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Tax Planning With Conservation Easements

Structuring Deals After Historic Boardwalk Hall
and Other IRS Challenges; Pairing With Other Tax Credits

THURSDAY, MARCH 7, 2013

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Conservation Easements

(Qualified Conservation Contributions)



Presented by Anthony Ilardi

What is a Conservation Easement?

An interest in real property established by agreement between landowner and qualified organization

- Agreement restricts the use of the property to achieve conservation purposes
- Ownership of the real property remains with the landowner, subject to the use restriction
- Easement is recorded in the chain of title
- Enforceable in perpetuity by the qualified organization against current and future owners

Historic Preservation Easement

An interest in real property established between a land/building owner and a qualified organization

- Agreement preserve historic land site or building façade in its historic state and restrict alterations
- Building owner covenants to maintain the façade
- Easement is recorded and is enforceable against current and future owners

Why Grant an Easement?

- Achieve environmental objectives by constraining certain uses of the property
- Achieve land enjoyment objectives by preventing development (e.g., scenic view)
- Preserve historic sites and buildings as part of preserving cultural heritage
- Obtain a charitable tax deduction upon grant of the easement

Other Names for Charitable Easements

- **conservation covenant**
- **conservation restriction**
- **conservation servitude**
- **preservation covenant**
- **preservation restriction**
- **façade easement**
- **development rights easement**

Charitable Easement Deductions

- Section 170(a) of the Internal Revenue Code of 1986, as amended (the “Code”) provides a charitable deduction for contributions to tax exempt organizations
- Code Section 170(f)(3)(A) disallows the deduction for any transfer that is less than a taxpayer’s entire interest in property
- Code Section 170(f)(3)(B)(iii) creates an exception for a “qualified conservation contribution”
- Code Section 170(f)(14) reduces the available deduction where a taxpayer also claims historic rehabilitation tax credits
- Basis in property reduced proportionately

Qualified Conservation Contribution

Required elements

- Contribution
- Qualified real property interest
- Qualified organization
- Exclusively for conservation purposes
- Protection in perpetuity

Treasury Regulation Section 1.170A-14

Contribution

- Donative intent – cannot be a quid pro quo
- Transfer in writing
- Appraisal to establish amount
 - Before and after value test
 - Highly technical requirements
- Substantiation and record retention requirements
- Corresponding reduction of contribution if taxpayer realizes other economic benefit from the contribution
- Denial of deduction if other economic consequences to taxpayer exceed the value of the contribution to the general public

Qualified Real Property Interest

- Entire Interest in the Property
 - No transfer of interest in property prior to donation if conservation purpose affected
 - Retained interest limitations where conservation purpose could be affected (documentation of property condition)
- Perpetual conservation restriction is a qualified real property interest, including any real property interest having attributes similar to an easement
- Special rules apply to interests in mineral rights

Qualified Organization/Eligible Donee

- Publicly supported charity or governmental unit (or supporting organization)
- Commitment to protect the conservation purposes of the donation
- Sufficient resources to enforce the restrictions

Exclusively for Conservation Purposes

Conservation Easements

- Preservation of land areas for outdoor recreation and education of general public
 - Substantial and regular use by public
- Protection of a significant “relatively natural” habitat or ecosystem
 - Rare, threatened or endangered species habitat
 - High quality example of terrestrial/aquatic community
 - Natural areas that contribute to ecological viability of national, state or local park or conservation area
- Preservation of certain open space
 - Farm or forest land
 - Pursuant to clearly delineated government policy, or for scenic enjoyment by general public, with significant public benefit
- Inconsistent use may be permitted if conservation purposes are in conflict with each other

Historic Preservation Easement Public Visual Access Required

- Preservation of historically important land area
 - Independently significant land area including any related historic resources meeting National Register Criteria for Evaluation
 - Land area within registered historic district that contributes to the significance of district
 - Land area adjacent to property listed in National Register of Historic Places where features of land contribute to historical/cultural integrity of listed property
- Preservation of a certified historic structure
 - Building, structure or land area listed in National Register or located in a registered historic district and certified by Secretary of Interior as having historic significance

