

Baker McKenzie.



Giving it Away Piece by Piece

An Update and Discussion on Conservation
Easement Deductions
From Planning and Controversy Perspectives

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Agenda



- 1. Conservation Easement Overview.**
- 2. Potential Tax Benefits.**
- 3. Technical Requirements for Income Tax Benefits.**
- 4. Valuing Easement Donations.**
- 5. The “Bad” Side of Easements: IRS Audits and Litigation.**
- 6. Future of Easement Donations.**



Overview, Requirements & Valuation

Investment Strategies

- Full Scale Development
- Buy and Hold
- Conservation Easement



What is a Conservation Easement?



Overview

- To encourage the preservation (in perpetuity) of land with significant conservation values, Congress has provided substantial tax benefits to landowners donating qualifying conservation easements.
 - Landowner who donates a "**qualified conservation contribution**" to a qualified governmental entity or land trust, and who satisfies the technical requirements of the regulations issued under Section 170, is eligible for a federal income tax deduction equal to the value of the donated easement.
 - Tax benefits: Decreases tax liability by lowering taxable income.
 - Deductions are "above the line"—so it does not operate to reduce tax liability on a dollar for dollar basis like a "tax credit"
- Legal conveyance between a landowner and a third party whose role is to monitor the easement and enforce it if necessary.
 - Third party must be a governmental entity or, more commonly, a special kind of tax-exempt entity.
 - "Land Trusts" are viewed by the conservation community and Congress as the "gate keepers" for conservation easements.

History, Purpose, and Public Benefits of Easement Donations



- Congress determined that it was in the country's best interest to encourage landowners to preserve land of ecological or historic importance in a manner that protects or preserves the conservation values identified by Congress as being important.
- To that end, Congress enacted Section 170(h) in 1980 to provide a permanent charitable contribution deduction for donations of easement interest.

Types of Conservation Easements

- Land (Conservation) Easements.
 - Open spaces
 - Farms
 - Hillsides
- Historic Preservation (Façade) Easements.

Conservation easement -- tax benefits

- **Landowner retains an interest in the property.**
 - This is an exception from the standard proscription on donors retaining an interest in donated property.
- **Increased limitation.**
 - The normal limitation on the deduction for contributions of capital assets is 30% of adjusted gross income, however, that amount is increased to 50% for conservation easements.
- **Increased carryover.**
 - Rather than the standard 5 year limitation, the carryover period that applies to qualified conservation contributions, in excess of the annual limitation on deductions is 15 years.



Technical Requirements For Income Tax Benefits

- 1. Perpetual**
- 2. Held by Qualified Governmental or Non-profit entity**
- 3. Valid Conservation Purpose**
- 4. Properly Substantiated and Reported**
- 5. Qualified Real Property Interest**
- 6. Properly Valued**



Technical Requirements For Income Tax Benefits



1. Easement Must Be “Perpetual”

- Legal Title Restriction - 170(h)(2)(C).
 - In order to be eligible for an income tax deduction, the donation must be perpetual.
 - The conservation restrictions will be recorded and will forever prohibit the uses of the property described in the conservation easement deed.
- Conservation Purpose Restriction - 170(h)(5)(A).
 - Second perpetuity requirement.
 - A contribution shall not be treated as exclusively for conservation purposes unless the conservation purpose is protected in perpetuity.
- Enforceable In Perpetuity - Treas. Reg. § 1.170A-14(g).
 - Donor’s interest in the property must be subject to legally enforceable restrictions (e.g., deed recordation) that will prevent uses of the property that are inconsistent with the conservation purposes of the donation.

Technical Requirements For Income Tax Benefits



2. Easement Must Be Held by a Qualified Governmental or Non-Profit Organization (Section 170(h)(3))

- A conservation easement must be donated to a qualified governmental entity or to a qualified tax-exempt organization.
- Tax-exempt donee organizations are generally referred to as “land trusts,” and they must be a tax-exempt entity that is qualified to receive tax-deductible contributions.
- A land trust will monitor conservation easement property periodically to assure that the property is in compliance with the terms of the conservation easement and that the conservation values of the property are being preserved.
- If a landowner violates the terms of a conservation easement, the land trust must be willing and able to take appropriate enforcement actions that are available under the law.

Technical Requirements For Income Tax Benefits



3. Easement Must Serve a Valid “Conservation Purpose” (I.R.C. § 170(h)(4))

- Natural Habitat: Fish, Wildlife, Plants
- Open Space: Parks
- Public Goods: Forests
- Historical Buildings: Façade Easements



Technical Requirements For Income Tax Benefits



4. Easement Must Be Properly Substantiated and Reported.

- Appraisal performed by qualified appraiser
- Written acknowledgment from land trust
- Baseline documentation
- Appraisal summary (Form 8283)

Technical Requirements For Income Tax Benefits



5. Easement Must Be A “Qualified Real Property Interest”

- Any of the following interests in real property:
 - Transfer of an entire interest in property except for qualifying mineral interest.
 - A remainder interest in real property.
 - A restriction on the use of the real property granted in perpetuity.
 - Easement, conservation restriction, and perpetual conservation restriction have the same meaning.

Technical Requirements For Income Tax Benefits



6. Easement Must Be Properly Valued (based on highest and best use taking into account realistic impact of zoning laws, conservation or historic preservation laws).

