NOT SO STRICT CONSTRUCTION: THE FIFTH CIRCUIT EXAMINES CONSERVATION EASEMENTS

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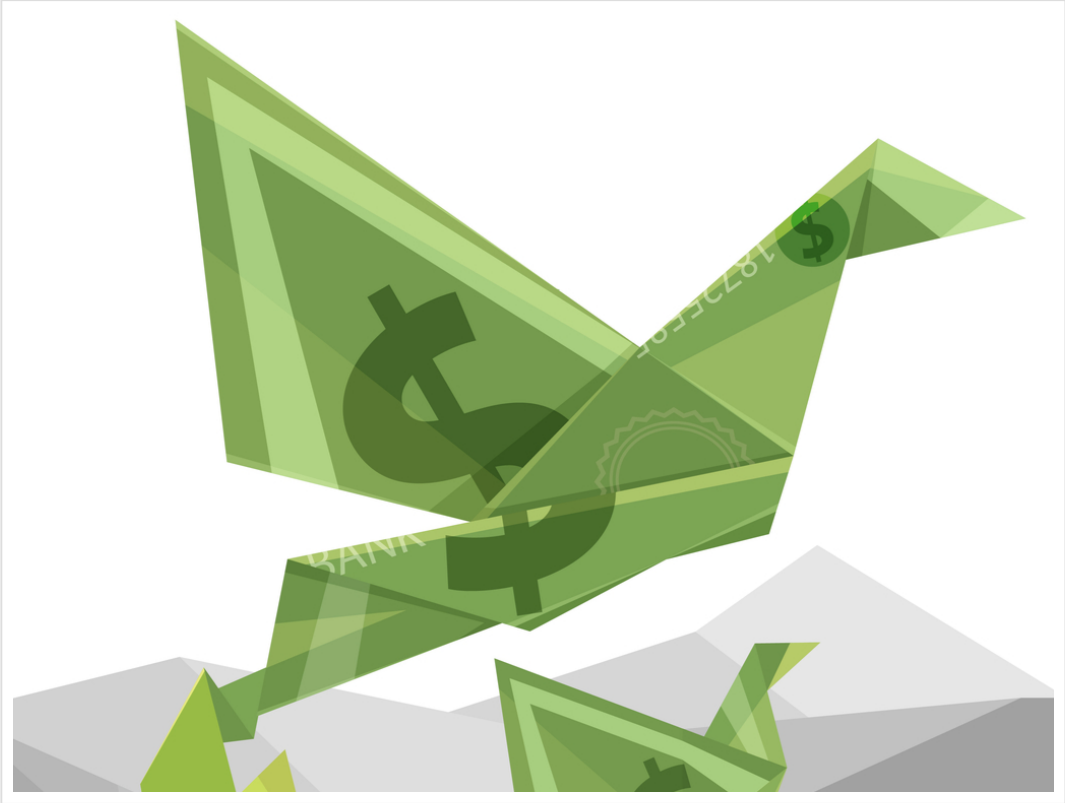

Qualified conservation easements have generated a significant volume of litigation; the IRS takes a strict approach to enforcement, and there are a lot of technical details that taxpayers can trip over. On August 11th, a divided Fifth Circuit panel issued an interesting decision that ruled in favor of the taxpayer, while disavowing the customary approach of strictly construing the requirements for a deduction in the government's favor. *BC Ranch II, L.P. v. Comm'r*, No. 16-60668, 2017 U.S. App. LEXIS 14947 (5th Cir. Aug. 11, 2017).

Background

The case involved a conservation easement on the Bosque Canyon Ranch, located in the Texas Hill country. In 2003, the ranch's developers worked with the North American Land Trust to evaluate the feasibility of a conservation easement; the Trust indicated that an easement would be feasible and would protect the habitat of the golden-cheeked warbler, which is an endangered species. *BC Ranch II*, 2017 U.S. App. LEXIS 14947 at *3-*4. Two partnerships, BCR I and BCR II, each granted the Trust a conservation easement; BCR I made its donation in 2005, and BCR II followed suit in 2007. *Id*. at *4. The terms of the easements were quite similar, and they covered land that featured the habitat of the warblers and other wildlife, along with a watershed, mature forest, and "scenic vistas." *Id*.

A portion of the parcel was intended to be developed for residential property, and the easements included a provision that permitted them to be amended with the Trust's consent to modify the configuration of the homesite parcels, although the size of the residential parcels could not be increased. *Id*. at *5. The two partnerships marketed partnership units: Each investor paid $350,000 for a partnership unit; this admitted

them to the Bosque Canyon Ranch Association, which was to hold title to all of the non-residential real estate at the ranch, and they also received a promise that the partnership would convey a fee simple interest in a five acre homesite. *Id*. at *5-*6.

