**MEMO TO:** Rep. Maxine Jo Grad

**CC:** Rep. Bill Lippert; Kate Wilson

**FROM:** Darby Bradley for the Vermont Land Trust

**SUBJECT:** Responses to Your Questions Concerning S.119 (Easement Amendments)

**DATE:** January 15, 2014

Following the hearing last week, you asked me to provide information and documentation on two questions posed by the Chair.

**The first was, had the Easement Amendment Working Group considered the approach taken by Maine, which requires judicial approval of any amendment which "materially detracts" from the protected purposes of the easement?**

Yes, we studied both the Maine statute and NH's system, where the Attorney General's office reviews almost all amendment proposals and decides which ones must be filed with the court. In the case of Maine, we interviewed (by Skype) former Assistant AG Jeff Pedot, who had handled most conservation issues and projects for the Attorney General's office, and who had written a lengthy report on ways to improve land conservation systems during a year-long fellowship for the Lincoln Institute for Land Policy. (He gave Vermont high marks.) Jeff was the principal architect of the 2007 Maine legislation which required judicial review for "materially detracting" amendments. One difficulty in evaluating the Maine law is that in the 6+ years since the law took effect, not a single amendment request has been filed with the court.

NH's system is certainly robust, but requires a significant commitment of resources on the part of the AG's office. NH had six assistant AG's assigned to the charitable organizations section at the time the new procedures went into effect. In contrast, Vermont has only one assistant AG assigned to this area on a part-time basis.

The principal reasons the working group preferred an administrative panel rather than a judicial review process (except where an easement requires judicial approval or the holder prefers this process) were:

- **Judicial review places a higher burden on the AG's office to represent the public's interests.** The Vermont AG's office has stated emphatically that it does not wish to be a "gatekeeper" for amendments, as in NH. The lack of public complaints about amendments does not justify devoting additional resources to this area. The AG does, however, wish to receive notice of major amendment requests and have the right to intervene where circumstances warrant.
- **Judicial review may have more limited public access in the review process.** Given the level of public investment in conservation projects through direct grants, foregone taxes for charitable deductions, and individual contributions – over 1,000 individuals contributed to the recent Bolton Valley conservation project, for example – the working group concluded that the public should have an opportunity to state their opinions on major amendment requests without having first to establish "standing".

- **Judicial proceedings are likely to be more expensive and take longer.** Attorneys on the working group estimated that it could take up to a year to get a final decision on an amendment petition. Such a lengthy process would impose a significant hardship in many cases, especially for farmers who may seek amendments to respond to changing business circumstances. The panel process should be much shorter, even in complex cases.
- **A five-person amendment panel is likely to have a greater breadth of knowledge and experience in relevant subject areas than a solitary judge.** The legislation asks the Governor to appoint to the panel people who are knowledgeable about agriculture, forestry and environmental sciences, as well as land conservation.
- **Maine's amendment statute has very limited criteria for review: purposes of the easement and the public interest.** The working group wanted the panel (or the court) to review all relevant information and policy considerations and apply very specific criteria in deciding whether to approve a particular amendment.
- **Finally, Vermont has a tradition of using citizens panels (eg, District Environmental Commissions) to arrive at reasoned and reasonable decisions in the public interest.** This process seems particularly appropriate in amendment cases, where there is no "right" or "wrong" answer, but where a careful balancing of public and private interests is required.

**Your second question asked me to document why there is urgency around this legislation, particularly with regard to the IRS's concerns about easement amendments generally.**

At the end of this memorandum, I have attached excerpts from a law review article and several IRS documents. I've also referred to a Tax Court case on the subject of "swaps". These documents tend to be quite voluminous, but I would be happy to provide a PDF file for any of these at your request.

**What is the risk?** If the IRS challenges a land trust's decision to amend an easement, the challenge is unlikely to be direct, where the IRS overturns the amendment or revokes the land trust's tax exempt status. Instead, the challenge would be indirect. Here is a likely scenario:

> A landowner donates a conservation easement on a large tract of undeveloped land, and claims a substantial charitable deduction on that year's federal income tax return. The easement is deemed to be a "qualified real property interest" serving a qualifying "conservation purpose" under Section 170(h) of the Internal Revenue Code. The land is located in an area where the town wishes to encourage agriculture, forestry and open space. The land trust which received the easement is a 501(c)(3) public charity with an excellent record of monitoring conserved properties every year and rectifying any violations that are found. The land has been properly documented, the gift has been properly acknowledged, and the amount of the charitable deduction has been established by a "qualified appraisal". All of the "ii's" have been dotted and all of the "tt's" have been crossed.
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> Yet, after the IRS field auditor has reviewed the files and the records of the land trust's operations, the charitable deduction is denied. In the auditor's opinion, the land trust is not a "qualified organization" for purposes of Section 170(h) because the land trust has failed to demonstrate the requisite willingness to enforce its easements in perpetuity. The auditor bases this conclusion on the fact that the land trust has approved amendments to easements in the past, even though those amendments preserved and even enhanced the stated conservation purposes.

As a result of the auditor's decision, the landowner is faced with the loss of a substantial charitable deduction, which can only be reinstated through a lengthy and costly appeal process. For the land trust, the situation is even more dire. It is faced with the loss of all future donations and bargain-sales of easements until the appeal process has been completed. Any other land trust which has ever amended an easement may be faced with the same situation.

**Background.** There are two general reasons why the land trust community fears that the above scenario could happen and why we feel a sense of urgency about the need for a state-sanctioned amendment process. The first is that **there is virtually no guidance on the subject of amendments in either the Internal Revenue Code or the Treasury Regulations.** This was explored in a recent Harvard Environmental Law Review article entitled *"When Perpetuity is Not Forever"*, by Jessica Jay, a Colorado attorney who specializes in land conservation and teaches an intensive two-week class on the subject at the Vermont Law School each summer. As Jessica points out (see excerpts in **Appendix A**), Congress does not appear to have contemplated whether easements might ever be modified or terminated at the time it crafted Section 170(h) in 1980. The Code does not mention either amendments or extinguishments. The Regulations mentions extinguishments in the context of requiring judicial review of extinguishments where, due to changed conditions, it is "impossible or impractical" to carry out the conservation purposes of the easement. Virtually every amendment approved in Vermont has maintained or enhanced the conservation purposes. Even minor "terminations", where a land trust may have released the restrictions on a small amount of land so the town could straighten a dangerous curve or expand a fire station, have had a negligible impact on the overall conservation purposes of the easement. But will the IRS conclude that such amendments to show a lack of "willingness" on the land trust's part to enforce its easements in perpetuity?

This lack of clarify in the federal Code and Regulations is significant, because it gives added weight to statements made in IRS documents or by individual IRS employees, whether or not the statements accurately represent existing law.

The second general reason is that for the past ten years, the IRS has been intensely scrutinizing land conservation transactions. Some of this scrutiny has been warranted, given some of the abusive transactions that occurred in other parts of the country, and especially in Colorado where an overly-generous and under-regulated tax credit program have led to a number of fraudulent easement transactions. At one time, the IRS had up to 500 audits underway, 300 in Colorado alone.

For landowners and land trusts, the problem has been that the audits swept in the good cases along the bad. A number of attorneys have described these audits to me, including Steven Small of Boston, who is one of the leading conservation tax attorneys in the country. Steve said that reviewing agents will often throw in every conceivable objection to the deduction, including valuing the conservation easement at $0, as a starting point for negotiations. Sometimes, taxpayers have been able to work out a settlement; sometimes, they have had to go to court. In most cases, where the taxpayer has acted in good faith and provided the required evidence, the courts have upheld the charitable deduction. Still, regardless of the outcome, the process is prolonged and expensive.

