

The background of the slide is a scenic landscape photograph. It features a large, rugged mountain range with light-colored rock faces and patches of snow or ice. In the foreground, there is a calm lake with clear, greenish water. Several tall, dark evergreen trees are scattered throughout the scene, particularly on the right side. The sky is a clear, bright blue with a few wispy white clouds.

TRENDS, TIPS, & TAXES: CURRENT ISSUES IN CONSERVATION DEFENSE

Virginia Land Conservation & Greenways
Conference, April 28, 2022





TRENDS, TIPS, & TAXES: CURRENT ISSUES IN CONSERVATION DEFENSE
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A. Introduction

Conservation easement defense and compliance are critically important (and continuously evolving) responsibilities for land trusts. Part I of this session will familiarize participants with current trends in enforcement and stewardship challenges, conservation litigation and defense. Part II will cover notable legal orders and decisions that affect qualified conservation contributions, as well as possible easement violations that trigger IRS actions.

B. National Trends and Observations on Stewardship Challenges

The following are the most common easement violations and causes of action that demonstrate evolving enforcement patterns accumulated from TerraFirma 2021 data.

1. **Public access** and **trail disputes** are increasing nationally with the intensified use during the pandemic. Dogs and horses are friction points with landowners and neighbors, followed by noise and loud music.
 - a) **Tips to consider:**
 - i. tighter public access language
 - ii. increased monitoring
 - iii. communication with neighbors
 - iv. more detailed management planning to attempt to head off disputes
 - b) refer to *Land Trust Standards & Practices (S&Ps)* 11C, 12B and 12C
2. **Land division** disputes also are increasing in more rural areas. This could be signs of natural disaster migration out of cities and relocation due to the pandemic. We expect this trend to increase.
 - a) **Tips to consider:**
 - i. evaluate your risks and adapt stewardship administration to address increased human pressure on conserved land
 - ii. add stewardship monitoring online and by public records title search for prohibited divisions

- iii. examine your easement template to ensure that you have modern division prohibition language
 - b) refer to *S&P* 9 and 11
- 3. **Title disputes, boundary disputes, and extinguishment** challenges are increasing nationally as neighbors and successor owners attempt to maximize the financial value of their land and any adjoining land that they perceive as not used for development.
 - a) **Tips to consider:**
 - i. have precise and complete records
 - ii. check records annually at a minimum
 - b) refer to *S&P* 9D, 9G, 11J
- 4. **Water rights** cases are increasing and span the country from the arid west to the wet southeast. Accretion issues also are increasing on oceanfront conservation land.
 - a) **Tips to consider:**
 - i. address uses of ground and riparian water, if not already included
 - ii. consult expert legal counsel in the water law of your state due to level of complexity
 - b) refer to *S&P* 9A and 9E
- 5. **Technical errors** can damage or end the defense of a conservation right. Recent examples include:
 - a) The land trust name on a 30-year-old Conservation Restriction was missing one word of which opposing counsel emphasized at great expense to the land trust
 - b) Landowner name in 10-year-old easement was an individual instead of an LLC
 - c) Multiyear protracted failure to check boundaries
 - d) Failure to obtain survey promptly upon persistent uncorrected trespass
 - e) Inconsistent legal description omitted a parcel, but a restriction included the parcel
 - f) Inconsistent baseline documentation undermined the correct conservation easement interpretation
 - g) **Tips to consider:**
 - i. establish a relationship with an attorney before you face legal challenges so you have a trusted legal advisor with no conflicts of interest to turn to when a challenge emerges
 - ii. have a full insurance portfolio
 - iii. comply with your land trust's policies, *S&Ps* and accreditation requirements
 - iv. focus on careful drafting, stewardship, and recordkeeping--details matter!
 - h) refer to *S&P* 9, 11, 12

Discussion (15 minutes):

What are you seeing in Virginia? What is not included in this list? What is your top stewardship challenge or enforcement issue? Share how to avoid these legal pitfalls and enforcement actions

Terrafirma Tips:

1. Have a full insurance portfolio including Terrafirma, general liability, directors & officers, volunteer and title coverage.

