New IRS Regulations For Conservation Easement Transactions

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Following a U.S. Tax Court decision in late 2020, the Internal Revenue Service is putting syndicated conservation easement transactions in the crosshairs once again.

The Tax Court invalidated IRS Notice 2017-10 in November 2022, which designated that syndicated conservation easement transactions are ?listed transactions?, meaning they must be reported to the agency as abusive tax shelter transactions. The IRS issued Notice 2017-10 in 2017 due to concerns that taxpayers were using conservation easements, which provide taxpayers a tax incentive to protect and conserve land, to avoid paying taxes, especially when investors buy the land together.

In Green Valley Investors, LLC, et al., Bobby Branch, Tax Matters Partner v. Commissioner of Internal Revenue, 159 T.C. No. 5, the Tax Court determined the IRS overstepped its authority in issuing Notice 2017-10 by failing to follow proper public comment and notice requirements outlined in the federal Administrative Procedure Act. The Tax Court ruling follows a similar decision on listed transactions published by the U.S. Court of Appeals for the Sixth Circuit in 2022.

In response to both decisions, the IRS in December said that it would pursue new regulations that would classify certain syndicated conservation easement (SCE) transactions as listed transactions. The IRS is currently accepting public comment on the proposed regulations and held a public hearing to discuss them on March 1, 2023. During the public hearing, many stakeholders urged the IRS to retain the current carveout in syndicated conservation easement regulations, arguing that labeling these transactions as listed transactions would harm compliant taxpayers.

IRS OBJECTIONS TO SCEs

Under the tax code, when someone donates real property for conservation purposes to an IRS-qualified charity, they are entitled to take a higher-than-normal charitable

deduction. In a syndicated easement, a number of investors form a partnership or other legal entity to buy or invest in the property. They then donate the property and take a charitable deduction.

The Department of the Treasury and the IRS, via Notice 2017-10, said they were aware that ?some promoters were syndicating conservation easement transactions that purport to give investors the opportunity to obtain charitable contribution deductions in amounts that significantly exceed the amount invested? and moved to classify such transactions as listed transactions.

Notice 2017-10 described a syndicated conservation easement that would be considered a listed transaction. Prospective investors, the IRS said, receive oral or written promotional materials that offer the possibility of a charitable contribution deduction that equals or exceeds 2.5 times their investment. The investor then purchases an interest, directly or indirectly in a pass-through entity that holds real property.

After investors purchase an interest, a pass-through entity contributes a conservation easement that encumbers a property to a tax-exempt entity and allocates a charitable contribution deduction to the investors. Following this contribution, the investors report a charitable contribution deduction with respect to the conservation easement on their federal income tax returns.

The IRS contends in Notice 2017-10 that promoters obtain an appraisal ?that greatly inflates the value of the conservation easement based on unreasonable conclusions about the development potential of the real property.? Therefore, the agency said it was challenging the ?purported tax benefits from this transaction based on the overvaluation of the conservation easement? and that it may also challenge tax benefits ?based on the partnership anti-abuse rule, economic substance, or other rules or doctrines.?

WHAT THE PROPOSED REGULATIONS DO

Under the new regulations, a syndicated conservation easement transaction would be a listed transaction if:

1. An investor receives promotional materials, whether written or oral, that offer investors in a pass-through entity the possibility of a charitable contribution deduction that equals or exceeds an amount that is 2.5 times the amount of the investor?s investment;
2. The investor purchases an interest, directly or indirectly (through one or more tiers of pass-through entities), in the pass-through entity that holds real property;
3. The pass-through entity that holds the real property contributes a conservation easement encumbering the property to a tax-exempt entity and allocates, directly or through one or more tiers of pass-through entities, a charitable contribution deduction to the investor; and

4. Following a contribution, the investor reports on his or her federal income tax return a charitable contribution deduction with respect to the conservation easement.

The proposal also includes new rules to prevent promoters and taxpayers from avoiding the 2.5 times rule (listed in no. 1 above):

- **Highest Deduction Amount**. Promoters, the IRS contends, may attempt to circumvent the 2.5 times rule by having promotional materials contain language that is ambiguous as to the amount of the potential charitable deduction. The proposed regulations provide that the highest deduction amount stated or implied in the promotional materials, taken as a whole, applies.
- **A Rebuttable Presumption**. To address taxpayers and promoters who may not be forthcoming about the content or receipt of the promotional materials, the proposed regulations include a rebuttable presumption deeming the 2.5 times rule to be met if:

1. The pass-through entity donates a conservation easement within three years following taxpayer?s investment in the pass-through entity;
2. The pass-through entity allocates a charitable contribution deduction to the taxpayer that equals or exceeds 2.5 times the amount of the taxpayer?s investment;
3. The taxpayer claims a deduction that equals or exceeds two and one-half times the amount of the taxpayer?s investment.

The presumption may be rebutted if the taxpayer establishes that promotional materials did not suggest or imply that investors might receive a charitable contribution deduction that equals or exceeds 2.5 times the amount of their investment.

- **Anti-Stuffing Rule**. Designed to prevent taxpayers from investing excess amounts in the pass-through entity to avoid meeting the 2.5 times rule, the anti-stuffing rule provides that? for purposes of determining application of the 2.5 times rule?the amount of a taxpayer?s investment in the pass-through entity is limited to the portion of their investment that is attributable to the portion of the real property on which a conservation easement is placed and that produces the charitable contribution deduction.

The proposed regulations make it clear that the IRS will continue to aggressively challenge conservation easement transactions in the years ahead. Taxpayers, material advisors (including promoters, appraisers and return preparers), and organizations receiving donations should work closely with their tax advisers and counsel to understand how the new regulations may affect them and to avoid significant penalties.

We will continue to closely monitor developments with syndicated conservation easements. To learn more, contact us for a consultation.

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