



Agricultural Law Press

Publisher/Editor

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Issue Contents

Adverse Possession

Fence 67

Bankruptcy

Federal tax

Discharge 67

Federal Estate and Gift Taxation

Income in respect of decedent 68

Federal Farm Programs

Cotton 68

Poultry 68

Wetlands 68

Federal Income Taxation

Disaster losses 69

Pension plans 69

Proof of mailing 69

Qualified Business income deduction 69

Qualified opportunity funds 69

S corporations

Employee benefits 70

Trusts 71

Safe harbor interest rates

May 2019 71

Travel expenses 71

Secured Transactions

Agricultural liens 71

Agricultural Law Digest

Volume 30, No. 9

April 26, 2019

ISSN 1051-2780

Conservation Easements

-by Robert P. Achenbach, Jr., J.D.

The IRS has added syndicated conservation easement transactions to its list of dirty dozen tax scams,¹ increasing its concern raised in a *Notice 2017-10*.² Perhaps this is a good time to review some of the requirements for deductible conservation easements and the pitfalls taxpayers have encountered. The stakes can be high, both as to the amount of deduction available and the penalties incurred when the easement is denied for failure to meet the requirements of the Code and regulations.³

Charitable Deduction for Gifts of Partial Interests in Property

Generally, a charitable contribution deduction is not allowed for a charitable gift of property consisting of less than the donor's entire interest in that property.⁴ However, a charitable contribution deduction is allowed for the transfer of a partial interest in property that is not placed in a trust, only if the transferred property is: a remainder interest in the taxpayer's personal home or farm; an undivided (fractional) interest that represents every substantial interest the taxpayer owns in the property and lasts as long as the taxpayer's interest in the property; a partial interest that would be deductible if transferred to certain types of trusts, such as charitable lead trusts; or a qualified conservation contribution.⁵

A property owner who intends to claim a tax deduction for a noncash charitable gift with a value in excess of \$5,000 generally must engage an independent qualified appraiser to determine the value of the gift in a qualified appraisal and include the appraisal information in Form 8283, *Noncash Charitable Contributions*, attached to the return for the year of the gift.⁶ The appraisal itself must be included with the return if the value of the deduction exceeds \$500,000.⁷

A qualified appraisal must describe the property, provide a valuation, and explain the method used to arrive at that value.⁸ The valuation of a conservation easement is frequently challenged by the IRS especially where the location of undeveloped property near other developed property can enhance the value of the developed property.⁹

In *Notice 2017-10*¹⁰ the IRS described the promotion of syndicated conservation easements which suggest that prospective investors may be entitled to a share of a charitable contribution deduction that greatly exceeds the amount of an investor's investment. The promoters obtain inflated appraisals to support the excessive tax benefits. The IRS advises that certain of these transactions are tax avoidance transactions and identifies them and similar transactions as "Listed Transactions."¹¹ The Notice applies to

* Publisher and editor of the Agricultural Law Press.

transactions in which the promotional materials suggest to prospective investors that they may be entitled to a share of a charitable contribution deduction that equals or exceeds two and a half times the amount invested. Individuals entering into these and substantially similar transactions must disclose them to the IRS.

Qualified Conservation Easements

Generally, a qualified conservation contribution is a contribution to a qualified organization¹² of a real property interest requiring the property to be used exclusively for conservation purposes in perpetuity.

Qualified Real Property

A qualified real property interest may be a remainder interest; a restriction (granted in perpetuity) on the use that may be made of the real property; or the entire interest in real estate other than a mineral interest.¹³ The donor may retain an interest in subsurface oil, gas, or other minerals, and the right of access to these minerals.

Qualifying Conservation Purpose

Qualifying conservation purposes are defined as preserving land areas for outdoor recreation by, or for the education of, the general public; protecting a significant relatively natural habitat of fish, wildlife, or plants, or a similar ecosystem; preserving open space, including farmland and forest land, if it yields a significant public benefit; or preserving a historically important land area or a certified historic structure.¹⁴ In *Atkinson v. Comm'r*,¹⁵ the taxpayer granted easements on two golf courses allowing for some construction on the property for improvement of the golf course and removal of trees within 30 feet of the golf course. The easement identified the conservation purpose as the preservation of natural habitat. However, the court found only one natural habitat for some trees on the golf courses and that area was allowed to be cut under the easement; therefore, the court held that the easement had no conservation purpose and was not eligible for the charitable deduction.