2. Stay in touch with Alliance Risk Management Services staff when you have a covered claim. Staff can help you coordinate, move decisions quickly and avoid delays in waiting for Terraforma approval of case management. **File claims on time!** Contact Leslie Ratley-Beach (802) 262-6051 lrbeach@lta.org
3. Call Terraforma early! Filing a notice of a possible problem is quick and easy. Waiting until after the trial to claim reimbursement of legal fees may lead to loss of coverage.

Collective Defense is Stronger than Ever

545 land trust member owner insureds	\$12 +/- million total market value all assets
48 U.S. states have member land trusts	\$4.6+ million paid to help land trusts
10.2 + million acres covered in the U.S.	\$1 million +/- total subrogation returned
\$3.5 + million actuary certified reserves	\$4 + million in capital

C. National Trends and Observations on Tax Challenges

We have entered a new phase of IRS challenges of charitable conservation contributions. It is somewhat unpredictable in its direction. Though it is focused on halting the abuse of syndicated conservation easement transactions, there is significant collateral damage to legitimate transactions.

2. Extinguishment and proceeds clauses (Treas. Reg. §1.170A-14(g)(6) and (g)(6)(ii))

- a) **Proceeds clauses.** For charitable conservation contributions, the IRS requires easements to include provisions to address extinguishment of easements and how the easement allocates any possible extinguishment awards (“proceeds”) between the landowner donor (and its lenders) and the land trust donee using a mathematical formula in the “proceeds clause.”

Put simply, a conservation easement must absolutely guarantee in all circumstances that the land trust donee receives its "proportionate share of the extinguishment proceeds." The proportionate share is interpreted as a fraction equal to the value of the easement when gifted [the recording date], divided by the value of the property as a whole at that time [of the gift]. See Treas. Reg. §1.170A-14(g)(6)(ii) and IRC §170(h)(1)(C)

Illustration: a taxpayer donates a conservation easement worth \$30,000 on unimproved property with an unencumbered value of \$100,000. The judicial extinguishment regulation mandates that the donee receive at least 30% of total sale proceeds ($\$30,000 \div \$100,000 = 0.3$). If the taxpayer later adds improvements worth \$50,000, and sells the property for \$150,000 following judicial extinguishment of the easement. The regulation requires that the donee receive at least 30% of \$150,000, or \$45,000. (adapted from *Briarcreek Preserve LLC v Cmsr*)

In the absence of regulatory clarity, land trusts have drafted proceeds clauses with various mathematical formulas to, as an example, clarify what happens with post-conservation permitted improvements. But the IRS has eliminated the variations

interpreting *any* deviations from the regulatory language as violating the perpetuity requirement.

b) Recent court opinions

- i. May 2020, the Tax Court in *Oakbrook Land Holdings LLC v. Commissioner* (154 T.C. No. 10) held that the proceeds regulation (Treas. Reg. §1.170A-14(g)(6)) was procedurally and substantively valid. The regulation was properly promulgated under the Administrative Procedure Act. The regulation as drafted ensures the statutory mandate that the conservation purpose be “protected in perpetuity,” sec. 170(h)(5)(A) and the court could not find the regulation to be “arbitrary, capricious, or manifestly contrary to the statute.” (Dissent by Judge Holmes: “I fear that our efforts to clear cut and brush hog our way out of the volume of conservation-easement cases we have to deal with has left us a field far stumpier than when we began.”)
- ii. December 2021, the U.S. Court of Appeals for the Eleventh Circuit (AL, FL, GA) in the case of *Hewitt v. Commissioner* concluded that the IRS’s interpretation (disallowing the subtraction of subsequent improvements) was arbitrary and capricious and violated the Administrative Procedure Act sending it back to the Tax Court on remand. The Eleventh Circuit’s opinion is subject to differing interpretations. In particular, it is not entirely clear whether the Eleventh Circuit invalidated the §1.170A-14(g)(6)(ii) termination proceeds regulation in its entirety, or whether the court invalidated that regulation only insofar as it is interpreted to disallow deductions based on carve-outs for donor improvements.
- iii. March 2022, the Sixth Circuit (KY, MI, OH, TN) decided the appeal of the Tax Court’s decision in *Oakbrook* regarding the validity of the proceeds regulation and the IRS’s interpretation of that regulation (in this case, specifically about the subtraction of the value of post-donation improvements from the proceeds). The Sixth Circuit affirmed the Tax Court opinion.
- iv. There is now a split in the appellate circuits with *Hewitt* applying in Georgia, Florida, and Alabama but the Tax Court’s decision affirmed by the Sixth Circuit in *Oakbrook* applying in the remainder of states. The Tax Court has put motions and decisions about proceeds clauses “pending further appellate developments on the validity of Treasury Regulation § 1.170A-14(g)(6).” The Fourth Circuit, which includes Virginia, has yet to hear a case on appeal addressing the proceeds regulation issue so the Tax Court’s decision in *Oakbrook* applies.
- v. More to come: *901 South Broadway LLC* in the Ninth Circuit (CA, OR, WA, HI, AK, AZ, ID, MN, NV) seeks to overturn the disallowance of a historic preservation easement on a historic rehab project. The Tax Court found the deduction invalid because the proceeds language allowed for debtors to be paid ahead of the easement holder (the “prior claims” argument). The easement provisions provided that the holder’s share of any termination proceeds in the event of condemnation would be calculated after the satisfaction of any prior claims such as a mortgage. It is still in the preliminary stages but this case touches on the