Protection in Perpetuity

- Subject to legally enforceable restrictions (recorded)
- Any retained or remainder interests in the property may not conflict with conservation purpose
- Mortgagee must subordinate its rights in the property to the right of the qualified organization to enforce conservation purposes
- Contingencies resulting in defeat of the gift are disregarded if based on events that are remote possibilities
- Donor must agree that easement gives rise to immediately vested property right with a fair market value at least equal to the proportionate value of the gift as compared to the property value as a whole determined as of the time of grant

Extinguishment of a Conservation Easement

- Subsequent unexpected change in conditions
- Conservation purpose no longer practicable or possible
- Judicial proceeding to extinguish easement
- Proceeds from subsequent sale of property used by donee qualified organization to further purpose of original contribution

Tax Planning With Conservation Easements

Presented by:

Anson H. Asbury

&

David M. Wooldridge

Case Law Developments: Overview

- Two basic types of conservation easements
 - Open Space/Wildlife Habitat
 - Historical Façade/Structure
- Two Primary Venues
 - Tax Court and Courts of Appeals
- Evolution of the IRS Approach
 - Valuation
 - Conservation Purpose
 - Technical legal requirements
- Greater scrutiny of formalistic details
- Application of the *Golsen* Rule
- Trend lines in active cases

Case Law Developments

- *Scheidelman v. Commissioner*, 682 F.3d 189 (2d Cir. 2012) vacating and remanding T.C. Memo. 2010-151.
 - Taxpayers contributed an architectural easement over their townhouse in the Fort Greene Historical District of Brooklyn.
 - The IRS moved for summary judgment on the grounds that the donation did not meet the regulatory requirements of IRC §170, specifically that the taxpayers did not obtain a “qualified appraisal.”
 - The court applied the definition of “qualified appraisal” under Treas. Reg. §1.170A-13(c) because the appraisal was issued before August 17, 2006. See Notice 2006-96.
 - After a trial, the Tax Court determined that the taxpayer’s appraisal did not meet the requirements for a qualified appraisal under the regulations.
 - The court denied deductions for cash contribution made to the donee organization but did conclude that the taxpayer acted in good faith and with reasonable cause and therefore was not liable for penalties.

Case Law Developments

- *Scheidelman* (con't)
 - The 2nd Circuit Court of Appeals vacated the Tax Court holding, finding that the taxpayer had obtained a “qualified appraisal” because the appraisal (1) adequately specified the appraiser's method of determining easement's fair market value and (2) adequately specified the basis for determining easement's fair market value.
 - The appellate court allowed the deduction for the taxpayer’s cash contribution. The appellate court also found that an incomplete Form 8283 “substantially complied” with the requirements for an appraisal summary to be attached to the tax return. The case was remanded to the Tax Court to value the easement.
 - On remand, T.C. Memo. 2013-18, the Tax Court assigned zero value to the easement for purposes of the charitable contribution. It did not reconsider its decision to impose penalties.
 - On February 12, 2013, the IRS filed a motion for reconsideration of the penalties. The court ordered the taxpayers to respond by March 13, 2013.

Case Law Developments

- *Scheidelman* -Aftermath
 - *Rothman v. Commissioner*, T.C. Memo. 2012-218 (“qualified appraisal” issue similar to *Scheidelman*; and also in 2d Circuit) (original opinion, T.C. Memo. 2012-163). In this supplemental Opinion, the Tax Court acknowledged that the Second Circuit’s opinion in *Scheidelman* was controlling precedent under the *Golsen* Rule.
 - The Tax Court vacated its previous finding that the taxpayer’s appraisal was not a qualified appraisal because of the two “qualified appraisal” requirements (statement of method and basis of value) addressed by the Second Circuit.
 - However, the Court nonetheless found the appraisal to be unqualified, based on failures to meet other requirements for qualified appraisals.

