PROPER — AND IMPROPER — DEDUCTIONS FOR CONSERVATION EASEMENT DONATIONS, INCLUDING DEVELOPER DONATIONS

By Stephen J. Small

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In this article, the author notes that a small number of "bad" conservation easement deals threaten to poison the well for otherwise successful, appropriate, and important private land conservation transactions if IRS enforcement is not targeted at the promoters, appraisers, and others engaged in the bad deals. Small also discusses the main tax and planning hurdles that make it difficult for a real estate developer to get a meaningful income tax deduction for the donation of a conservation easement, including the tricky question of whether a conservation easement is characterized as a capital asset or inventory. Finally, Small makes suggestions for better enforcement in this area, including presenting a list of questions the IRS might ask on a revised Form 8283, "Noncash Charitable Contributions," or other reporting form. A shorter version of this article was originally written for *Exchange*, the quarterly publication of the Land Trust Alliance, and is scheduled to appear in the fall issue.

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More than five years ago I was in Washington on business and had lunch with an old friend, a smart tax guy who was with one of the big accounting firms.

I knew his knowledge of the tax code was broad and deep, and I asked, "What kind of work are you doing now?"

"Selling tax shelters to very rich people," he said as he took another bite of salad. "There's a lot of money to be made."

How sad, I thought, comfortable in the knowledge that in my narrow niche of tax code work the deals were clean, the air was fresh, and the sun shone brightly over preserved meadows, forests, farms, and ranches.

Well, some of that has changed, and while that pleasant field of endeavor has been jolted by more than one event over the past 18 months, the latest shot across the bow came in July with the publication of IRS Notice 2004-41, 2004-28 IRB 31, *Doc 2004-13514, 2004 TNT 127-6*, "Regarding Improper Deductions for Conservation Easement Donations."

But first a little background.

I. Background

Section 170(h) provides an income tax deduction for the donation of a "qualified conservation contribution" to a "qualified organization" for "conservation purposes." Specifically, for purposes of this article, section 170(h) provides a deduction for the donation of a conservation easement to a qualifying charity (or unit of government).

Section 170(h) became law in 1980, and, as an attorney-adviser in the Office of Chief Counsel at that time, I participated in the drafting of the statute and then wrote the income tax regulations under section 170(h). In 1985, three years after I left the IRS, I wrote *The Federal Tax Law of Conservation Easements*, an annotated commentary on the statute and the regulations. In 1985 almost no one cared; I did not expect the book to be a bestseller and it was not. This was a sleepy little field, generally marked

by conservation easements donated by caring landowners on farmland, forestland, or ranchland, and often on property that had been in the family for decades, if not generations.

In 1996, in the Second Supplement to *The Federal Tax Law of Conservation Easements*, I wrote that "the most significant development in the law is simply the *continuing development of favorable law* for easement donors and charitable donee organizations, including land trusts." In the Third Supplement, published in 2000, I said developments in the law continued to be good, "and the pronouncements by the Internal Revenue Service and the courts generally tended to be good." By "good" I meant, again, that developments in the law continued to be favorable to donors.

Before we move to what has gone wrong, here are two fundamental points about how section 170(h) is supposed to work.

First, many people, including many tax professionals, think you can get an income tax deduction under section 170(h) for putting fewer houses on a piece of property than allowed under local zoning. I have heard many people say something like this: "I have one hundred acres, and under local zoning I can put one hundred houses on it. Instead of doing that, I'm going to limit it to twenty houses, and put an easement on it, and take a huge deduction for the eighty houses I give up."

There are many reasons why this statement is not correct, but the fundamental error here is that the code does not give you a deduction for building fewer houses. The code gives you a deduction for protecting open space, protecting wildlife habitat, protecting farmland and forestland and watershed and scenic property. Once you have protected important conservation values, then you can take an income tax deduction for the value you give up.

And that leads to the second important point. As a general rule, the income tax deduction is equal to the fair market value of the subject property before the conservation easement minus the fair market value of the subject property after the conservation easement, or, the "value before" minus the "value after." Fair market value is a carefully defined tax term and the promoters and appraisers the IRS talks about going after in Notice 2004-41 (more on this below) are either unaware of the valuation rules or are disregarding them. Fair market value is a market-based concept: Simply put, fair market value is what a knowledgeable and willing buyer would pay for the property if you put it on the market and sold it.