regulation's validity and may add the Ninth Circuit's take to that of the Eleventh in *Hewitt* and the Sixth in *Oakbrook*.

c) Tips to consider:

- i. wait for the Tax Court to address *Hewitt* on remand; whether the taxpayers ask for and are granted reconsideration in *Oakbrook*; whether the Supreme Court of the United States will take up the case if or when *Oakbrook* files for it. The latter is a possibility as the existence of a circuit split is one of the factors that the Supreme Court considers when deciding whether to grant review of a case
 - ii. sit tight, to avoid quick reactions, such as altering any easement template or agreeing to any donor request to eliminate or alter the proceeds clause language at this time, and to let this evolve in the courts
 - iii. be aware that the IRS discounts deed reformations or "retroactive amendments" removing "faulty" language. Tax Court looks to the interpretation under state law. Some cases are in preliminary stages so this may evolve.
- d) refer to *S&P 10* and 11

2. Reserved Rights (Treasury Regulation § 1.170A-14(g)(5))

We are tracking IRS challenges to reserved rights as an emerging pattern, one that delves into the routine practices of land trusts. The IRS is scrutinizing clauses addressing unspecified locations, baselines, monitoring, inspections and approvals and their compliance with the Treasury Regulations. To put it into context, the IRS is challenging reserved rights such as forest management activities (*Sand Valley*), commercial forestry activities (*Rocky Comfort*), construction of hunting stands and trails (*Hickory Equestrian*), and maintenance of existing ponds (*Piedmont Breeze*).

These cases are in preliminary stages and, for the most part, the Tax Court has denied IRS motions for summary judgment on the reserved rights arguments. The court has determined that these are factual questions whether the exercise of particular reserved rights could impair the conservation purposes, and so is allowing them to go to trial. At trial, the Tax Court plans to delve into the everyday operations of land trusts, their "internal procedures and past practices," to shed light on whether the conservation purposes would be impaired.

a) Unspecified locations

Example: IRS argued that the donation fails because the easement permits the construction of five undefined "equestrian areas" (and an unlimited number of "pipe corrals" and "other structures" within the equestrian areas) anywhere stating that these broad reserved rights provide only "illusory" protection and a CE that allows for the construction of future, undefined structures in unspecified locations and sizes within a conserved area cannot be a qualified conservation contribution. Tax Court distinguished the building areas here from those in *Pine Mountain Preserve* and *Belk* because they were limited to equestrian purposes, one of the expressly permitted uses of the protected property. Thus, there was no threat to perpetuity by allowing these building areas to be unfixed in size or location. (*Malibu Valley*)