Case Law Developments

- *Scheidelman* -Aftermath
 - *Gorra v. Commissioner*, T.C. Doc. No. 15366-10 (“qualified appraisal” issue similar to *Scheidelman*; and also in 2d Circuit). In responses filed August 24, 2012, relating to summary judgment motions, the Commissioner denied that *Scheidelman* was controlling precedent (notwithstanding the *Golsen* Rule).
 - More detailed requirements for qualified appraisals were enacted beginning with the 2006 tax year (Pension Protection Act of 2006). The Commissioner claimed that these rules create a functionally different “statutory scheme” under which a “qualified appraisal” is evaluated.
 - The Commissioner also claimed critical factual differences between the cases, particularly that the *Gorra* appraisal “did not adequately explain how it arrived at” its value.

Case Law Developments

- *Kaufman v. Shulman*, 687 F.3d 21 (1st Cir. 2012) aff'g in part, vacating in part, and remanding, 136 T.C. 94 (2011) (*Kaufman III*).
 - The taxpayers donated a façade easement over their townhouse in the South End Landmark District of Boston.
 - The Tax Court issued two opinions on the initial pleadings. The first opinion, 134 T.C. 182 (2010) (*Kaufman I*), granted partial summary judgment for the government.
 - *Kaufman I* held that the conservation purpose was not protected in perpetuity as required under IRC §170(h)(5)(A) (perpetuity requirement) because the property was subject to a mortgage which gave the lender a prior claim to proceeds from condemnation or casualty. The court reasoned that the prior claim provision obviated the requirement that the donee must be entitled to a proportionate share of proceeds if the easement is extinguished under Treas. Reg. §1.170A-14(g)(6)(ii) (extinguishment provision).

Case Law Developments

- *Kaufman* (con't)
 - In *Kaufman v. Commissioner*, 136 T.C. 94 (2011) (*Kaufman II*), the Tax Court reconsidered its grant of partial summary judgment and determined facts on the deductibility of cash contributions and application of penalties.
 - In *Kaufman II*, the court explained that Treas. Reg. §1.170A-14(g) elaborated on the “enforceability-in-perpetuity” requirements of IRC §170(h)(5)(A). Even though the court relied on the provisions of the mortgage subordination agreement in its ruling, it clarified that the easement failed not because the mortgage was not protected from foreclosure (i.e., not subordinated) but because the easement was not protected in the event of judicial condemnation or other casualty loss.
 - The court also disallowed a portion of the cash donations and imposed a negligence penalty on that donation (but not on the easement).

Case Law Developments

- *Kaufman* (con't)
 - The 1st Circuit Court of Appeals rejected the Tax Court's reasoning on the extinguishment provision holding the interpretation of Treas. Reg. §1.170A-14(g)(6) to be an unreasonable "impromptu reading that is not compelled and would defeat the purpose of the statute."
 - The Circuit Court also rejected supplemental arguments that the donee might abandon the easement or that the taxpayer failed to meet reporting requirements by not including a summary appraisal or fully completing Form 8283, Noncash Charitable Contributions.
 - The Circuit Court vacated the Tax Court's decision except for the disallowed cash donations and associated penalties and remanded the case for findings on the value of the easement.
 - The case is now at the Tax Court per remand and supplemental briefs have been filed by the parties.

Case Law Developments

- *Kaufman* (con't) – The Aftermath
- *Estate of Mount v. Commissioner*, T.C. Doc. No. 17390-09, involved a subordination agreement quite similar to that in *Kaufman*, but the applicable law for interpretation of the agreement was New York. Also, the case would be appealable to a different court, the Second Circuit Court of Appeals.
 - In addition to the issues of interpretation of the Regulations decided in the *Kaufman* appeal, the taxpayer in *Estate of Mount* also argued that the allocation of proceeds desired by the Commissioner was actually dictated by applicable New York law, even though the subordination agreement was silent.
 - After the *Kaufman* appellate decision, and without conceding that the *Kaufman* decision was correct, the Commissioner conceded the subordination issue in *Estate of Mount*, ostensibly because the desired allocation of proceeds would be required by New York law.

Case Law Developments

- *Mitchell v. Commissioner*, 138 T.C. No. 16 (2012)
- Taxpayer donated an easement over 180 acres of unimproved land.
- The acreage was part of a larger parcel purchased by a family limited partnership. The seller financed the sale and held a promissory note and deed of trust.
- The donation was made in 2003 and the conservation deed was recorded but the subordination to the deed was not signed until 2005.
- From 2003 to 2005, the partnership had the money to pay off the promissory note at any time. There were no lawsuits, potential or otherwise; all bills were paid; payments on the promissory note were current, and casualty insurance was in place.
- The IRS denied the deduction for the conservation easement arguing in part that the donation did not meet the regulatory requirements.

