A Split Regarding Conservation Easements Leaves Questions in the 11th Circuit

By: J. Austin Alderman

In 2016 the IRS began to apply extra scrutiny to deductions claimed under Section 170(h) arising from the donation of developmental rights to real estate in the name of conservation, or commonly known as conservation easements. Part of the IRS strategy has been to attack what it deems to be technical defects in the transaction documents, especially language that calls into question the requirement that restrictions on development must be granted in perpetuity. This focus has drawn particular attention to conservation easements containing certain language regarding the division of proceeds in the event the easement is judicially extinguished, and the property eventually sold. At the center of this focus is Treasury Regulation 1.170A-14(g)(6)(ii) which provides specific guidance on how proceeds are to be distributed in the event of extinguishment. It is this regulation that has drawn a difference of opinion in the Sixth and Eleventh Circuits.

The 6th Circuit Sides With the IRS

Oakbrook Land Holdings et al. v. Comm'r of Internal Rev was appealed to the Sixth Circuit from the Tax Court who found in favor of the IRS. Oakbrook Land Holdings, LLC, a Tennessee company, purchased a 143-acre parcel near Chattanooga, Tennessee in 2007 with the intent of developing the property into residential units. However, in 2008 Oakbrook elected to donate a conservation easement over 106 acres of the parcel to the Southeast Regional Land Conservancy ("SRLC"), maintaining the remainder for future development. In the language of the donation agreement Oakbrook maintained a right to reclaim the costs of any post-donation improvements it makes to the land subject to the easement, as a reduction of the easement value paid to SRLC as part of a fixed value set by the fair market value at the time of the donation. It was this language that the IRS stated did not comply with Treas. Reg. § 1.170A-14(g)(6)(ii) and disallowed the deduction. The Taxpayer in part contends that this rule is invalid because of the failure by the Department of the Treasury to follow the notice-and-comment procedures of the Administrative Procedures Act (the "APA").

The Taxpayer attacked the promulgation of the rule in two ways: (I) Treasury inadequately explained the rationale for the regulation in its statement of basis and purpose; and (II) failed to respond to certain comments about the regulation that raised significant issues. The Court analyzed both the rule making process and legislative history of the underlying statute as cited by Treasury in its notice for the proposed rule and found that there was sufficient evidence to determine the rule's basis and purpose, and it evidenced a "reasoned path" from the original legislation and disagreed with the Taxpayer. The Taxpayer in this case also cited to four specific comments that it believes Treasury was required to respond to for bringing a challenge to a fundamental premise of the proposed rule. One of these comments specifically was that made by The New York Landmark Conservancy (the "NYLC") that noted three potential issues, but most relevant to the instant case were concerns regarding the equitability of assigning the value of any post-donation improvements by the donor to the done and the possibility of the required distribution of funds to conflict with state laws regulating the distribution of funds following condemnation proceedings. The Court was not persuaded by the Taxpayer's arguments and found in favor of the IRS, reasoning that the comments were not significant to the enforcement of the goal of providing deductions for conservation easements which can satisfy the statute's perpetuity requirements, not just the encouragement of donations of conservation easements.

A Split by the 11th Circuit

The Tax Court in *Hewitt v. Comm'r of IRS*, citing to their earlier decision in Oakbrook, determined that David and Tammy Hewitt were not entitled to the charitable contribution deduction for their donation of a conservation easement. Similar to Oakbrook, the Tax Court found that the language in the easement deed included a section allowing for the recovery of post donation improvement costs in the event of an extinguishment, a violation of the requirement to protect property in perpetuity and the requirements under Treas. Reg. § 1.170A-14(g)(6)(ii). This decision was appealed to the 11th Circuit and the taxpayers made an argument similar to those in Oakbrook, Treas. Reg. § 1.170A-14(g)(6)(ii) was invalid under the APA for failing to respond to significant comments regarding the improvements issue, and cited to the same comments by the NYLC as discussed in Oakbrook as well as six other comments addressing the same issue that is considered to be significant. Unlike the 6th Circuit, the 11th

