

“Perpetuity” Restrictions on Use of Retained Interests

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“Perpetuity” Restrictions on Use of Retained Interests

1. Any interest in the donated property which is retained by the Donor “must be subject to legally enforceable restrictions that will prevent uses of the retained interest inconsistent with the conservation purposes of the donation”. Treasury Regulation Section 1.170A-14(g)(1). In order to satisfy the requirement that the Contributed Easement be “exclusively for conservation purposes” the conservation purpose or purposes underlying the easement must be protected “in perpetuity”. Code Sections 170(h)(2)(A) and 170(h)(5)(A).
2. For example, if there is a mortgage on the Restricted Property, the mortgage holder must subordinate its interest to the rights of the Qualified Organization to enforce the conservation purposes of the Conservation Easement. Treasury Regulation Section 1.170A-14(g)(2). If there is an existing mortgage or deed of trust against the Restricted Property, it is best to have either a release or subordination agreement filed prior to the Conservation Easement. **Minnick**, 796 F.3d 1156 (9th Cir. 2015). The subordination must also apply to the mortgagee’s claims against any condemnation or casualty proceeds. **See**, for example, **Palmolive Building Investors**, 149 T.C. 380 (2017).
3. Transactional attorneys should draft around many of the IRS technical positions taken since at least 2017. Tax

Counsel who are involved in disputes with the IRS are frequently still involved with Conservation Easement that were granted in former periods. For instance, the language included in many earlier Conservation Easements may have been based upon the ***Model Conservation Easement*** clause as circulated by several national organizations. This language was found to be defective under the decision in ***Hoffman Properties, II***, 956 F.3d 832 (6th Cir. 2020).

4. If the mineral interests have been severed from the surface estate, the Donor must show that the “**probability**” of extraction or removal of mineral by surface mining is “so remote as to be **negligible**.” Treasury Regulation Section 1.170A-14(g)(4)(ii). Conservation Easements that present questions relating to severed mineral and mining rights are not mentioned at all in the **IRS Audit Guide**. In our **CASE STUDIES** we will address ***Whitney Benefits***, 18 Cl. Ct. 394 (1989); PLR 9318027; ***Terrene Investment***, T.C. 2007-218; ***Esgar Corp.***, 744 F.3d 648 (10th Cir. 2014); and ***Coal Property Holdings***, 153 T.C. No. 7 (October 28, 2019).
5. The Donor may reserve rights under a Conservation Easement which will not “impair the conservation interests associated with the property.” Treasury Regulation Section 1.170A-14(g)(5).
6. In order to document the then-condition of the Restricted Property the Donor must make certain information (the “**Baseline Documentation**”) available to the Qualified

Organization **before** the Conservation Easement is granted. We will consider **BC Ranch II** (a/k/a **Bosque Canyon Ranch**) (5th Cir. 2017) in connection with the Baseline Documentation preserved in that case.

CERTAIN VALUATION ISSUES.

1. The value of the easement contribution (and the attendant income tax deduction) is the fair market value of the perpetual conservation restrictions at the time of the contribution. Treasury Regulation Section 1.170A-14(h)(3)(i). Fair market value is the price at which property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of relevant facts. Treasury Regulation Section 1.170A-1(c)(2).
2. In determining fair market value, one must take consider not only the **current** use of the property but also its highest and best use for which the property is adaptable and likely to be needed in the reasonably near future. Treasury Regulation Sections 1.170A-14(h)(3)(i) and (ii). The highest and best use can be any **realistic, objective potential** use of the Restrictive Property. Under the IRS Audit Guide to qualify as a highest and best use of property the use must be (a) physically possible, (b) legally permissible, (c) financially feasible, and (d) maximally productive.

3. Under the Regulations, if a “**substantial record**” exists of sales of Conservation Easements, the fair market value of the Donor’s Conservation Easement will be based on the sales price of such Conservation Easements. Treasury Regulation 1.170A-14(h)(3)(i). In virtually every instance, however, there will be **no** substantial record of sales “**comparable**” to the donated Conservation Easement. In such cases, the value of a particular Conservation Easement will equal the difference between the fair market value of the property before and after the of the Conservation Easement. Treasury Regulation Section 1.170A-14(h)(3)(i). (This methodology is referred to as the “**Before and After**” valuation technique.)
4. When Before and After valuation is used, the Before value of a Conservation Easement must consider “not only the current use of the property but also an **objective assessment** of how **immediate** or **remote** the likelihood is that the property, absent the restrictions, would in fact be developed, as well as any effect from zoning, conservation, or historic laws that **already** restrict the property’s highest and best use.” Treasury Regulation Section 1.170A-14(h)(3)(ii).
5. The two most common methodologies for the application of the Before and After technique are: (a) the comparable sales method; and (b) the discounted cash flow method (referred to as the “**DCF**” method). In the comparable sales method, the Qualified Appraiser derives a Before and After value by comparing the Restricted Land (**sans**

Conservation Easement) to similar properties, hopefully in the market area, that have recently sold. In conducting the comparison analysis, an appraiser may apply appropriate **adjustments** to reflect differences between the subject property and the **comparable** properties. These adjustments generally are of two varieties: (a) **transactional adjustments** which reflect differences in the transaction in which the property was sold, such as market conditions, rights conveyed, and financing terms; and (b) **property adjustments** which reflect differences in the specific property, such as location, physical characteristics, legal restrictions. See Conservation Easement Audit Techniques Guide (the "**IRS Audit Guide**") dated November 2020, at pages 65-66.

