Investing in Conservation Easements

Q. Should I invest in conservation easements? I keep hearing good things about them but don't really understand how they work or whether it is a good idea.

Conservation Easement Investments Have High Abuse Potential

A. Conservation easements are a great idea, in theory. Here's the way they work. Basically, if you are willing to donate your property for the public good, and that donation reduces the value of your property, you get to take a tax deduction equal to the reduction in value of your property. You can use an amount of it up to 50% of your adjusted gross income as a deduction in any given year. Seems fair, right? It encourages the wealthy to do things that promote the public good, particularly the environment.

However, the amount of deductions being taken for conservation easements have been skyrocketing in recent years, and when you look into it, the increase isn't what you might think. You see, there are now people who are buying the properties (often in syndications) primarily for the purpose of then putting a conservation easement on it. It's an investment.

"But wait," you say. If the value of the property drops by the amount of the deduction, and you only get 37% (+ state) of the easement back as a deduction, how is that a winning move? That's like donating money to charity for the tax deduction and being surprised when you have less money afterward.

Well, the way they become investments is by, at a minimum, abusing the intent of the tax code provision, and in many cases, through outright fraud. Imagine a situation where you put $100,000 into an investment and then two years later pull out a $900,000 tax deduction. Pretty fishy huh. That's why the IRS now has placed conservation easements on their "listed transactions" list, where they highly scrutinize them.

Where does the fraud come in? Well, the fraud generally comes in with the appraisal. For example, let's say you buy a hunting property for a million bucks. It has a little tiny run-down shack on it and 60 acres of woods. Then you put a conservation easement on it saying it can only be used for hunting. But you get an appraiser to say if it were developed as a housing development it would be worth $10 Million. But as a hunting property, it's only worth $1 Million. You've now somehow created $9 Million in value that can be taken as a tax deduction. If your marginal tax rate, like mine, is 42%, you've now spent $1 Million in order to buy a $9 Million deduction (worth 42%*$9M = $3.78M off my taxes) + a $1 Million property.

Well, that's such an awesome deal, let's get a bunch of other people together and do it as a syndication. Let's get 10 doctors together and each of them can put $100K into the deal and get a $378K deduction for it. Meanwhile, the syndicator takes the usual hefty syndication fees for putting it all together. Then the doctors start talking in the doctors' lounge and before long WCI gets an emailed question like the one at the beginning of this post.

What if you just want to buy the tax deduction at a discount? How does that work? Well, Timothy Lindstrom describes it like this:

> *Assume that instead of donating the conservation easement himself, John transfers his farm to a limited liability company ("John's LLC"). Initially John is the only member. John sells four memberships to wealthy neighbors for $50,000 each. John and his neighbors agree (in an "operating agreement") that the income and losses of John's LLC will be allocated entirely to John and the tax deductions will be allocated entirely to the four neighbors. Upon liquidation, John will be entitled to 94% of the assets of the LLC after payment of all debts, and the neighbors will each be entitled to 1.5% of the assets. John also has the right to buy out his neighbors after three years for $3.*
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> *Thus, John gets the $200,000 paid into the LLC by the neighbors, and the neighbors each get $250,000 of the*

easement donation deduction. This saves each neighbor $99,000 in federal income taxes, a pretty good result for a $50,000 investment. John also gets to buy out his neighbors for a pittance and recover his ownership of the farm.

What has happened here? It is still simple: John has just sold a tax deduction that he can't use to other taxpayers who can. The fact that he used a limited liability company to make the transfer doesn't change what happened, or make it legitimate. It does change the applicable tax rules, however, because we are no longer dealing with an individual transferring a deduction, but the "allocation" of a deduction among members of a limited liability company….

In the case of John's LLC, the allocation of income and loss to John and the allocation of all tax benefits to the neighbors lack a business purpose and are, instead, designed to help the neighbors avoid taxes. The members' economic interest in the LLC is clearly at variance with the allocation of tax benefits. In the event of an audit, John's LLC can expect the IRS to reallocate most of the tax benefits to John in accord with economic interests of the LLC in which John, considering all of the relevant factors, has at least a 94% interest. Each member's $250,000 tax deduction will be reduced to $15,000, and his or her tax liability will be recalculated. The members will owe the additional tax, plus interest and a substantial penalty….

Lindstrom goes on about disguised sales and state tax credits:

Syndications are sometimes used to attempt to "sell" otherwise unusable charitable deductions. Syndications are also used to attempt to avoid tax on the sale of tax credits generated by conservation easement donations.

Donations made to a partnership by partners are not treated as taxable events. In other words, when John transferred his $3 million farm to John's LLC, no tax was due on the *transfer. By the same token, when assets are distributed by a partnership to its partners, the distribution (so long as it is not partnership income) is not taxable.*

Some states, such as Virginia and Colorado, grant tax credits (which are much more beneficial than deductions because they offer a dollar-for-dollar offset of tax liability) to easement donors. These credits may, depending on state law, be sold by the donor to other taxpayers (unlike deductions, which cannot be transferred). The Tax Court has ruled that such sales are taxable.

Easement donors sometimes attempt to use the favorable partnership tax rules described above to sell tax credits without paying tax on the sale. In these schemes, the easement donor "contributes" his tax credits to a partnership or other pass-through entity. Taxpayers who wish to acquire the credits pay cash into the partnership in amounts that represent the purchase price of the credits. Then the partnership allocates the credits to the purchasers and the cash to the donor. The partners argue that the transaction is not taxable. (Once again, this is a dramatic oversimplification.)