In Perpetuity

The cases have demonstrated that the perpetuity requirement must be in place immediately upon the grant of the easement. In most states, an easement is not enforceable against a *bona fide* purchaser of the affected real property until the easement is recorded. In *Zarlengo v. Comm'r*,¹⁶ the court held that an easement not recorded until the tax year following the grant of the easement was not made in perpetuity because during the unrecorded period, the easement could be defeated by a *bona fide* purchaser.

Cases have demonstrated a split of authority as to whether the perpetuity requirement applies to the specific property described in the easement such that any alteration of the property subject to the easement destroys the perpetuity of the easement. In *Pine Mountain Preserve, LLLP v. Comm'r*,¹⁷ the easement allowed development of some parcels subject to the easement with substitution of other property to be subject to the easement. The court held that such substitution violated the perpetuity requirement. The Fifth Circuit Court of Appeals,¹⁸ however, allowed the grantors of the easement to shift the boundaries of parcels subject to the easement so long as the total amount of land subject to the easement remained constant.

In support for the perpetuity requirement, where the property subject to the easement is mortgaged, the donor must obtain a subordination agreement from the mortgagee effective on the date of the grant of the easement.¹⁹

Unexpected Extinguishment of the Easement

The regulations require the grantor to prove that any possibility that the easement could be defeated by the performance of some act or the happening of some event was so remote as to be negligible.²⁰ In addition, the easement must provide that, if an unexpected termination of the easement arises, the charitable organization holding the easement is entitled to the proceeds in the same proportion as the fair market value of the easement at the time of the gift bore to the fair market value of the entire property, unless state law provides otherwise.²¹ In *PBBM-Rose Hill, Ltd. v. Comm'r*,²² the easement extinguishment provision allowed for deductions from the donee's share of the cost of improvements and cost of the sale. The court held that this violated the regulation's requirement that the donee receive a share of the proceeds based on the full fair market value of the easement at the time of the grant.

ENDNOTES

¹ IR-2019-47.

² I.R.B. 2017-4, 542. *See discussion below.*

³ I.R.C. § 6662(a), (b)(2) (20 percent accuracy-related penalty on any portion of underpayment attributable to substantial understatement of income tax). *See Carroll v. Comm'r*, 146 T.C. 196 (2016) (denial of charitable deduction for unqualified conservation easement, not granted in perpetuity, resulted in imposition of understatement penalty).

⁴ I.R.C. § 170(f)(3)(A).

⁵ I.R.C. § 170(f)(3)(B).

⁶ I.R.C. § 170(h)(4)(B)(iii)(I). *See, e.g., Gemperle v. Comm'r*, T.C. Memo. 2016-1 (failure to attach qualified appraisal was absolute requirement, causing loss of deduction for facade preservation easement).

⁷ I.R.C. § 170(f)(11).

⁸ Treas. Reg. § 1.170A-13(c). *See, e.g., Costello v. Comm'r*, T.C. Memo. 2015-87 (appraisal not qualified because missing statement of value of easement, and appraiser did not have all relevant information about easement).

⁹ *See, e.g., Wendell Falls Development, LLC v. Comm'r*, T.C. Memo. 2018-45, *aff'd on reconsideration*, T.C. Memo. 2018-193 (charitable deduction for conservation easement denied where value of land before and after easement was identical because highest and best use of property was as park).

¹⁰ I.R.B. 2017-4, 542.

¹¹ *See* I.R.C. §§ 6111 and 6112; Treas. Reg. § 1.6011-4(b)(2). Persons entering into these transactions on or after January 1, 2010, must disclose the transactions as described in Treas. Reg. § 1.6011-4 for each taxable year in which the taxpayer participated in the transactions, provided that the period of limitations for assessment of tax has not ended on or before December 23, 2016.

¹² I.R.C. § 170(c). Qualified organizations include: (1) A community chest, corporation, trust, fund, or foundation organized or created in or under the laws of the United States, any state, the District of Columbia, or any possession of the United States (including Puerto Rico). It must, however, be organized and operated only for charitable, religious, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals. Certain organizations that foster national or international amateur sports competition also qualify. (2) War veterans' organizations, including posts, auxiliaries, trusts, or foundations, organized in the United States or any of its possessions (including Puerto Rico). (3) Domestic fraternal societies, orders, and associations operating under the lodge system. (4) Certain nonprofit cemetery companies or corporations. (5) The United States or any state, the District of Columbia, a U.S. possession (including Puerto Rico), a political subdivision of a state or U.S. possession, or an Indian tribal government or any of its subdivisions that perform substantial government functions.