Even though the rules are clear, the most common appraisal "trick" I have seen is for an appraiser to assume the highest possible level of development that could be approved under local zoning (and where there is no zoning then of course you can build anything) and value the land based on that intense level of buildout, totally without regard for whether there is sufficient and realistic market demand for that product. My favorite illustration is an appraisal of Aunt Sally's farm, 20 or more miles from the nearest city, based on a 3,500-unit planned unit development, with hotel and conference center, that in fact could be approved for that location under local zoning but that no builder in his or her right mind would ever build because the demand simply does not exist.

Through the 1980s and 1990s, the statute generally worked the way Congress intended it to for a simple reason: People were following the rules. The once-sleepy little field grew fast but easement donations were still (and still are) generally made by landowners who care about their land, who understand that these are tax incentives *for land conservation*, and who used generally sensible appraisals.

Beginning around 2000, however, things began to change. Private land protection was growing at exponential rates and real estate developers, tax advisers, and "promoters" outside of the traditional land conservation field started to become more interested in the potential tax advantages provided by section 170(h) for conservation easement donations. This resulted in at least three things: (1) some very creative new conservation transactions; (2) some transactions that generated huge income tax deductions but only questionable conservation benefits; and (3) some transactions that generated important conservation benefits and income tax deductions way out of relationship with reality.

Here are two examples:

Deal #1. Developer/promoter purchases less than 1,000 acres in a rural but growing area. The purchase price is $3 million. The developer plans to syndicate interests in this "deal" to investors, based on an appraisal that says a conservation easement on the land is worth more than $50 million. This is outrageous.

Deal #2. Owner donates a conservation easement on a large and valuable property. All of the relevant facts are complex, and the issues behind the appraisal are complex. The appraiser says the conservation easement is worth more than $90 million. While the property is valuable, more than one knowledgeable person familiar with local real estate values believes the easement is worth no more than $30 million and possibly less than that.

An experienced Washington observer, who asked that I not quote him by name, said this: "The IRS is looking for someone to blame but they are looking in the wrong places." With a little effort, and the notice indicates that effort is beginning, and with a little help, the IRS can find out who is to blame and can clamp down on those deals.

Let me cut to the chase. The only reason I can see why anyone would want to do what we could characterize as a "bad" conservation easement transaction is to be able to take a huge and totally unjustified income tax deduction. This can happen in one of two ways. Either there are no significant conservation values being protected (for example, a conservation easement that allows way too much building to protect anything except the owner's investment; more on this below), or there may be some significant conservation achieved but the appraisal is out of step with reality. I believe there are ways to begin to shut down the bad transactions while allowing the good ones to continue to flourish.

II. The Notice

In the spring of 2003, *The Washington Post* began a series of articles on The Nature Conservancy (TNC) and some transactions the organization had entered into, as

well as some corporate issues relating to TNC. Those stories were followed with others on certain conservation easement "deals." The stories caught the attention of the Senate Finance Committee, which has been looking into the charitable field, and, of course, the IRS. Certainly, at the very least, the notice is an acknowledgement by the IRS that it needs to step up enforcement efforts in this area.

From my perspective, there are three particularly important points in the notice.

Collecting more and better information. Here is the first one, from the text of the notice: "The Service is considering changes to forms to facilitate compliance with and enforcement of the substantiation requirements." In short, the IRS is considering collecting more information on conservation transactions through Forms 8283 and 990, as one means of helping them sort out bad deals from good. (Form 8283, "Noncash Charitable Contributions," is the form that must be filed with the donor's income tax return as part of the substantiation for certain charitable gift deductions; Form 990, "Return of Organization Exempt From Income Tax," is an information return filed by charitable organizations.) More on that point below.