- Before Value
- - After Value
- Easement Value



\$1,000,000

fair market value of the property without the conservation easement / all development rights intact

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\$660,000

value of the parcel with the easement / without development rights

=

\$340,000

Value of conservation easement or amount of deduction (subject to limits & ability to carryforward)

Example of a Conservative Easement Investment

- Development Budget for Typical Program = \$3,600,000
- Lost Economic Value by Donation of Conservation Easement: \$23,095,000
- Possible Federal Tax Savings = \$8,545,150 (37%)
- Possible State Tax Savings = \$1,963,075 (8.5%)

2 The “Bad” Side of Easements: IRS Audits and Litigation

Notice 2017-10

- Notice 2017-10 designates donations of certain conservation easements that arise out of certain syndication transactions as “reportable” or “listed” transactions.
- Notice requires any individual who participates in a so-called syndicated conservation easement (that generally took place since 2010) that produces a deduction greater than 250% of the Participant’s investment amount in the transaction to file IRS Form 8886, Reportable Transaction Disclosure Statement, provided that the applicable statute of limitations remains open for the year in which the investment was made.

Perpetuity Challenges - 170(h)(2)(C)

- IRS argues that an easement is not a qualified real property interest (on the grounds that the boundaries are not fixed) if:
 - Contains floating homesites and/or the right to carve-out out-parcels, which the IRS treats as movement of boundaries.
 - Contains amendment clause (right of the parties to amend the easement, which could include moving boundaries).
 - Allows the land trust and owner to agree to move the boundaries of the easement.

Perpetuity Challenges (170(h)(5)(A))

- The Treasury Regulations contain several requirements that must be met to ensure that the conservation purposes are protected in perpetuity.
- **Mortgage Subordination.** Pursuant to Treas. Reg. § 1.170A-14(g)(i)(2), a mortgagee must subordinate its rights in the property to the land trust.
- **Extinguishment Rights and Proceeds.** Pursuant to Treas. Reg. § 1.170A-14(g)(6)(i), in cases where the conservation purposes can no longer be served, the conservation purposes can nonetheless be treated as protected in perpetuity if the restrictions are extinguished by judicial proceeding.
- **Reserved Rights.**
- **Deemed Consent Rights.**

Conservation Purpose Challenges

170(h)(4)(A)



- **“Exclusively for conservation purposes.” I.R.C. 170(h)(1)(C).**
- **Outdoor recreation or education for general public.**
 - The general public does not have access to the property at the time of the easement grant, or at some subsequent time.
- **Relatively natural habitat.**
 - habitat is too small,
 - the wildlife, fish, or plants are not “significant”, or
 - the habitat has been altered to such an extent that it is no longer “natural.”

Conservation Purpose Challenges (170(h)(4)(A))

- **Preservation of Open Space.**
 - general public cannot view the open space.
 - the preservation is not made in connection with a specific policy.
 - no significant public benefit.

- **Historically important land area or certified historic structure.**
 - Restrictions imposed by the easement are not more restrictive than applicable restrictions under existing local law.

Valuation Challenges

- Previous purchase price of the property is best indicator of value.
- If property was worth what taxpayer claimed on return, the taxpayer would have developed and/or sold the property.
- Comparable analyzed by adjusting for differences between the subject and comparable properties.
 - IRS will argue analysis provided by taxpayer's qualified appraiser and other experts is incomplete or wrong.

Substantiation Challenges

- **Appraisal - Section 170(f)(11).**
 - IRS will argue that the appraisal fails to comply with the regulations and that it fails to comply with USPAP.
 - IRS will argue that the appraiser is not a qualified appraiser and/or that the appraisal is not a qualified appraisal.
 - IRS will argue that the Form 8283 is not complete and does not accurately describe the eased property.
 - IRS will argue that the taxpayer did not provide its basis on Form 8283. (RERI Holdings, I)
 - Reasonable cause exception - Section 170(f)(11)(A)(ii)(II).

- **CWA - Section 170(f)(8).**
 - IRS will argue that Section 170(f)(8) letter not provided by donee.

Penalties

- **Accuracy-Related Penalties - Section 6662: 20% of Underpayment**
 - An underpayment attributable to one or more of the following:
 - Negligence or disregard of rules and regulations.
 - Substantial understatement of income tax.
 - Substantial valuation misstatement
- **Substantial Valuation Misstatement - Section 6662(b)(3) and (e): 20%**
 - The value of any property (or the adjusted basis of any property) is 150% or more of the amount determined to be the correct amount of such valuation or adjusted basis.
- **Gross Valuation Misstatements - Section 6662(b)(5) and (h)**
 - The 20% penalty is increased to 40% when there is a “gross valuation misstatement.”
 - Valuation misstatement is 200% or more.

3 Current State of Easement Litigation

Tax Court Settlement Offer

The above-referenced matter is currently docketed in the United States Tax Court and involves petitioner's syndicated conservation easement transaction for which the Internal Revenue Service determined adjustments for tax year 2011.

In Notice 2017-10, the IRS identified certain syndicated conservation easement transactions as tax avoidance transactions and provided that such transactions (and substantially similar transactions) are listed transactions for purposes of Treasury Regulation § 1.6011-4(b)(2) and §§ 6111 and 6112 of the Internal Revenue Code (IRC). In 2019, the IRS also added syndicated conservation easement transactions to its annual "Dirty Dozen" list of tax scams. The Tax Court has issued several opinions and orders in syndicated conservation easement cases in which it held in the government's favor.