Case Law Developments

- *Mitchell* (con't)
- The government argued that the donation was invalid because the mortgage was not subordinated to the easement, as required by Treas. Reg. §1.170A-14(g)(2), at the time the donation was made.
- The taxpayer countered that although the subordination was not in place upon donation the risk of default was not possible or so remote as to be negligible. The taxpayer urged that Treas. Reg. §1.170A-14(g)(3) (remote future events) modified the subordination requirement.
- The Tax Court rejected the taxpayers suggestion instead following *Kaufman II* on the principle that the subparts of Treas. Reg. §1.170A-14(g) do not modify one another. The deduction for the easement donation was denied. The taxpayers avoided penalties based on a finding of good faith and reasonable cause.
- Taxpayers filed a motion for reconsideration based on *Kaufman III* which was granted. Supplemental briefs were lodged in December.

Case Law Developments

- *Belk v. Commissioner*, 140 T.C. No. 1 (2013)
 - Taxpayers donated a conservation easement over a 184 acre golf course. The easement agreement included a provision that allowed the donor to substitute the property subject to the easement with “an area of land owned by Owner which is contiguous to the Conservation Area for an equal or lesser area of land comprising a portion of the Conservation Area.” The substitute land would have to have economic and conservation values at least equal to the original land.
 - The IRS challenged the deductibility of the donation arguing that this substitution provision violated the requirement under IRC §170(h)(2)(C), which defines a qualifying “interest in property” to include “a restriction (*granted in perpetuity*) on the use which may be made of the real property.”
 - The Tax Court distinguished cases dealing with perpetuity of *conservation purpose* under IRC §170(h)(5)(a).

Case Law Developments

- *Belk v. Commissioner* (con't)
 - The Court found that §170(h)(2)(C) creates a perpetuity requirement relating to the *property* subject to the easement, in addition to protection *in perpetuity* of the conservation *purpose*. The Court acknowledged that this was a case of first impression on this issue.
 - The court held that the conservation easement failed because the substitution provision created the possibility that the conservation easement might be “swapped” and placed upon other property was not subject to a use restriction in perpetuity as required by IRC §170(h)(2)(C).
 - This ruling may have implications to other types of easement amendments and to easements allowing subsequent location or relocation of reserved features within the easement, such as home sites, lakes and roads.

Case Law Developments

- *Dunlap v. Commissioner*, T.C. Memo 2012-126
 - Condo owner/taxpayers donated a façade easement over a historic Tribeca building.
 - Taxpayers took deductions for the easement contribution plus cash contributions to the donee organization. The IRS denied the deductions and asserted penalties.
 - The IRS presented several arguments attacking the “validity” of the easement under the regulations but the Tax Court adopted a valuation approach. However, the Tax Court rejected the valuations of the taxpayers’ experts and assigned no value to the easement.
 - The court allowed deductions for the cash contributions and found that the taxpayers had reasonable cause to avoid the penalties asserted by the government.

Case Law Developments

- Other Recent Cases
 - *Averyt v. Commissioner*, T.C. Memo. 2012-198 (finds that a contemporaneous written acknowledgement may be satisfied by the easement deed itself, even though the “no goods or services” language was not present)
 - *R.P Golf, LLC v. Commissioner*, T.C. Memo. 2012-282 (similar ruling to *Averyt*, but with somewhat less precise language in the deed).
 - *Butler v. Commissioner*, T.C. Memo. 2012-72 (allowing a deduction for an easement over forest and farm land, but making a careful analysis of whether reserved uses of the land might damage the conservation values; the “inconsistent use” prohibition).
 - *Crimi v. Commissioner*, T.C. Memo 2013-51 (requirement of qualified appraisal avoided because failure resulted from reasonable reliance on tax professional; see IRC §170(f)(11)(A)(ii)(II))

Case Law Developments Summary

- Case law continues to frame the planning landscape.
- The threshold requirement for a “qualified appraisal” may be modest but the quality of the appraisal is still important.
- Treas. Reg. §1.170A-14(g) modifies the perpetuity requirement of §1.170A-14(a)(2).
- Treas. Reg. §1.170A-14(g)(3) does not modify the mortgage subordination requirement of (g)(2) or the extinguishment provision of (g)(6).
- IRC §170(h)(2)(C) requires that the *property* must be subject to a perpetual restriction on use.
- IRC §170(h)(5) requires that the *conservation purpose* be protected in perpetuity.