Certain 'conservation buyer' transactions. The second important point in the notice is covered in "Purchases of Real Property from Charitable Organizations" and appears to address certain of the "conservation buyer" transactions, written about in last year's *Washington Post* series, in which TNC was the seller. (Author's note: TNC has long been in the forefront of private land conservation transactions, and TNC continues to do important work. I have known and worked with TNC people since my days at IRS and they are committed to doing good work and doing it right.) Those included transactions in which TNC purchased a property in fee, put a conservation easement on the property, and sold the property to a conservation buyer for the value of the land minus the value of the conservation easement. As part of the transaction, the conservation buyer made a cash contribution to TNC that was roughly equal to the value of the conservation easement; it was reported that many of the conservation buyers took income tax deductions for that contribution of cash. TNC has taken the position that adequate tax authority exists for the way they structured those transactions, and argues that the notice's interpretation, if taken broadly, runs contrary to prior IRS rulings and to principles accepted in the treatment of certain other kinds of charitable donations. However, the notice says, "In appropriate cases, the Service will treat these transactions in accordance with their substance, rather than their form. Thus, 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."

Insiders, promoters, and appraisers. The IRS notes that it may challenge the tax-exempt status of nonprofit organizations that operate outside the law. Without here going into the technical analysis of the specific tax code rules, the notice seems to target transactions between charitable organizations and "insiders," that is, on one hand staff and board members or trustees, and on the other hand major contributors.

More important is the final substantive paragraph of the notice, in which the IRS points the finger at "promotions of transactions involving improper deductions of conservation easements" and targets "promoters, appraisers, and other persons involved in these transactions." My best educated guess is that those transactions, still relatively new to the field, represent less than 2 percent of all conservation easement transactions around the country, but if those transactions are not shut down they have the potential of poisoning the well. People who have been working seriously and quietly in the private land protection field will agree. If you take away the "promoters, appraisers, and other persons involved" in tax-fraud-type transactions (Deal #1 and Deal #2 above), what you have left is an effective private land conservation movement across the country, doing good deals with important conservation results. That is precisely why IRS enforcement that focuses on seeking penalties for appraisers, attorneys, financial advisers, and donee organizations who knowingly take part in transactions the IRS believes abuse the tax law can be a very positive development.

III. What Developers Need to Know

Some of my best clients have been real estate developers, and I want to cover this material in this article because there seem to be a lot of misconceptions, and there seems to be a lot of bad advice, about how easy or how difficult it is for a developer to get a deduction for a conservation easement donation. In the current climate, this is a necessary discussion.

There are five reasons why it is difficult (although not impossible) for a real estate developer to get a meaningful income tax deduction from the donation of a conservation easement:

- the requirements of section 170(h), most particularly (though not entirely) the conservation purposes tests;
- the so-called quid pro quo rule;
- the basis allocation rule;
- the appraisal requirements; and
- the tax character of the conservation easement, that is, whether or not it is a capital asset.

IV. The Requirements of Section 170(h)

As I noted earlier in this article, many people around the country, including many tax professionals, think you can get a deduction under section 170(h) for building fewer houses on a piece of property than you could under local zoning. That is not correct. To qualify for a deduction, you must meet one of the "conservation purposes" tests: protecting property for public outdoor recreation and education, protecting significant wildlife habitat, protecting certain qualifying open space, or protecting historic property. Once you have done that, once you have protected some important conservation values, you get an income tax deduction for the value you have given up. Most "landowners" (as opposed to "developers," who are of course also landowners) who donate conservation easements are motivated in large

part by love of their land and the "conservation" qualities that make it desirable. Most developers are motivated by profit, and that is not a bad thing but it means the developer's mindset about any particular piece of real estate generally starts with building, not conservation. Section 170(h) starts with conservation, not building.

The statute was intended to encourage the protection of open space and property with significant conservation values, and was not intended to be a tax incentive for "conservation development" projects that left a little open space between estate lot building envelopes. While the determination of what works and what doesn't work is subjective, here is one generalization and one clear example of what I mean.

In general, the larger the contiguous block of uninterrupted open space (uninterrupted by driveways, cul-de-sacs, house lots, swing sets, etc.), the more likely a conservation easement is to meet the requirements of section 170(h). A large contiguous uninterrupted block of open space is not a prerequisite but it helps. Also, it is important to understand that the definition of "large" can vary quite a bit from region to region, state to state, and even within states.