In light of the above, the Office of Chief Counsel is offering certain petitioners who participated in a syndicated conservation easement transaction an opportunity to fairly and efficiently resolve their docketed cases and avoid litigation. The Office of Chief Counsel is making this time-limited offer to resolve cases on standard terms that we believe are more favorable than what petitioner should expect if the case proceeds to trial.

Tax Court Settlement Offer

- The deduction for the contributed easement is disallowed in full.
- All partners must agree to settle, and the partnership must pay the full amount of tax, penalties, and interest before settlement.
 - BUT, IRS “may consider offers to resolve cases on terms similar to those contained herein where fewer than all partners . . . agree to enter into the settlement”

Tax Court Settlement Offer

- “Investor” partners can deduct their cost of acquiring their partnership interests and pay a reduced penalty of 10% to 20% depending on the ratio of the deduction claimed to the partnership investment.
- Partners who provided services in connection with any Syndicated Conservation Easement transaction must pay the maximum penalty asserted by IRS (typically 40%) with no deduction for costs.

Pine Mountain v. Commissioner

- October 22, 2020--Reversed in part, the Tax Court's decision that disallowed deductions on development clauses.
- The 11th Circuit found that the development clause did not violate that provision's requirement that the land be protected in perpetuity.
- “An easement granted in perpetuity over a defined conservation area clears Section 170(h)(2)(C)'s relatively low threshold, even if it reserves targeted development rights for homesite construction....”

4

Future of Easement Transactions: Is The IRS Burning the Forest to Save It?

Should The IRS Litigate Technicalities or Valuation?

- Technical Requirement Challenges or Valuations?
- IRS typically responds that Congress intended strict compliance with all statutory and regulatory requirements (i.e., no substantial compliance defense), and that disallowance is always proper on that basis.
 - BUT, the legislative history of Section 170(h) arguably shows the opposition—Congress intended to incentivize taxpayers to preserve the character of historic buildings and scenic panoramas so they would not fall prey to commercial development. See Tax Treatment Extension Act, Pub. L. No. 96-541, § 6(b), 94 Stat. 3204, 3206 (1980).

Will the IRS Assert More Judicial Recast Doctrines?

- Recently, the IRS and state taxing authorities have begun asserting judicial recast doctrines as a basis for disallowing the easement deductions.
- No court has sustained a disallowance on the basis of a judicial recast doctrine.
 - Economic Substance: Typically rejected because underlying land transfers have substance.
 - Sham Transaction: Typically rejected land transfers are bona fide.
 - Substance Over Form: Typically rejected, but potentially an avenue for disallowance for use of multi-tiered partnership arrangements.
 - Step Transaction: Typically rejected where donations were not preset at outset and investors made bona fide capital contributions.

Partnership Considerations

- The IRS has begun asserting the partnership anti-abuse rules

Typical fact pattern:

- Individual contributes real estate to newly formed “Land LLC”
 - Third-party investors form and contribute capital to “Investor LLC”
 - Investor LLC acquires membership interests in Land LLC and votes to donate conservation easement.
- IRS attempts to argue that Land LLC should be disregarded and Investor LLC should be treated as acquiring real estate directly and donating easement.
 - This avoids treating property as long-term capital property and limits charitable deduction amount to cost basis of property.
- Taxpayer should argue that partnership’s holding period, as an entity, controls (Rev. Rul. 68-79).

Partnership Considerations

- The IRS has asserted disguised sale rules in at least one case. Has also been asserted by at least one state taxing authority.
- Typical argument is that investors entered into partnership capital contribution and easement donation transactions with prearranged intent to acquire easement donations.
- Taxpayers should argue that the Land LLCs are formed to purchase the real properties and that the real property had potential uses (e.g., residential or commercial development) that provided a profitmaking potential, other than easement donations.

Promoters and Appraisers

- In December of 2018, DOJ brought a promoter injunction lawsuit against two appraisers, an Atlanta-based real estate promoter, and three officers of the promoter (Zak v. United States, No. 1:18-cv-05774 (complaint filed Dec. 18, 2018)).
- The government alleges that the defendants promoted or sold ownership interests in a conservation easement syndication scheme that “amounts to nothing more than a thinly veiled sale of grossly overvalued federal tax deductions under the guise of investing in a partnership.”

Promoters and Appraisers

- On March 26, 2020, a group of real estate investors filed a RICO class action, claiming that promoters of syndicate arrangements convinced the participants to purchase interests in the syndicates with a plan of claiming tax deductions for donating a conservation easement on the land—where the landowner gives away rights to develop the land (*Lechter v. Aprio, LLP*, N.D. Ga., No. 1:20-cv-01325, complaint filed 3/26/20).

Conclusion

- Conservation easements can provide landowners with significant tax and non-tax benefits when done correctly.
- Despite Congress's clear intent to promote easement transactions, however, the IRS has been active trying to weed out what they perceive as bad easements.
 - If it sound too good to be true, you can assume the IRS will think so too!



US Domestic Planning Opportunities Amidst Crisis

Global Wealth Management Webinar Series | November 10, 2020



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Overview of Presentation

Why is this important . . .

- The economic downturn has resulted in the lower market valuations.
- Record low U.S. federal interest rates enable leveraged transactions.
- Shift in political power from the November elections creates tax uncertainty.
- Historically high tax thresholds that benefit wealthy clients may be fleeting as thresholds may decrease.

It's time for US citizens and domiciliaries to review their estate plans.



