservation easement more than 100 acres, retaining the right to divide the property into two parcels, each having the retained right to one single-family homesite. Before the easement, the donor could have divided the property into 50 parcels, each with one homesite. An appraisal finds that before the easement the value of the property was $2 million, and that after the easement the value of the property is $500,000. The value of the easement is $1.5 million. Thus, the proportionate value for purposes of the proceeds clause is 75 percent ($1.5 million/$2 million). The after-easement value of $500,000 represents the value of the property rights retained by the donor.

Five years later the donor divides the property and sells one portion, including one of the two retained homesites, for $250,000. The buyer takes out a construction loan for $400,000 and builds a $500,000 home. (The construction loan is subject to the provisions of the easement because the easement represents a prior right.) The buyer pays $2,500 per month on the construction loan, which is later converted to a 30-year mortgage. Two years later the buyer's entire parcel is condemned for a flood control project. She receives $600,000 in compensation and still owes most of the $400,000 she borrowed.

Under the Tax Court's interpretation of the proceeds clause, the landowner must pay $450,000 of the $600,000 to the easement holder, leaving her in debt to the lender for $250,000 (assuming she pays the remaining $150,000 of the condemnation award to the lender). This result not only ensures that the conservation purposes of the original easement are protected in perpetuity, but it also confers a windfall on the easement holder considerably beyond the original donation, with rather harsh consequences for the landowner. Such a result should give any prospective easement donor, as well as future purchasers of easement land, considerable pause.

Keep in mind that the purpose of the proceeds clause is to ensure that even if the easement is extinguished, the conservation purposes of the easement can be realized in perpetuity.[76] Except for historic preservation easements, the purposes of conservation easements do not include the preservation of existing or future improvements.[77] Requiring that a donee's proportionate share of extinguishment proceeds include existing and future improvements — which are not included in the property rights conveyed with the easement, in the value of the donation, or in the tax benefits received by the donor — is inconsistent with the stated purpose of the regulation.

Further, the regulation providing for allocation of basis reflects that the donation of a

[76] Reg. section 1.170A-14(g)(6)(ii).

[77] *See* reg. section 1.170A-14(d) for a list of recognized conservation purposes.

conservation easement does not necessarily include structural improvements:

> In the case of the donation of a qualified real property interest for conservation purposes, the basis of the property retained by the donor must be adjusted by the elimination of that part of the total basis of the property that is properly allocable to the qualified real property interest granted. The amount of the basis that is allocable to the qualified real property interest shall bear the same ratio to the total basis of the property as the fair market value of the qualified real property interest bears to the fair market value of the property before the granting of the qualified real property interest. *When a taxpayer donates to a qualifying conservation organization an easement on a structure* with respect to which deductions are taken for depreciation, the reduction required by this paragraph (h)(3)(ii) in the basis of the property retained by the taxpayer must be allocated between the structure and the underlying land.[78] [Emphasis added.]

This regulation distinguishes between conservation easements in general and easements on structures. Only in a case in which the easement expressly pertains to a structure must the basis adjustment be allocated between the land and the structure to reflect the fact that an interest *in the structure* has been included in the donation. No allocation is required for easements in general. This is illustrated by reg. section 1.170A-14(h)(4), Example 12.

3. The meaning of 'property as a whole.'

The key to the courts' interpretation that proceeds must include the value of improvements is its implicit assumption that "property as a whole" means land *and improvements*. If that is the case, it would make sense for "proceeds" to pertain to the value of land and improvements. However, to interpret "property as a whole" to include property rights that were not donated to the easement holder violates the intent of the donor and donee, the nature of the donation, and the principles of valuation, all as discussed earlier.

The Tax Court and the IRS can, of course, respond that it is perfectly possible that the authors of the regulations intended to include improvements even though their value is not included in the value of the donation or the property rights conveyed to the donee with the easement. If there were no other rational meaning for the phrase "property as a whole," that position might be acceptable (except, perhaps, on the grounds that the regulation is arbitrary and capricious, which is a separate matter entirely).

However, there is another meaning for the phrase "property as a whole" that is more logical and consistent with the entire regulation than is the meaning assumed by the courts to date. Under this alternative interpretation, "property as a whole" means the property *unencumbered* by the conservation easement. Unless "property as a whole" means the property unencumbered by the easement, there is nothing to say that the calculation required by the regulation isn't to be based on the value of the property as restricted by the easement.[79]

For example, suppose that the value of property before an easement donation is $100,000 and that the value after the donation is $70,000. The easement, using the "before and after" method, is worth $30,000. Unless "property as a whole" means the value of the property unrestricted by the easement, there is no reason why the proportionate value wouldn't be 43 percent ($30,000/$70,000) rather than 30 percent ($30,000/$100,000).[80] It is more reasonable to assume that the drafters of the regulation used the phrase "value of the property as a whole" to

[78] Reg. section 1.170A-14(h)(3)(iii).

