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Federal Income Taxation

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In 2021, the United States Court of Appeals for the Eleventh Circuit handed down several opinions involving U.S. federal income tax issues.[1] Two of the court's published opinions address federal income taxation of conservation easements.[2] Conservation easements have been under significant scrutiny by the Internal Revenue Service (IRS), having earned a spot on the "Dirty Dozen" list of tax scams in 2019.[3] This Article surveys the two published opinions issued in 2021 involving the U.S. federal income taxation of conservation easements.

I. Introduction: Taxation of Conservation Easements

Section 170 of the Internal Revenue Code of 1986 (the Code), was amended in 1980 to provide tax benefits in the form of a charitable contribution deduction for property owners who enter conservation easements.[4] Congress established this tax benefit to aid in preserving the nation's rich cultural heritage and vast natural resources at the risk of providing an opportunity for taxpayer abuse.[5]

A taxpayer is entitled to a charitable contribution deduction upon making a qualified conservation contribution.[6] A qualified conservation contribution is the donation (1) of a "qualified real property interest"; (2) to a "qualified organization"; (3) that is made exclusively for a

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1. For an analysis of the court's cases involving U.S. federal income taxation during the prior Survey period, *see* Nikolai Karetnyi & Ruoxi Zhang, *Federal Income Taxation, 11th Circuit Survey*, 72 MERCER L. REV. 1185 (2021).

2. TOT Prop. Holdings, LLC v. Comm'r (*TOT Prop. Holdings II*), 1 F.4th 1354 (11th Cir. 2021); Hewitt v. Comm'r, 21 F.4th 1336 (11th Cir. 2021).

3. I.R.S. News Release IR-2019-182 (Nov. 12, 2019).

4. S. REP. NO. 96-1007, at 9–10 (1980).

5. *Id.*

6. I.R.C. §§ 170(f)(3)(B)(iii), (h)(1).

conservation purpose; and (4) for which the conservation purpose is protected in perpetuity.[7]

First, a "qualified real property interest" may be an entire interest in real property—excluding mineral rights, a remainder interest in real property, or a restriction on the use of real property granted in perpetuity.[8] For a real property restriction to be enforceable in perpetuity, the donor must have a legally enforceable vested right in the property and the restriction must prevent the donor from using the property in a manner inconsistent with the restriction's conservation purpose.[9] Restrictions that expire are insufficient and will disqualify the conservation contribution as a charitable deduction.[10] However, restrictions which can only be defeated by remote contingencies unlikely to occur are considered to be "granted in perpetuity."[11]

Second, under section 170(h) of the Code, a qualified organization may be a governmental unit, [12] an entity receiving substantially all of its support from a governmental unit,[13] certain organizations described in section 501(c)(3) of the Code,[14] or organizations controlled by certain organizations described in section 501(c)(3) of the Code.[15] An organization described in section 501(c)(3) of the Code is a qualified organization if (1) more than one-third of such organization's annual revenue normally consists of more than one-third of its annual support from contributions, grants, charitable gifts, membership fees, and revenues from the performance of its exempt purposes;[16] and (2) not

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7. *Id.* at (h)(1).
8. *Id.* at (h)(2).
9. Treas. Reg. § 1.170A-14(g)(1) (2022).
10. *See id.*
11. Treas. Reg. §§ 1.170A-14(b)(2), (g)(3) (2022).
12. I.R.C. §§ 170(b)(1)(A)(v)–(vi), (h)(3)(A).
13. *Id.*
14. I.R.C. § (h)(3)(B).
15. *Id.* An organization described in section 501(c)(3) of the Code qualifies if it is:

> [O]rganized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation . . . and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

I.R.C. § 501(c)(3).