**IRS Statements about Amendments.** Here is what the IRS says about amendments in its Conservation Easement Audit Techniques Guide, excerpted in **Appendix B** (page 3):

**Amendments to Easements.** The restriction on the use of the real property must be enforceable in perpetuity, meaning that it lasts forever and binds all future owners. Conservation easements should not be amended except in limited circumstances such as to correct a typographical error in the original easement document.

An easement is not enforceable in perpetuity if it allows amendments that change the nature of the restrictions imposed on the property. An easement is not enforceable in perpetuity if it ends after a period of years or if it can revert to the donor or another private party. However, if a remote future event, like an earthquake, can extinguish the easement, the donation would nevertheless be treated as in perpetuity. (emphasis added)

If field auditors, who have relatively little background in conservation easements, are being instructed that the only proper amendments are those to correct typographical errors or respond to catastrophic events like earthquakes, is it any wonder that land trusts tend to be nervous? As a result, the vast majority of land trusts refused to consider all but the most innocuous of amendment requests.

One type of amendment that IRS personnel have been particularly aggressive in discouraging is "swaps", where restrictions may be released on some portion of the conserved land in return for an easement on other lands. (See **Appendix C**) Unfortunately, in some parts of the country, there have been "swaps" where private interests were clearly the motivation and where the public conservation interest was clearly the loser. But "swaps" can also enhance conservation values. In Stowe, for example, the Stowe Land Trust, after consulting with state and local officials and holding public meetings, released the easement on 35 acres (out of 1,100 acres) of low conservation-value land in order to acquire an easement on 500 acres of adjacent, very high conservation-value land. The Stowe Land Trust had universal public support for its decision and the public conservation interest was clearly the winner.[1]

On the one hand, it is understandable why the IRS seems to be taking a hard line on amendments. With examples of abusive amendments in some parts of the country and with approximately 35,000 conservation easements in existence nationally, there is no way the IRS can keep track of all that is happening and determine whether a particular amendment is for legitimate public purposes or not. At least, for judicial review of extinguishments, the IRS is assured that some independent body is watching.

But on the other hand, a policy that is based on the assumption that every easement maximizes the public interest exactly as written, in all circumstances and for all time, is clearly untenable. As we've seen in Vermont, amendments often serve the public conservation interests when circumstances change in ways that the original drafters never contemplated. By creating (as S.119 does) a comprehensive amendment process, which is open, transparent, accessible to the public, requires third-party review of major amendments, and has established criteria and procedures for determining whether an amendment is in the public conservation interest, Vermont can ensure that the interests of the IRS, taxpayers, owners of conserved land, land trusts and the community at large will best be served.

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[1] It is well established that if an easement gives the landowner the right to "swap" conserved land for other land, the deduction will be disallowed. See Belk v. Commissioner, 140 TC 1 (2012). So far as I am aware, no easements in Vermont have such a provision. What is unknown is whether a "swap" which is the result of a subsequent amendment would subject either the landowner or the land trust to penalties, even when the amendment furthers the conservation purposes of the easement and responds to changed circumstances.

APPENDIX A

# WHEN PERPETUAL IS NOT FOREVER: THE CHALLENGE OF CHANGING CONDITIONS, AMENDMENT, AND TERMINATION OF PERPETUAL CONSERVATION EASEMENTS

*Jessica E. Jay**

*As the use of perpetual conservation easements to protect private property for the public's benefit grows in popularity, so grow the challenges associated with these perpetually binding promises. Today's conservation community faces significant challenges to amending and terminating perpetual conservation easements in the face of changing conditions, landscapes, climate, and public interests. Because of variations among different legal regimes' guidance for perpetual conservation easements, much remains unsettled regarding perpetual conservation easement amendment and termination. This Article examines inconsistencies in the legal regimes and explores current and emerging common law, legislation, and policies addressing perpetual easement amendment and termination. This Article posits that the conservation community can protect the integrity of perpetual conservation easements by providing clear, consistent guidance through existing or new legal frameworks for state legislatures, courts, landowners, and easement holders, and suggests the means to achieve or craft such guidance.*



* Founder, Conservation Law, P.C., a law firm devoted to ensuring the permanence of land conservation through sound transactions and the defense and enforcement of perpetual conservation easements; Adjunct Professor, Vermont Law School; Adjunct Professor, Denver University Law School. A special thanks to all those who helped me develop my thoughts, review the draft Article, and provide invaluable comments and insight based on their direct knowledge, expertise, and many years of experience in the conservation field, especially to Darby Bradley, Andy Dana, Sally Fairfax, Karin Gross, Nan Jenks-Jay, Jim Olmsted, Dan Pike, Leslie Ratley-Beach, and Steve Small, and to the Harvard Environmental Law Review for its members' stellar editorial skills.

### *A. Internal Revenue Code and Treasury Regulations*

Congress crafted section 170(h) of the Code to create an income-tax deduction for donated conservation easements with conservation purposes, the protection of which provides significant public benefits.[18] The defining characteristic of all qualifying easement gifts is that they are perpetual, ostensibly to provide public benefit forever.[19] Although legislative history suggests the intention to revisit and possibly modify this provision of the Code, Congress does not appear to have contemplated the modification or termination of perpetual conservation easements.[20]

The Code states that to be eligible for a tax deduction based on the gift of a qualified conservation contribution, the contribution must be "of a qualified real property interest," given in perpetuity "to a qualified organization," and made "exclusively for conservation purposes."[21] For the conservation gift to be made "exclusively for conservation purposes," the conservation purpose must be protected in perpetuity.[22] Congress therefore required both the conservation easement and the easement's purpose to be perpetual, because the conservation easement is a qualified real property interest that is given *in perpetuity*, and the conservation easement's conservation purposes must be protected *in perpetuity*.[23]

The IRS together with the Department of Treasury drafts the Regulations to interpret the Code and guide taxpayer actions consistent with the Code. Section 1.170A-14 of the Regulations, drafted for Code section 170(h), similarly defines a qualified conservation contribution as "the contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes . . . [which] must be protected in perpetuity."[24] To be eligible for a tax deduction, the qualified real property interest must be a perpetual conservation restriction, such as an easement or other similar real property interest under state law, which is "granted in perpetuity on the use which may be made of real property . . . ."[25] The qualified organization may only transfer an easement to another qualified organization if the recipient agrees to carry out the easement's conservation purposes forever.[26] The Regulations, like the Code, state that both conservation purposes and conservation easements are perpetual.[27] However, by al-

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[18] 26 U.S.C. § 170(h) (2006).

[19] S. REP. No. 96-1007, at 8–9 (1980). The legislative history shows the requirement of perpetuity created an exception to the restriction on gifts of partial interests in real property by allowing the perpetual easement to be treated as an undivided interest in real property. *Id. at 7.*

[20] *See id.* at 9–10 (discussing the revision of the definition of "conservation purposes," but not anticipating easement modification or termination).

[21] 26 U.S.C § 170(h)(1); *see also id.* § 170(h)(2) (defining a "qualified real property interest"); *id.* § 170(h)(3) (defining a "qualified organization").

[22] *Id.* § 170(h)(5)(A).

[23] *Id.* § 170(h)(1), (2)(C), (5)(A).

[24] Treas. Reg. § 1.170A-14(a) (as amended in 2009).

