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GROUND ZERO: THE IRS ATTACK ON SYNDICATED CONSERVATION EASEMENTS

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ABSTRACT

On June 25, 2020, the Internal Revenue Service ("IRS") announced a settlement initiative ("SI") to certain taxpayers with pending docketed cases involving syndicated conservation easement ("SCE") transactions. The SI is the current culmination of a long series of attacks by the IRS against SCE transactions. The IRS has recently found success in the Tax Court against SCEs, but the agency's overall legal position may be overstated. It is possible that the recent SI is merely an attempt to capitalize on leverage while the IRS has it. Regardless, the current state of the law surrounding SCEs is murky at best. Whether a taxpayer is contemplating the settlement offer, is currently involved in an unaudited SCE transaction, or is considering involvement in an SCE transaction in the future, the road ahead is foggy and potentially treacherous.

This Article attempts to shed light on the obstacles that face SCE transactions. This Article: (1) provides an overview of SCE transactions and the main attacks against them; (2) analyzes each of the IRS's main attacks and the relevant issues that arise; (3) illustrates the relevant pro-taxpayer and anti-taxpayer cases on each issue; (4) discusses the subsequent considerations that taxpayers need to take into account and the future outlook of SCE; and (5) concludes with a summary of the Article's findings.

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OVERVIEW

Under Section 170 of the Internal Revenue Code, taxpayers are allowed to take a deduction for donating a conservation easement on their land.[1] The purpose of the deduction is to encourage the preservation of land.[2] The amount of the deduction is generally equal to the difference between the value of the land at its "highest and best use" and the value of the land after the conservation easement is executed.[3] To take advantage of this deduction, many taxpayers have created transactions which are now referred to as "syndicated conservation easement [SCE] transactions."[4] Typically in these cases, investors form and contribute funds to a partnership.[5] The partnership then buys another partnership containing a tract of land that has been held by it for more than one year.[6] The partnership obtains an appraisal of the land's "highest and best use" which is considerably higher than the amount the land-owning partnership paid for the land.[7] Then, the partnership donates a conservation easement over

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1 *See* I.R.C. § 170(a)(1) (2020).
2 *See id.* § 170(h)(1) (2020).
3 26 C.F.R. § 1.170A-14 (2019).
4 *See* Guinevere Moore, *IRS Settlement Program For Syndicated Conservation Easements Announced*, FORBES (Jun. 26, 2020), https://www.forbes.com/sites/irswatch/2020/06/26/irs-settlement-program-for-syndicated-conservation-easements-announced/#13291152e3cf [https://perma.cc/A33G-ASK7].
5 *See id.* at 3.
6 *See id.* at 2–3; S. Rep No. 116-44, at 18 (2020).
7 Moore, *supra* note 4, at 3–4.

the land to a local conservancy.[8] Finally, the partners take large deductions (usually far more than their initial investment in the partnership) based on the new valuation of the land for their charitable contribution under Section 170.[9]

The IRS became suspicious of conservation easements in 2016, when it first designated SCE transactions as "listed transactions."[10] In 2019, the IRS announced a "significant increase in enforcement actions" related to SCE transactions as SCEs made the IRS's "Dirty Dozen" list of tax scams.[11] This increase in enforcement actions has primarily resulted in IRS victories in the Tax Court.[12] Thus, the IRS recently announced a Settlement Initiative ("SI") to leverage its favorable outcomes against the taxpayers.[13] Some critics are skeptical of the SI, claiming the IRS only wins SCE cases on technical grounds and the IRS does not hold as strong of a position as it claims on the true issues surrounding conservation easements.[14] Accordingly, many suggest that few taxpayers will take part in the SI.[15]

In the Tax Court, the IRS is fighting the entire deduction, which many argue cuts against congressional intent.[16] In the cases where the taxpayers prevail, the IRS is typically still able to reduce the value of the easement.[17] There is virtually no case where the taxpayers get to keep the entire deduction.[18] Despite their recent success in the Tax Court, the IRS is far from an outright victory in the war on conservation easements.[19]

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[8] *See, e.g.*, Lumpkin One Five Six, LLC, v. Comm'r, T.C.M. (RIA) 2020-094, 1 (T.C. 2020).
[9] I.R.S. News Release IR-2020-130 (June 25, 2020) [hereinafter IR-2020-130].
[10] I.R.S. Notice 2017-10, 2017-4 IRB 544.
[11] I.R.S. News Release IR-2019-182 (Nov. 12, 2019).
[12] *See, e.g.*, Pine Mountain Pres., LLP v. Comm'r, 151 T.C. 247 (2018); *see also* Oakbrook Land Holdings, LLC, v. Comm'r of Internal Revenue, Respondent, 119 T.C.M. (CCH) 1352 (T.C. 2020).
[13] IR-2020-130, *supra* note 9.
[14] Kaustuv Basu & Aysha Bagchi, *IRS Land Deal Offer Has Little to Entice Challengers to Settle*, BLOOMBERG LAW (Jul. 9, 2020), https://news.bloombergtax.com/daily-tax-report/irs-land-deal-offer-has-little-to-entice-challengers-to-settle [https://perma.cc/4MFL-WGVX].
[15] *Id.*
[16] Nancy O. Kuhn, *INSIGHT: Charitable Conservation Easements—IRS and Tax Court Act To Shut Them Down*, BLOOMBERG LAW (July 22, 2020), https://news.bloombergtax.com/daily-tax-report/insight-charitable-conservation-easements-irs-and-tax-court-act-to-shut-them-down [https://perma.cc/TM5P-N4RW].
[17] *See, e.g.*, Gorra v. Comm'r, 106 T.C.M. (CCH) 523, 521, 525 (T.C. 2013).
[18] In 2009, the taxpayers won a near outright victory. *See* Kiva Dunes Conservation, LLC v. Comm'r, 97 T.C.M. (CCH) 1818 (T.C. 2009).
[19] Peter J. Reilly, *IRS Victory In Easement Case Prompts An Offer Not To Be Refused*, FORBES (June 25, 2020), https://www.forbes.com/sites/peterjreilly/2020/06/25/irs-victory

The determinative issues in these cases are temporary roadblocks for SCE transactions. Eventually, taxpayers will figure out how to structure their SCE transactions to avoid the pitfalls of recent cases. For example, the IRS recently convinced the Tax Court that certain taxpayers' easement deeds violate the perpetuity requirement of conservation easements because the extinguishment clause of the deed provides the donee with a fixed value instead of a "proportionate value" upon extinguishment.[20] Going forward, those drafting SCE deeds will make sure that the extinguishment clause complies with this requirement. Additionally, many conservation easements struck down in the Tax Court found much more favorable outcomes upon appeal.[21] In fact, the most influential recent case is likely to be appealed in the Sixth Circuit.[22] The Tax Court avoids circuit precedent when possible,[23] but as the number of cases rises the Tax Court may not be able to hide much longer. The IRS may eventually have to concede that SCEs are technically valid conservation easements. When that happens, the IRS will fall back on one of its original arguments—conservation easements overvaluation. Thus, valuation is the real issue and it is extremely fact-intensive and differs from case to case.[24]

Currently, the IRS primarily attacks SCEs by arguing that the taxpayers did not make a "qualified conservation contribution."[25] This is required for the taxpayers to receive the deduction for donating a conservation easement.[26] There are three necessary requirements for a contribution to be considered a "qualified conservation contribution":

1. The contribution must be of a qualified real property interest ("QRPI").
2. The contribution must be made to a qualified organization.

-in-easement-case-prompts-an-offer-to-not-be-refused/#2412d0f32d83 [https://perma.cc/MR7G-ZTN4].