16. I.R.C. § 170(h)(3)(B)(i) (citing I.R.C. § 509(a)(2)(A)).

more than one-third of such organization's annual support comes from investment income and unrelated business taxable income.[17]

Next, a qualifying conservation contribution must be made exclusively for conservation purposes. Conservation purposes may include: preservation of land for recreational or educational use by the general public; protection of habitats for wildlife; protection of ecosystems; preservation of open space for the scenic enjoyment of the public pursuant to government conservation plans; or the preservation of certain historically important land or structures.[18]

Finally, the property's conservation purpose must be "protected in perpetuity" for a contribution to be deemed exclusively for conservation purposes.[19] The statute does not define what it means for a conservation purpose to be protected in perpetuity.[20] In the absence of statutory guidance, the IRS issued regulations outlining what may meet this requirement. Generally, taxpayers may satisfy this requirement by providing the donee with a legally enforceable right to prohibit the use of the property in a manner inconsistent with the conservation purpose.[21]

In its regulations, the IRS recognized that circumstances could arise that may justify extinguishment of a restriction, or that parties may simply change their mind and wish to terminate the restriction.[22] To address this concern, the regulations allow a restriction to be terminated by a judicial proceeding and to still be treated as protected in perpetuity if: (1) the proceeds of any subsequent sale, exchange, or condemnation "of the property are used by the donee organization in a manner consistent with the conservation purposes of the original contribution";[23] and (2) the parties agree at the time the restriction is granted that the donee will be entitled to a portion of any proceeds from the eventual sale, exchange, or conversion of the property.[24] The amount owed to the donee is the same proportion that the restriction's fair market value bears to the unencumbered fair market value of the

17. *Id.* Unrelated business taxable income generally consists of income from activities which are not substantially related to the performance of an organization's tax-exempt purpose. I.R.C. § 513(a).

18. I.R.C. § 170(h)(4).

19. I.R.C. § 170(h)(5)(A).

20. *Id.*

21. Treas. Reg. § 1.170A-14(g)(1).

22. *Id.*

23. *Id.* at (g)(6)(i).

24. *Id.* at (g)(6)(ii).

property.[25] This regulation is the subject of the cases examined in the Article below.

II. TOT PROPERTY HOLDINGS, LLC V. COMMISSIONER

A. Factual Background

George R. Dixon purchased 2,602 acres of undeveloped real estate in rural Van Buren County, Tennessee, for approximately $1.9 million in 2005.[26] Three years later, Dixon transferred 652 of those acres to two limited liability companies that he controlled. The transferred acreage accounted for approximately $486,000 of the original purchase. In November 2013, the same 652 acres were transferred from Dixon's two limited liability companies to TOT Property Holdings, LLC (Taxpayer).[27]

After the November 2013 transfer, Taxpayer's total assets included the 652 acres of real property and $100 cash.[28] On December 10, 2013, PES Fund VI, LLC purchased a 98.99% ownership interest in Taxpayer in exchange for $717,200 in cash and assumed the seller's obligations to make $322,000 in capital contributions to the Taxpayer, for a total purchase price of $1,039,200 (the PES Transaction).[29]

A few weeks later, on December 27, 2013, Taxpayer executed a deed (the Deed) that granted a conservation easement on nearly the entire property to Foothills Land Conservancy (Foothills).[30] Section 9.1 of the Deed contained a provision concerning extinguishment of the easement, providing that the easement could only be terminated by appropriate judicial proceedings. If the easement was terminated, Foothills would be entitled to a portion of the proceeds from any termination proceeding "as determined in accordance with Section 9.2 [of the Deed] or 26 C.F.R. Section 1.170A-14, if different."[31]

Section 9.2 of the Deed prescribed a formula for valuation of the easement in the event of termination.[32] The formula provides that the value of the easement at the time of extinguishment is calculated by:

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25. *Id.*
26. *TOT Prop. Holdings II*, 1 F.4th at 1357.
27. *Id.* at 1357–58.
28. *Id.* at 1358.
29. *Id.*
30. *Id.*
31. *Id.*
32. *Id.*

> [M]ultiplying (a) the fair market value of the Property unencumbered by this Easement (minus any increase in value after the date of this grant attributable to improvements) by (b) a fraction, the numerator of which is the value of this Easement at the time of the grant and the denominator of which is the value of the Property without deduction of the value of this Easement at the time of this grant.[33]