[25] *Id.* § 1.170A-14(b)(1)(ii), (b)(2).

[26] *Id.* § 1.170A-14(c)(2).

[27] *Id.*

lowing an easement's termination under certain circumstances, the Regulations emphasize perpetuating an easement's purposes over time, as opposed to perpetuating the deed of the easement itself.[28]

The Regulations envision specific circumstances in which an easement gift will be considered perpetual and therefore tax-deductible, even if the easement itself is extinguished, provided that the easement's purposes survive through the dedication of "proceeds" to those purposes elsewhere.[29] If an easement is terminated due to changed conditions, "proceeds" from any subsequent sale or exchange of the unencumbered property must be returned to the easement holder in proportion to the easement's value.[30] When the holder uses these "proceeds" in a manner consistent with the terminated easement's purposes, the conservation easement gift continues to be considered perpetual and tax deductible, even though the conservation easement itself has been terminated.[31] The Regulations therefore provide that even when a conservation easement deed itself is terminated, the gift of a qualified conservation contribution will continue to be defined as perpetual and will be tax-deductible, so long as the conservation easement's purposes continue to be promoted elsewhere through the dedication of proceeds.[32] Therefore, the deductibility of a perpetual conservation easement, which is determined at the time of its grant, is not necessarily defeated when at some time in the future the deed of conservation easement is terminated. The Regulations' process for the redistribution of proceeds to further the easement's

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[28] *See id.* § 1.170A-14(a), (c)(2), (g)(6). It may be useful to envision the deed of conservation easement as a vehicle such as a taxicab, carrying its conservation purposes as passengers through time. In this way, the Code describes the perpetuation or continuation of both the taxicab and its passengers over time, with no concept of either the taxicab (conservation easement) or its passengers (purposes) ever being terminated or discontinued. The Regulations, on the other hand, envision a time when the taxicab might be terminated; in that case, as long as the passengers of the taxicab continue to be perpetuated over time, the easement will still be defined as perpetual and qualify for a tax deduction. The Regulations, therefore, emphasize the perpetuation of the taxicab's passengers as conservation purposes over time, even though the taxicab itself is terminated or extinguished (those terms being used interchangeably). In other words, a conservation easement may be terminated pursuant to the Regulations, but provided that its purposes continue to be perpetuated over time, both the easement and its purposes will still be considered to be perpetual, and the qualified contribution will still be tax-deductible, even though the conservation easement ceases to exist. The Regulations' taxicab, therefore, would let its passengers out to get into a new taxicab, while the original taxicab would be taken to a junkyard or driven off a cliff.

[29] *Id.* § 1.170A-14(c)(2), (g)(6). *See* Kaufman v. Comm'r, 134 T.C. 182, 186 (2010) (*Kaufman I*), *aff'd* 136 T.C. 294 (2011) (*Kaufman II*) (holding the dedication of proceeds to be a necessary part of the Code and Regulations' perpetuity requirements). In *Kaufman II*, Judge Halpern also comments on the judicial processes that appear to be required by the Regulations. *See* 136 T.C. at 306–07*; see also infra* note 50.

[30] Treas. Reg. § 1.170A-14(c)(2). It is unclear how these proceeds might be tracked over time, as it could be quite some time before the subsequent sale, exchange, or conversion of the unencumbered property. For a discussion of how proceeds must be distributed upon termination, see *Kaufman I*, 134 T.C. at 186–87 (finding that a perpetual easement holder must have a guaranteed and unfettered right to its proportionate share of future proceeds and that failure to so provide will render a conservation easement non-perpetual and not a qualified gift).

[31] Treas. Reg. § 1.170A-14(c)(2).

[32] *Id.* § 1.170A-14(c)(2), (g)(6).

purposes underscores the Regulations' focus on perpetuating conservation *purposes* in perpetuity, but not necessarily the deed of the conservation easement — the vehicle initially designed to protect and shepherd those purposes through time.

The Regulations anticipate various situations in which it will be difficult or impossible to enforce an easement into perpetuity. These scenarios fall into three categories: those that foreseeably could allow uses of land inconsistent with the purposes of the doctrine; those that have a likelihood of occurring which is "so remote as to be negligible;" and those that are the result of unexpected changed conditions.[33] Foreseeable uses of land that will be inconsistent with the purpose of the donation must be restricted by legally enforceable means.[34] The Regulations identify foreseeable inconsistent uses as including — but not limited to — foreclosure of mortgages or interests not subordinated to the terms of the conservation easement;[35] mineral extraction using any surface or irremediably destructive mining methods;[36] and protection of conservation purposes where the landowner reserves certain rights, the exercise of which may impair the protected conservation values.[37] The Regulations also recognize that although unanticipated or unlikely events may occur to defeat an easement, these events will not render the easement "non-perpetual" if, at the time of the grant, the possibility of these events occurring was so remote as to be negligible.[38] The Regulations further anticipate situations where a property's use for conservation purposes may later become impossible or impractical due to unexpected changed conditions.[39] In those cases, the Regulations allow the easement to be terminated.[40] If an easement is extinguished because of unexpected changed conditions surrounding the protected property, the Regulations provide that its purposes can still be perpetuated, even though the easement is terminated, by dedicating proceeds from the sale of the unencumbered land to the same purposes elsewhere. The Regulations therefore treat the easement purposes as perpetual, even though the easement itself is terminated, because the purposes continue to be promoted over time.[41] This language is important enough to parse through with attention to detail and word choice. Section 1.170A-14(g)(6), entitled "Extinguishment," 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 none-

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[33] *Id.* § 1.170A-14(c)(2), (g)(2)-(6).
[34] *Id.* § 1.170A-14(g).
[35] *Id.* § 1.170A-14(g)(2).
[36] *Id.* § 1.170A-14(g)(4).
[37] *Id.* § 1.170A-14(g)(5).
[38] *Id.* § 1.170A-14(g)(3).
[39] *See id.* § 1.170A-14(c)(2).
[40] *Id.* § 1.170A-14(g)(6).
[41] *See id.*

> theless be treated as protected in perpetuity if the restrictions are extinguished by judicial proceeding and all of the donee's proceeds (determined under paragraph (g)(6)(ii) of this section) from a subsequent sale or exchange of the property are used by the donee organization in a manner consistent with the conservation purposes of the original contribution.[42]

And the next subsection, "Proceeds," reads:

> Accordingly, [w]hen a change in conditions give [sic] 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.[43]

As written, the circumstances under which a perpetual easement can be terminated seem fairly straightforward: if changes surrounding the property that were unexpected at the time of the easement donation make it impossible or impractical to achieve the easement's conservation purposes, the easement can be terminated.[44] The Regulations describe no intermediate step, such as amendment, between the changed circumstances and the easement's termination.[45] One might surmise that, because nothing in the Regulations expressly prohibits it, amendment would be permitted.[46] However, termination as a response to changed conditions, without mention of amendment, would be typical of the traditional application of the changed-conditions doctrine at the time of the Regulations' drafting.[47] If an easement's original

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[42] *Id.* § 1.170A-14(g)(6)(i).
[43] *Id.* § 1.170A-14(g)(6)(ii).
[44] *Id.* § 1.170A-14(g)(6)(i).
[45] *Id.*
[46] *See id.*; *see also* Letter from Stephen J. Small, Esq., to author 4 (Jan. 17, 2011) (on file with author) (describing that amendment of perpetual conservation easements is neither contemplated nor prohibited by the Regulations).
[47] *See* RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 7.10 cmt. a (2000) ("The changed-conditions rule has traditionally been used to terminate servitudes, rather than to modify them, but the less drastic step should be taken if modification would permit the servitude to continue to serve the purpose for which it was designed to an extent that is worthwhile."). The reporter for the previous statement points out that in 1982, the changed-conditions doctrine was typically used to terminate servitudes:

> The changed conditions doctrine provides courts with a mechanism for refusing to enforce servitudes that have become obsolete or unreasonably burdensome. It is normally applied to lift restrictions when the character of the area surrounding the burdened property has changed so radically that the original benefit can no longer be gained from continued enforcement. The doctrine thus operates to protect the specified use . . . until the time that the neighborhood becomes unsuitable for the . . . original purposes.

purposes became impossible or impractical to accomplish, pursuant to the traditional application of the changed-conditions doctrine, the easement would be terminated — not amended to adjust to the changing circumstance or to substitute purposes. The changed-conditions doctrine has since adapted to allow for an easement's modification prior to its termination to accomplish the original or new purposes.[48]

One might read the Regulations to imply that other purposes should be substituted through amendment prior to an easement's termination. The Regulations state that, if changed conditions surrounding the property make impossible or impractical the "continued use of the property for conservation *purposes*, the conservation *purpose* can nonetheless be treated as protected in perpetuity."[49] This could be read as providing that, if continued use of the property for *any* conservation purpose is no longer possible, the easement could be terminated, implying that other purposes ought to be substituted prior to termination. An interpretation allowing for easement modification prior to termination certainly would afford more flexible easements over time. This interpretation is in accord with the modern changed-conditions and cy pres doctrines the Restatement describes.[50] However, the

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Susan F. French, *Toward a Modern Law of Servitudes: Reweaving the Ancient Strands*, 55 S. CAL. L. REV. 1261, 1300 (1982) (footnotes omitted); *see also id.* at 1269 ("There is nothing comparable to the 'changed conditions' doctrine of equitable servitudes which terminates a restraint where neighborhood conditions have changed so that the restriction no longer accomplishes the purpose intended by the original parties." (footnotes omitted)).

[48] *See* RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 7.10 (2000).

[49] Treas. Reg. § 1.170A-14(g)(6)(i) (emphasis added). "Impractical" as used in the Regulations is a notable step down from the Restatement's higher standard of "impracticable." *See* RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 7.11 (2000); *see also infra* Part II.B.

[50] *See infra* Part II.B; *see also* Alexander R. Arpad, *Private Transactions, Public Benefits, and Perpetual Control Over the Use of Real Property: Interpreting Conservation Easements As Charitable Trusts*, 37 REAL PROP. PROB. & TR. J. 91, 128–49 (2002) (providing a detailed discussion of the possible evolution and potential drawbacks of the application of the charitable trust doctrine to perpetual conservation easement processes of amendment and termination); Andrew Dana & Michael Ramsey, *Conservation Easements and the Common Law*, 8 STAN. ENVTL. L.J. 2, 39–42 (1989) (concluding that although there are sound arguments for and against applying the traditional changed-conditions doctrine to conservation easements, the balance of interests tips in favor of not applying the traditional doctrine); French, *supra* note 4, at 253 (noting the limitations of the changed-conditions and charitable trust cy pres doctrines in addressing "better" uses for land protected by conservation easements); Mary Ann King & Sally K. Fairfax, *Public Accountability and Conservation Easements: Learning from the Uniform Conservation Easement Act Debates*, 46 NAT. RESOURCES J. 65, 105–10 (2006) (describing the debate between UCEA drafters surrounding use of the charitable trust and changed-conditions doctrines); Gerald Korngold, *Privately Held Conservation Servitudes: A Policy Analysis in the Context of in Gross Real Covenants and Easements*, 63 TEX. L. REV. 433, 482–94 (1984) (noting that applying the changed-conditions doctrine to perpetual conservation easements differs from applying it to other servitudes due to the consideration of public interests involved with conservation easements); McLaughlin, *Rethinking*, *supra* note 4, at 508–09 (arguing that an easement donated for federal tax benefits may be considered for substitution of its original purpose through application of the charitable trust doctrine of cy pres and its attendant judicial processes). In *Kaufman II*, Judge Halpern states that the Regulations essentially require a cy pres proceeding: "The drafters of [Regulations] section 170A-14 . . . understood that forever is a long time and provided what appears to be a regulatory version of cy pres to deal with unexpected changes that make the continued use of the property for conservation purposes impossible or impractical." 136 T.C. 294, 306–07 (2011). Judge Haines

absence of any language further describing this intermediate step, paired with statements by the Regulations' drafters that they did not contemplate amendment at the time the Regulations were drafted,[51] makes this interpretation less likely and the issue a good candidate for IRS guidance. Ideally, the IRS would either make an individual private letter ruling regarding the basis of amending an easement prior to termination or revise the Regulations to specifically address amendments to easement conditions.[52]

The Regulations may seem unequivocal in describing the process for termination as "judicial" in the phrase "if the restrictions are extinguished by *judicial* proceeding . . . ."[53] Yet this clause also has been read to imply a broader range of possibilities, with the judicial process interpreted as a "safe harbor," or one option that "can" be used in termination to ensure compliance with the Code and Regulations.[54] The key word "can" in the phrase "*can* nonetheless be treated as protected in perpetuity if the restrictions are extinguished by judicial proceeding"[55] has been read to suggest that there may be other processes available for termination, perhaps as created by state law.[56] A tax court judge recently endorsed this exact interpretation by explicitly refusing to create a bright line rule requiring a judicial proceeding and finding instead that the extinguishment clause of the Regulations "provides taxpayers with a guide, a *safe harbor*, by which to create the necessary restrictions to guarantee protection of the conservation purpose in perpetuity."[57]

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later rejects this interpretation of the Regulations and application of cy pres to a conservation easement in Carpenter v. Comm'r, T.C. Memo 2012-1, at 11–13 (2012).

[51] Letter from Stephen J. Small, Esq., to author, *supra* note 46, at 4 (describing how amendment of perpetual conservation easements was not even considered when the Regulations were drafted).

[52] *See infra* Part III.

[53] Treas. Reg. § 1.170A-14(g)(6)(i) (emphasis added).

[54] ANDREW C. DANA, COMMENTARY TO THE MODEL MONTANA CONSERVATION EASEMENT AMENDMENT POLICY 19 n.7 (2011). According to the Commentary,

> [Regulations section] 1.170A-14(g)(6)(i) is sometimes assumed to *require* judicial termination or reform — and *only* judicial termination or reform — [sic] of conservation easements in the event of changed circumstances. This understanding is not accurate. The Regulation actually says that in the event of changed circumstances, the conservation purpose *can* nonetheless be treated as protected in perpetuity if the restrictions are extinguished by judicial proceeding . . . . The plain language of the Regulation does not mandate termination or reformation by the courts if the conservation purposes have become impossible or impractical to accomplish. The Regulation simply states that judicial termination is one option open to land trusts — a safe harbor — but it leaves open the door for other methods of protecting perpetuity in easement extinguishment situations.

*Id.* The *Carpenter* interpretation of the Regulations' extinguishment clause allowing judicial proceedings as a "safe harbor," *Carpenter*, T.C. Memo 2012-1, at 18, implies that other state processes for termination, perhaps such as Vermont's proposed administrative process for reviewing proposed perpetual easement amendment and termination, discussed *infra* Section II.B.4, may be acceptable.

[55] Treas. Reg. § 1.170A-14(g)(6)(i) (emphasis added).