However, in several very recent Tax Court decisions these schemes have been recharacterized as "disguised sales" and taxed accordingly. In some schemes I have seen, landowners have sought to use pass-through entities to not only transfer deductions they cannot use to other taxpayers who can, but to sell tax credits without paying tax. The variations are infinite. The facilitators who sometimes create these schemes often claim six-figure fees for doing so.

No taxpayer contemplating involvement in the syndication of a conservation easement tax deduction should do so without the advice of a partnership tax expert and without the benefit of a formal tax opinion letter from that expert.

Is This Really Happening?

This can’t really be happening, can it? I mean, 9:1? Well, from the time the IRS made these listed transactions at the beginning of 2017 until July when Senator Wyden asked IRS commissioner John Koskinen what the IRS had uncovered, there were 200 required forms filed and the IRS analyzed 40 of them before [Koskinen replied]. I quote Koskinen:

> *“The average contribution deduction from this preliminary analysis was 9 times the amount of the investment in the transaction.”*

So what does the IRS intend to do about this? I quote again from Koskinen:

> *“As disclosures are filed, we are compiling the information and will use it as part of our enforcement program. Once we compile and analyze all information from the disclosures, we intend to identify the syndication transactions that pose the most compliance risk and refer them for examination.”*

What does “enforcement program” and “examination” mean? At best it means an audit, and perhaps not just of this transaction. At worst, it means jail time for tax evasion.

What Do Experts Say?

A local law professor here in Utah has made herself an expert on these transactions. Here are her thoughts on syndicated conservation easements as an investment:

> *"IRS Commissioner Koskinen's letter to Senate Finance Committee leadership confirms what many have known for a long time– most syndicated easement donation transactions are patently abusive . It would be a great disservice to federal taxpayers if Congress were to curtail the IRS's ability address these abuses….It also is important that the IRS continue its enforcement efforts with regard to conservation easement donations generally. The case law reveals persistent overvaluation of easements and many failures to comply with the deduction requirements in non-syndicated transactions. Federal taxpayers should not be expected to invest billions of dollars in easements that are overvalued or that don't actually protect land with important conservation values in perpetuity as promised."*

Most syndicated easement donation transactions are patently abusive. So if this is something you want to get into, you'd better make sure yours is one of the minority that is not abusive.

Forbes writer CPA Peter Reilly saw this coming in a 2014 blog post he entitled Conservation Easements a New Field for Villainy.

Former IRS conservation easement regulation writer and author of The Federal Tax Law of Conservation Easements, Stephen Small said the following:

> *I think the numbers in the IRS letter are staggering, and this is only the beginning of this information-gathering. These transactions are nothing but tax shelters. Some of them may possibly have some conservation benefits, although many I have seen do not, but the real goal of these deals is getting big write-offs to investors. I am very glad the IRS is finally pursuing this, and I hope they keep up the effort.*

Ike Devji who writes a lot for physicians about asset protection calls conservation easements that "tax scam that doctors sell each other."

> *Again, the issue here is not that easements are inherently illegal or abusive, at least not yet (remember, what's legal today may not be in the future). Rather, it's that they can be abused by bad planners, bad clients, and bad facts when they don't comply with the law.*

What Does the IRS Say?

Believe the IRS when they say this:

> *In recognition of our need to preserve our heritage, Congress*

allowed an income tax deduction for owners of significant property who give up certain rights of ownership to preserve their land or buildings for future generations.

The IRS has seen abuses of this tax provision that compromise the policy Congress intended to promote. We have seen taxpayers, often encouraged by promoters and armed with questionable appraisals, take inappropriately large deductions for easements. In some cases, taxpayers claim deductions when they are not entitled to any deduction at all (for example, when taxpayers fail to comply with the law and regulations governing deductions for contributions of conservation easements). Also, taxpayers have sometimes used or developed these properties in a manner inconsistent with section 501(c)(3). In other cases, the charity has allowed property owners to modify the easement or develop the land in a manner inconsistent with the easement's restrictions.

Another problem arises in connection with historic easements, particularly façade easements. Here again, some taxpayers are taking improperly large deductions. They agree not to modify the façade of their historic house and they give an easement to this effect to a charity. However, if the façade was already subject to restrictions under local zoning ordinances, the taxpayers may, in fact, be giving up nothing, or very little. A taxpayer cannot give up a right that he or she does not have.

and when they say this:

> *The Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) are aware that some promoters are syndicating conservation easement transactions that purport to give investors the opportunity to obtain charitable contribution deductions in amounts that significantly exceed the amount invested. This notice alerts taxpayers and their representatives that the transaction described in section 2 of this notice is a tax avoidance transaction and identifies this transaction, and substantially similar transactions, as listed transactions for purposes of § 1.6011-4(b)(2) of the Income Tax Regulations (Regulations) and §§ 6111 and 6112 of the Internal Revenue Code (Code). This notice also alerts persons involved with these transactions that certain responsibilities may arise from their involvement….*
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> *The Treasury Department and the IRS recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the type of transaction described in this notice. These taxpayers should take appropriate corrective action and ensure that their transactions are disclosed properly.*

As for me and my house, we'll be staying away from investing in syndicated conservation easements. We simply don't need complicated shenanigans like that to meet our financial goals. If you decide to go down this path, don't say I didn't warn you and please, please, please make sure the appraisal is truly accurate and at a minimum no more than 250% of what you invested.

What do you think? Have you participated in a syndication of a property bought in order to donate a conservation easement? What was the outcome? What was the ratio of your investment to your deduction? Comment below!