6. The Appraisal Standards Board, which promulgates the Uniform Standard Professional Appraisal Practice ("**USPAP**") has recognized DCF as an acceptable analytical tool and method of valuation for the valuation of real property. **See** USPAP Advisory Opinion 33. Advisory Opinion 33 notes that the "[u]se of DCF analysis requires specialized knowledge and experience," and that its "application requires a high degree of diligence". Any DCF analysis must be supported by market-derived data and the assumptions used by the appraiser must be both market- and property-specific. At page 68 of the IRS Audit Guide, the IRS observes that with DCF "there is a greater chance of errors". The IRS Audit Guide particularly lists among the common faults with a DCF appraisal the failure

to account for: time to obtain project approvals, time to install infrastructure, cost of infrastructure, time for absorption of the units to be constructed, inclusion of a reasonable developer's profit, consideration of any existing competitive projects and those in the planning stage, and inadequate assessment of the risk associated with the proposed development. IRS Audit Guide, page 68.

7. Under Treasury Regulation Section 1.170A-17(a)(2), it is recognized that the substance and principles of **USPAP** will result in an appraisal meeting the "**generally accepted appraisal standards**" as referred to in Treasury Regulation Section 1.170A-17.
8. Any increase arising because of the Conservation Easement in the value of: (a) real property which may be owned by the Donor's or his or her family, as defined in the Code and (b) land contiguous to the Restricted Property, must be applied in reduction of the value of the Conservation Easement. Similarly, any increase arising because of the Conservation Easement in the value of any real property, **wherever located**, owned by the Donor or related parties, as defined, will reduce the value of the Conservation Easement deduction. These rules are set forth in Treasury Regulation Section 1.170A-14(h)(3)(i), fourth and fifth sentences.
9. While not legally required, it may be advisable to obtain a **review appraisal** of the Qualified Appraisal. Under USPAP, an "appraisal review" involves "the act or process of developing and communicating an opinion about the

quality of another appraiser's work that was performed as part of an appraisal." See Common Errors and Issues in Review, Appraisal Institute (April 23, 2015). A valid review appraisal may establish the Donor's good faith reliance, so that a gross undervaluation penalty might be avoided.

LISTED TRANSACTIONS FOR NON-SYNDICATED CEs.

1. "Substantially Similar" Transactions. Notice 2017-10 applies to **substantially similar** transactions to the arrangement expressly outlined in the Notice. There are **no** statutory or regulatory provisions that define this language with any precision. Treasury Regulation 1.6011-4(c)(4) picks up as substantially similar transactions "any transaction that is expected to obtain the same of similar types of tax consequences and that is factually similar to or based on a similar tax strategy". IRS Form 8886, item C, and IRS Form 8918, item B, have spaces to mark a given Disclosures as a **protective disclosure**. The Material Advisor Disclosure (Form 8918) is to be made by the last day that follows the end of the **calendar quarter** in which the material advisor became a material advisor with respect to the reportable transaction. The Form 8886 is to be attached to the income tax return or information return. Thus, the Form 8918 will commonly be due **before** any related Form 8886. It is always best to have an understanding at the earliest date between the taxpayer and all Material Advisors as to whether protective

disclosures are appropriate. IRS pronouncements and case law, although technically not in the ambit of IRS Notice 2017-10, have uniformly found that these situations presented were **substantially similar**: Rev. Rul. 201017076; Field Service Advice 200218014; Chief Counsel Advice 200712044; Chief Counsel Advice 200929005; **Polowniak**, T.C.M. 2016-31; **Blak Investments**, 133 TC 431 (2009); **Our Country Home**, 145 TC 1 (2015); **Interior Glass Systems**, 927 F.3d 1081 (9th Cir. 2019); and **Turnham**, 979 F.3d 1322 (11th Cir. 2020).

2. Participant Penalties. For the failure to file IRS Form 8886, if applicable, a penalty can be asserted by the IRS equal to seventy-five (75%) of the tax savings involved, capped at one hundred thousand dollars (\$100,000) for an individual. The IRS does **not** have any authority to rescind or abate any penalty against a **listed transaction**. If a taxpayer participates in a reportable transaction, including any listed transaction, a twenty percent (20%) penalty also will apply to any resulting increase in tax. This penalty increases to thirty percent (30%) if the participant fails to file a Form 8886. **See** Code Section 6662A. If the Form 8886 was **not** enclosed with a participant's tax return when filed, the period for assessment will remain **open** until one (1) year after (a) the participant in fact files Form 8888; or (b) a Material Advisor provides the IRS with the data as required. Code Section 6501(c)(10).

3. Material Advisor Penalties. For listed transactions, the penalty is the **greater** of two hundred dollar dollars or seventy-five percent of the gross income derived. The IRS must assess the penalty within three (3) years of filing the Form 8918, but if none is ever filed, the penalty may be assessed at any time. Code Section 6501(a). The IRS has the discretion to rescind a Material Advisor's penalty, but the IRS's decision is **not** reviewable by any Court. Code Section 6707A(d)(2).



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