Historic Rehabilitation Tax Credits Distinguished

- A type of investment tax credit granted under Code Section 38, and governed by Code Sections 46 and 47.
- Credit equals 20% of qualified rehabilitation expenditures (QREs) to a certified historic structure (or 10% of QREs to other qualified rehabilitated buildings)
- Perceived abuse of claiming deduction for a qualified conservation contribution and a rehabilitation tax credit with respect to the same property
 - Revenue Ruling 89-90
 - Rome I, Ltd. v. Commissioner
- Perceived abuse of “selling” rehabilitation tax credits
 - Historic Boardwalk Hall

Issues in Combining with Conservation Easement

- Code Section 170(f)(14)
 - Requires reduction for historic easements placed within 5-year HTC recapture period
 - IRS position: appears to continue to believe reduction in credits if easement is placed before credits are earned

Factors on Which the Third Circuit Relied

- Substance-over-form analysis
- The Court heavily relied on its interpretation of *Comm'r v. Culbertson*, 337 U.S. 733 (1949)
- Specific Factors
 - Lack of “downside” risk
 - Investor’s contribution contingent on sufficient construction progress to ensure anticipated credit allocation
 - The NJSEA guaranteed the tax benefits, plus penalties, interest and up to \$75,000 in legal fees

Factors on Which the Third Circuit Relied (cont'd.)

- The Investor lacked risk because the project was fully funded before the Investor entered into the transaction and, accordingly, the investment funds were not necessary to complete the project (the Court thus implying that the investment did not meet the Congressional goal of encouraging tax credit investments in projects that otherwise would not be funded)
- Although the 3% preferred return was not formally guaranteed, the Investor could exercise a put option and obtain any unpaid preferred return
- Moreover, the put option was supported by a Guaranteed Investment Contract purchased by NJSEA

Factors on Which the Third Circuit Relied (cont'd.)

- The Third Circuit noted:

“[T]he parties agreed to shield [the Investor’s] ‘investment’ from any meaningful risk. [The Investor] was assured of receiving the value of the [historic rehabilitation tax credits] and its Preferred Return regardless of the success or failure of the rehabilitation of the East Hall and [the Partnership’s] subsequent operation.”
- Lack of meaningful upside potential
 - NJSEA had a call option at fair market value
 - The Court concluded that the fair market value would never exceed the unpaid preferred return; thus, there was no upside

Historic Boardwalk Hall

Conclusions & Recommendations

- “No risk, no partner” is a basic tenet of federal tax common law
- Bad facts make bad law
- Partnerships should be cautious in excessively reducing risk to investors when structuring HTC transactions
- Some practitioners have concluded that a put option may be reasonable on the theory that it protects against being stuck in a bad deal, but a call option should not be used since the call option arguably eliminates the ability to make a profit (but others have proposed eliminating the put and keeping the call, while yet others are keeping both)
- Caution should be exercised in restructuring closed transactions now, since such restructuring may trigger unintended consequences and create a roadmap for the IRS

Historic Boardwalk Hall

Conclusions & Recommendations (cont'd.)

- Master Tenant Structure
 - Some have suggested this as a solution
 - Under the Master Tenant structure, the Investor leaves the property and, in accordance with tax rules, passes through the credit to the Master Tenant
- Issues with this structure
 - Lease must be a true lease, including rent at fair rental value
 - The owner recoups its costs from rental payments, which typically are not received up front. This may necessitate additional financing
- Traditionally, master tenants frequently are also partners making capital contributions (which are then used to fund construction) thus not avoiding the Historic Boardwalk issues
- There is some limited indication that the IRS may consider issuing guidance, but no certainty that it will