

Fox Rothschild Podcast

The Presumption of Innocence Podcast Series: Episode 21

**Conservation Easement Donations:
Tax Shelter or Charitable Contribution Deduction?**

Featuring Matt Lee and Brian Bernhardt of Fox Rothschild LLP

Lee: Welcome to "The Presumption of Innocence" podcast. My name is Matthew Lee, and along with Matt Adams, I co-chair the White-Collar & Regulatory Compliance Practice Group at Fox Rothschild. We are very happy to have you all back listening to what will undoubtedly be another interesting topic to listeners of our podcast series.

I am coming at you from Philadelphia, which is where I practice. And we are pleased to welcome to the podcast today our Fox Rothschild colleague Brian Bernhardt, who practices in Charlotte, North Carolina. Brian is a member of the Taxation and Wealth Planning Practice Group at Fox Rothschild. He is a graduate of the University of Michigan Law School and we are thrilled to have him here on the podcast today, so, Brian, welcome.

Bernhardt: Thank you, Matt. It's a pleasure to be here. I appreciate the invitation and look forward to speaking with you.

Lee: Yeah well, we're really happy to have you here. Today we're gonna be talking about something called a conservation easement. Brian's gonna give you a lot more information about what that is and why you should care about it, but it is something that is of great interest to the Internal Revenue Service and the United States Department of Justice. So, we're gonna take a deep dive today into conservation easements, and what they are and why the government, and in particular the IRS, is so concerned about them.

So, let's just start with the basics, Brian. Tell us, what is a conservation easement?

Bernhardt: Thanks Matt. Conservation easement at its most basic is a limitation that's placed on real property. A landowner and a third party -- typically a 501(c)(3) tax exempted organization -- will enter into some type of an agreement to permanently limit future development of the land in order to protect that land for conservation purposes. There'll be a deed of conservation that is filed locally and the 501(c)(3) will enforce these restrictions. Now, the owner of the fee simple land that the easement is placed on still owns that fee simple and they still retain possession of it, and they can still retain certain uses of that property. But those uses are limited and have to be consistent with the conservation purposes of the easement.

So, for instance, if you created a conservation easement over, say, 50 acres of land so that the land is preserved for the prevention of extinction of certain animals or for open space or for some other acceptable conservation purpose, that's going to prohibit the landowner from developing that property, selling it to a developer to develop that property. The land is gonna remain as-is, undeveloped, going forward, theoretically in perpetuity.

And what the conservation easement does then is it makes it so the land can't be developed. And this is something that lots of folks do for altruistic purposes. You might have someone who owns a whole lot of land near a beautiful lake or near a beautiful mountain, and they wanna make sure that the views and the vistas and the use of that land are never undermined. So, they might put a conservation easement on that property to prevent the development so that future generations, whether in their family or somebody else, can enjoy the lake, the view, the mountain and that sort of thing.

Lee: So, it sounds to me like these conservation easements are not necessarily a bad thing. Is there anything inherently illegal or improper about doing what you just described?

Bernhardt: Inherently, no. There are many, many reasons why somebody might want to conserve land. What the IRS is concerned about is people doing it in order to make money, which sounds kind of strange when you think about the fact that they're limiting development on their property.

What the IRS is concerned about is not just an individual or a family who puts an easement on their property to prevent development, to make sure that they can enjoy the land as it is for generations to come.

But they're worried about what's called a syndicated conservation easement, which is a partnership obtaining real property, and then another investment partnership owning that partnership. The investment partnership syndicating ownership interests in itself, and then the underlying partnership donating that conservation easement to a 501(c)(3). And what the IRS is worried about in that context is that the valuation of the property that's being contributed isn't what it really is. And what I mean when I say that is, if I own a piece of land that's worth \$10 million and I donate a conservation easement, then I've donated some portion of that \$10 million.

If my land is worth \$10 million, the easement is part of that, and so afterwards, the land isn't worth as much and that difference is what the conservation easement is worth. But in these syndicated conservation easements, the IRS believes that, among other things, the donors are inflating the value of what they're donating in the conservation easement, such that the charitable contribution deduction that they get for donating to a 501(c)(3) -- which then is distributed out to all the investors in the partnership that owns the partnership, that owns the real property -- is much larger than the fair market value.