When the partnerships claimed the deduction for the easements, the IRS disallowed the charitable deduction claimed by each partnership, and it imposed gross valuation misstatement penalties. *Id*. at *6. Under the Internal Revenue Code, a gross valuation misstatement penalty adds forty percent to the taxpayer's liability. *See* I.R.C. § 6662(h)(1). The partnerships filed petitions for review with the Tax Court, but were not successful.

For a donation of property to a conservation organization to qualify for a tax deduction, one requirement is that the property transferred must be a "qualified real property interest." I.R.C. § 170(h)(1)(A). A conservation easement will qualify, but only if it imposes "a restriction (granted in perpetuity) on the use which may be made of the real property." I.R.C. § 170(h)(2)(C). The central issue in *BC Ranch II* was whether the easements created a permanent restriction on the use of the property, since they permitted some adjustment to the boundaries of the homesites. That issue divided the panel.

The Majority's Approach

The majority viewed the adjustment provision as a minor issue, noting that adjustments could only made if the Trust, the relevant partnership, and the relevant limited partners agreed, and then only if, in the Trust's judgment, the adjustment would not have any adverse effect on "the Conservation Purposes" under the relevant easement. *BC Ranch II*, 2017 U.S. App. LEXIS 14947 at *9-*10. In addition, there could be no change in the overall amount of land available for homesites. *Id*. at *10. In light of the limited scope of potential changes that could be made, the majority concluded that section 170(h)(2)(C) was satisfied.

Specifically, the majority distinguished *Belk v. Commissioner*, 140 T.C. 1 (2013), *aff'd*, 774 F.3d 221 (4th Cir. 2014), emphasizing that the easement there had incorporated a provision that "allowed the parties to substitute other land for the land that was originally restricted under the easement." *BC Ranch II*, 2017 U.S. App. LEXIS 14947 at *10. The easement in *Belk* permitted the donor to substitute land that was contiguous to the property subject to the easement for a like portion of the protected area if there was no adverse effect on the conservation purposes of the easement. *See Belk*, 774 F.3d at 223. In *BC Ranch II*, the majority focused on the fact that exterior boundaries of the land subject to the easement would not be altered, and the acreage would not be changed: "Only the lot lines of one or more of the five-acre homesite parcels are potentially subject to change." 2017 U.S. App. LEXIS 14947 at *11. The panel majority viewed *Belk* as a situation in which "the easement . . . could be moved, lock, stock, and barrel, to a tract or tracts of land entirely different and remote from the property originally covered by that easement." *Id.* (footnote omitted).

The majority likened the adjustments available in the easements to provisions permitting alterations and repairs to building façades subject to conservation easements that other courts had upheld. *Id*. at *12. Specifically, the court relied upon *Commissioner v. Simmons*, 646 F.3d 6 (D.C. Cir. 2011), and *Kaufman v. Shulman*, 687 F.3d 21 (1st Cir. 2012). In *Simmons*, the easements included language that gave the donee the ability to consent to changes in the façade and to abandon its enforcement rights. 646 F.3d at 9. The D.C. Circuit concluded that the consent provision did not undercut the permanency of the easements given the fact that the District of Columbia's historic preservation laws independently restricted changes in the façades subject to the easements. *Id.* at 11. The Court also observed that the IRS had failed to show that the prospect the donee would abandon its rights was "more than negligible." *Id.* at 10. In *Kaufman*, the First Circuit followed *Simmons*. 687 F.3d at 28.

In the panel's view, the flexibility built into the easement structure for the Bosque Canyon Ranch was ultimately beneficial for all concerned: "The need for flexibility to address changing or unforeseen conditions on or under property subject to a conservation easement clearly benefits all parties, and ultimately the flora and fauna that are their true beneficiaries." *BC Ranch II*, 2017 U.S. App. LEXIS 14947 at *12-*13.

The majority opinion then took a more controversial step: While tax deductions are normally strictly construed against the taxpayer, the panel majority declared that this principle should not apply to the requirements for conservation easements because section 170(h) "was adopted (1) at the behest of conservation activists, not property-owning, potential-donor taxpayers (2) by an overwhelming majority of Congress (3) in the hope of adding untold thousands of acres of primarily rural property for various conservation purposes." *Id*. at *13-*14. Instead, the panel majority announced that it would "analyze tax deductions for the grant of conservation easements made pursuant to that article of the IRC under the ordinary standard of statutory construction." *Id*. at *14. The panel then indicated that under normal standards of statutory construction the permanence requirement under section 170(h)(2)(C) was met. *Id.*

The Dissent

Circuit Judge James L. Dennis expressed two concerns with the disposition by the majority:

- First, he believed the panel majority erred in holding that the easements satisfied the permanent encumbrance requirement of section 170(h)(2)(C);
- Second, Judge Dennis characterized the majority's approach to statutory construction as "an impermissibly lax standard." at *28 (Dennis, J. dissenting).