[20] *See* Oakbrook Land Holdings, LLC, 119 T.C.M. (CCH) 1352 (T.C. 2020).

[21] *See, e.g.*, Champions Retreat Golf Founders, LLC v. Comm'r, 959 F.3d 1033, 1041 (11th Cir. 2020) (remanded to Tax Court for valuation).

[22] *See Oakbrook*, 119 T.C.M. at 1352.

[23] *Compare* Pine Mountain Pres., LLLP v. Comm'r, 151 T.C. 247, 272–73 (2018), *with* BC Ranch II, L.P. v. Comm'r, 867 F.3d 547 (5th Cir. 2017).

[24] *See* Peter J. Reilly, *Conservation Easement Tax Deductions and Valuation Abuse*, FORBES (Jan. 14, 2016), https://www.forbes.com/sites/peterjreilly/2016/01/14/conservation-easement-tax-deductions-and-valuation-abuse/#4917cbd15f63 [https://perma.cc/E4Y3-6A5N].

[25] I.R.C. § 170(h)(1) (2020).

[26] *See id.* § 170(f)(3)(A)(B)(iii).

3. The contribution must be "exclusively for conservation purposes."[27]

The qualified organizations requirement is rarely litigated.[28] This Article shall discuss the relevant pro-IRS and pro-taxpayer cases on the other requirements below. Further, this Article discusses the current state of the law surrounding syndicated conservation easements and the factors taxpayers will need to consider as they make decisions in this area.

I. QUALIFIED REAL PROPERTY INTEREST

The determinative issue in some conservation easement cases has been whether a QRPI was contributed as a part of the deal.[29] At its core, this attack on the easement deed is an attack on the perpetuity of the conservation easement.[30] While the perpetuity of an easement is typically challenged under the "exclusively for conservation purposes" element, the QRPI argument still rears its head every now and then.[31] This is evidence that the IRS is looking to exploit even the slightest of deficiencies in easement deeds.[32] However, the decline in recent cases decided on this issue may be due to transaction organizers adapting to adverse caselaw in their drafting.

Section 170(h)(2)(c) defines a QRPI as: ". . . a restriction (granted in perpetuity) on the use which may be made of the real property."[33] The applicable regulation[34] provides that a "'perpetual conservation restriction' is a qualified real property interest."[35] A "'perpetual conservation restriction' is a restriction granted in perpetuity on the use which may be made

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[27] *Id.* § 170(h)(1).
[28] *See Most Litigated Issues—Charitable Deductions Under IRC § 170*, TAXPAYERSADVOCATE.ORG 530, 537 (2018), https://taxpayeradvocate.irs.gov/Media/Default/Documents/2018-ARC/ARC18_Volume1_MLI_08_CharitableDeductions.pdf [https://perma.cc/M2K2-97SF].
[29] *See* Hale E. Sheppard, *Conservation Easement Enforcement: IRS Quietly Eliminates Procedural Protections for Appraisers*, J. TAX'N 17, 18 (May 2020), https://www.chamberlainlaw.com/assets/htmldocuments/IRS%20removes%20procedural%20protection%20for%20appraisers.pdf [https://perma.cc/2MT4-2RSG].
[30] *See* Joshua Sage, *Recent Conservation Easement Attacks by the IRS*, ESA LAW (Mar. 5, 2020), https://esapllc.com/march2020-conservation-update/ [https://perma.cc/MZ4V-YXCV].
[31] Micah G. Fogarty, *Navigating IRS Challenges To Conservation Easements*, 90 FLA. BAR J. 52, 53 (July/Aug. 2016), https://www.floridabar.org/the-florida-bar-journal/navigating-irs-challenges-to-conservation-easements/ [https://perma.cc/3HQQ-PQWG].
[32] Kuhn, *supra* note 16.
[33] I.R.C. § 170(h)(2)(c) (2020).
[34] 26 C.F.R. § 1.170A-14 (2019).
[35] *Id.* at (b)(2).

of real property—including an easement or other interest in real property that under state law has attributes similar to an easement (e.g., a restrictive covenant or equitable servitude)."[36] It is critical that conservation easements exist in perpetuity. There is only one, extremely narrow exception to the perpetuity of such easements.[37] As we will see in Part III, the Treasury Regulations provide for judicial extinguishment of conservation easements in situations where the conservation purpose becomes either "impossible or impracticable" to carry out.[38]

The seminal case on the issue of QRPI and perpetuity in the context of conservation easements is *Belk v. Commissioner*.[39] In *Belk*, the taxpayers purchased a 410-acre tract of land, then transferred such land to their own limited liability company.[40] The taxpayers then developed the land to include a golf course surrounded by residential lots.[41] A few years later, the taxpayers executed a conservation easement over the portion of the tract which included the golf course.[42] The easement was "granted in perpetuity, but was subject to certain 'reserved rights.'"[43] One of those rights, the centerpiece of the case, essentially allowed the taxpayers to modify which parcels of land were or were not covered by the conservation easement, as long as the change was proportionate and did not adversely affect the conservation purpose of the easement.[44]

The Tax Court held, and the Fourth Circuit affirmed, that the taxpayers had not donated a QRPI.[45] Therefore, they lost the entire deduction.[46] The Tax Court reasoned that because the conservation easement allowed the taxpayers to change the boundaries of the easement, "the easement was not granted in perpetuity."[47] The taxpayers contended that since the provision required them to maintain a certain proportion of land within the conservation easement, the value of the easement does not change—thus, it exists in perpetuity.[48] The Fourth Circuit rejected this argument by emphasizing the plain language of the statute: "a [QRPI] includes a

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[36] *Id.*
[37] *See infra* note 148 and accompanying text.
[38] 26 C.F.R. § 1.170A-14(g)(6)(I) (2019).
[39] 774 F.3d 221 (4th Cir. 2014).
[40] *Id.* at 223.
[41] *See id.*
[42] *See id.*
[43] *Id.*
[44] *See id.* at 223–24.
[45] *Belk*, 774 F.3d at 224, 230.
[46] *See id.* at 228–30.
[47] *Id.* at 225–26.
[48] *See id.*

restriction (granted in perpetuity) on the use . . . of *the real property*."[49] The Fourth Circuit held that the perpetuity of a restriction is inevitably attached to the real property originally designated as a conservation easement.[50] "Thus, while the restriction [in this case] may be perpetual, the restriction on 'the real property' is not."[51] Therefore, the taxpayers had not donated a QRPI and the easement did not qualify as a "qualified conservation contribution."[52]

A. Pro-Taxpayer Cases

While *Belk* continues to spearhead the dismantling of many conservation easements, some cases have come out in the taxpayers' favor as the courts wrestle how to interpret and distinguish *Belk*.[53] In 2013, the Tax Court decided *Gorra v. Commissioner*.[54] In *Gorra*, the taxpayers donated a conservation easement on the façades of a townhouse in New York.[55] The Commissioner contended that the easement was not perpetual because "there are facts to indicate that the [donee] was willing to terminate the [e]asement upon [the taxpayers'] request."[56] The court ignored this argument—focusing exclusively on the language of the easement deed. Accordingly, the court differentiated this case from *Belk* because the deed clearly defined the property donated under the easement and restricted the easement to that property in perpetuity.[57] Thus, the taxpayers had donated a QRPI and the easement donated qualified as a "qualified conservation contribution."[58]

Importantly, the court affirmed that the term "QRPI" includes the perpetuity requirement.[59] In other words, for a parcel of land to be considered a QRPI for purposes of a conservation easement, the interest must be set aside in perpetuity.[60] The taxpayer cannot switch what land