¹³ I.R.C. § 170(h)(2).

¹⁴ I.R.C. § 170(h)(4).

¹⁵ T.C. Memo. 2015-236.

¹⁶ T.C. Memo 2014-161. See also Ten Twenty Six Investors v. Comm'r, T.C. Memo. 2017-115 (easement not recorded until almost a year later).

¹⁷ T.C. Memo. 2018-224. See also Belk v. Comm'r, 774 F.3d 221

(4th Cir. 2014), *aff'g*, 140 T.C. 1 (2013) (right to alter boundaries of property subject to conservation easement disqualified easement for charitable deduction).

¹⁸ BC Ranch II, L.P. v. Comm'r, 867 F.3d 547 (5th Cir. 2017), *vac'g and rem'g*, T.C. Memo. 2015-130.

¹⁹ Treas. Reg. § 1.170-14(g)(2). See RP Golf, LLC v. Comm'r, 860 F.3d 1096 (8th Cir. 2017), *aff'g*, T.C. Memo. 2016-80 (charitable deduction denied where subordination agreement by mortgagee not executed until seven months after grant of easement); Mitchell v. Comm'r, 775 F.3d 1243 (10th Cir. 2015), *aff'g*, 138 T.C. 324 (2012) (charitable deduction denied where subordination agreement by mortgagee not executed until two years after grant of easement); Minnick v. Comm'r, 796 F.3d 1156 (9th Cir. 2015), *aff'g*, T.C. Memo. 2012-345 (same).

²⁰ Treas. Reg. § 1.170-14(g)(3).

²¹ Treas. Reg. § 1.170(h)(6)(ii).

²² 900 F.3d 193 (5th Cir. 2018). See also Palmolive Bldg. Investors, LLC v. Comm'r, 149 T.C. 380 (2017) (charitable deduction denied where mortgagee had priority to proceeds over donee easement holder); Carroll v. Comm'r, 146 T.C. 196 (2016) (charitable deduction denied where ratio of split of proceeds determined by ratio of charitable deduction to the fair market value of subject property).

CASES, REGULATIONS AND STATUTES

ADVERSE POSSESSION

FENCE. The plaintiff purchased a part of a farm in 1991. The owner and the plaintiff walked the boundary of the plaintiff's portion of the farm and the owner indicated that an old fence was the boundary line of the plaintiff's property. The defendant purchased the remainder of the farm from the owner's estate after the owner died. The defendant had a survey performed which showed that the true boundary line ran several feet onto the plaintiff's side of the fence, creating about two acres of disputed land. The plaintiff then filed suit to quiet title to the disputed property because the plaintiff acquired title by adverse possession. The trial court found that the plaintiff had usually cultivated or improved the disputed parcel by hunting on it, erecting permanent deer stands, planting trees, cutting wood, and posting "No Trespassing" signs. Wis. Stat. § 893.25(1) permits a party to acquire title to real property by showing that the party and/or its predecessors in interest adversely possessed the property for an uninterrupted period of 20 years. To establish adverse possession under Wis. Stat. § 893.25, a party must show: (1) actual continued occupation under claim of title, exclusive of any other right and (2) that the property was either protected by a substantial enclosure or usually cultivated or improved. The appellate court affirmed, holding that the plaintiff had demonstrated both a substantial enclosure existed between the properties and that

the plaintiff had used the disputed property sufficiently to show open, notorious, visible, exclusive, hostile and continuous use of the property. **Fabry v. Jagiello, 2019 Wis. App. LEXIS 150 (Wis. Ct. App. 2019).**

BANKRUPTCY

FEDERAL TAX

DISCHARGE. The debtor filed for Chapter 7 in January 2017 and listed unpaid taxes as a nonpriority unsecured claim. The taxes related to taxes owed for 2001, 2002, 2005, 2006, 2009, 2010 and 2012, for which returns were all filed in September 2015. The debtor received a discharge in May 2017 and the case was closed soon after. In September 2017 the debtor filed a motion to vacate the discharge and dismiss the case, claiming that the debtor filed the case in error too early because the failure to wait more than two years after filing the return caused the taxes to be nondischargeable in the case. The Bankruptcy Court denied the motion because the debtor had not presented any new information or argument which could not have been presented at the original case and the revocation would prejudice the claims of the IRS and other creditors. Under Civil Rule 60(b), a Bankruptcy Court has equitable powers to revoke a discharge because of "mistake, inadvertence, surprise, or excusable neglect." On appeal the appellate court affirmed, holding that Civil Rule 60(b) was not