The way that happens is that there are different ways of looking at valuation. Appraisers do different types of valuations, they use different types of analyses. And the IRS is concerned that people aren't doing this just for altruistic purposes, they're doing it purely for the tax deductions and that it's not a real transaction. It's all a tax-driven transaction with no other motive whatsoever.

So, what the IRS does is they examine these transactions in order to determine whether or not they are legitimate. And if they are not legitimate, then they deny the deduction. And if they are legitimate, then they let the deduction go through.

One of the ways that the IRS has the ability to examine these is because they audit all of them. In 2017, the IRS issued a notice that said, more or less, anytime anybody does a conservation easement, you have to tell us on your tax return, and you have to fill out a certain form and you have to provide certain information. And the promoters and marketers and everyone involved has to file a form. And so we, the IRS, will find out about your conservation easement and we are going to audit every single one of them to see whether you're doing it purely for altruistic purposes and get the benefit of a deduction, or whether you're really letting the tax tail wag the dog.

Lee: Brian, I took note of the fact on the that on the IRS Dirty Dozen list, which is something that we've talked about in prior episodes of the podcast, the IRS has identified syndicated conservation easements as a potential tax avoidance scheme. And the Dirty Dozen, as you know, is the annual list that the IRS puts out of what it considers to be the most abusive types of tax transactions. And I believe that conservation easements have been on that list for a number of years. What does that tell you about the way the IRS's general view of conservation easement transactions in general?

Bernhardt: The IRS's view of conservation easements in general is, if it's done by individuals who are not related to each other, a family, for instance, and especially if the interests in the partnership are syndicated, the IRS view is that it is going to be a tax shelter.

Whether or not that is true, in fact, is what taxpayers have spent millions and millions of dollars over many years litigating with the IRS. But the IRS position is, if it is a conservation easement and the people who are receiving the deduction are more than simply outside of family, and especially if it's a syndicated transaction, the IRS assumption is that it's a tax shelter because the IRS gets notice of all the tax shelters. Because of filings that are required, they're going to audit every single one of them, and they are going to look for many, many reasons why they might deny the charitable contribution deduction.

And there are a host of reasons why the IRS might argue that the deduction should be denied, only one of which is that the taxpayer has misstated the value of the conservation easement. The IRS has spent a number of years looking for all kinds of problems in the conservation deeds, for instance, arguing that the deeds include language or -- do not include language -- making it so they violate section 170 of the Internal Revenue Code, which is the provision that allows for charitable contribution deductions as well as those for qualifying conservation easements.

They look at what I would call a lot of ticky-tack type issues, and they do all of that before they ever get to the question of, let's look at the appraisal and see what the value is and see if we agree with the value, which they never do.

Lee: So since 2017, Brian, every investor in a syndicated conservation easement transaction is required, as you said, to disclose that fact to the IRS. So the IRS, at least theoretically, is supposed to now have a list of every single person who's invested in one of these transactions. Is that correct?

And two, is there a penalty that an investor could face if they didn't disclose their participation in one of these transactions?

Bernhardt: So theoretically, yes. The IRS should have notice and information about all the investors, all the marketers, all the appraisers who have been doing these easements for going back a number of years.

One of the things that we've learned in audit defense, and litigation defense is, notwithstanding that information that taxpayers and other folks are required to provide to the IRS, the IRS sometimes, some would, say use their information document requests in audit and their discovery in litigation to look very broadly. Anything they can that might relate to the transaction that they're auditing or litigating, to see if they find more people. They're looking for more appraisers. They're looking for more marketers. They're looking for more transactions. People who didn't necessarily file the form 8886, or who didn't attach a form 8283 to their tax return.

There are probably people out there, especially promoters and marketers, that the IRS does not know about, and they're looking very hard to find all those people. If you do not disclose the

transaction to the IRS -- the notice in 2017, it's IRS notice 2017-10, which requires you to disclose the conservation easement to the IRS -- there's a 20% penalty if you don't do that. And that penalty would be, the IRS comes in, they determine that the value of your deduction is x not y and the difference that results of tax, they add a 20% penalty onto that.