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Circuit was convinced by this argument, and relying in part on the dissent at the Tax Court in Oakbrook, found in favor of the taxpayers and invalidated Treas. Reg. § 1.170A-14(g)(6)(ii) as arbitrary and capricious for failing to comply with the APA's procedural requirements. The Court rejected arguments by the IRS that the comments by NYLC were not significant and did not require a response, or that a blanket statement that the IRS had considered "all comments" mean that they had specifically addressed the comment by NYLC. The 11th Circuit reversed the decision of the Tax Court and reinstated the taxpayers' deduction based on the deed as it was originally written.

How has the IRS Responded?

Despite the split by the Circuits, the IRS is not waiting for any further guidance in its implementation of the Regulations. On April 10 of this year, the IRS released Notice 2023-30, which included a guide for specific safe harbor deed language related to the possible extinguishment of a conservation easement. This Notice comes out of the SECURE 2.0 Act, passed in December of 2022, which requires the publishing of safe harbor deed language for extinguishment clauses and provides a period for the amendment of original deeds to substitute the safe harbor language for any preexisting language. The language used in the Notice mirrors that found in Treas. Reg. § 1.170A-14(g)(6)(ii), the subject of the discussed cases, creating the question of if taxpayers in the 11th Circuit should be concerned about the new language or risk having their deduction denied. Because of the recency of the Notice coming from the IRS no cases have been presented to the 11th Circuit to consider the validity of the deed language under the new rule, but the Supreme Court has shown no interest in helping to resolve the split, having rejected an appeal in the Oakbrook case in January of this year.

Conclusion

While the Courts and the IRS maneuver to determine how deductions for conservation easements moving forward, it is left to us to decide how to best advise clients moving forward. Even considering the current disagreement amongst the Courts, the prudent decision for the how to best serve clients looking to take advantage of deductions for the donation of conservation easements seems to be to take notice of the IRS' focus on the issue and follow the safe harbor language. Until the IRS issues a model deed that can reflect exactly what is required to successfully claim the deduction without further scrutiny then this guidance is all that addresses the exact issues the IRS is paying most attention to in its denials.

About the Author:

J. Austin Alderman comes from a family of farmers and ranchers, and uses his agricultural experience to effectively help clients with any manner issues that arise in the industry. In addition to helping grow or maintain agricultural business, Austin's practice also includes advising landowners who wish to explore committing their properties to renewable energy production, such as solar, or committing their properties to conservation through the use of conservation easements.

Endnotes

1 See; IRS Notice 2017-10; Invalidated by *Green Valley Investors, LLC v Comm'r*, 159 T.C. 5 (Nov. 9, 2022) for violating the APA.

2 *Oakbrook Land Holdings, LLC v. Comm'r*, 154 T.C. 180 (2020).

3 Id. at 3.

4 Id. at 4.

5 Id.

6 See; 5 U.S.C. sec. 553 (2018).

7 *Oakbrook Land Holdings, LLC v. Comm'r*, 28 F.4th 700, 714 (6th Cir. 2022).

8 Id. at 715.

9 Id. at 717-718.

10 *Hewitt v. Comm'r*, T.C. Memo. 2020-89 (U.S.T.C. Jun. 17, 2020)

11 Id. at 15.

12 *Hewitt v. Comm'r*, 21 F.4th 1336 (11th Cir. 2021)

13 Id. at 1352.

14 Id. at 1353.

15 See; y § 605(d)(1) of the SECURE 2.0 Act of 2022 (SECURE 2.0 Act), enacted as Division T of the Consolidated Appropriations Act, 2023, Public Law 117-328, 136 Stat. 4459 (December 29, 2022).

16 *Oakbrook Land Holdings, LLC v. Comm'r*, 28 F.4th 700 (6th Cir. 2022), cert. denied (U.S. January 9, 2023)(No. 20-2117).