[79] The Tax Court *assumes* that the calculation of proceeds is to be based on the unencumbered value of the property — *e.g.*, the proportionate share due to the donee is based on "a fraction defined by the ratio of the FMV of the easement to the FMV of *the unencumbered property* determined as of the date of the Deed." *Oakbrook Land Holdings*, T.C. Memo. 2020-54 at *41. However, there is nothing in the regulations to support that assumption unless one interprets "property as a whole" to mean the property unencumbered by the easement.

[80] Basing proportionate value on the restricted value of the property clearly increases the proceeds due to the donee. If the value of the easement in this example was $70,000 and the value of the restricted property was $30,000, the donee's proportionate share would be even greater: 233 percent ($70,000/$30,000). While such an outcome might appear extreme, it isn't any more extreme than reading "property as a whole" to include property interests that were not part of the donation and may not even exist at the time of the donation.

provide guidance on this point than it is to assume that the phrase includes property rights never included in the donation.

4. Effect on the amount of a donee's proceeds.

The consequences of the Tax Court's interpretation of the regulation are widely assumed to increase the amount of proceeds due to the donee in the event of an extinguishment.[81] However, that is only the case if the extinguishment affects land on which improvements are located. In most cases, extinguishments are the result of condemnations for public infrastructure projects,[82] which typically take less than all of the easement property and typically take only land that does not contain substantial improvements. If the extinguishment does not include land with improvements, and if there are no improvements on the easement property at the time of the donation, the Tax Court's interpretation of the proceeds clause has no effect on the amount of proceeds due to the donee.

Alternatively, if the easement land included improvements at the time of the donation, and if the extinguishment did not include land with improvements (the most likely scenario), the Tax Court's interpretation of the proceeds clause can *substantially reduce* the proceeds due to the donee. For example, suppose that a conservation easement covers a 100-acre property containing a $1 million residence. The value of the land before the easement is $1 million. After the easement, the value of the land is reduced to $200,000. The restrictions of the easement do not affect the value of the residence, which remains $1 million, so the easement is worth $800,000.

Later, a 10-acre portion of the property is taken for road improvements. Proceeds from the taking are $100,000. Including the value of the existing improvements in calculating the donee's proportionate share results in a proportionate share for the donee of 40 percent ($800,000/$2 million). Excluding the value of the existing improvements results in a proportionate share for the donee of 80 percent ($800,000/$1 million). In other words, interpreting "property as a whole" to include improvements reduces the donee's share by 50 percent in this example.

Adding the value of improvements to the proportionate share fraction increases the denominator, not the numerator, resulting in a decreased proportionate share for the donee. Of course, if the proceeds actually include proceeds from the sale of improvements, allowing the donee a share of those proceeds will increase the proceeds due to the donee. However, that is the only scenario in which the donee's proceeds will increase under the Tax Court's interpretation.

5. Extinguishments are rare.

If the only case in which the donee's proceeds will be increased is one in which extinguishment proceeds include improvements, and given the widespread effect of the Tax Court's decisions on existing deductions, it is worth looking at the incidence of easement extinguishments. Data collected by the Land Trust Alliance indicates that the likelihood of extinguishment is very small. According to a study published by the group, as of 2014, land trusts reported only 35 conservation easements entirely extinguished (referred to as "releases" by the Alliance) (2,395 acres), and only 155 partial extinguishments (2,207 acres). Total acreage affected by these reported releases was 0.05 percent of total reported easement acreage at the time.[83] Although these data are based on reporting by land trusts and may undercount actual extinguishments, it nevertheless demonstrates that extinguishments are rare.

Fifty-one percent of the releases reported by the Land Trust Alliance were attributable to condemnation or settlement in lieu of condemnation. Those extinguishments would result in proceeds. Fifteen percent of extinguishments reported were classified as "other," so it is hard to say whether proceeds

[81] *E.g.*, the Tax Court's explanation of the IRS's position in *Oakbrook Land Holdings*: "He [the commissioner] argues this clause actually reduces the Conservancy's interest in extinguishment proceeds by the value of such improvements, and the value may fluctuate over time. In the event those improvements are 'quite extensive,' he argues, a situation could arise in which the Conservancy *would receive nothing upon extinguishment*." *Oakbrook Land Holdings*, T.C. Memo. 2020-54, at *30. (Emphasis added.) It is hard to see how extensive improvements could eliminate all proceeds due to the donee under any reading of the regulations unless somehow the underlying land ceased to have any value whatsoever.