Agenda

1 Overview of Estate & Gift Tax

2 Election Influence

3 Gifting Techniques with Trusts

4 Market Factors - Leverage

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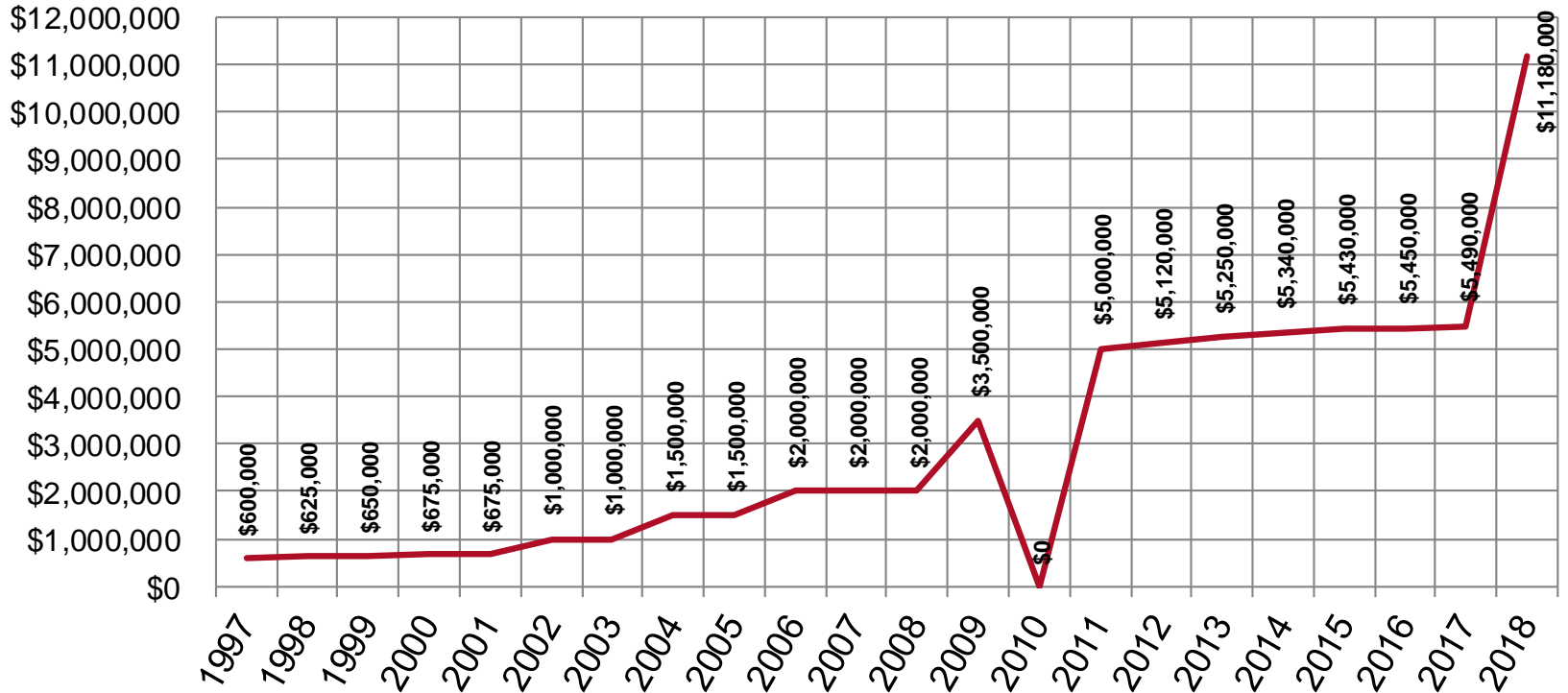
Estate and Gift Fundamentals

Overview of 2020 Gift Planning

Current Landscape

- Gift and estate tax 40%.
- Separate 40% tax on transfers to skip persons (generation skipping transfer “GST” tax).
- TCJA doubled lifetime applicable exclusion amount from \$5MM to \$10MM per person (indexed for inflation).
- 2020 applicable exclusion amount \$11.58MM (married couples can shelter gifts up to \$23.16MM) - \$11.8MM in 2021.
- Scheduled to revert to pre-TCJA levels January 1, 2026.

Historical Federal Gift/Estate Exclusion Amounts



2020 Gift Planning

Changing government and shifting needs

- COVID-19 resulted in record government deficit as a result of stimulus efforts, with no end in sight (i.e., federal government will be looking for revenue).
- Democrats control the White House and are on track to control the House of Representatives. Senate control remains unclear until January 2021.
- Even if Republicans end up with control of the Senate, the current applicable exclusion amount may well come into play as a legislative bargaining chip.

2

Election Influence

Election Results

- President Elect/Vice President Elect – Democrats Joe Biden and Kamala Harris
- House of Representatives – projected democratic majority (though diminished margin)
- Senate – Uncertain but narrow path for democrats to take control
 - 48 Democrats, 48 Republicans
 - 4 seats undecided
 - North Carolina—likely Republican
 - Alaska—unclear, but presumed Republican (no mail-in ballots yet counted)
 - Georgia 2 seats—run-off elections January 5, 2021
 - If 50-50, Vice President Kamala Harris will cast the deciding vote



Senate - What Current Elections are At Stake

- North Carolina – 97% of the vote is in and Republican Senator Tillis (incumbent) is up about 1.8%.
- Alaska – 61% of the vote is in and Republican Senator Sullivan (incumbent) is up 30% (no mail in votes have been counted yet).
- Georgia – Since no candidate has won more than 50% of the vote, a runoff will be held.
 - Perdue v. Ossoff – First term Republican senator David Perdue is running off against Jon Ossoff.
 - Warnock v. Loeffler – Senator Kelly Loeffler, a Republican who was appointed to her seat last year, was running in a special election with Representative Doug Collins (a Republican) on the ballot and Rev. Warnock (Dem), among others.



