Follow The Rules: Another Conservation Easement Mess.

Section 170(h) of the Internal Revenue Code permits a taxpayer to claim a charitable deduction for donating property without transferring title. This can be done through a qualified conservation easement, which grants a permanent restriction on property, I.R.C. § 170(h)(2)(C), for conservation purposes, I.R.C. § 170(h)(4)(A), to an appropriate charitable organization, I.R.C. § 170(h)(3). The taxpayer is then entitled to deduct the value of the easement. *See* I.R.C. § 170(f)(3)(B); *see also* Treas. Reg. § 1-170A-14(a).

This area has seen a fair volume of litigation recently, and last week the Ninth Circuit addressed a recurring problem: to meet regulatory requirements, any mortgage on the property must be subordinated. *Minnick v. Comm'r,* 2015 U.S. App. LEXIS 14097 (9th Cir. Aug. 12, 2015).

The regulatory background is straight-forward: to qualify for a charitable deduction, the easement's conservation purpose must be "protected in perpetuity." I.R.C. § 170(h)(5)(A). In keeping with that statutory requirement, the relevant regulations direct that where the relevant property is subject to a mortgage, a deduction will not be allowed unless "the mortgagee subordinates its rights in the property to the right of the qualified organization to enforce the conservation purposes of the gift in perpetuity." Treas. Reg. § 1-170A-14(g)(2).

In *Minnick*, the taxpayers owned undeveloped land that they planned to develop, and they created a conservation easement on the portion of the property that was not part of the development plan. 2015 U.S. App. LEXIS 14097, slip op. at *2-*3. While the agreement creating the easement had warranties indicating that the mortgage would be subordinated to the easement, the taxpayers failed to obtain a subordination agreement from their lender. The taxpayers obtained an appraisal of the value of the easement and then deducted the appraised value of the easement over the course of three tax years, beginning in 2006. *Id.,* slip op. at *3.

The IRS disallowed the deductions and issued a notice of deficiency in 2009, citing a failure to provide "documentation of fair market value." *Id.* The taxpayers sought a redetermination from the Tax Court; in 2011 as their case approached trial, they contacted the lender and obtained a subordination agreement. At roughly the same time, the government filed a pretrial memorandum in the Tax Court that cited the absence of a subordination agreement as a reason to sustain the deficiency.

Following trial, but prior to ruling on the *Minnick* case, the Tax Court issued an opinion holding that the subordination agreement must be in place at the time the interest is donated for the easement to qualify. *Mitchell v. Comm'r,* 138 T.C. 324, (T.C. 2012) ("*Mitchell I*"), *vacated on denial of reconsideration by Mitchell v. Comm'r,* T.C. Memo 2013-204, (T.C. 2013). Consequently, the Tax Court ruled against the taxpayers.

By the time *Minnick* reached the Ninth Circuit, the Tenth Circuit had affirmed *Mitchell I. See Mitchell v. Comm'r,* 775 F.3d 1243 (10th Cir. 2015) ("*Mitchell II*"). *Mitchell II* essentially provided a template for the decision in *Minnick.* In the Ninth Circuit's view the issue was very simple: the plain language of the regulation supported the Tax Court's interpretation, as it made a subordination agreement a prerequisite for any deduction. *Minnick,* 2015 U.S. App. LEXIS 14097, slip op. at *6-*7 (citing *Mitchell II,* 775 F.3d at 1250).

At this point, there seems to be little room for debate, and taxpayers who contemplate the creation of a qualified conservation easement are plainly on notice that the IRS will strictly enforce the regulatory requirements.

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