That penalty, however does not apply any longer, because about six months ago our firm won a motion in a case called *Green Valley v. Commissioner* in which the tax court concluded that the notice violated the Administrative Procedures Act because the notice and comment requirements of the act were not complied with by the government. So currently, the 20% penalty does not apply. Interestingly enough, while most cases have an order that only applies to their case, the *Green Valley* case included a footnote in which the tax courts stated that it was going to apply this rule nationwide from here on out. So, for now, this 20% penalty doesn't apply.

We anticipate that when this *Green Valley v. Commissioner* case is ultimately finished, the government is going to appeal that order. And the Court of Appeals, and perhaps even eventually the Supreme Court, will have to decide whether the Administrative Procedures Act was complied with. But for now, the penalty in place is on hold for the time being.

Lee: Brian, it sounds like there's a lot of attention that is being paid to conservation easements by government agencies and in particular the IRS. Is that attention really focused on the promoters of these transactions, you know, the firms that are out marketing and selling conservation easements? Or is the focus on the investors who purchase an interest in a partnership and get a deduction that they can claim on their tax returns? Or is it both?

Bernhardt: So interestingly, the focus is not really on the investors themselves. And the reason is because the investors are simply investors in a partnership, and the deduction comes to the partnership, so, the focus is on the partnership. And the idea is that, if and when the partnership loses the tax deduction, that change in the partnership tax return will just automatically float up to the investors. The investors are not being investigated by the IRS but the partnerships are.

The investors tend to get contacted by the IRS during the course of an audit, during the course of litigation, because the IRS believes, rightly or wrongly, that they may have information about the transaction. Especially, the IRS is looking for some type of smoking gun that says that everybody's working together to find a certain value and make sure that happens.

At the same time, the IRS is also looking at the promoters and the marketers because they wanna stop these transactions. So, there have been a number of civil and criminal investigations of promoters. There have also been investigations, both civil and criminal, of the appraisers who have done appraisals of conservation easements.

When you're trying to value a conservation easement, you use what is called the before-and-after method, which is, you value the property on which the conservation easement is going to be placed before the easement is on it. Then you value it after the easement is on it, and the difference is the value of the conservation easement. The IRS is investigating appraisers, trying to impose a penalty. It's a penalty that is either 10% of the difference in tax or 125% of the fee the appraisers receive. So, they're going after appraisers. In a lot of cases, while that penalty doesn't seem like a lot, if an appraiser only got paid \$15,000 or so for an appraisal, it's not necessarily financially worth it for them to spend tens of thousands of dollars fighting these penalties. But if they don't fight the penalty, that has implications for the actual case in which the appraisal is being used.

So, there's a lot of interesting conflicts, potential conflicts. And then once you add in the investigations of the promoters, there's another conflict. And then you have investors, many of whom were simply advised by their financial advisors that they should invest in this conservation easement, or in this transaction that might result in a conservation easement, and then they suddenly find out that their investment is being audited. They have to come up with a capital contribution to pay for lawyers. And these are expensive cases, especially once the values of the conservation easements hit multimillion dollars. And, in many cases, we've seen conservation easement transactions where the deduction is in the hundreds of millions of dollars because the property is so large and so valuable beforehand.

There's a lot of folks that are not necessarily financially advantaged anymore. And sometimes it looks like a circular firing squad with everyone trying to figure out who to blame while, for instance, when we represent the partnerships that made their donations, we're trying to make sure that everybody stays on the same side so that we can find the beneficial outcome that establishes that the appraiser did do a proper appraisal upfront. And if that's established, then everything turns out to be fine. If you have a good appraisal, then you have a good result from your audit or your litigation, and everything turns out fine for everybody.

Lee: So, it sounds like, Brian, there's a lot of litigation going on around conservation easements, particularly in the United States Tax Court.

Can you talk a little bit about that litigation process in tax court and what you're seeing? For example, is the IRS taking a hard line and wanting to litigate every case? Is there any chance of settlement? What's the whole litigation process look like these days?