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[49] *Id.* at 226.
[50] *See id.* at 225–26.
[51] *Belk*, 774 F.3d at 226.
[52] *Id.* at 225–26.
[53] *See* 106 T.C.M. (CCH) 523, 522–24 (T.C. 2013).
[54] *Id.* at 523.
[55] *See id.* at 522–24.
[56] Amended Reply Brief for Respondent at 93, Gorra v. Comm'r, 106 T.C.M. (CCH) 523 (T.C. 2013) (No. 15336-10).
[57] *Gorra*, 106 T.C.M. (CCH) at 21.
[58] *Id.* at 18–19.
[59] *Id.* at 20.
[60] *Id.* at 20–22.

is protected and what is not—that would violate perpetuity.[61] Additionally, it is important to note that although the taxpayers prevailed in securing their deduction, they ultimately lost on valuation.[62] The court held that the easement was overvalued by over 400%.[63] Therefore, the taxpayers lost over 80% of their deduction and were also assessed the maximum accuracy-related penalty of 40%.[64]

A couple years later, the Tax Court decided *Bosque Canyon Ranch, L.P. v. Commissioner*.[65] In this case, two related partnerships sold a tract of land to their partners for the purposes of development and conservation.[66] Part of the land was developed, while the other was donated as a conservation easement to a charity donee land trust.[67] Crucially, the easement deed allowed the partners to slightly modify the easement boundaries by mutual agreement with the donee.[68] The Tax Court agreed with the IRS that this provision was similar to the provision in *Belk*.[69] Therefore, the Tax Court held that the taxpayers had, in turn, violated perpetuity, not donated a QRPI, and not made a "qualified conservation contribution."[70]

Interestingly, the Fifth Circuit reversed the Tax Court's decision two years later in favor of the taxpayers.[71] The Fifth Circuit held that the instant case was different from *Belk* because the easement could only be modified if it left the original exterior boundaries intact and if the total acreage of the easement remained the same.[72] To illustrate, picture a slice of Swiss cheese.[73] The piece of cheese is the tract of land and the holes represent the parts of the land that the easement does not cover.[74] In this case, the Fifth Circuit is saying that the sizes of the holes can change as long as the total amount of cheese remains constant (i.e., when

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[61] *Id.*
[62] *Id.* at 58–61.
[63] *Gorra*, 106 T.C.M. (CCH) at 61.
[64] *Id.* at 25.
[65] 867 F.3d 547, 547 (5th Cir. 2017).
[66] *Id.* at 549–51.
[67] *Id.*
[68] *Id.* at 552.
[69] Bosque Canyon Ranch, L.P. v. Comm'r, 110 T.C.M. (CCH) 48 (T.C. 2015), *vacated* and remanded sub nom. *Id.* at 553.
[70] *BC Ranch II*, 867 F.3d at 553–54.
[71] *Bosque Canyon Ranch*, 110 T.C.M. (CCH) at 12.
[72] *BC Ranch II*, 867 F.3d at 553.
[73] *See id.* at 562.
[74] *Id.*

one hole gets bigger, another hole or holes must get smaller to compensate) and the external square shape of the slice also stays intact.[75] Additionally, the court recognized that the modifications at issue were "de minimis at most."[76] Finally, although the taxpayers won at the appellate level, the case was remanded to the Tax Court for a valuation analysis.[77] The dispute over valuation is ongoing.[78]

B. Anti-Taxpayer Cases

Gorra and *Bosque Canyon Ranch* are unique cases. *Belk* is typically interpreted by the Tax Court to leave no room for error regarding the QRPI requirement.[79] In 2015, the Tax Court decided *Balsam Mountain Investments, LLC v. Commissioner*.[80] In that case, the taxpayers executed a conservation easement with a provision allowing the taxpayers to shift the easement boundaries up to 5% in the first five years of the easement's existence.[81] The court held that while this provision was slightly different and much less dramatic than the provision in *Belk*, the difference is not enough for the easement to qualify.[82] The court held that the taxpayers had not contributed a perpetual QRPI sufficient to receive the desired deduction.[83] Importantly, the court further asserts that under Section 170(h)(2)(C) there must be an "identifiable, specific piece of real property."[84]

The most recent case on the QRPI issue is *Pine Mountain Preserve, LLLP v. Commissioner*.[85] The easement deed in *Pine Mountain* is similar to the deed in *Bosque Canyon Ranch* in that it permitted slight changes to the interior boundaries of the easement, but not to the total acreage or exterior boundaries of the easement.[86] The court explicitly acknowledged that the facts in this case are similar to those in *Bosque*

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75 *See id.* at 552–53.
76 *Id.* at 554.
77 *Id.* at 560.
78 *See generally* BC Ranch II, L.P. v. Comm'r of Internal Revenue, 867 F.3d 547 (5th Cir. 2017).
79 *Gorra*, 106 T.C.M. (CCH) at 21–22.
80 109 T.C.M. (CCH) 1214, 1 (T.C. 2015).
81 *Id.* at 3–4.
82 *See id.* at 7–8.
83 *Id.* at 9.
84 *Id.* at 8 n.2.
85 151 T.C. 247 (2018).
86 *See id.* at 256–60.

Canyon Ranch, but chose not follow the Fifth Circuit's precedent because this case was not appealable in the Fifth Circuit.[87]

The court uses the Swiss Cheese analogy from the dissent in *Bosque Canyon Ranch* to illustrate its decision and how it believes this case, along with *Bosque Canyon Ranch*, should be treated the same as *Belk*.[88] The court claimed that *Belk* and *Bosque Canyon Ranch* are the same in that they make new holes in the cheese.[89] Regardless of whether or not the acreage proportion is the same, creating new holes or changing the sizes of each hole is not permissible under *Belk* and violates perpetuity.[90] Accordingly, the court held its ground on the QRPI issue in this case.[91]

C. *Analysis*

While the issue of whether a QRPI is contributed is not usually the main issue in conservation easement cases, taxpayers (and drafters) should take a second look at their deeds to make sure that they are truly contributing a QRPI in perpetuity given recent caselaw. These cases reveal multiple key insights to help with this analysis. First, for the Tax Court, there must be an "identifiable, specific piece of real property" that is restricted and perpetual in size and shape.[92] Additionally, the Tax Court is very skeptical of any provision in the easement deed which allows for modifications of the easement boundaries.[93] The appellate courts might be more taxpayer-friendly.[94] However, the court also noted in *Pine Mountain* (and affirmed in *Oakbrook*)[95] that the retained powers of all parties to change contractual terms does not by itself deprive a deed of easement of its required perpetuity.[96]

II. EXCLUSIVELY FOR CONSERVATION PURPOSES

The majority of conservation easement cases center on whether the contribution is "exclusively for conservation purposes."[97] There are

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[87] *See id.* at 272–73.
[88] *See id.* at 273–74.
[89] *Id.*
[90] Pine Mountain Pres., LLLP v. Comm'r of Internal Revenue, 151 T.C. 247 (2018).
[91] *Id.*
[92] *Balsam Mountain Investments*, 109 T.C.M. (CCH) at 8.
[93] *See id.* at 7; *see also Pine Mountain Pres.*, 151 T.C. at 266–67.
[94] *See BC Ranch II*, 867 F.3d at 553.
[95] Oakbrook Land Holdings, LLC, v. Comm'r, 119 T.C.M. (CCH) 1352, 1–4 (T.C. 2020).
[96] *See Pine Mountain Pres.*, 151 T.C. at 281–82.
[97] 26 U.S.C.A. § 170(h)(1)(c) (West 2019).

three main categories of challenges by the IRS under this issue: environmental/wildlife,[98] exchange,[99] and perpetuity.[100]

Section 170(h) defines "conservation purpose" as:

> (I) the preservation of land areas for outdoor recreation by, or the education of, the general public,
> (ii) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem,
> (iii) the preservation of open space (including farmland and forest land) where such preservation is—
> (1) for the scenic enjoyment of the general public, or
> (2) pursuant to a clearly delineated Federal, State, or local governmental conservation policy, and will yield a significant public benefit, or
> (iv) the preservation of an historically important land area or a certified historic structure.[101]

A. Environmental & Wildlife Protection

1. Cases

The IRS has challenged conservation easements on section 170(h)(ii), "the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem."[102] The regulations add the word "significant" before the word "relatively."[103] Thus, to the extent the Code allows, the protection at issue must be "significant."[104] Significance is subjective and is typically decided on a case by case basis.[105]

The most recent case challenging the significance of the protection of environmental and wildlife interests is *Champions Retreat Golf*

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[98] *See infra* Section II.A.
[99] *See infra* Section II.B.
[100] *See infra* Section II.C.
[101] 26 U.S.C.A. § 170(h)(4)(A) (West 2019).
[102] *Id.* at (ii).
[103] 26 C.F.R. § 1.170A-14(d)(3)(I) (2018).
[104] *See id.*
[105] Champions Retreat Golf Founders, LLC v. Comm'r of IRS, 959 F.3d 1033, 1041 (11th Cir. 2020).

Founders, LLC v. Commissioner.[106] In that case, the taxpayers bought a 463-acre tract of land in 2002.[107] Two-thirds of the parcel was used as a golf course.[108] The other third was either used for homesites or was undeveloped.[109] In 2010, the taxpayers executed a conservation easement on a 348-acre portion of the land including the undeveloped land and the golf course.[110] The easement land "is home to abundant species of birds, some rare, to the regionally declining fox squirrel, and to a rare plant species, the dense flower knotweed."[111]

The issue in the case was whether the taxpayers contributed the easement for "the protection of a [significant][112] relatively natural habitat of fish, wildlife, or plants, or similar ecosystem," or for "the preservation of open space . . . for the scenic enjoyment of the general public [that] will yield a significant public benefit."[113] The Tax Court held that it did not.[114] The Eleventh Circuit reversed.[115] The Eleventh Circuit took a broad approach to the regulations, ultimately deciding that at least part of the easement was exclusively for conservation purposes and that it protected both a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem and an open space for scenic enjoyment under § 170(h)(ii) and (iii).[116] The IRS argued that the presence of a golf course on most of the easement property prohibited the land from being considered "natural."[117] The court rejected this argument, saying that what matters under the regulation is not that the *land* is natural, but that the *habitat* is.[118] Thus, the court acknowledged that the taxpayers are entitled to a deduction if the easement is made to protect the habitat of a "rare, endangered, or threatened species."[119] Since the easement included the habitat of some rare, endangered, and threatened species of plants and animals, the court found

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[106] *Id.* at 1036.
[107] *Id.* at 1034–35.
[108] *Id.*
[109] *Id.*
[110] *Id.* at 1041.
[111] *Champions*, 959 F.3d at 1034.
[112] 26 C.F.R. § 1.170A-14; *See* Balsam Mountain Investments, LLC v. Comm'r, 109 T.C.M. (CCH) 1214, 1 (T.C. 2015) (The word "significant" is added to account for the regulation).
[113] *See generally Champions*, 959 F.3d at 1040–41.
[114] *Id.* at 1041.
[115] *Id.* at 1040–41.
[116] *See id.* at 1036–38.
[117] *Id.* at 1038.
[118] *Id.*
[119] *Champions*, 959 F.3d at 1038.

that the Tax Court's finding otherwise was clearly erroneous and wrong as a matter of law.[120] Additionally, the court found that, but for the golf course being built on the property, the easement would clearly be a preservation of open space for the public enjoyment.[121] Again, while the taxpayers prevailed on appeal, the case has been remanded to the Tax Court for a valuation analysis.[122]

2. Analysis

In general, the Tax Court will be much more hesitant to find that easements are made exclusively for conservation purposes.[123] As seen in *Champions*, the Tax Court relies on the term "significant" in the relevant regulation to justify its analyses. The Tax Court seems to want to weigh the particular facts and circumstances for itself in each case.[124] However, the Tax Court fails to create any sort of identifiable or objective framework for deciding what is "significant" under the regulation.[125] Accordingly, it seems like the Tax Court's standard for what is "exclusively for conservation purposes" is both high and unpredictable.[126]

Although circuit courts, like the Eleventh Circuit in *Champions*, have generally been more sympathetic to taxpayers and have interpreted the applicable regulations quite broadly, the Tax Court has resisted at every point that it can.[127] The Tax Court has insisted on construing the regulations narrowly.[128] Any ground given up on the regulations is granted to the IRS by deference to the administrative agency.[129] Additionally, the Tax Court's eagerness in *Pine Mountain* to voice its disagreement with the Fifth Circuit's *Bosque Canyon* opinion shows how strongly the Tax Court feels about its positions regarding conservation easements.[130] That is not likely to change soon. Thus, it is likely that if a case like *Champions* came through the Tax Court from outside the Eleventh Circuit, the Tax Court would maintain its position against the

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[120] *Champions*, 959 F.3d at 1039.
[121] *Id.* at 1041.
[122] *Id.*
[123] *Id.* at 1040.
[124] *Id.* at 1041.
[125] *Id.*
[126] *Champions*, 959 F.3d at 1040.
[127] *See, e.g.*, Pine Mountain Pres., LLLP v. Comm'r of Internal Revenue, 151 T.C. 282 (2018).
[128] *Id.*
[129] *See, e.g.*, *infra* Section II.C.2.
[130] *Pine Mountain Pres.*, 151 T.C. at 271–72.

taxpayer.[131] Perhaps most importantly, even if taxpayers win on this issue, valuation remains a significant hurdle going forward.

B. *Exchange or Gift*

To be *exclusively* for conservation purposes, the taxpayer can receive no other consideration from the donee and can place no conditions on the gift.[132] While this argument is not usually made within the context of Section 170(h), it is implicit in the analysis.[133] Section 170(c) defines a charitable contribution as a contribution or gift to or for the use of various specified entities or other types of entities for certain approved purposes.[134] This means a charitable contribution—eligible for a deduction—cannot include a *quid pro quo* arrangement.[135] A few conservation easements have been defeated in cases where the donor conditioned the gift or received something in return.[136] For example, in *Pollard v. Commissioner*, the Tax Court denied a deduction related to a conservation easement because the taxpayer had given the conservation easement to the county in exchange for a subdivision exemption.[137] The court held that there was a *quid pro quo* arrangement and therefore there could be no deduction for a charitable contribution.[138]

Moreover, in *Graev v. Commissioner*, the taxpayer made a side deal with the donee which placed a condition on the conservation easement.[139] The side deal provided that in the event the IRS disallows the taxpayer's charitable deduction, the taxpayer would recoup his investment and both parties would work together to extinguish the conservation easement.[140] The court pointed to Reg. § 1.170A-1(e) which "clarifies that . . . no deduction for a charitable contribution that is subject to a condition . . . is allowable, unless on the date of the contribution the possibility that a charity's interest in the contribution "'would be defeated' is 'negligible'."[141] The court held that since the possibility of the donee's

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[131] *Champions*, 959 F.3d at 1035.
[132] 2008 PLR Lexis 1536, at *8–9.
[133] *Id.*
[134] *See* 26 U.S.C.A. § 170(c) (West).
[135] Pollard v. Comm'r, 105 T.C.M. (CCH) 1249, 31–32 (T.C. 2013).
[136] *Id.* at 31–33.
[137] *Id.*
[138] *Id.*
[139] 140 T.C. 377 (T.C. 2013).
[140] *Id.*
[141] *Id.* at 390 (citing Treas. Reg. § 1.170A-1(e) (2020)).