Here is an example of what does not work: A "conservation easement" allowing 19 five-acre house lots on 100 acres does not protect the conservation values of that 100 acres. It may protect some of the conservation values, and it will prevent more intense development of the 100 acres, but *it does not protect the conservation values of that 100 acres in a way that meets the requirements of section 170(h) of the tax code*. There comes a time in the life of every piece of land when there are too many house lots (1? 5? 10?) to protect its conservation values, as the tax code defines them, no matter how strategically situated those house lots might be, and anyone who tries to convince you otherwise (either in a debate or with a glossy flora and fauna report) is ill-informed. There is nothing at all wrong with a 19-lot subdivision but the builder is not entitled to an income tax deduction under section 170(h) for doing it.

I have also heard developers say: "I am going to do 40 house lots, and in the middle of the subdivision I am going to keep five acres of woods. I'm going to put a conservation easement on the woods and take a big deduction." Once again, although there may be a number of other problems with this concept, a conservation easement on those particular five acres, the conservation benefit of which accrues only to the homeowners in the surrounding lots, simply does not rise to the level of what the statute is looking for (although it is closer). A larger, voluntary "set-aside" of open space may or may not meet the requirements of section 170(h), depending, of course, on the facts and circumstances. If the protected open space is within a gated development, for example, the conservation "benefit" from the easement may accrue only to homeowners within the development. In that connection, see Example (4) of Treas. reg. section 1.170A-14(f) ("Owners of homes in the clusters will not have any rights with respect to the surrounding Greenacre property that are not also available to the general public.").

Finally, under the "conservation purposes" heading, there is a lot of loose talk these days about conservation easements on private golf courses. This is a generalization, but 98 percent (although not 100 percent) of the proposed "golf course easement" deals I hear about (many of which never come to fruition) simply do not meet the threshold section 170(h) requirement that the easement protect some significant conservation values. I enjoy golf, but most private golf courses, although they look nice for the members, are intensely disturbed environments *for section 170(h) purposes* and have no significant "conservation" values under section 170(h). Also, many golf course easements seem to be the subject of proposed "syndicated" deals, in which ownership interests in the course are proposed to be sold at a remarkably low price to "investors" who are to receive some share of large easement deductions through a new LLC golf course owner.

There is another section 170(h) problem that comes up in a limited number of situations. A developer wants to donate a conservation easement to the local land trust. (I use "land trust" as the generic term for the tax-exempt charitable organization in the business of protecting open space. Some land trusts are local, some are regional or statewide, and some are national.) The land trust tells the developer either that the assumed "conservation values" are not high enough (like the five wooded acres in the middle of the subdivision) or that the conservation easement reserves the right to build too many residences and that that construction will effectively destroy any real conservation values the property may have. The land trust declines to accept the easement. Undaunted, the developer sets up "his own" charitable organization, with a name like "Fox Run Estates Conservation Trust," and donates the conservation easement to it.

Without knowing more, of course, it is impossible to know for sure, but on those facts it is a good guess that the Fox Run Estates Conservation Trust is classified as a private foundation under section 509(a)(1), and while that is generally not a bad thing the developer has made a serious mistake here because under section 170(h)(3) a private foundation is not an eligible donee for a deductible conservation easement.

At the moment I am aware of more than a few situations in which organizations that appear to be private foundations have accepted conservation easements. While the conservation purposes tests under section 170(h) often have some degree of subjectivity ("is the habitat significant enough to qualify?"), the public charity/private foundation issue is almost always clear as a matter of law and can usually be confirmed with only a little due diligence.

V. The Quid Pro Quo Rule

Unlike the conservation purposes test, the *quid pro quo* rule is not unique to section 170(h) but cuts broadly across section 170 charitable contributions law. I could state the rule this way: If I convey an asset to a charitable organization as part of a deal or arrangement to get something from that organization, my "contribution" is not charitable and it is not deductible; it is part of a business deal. See, for example, *Ottawa Silica Company*, Ct. Cl. No. 27-278, 49 AFTR 2d 1160 (1982); *Jordan Perlmutter*, 45 T.C. 311 (1965); and Treas. reg. section 1.170A-14(h)(3)(i).