[56] DANA, *supra* note 54, at 19 n.7.

[57] *Carpenter*, T.C. Memo 2012-1, at 18 (citing *Kaufman II*, 136 T.C. 294, 307 n.7 (2011)).

That the Regulations might defer to state law for processes other than a judicial process as a safe harbor would not be so surprising; the Regulations defer to state law in other contexts — for example, in dealing with distribution of proceeds in proportion to the easement's value "unless *state law* provides that the donor is entitled to the full proceeds . . . ."[58] Further, the phrase "judicial proceeding" itself likely refers to a state court implementing state law for termination.[59] Whether a judicial process is required by the Regulations or is a safe harbor could be further clarified with IRS guidance, either through an individual private letter ruling proposing a non-judicial process for termination or by a revision to the Regulations specifically addressing deference to state law and other processes, among other options.[60]

In summary, the plainest interpretation of the Regulations' language for perpetual easement termination would be: if circumstances change surrounding the property, making the continued use of the property for its protected conservation purpose impossible or impractical, the easement can be extinguished by judicial proceeding. If all of the proceeds later received by the donee are used in a manner consistent with the purposes of the original contribution, the easement is treated as protected in perpetuity, even though it has been terminated.[61] This interpretation emphasizes simply that when the *original purpose* of the conservation easement is impossible or nearly impossible to achieve, the easement *can be allowed* to be terminated. Because the judicial process itself is not further defined, however, this section of the Regulations remains open to interpretation. It would seem that parties to an easement could walk into a court and ask for an easement's release or termination based on changed conditions that make its purposes impossible or impractical to accomplish.[62] In fact, the Walters and the Otero County Land Trust purported to do just this.[63]

Even if the IRS, as the Code's enforcement agency, disagreed with this or any other interpretation of the Regulations, it might struggle to reach any of the involved parties to hold them accountable. Barring fraud, the IRS's only way to reach beyond the three-year statute of limitations for donors claiming a tax deduction would be to explore actions through the easement holder's reporting, which, if the holder is a tax-exempt nonprofit entity, in-

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[58] Treas. Reg. § 1.170A-14(g)(6)(ii) (emphasis added).

[59] *Id.* § 1.170A-14(g)(6)(i). In fact, the court in *Carpenter* does just this when it defers to Colorado state law in order to determine the effect of the conservation easement deeds at issue and, more specifically, how conservation easements may be extinguished, because "state law determines the nature of the property rights at issue." *Carpenter*, T.C. Memo 2012-1, at 11.

[60] *See infra* Part III.

[61] IRS Priv. Ltr. Rul. 08-36-014 (June 3, 2008).

[62] Parties to an easement could seek to end the easement in a variety of ways, including requesting termination or extinguishment of the easement deed or release from the terms of the easement. *See* UNIFORM CONSERVATION EASEMENT ACT § 2(a) (2007).

[63] *See infra* Part II.A.2.

cludes annual federal tax returns documenting the easements it holds and their disposition, including modification and termination.[64]

Though the Regulations are silent as to easement amendment, the IRS still is interested to know if holders and taxpayers are modifying or terminating their easements, largely because of the substantial public investment in donated perpetual easements through tax subsidy. The IRS recently issued revised Tax Form 990 and instructions for tax-exempt organizations that essentially require easement holders to demonstrate that they are committed to and capable of enforcing and defending the conservation easements they hold.[65] Land trusts need to prove that they keep adequate records, maintain easement endowments, and enforce their easements.[66] The new form also requires an account of the "[n]umber of conservation easements modified, transferred, released, extinguished, or terminated by the organization during the tax year."[67] It is not clear exactly why the IRS requires this information, what an inappropriate response might be, or what the reaction would be to an inappropriate number. The IRS evaluates transactions based on whether they comply with the Code or are abusive or fraudulent.[68] Possibly the IRS might audit the holder to determine why easements were amended or terminated pursuant to its Form 990 reporting as a tax-exempt Code section 501(c)(3) entity.[69] It might find that, by failing to protect conservation purposes in perpetuity, the holder does not constitute a "qualified organization" or "eligible donee" as defined by Code section 170(h)(3) and Regulations section 1.170A-14(c)(1), respectively.[70] Or the IRS might sanction the holder for participating knowingly in an excess benefit transaction, or find it not to be operating in furtherance of its exempt purpose, and revoke its tax-

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[64] It may be possible to audit the tax return of an easement holder who reports the amendment or termination of an easement it holds within the audit period for that return, even long after an easement's grant and the donor's own audit period has expired.

[65] IRS Form 990, pt. IV, l.7, *available at* http://www.irs.gov/pub/irs-pdf/f990.pdf; IRS Form 990 Schedule D, pt. II, *available at* http://www.irs.gov/pub/irs-pdf/f990sd.pdf.

[66] IRS Form 990 Schedule D requires the following information:

> 3. Number of conservation easements modified, transferred, released, extinguished, or terminated by the organization during the tax year; 4. Number of states where property subject to conservation easement is located; 5. Does the organization have a written policy regarding the periodic monitoring, inspection, handling of violations, and enforcement of the conservation easements it holds?; 6. Staff and volunteer hours devoted to monitoring, inspecting, and enforcing easements during the year; 7. Amount of expenses incurred in monitoring, inspecting, and enforcing easements during the year.

*Id.* pt. II, ls.3–7. For general guidance and discussion of the law applicable to tax-exempt organizations, see BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS (10th ed. 2011).

[67] IRS Form 990 Schedule D, pt. II, l.3.

[68] *See* Letter from Stephen J. Small, Esq., to author, *supra* note 46, at 11.

[69] IRS Form 990 Schedule D, pt. II, l.3.

[70] 26 U.S.C. § 170(h)(3) (2006); Treas. Reg. § 1.170A-14(c)(1) (as amended in 2009).

exempt status pursuant to Code section 501(c)(3) and intermediate sanctions outlined at Code section 4958.[71]

Tax-exempt organizations created pursuant to Code section 501(c)(3) must be organized and operated exclusively in furtherance of their exempt purpose to serve public, and not private, interests.[72] They therefore are barred from transferring assets to a private individual without adequate compensation because of that individual's relationship with the organization, or from allowing more than an insubstantial benefit to accrue to private individuals or organizations.[73] Such transactions create private inurement for insiders or private benefit for non-insiders, respectively, depending on the beneficiary.[74] The IRS response in these cases may be either the proverbial "death sentence" (to strip that organization of its tax-exempt status), or in cases of private inurement and excess benefit, perhaps the more lenient intermediate step of imposing excise taxes and penalties on persons and organizations who engaged in the excess benefit transactions.[75]

An individual may be given an impermissible private benefit through amendment or termination of a conservation easement on his property. For example, the holder might return to the landowner relinquished development rights, change the easement's boundary lines, swap protected land for unprotected land, decline to enforce easement violations, or release land from an easement. If the IRS determines that these actions create an impermissible private benefit, and the land trust's overall operation substantially serves a purpose that is not its exempt purpose, the IRS could revoke the organization's tax-exempt status.[76] If these actions benefit an insider to the organiza-

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[71] IRS, COMPLIANCE GUIDE FOR 501(C)(3) PUBLIC CHARITIES 2–3 (2009), *available at* http://www.irs.gov/pub/irs-pdf/p4221pc.pdf.

[72] Treas. Reg. § 1.501(c)(3)-1(d)(ii).

[73] *See Id.* § 1.501(c)(3)-1(c)(2) (requiring that no part of a tax-exempt organization's net earnings may "inure to the benefit of any private shareholders or individuals").

