ROBERTS & HOLLAND LLP

Originally published in the:
New York Law Journal ***April 26, 2023***

Protecting the Environmental Protectors: New Guidance on Conservation Easements

By: Ezra Dyckman and Charles S. Nelson

A taxpayer can often claim an income tax deduction for a donation of a conservation easement to a charitable organization, provided that the conservation easement protects land or a historic building from development in perpetuity and meets numerous technical requirements.

However, for many years, conservation easements have been subject to rigorous IRS scrutiny, especially when they relate to syndicated transactions.

The IRS has often contested the valuation of conservation easements, which is generally measured as the difference between the fair market value of property before the contribution and the fair market value of the property once subject to the easement.

In addition, the IRS has aggressively sought to find various technical flaws in conservation easement deeds.

One such requirement that has been the subject of much litigation relates to extinguishment clauses. Although an easement generally must protect a property in perpetuity to qualify for a deduction, the regulations permit an easement to be extinguished by judicial proceeding in the event that subsequent unexpected changes in conditions render it impossible or impractical to use the property for conservation purposes, as long as the easement holder's share of any proceeds from the extinguishment are used for similar conservation purposes.

In any such proceeding, the easement holder must be entitled to receive its proportionate share of any proceeds, determined by dividing the value of the conservation easement at the time of the donation by the total value of the property at such time.

In several court cases, the conservation easement at issue provided that, in the event of a judicial extinguishment, the donor was entitled to first receive proceeds equal to any increase in value of the property from the date of grant attributable to improvements constructed by the donor. Only after the donor received this amount would the easement holder be entitled to its share of proceeds.

In most such cases, the court disallowed the deduction, holding that these extinguishment clauses did not comply with the regulations, even if there was only a remote possibility that the easement would ever be extinguished, and even if the easement contained a savings clause.

Despite the government's success in litigating conservation easement cases, many in Congress felt that further legislation was needed to prevent perceived abuses, particularly in the case of syndicated transactions.

Accordingly, in December 2022, as part of the appropriations legislation, further restrictions on the deductions for conservation easements were enacted. Specifically, the law generally limits a partnership's deduction for conservation easements to 2.5 times the sum of the partners' tax bases in the partnership that are allocable to the property subject to the easement.

However, this limitation does not apply if both (1) the partnership has held the property for at least three years and (2) each partner has held its partnership interest for at least three years. The limitation also does not apply to certain family partnerships or to conservation easements to protect certain historic buildings. While this limitation may have been intended to apply only to abusive syndicated transactions, it could have a much broader effect.

In response to the IRS's aggressive enforcement actions, the new law also contained a provision designed to help taxpayers avoid certain technical flaws in conservation easement deeds.

Specifically, the law requires that the IRS publish "safe harbor" clauses for conservation easement deeds, both for extinguishment provisions and provisions relating to boundary line adjustments. A taxpayer who includes these safe harbor provisions in a conservation easement deed can be certain that they will comply with the applicable tax regulations.

The IRS recently released this language in Notice 2023-30. The safe harbor extinguishment clause contained in the notice is consistent with the applicable regulations. The safe harbor boundary line adjustment clause (for which there was no previous regulatory guidance) provides that the boundaries of real property subject to a conservation easement cannot be modified except pursuant to a judicial proceeding to resolve a bond fide dispute regarding a boundary line's location.

In addition to helping taxpayers comply with conservation easement requirements going forward, the new law also permits taxpayers with existing conservation easements to modify extinguishment and boundary line adjustment clauses to include the safe harbor language.

Such modifications will be treated as having retroactive effect for purposes of complying with the tax regulations. However, to qualify, a modification must be made by July 24, 2023, and the easement must not be part of a reportable transaction or the subject of pending litigation, among other requirements.

In sum, the enactment of the new conservation easement law adds further restrictions to an area of the tax law that was already rife with potential pitfalls. Given the intense IRS scrutiny of conservation easements, any taxpayer considering making a donation of a conservation easement should exercise extreme caution in ensuring that all applicable requirements for an income tax deduction have been satisfied.

On the positive side, the new IRS safe harbor language provides some taxpayers who may have deficient conservation easements with a unique but short-lived opportunity to correct those mistakes. While it is disappointing that there are now further limitations on deductions for conservation easements that could apply to non-abusive transactions, it is good news for taxpayers that Congress is also trying to help facilitate compliance.

Ezra Dyckman *is a partner at Roberts & Holland LLP.* Charles S. Nelson *is an associate at the firm.*