Practitioner's Corner
CONSERVATION EASEMENTS: *QUID PRO QUO* REVISITED

by
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I.. Introduction

I have long found charitable contributions of real estate to be an interesting topic. Valuation issues arise with just about any type of property, though they are perhaps more exaggerated when it comes to real property, each parcel by legal definition being "unique." However, unlike many other types of property, charitable contributions of real property often raise issues of donative intent.

Real estate contributions have engendered considerable case law about suspect motives for a contribution, and about concerns over ostensible "gifts" to charity in exchange for some item of value. Other types of property are simply less likely to raise these issues. How does one determine if a purported gift is in the nature of a transfer for value, rather than being purely motivated by charity?

The *quid pro quo* problem can arise with a charitable contribution made in exchange for something given now or in the future. If charitable contributions of real estate underscore the need to understand the quid pro quo problem, then conservation easements may be the most likely type of charitable contribution of real estate to raise this issue. Conveying an asset to a charitable organization as part of a deal or arrangement to get something back from the organization taints the contribution.

It is, in short, merely a business deal.[1] One would think that there would be a fair amount of case law on the application of the *quid pro quo* concept specifically involving conservation easements. While the issue probably comes up fairly frequently, there is little case law.

Example. A developer conveys land to a town. As part of that transaction, the developer secures approval for the development of an adjacent (or even some far distant) parcel. There is nothing improper about this kind of transaction. Indeed, from a developer's perspective, it may purely be survival. The question, though, is whether this conveyance to the town of one parcel qualifies as a charitable contribution.

Turning to the conservation easement context, rather than the transfer of property in fee, the developer may in fact agree to place a conservation easement on one parcel in exchange for development rights on another. The same *quid pro quo* issue clearly arises. Lest we accuse the developer of any kind of improper activity or even improper motive, it is worth noting that in many cases the developer has no choice in this conversation. The developer may apply to construct tract housing on a particular portion of a parcel, and be told by the town counsel, zoning commissioner, or other local authority that he can do so, but only if he places a conservation easement on other land. The developer may initially fight this idea, but may ultimately agree to the easement.

Of course, from a technical viewpoint there is simply no charitable contribution here because one act was tied to the other. There is hardly a charitable motivation on the part of the developer if the developer has reluctantly made the contribution to secure some other types of favors.

II. IRC Section 170(h) Basics

To qualify for a conservation easement deduction, one must meet a conservation purpose test. The permissible conservation purposes include: protecting property for public outdoor recreation and education; protecting significant wildlife habitats; protecting certain qualifying open space; or protecting historic property. If one makes a contribution of a conservation easement with one of these conservation purposes, thus protecting legislatively

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[1] See Regulations § 1.170A-14(h)(3)(i).

designated conservation values of some import, a tax deduction is available.

It is useful to separate owners of property from developers, since developers may not have conservation purposes foremost in their minds in at least some cases. After all, they are in business to make a profit, not to benefit the community. There are many difficult factual issues here. It is not surprising that a developer may want to suggest a density of homes in a subdivision that is buffered by an open space designation fostered by a conservation easement.

Should this be prohibited, at least on a deductible basis? If the conservation easement benefits only the homeowners in the surrounding lots, the answer is that the charitable contribution deduction is not available. In fact, the regulations expressly note this with an illustration, showing that in that circumstance a deduction is not available because the general public is not being benefitted.[2]

Quite apart from valuation — which is often the most nagging question one issue may be the motive of the taxpayer. There are many cases on this point. In *McConnell v. Commissioner*,[3] for example, the Tax Court disallowed a deduction for a contribution of property to a municipality on the grounds that the transfer was motivated by an anticipated benefit "beyond the mere satisfaction flowing from the performance of a generous act." The court found that the McConnells' motives in transferring their interests in donated streets and sewers were: (1) to avoid responsibility for future maintenance of the streets and sewers; and (2) to enhance the value of their interest in the remaining property. In the Tax Court's view, this rendered IRC Section 170 inapplicable.

Similarly, in *Sutton v. Commissioner*,[4] the donor granted a perpetual easement that the court found was for the primary purpose of allowing the donor to develop his property. Thus, a charitable contribution deduction was denied. In addition, *McLennan v. U.S.*,[5] a scenic easement was donated in conjunction with a retained right to develop. The Claims Court held that the McLennans had transferred the easement with donative intent, and with exclusive conservation purpose. In the court's view, the McLennans were concerned about the pristine quality of the surrounding land, and were also aware that the grant of the easement would reduce the total value of their property. The government's argument, on the other hand, was not very sophisticated. The government contended that the McLennans were motivated by tax savings rather than by a desire to preserve and protect the land. Here, the Claims Court was convinced that the taxpayers meant the donative intent and conservation purpose thresholds, so the deduction was allowed.

III. Valuation Problems

Even if one circumnavigates all of the other issues applicable to a conservation easement, there are valuation issues that clearly need to be addressed. Predictably, there is a "before and after" rule here. Suppose a landowner donates a conservation easement on a portion of some real estate owned by that landowner that is contiguous to the other parcel.

Here, the charitable contribution deduction (assuming other requirements are met) should be equal to the value of all of the contiguous property the landowner owns *before* the easement, less the value of all of the contiguous property *after* the easement. That is pretty simple. That is supposed to reflect any enhancement to (or increase in the value of) the land which is adjacent to the restricted land, reducing the charitable contribution by any ancillary benefit that property receives.