[74] *Id.*; *see* IRS, *supra* note 71, at 2–3 ("No part of an organization's net earning may inure to the benefit of an insider. An insider is a person who has a personal or private interest in the activities of the organization such as an officer, director, or a key employee.").

[75] Taxpayer Bill of Rights 2, Pub. L. No. 104-168, § 1311, 110 Stat. 1452, 1475–79 (1996) (codified at 26 U.S.C. § 4958) (amended in 2006); *see also* Bill Silberstein & Jessica Jay, *Staying Within the Bounds of the Income Tax Code and Public Perception: Private Inurement and Private Benefit*, LAND TRUST ALLIANCE EXCHANGE, Spring 1999 at 22–23, *available at http://www.conservationlaw.org/publications/09-PrivateBenefitandInurement.pdf* (discussing the then newly enacted Code provision for excess benefit transactions in the context of its effect on land trusts actions in creating private benefit, inurement, and conflict of interest).

[76] *See* 26 U.S.C. § 501(c)(3) (2006). It would be difficult to conceive of a tax-exempt organization losing its exempt status on the basis of one arguably poor choice or judgment in decision-making regarding amendment or termination. The language of Code section 501(c)(3) and its Regulations seems to focus on whether an organization's overall operation is substantially for a non-exempt purpose. *See id.* Two conservation organizations lost their tax-exempt status in December 2010: the Panhandle Land Conservancy, Inc. in Florida and the Chesapeake Wildlife Sanctuary in Maryland. *See* IRS, *Recent Revocations of 501(c)(3) Determinations,* http://www.irs.gov/charities/charitable/article/0,,id=141466,00.html (last visited Feb. 1, 2012) (on file with the Harvard Law School Library). The Maryland case involved failures to file the Form 990 annual reports, record-keeping violations, and misappropriation of funds, the last of which resulted in jail time. *See* Ernesto Londoño, *Head of Wildlife Sanctuary Strikes Plea Deal: Woman Was Accused of Diverting Funds,* WASH. POST, Aug. 23, 2007,

tion, the IRS could also revoke the organization's tax-exempt status, or impose on the insider and organization sanctions and excise taxes on the benefit received.[77]

From the taxpayer standpoint, the IRS might treat an amendment or termination that returned substantial and valuable rights to the taxpayer as creating a tax benefit and apply the inclusionary version of the tax benefit doctrine.[78] The tax benefit doctrine provides that the later recovery of amounts deducted in previous years must be included as taxable income for the later year, especially if the event giving rise to the recovery is "fundamentally inconsistent" with the premise upon which the earlier deduction was based.[79] This doctrine might extend to granting a perpetual conservation easement to obtain a tax deduction, and then regaining the rights bound by that conservation easement in a later year through amendment or termination. It is unlikely, however, that pursuant to this doctrine, the actions of a subsequent landowner to unwind a conservation easement would be treated the same as similar actions of the original donor, who benefited from the tax deduction. In light of the IRS's scrutiny of these transactions and the potential consequences of that scrutiny, it is crucial that both tax-exempt easement holders and conservation easement donors strive to make their actions consistent with the Code and Regulations when amending and terminating perpetual easements.

At least one reported IRS case, *Strasburg v. Commissioner*,[80] has broached the subject of amendment. That case mainly concerned issues of valuation. In *Strasburg*, the IRS determined tax return deficiencies were owed for the overvaluation of a conservation easement a landowner had granted to the Montana Land Reliance, as well as the overvaluation of the easement's later amendment, in which the landowner gave up additional rights.[81] The basic issues before the Tax Court were whether the conserva-

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http://www.washingtonpost.com/wpdyn/content/article/2007/08/22/AR2007082202576.html. The IRS also recently denied a conservation organization's application for tax exemption, in part because the entity's two conservation easements allowed the entity to terminate the easements by conveying the easements back to the landowners if circumstances arising in the future made the purposes of the easements impossible to accomplish. IRS Redacted Proposed Adverse Determination Ltr. at 1–2 (Mar. 16, 2010), *available at* http://www.irs.gov/pub/irs-wd/1048045.pdf. The IRS stated that these provisions "contravene the apparent intent of Congress that qualified conservation easements be 'granted in perpetuity.'" *Id.* at 12 (citing 26 U.S.C. § 170(h)(2)(C) (2006)). In *Carpenter*, Judge Haines agrees, determining that the ability of the easement donor and holder to mutually agree to terminate a perpetual easement defeats the easement's qualification for a federal tax deduction because the easement is not enforceable in perpetuity. Carpenter v. Comm'r, T.C. Memo 2012-1, at 18–19 (2012).

[77] 26 U.S.C. § 4958(a)-(b), (d)(2) (2006). The IRS could impose on the insider a 25% excise tax on the benefit received or payment of an additional 200% of the benefit should the excess benefit not be corrected within the taxable period. *Id.* § 4958(a)-(b). Additionally, the IRS may impose a tax of 10% of the excess benefit, up to a maximum of $20,000 per transaction, on the organization manager who participated in the excess benefit transaction. *Id.* § 4958(a)(2), (d)(2).

[78] Hillsboro Nat'l Bank v. Comm'r, 460 U.S. 370, 372 (1983).

[79] *Id.*; *see also* 26 U.S.C. § 111 (2006).

[80] 79 T.C.M. (CCH) 1697, 2000 Tax Ct. Memo LEXIS 107 (2000).

[81] *Id.* at *1–2.

tion easement was worth $1,080,000 and whether the later amendment to the easement was worth $290,000.[82] The court held that the easement was worth $800,000 and that the amendment was worth $290,000.[83] This decision showed two important principles: first, it demonstrated that amendments to conservation easements can occur and be consistent with the Code and Regulations; second, it showed that amendments giving up value can create *new* charitable gifts. A logical extension of this holding is that amendments that increase protected conservation values or an easement's monetary value, such as those adding acres or increasing limitations on development, will also qualify for additional tax benefits. In the absence of further case law, guidance, private letter rulings, or Regulation revisions related to perpetual easement amendments, however, this proposition remains only speculative.

### *B. Restatement (Third) of Property: Servitudes*

Restatements of Law distill legal doctrines of judge-made common law to inform judges and attorneys about general legal principles.[84] Though a Restatement of Law is not binding legal authority, it is persuasive, because it is thought to be reflective of the legal community's consensus as to what the law is, or in this case, what the law should be or should become.[85]

The drafters of the Restatement (Third) of Property: Servitudes make clear that section 7.10 addresses traditional easements only and not perpetual conservation easements, which are addressed in section 7.11.[86] Section 7.10 therefore defines traditional easements and the circumstances for their modification and termination.[87] Its definition applied the changed-conditions doctrine and is nearly identical to the Regulations' language regarding perpetual

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[82] *Id.*

[83] *Id.* at *32–33.

[84] *See ALI Overview: How ALI Works*, AM. LAW INST. http://www.ali.org/index.cfm?fuseaction=about.instituteworks (last visited Feb. 1, 2012) (on file with the Harvard Law School Library).

[85] *See Secondary Sources: ALRs, Encyclopedias, Law Reviews, Restatements, & Treatises: Intro to Restatements*, HARVARD LAW SCH., http://libguides.law.harvard.edu/content.php?pid=103327&sid=1036651 (last visited Feb. 1, 2012) (on file with the Harvard Law School Library) ("The [American Law Institute's] aim is to distill the 'black letter law' from cases to indicate trends in common law, and occasionally to recommend what a rule of law should be. In essence, they restate existing common law into a series of principles or rules."). The American Law Institute is comprised of law professors, practicing attorneys, and judges. *ALI Overview*, AM. LAW. INST., http://www.ali.org/index.cfm?fuseaction=about.overview (last visited Feb. 1, 2012) (on file with the Harvard Law School Library).