interest in the land being defeated was not "so remote as to be negligible." Thus, the taxpayer's deduction is not allowable.[142]

Therefore, while contributions of conservation easements do not usually run into this issue, it is important to note that for a contribution to be considered a "qualified conservation contribution," it must first be a charitable contribution.[143] Only under rare circumstances can a charitable contribution be subject to a condition and remain charitable.[144] If a contribution is not charitable, it cannot be a "qualified conservation contribution" because it would not be "exclusively for conservation purposes."[145] Therefore, taxpayers with conservation easements that are subject to one or more conditions or are a product of a *quid pro quo* arrangement are likely to lose their entire deduction if challenged.[146]

C. Perpetuity

Conservation easements, to be made *exclusively* for conservation purposes, must exist in perpetuity.[147] Perpetuity is the core aspect of what makes a conservation easement work and it is central to the policy considerations that underlie its existence.[148] This is the most common way the IRS targets deductions attached to conservation easements.[149] It is their recent victories on this issue that have prompted the recent SI.[150]

There are over twenty cases that have been decided on the issue of perpetuity, and of those cases, the taxpayers prevail in only three.[151] This disparity shows the importance of perpetuity as the cornerstone of conservation easements. It also displays the painstaking determination both the IRS and the Tax Court possess to ensure that conservation easements are truly perpetual in existence if they are to allow accompanying

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[142] *Id.* at 409.
[143] *See* I.R.C. § 170 (2020).
[144] Treas. Reg. § 1.170A-1(e).
[145] I.R.C. § 170(h)(5) (2020).
[146] *See generally* Sage, *supra* note 30.
[147] I.R.C. § 170(h)(5) (2020).
[148] *See* Ann T. Schwing, *Perpetuity Is Forever, Almost Always: Why It Is Wrong to Promote Amendment and Termination of Perpetual Conservation Easements*, 37 HARV. ENV'T L. REV. 217, 221 (2013). There is only one limited exception to perpetuity, discussed *infra* note 129 and accompanying text.
[149] *See* Sage, *supra* note 30.
[150] *See* IR-2020-130, *supra* note 9.
[151] *See, e.g.*, BC Ranch II, L.P. v. Comm'r, 867 F.3d 547, 549 (5th Cir. 2017); Gorra v. Comm'r, 106 T.C.M. (CCH) 524 (T.C. 2013).

deductions.[152] The IRS and the Tax Court have demonstrated their willingness to go great lengths to find that a certain aspect of a conservation easement deed violates perpetuity.[153] Once they have this hook into perpetuity, they can drag the entire deduction down.

1. Pro-Taxpayer Cases

Two of the three pro-taxpayer cases on this issue, *Gorra* and *Bosque Canyon Ranch*, have already been discussed in the context of QRPIs.[154] This is because perpetuity applies to both the first and third elements of a "qualified conservation contribution."[155] We have seen how a QRPI necessarily includes a restriction in perpetuity.[156] However, outside of the QRPI issue, recent cases simply recognize that conservation easements *have* to be perpetual in order to be valid.[157] If they are not perpetual, they are not "exclusively for conservation purposes."[158]

The other pro-taxpayer case is *Irby v. Commissioner*.[159] *Irby* was a unique case decided in 2012.[160] In that case, the IRS tried to challenge the extinguishment clause of the conservation easement deed, claiming the conservancy would not get its fair share upon extinguishment.[161] Thus, the deed was "superficial" and not exclusively for conservation purposes.[162] Unlike the other extinguishment clause cases discussed below, this clause provided for the donee (a government-funded organization) to repay the government upon extinguishment of the easement.[163] The IRS argued that this deprived the donee of their proportionate share under the regulation.[164] However, the court reasoned that this situation was different because the donor would not receive a windfall as a result of the extinguishment of the easement.[165] Thus, what happens to the donee's proportionate share

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[152] *Id.*
[153] *See, e.g.*, Oakbrook Land Holdings, LLC, 119 T.C.M. (CCH) 1352 (T.C. 2020).
[154] *See infra* Section I.A.
[155] *See infra* Section I.A.
[156] *See infra* Section I.A.
[157] *See, e.g.*, *Oakbrook*, 119 T.C.M. (CCH) at 9.
[158] I.R.C. § 170(h) (2020).
[159] 139 T.C. 371 (2012).
[160] *Id.*
[161] *Id.* at 380. As we will see later, this is a typical IRS argument on this issue.
[162] *Id.*
[163] *Id.* at 376–77.
[164] *Id.* at 380.
[165] *Irby*, 138 T.C. at 382.

apart from the donor is beyond the scope of the regulation.[166] Therefore, the court disagreed with the IRS and upheld the clause and the easement.[167]

2. Anti-Taxpayer Cases

The most influential conservation easement case as of late is *Oakbrook Land Holdings, LLC v. Commissioner*.[168] While this case is currently on appeal in the Sixth Circuit, it has been used to strike down many conservation easements in the past couple months.[169] In *Oakbrook*, the taxpayers bought a 143-acre piece of land.[170] The taxpayer set aside thirty-seven acres for development, and donated the remaining 106 acres to a local conservancy.[171] The IRS took issue with the extinguishment clause of the easement deed.[172] Extinguishment clauses are commonly found in conversation easement deeds.[173] These clauses outline the division of hypothetical proceeds from a future hypothetical extinguishment of the easement.[174] To understand how these clauses work, a closer look at the regulations is helpful.

Although conservation easements must exist in perpetuity, the law does provide a very limited avenue to dissolve them. The relevant regulation provides:

> If a subsequent unexpected change in the conditions surrounding the property that is the subject of a donation under this paragraph can make impossible or impractical the continued use of the property for conservation purposes, the conservation purpose can nonetheless *be treated as protected in perpetuity* if the restrictions are extinguished by judicial proceeding and all of the donee's proceeds . . . from a subsequent sale or exchange of the property are used

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[166] *Id.*
[167] *Id.* at 390.
[168] 119 T.C.M. (CCH) 1352 (T.C. 2020).
[169] *See, e.g.*, Plateau Holdings, LLC v. Comm'r, T.C. Memo 2020-093 (T.C. 2020); Lumpkin HC, LLC v. Comm'r, T.C. Memo 2020-095 (T.C. 2020).
[170] *Oakbrook*, 119 T.C.M. (CCH) at 3.
[171] *Id.* at 5.
[172] *Id.* at 11.
[173] *Id.* at 2.
[174] *Id.*

> by the donee organization in a manner consistent with the conservation purposes of the original contribution.[175]

The following section governs how the proceeds of the extinguishment are distributed between the parties:

> . . . 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 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. *Accordingly, when a change in conditions give rise to the extinguishment of a perpetual conservation restriction under paragraph (g)(6)(I) of this section, the donee organization, on a subsequent sale, exchange, or involuntary conversion of the subject property, must be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction*, unless *state* law provides that the *donor* is entitled to the full proceeds from the conversion without regard to the *terms* of the prior perpetual conservation restriction.[176]

In other words, even though conservation easements with extinguishment clauses may not be perpetual in fact, they can be "treated as protected in perpetuity" if the extinguishment clause complies with the regulations.[177] Accordingly, the regulations provide that upon extinguishment, the donee is entitled to a "proportionate share" of the subsequent proceeds.[178] In *Oakbrook*, the IRS argued that the deed's extinguishment clause did not provide for the donee to get their "proportionate share."[179]