Election Mandate?

How likely is it that tax changes will be made effective Jan 1, 2021?

1. Not a sweeping Democratic victory so may be more difficult to make significant changes to the tax code (especially if split-party control).
1. Priorities - Need for additional COVID-19 relief and economic stimulus likely to be higher priority than tax legislation. But also need for revenue.
1. Can tax change be retroactive to Jan. 1, 2021 constitutionally? Likely yes.



Biden/Sanders Task Force – July 2020

Principles Adopted per Task Force:



Raise corporate tax rates and restore the estate tax to its "historical norm"



Increase progressivity in the tax system and eliminating "unequal and unproductive" tax expenditures that primarily benefit the wealthy

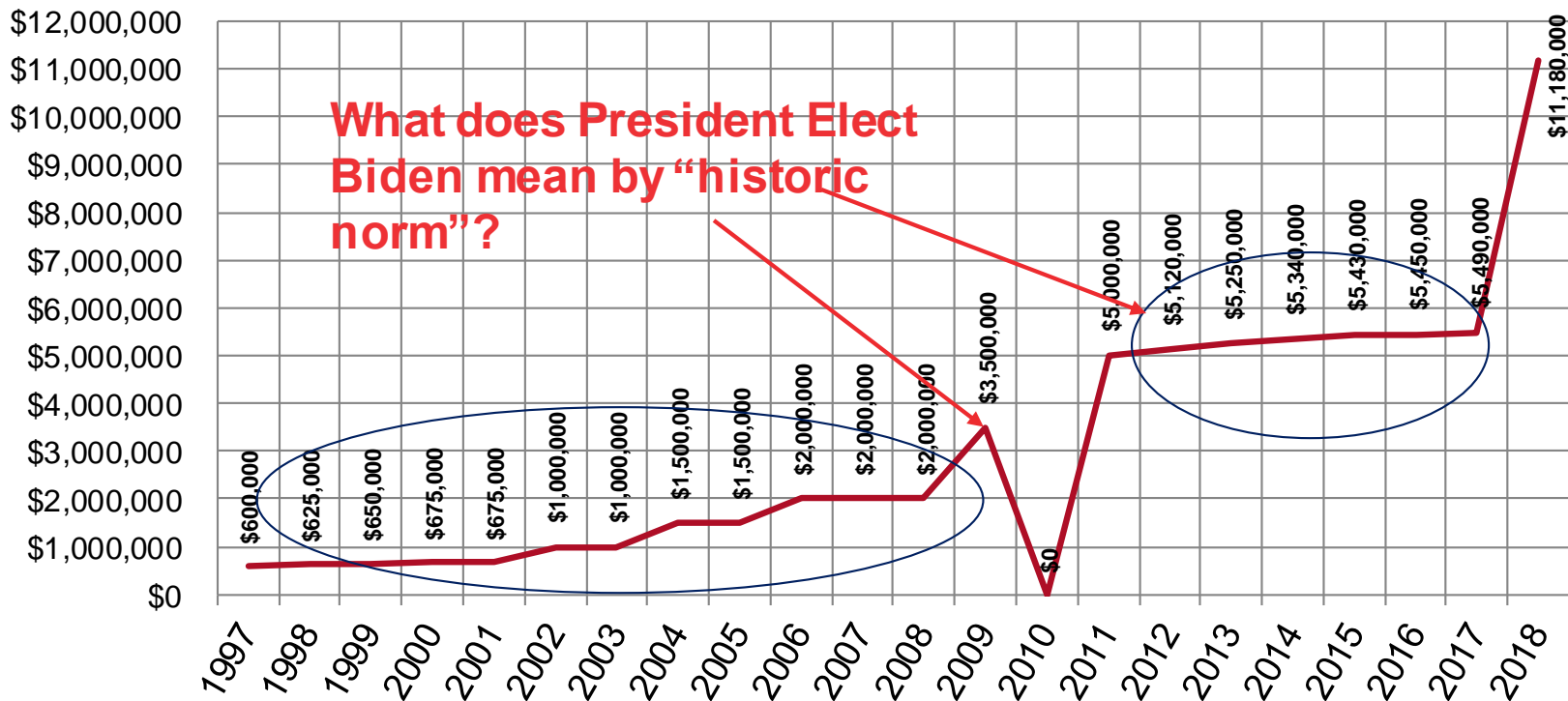


Limit the ability of the wealthy to defer or avoid taxes on income



Expand payroll taxes on high-income taxpayers

Historical Federal Gift/Estate Exclusion Amounts



Biden Tax Plan

- **Individuals**

- The gift and estate tax exemption may drop (unclear by how much).
- Repeal step-up in basis on death.
- No talk of wealth tax.
- The top individual federal income tax rate would rise from 37% to the pre-Trump rate of 39.6% and cap itemized deductions at 28%.
- Taxpayers earning more than \$1 million of income would pay the same rate on investment income as wages and end “carried interest loophole.”
- Individuals earning \$400,000 or more would pay additional Social Security payroll taxes.