Bernhardt: So, the short story is, the litigation process is long and it's costly. Our experience over the last few years is that the IRS is not settling these cases unless the taxpayers are willing to concede pretty much everything, up to 90% to 95% of the value of the conservation easement, except penalties, which would include a 40% penalty for a gross valuation understatement. It would include interest on the tax and the penalty. And then all of that, because it's imposed against a partnership, flows through to the investors who invested X dollars, but now have to pay a multiple of X to the IRS on an audit.

So, the hard attack the IRS is taking prevents settlements that would impact audit. It prevents settlements when cases go to the Independent office of appeals. And it prevents settlement in litigation. And in litigation, the IRS is investigating everything. They're looking to make sure that every part of the deed was done correctly. They're making sure that the transaction was done a very specific way.

Some conservation easements are placed on properties that were carved out of larger parcels. So, there might be three or four parcels that engage in conservation easements that are all part of the same parent tract of land. And the IRS is going to either be auditing all of those or some of those. But they're going to be looking at the facts relating to all the conservation easements, even if, for some reason, they don't happen to be auditing one of those conservation easements. Again, they're doing that to find more people, more information and to use that information against you in your case. We have a number of cases that we've been litigating since 2019 and right now it's, May of 2023.

And certainly, the pandemic slowed down some of those cases for a while, but four years is quite a long time. We've had cases where the attorney fees become very high, very quickly because of the amount of discovery that the IRS is doing. Now, we can't simply not respond to the discovery, and so

we have to provide documents, provide information, much of which has already been provided during the audit process.

So it turns out to be long. It turns out to be expensive. It turns out that there are very few opportunities for a fair settlement. It turns out that the IRS is imposing, or trying to impose, very high penalties. Because these cases go on for so long and because the audit process typically goes on for a while, there's a lot of interest out there that has a potential liability as well. If we're sitting in 2023 litigating a case that was filed in 2019 about an easement that was done in 2015, you're looking at interest from April of 2016 all the way to now. And once you're talking millions or tens of millions of dollars, the interest alone eventually becomes more than the tax deduction that was taken.

So, the costs are very, very high. And there are probably two things that can potentially put a halt to this. One would be a number of taxpayer victories in tax court. And I think if that happens, then the tax court is going to implicitly let the IRS know you need to start settling in these cases. Here are the issues we care about. We may or may not care about these ticky-tack issues with the deed. We care more about the actual fair market value analysis. Here's how we're gonna look at it. You need to do a better job at settling these cases along these terms.

The second way that it could happen is if the IRS issues a formal national settlement offer. A few years ago, the IRS issued a settlement offer nationally, but it wasn't a very good one. Not a lot of people who engaged in conservation easements took the settlement, although some did. The result of that settlement offer not being quite as good as it should be, and not having been one that appealed to taxpayers, didn't result in many cases going away.

There's a new commissioner of the IRS. Soon, hopefully, there'll be a new Chief Counsel of the IRS when one is nominated and confirmed. And it's our hope that the IRS will at that point put together a national settlement initiative that actually is one that's attractive to the taxpayers. But also is one that's attracted to the IRS.

At the last ABA meeting, someone who spoke mentioned that if the Tax Court did nothing but hear conservation easement cases going forward, it would take over seven years to hear all the cases that were currently docketed in the tax court. Add to that the cases that are in audit that have not yet had petitions filed, and you can see that we're talking 10 to 15 years of conservation litigation. That is not just an enormous resource use by private parties, but an enormous use of government resources. An enormous use of government attorneys who therefore are not looking at other issues, who are not looking at the initiatives that the Department of Justice, that the Department of Treasury, that this administration, the last administration, the next administration might want the IRS to look into. And I think the hope, or the expectation, is that a settlement initiative might look a lot like a recent law that was passed to impact conservation easements going forward.

Lee: Before we talk about Congress, let me ask you one other question, Brian. And that is, as we all know, because there's been a tremendous amount of media coverage, the IRS has gotten substantial additional funding from Congress that was part of the Inflation Reduction Act. And you know, it's the largest budgetary increase that the IRS has gotten in decades and the IRS has said that a large amount of that money is going to be used towards enforcement.