The easement deed in *Oakbrook* provided that upon extinguishment and subsequent sale, the donee "shall be entitled to a portion of the

[175] Treas. Reg. § 1.170A-14(g)(6)(i) (emphasis added).
[176] *Id.* § 1.170A-14(g)(6)(ii) (emphasis added).
[177] *See id.* § 1.170A-14(g)(6)(i)–(ii).
[178] *Id.*
[179] *Oakbrook*, 119 T.C.M. (CCH) at 11.

proceeds equal to the fair market value of the [c]onservation [e]asement."[180] The IRS argued that this provision did not comply with the regulation because the donee should get a "proportionate share"—a fraction, not a fixed value.[181] The taxpayers argued that the regulation says "value" not "share."[182] Therefore, the whole number they provided for in their deed is permissible.[183] The court ruled that the IRS's interpretation is correct without relying on deference to the agency's interpretation.[184] Thus, the regulation prohibits any scenario in which a donor gets to recover compensation other than a proportionate share (a fraction) of the proceeds, with the proportion defined by the easement's fair market value over the fair market value of the unencumbered and unimproved property.[185]

In sum, the court disallowed the deduction because the extinguishment clause in the easement deed did not comply with the applicable regulations.[186] Because the clause existed (jeopardizing the perpetuity of the conservation easement) and did not comply with the regulations, it cannot be treated as protected in perpetuity as the regulation requires.[187] Thus, a small defect in the easement deed cost the taxpayers their entire deduction.[188]

This case is likely to be appealed to the Sixth Circuit, and the outcome is uncertain based on Sixth Circuit precedent.[189] There are two relevant cases in the Sixth Circuit: *Hoffman Properties II, LP v. Commissioner*[190] and *Glass v. Commissioner*.[191] *Glass* was decided in 2006, in favor of the taxpayers.[192] In *Glass*, the court affirmed the Tax Court's decision that the easement in that case was protected in perpetuity, but offered little analysis on the issue.[193] In April of 2020, the court decided *Hoffman* in favor of the IRS.[194] In that case, the easement deed gave the

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[180] *Id.* at 6–7.
[181] *Id.* at 21–22.
[182] *Id.*
[183] *Id.* In a companion case, *Oakbrook* challenged the validity of the regulation and failed.
[184] *Id.* at 25.
[185] *Oakbrook*, 119 T.C.M. (CCH) at 25.
[186] *See id.*
[187] *See id.*
[188] *See id.* at 43.
[189] *See generally* Hoffman Properties II, LP v. Comm'r, 956 F.3d 832 (6th Cir. 2020); Glass v. Comm'r, 471 F.3d 698 (6th Cir. 2020).
[190] 956 F.3d 832, *Reh'g en banc denied*, No. 19-1831, 2020 WL 3839687 (6th Cir. 2020).
[191] 471 F.3d at 698.
[192] *Id.*
[193] *Id.*
[194] *Hoffman*, 956 F.3d at 832.

donor the ability to make changes to the easement as donee permits.[195] Thus, the circuit court affirmed the Tax Court's decision that this provision defeated the perpetuity of the conservation easement.[196]

Although appellate courts have generally been more sympathetic towards taxpayers, the Sixth Circuit has typically deferred to the Tax Court on these issues.[197] Additionally, neither of these cases made a sincere attempt to analyze the relevant regulations and apply them to the easement deed.[198] Further, neither of these cases involved an extinguishment clause.[199] Thus, an appellate decision in *Oakbrook* is a wild card. Nonetheless, many cases have come out of the Tax Court in the past month following *Oakbrook* and striking down conservation easements over defective extinguishment clauses.[200] Even if the Sixth Circuit reverses *Oakbrook*, the Tax Court is likely to maintain course in cases ineligible for appeal in the Sixth Circuit.

3. Analysis

Right now, the IRS is hanging their hat on improper extinguishment clauses, which render conservation easement deductions wholly invalid.[201] Some believe the IRS is engaging in scare tactics by issuing a SI before the courts have truly settled these issues, but the IRS also knows that it has valuation as a backstop.[202] Moreover, *Oakbrook* differs from *Irby* in that the issue in *Irby* was how the donee's "proportionate share" was allocated *after distribution*.[203] However, in *Oakbrook*, the issue was whether the donee *received* their "proportionate share."[204] In *Oakbrook*, the court was worried about the donor obtaining a windfall upon extinguishment.[205] Conversely, in *Irby*, the donor would never receive a windfall

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[195] *Id.* at 834.
[196] *Id.* at 833.
[197] *See id.*; *Glass*, 471 F.3d at 700.
[198] *See Hoffman*, 956 F.3d at 832; *Glass*, 471 F.3d at 698.
[199] *See id.*
[200] *See, e.g.*, Plateau Holdings, LLC v. Comm'r, T.C.M. 2020-093 (T.C. 2020); Lumpkin HC, LLC v. Comm'r of Internal Revenue, T.C.M. (RIA) 2020-095 (T.C. 2020).
[201] Oakbrook Land Holdings, LLC, 119 T.C.M. (CCH) 1352, 11 (T.C. 2020); *see also* IR -2020-130, *supra* note 9.
[202] Kristen A. Parillo, *Criticism of Easement Settlement Deal Doesn't Worry IRS*, TAX-NOTES (July 15, 2020), https://www.taxnotes.com/tax-notes-today-federal/charitable-giving/criticism-easement-settlement-deal-doesnt-worry-irs/2020/07/15/2cqf4 [https://perma.cc/DD5F-G6AL].
[203] *See Oakbrook,* 119 T.C.M. (CCH) at 19; Irby v. Comm'r, 139 T.C. 371, 20 (2012).
[204] *See Oakbrook*, 119 T.C.M. (CCH) at 19.
[205] *See id.* at 39.

from the extinguishment of the easement because the donee would be repaying the government, not the donor.[206]

Finally, it is also worth noting the Tax Court's approach to the applicable regulations in *Oakbrook*. The court recognized that both parties' interpretations of the regulation at issue were not plain readings of the text.[207] The court also acknowledged that the Fifth Circuit previously found the regulation to be ambiguous.[208] The Fifth Circuit recognized that when a regulation is ambiguous, courts should defer to the agency that issued it.[209] However, the Tax Court in *Oakbrook* specifically concluded that this type of deference was unwarranted in this case.[210] Curiously, the court asserts that although the Commissioner's interpretation is "not a plain reading," it is the correct conclusion based on "traditional tools of construction."[211] Thus, the court held that deference to the agency was unnecessary.[212] Interestingly, this is not the first time in which a circuit court deferred to the IRS while the Tax Court did not.[213]

In recent cases, the Tax Court seems almost merciless in their insistence that the IRS wins even without any deference to the IRS. The Tax Court appears to be almost an IRS ally in the war on SCE transactions.[214] However, speculation and technicalities seem insignificant when taxpayers realize that even if they win on these issues, the dispute over valuation lurks around the corner.[215]

III. VALUATION

Once the dust settles on the IRS's attack on SCE deductions, taxpayers are still not in the clear. It now seems like the imperfections in the various deeds from these cases can be fixed and adjusted by those still seeking to create a SCE transaction.[216] Future drafters now know the pitfalls to avoid. For example, do not allow changes to the easement boundaries and make sure any extinguishment clause complies with the

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[206] *See Irby*, 139 T.C. at 376.
[207] *Oakbrook*, 119 T.C.M. (CCH) at 23.
[208] *Id.* (citing PBBM-Rose Hill, Ltd. v. Comm'r, 900 F.3d 193, 205–07 (5th Cir. 2018).
[209] *Id.*
[210] *Id.* at 25.
[211] *Id.*
[212] *Id.*
[213] *See, e.g.*, PBBM-Rose Hill, Ltd. v. Comm'r, 900 F.3d 193, 205–07 (5th Cir. 2018).
[214] *See* Kuhn, *supra* note 16.
[215] *See id.*
[216] *See id.* (Kuhn highlights the specific, avoidable imperfections that have invalidated deeds).