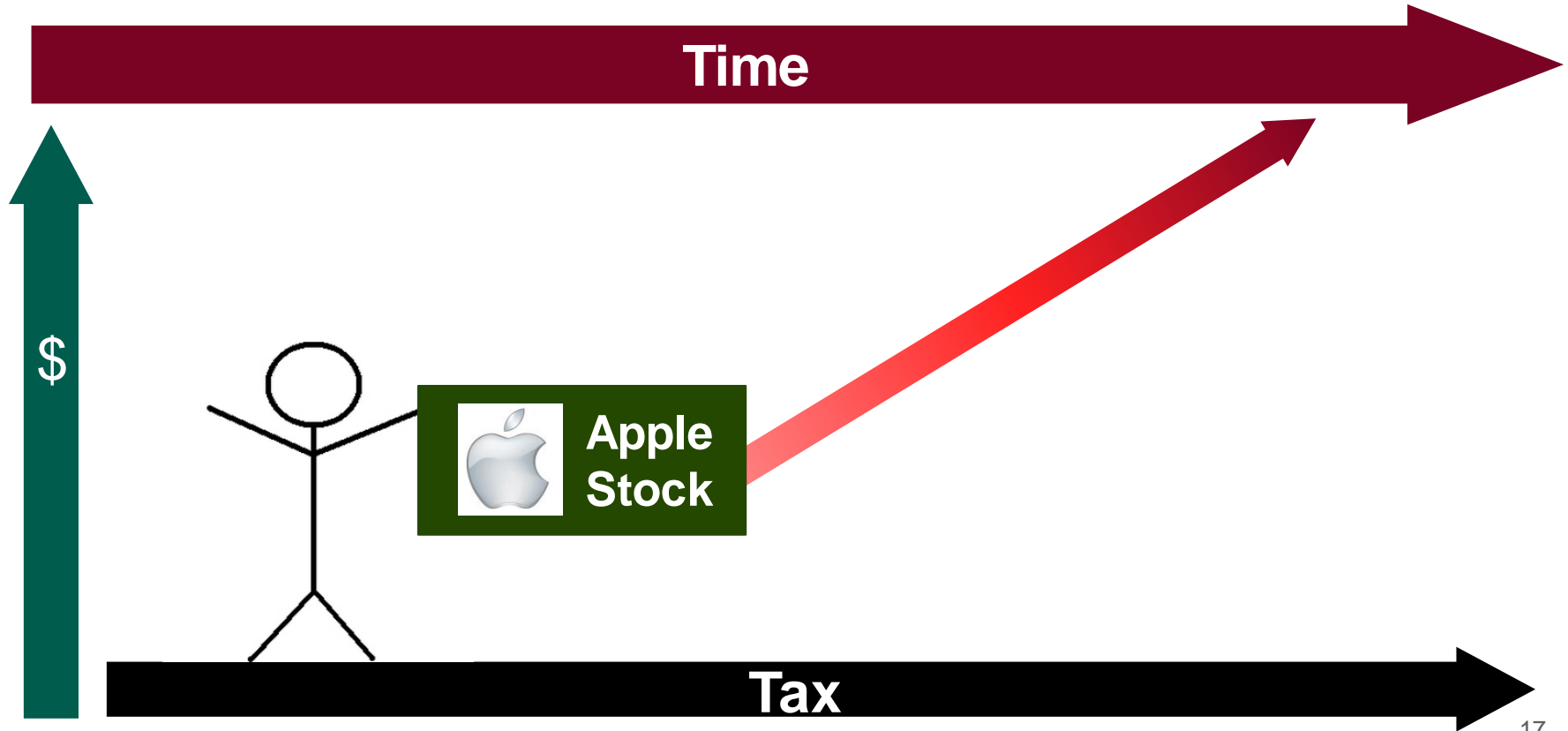
- **Corporations**

- The corporate rate would rise from 21% to 28%; a 15% alternative minimum tax would apply to corporate book income of \$100 million and higher.
- Double existing minimum tax on profits earned by foreign subsidiaries of US firms (from 10.5% to 21%).