Judge Dennis started with the premise that *all* tax deductions are strictly construed. *Id.* at *29 (Dennis, J. dissenting) (citing *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79, 84 (1992)). Next, he noted that several circuits had previously applied this rule in the context of conservation easements, including the Fourth Circuit in *Belk*. *Id.* While acknowledging that the majority had deviated from the normal rule of strict construction for policy reasons, Judge Dennis indicated that it was not the court's role to do so: "It is not our domain to decide that the goal served by this deduction is more important than that served by any other." *Id.* at *29 n.3 (Dennis, J. dissenting).

On the merits, Judge Dennis questioned the majority's conclusion that *Belk* was distinguishable; in his view, the easements permitted the substitution of property, the very same problem at issue in *Belk*. Since the scope of the land that was subject to the easement was not fixed, the encumbrance was not permanent, as required by section 170(h)(2)(C). *Id.* at *30-*31 (Dennis, J. dissenting). Judge Dennis also questioned the majority's conclusion that the impact of the adjustments was minimal, noting that the homesites represented almost seven percent of the entire tract, and there were no limits on when and how often the boundaries of homesites could be adjusted. *Id.* at *31-*32 (Dennis, J. dissenting).

Analysis

While conservation is a worthy goal, the dissent seems to have the stronger argument.

First, the analogy that the majority draws between cases involving an easement imposed on a building façade and a conservation easement designed to preserve the habitat of an endangered species misses some key points:

- At a practical level, some changes to the façade of an historic building will almost certainly become necessary: Stone or brick buildings require pointing periodically to prevent deterioration, and metal decorative work may require periodic

repairs. Both categories of repairs would arguably involve changes to the façade, but they may well be necessary to protect the overall integrity of the historic structure.

- In contrast, adjustments to the boundaries of an easement designed to preserve raw land for wildlife do not appear to have the same intrinsic necessity. And the adjustment provision was presumably designed to enhance the marketability of the homesites, a markedly different purpose than alterations to an historic façade that may be needed to maintain its structural integrity.

Second, while there are differences between the easement provisions at issue in *Belk* and in *BC Ranch II*, the differences are really a matter of degree. The adjustment provision in *Belk* allowed substitution of property from a contiguous tract, while the provisions in *BC Ranch II* permitted boundary adjustments within the same basic tract. And the amount of property subject to the adjustment provision was not minimal; as the dissent notes, 6.69% of the easement tract was subject to the adjustment provision. *BC Ranch II,* 2017 U.S. App. LEXIS 14947 at *31 (Dennis, J. dissenting).

Third, the majority's decision that conservation easements should not be strictly construed is also problematic. As the dissent notes, the fact that the statute creating the deduction passed by a wide margin is not necessarily an indication that it should be construed more liberally than other Code provisions that authorize different deductions. *Id.* at *29 n.2. And nothing in the text of the relevant statute suggests that the permanence requirement does not require that the boundaries of an easement to be fixed. To qualify for a deduction, the donor must contribute "a qualified real property interest." I.R.C. § 170(h)(1)(A). Congress chose to define this term as follows:

For purposes of this subsection, the term "qualified real property interest" means any of the following interests in real property:

(A) the entire interest of the donor other than a qualified mineral interest,

(B) a remainder interest, and

(C) *a restriction (granted in perpetuity) on the use which may be made of the real property.*

I.R.C. § 170(h)(2) (emphasis supplied). The use of the definitive article "the" in section 170(h)(2)(C) certainly does suggest that the metes and bounds of the easement have to be fixed. *BC Ranch II,* 2017 U.S. App. LEXIS 14947 at *30 (Dennis, J. dissenting) (citing *Belk*, 774 F.3d at 225). Moreover, the other types of qualified real property interests do not appear to contemplate adjustment in the scope of the property donated after the gift is made; they call for the donor to give up her "entire interest" in real property or a "remainder interest" in real property. Absent some language in the text, it is hard to see why an easement should be treated differently and subject to adjustment after the gift is made.

Perhaps there is a case to be made that the provisions for certain types of deductions should be construed liberally. After all, the Supreme Court's decision in *INDOPCO* involved the question whether expenditures could be deducted as business expenses, rather than capitalized, a context which is pretty far removed from a gift to a charity. The problem is that adopting such an approach on a case-by-case basis leaves courts to make policy decisions about which deductions serve more important purposes, a process that is sure to yield highly unpredictable results. It is probably wiser from a policy perspective to let Congress spell out which deductions deserve to be construed broadly. After all, Congress presumably knows that the normal rule is that deductions are to be construed strictly.

And provisions of the Code that create deductions to promote worthy goals remain susceptible to abuse; conservation easements are no exception. Questionable appraisals have been used in some cases to inflate the amount of the deduction. The problem is grave enough that the IRS issued a listing notice covering syndicated conservation easements late last year. Notice 2017-10, 2017-4 I.R.B. 544 (Dec. 23, 2016). Some of these transactions have promised investors with deductions of over twice their investment, an outcome that can only come from a wildly inflated appraisal.

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