There is no case law on the application of the quid pro quo rule in the conservation easement field, but there are a number of cases that have come up in the real estate development context. The typical fact pattern involves a developer who conveys land in fee to the town and *as part of that transaction* secures approval for development on an adjacent parcel. Of course, there is nothing illegal or even unseemly about this sort of thing and in one form or another it happens quite a bit, but the conveyance to the town is simply not a charitable contribution.

Similarly, the fact pattern involving conservation easement "contributions" comes up often in the real estate development business. The developer says to the town zoning board, "If you let me put houses on 60 percent of the property I own, I will dedicate the balance of the property to open space." That is workable and again not uncommon or illegal or even unseemly, but when the developer puts the conservation easement on the open space to secure that commitment that is a *quid pro quo*, it is part of a business deal, and it is not a charitable contribution.

The variation on that theme occurs when the developer approaches the town with a plan to put houses on the eastern half of the 100 acres the developer owns and the zoning board says, "We will let you do that, but as a condition of approval we are going to require that you put a conservation easement on the western half of your 100 acres." That is an exaction by the zoning board, and the conveyance of the conservation easement is neither charitable nor deductible because it is required.

VI. Basis Allocation Rule

The income tax regulations under section 170(h) require that when a landowner donates a conservation easement, the donor must allocate to the conservation easement a portion of the basis of the underlying property. Treas. reg. section 1.170A-1414(h)(3)(iii).

The rule works like this. Say Aunt Sally purchased her farm for $100,000, and the farm is now worth $1 million. Aunt Sally donates a conservation easement on the farm that lowers its value to $650,000. Under the income tax rules, the value of the easement is $350,000; that is, the value of the property before the easement minus the value of the property after the easement. Because the value of the conservation easement represents 35 percent of the value of the property, the regulations require that 35 percent of the property's basis, or $35,000, be "allocated" to the easement. In most cases, the basis of Aunt Sally's easement donation will be irrelevant. However, what Aunt Sally has done is lower the basis of her remaining property to $65,000.

Now, if Aunt Sally holds her property until she dies, and if historical tax rules apply, the basis of her property will be "stepped up" to its fair market value as of the date of Aunt Sally's death. If she sells the property 20 years after she has donated the easement, the lower basis will mean she has more gain and therefore more tax to pay, but 20 years is a long time where tax matters are concerned. If Aunt Sally sells the property shortly after she has donated the easement, the lower basis will have a more immediate income tax consequence (although on those numbers and under current code rules the tax benefit of the deduction may well be much greater than the tax cost of the reduced basis).

If the landowner is not Aunt Sally but XYZ Development Co., these rules are the same, but the tax results may hurt more and the numbers are likely to be quite different. Assuming that XYZ has been able to plan for and around the other tax issues (discussed above and below), let's also assume these are the numbers: Assume XYZ's basis is $600,000 and the fair market value of the land is $900,000. XYZ donates a conservation easement that reduces the value of the land to $600,000. The basis allocated to the easement is $200,000 (which may or may not have any income tax consequences; see below). The reduced basis of XYZ's land is $400,000, and assuming XYZ sells lots reasonably soon thereafter, additional income tax may be due because of the basis reduction. There may (or may not) be ways to make the tax results better. My point is simply to point out the rule and the potential tax planning problem.

VII. Appraisal and Valuation

This is a generalization, but a safe one: The highest and best use of most real estate today often involves developing a property to its maximum permissible density. Assume Aunt Sally owns Greenacres. Greenacres is 100 acres, and under local zoning, Aunt Sally, or XYZ, could put 80 houses on that property. If instead Aunt Sally donates a conservation easement on that property, limiting it to two houses, carefully sited to avoid harm to the property's conservation values, the value of that conservation easement could be significant.

Today, in many markets around the country, the maximum allowable number of house lots does not necessarily bring the maximum number of dollars. For example, in some markets the highest and best use of Greenacres might be, for example, ten 10-acre house lots, or even five 20-acre house lots. In those particular markets, the reduction in value attributable to a conservation easement limiting Greenacres to those 10 or those 5 "estate" lots might be nominal.