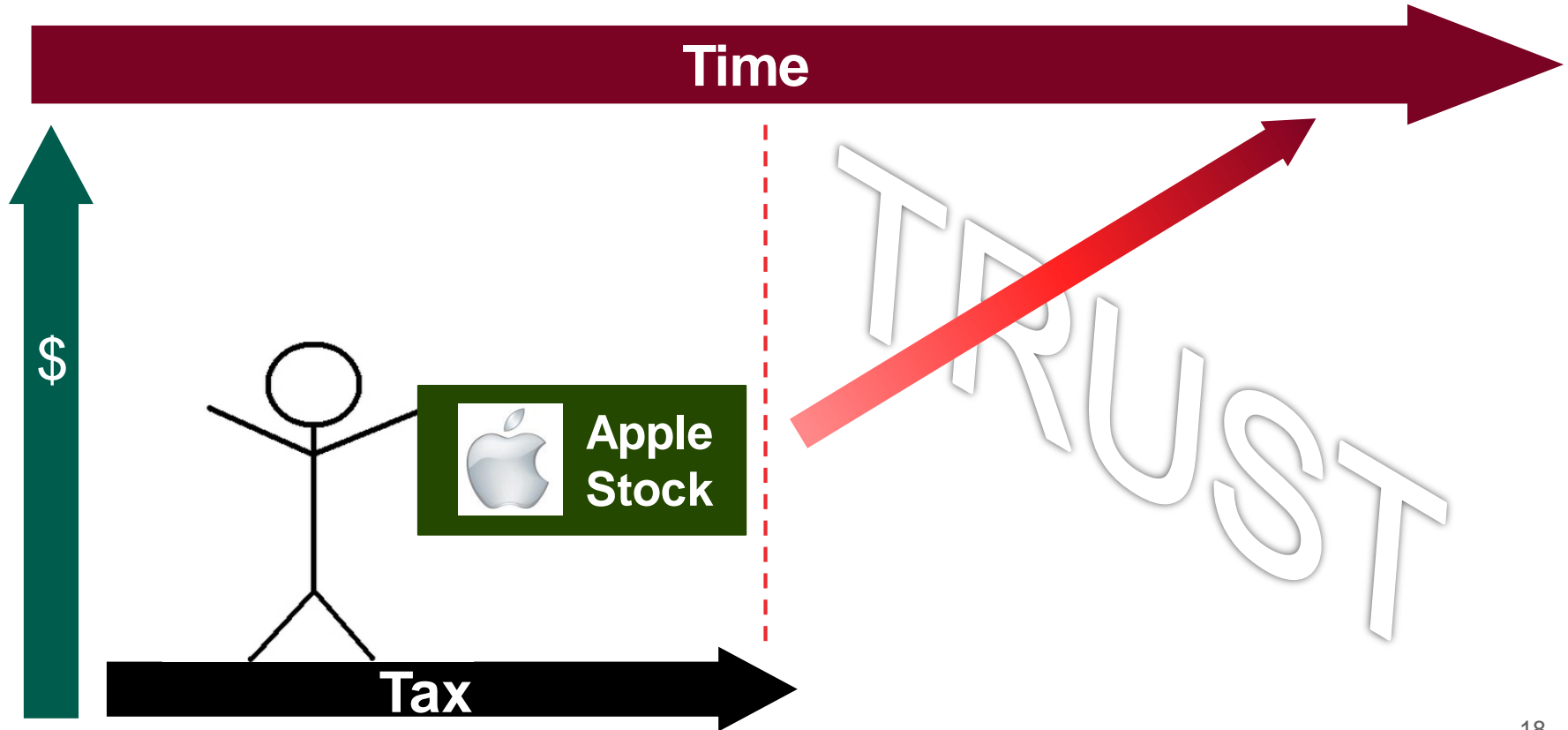
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Gifting Techniques