[82] *See infra* note 84.

[83] Land Trust Alliance, "Results of Land Trust Alliance Research and Survey on Easement Modification and Termination," at 27 (2014).

resulted. The rest of the extinguishments reported were attributable to extinguishments in exchange for the placement of easements on additional land, merger of title in the easement holder, and boundary line adjustments, none of which are likely to have resulted in proceeds.

In other words, the number of cases in which a proceeds clause actually comes into play is exceedingly small.

6. A solution.

There is a solution to the problem created by the court's interpretation of the proceeds clause: Simply exclude improvements from future conservation easements by creating "holes in the cheese." The holes are building areas entirely excluded from the conservation easement.[84] It is important that the land actually made subject to the easement have sufficient conservation value for the easement to generate a publicly significant conservation purpose. Because the value of retained development in a conservation easement is subtracted from the value of the easement in determining the amount of the deduction, there should be little effect on the overall value of the easement as a result of carving out the building areas.

There is a caveat to ensuring that the carveouts don't significantly affect the easement value: The areas carved need to be small enough that local planning regulations won't allow them to be used for more than what they could have been used for if they had been included in the easement (for example, one single-family residence and appurtenances). If there are no reliable applicable local ordinances, it may be necessary for the easement donor to place a restrictive covenant on the carved-out areas in favor of the easement holder to limit future use of those areas. Otherwise, because the easement appraisal must include the value of the entire contiguous property owned by the donor or members of the donor's family,[85] the appraiser may conclude that the donation of the easement increases the value of the carved-out areas significantly beyond what their value would be if included in the easement.

There is one other important caveat: The boundaries of the carved-out areas must be perpetually fixed, or they will violate provisions of section 170(h)(2)(C), as discussed at length in Section II of this report.

Carving out areas for existing or future improvements also simplifies easement drafting, because provisions controlling the use of the land within the building areas will not be necessary. This also simplifies the donee's stewardship responsibilities because there will be no responsibility for enforcing restrictions on uses within the building areas (unless they are restricted by a covenant in favor of the donee) because they won't be part of the easement.

This is not a solution that is consistent with good land conservation, but it may be necessary to avoid the potentially unfortunate consequences of reserving improvements in a conservation easement in the event of extinguishment. Because extinguishments are so rare, and extinguishments generating proceeds from the sale of improvements are even rarer, it is a shame to have to resort to carveouts. However, the Tax Court leaves land trusts, landowners, and their advisers with little recourse other than to assume that extinguishment will not happen. It is hard to practice tax law by relying on the law of probabilities.

C. Conclusion

The proceeds clause cases appear to have no meaningful outcome in correcting abuses, or even in addressing real-world occurrences. The decisions pertain to cases that for the most part are characterized by questionably dramatic increases in property values over very short periods.[86] In several cases, the donors failed to properly complete Form 8283, "Noncash Charitable Contributions," stating that the

[84] This was the approach taken in *Balsam Mountain*, T.C. Memo. 2015-43, with the fatal flaw (so far as the Tax Court was concerned, anyway) being that the boundaries of the excluded areas could be changed.

[85] Reg. section 1.170A-14(h)(3)(i).

[86] *PBBM-Rose Hill*: 680 percent increase in less than one year; *Oakbrook Land Holdings*: at least 561 percent (based on claimed deduction); *Lumpkin One Five Six*: 847 percent in less than one year; and *Englewood Place*: 1,900 percent in less than one year. Several of these cases also appeared to involve easement syndications, which are tax shelters identified as listed transactions by Notice 2017-10, 2017-4 IRB 544. Others failed to comply with the requirements of Form 8283 to properly substantiate their deduction, in direct contravention of the precedent established in *RERI Holdings LLC v. Commissioner*, 149 T.C. 1 (2017).

information requested wasn't relevant to the deduction claimed.

Overvaluation and failure to properly complete Form 8283 are established grounds for the denial or reduction of deductions. They were, to one degree or another, present in each of these cases. Nevertheless, the IRS chose to raise novel technical objections, and the Tax Court has gone along with those objections. The result is the undermining of hundreds, if not thousands, of deductions based on legitimate, meaningful conservation donations, which relied on commonly accepted practices, seemingly endorsed by the IRS, at least in private letter rulings.[87] The parallels with the novel attacks on the location of building envelopes discussed in Section II of this report are striking.

To return to Holmes's observation in *Oakbrook Land Holdings*, "This is the second time we've taken an ax to entire forests of these deductions."[88] The question remains, why? ■

[87] LTR 200836014.

[88] *Oakbrook Land Holdings*, 154 T.C. No. 10.