Treasury Regulations. Assuming this happens, there will likely be a time where the IRS can no longer win these cases on such technicalities—disallowing entire deductions. However, when that time comes, the IRS will likely turn to valuation as the main issue. Objectively, this is the real reason why the IRS dislikes SCE schemes.[217] In fact, the IRS said they don't care if they lose on everything else—they believe they will win on value.[218] The IRS has no issue with conservation easements or the conjunctive deductions. The IRS is targeting those it believes to be abusing conservation easements for large tax savings.[219]

The valuations of SCEs are problematic because they directly relate to the amount of the subsequent deductions—which is arguably the main goal of SCE transactions. Thus, there is an incentive for taxpayers to obtain an inflated valuation. The value of a conservation easement is the difference between the fair market value of the land before the easement and the fair market value of the land after the easement.[220] Theoretically, this value should reflect the forgone value of development rights on the land. It is standard practice to value property at its most valuable reasonably probable use—or "highest and best" use.[221] However, such a determination is highly subjective and thus highly contestable.[222]

The IRS must believe the taxpayers in these cases have no reason to pursue a conservation easement other than tax savings. If not, the IRS would not have attempted to disallow the entire deduction in recent cases. The IRS would have gone straight to disputing the valuation. However, assuming certain fact patterns in which taxpayers would prevail on the "qualified conservation contribution," the IRS will have to settle for arguing for a reduced valuation.[223] In that case, the outcome of each case will truly depend on its own facts and circumstances. Unfortunately, the Treasury Regulation does not provide helpful guidance on the valuation of conservation easements.[224] In short, the regulation states that: (1) the value of the easement is the fair market value; (2) if there are relevant comparable transactions, the fair market value should be based on those;

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[217] *See* IR-2020-130, *supra* note 9.
[218] Parillo, *supra* note 202.
[219] *See* IR-2020-130, *supra* note 9.
[220] 26 C.F.R. § 1.170A-14(h)(3)(i) (1986).
[221] *See* Frazee v. Comm'r, 98 T.C. 554, 563 (1992).
[222] William E. Ellis, *Syndicated Conservation Easements, Valuation Abuse, and Penalties*, TAXNOTES (July 27, 2020), https://www.taxnotes.com/tax-notes-federal/appraisals-and-valuations/syndicated-conservation-easements-valuation-abuse-and-penalties/2020/08/03/2csc2 [https://perma.cc/JWK5-9YAT].
[223] *See* Kuhn, *supra* note 16.
[224] *See* 26 C.F.R. § 1.170A-14(h)(3)(i).

(3) if there are no relevant comparable transactions, the fair market value equals the difference between the value before the easement and the value after the easement; and (4) that this value is the value of the deduction.[225]

A new methodology has emerged by those appraising SCEs which has not yet seen significant challenge by the Tax Court.[226] This methodology applies four main criteria pulled from the Uniform Standards of Professional Appraisal Practice[227]: what is legally allowable, physically possible, financially feasible, and maximally productive.[228] The "maximally productive" element is the most controversial.[229] The regulations require an "objective assessment" of such development's likelihood.[230] Critics suggest that many SCE valuations do not contain this "objective assessment" to substantiate their valuation.[231] Thus, typical SCE valuations reflect a hypothetical value derived from inappropriate assumptions about the land's maximum productivity.[232] Thus, a discounted cash flow analysis will project a value which no buyer would ever pay.[233] This directly conflicts with the definition of fair market value—which requires a willing buyer and seller.[234]

Recently, the Tax Court has seldom addressed the issue of valuation as it has found other ways to extinguish these conservation easements completely.[235] However, many of the cases pending and those remanded from the appellate level are currently being decided on the issue of valuation.[236] Past results in the Tax Court have varied. In most cases, the court leans toward the valuation of the IRS which is usually far less than the taxpayers' valuation.[237] There are a couple of favorable outcomes for taxpayers, but far from an outright victory on valuation. Therefore, even if taxpayers successfully retain their deduction, they face an uphill battle on the amount of such deduction. Adding insult to injury, taxpayers could

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[225] *See id.*
[226] Ellis, *supra* note 222.
[227] *Id.*
[228] *Id.*
[229] *Id.*
[230] *Id.*
[231] *Id.*
[232] Ellis, *supra* note 222.
[233] *Id.*
[234] *See id.*
[235] *See, e.g.*, Oakbrook Land Holdings, LLC, v. Comm'r, 119 T.C.M. (CCH) 1352 (2020).
[236] *See, e.g.*, Champions Retreat Golf Founders, LLC v. Comm'r, 959 F.3d 1033 (11th Cir. 2020).
[237] Harwell E. Caole III, *Conservation Easements as Qualified Conservation Contributions*, 41 TENN. B. J. 25, 31 (2005).

still face a hefty penalty for overvaluing their deduction.[238] Altogether the return on investment for those involved in SCE transactions seems bleak.

IV. PENALTIES AND THE IRS SETTLEMENT INITIATIVE

Generally, there is a 10%–20% penalty applied to gross misstatements of deductions.[239] The IRS routinely goes for the maximum of 40% in conservation easement cases.[240] It is either all or nothing.[241] In most of the cases, the Tax Court has upheld the 40% penalty.[242] However, there is a considerable amount of circumstances, like *Oakbrook*, in which the court disallows the entire deduction but does not impose a penalty at all.[243] This is based on the reasonableness of the taxpayers' actions and assumptions.[244] If the court decides the taxpayers acted reasonably, then no penalty will be assessed.[245] However, in most cases in which the Tax Court invalidates a conservation easement and decides the partners acted unreasonably, the court imposes the 40% maximum penalty.[246] This might be different for cases in which valuation is the only issue. Since the taxpayers would be overvaluing a deduction rather than claiming one they do not have, the penalty might be less severe—like the typical 10%–20%.

The uncertainty regarding penalties is a crucial issue for those contemplating the recent SI offer. There are four key terms of the settlement agreement—one condition and three effects.[247] To accept the settlement, "[a]ll partners must agree to settle, and the partnership must pay the full amount of tax, penalties, and interest before settlement."[248] Once the taxpayers accept the offer:

(1) The deduction for the conservation easement is disallowed in full;

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[238] Nicholas Carson, *Easier Easements: A New Path for Conservation Easement Deduction Valuation*, 109 NW. L. REV. 739, 756 (2015).
[239] 26 U.S.C.A. § 6662(a) (West 2018).
[240] 26 U.S.C.A. § 6662(h) (West).
[241] Carson, *supra* note 238, at 753.
[242] *See, e.g.*, Gorra v. Comm'r, 106 T.C.M. (CCH) 523 (2013).
[243] *See* Oakbrook Land Holdings, LLC, v. Comm'r, 119 T.C.M. (CCH) 1352 (2020).
[244] *Id.* at 41–42.
[245] *Id.*
[246] *See, e.g.*, Plateau Holdings, LLC, v. Comm'r, T.C.M. (RIA) 2020-093 (2020).
[247] *See* IR-2020-130, *supra* note 9.
[248] *Id.*

(2) "Investor" partners can deduct their cost of acquiring their partnership interests and pay a reduced penalty of 10% to 20% depending on the ratio of the deduction claimed to partnership investment;

(3) Partners who provided services in connection with any SCE transaction (promoters) must pay the maximum penalty asserted by the IRS (typically 40%) with no deduction for their costs.[249]

The settlement offers only the 10%–20% penalty and gives a deduction for the partner's initial investment.[250] This might be intriguing, but the promoters get nothing and are subject to the maximum 40% penalty.[251]

At the end of the day, the SI pits investor partners against promoters.[252] This puts additional pressure on taxpayers because participation in the SI requires unanimous consent of all partners.[253] Litigation promises only uncertainty, but settlement might only offer minimal relief for investors while ensuring disappointment for promoters. Taxpayers should carefully consider the strength of their cases, the durability of their valuations, the penalties at stake, and the costs of litigation as they contemplate the SI offer.