[86] RESTATEMENT (THIRD) OF PROP.: SERVITUDES § 7.10(3) (2000).

[87] *Id.* § 7.10(1). The Restatement provides that:

> When a change has taken place since the creation of a servitude that makes it impossible as a practical matter to accomplish the purpose for which the servitude was created, a court may modify the servitude to permit the purpose to be accomplished. If modification is not practicable, or would not be effective, a court may terminate the servitude. Compensation for resulting harm to the beneficiaries may be awarded as a condition of modifying or terminating the servitude.

*Id.*

APPENDIX B

http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Conservation-Easement-Audit-Techniques-Guide

# Conservation Easement Audit Techniques Guide

**Revision Date** - January 3, 2012; 9-30-13

**Note:** This document is not an official pronouncement of the law or position of The National Register of Historic Places the Service and cannot be used, cited, or relied upon as such. This guide is current through the publication date.

The easement must be created by deed and be exclusively for conservation purposes. Donations of conservation easements may meet more than one conservation purpose.

See Chapter 5 for additional information on conservation purpose.

**Perpetuity**

A deductible conservation easement must be made in perpetuity, permanently restricting the use of the property. IRC § 170(h)(2)(C) and (5)(A) and Treas. Reg. § 1.170A-14(b)(2).

This means that the deed of conservation easement must state that:

- The restriction remains on the property forever and,
- Is binding on current and future owners of the property.

A deed of conservation easement that does not include these requirements is not in perpetuity; therefore, the easement is not a deductible charitable contribution.

**Example:** Some conservation easement deeds only impose restrictions for a specific period such as 10 years. These easements are not deductible since the easement is not in perpetuity.

**Recording of Easements**

The complete deed of conservation easement must be recorded in the appropriate recordation office in the county where the property is located. Under state law, an easement is not enforceable in perpetuity before it is recorded.

All exhibits or attachments to the deed such as a description of the easement restrictions, diagrams and lender agreements must also be recorded.

The effective date of the gift is the recording date. Treas. Reg. § 1.170(A)-14(g)(1).

In *Herman v. Commissioner*, T.C. Memo. 2009-205, the taxpayer recorded a "Declaration of Restrictive Covenant" for a donation of unused development rights above a building. The covenant referred to an attached architectural drawing, which described the easement restrictions but the drawing was not recorded. The court ruled that because the attached drawing was not recorded, it could not bind subsequent purchasers, did not protect the conservation purpose of preserving the apartment building "in perpetuity" and failed to meet the requirements of IRC § 170(h)(5)(A).

**Amendments to Easements**

The restriction on the use of the real property must be enforceable in perpetuity, meaning that it lasts forever and binds all future owners. Conservation easements should not be amended except in limited circumstances such as to correct a typographical error in the original easement document.

An easement is not enforceable in perpetuity if it allows amendments that change the nature of the restrictions imposed on the property. An easement is not enforceable in perpetuity if it ends after a period of years or if it can revert to the donor or another private party. However, if a remote future event, like an earthquake, can extinguish the easement, the donation would nevertheless be treated as in perpetuity. Treas. Reg. § 1.170A-14(g)(3).

In *Carpenter v. Commissioner*, T.C. Memo 2012-1, the conservation easement deeds allowed for the extinguishment of the easement by mutual consent of the parties. The Tax Court denied the taxpayers charitable contribution deductions because the easements were not enforceable in perpetuity.

Examiners should contact Counsel for assistance if the conservation easement has been amended or terminated.

### Subordination of Mortgages in Lender Agreements

If the property has a mortgage or other lien in effect at the time the easement is recorded, the easement contribution is not deductible unless the pre-existing mortgagee or lien holder subordinates its rights in the property to the rights of the donee organization to enforce the conservation purposes of the easement. Treas. Reg. § 1.170A-14(g)(2).

The subordination agreement must be recorded in the public records.

### Allocation of Proceeds in Deed & Lender Agreements

In order to claim a charitable contribution deduction for the donation of a conservation easement, the donor, at the time of the gift, 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. The proportionate value of the donee's property rights is a percentage of the value of the entire property that never changes. Treas. Reg. § 1.170A-14(g)(6)(ii).

Lenders are generally reluctant to give up a priority right to proceeds. Frequently, the lender agreement merely acknowledges the conservation easement and agrees to the conservation purposes, but it does not provide for an allocation of proceeds as required in the Treasury Regulation.

In *Kaufman v. Commissioner*, 134 T.C. No. 9 (2010), aff'd, 136 T.C. No. 13 (2011), the taxpayers transferred an easement on property that was subject to a mortgage, and the bank retained a prior claim on any proceeds on extinguishment (e.g., condemnation, casualty, hazard, or accident) of the easement. The Tax Court held that the easement was not deductible since neither the deed of conservation easement nor the lender agreement complied with Treas. Reg. § 1.170A-14(g)(6)(ii). The Tax Court determined that the contribution was not a qualified conservation contribution under IRC § 170(h), stating, "the facade easement contribution thus fails as a matter of law to comply with the enforceability in perpetuity requirements under section 1.170A-14(g)."

Examiners should contact Counsel for assistance in review of deeds and lender agreements to determine if the documents satisfy the allocation of proceeds requirements of Treas. Reg. § 1.170A-14(g)(6)(ii).

## Chapter 4: Qualified Organization

### Overview

A taxpayer must transfer the conservation easement to an eligible donee to qualify for a contribution deduction. An eligible donee:

- Is a qualified organization,
- Must have the commitment to protect the conservation purpose of the donation, and
- Must have the resources to enforce the conservation restrictions.

See IRC § 170(h)(3) and Treas. Reg. § 1.170A-14(c).

### Qualified Organization

A qualified organization is one of the following:

- A governmental unit, including the Federal government, a United States possession, the District of Columbia, a state government, or any political subdivision of a state or United States possession.
- A public charity described in section 501(c)(3) of the Internal Revenue Code that meets the public support test of section 170(b)(1)(A)(vi) or section 509(a)(2).
- A section 501(c)(3) organization that is classified as a supporting organization 509(a)(3) and that is operated, supervised, or controlled by one of the organizations described above.

## Commitment & Resources

The organization must have the commitment to protect the conservation purposes of the donation and resources to enforce the restrictions of the conservation easement. Treas. Reg. § 1.170A-14(c)(1).

A conservation group organized or operated for one of the conservation purposes in IRC § 170(h)(4)(A) is considered to have the commitment required to protect the conservation purposes of the donation. Treas. Reg. § 1.170A-14(c)(1).

Organizations that accept easement contributions and are committed to conservation will generally have an established monitoring program such as annual property inspections to ensure compliance with the conservation easement terms and to protect the easement in perpetuity.

The organization must also have the resources to enforce the restrictions of the conservation easement. Resources do not necessarily mean cash. Resources may be in the form of volunteer services such as lawyers who provide legal services or people who inspect and prepare monitoring reports.

If the organization at the time of contribution does not have the commitment to protect the conservation purposes of the donation or resources to enforce the easement restrictions, no deduction is allowed.

See Chapter 11 for suggestions on how to evaluate the organization's commitment and resources.