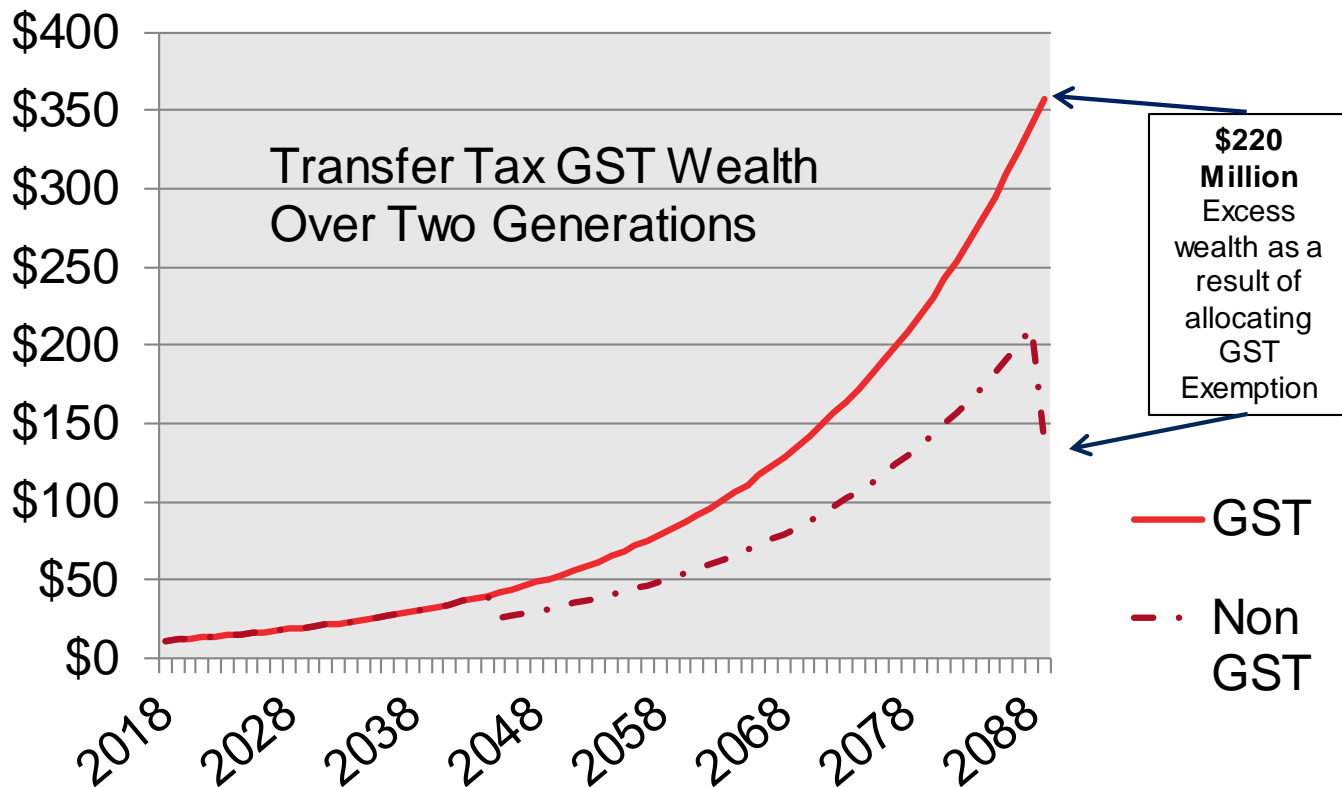
Keeping an Appreciating Asset



Gifting an Appreciating Asset



GST Trust Exemption Allocation Comparison

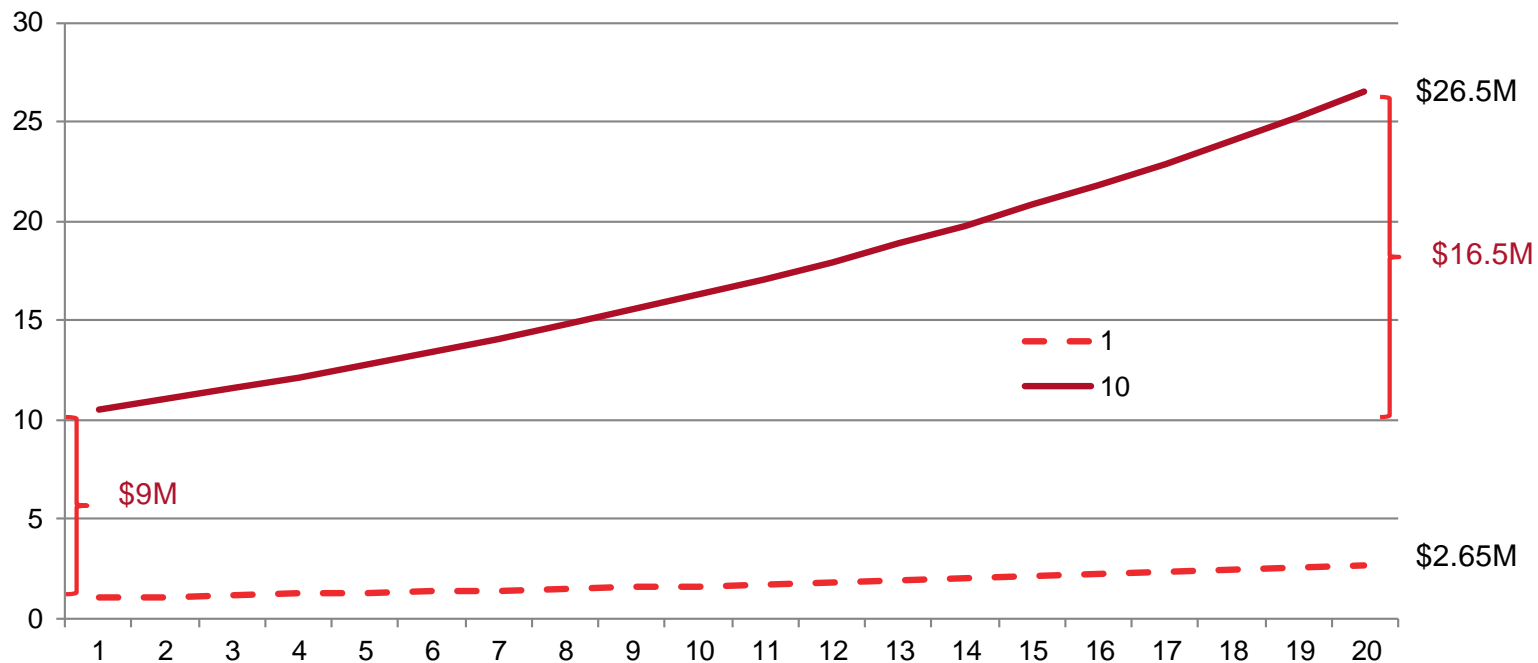




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The Power of Leverage

The Power of Leverage

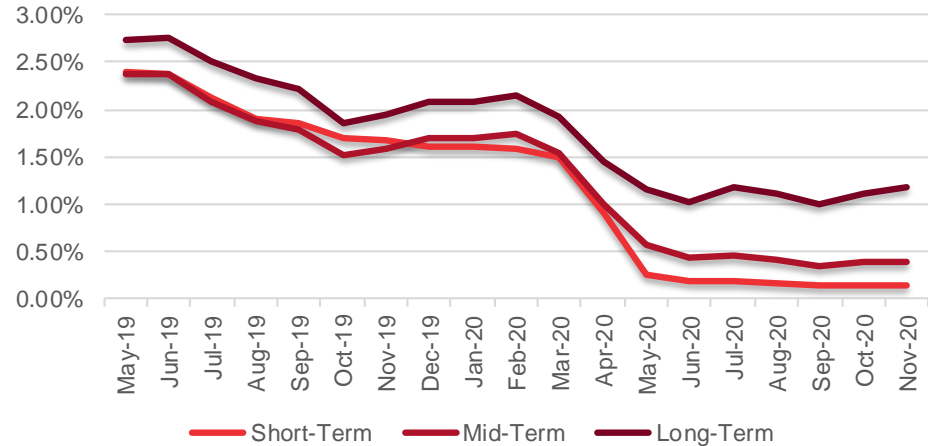


Intra-Family Loans – Historically Low Rates

Sales to Dynasty Trusts

- A grantor can sell property to a Dynasty Trust they created, but there must be a minimum rate of interest.
- Transactions between a Grantor and a grantor-type Dynasty Trust are not recognized for income tax purposes.
- No Capital Gain, No Taxable Interest.

May '19 thru November '20 AFRs





Questions



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