b) **Baselines:**

Example: Easement's conservation purposes include the protection of water quality, water resources, and subsurface water. IRS claims that the baseline documentation was "insufficient to establish the condition of these water resources on the date of the gift." Therefore, IRS argues that holder would be unable to make a reasoned determination as to whether landowner's exercise of a reserved right would adversely affect the conservation purpose. Tax Court lets this go to trial for expert and party testimony. (*Georgia Crushed Stone*)

c) **Approvals/consents:**

Example: IRS faults an easement for including a "deemed consent" provision, which allegedly renders holder "powerless to prevent [an] inconsistent use" if it does not respond to a request from landowner within 30 days. IRS argued that an easement with a "deemed consent" provision cannot satisfy the "protected in perpetuity" requirement because the donee is stripped of its "perpetual right to prevent uses of the Property that are inconsistent with the conservation purposes." Landowner relies on other easement provisions: prohibits engaging in an activity that "would result in an adverse effect on the Conservation Purposes . . . in any material respect and authorizes holder to enjoin a violation" and "require restoration of the Property" to the status quo. Also contends that exercise of the rights in question would not, in fact, risk any damage to the conservation purposes. Tax Court held that impairment of any conservation purpose presents factual questions so summary judgment is inappropriate. (*Sand Valley*)

d) **Notice:**

i. *Exercise of reserved rights:*

Example: certain provisions of the easement that reserve rights--e.g., the rights to hunt and fish and to construct hunting stands, trails, and a storage shed--do not explicitly require advance notice to the holder but the easement has a general requirement that landowner must notify holder "in writing before exercising any Reserved Right that may impair the conservation interests associated with the Conservation Area." IRS claims this violates the regulations. Tax Court holds this as a factual question whether the exercise of these particular rights could "have an adverse impact on the conservation interests." (*Hickory Equestrian*)

ii. *Monitoring:*

Example: Easement gave the holder the right "to enter onto the easement by giving prior written notice to the legal owner to monitor compliance with and otherwise enforce the terms" of the deed. IRS argued that the deed violated the regulation's inspection requirements contending that (1) the provision creates "an obstacle to [the holder] protecting the conservation purposes [by] requiring [holder] to wait until [landowner] is notified", and (2) holder could be barred from entering the property in that the easement "does not include any provisions to prevent [landowner] from restricting holder's access once written notice is received." The Tax Court disagreed with the IRS. Ultimately, the IRS is asserting that written notice must be explicitly required even for relatively minor structures such as hunting blinds, viewing platforms, and fences. It remains to be seen whether this argument will prevail in the

Tax Court, but cautious donors and land trusts should take note that this is now a very live issue in the eyes of the IRS. (*Malibu Valley*)

- e) For case information**, see: *Malibu Valley Land LLC v. Commissioner* (Docket No. 20442-19), *Sand Valley Holdings, LLC v. Commissioner* (No. 12141-20), *Hickory Equestrian, LLC v. Commissioner* (No. 347-21), *Piedmont Breeze, LLC v. Commissioner* (No. 12011-20), *Rocky Comfort Creek Holdings, LLC v. Commissioner* (No. 12106-20), *Pickens Decorative Stone LLC v. Commissioner* (Docket No. 13614-20), *Georgia Crushed Stone, LLC v. Commissioner* (Docket No. 12192-20)
- f) Tips to consider:**
- i. If there are any reserved rights in the easement, lay out why their exercise would not affect the conservation values.
 - ii. If there are any reserved rights in the easement, the land trust must have documented decision making procedures for review of those rights. (Refer to *S&P 11F*)
 - iii. If there are any reserved rights in the easement, consider consulting a third party for support of land trust decisions--IRS prefers third-party, specialized support of decision making
 - iv. make sure notice and inspection language tracks closely with regulatory language
 - v. ensure good recordkeeping to promote efficiency and defense of the land trust when the Tax Court delves into the land trust's "internal procedures and past practices"
 - vi. be aware that the IRS does not afford local or state agencies as easement holders any type of presumption of reasonableness or validity as to the charitable donation.

D. Q&A

This material is being provided for informational purposes only. The material in this written outline is general and is not intended to be legal advice. Nothing in this written outline should be relied upon or used without consulting a lawyer to consider your specific circumstances, possible changes to applicable laws, rules, and regulations, and other legal issues.