### Special Rules for Buildings in Registered Historic Districts

For a contribution made after July 25, 2006 of a qualified real property interest with respect to a building in a registered historic district, an additional requirement must be met to satisfy the commitment and resources test.

IRC § 170(h)(4)(B)(ii) requires the taxpayer and the donee to certify, under penalty of perjury, in a written agreement, that the donee is a qualified organization with a purpose of environmental protection, land conservation, open space preservation, or historic preservation, and that the donee has the resources to manage and enforce the restriction and a commitment to do so. **Note:** This special rule does not apply to properties listed on the National Register.

See Chapter 5 for a complete discussion of the special rules for buildings in registered historic districts.

## Cash Contributions

A common practice for conservation organizations is to request a cash contribution (sometimes referred to as a "stewardship fee") from donors of conservation easements. To be deductible as a charitable contribution, the cash payment must be a voluntary transfer made with charitable intent to a qualified organization. IRC § 170 (a) and (c).

Charitable intent may exist if the transfer is made without the receipt of, or the expectation of receiving, a quid pro quo for the transfer. As a general rule, if the benefits the transferor receives or expects to receive are substantial, rather than incidental to the transfer,, the transfer does not satisfy the charitable intent requirement under IRC § 170. *Hernandez v. Commissioner*, 490 U.S. 680, 691 (1989); *United States v. American Bar Endowment*, 477 U.S. 105, 117 (1986); *Singer Co. v. U.S.*, 196 Ct. Cl. 90, 449 F.2d 413, 422-423 (1971).

If a direct or indirect economic benefit (other than a tax deduction) is received as a result of making a contribution, the deduction is limited or disallowed. See Publication 526, Charitable Contributions (PDF).

**Quid Pro Quo Contribution**

A quid pro quo contribution is a transfer of money or property made to a qualified organization partly in exchange for goods or services in return from the charity or a third party.

Many conservation organizations offer some level of services to facilitate the easement such as conducting baseline studies, completion of National Park Service applications, preparing legal documents, soliciting subordination or lender agreements or arranging for appraisals. Depending on the nature and extent of the services provided, a portion of the claimed deduction may not be deductible.

A quid pro quo may also be in the form of an indirect benefit from a third party.

**Example:** A land developer agrees to grant a conservation easement to the county or other qualified organization in exchange for the approval of a proposed subdivision.

If a taxpayer receives a quid pro quo, the cash payment may be deductible as a charitable contribution, but only to the extent the amount transferred exceeds the fair market value (FMV) of the quid pro quo, and only if the excess amount was transferred with charitable intent.

The burden is on the taxpayer to show that all or part of a payment is a charitable contribution or gift. Treas. Reg. § 1.170A-1(h)(1) and (2); *United States v. American Bar Endowment*, 477 U.S. 105, 116-118 (1986); and Rev. Rul. 67-246, 1967-2 CB 104.

In *Scheidelman v. Commissioner*, T.C. Memo 2010-151, the taxpayers claimed a charitable contribution deduction for a cash payment paid to the donee organization in conjunction with the granting of the conservation easement. The donee organization had provided services to the taxpayers. The Tax Court concluded that the taxpayers did not provide sufficient evidence that they received nothing of substantial value or, if they had received something of substantial value, what the value was of the benefits received.

## Chapter 5: Conservation Purpose

### Overview

A charitable contribution made under the provisions of IRC § 170(h)(4)(A) (conservation easement) must be made exclusively for one of the following conservation purposes:

- Preservation of land for outdoor recreation by, or the education of, the general public.
- Protection of relatively natural habitat or ecosystem.
- Preservation of open space, where there is significant public benefit, and (1) the preservation is for the scenic enjoyment of the general public, or (2) pursuant to a clearly delineated Federal, State or local governmental conservation policy.
- Preservation of historically important land area or a certified historical structure.

APPENDIX C

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF THE CHIEF COUNSEL

March 05, 2012

Number: **2012-0017**
Release Date: 3/30/2012

CC:ITA:B01
GENIN-150346-11

UIL: 9300.40-00

Dear :

This letter responds to your request for information concerning a conservation contribution described in sections 170(f)(3)(B)(iii) and 170(h) of the Internal Revenue Code (the "Code").

You request a general information letter, which calls attention to a well-established interpretation or principle of tax law without applying it to a specific set of facts. See sec. 2.04 of Rev. Proc. 2012-1, 2012-1 I.R.B. 1, 7 (Jan. 3, 2012).

Specifically, you ask whether a contribution of an easement is deductible under section 170(h) of the Code if it is made subject to the condition that the easement can be swapped.

You define a "swap" as an agreement to remove some or all of the originally protected property from the terms of the original deed of conservation easement in exchange for either the protection of some other property or the payment of cash. You state "[t]he goal of a swap is generally to free all or a portion of the originally protected property from the easement's restrictions so that such property can be put to previously prohibited uses." You state that the transaction may be characterized by the parties as an amendment, modification, adjustment, or migration.

Under section 170(f)(3) of the Code, a charitable contribution deduction is generally not allowed for the donation of a partial interest in property. Section 170(f)(3)(B)(iii) of the Code, however, provides an exception for "qualified conservation contributions." A "qualified conservation contribution" is defined in section 170(h)(1) of the Code as a contribution (1) of a "qualified real property interest," (2) to a "qualified organization," (3) which is made "exclusively for conservation purposes."

Under section 170(h) of the Code, a contribution is not treated as made "exclusively for conservation purposes" unless it is granted in perpetuity (section 170(h)(2)) and protected in perpetuity (section 170(h)(5)). Section 1.170A-14(g)(1) of the Income Tax Regulations (the "Regulations") provides that in order for a conservation easement to be protected in perpetuity, the interest in the property retained by the donor (and the donor's successors in interest) must be subject to legally enforceable restrictions that will prevent uses of the retained interest inconsistent with the conservation purposes of the donation.

Under section 1.170A-14(e)(2) of the Regulations, inconsistent use is prohibited. Specifically, a deduction for a conservation easement donation will not be allowed if the contribution would accomplish one conservation purpose but would permit destruction of other significant conservation interests. There is an exception under section 1.170A-14(e)(3) of the Regulations that permits a use that is destructive of conservation interests *only* if such use is necessary for the protection of the conservation interests that are the subject of the contribution.

Section 1.170A-14(g)(6) of the Regulations allows for extinguishment of a conservation easement if subsequent unexpected changes in the conditions surrounding the property can make impossible or impractical the continued use of the property for conservation purposes. The conservation purposes will be treated as protected in perpetuity if the easement is extinguished by judicial proceeding and all of the donee's proceeds from a subsequent sale or exchange of the property are used by the donee organization in a manner consistent with the conservation purposes of the original contribution.

Therefore, except in the very limited situations of a swap that meets the extinguishment requirements of section 1.170A-14(g)(6) of the Regulations, the contribution of an easement made subject to a swap is not deductible under section 170(h) of the Code.

We note that you also ask whether a donee that agrees to swaps would lose its tax exempt status or status as an eligible donee under section 1.170A-14(c)(1). We have forwarded that question to IRS's Office of Tax Exempt and Government Entities for its consideration.

This letter has called your attention to certain general principles of the law. It is intended for informational purposes only and does not constitute a ruling. See sec. 2.04 of Rev. Proc. 2012-1, 2012-1 IRB at 7. If you have any additional questions, please contact me at ( ) or (ID# ) at .

Sincerely,

Karin Goldsmith Gross
Senior Technician Reviewer, Branch 1
(Income Tax & Accounting)