Although the IRS's legal position on conservation easements is questionable, it may not be worth the fight.[254] Those taxpayers with subpar easement deeds[255] or extremely inflated valuations will likely find the SI to be an attractive option. However, those taxpayers who are confident in the viability of their conservation easements and believe their valuation is accurate enough for them to break even on their investments might resist folding to the IRS's demands.

Furthermore, appraisers themselves are currently at a heightened level of risk in being assessed a penalty for their valuation of conservation easements.[256] Normally, appraisals are a matter of judgment guided

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[249] *Id.*
[250] *Id.*
[251] *Id.*
[252] Moore, *supra* note 4.
[253] *See* IR-2020-130, *supra* note 9.
[254] *See* Moore, *supra* note 4.
[255] For example, those deeds that will lose in the Tax Court following Oakbrook Land Holdings, LLC, v. Comm'r, 119 T.C.M. (CCH) 1352 (2020).
[256] Jeff Kauttu, *Conservation Easements at Risk Because of IRS Appraisal Penalties*, TAXNOTES (Aug. 12, 2020), https://www.taxnotes.com/tax-notes-federal/appraisals-and-valuations/conservation-easements-risk-because-irs-appraisal-penalties/2020/07/27/2cqkj [https://perma.cc/2MTT-QKRT].

by certain valuation procedures and standards such as the Uniform Standards of Professional Appraisal Practice mentioned in Part III.[257] Such judgment is typically subject to a review process before an IRS penalty is applied.[258] This process would usually include input from at least five experienced opinions from IRS employees and a second opinion from another appraiser.[259] However, the IRS recently eliminated this review process entirely.[260] Thus, "under the revised IRS procedure, a single IRS employee, who may have no background whatsoever in land appraisal, could advance a penalty assessment."[261] This action destroys all checks and balances in the review process, meaning appraisers now have little ability to defend their valuations.[262] In the end, the IRS gets to make an arbitrary decision on the validity of valuations.

Such an aggressive regulatory change tips the IRS's hand. It seems that the IRS may not actually care about the true valuation of conservation easements. Rather, it seems the IRS would prefer to eliminate the deduction for conservation easements entirely. However, as the saying goes, "deductions are a matter of *legislative* grace."[263] The IRS does not have the right to decide to which deductions a taxpayer is entitled.[264] It may disagree with the value, but not with the deduction itself.[265] Effectively, this is what the IRS is attempting to do. The agency does not like the way taxpayers and appraisers are playing under the statutory and regulatory rules, so it simply changes the rules to stack against the taxpayer. The commandeering of authority on conservation easement valuations shows that the IRS cares more about winning on all SCE audits than it does about solely targeting abusive SCE transactions.

CONCLUSION

The IRS is waging war on SCE transactions.[266] Moreover, the Tax Court seems skeptical—if not hostile—towards these transactions as

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[257] *Id.*
[258] *Id.*
[259] *Id.*
[260] Internal Revenue Serv,, *Memorandum for All LB&I and SB/SE Employees* (Jan. 22, 2020), https://www.irs.gov/pub/foia/ig/lmsb/lbi-20-0120-0001.pdf [https://perma.cc/TK56-65X5].
[261] Kauttu, *supra* note 256.
[262] *Id.*
[263] New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934).
[264] *See id.*
[265] *Id.*
[266] *See* IR-2020-130, *supra* note 9.

well. The two main attacks on SCEs are: (1) that they do not contribute a "qualified real property interest";[267] and (2) that they are not made "exclusively for conservation purposes."[268] Both of these are required for the donation of a conservation easement to be considered a "qualified conservation contribution."[269] If there is no "qualified conservation contribution," there is no deduction allowed for the donors.[270] While some taxpayers have been able to fend off these attacks, the IRS has mostly been successful in these attacks in the Tax Court. Appellate courts have been more sympathetic towards taxpayers, but the Tax Court has maintained course when possible.[271]

Taxpayers will eventually figure out how to construct their easement deeds to avoid the pitfalls of the recent cases (e.g., extinguishment clauses). When that happens, valuation will be the main issue. Unfortunately for taxpayers, the road gets even foggier at this point as it is difficult to predict how the courts will come out on valuation. Regardless, we do know that such a determination is extremely fact intensive and will vary from case to case. On top of everything else, taxpayers must worry about the possibility of significant penalties if they lose their cases.[272]

For those contemplating the current settlement offer, they likely cannot do anything about issues with their deeds, if they have them, considering *Oakbrook*.[273] Since those taxpayers are facing a likely disallowance of the entire easement, the SI is probably a better deal even without considering the possibility of a 40% penalty.[274] However, there could easily be multiple scenarios where there is a proper extinguishment clause and where the rest of the deed complies with the regulations. In those cases, valuation will be the key issue. If so, the decision on whether to take the SI offer becomes more complicated than it already is—considering litigation fees and the strength of the taxpayers' valuation.

The evidence is mounting that the IRS's attack on SCEs is overaggressive. The cumulative effect of recent IRS actions such as eliminating the appraisal penalty review process, attempting to completely strike down conservation easements, and offering a one-sided SI, has the effect

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[267] *See, e.g.*, Belk v. Comm'r, 774 F.3d 221 (4th Cir. 2014).

[268] *See, e.g.*, Champions Retreat Golf Founders, LLC v. Comm'r, 959 F.3d 1033 (11th Cir. 2020); *see also* Oakbrook Land Holdings, LLC, 119 T.C.M. (CCH) 1352 (2020).

[269] 26 U.S.C.A. § 170(h) (West).

[270] *See id.*

[271] *See, e.g.*, Pine Mountain Pres., LLLP v. Comm'r, 151 T.C. 247 (2018).

[272] *See, e.g.*, Plateau Holdings, LLC v. Comm'r, T.C.M. (RIA) 2020-093, 1 (2020).

[273] *See, e.g.*, *Oakbrook*, 119 T.C.M. (CCH) at 39.

[274] *Id.* at 43.

of heavily discouraging the donation of conservation easements.[275] This cuts against congressional intention to incentivize the conservation of land and it is arguably a regulatory overstep by the agency.

The IRS is demanding surrender on SCEs. They may or may not be well positioned to make such demands. Regardless, the battle ahead for taxpayers is long, treacherous, and unforgiving. Some might lose their entire deduction. Some of those might wind up paying an additional 40% penalty. Others might successfully defend their deduction, but many of those will lose on valuation.[276] The likelihood of a taxpayer escaping with their full deduction is slim to none.[277] The last time that happened was in 2009, before the dramatic rise of SCE transactions.[278] The fate of SCE transactions will be revealed in due time. For now, taxpayers have a difficult decision to make: potentially premature surrender or a tedious gamble.

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[275] *See* Kuhn, *supra* note 16.
[276] Parillo, *supra* note 202.
[277] *See* Kuhn, *supra* note 16.
[278] *See* Kiva Dunes Conservation, LLC v. Comm'r, 97 T.C.M. (CCH) 1818 (T.C. 2009).