Section 9.2 of the Deed concluded with a statement that the parties "intended that this Section 9.2 be interpreted to adhere to and be consistent with 26 C.F.R. Section 1.170A-14(g)(6)(ii)."[34] In effect, this formula subtracts any increase in value attributable to improvements from any extinguishment proceeds. The reduced value would then be multiplied by the defined fraction. As a result, the portion of the extinguishment proceeds that Foothills would receive equals the easement's proportionate value of the unencumbered property at the time of the grant.[35]

On its partnership tax return for the taxable period ending on December 31, 2013, Taxpayer reported a charitable contribution via conservation easement of $6.9 million.[36] Upon examination, the IRS determined that the easement did not qualify for the claimed charitable contribution deduction and assessed accuracy-related penalties. The IRS sent the Taxpayer a copy of the revenue agent's report and a transmittal letter signed by the examining agent's immediate supervisor, an IRS group manager. That letter stated that the "[revenue agent's] report explains all proposed adjustments including facts, law, and conclusion."[37] Approximately two months later, the IRS group manager who signed the transmittal letter signed a form approving the civil penalties recommended in the revenue agent's report.[38]

The "IRS issued a notice of final partnership administrative adjustment" (FPAA) to Taxpayer in January 2017, disallowing the conservation easement deduction and assessing accuracy-related penalties under section 6662 of the Code.[39] The deduction was disallowed due to Taxpayer's failure to establish that the deduction met the statutory requirements or that the value of the deduction was correct as claimed.[40] Taxpayer timely challenged the FPAA by filing a

33. *Id.* at 1358–59.
34. *Id.* at 1359.
35. *Id.*
36. *Id.*
37. *Id.*
38. *Id.* at 1359–60.
39. *Id.* at 1360.
40. *Id.*

petition in the tax court (the tax court case name is the same as the Eleventh Circuit case name).[41] The tax court decided three main issues, holding for the IRS on all three.[42]

B. Did the Conservation Easement Protect the Conservation Purpose in Perpetuity?

First, the tax court determined that the valuation formula in section 9.2 of the Deed was inconsistent with regulatory requirements and that the language in the deed attempting to substitute the preferred formula with regulatory language was an unenforceable "condition subsequent savings clause."[43] Thus, according to the tax court, the IRS properly denied the deduction for charitable contribution of the conservation easement because the Deed did not protect the conservation purpose in perpetuity, as required by section 170(h)(5) of the Code.[44]

The Eleventh Circuit began by considering whether the tax court properly determined that the Deed did not protect the conservation purpose of the easement in perpetuity, as required by section 170(h)(5) of the Code.[45] The court first examined whether the allocation formula in the Deed differed from allocations provided in the Treasury Regulations.[46] Although the Code is silent as to what it means for a conservation purpose to be protected in perpetuity, the Treasury Regulations provide guidance by addressing the possibility of unexpected changes to a property that might undermine its conservation purpose and establishes specific requirements that must be included in the property's deed.[47]

The regulations require that the donee receive a vested, legally enforceable property right "with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction at the time of the gift, bears to the value of the property as a whole at that time"; and that the donee "must be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction" upon the sale, exchange, or involuntary conversion of the property which extinguishes the easement.[48] The

41. *Id.*; TOT Prop. Holdings, LLC v. Comm'r (*TOT Prop. Holdings I*), No. 5600-17, 2019 WL 11880554, at *3 (T.C. Nov. 22, 2019).

42. *TOT Prop. Holdings II*, 1 F.4th at 1360.

43. *TOT Prop. Holdings I*, 2019 WL 11880554 at *4–6.

44. *Id.* at *6.

45. *TOT Prop. Holdings II*, 1 F.4th at 1362.