Some developers also have a tendency to think that the creature called a conservation easement, regardless of how or where imposed, brings with it significant income tax deductions. The question I hear frequently is, "Can I donate a conservation easement on the wetlands I can't build on and take a big income tax deduction?" The answer to that question is, "Yes; no." In other words, a conservation easement on wetlands certainly protects some significant conservation values and would be likely to meet at least one of the conservation purposes tests. But if you can't build on the wetlands anyway, there is no appreciable "dollar value" to give up and therefore little or no income tax deduction.

Finally, the conservation easement regulations, at Treas. reg. section 1.170A-(h)(3)(i), include two appraisal rules of particular concern in many developer easement situations.

The first rule is this: When a landowner donates a conservation easement on a portion of the contiguous real estate owned by that landowner and the landowner's family, the deduction is equal to the value of all the contiguous property owned by the landowner and the landowner's family before the easement minus the value

of all of the contiguous property after the easement. In those situations, the appraisal rule picks up any enhancement or increase in value to land abutting the restricted land and reduces the deduction accordingly. In some situations the "*all* before minus *all* after" rule can have a significant impact on the amount of the deduction (but a longer analysis of that issue is beyond the scope of this article). Finally, the rule also tends to make the appraisal more expensive since the project is a bigger one.

The second appraisal rule is similar, and is also designed to pick up any "enhancement" to certain other real estate as a result of a conservation easement donation. This is the second rule: When a landowner donates a conservation easement and as a result there is an increase in the value of any other land, whether or not contiguous, owned by the landowner, the landowner's family, or a "related party" (broadly defined to include certain partners and partnerships, corporations and shareholders, trusts and beneficiaries, and so on), the value of the deduction is reduced by any such increase in value to such other property.

In many (though not all) "routine" easement situations, involving donations by individual landowners or families on family land, those two appraisal rules usually do not come into play. In most situations involving conservation easement donations by real estate developers, who might be likely to donate a conservation easement on a portion but not all of a particular landholding, one of those rules is likely to be triggered.

VIII. Is It a Capital Asset?

Parsing through all of the tax code definitions and cross-references, simply put for purposes of this article, the relevant rule under section 170(e)(1)(A) is this: If the asset you donate to charity is a capital asset and you have held it for more than one year, you are entitled to a deduction for the full fair market value of the asset (subject of course to other section 170 rules, such as the limitation that individuals can generally take such a deduction only up to 30 percent of adjusted gross income for the year of the gift, with a five-year carryforward of any unused amount). If the asset you donate to charity is not a capital asset, or, for purposes of this article is inventory (again, simply put, property held for sale to customers in the ordinary course of business; the capital asset-inventory analysis is beyond the scope of this article), your deduction is generally limited to your cost or basis of the asset contributed. Also, regardless of whether the asset is inventory or a capital asset, if you donate the asset to charity before you have owned it for more than one year, your deduction is also limited to cost or basis.

In the conservation easement field, most (although not all) donors and donees are aware of the one-year holding period rule.

What about the capital asset/inventory question? It is clear that if a real estate developer is working on a subdivision in Ohio, and donates some of the lots in the subdivision to the town, or to the local land trust, those lots are inventory and the deduction is clearly limited to basis. It is also clear that if Aunt Sally donates a conservation easement on her Virginia farm, or if Uncle Bob donates a conservation easement on his Montana ranch even if Uncle Bob happens to be an investment banker and lives elsewhere, by any stretch or analysis the conservation easement is a capital asset and is not inventory.

But here is the harder question: If a real estate developer is working on a subdivision in Ohio and donates a conservation easement on some of the land within that subdivision, is the easement inventory? Is the easement ordinarily held for sale to customers? Is the tax character of the easement determined by the tax character of the underlying fee from which the easement was "unbundled"? Is the tax character of the easement determined without regard to the underlying fee? Whether a conservation easement is a capital asset or inventory does not appear to have come up in any of the reported conservation easement cases. That is understandable, based on the still-evolving history of the donation of conservation easements in this country: For many years, even decades, it seems that few if any real estate developers were interested in donating conservation easements, so the narrow but important tax issues raised by the capital asset/inventory question rarely if ever came up.