Do you see that -- if in fact that money does go to the IRS, and there is a question about that, I think it's fair to say -- but if the IRS does get a big infusion of funding for enforcement, how does that impact conservation easements? Can you use your crystal ball and give us your sense of how that might impact this particular issue?

Bernhardt: Sure. So, the \$80 billion that was part of the Inflation Reduction Act dedicated to the IRS, a lot of that is going to things other than enforcement. Capital improvements, in hiring, for instance. But a large chunk of it -- assuming that Congress doesn't take that money away, whether it's part of debt selling negotiations or future budgets -- assuming that money stays, the plan from the IRS, in relevant part, states that the IRS is going to leave folks with \$400,000 and less of income alone.

These conservation easements are vastly larger in tax implications. Millions of dollars, tens of millions of dollars, in some cases, hundreds of millions of dollars. They are a listed transaction. The IRS has passed another regulation in order to make sure disclosures continue to happen, notwithstanding the *Green Valley* case in which the disclosure notice was set aside. And as you mentioned earlier, they've been on the Dirty Dozen list for a number of years. I think it's safe to say that unless -- or until -- there is a national settlement initiative where the IRS decides on a better settlement on a case-by-case basis, that the IRS is gonna keep coming after these. And taxpayers who have entered into these transactions in the past need to know that they are extraordinarily likely to be audited.

I said earlier that all of them are being audited. I probably shouldn't say all or a hundred percent, but it would be a very large surprise to me if people who entered into conservation easements in 2016, 2017, 2018, are not getting audited, going through the lengthy audit process and having to endure litigation.

At a certain point after the notice 2017-10 came out and disclosures were required, the number of easements started to slow down. That doesn't mean they're still not happening. And the IRS is still requiring them to be disclosed through a regulation. And I think it's safe to say the IRS is going to keep auditing and keep litigating.

It's too much money for the IRS not to do so. Even though they have a lot of resources in terms of personnel that they're putting on these cases that could be used elsewhere, these cases have such a tax impact on the treasury and on taxpayers that they simply can't be ignored.

Lee: So, let's shift gears slightly, Brian, and talk about Congress.

You mentioned Congress a moment ago. What exactly is Congress doing about conservation easements? Is Congress sitting on the sidelines and just letting the IRS run the show? Or is Congress taking a more active role here?

Bernhardt: So, Congress had been sitting on the sidelines. Whether that was intentional or a function of gridlock is hard to say. In December of 2023, Congress passed, and the president signed, the Charitable Conservation Easement Program Integrity Act. It was part of the year end omnibus spending bill. And what it did was say that if there's a charitable deduction and the deduction, when it goes up to the investors, is more than two and a half times the amount the investor invested, that's problematic, unless the property had been owned by the partnership for three years, or the property is owned by members of a family.

What the IRS is trying to do is eliminate these deductions that are huge multiples of what investors have invested into these partnerships. So, for instance, you might put in, and I'm gonna make up numbers, \$100,000 to buy an interest in an investment partnership that owns a partnership that owns real estate making a charitable contribution deduction. And you might put in that \$100,000 and then get a deduction that's worth up to \$500,000 or \$600,000, five or six times a multiple of five or six times. What Congress is saying is, we're going to disallow the deduction going forward if the

amount claimed is more than two and a half times the amount you invested. So, in the hypothetical I gave of \$100,000 investment, if your return is more than a quarter of a million dollars, that's a problem.

One problem I've noticed about the language, is that the language in the statute seems to be a little unclear as to whether they're going to disallow the amount over two and a half times the investment, or whether the entire investment is disallowed if the deduction is greater than two and a half times. You can read the language either way. I think Congress probably meant to disallow the deduction that's more than two and a half times. But you can make a good reading of that statute that says if the deduction to which you're entitled is more than two and a half percent, the IRS is going to reject all of it.

And if the language is vague and does allow for that type of interpretation, I think we can all assume the IRS is gonna take the harder tact, and we'll have to see what the courts say about what that language actually means. But Congress has done something, and the hope is that once cases get through the end of tax years ending in 2022, this won't be an issue anymore. That going forward, people will have charitable contribution deductions for conservation easements that are no more than two and a half times the investment they put in.