46. *Id.*

47. *Id.*

48. *Id.* (quoting Treas. Reg. § 1.170A-14(g)(6)(i) to (ii)).

court determined that the regulations do not permit any reductions for the value of improvements such as those contained in the Deed.[49] Following an examination of recent case law, the court noted that other courts had reached the same conclusion.[50] Accordingly, the court concluded that the formula in the Deed did not comply with regulatory requirements.[51]

Taxpayer argued that any contradictory language in the Deed was overridden by the regulation, pointing to the language of sections 9.1 and 9.2 of the Deed.[52] According to Taxpayer, these provisions were interpretive and required the Deed to be construed so that it complied with the regulations.[53]

In addressing Taxpayer's argument, the court discussed the difference between interpretive provisions and "condition[s] subsequent savings clauses."[54] Condition subsequent savings clauses "seek to 'recharacterize the nature of the transaction in the event of a future' occurrence [and] 'will be disregarded for federal tax purposes.'"[55] Conversely, interpretive clauses will be upheld because they simply help illustrate and are not dependent upon subsequent adverse action before being operative.[56]

The court discussed two Fourth Circuit cases it found helpful in determining whether clauses are valid interpretive provisions or invalid savings clauses.[57] In *Belk v. Commissioner*,[58] the taxpayers challenged the disallowance of a deduction for a conservation easement.[59] The deed granting the easement contained a clause stating that the donee "shall have no right or power to agree to any amendments . . . that would result in this Conservation Easement failing to qualify . . . as a qualified conservation contribution under Section 170(h) of the Internal Revenue

49. *Id.* at 1363.

50. *Id.* at 1363–64 (discussing PPBM-Rose Hill, Ltd. v. Comm'r, 900 F.3d 193 (5th Cir. 2018); then Coal Prop. Holdings, LLC v. Comm'r, 153 T.C. 126 (2019)).

51. *Id.* at 1366.

52. *Id.* at 1364. Recall, that section 9.1 of the Deed provides that Treasury Regulation 1.170A-14 would apply in determining Foothill's share of extinguishment proceeds, rather than section 9.2 of the Deed, "if different." *Id.* at 1359. Also recall the language in section 9.2 of the Deed states that the parties intended for that section to be consistent with Treasury Regulation Section 1.170A-14(g)(6)(ii). *Id.* at 1359.

53. *Id.* at 1364.

54. *Id.* at 1364–65 (citing Belk v. Comm'r, 774 F.3d 221, 229 (4th Cir. 2014)).

55. *Id.* at 1364 (quoting *Belk*, 774 F.3d at 229).

56. *Id.* (citing *Belk*, 774 F.3d at 230).

57. *Id.* at 1365–66.

58. 774 F.3d 221 (4th Cir. 2014).

59. *Id.* at 228.

Code and applicable regulations."[60] The taxpayers in that case argued that this clause ensured regulatory compliance, notwithstanding actual noncompliance with section 170(h)(2)(C) of the Code.[61]

The Fourth Circuit held that the clause was unenforceable because its operation depended on a future occurrence, effectively asking the court to void the offending language and preserve the tax benefit absent any interpretive question in need of clarification.[62] According to the Fourth Circuit, applying the savings clause would "hamper the [IRS's] enforcement power," leading to tax collection "grind[ing] to a halt."[63]

In the second case, *Commissioner v. Procter*,[64] the Fourth Circuit considered whether language in a trust indenture was effective to avoid the possibility of gift tax.[65] In that case, the applicable trust instrument stated:

> [I]n the event it should be determined by final judgment or order of a competent federal court of last resort that any part of the transfer in trust hereunder is subject to gift tax, it is agreed by all the parties hereto that in that event the excess property hereby transferred which is decreed by such court to be subject to gift tax, shall automatically be deemed not to be included in the conveyance in trust hereunder and shall remain the sole property of Frederic W. Procter free from the trust hereby created.[66]

The Fourth Circuit reversed the decision of the tax court, holding that the clause was invalid.[67] According to the Fourth Circuit, "condition[s] which involve[] [that] sort of trifling with the judicial process cannot be sustained."[68] If the clause were to be enforced, it would discourage tax collection because attempts to collect the tax would result in the tax being defeated—a lose-lose for the government.[69] Accordingly, such a condition subsequent was contrary to public policy and would not be enforced.[70]