As a participant in the drafting of section 170(h), and as the author of the income tax regulations, I can say that never ever at any time throughout that process did a question come up about whether a conservation easement is a capital asset or inventory. Put a slightly different way, never ever was there any hint or thought that the income tax incentive (deduction) for a conservation easement donation could or should be any different depending on whether the donor was Aunt Sally, Uncle Bob, or XYZ Development Co. In fact, it is safe to say that the thought never even surfaced that XYZ Development Co. could one day be an easement donor. Remember, this was 1980, and to the best of my recollection the terms "conservation easement" and "real estate developer" had at the time never appeared in the same sentence.

Had the question come up, there is no doubt in my mind Congress would have said: "We do not care what the donor of a conservation easement does for a living. We do not care if the donor is a farmer or rancher or investment banker or real estate developer. We believe the test should be whether important conservation values are being protected. If important conservation values are being protected, the donor should be entitled to an income tax deduction for the full fair market value of the conservation easement."

Section 170(h) became law in December 1980 after hearings on the subject and extensive congressional committee reports. There was not a word on the dealer/inventory/capital asset issue because the issue never came up. The statute and the regulations talk about scenic enjoyment, habitat, governmental policy, significant public benefit, and the valuation of conservation easements. It is clear that the emphasis in the statute and the regulations is on meeting the conservation purposes tests, not on the donor's race, religion, sex, or line of business. For purposes of section 170(h), those matters should make no difference.

Also, ample authority exists for the proposition that a perpetual conservation easement and the fee interest are

to be analyzed separately for federal income tax purposes. (A longer discussion of that point is beyond the scope of this article, but see, for example, *Pasqualini v. Commissioner*, 103 T.C. 1, *Doc 94-6784, 94 TNT 139-11* (1994); I.T. 4003, 1950-1 C.B. 10; *Commissioner v. P.G. Lake Inc.*, 356 U.S. 260 (1958); LTRs 9621012, *Doc 96-15572, 96 TNT 104-45*, and 200201007, *Doc 2002-337, 2002 TNT 4-21*; Rev. Rul. 72-601, 1972-2 C.B. 467.)

All that having been said, however, it is now understood that the IRS believes that for capital asset/inventory characterization purposes a conservation easement retains the same character as the underlying fee from which it has been unbundled. What does this mean for a real estate developer? It means that assuming the developer/donor can deal satisfactorily with the other deduction and valuation issues described above, the IRS's belief is that a restrictive conservation easement donated by a developer on 100 acres of land with extraordinary conservation qualities will be deductible at full fair market value only if it can be established that the 100 acres is not inventory.

I do not agree with that position and I believe it makes no sense as a matter of tax policy. Here is an example of a result that makes no sense. Under the regulations, it is clear that some additional limited residential development is permitted under qualifying conservation easements; see Example (4), Treas. reg. section 1.170A-14(f), allowing a number of reserved house sites under a conservation easement. Assume that with careful planning, Aunt Sally could craft a conservation easement allowing two reserved house sites on her 100-acre property, and assume that easement would meet all the requirements of section 170(h). By no stretch of analysis could the 100 acres, or the house sites, or the easement, be considered inventory, and a full fair market value deduction for the easement would be allowed. Should the result be any different if XYZ Development Co. owned the same piece of land and donated the same easement? If the reserved lots are inventory, the IRS seems to believe the result is different under section 170(e)(1)(A).

With the increased level of scrutiny of conservation easement donations announced by the IRS in Notice 2004-41, developers and their advisers need to be aware of these rules and need to understand what works and what doesn't. A conservation easement on a large contiguous block of uninterrupted open space on land that is not held as inventory is a good starting point. That should be accompanied by an accurate appraisal, taking into account the special conservation easement appraisal rules, and assuming a market-based (rather than fictional) level of development that is extinguished by the easement. Finally, of course, in some situations an income tax deduction that is limited to the basis of the asset contributed may be enough of an income tax deduction to make the transaction work for the donor.

Here is a final observation on the capital asset-inventory issue. Unfortunately there is no "silver bullet" in the code or the cases to point to that would substantiate my belief that Congress would have made a different decision had the question been asked in 1980. Perhaps one of the taxwriting committees could resolve this policy matter with the following language in the appropriate committee report:

> The Committee confirms that, consistent with tax policy since 1980, when the tax incentives under Section 170(h) were codified, a perpetual conservation easement that is a qualified real property interest under Section 170(h)(2)(C) shall be treated for purposes of Section 170(e)(1)(A) as an asset separate and distinct from any underlying fee interest. Therefore, such a qualified real property interest shall be treated as a capital asset in all cases (unless the donor is engaged in a regular business of selling conservation easements to customers). The Committee notes that such capital asset treatment is also consistent with established capital asset treatment of a perpetual conservation easement as "like-kind" investment property under Section 1031(a)(1).