What if a landowner donates a conservation easement and there is an increase in the value of other land, even if it is not contiguous that is owned by the landowner? The value of the charitable contribution deduction will be reduced by any such increase in value to other property. In fact, not only does one have to take into account other noncontiguous land that is owned by this landowner/contributor, but any land that is owned by family members or any related party. A related party for this purpose is defined quite broadly, including the usual shareholders, trusts, beneficiaries, corporations, partnerships, etc.

IV. IRS Scrutiny

Recently, the IRS announced that conservation easement donations are being scrutinized. In Notice 2004-41,[6]

2 See Reg § 1.170A-14(f), Example (4).

3 55 TCM 1284 (1988), *aff'd w/o opinion* 870 F2d 651 (3d Cir 1989).

4 57 TC 239 (1971).

5 92-1 USTC ¶ 50,447 (Cl Ct 1991).

6 2004-28 IRB 31, the Service put the world on notice of what it sees as potentially abusive problems in the conservation easement field.

Notice 2004-41 indicates that the Service will be scrutinizing transfers of easements on real property to charitable organization, and on the making of payments to charitable organizations in connection with a purchase of real property from the organization. Notice 2004-41 first recites a number of obvious points about charitable contribution deductions, about qualified conservation contributions, and so on.

First, a few definitions. A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for certain conservation purposes.[7] A "qualified real property interest" includes a restriction (granted in perpetuity) on the use that may be made of the real property.[8] I will refer to qualified real property interests described in IRC Section 170(h)(2)(C) as conservation easements.

One of the permitted conservation purposes listed in IRC Section 170(h)(4) is the protection of a relatively natural habitat of fish, wildlife, plants, or similar ecosystem.[9] Another of the permitted conservation purposes is the preservation of open space ("open space easement"), including farmland and forest land, for the scenic enjoyment of the general public or pursuant to a clearly delineated governmental conservation policy. However, if the public benefit of an open space easement is not significant, the charitable contribution deduction will be disallowed.[10] IRC Section 170(h) and Regulation Section 1.170A-14 contain many other requirements that must be satisfied for a contribution of a conservation easement to be allowed as a deduction.

Of course, there are substantiation requirements. A taxpayer must substantiate its contributions of $250 or more by obtaining from the charitable organization a statement that includes (1) a description of any return benefit provided by the charitable organization, and (2) a good faith estimate of the benefit's fair market value.[11] In appropriate cases, the Service will disallow deductions for conservation easement transfers if the taxpayer fails to comply with the substantiation requirements. The Service is considering changes to forms to facilitate compliance with and enforcement of the substantiation requirements.

If all requirements of IRC Section 170 are satisfied and a deduction is allowed, the amount of the deduction may not exceed the fair market value of the contributed property (in this case, the contributed easement) on the date of the contribution (reduced by the fair market value of any consideration received by the taxpayer).[12] Fair market value is the price at which the contributed property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and each having reasonable knowledge of relevant facts.[13]

If the donor reasonably expects to receive financial or economic benefits greater than those that will inure to the general public as a result of the donation of a conservation easement, no deduction is allowable.[14] The same rule applies if a person related to the donor reasonably can expect such a benefit. If the donation of a conservation easement has no material effect on the value of the real property, or enhances rather than reduces the value of real property, no deduction is allowable.[15]

V. Purchases of Real Property from Charitable Organizations

Notice 2004-41 states that some taxpayers claim inappropriate charitable contribution deductions for cash payments or easement transfers to charitable organizations in connection with the taxpayers' purchases of real property.

How does this work? Well, in some of these questionable cases, the charitable organization purchases the property and places a conservation easement on it. Then, the charitable organization sells the property subject to the easement to a buyer for a price that is substantially less than the price paid by the charitable organization for the property. As part of the sale, the buyer makes a second payment, designated as a "charitable contribution," to the charitable organization. The total of the payments from the buyer to the charitable organization fully

7 IRC § 170(h)(1), (2), (3), and (4); Reg § 1.170A-14(a).

8 IRC § 170(h)(2)(C); see also Reg § 1.170A-14(b)(2).

9 IRC § 170(h)(4)(A)(ii); see also Reg § 1.170A-14(d)(1)(ii) and (3).

10 See IRC § 170(h)(4)(A)(iii); see also Reg § 1.170A-14(d)(1)(iii) and (4)(iv), (v), and (vi).

11 Reg § 1.170A-13 for additional substantiation requirements.

12 Reg § 1.170A-1(c)(1), (h)(1) and (2).

13 Reg § 1.170A-1(c)(2).

14 Reg § 1.170A-14(h)(3)(i).

15 Reg § 1.170A-14(h)(3)(ii).

reimburses the charitable organization for the cost of the property.

Notice 2004-41 announces that the Service will treat these transactions in accordance with their substance, rather than their form. The Service may treat the total of the buyer's payments to the charitable organization as the purchase price paid by the buyer for the property.

VI. Excise Taxes, and Tax-Exempt Status

Interestingly, the Service may also disallow all or part of any improper deductions and may impose penalties under IRC Section 6662. Moreover, the Service can assess excise taxes under IRC Section 4958 against any disqualified person who receives an excess benefit from a conservation easement transaction, and against any organization manager who knowingly participates in the transaction. In appropriate cases, the Service can even challenge the tax-exempt status of the organization, based on the organization's operation for a substantial nonexempt purpose or impermissible private benefit.

Finally, Notice 2004-41 announces that the Service intends to review the promotion of transactions involving improper deductions for conservation easements. Promoters, appraisers, and other persons involved in these transactions may be subject to penalties under IRC Sections 6700, 6701, and 6694.