Because of the way these things are structured, because of the monies that flow to all the appraisers, to all the lawyers, to all the other people who are involved two and a half times the deduction is an amount that Congress believes is low enough to push people away from doing these transactions at all. That the return on what you're getting isn't enough for the money that you have to put in. And that's Congress's goal. That's IRS's goal. We'll see what happens. My experience, I've been practicing law for a couple decades and been practicing during a series of different tax shelters over those years, is it's a little bit like whack-a-mole.

There's somebody sitting in a fancy office somewhere who says, okay, Congress has done something with conservation easements. Let's find another loophole somewhere and see what we can do, whether it's conservation easements or something else. But for conservation easements, this ought to -- and it's certainly Congress's hope -- put an end to this type of litigation for 2023 tax years and going forward.

Lee: So Brian, What is the end game here? And I understand with that new law that, at least hopefully, would put an end to these IRS challenges and lengthy litigation going forward. But for investors, who, you know, entered into conservation agent transactions for tax years 2022 and earlier, what's your best guess as the end game here? Is this gonna really go on for another seven years of litigation as you said, has been estimated? Is there a settlement initiative on the horizon? You spoke about that. What do you think is the future of this area?

Bernhardt: I think it's a combination of both. So, on the one hand, you have hundreds of audits and hundreds of pieces of litigation that are ongoing and ultimately, probably dozens right now, and more eventually, cases that'll be in the Courts of Appeals. And, those are gonna be ongoing because there is no good way to get those settled.

And the taxpayers, if they concede, in order to not pay attorney fees, for instance, or to move on with their life, are not only gonna have to repay the tax, they're gonna pay enormous penalties, they're gonna pay large amounts of interest. They may decide that they're gonna sue other people who got them involved in these to try to recoup some of that, whether it's their own personal financial advisors, whether it's the marketers of these conservation easements. So, I think that's definitely gonna keep going.

But at the same time, I hear a word of conversations percolating in DC about a potential settlement initiative. And I think that if the IRS does a national settlement initiative, that will tend to give taxpayers an opportunity to find the exit ramp.

If the settlement initiative is one that is better than the last one and gives taxpayers the ability to come out, if nothing else, even, as if they had never entered into the transaction in the first place. It may well be that the settlement initiative matches up with the statute that Congress passed in December so that you can only claim two and a half times your investment as a deduction. These people are also already out a lot of lawyers' fees, CPA fees, valuation fees and so at the end of the day, they're probably not gonna come out too far ahead. And at the same time, that's gonna pull a lot of money back to the IRS. So, I see it more as a dual track. The litigation is gonna keep going, the audits are gonna keep going, unless or until the IRS issues a satisfactory settlement initiative, which...

I think a lot of us in this business think has to come at some point in the next year or 18 months. We now have a new commissioner, so the political will, necessarily, can be there because the commissioner who started the enforcement is no longer the commissioner. So, it's a new person, a new regime, someone who can say we were successful. The last commissioner did a fantastic job with enforcement. We found all these people who were violating the tax laws. We found all these alleged tax shelters. And now we are going to settle these things, get a lot of money back in the treasury and move on to the next enforcement mechanism.

Lee: Brian, I'd like to thank you for coming on the podcast today and giving us a deep dive into the world of conservation easements. This is a fascinating area for which there is, and likely will be, continued government attention. Really appreciate your time and your insights today.

As I said at the top of the program, Brian Bernhardt is a colleague of mine. He practices in Fox Rothschild's Charlotte, North Carolina office. He is a member of our firm's Taxation and Wealth Planning Department and focuses practice largely on federal tax controversy, which is exactly what we spent the last 30 or 40 minutes talking about here today as we delved into the world of conservation easement.

So, Brian, again, thank you for coming on the program. It's great to speak with you today.

Bernhardt: Thank you for having me. I really appreciate it.

Lee: And to our listeners, thank you for tuning in once again to "The Presumption of Innocence" podcast. Thank you for joining us today.