IX. Three Suggestions for Better Enforcement

As noted above, I believe the single biggest reason for "bad" conservation easement transactions is an inflated income tax deduction by way of an inflated appraisal. If we want to focus on bad appraisals, my first suggestion is that in its effort to collect more useful information the IRS might think about some additional questions on the Form 8283 (or some other form) specifically for conservation easement transactions.

Here is a short list of some questions that might be asked. It is important to understand that for many transactions that are legitimate and correct in every way the answers to one or more of these questions will be yes. However, it seems to me that if a donor answers yes to, say, four or more of these questions, there are indicia that the transaction might warrant further scrutiny. As always, when a taxpayer claims an income tax deduction the burden is on the taxpayer to substantiate the deduction, and in legitimate transactions done correctly the taxpayer will have no trouble doing that. I further believe that simply the existence of these questions on an IRS form will start to turn the tide against the "promoters" and appraisers who think that this field is another place to make a quick buck.

1. Has the taxpayer owned the property for less than 24 months?

2. If the answer to question 1 is yes, is the claimed deduction greater than two and one-half times the cost basis?

3. Is the taxpayer a limited liability company or partnership?

4. If the answer to question 3 is yes, did the taxpayer purchase the property from one of its members or partners or a party related (under section 707(b)) to one of its members or partners?

5. If the answer to question 3 is yes, does the taxpayer or a party related to one of its members or partners own abutting land, or land in the immediate vicinity of the property, that is being used (or that will be used) for real estate development purposes?

6. Does the conservation easement reserve the right to build more than six (or five, or eight, etc.) new residences on the property?

7. Is the principal place of business of the appraiser in a state that is different from the state in which the property is located?

8. Is the principal place of business of the donee in a state that is different from the state in which the property is located?

9. Has the property been part of any submission to authorities for zoning or subdivision approval in the 18-month period before the donation?

10. Are any of the comparable sales relied on by the appraiser for the conclusion of value more than 50 (30? 20?) miles from the property?

11. What was the fee for the appraisal?

My second suggestion is that in some states the taxing authorities can assist the IRS in its enforcement efforts in this field. A number of states now have state income tax credits for conservation easement donations; in Colorado and Virginia, those credits are refundable and transferable. In South Carolina, which has a state income tax credit for conservation easement donations, the Department of Revenue has mailed out a "Land Trust Desk Audit" to organizations it believes have accepted conservation easements in South Carolina, requesting copies of Forms 8283, information on monitoring and enforcement of easements, and information on conservation easements that were "granted pursuant to a proposed development. . . . " (I have posted a copy of the Desk Audit letter, with the permission of the Department, on my Web site at http://www.stevesmall.com.) Other states may want to follow suit.

Finally, donee organizations need to step up. Right above the signature on the "Donee Acknowledgment" portion of Form 8283, the form notes, "This acknowledgment does not represent agreement with the claimed fair market value." I understand many donees have executed Form 8283 before the claimed deduction amount has been filled in; although that appears to be legal this practice should stop.

Further than that, however, I have been urging donee organizations to adopt policies on how to deal with a completed Form 8283, presented for signature, when the claimed deduction shocks the conscience of the donee representative who is signing. The form of course means what it says, that the acknowledgment does not represent agreement with the claimed deduction. Donee organizations are not responsible for substantiating the claimed deduction, but they are responsible for doing the right thing. In the good old days that was not an issue but it is now.

Last year The Nature Conservancy appointed an outside governance advisory panel to review certain TNC operations and make recommendations. While the full scope of the panel's work and recommendations is beyond the scope of this article, the panel recommended that TNC review donors' appraisals and, under certain circumstances, refuse to sign a Form 8283. I applaud those recommendations, and I urge other easement donees to take a careful look at them and to adopt appropriate policies to deal with these matters.