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60. *Id.*
61. *Id.* at 228–29.
62. *Id.* at 229.
63. *Id.* at 230.
64. 142 F.2d 824 (4th Cir. 1944).
65. *Id.* at 825–26.
66. *Id.* at 827.
67. *Id.* at 828.
68. *Id.* at 827.
69. *Id.*
70. *Id.*

In addition to the cases reviewed from the Fourth Circuit, the Eleventh Circuit noted that the tax court had also refused to enforce such savings clauses.[71] Indeed, when confronted with nearly identical language in a deed just two years earlier, the tax court refused to enforce a savings clause which would have replaced deficient language with the regulatory provisions, thereby preserving a tax benefit.[72]

Armed with these cases, the Eleventh Circuit proceeded to uphold the tax court's determination that the savings clause was unenforceable.[73] The formula in section 9.2 of the Deed was clear, unambiguously providing that the value attributable to improvements will be subtracted from extinguishment proceeds before allocating such proceeds to the donee.[74] Thus, there was no ambiguity to interpret.[75] Absent any ambiguity, the clause's only function was to nullify the deficient language and although the clause contemplated application of the regulatory language, the regulatory language would only apply if it is "different" from the preferred formula—an "impermissibl[e] 'countermand [to] the plain text of the [] deed.'"[76] Moreover, the regulatory formula only applied if the IRS or a court subsequently determined that the preferred formula was deficient, thereby preventing Foothills's property right from being "immediately vested" as required by the regulation.[77] Accordingly, the court affirmed the tax court's decision upholding the IRS's disallowance of Taxpayer's charitable contribution deduction.[78]

C. Was the Tax Court's Valuation of the Easement Clearly Erroneous?

After upholding the tax court's determination that the Deed did not satisfy the requirements to preserve the conservation purpose of the easement in perpetuity, the Eleventh Circuit proceeded to address Taxpayer's argument that the tax court's valuation of the easement was clearly erroneous.[79] Taxpayers generally are liable for an accuracy-related penalty if certain valuation misstatements result in an underpayment of federal income tax.[80] If a valuation is 150% or more of

71. *TOT Prop. Holdings II*, 1 F.4th at 1366.
72. *Coal Prop. Holdings, LLC*, 153 T.C. at 144.
73. *TOT Prop. Holdings II*, 1 F.4th at 1374.
74. *Id.*at 1367.
75. *Id.*
76. *Id.* (quoting *Coal Prop. Holdings, LLC*, 153 T.C. at 141).
77. *Id.*
78. *Id.*at 1368.
79. *Id.*
80. I.R.C. §§ 6662(a), (b)(3).

the correct value, the misstatement is a "substantial valuation misstatement" and will result in assessment of a 20% accuracy-related penalty.[81] If the valuation is 200% or more of the correct value, the misstatement is a "gross valuation misstatement[]," which results in an assessment of a 40% accuracy-related penalty.[82]

Because it was confronted with a challenge to an IRS accuracy-related penalty assessment, the tax court had to determine the correct value of the easement, which is generally a mixed question of fact and law.[83] However, on appeal, Taxpayer challenged only the tax court's factual determinations.[84] Thus, the Eleventh Circuit's review was limited to whether the valuation was clearly erroneous. Specifically, the court had to determine whether the tax court's determination of the property's highest and best use before donation was clearly erroneous.[85]

Both parties submitted expert evidence regarding the valuation of the easement and its highest and best use before donation.[86] Taxpayer's expert determined that the pre-donation highest and best use of the property was as for "low density destination mountain resort residential development" and was valued at $3,913,000.[87] Post-donation the highest and best use was for recreation and timber revenue worth $1,181,000. [88] This resulted in a fair market value of $2,732,000 for the easement.[89] The IRS's expert determined that the property's highest

81. I.R.C. §§ 6662(a), (e)(1)(A).

82. I.R.C. §§ 6662(h)(1), (h)(2)(A)(i).

83. Palmer Ranch Holdings Ltd. v. Comm'r, 812 F.3d 982, 994 (11th Cir. 2016).

84. *TOT Prop. Holdings II*, 1 F.4th at 1369.

85. *Id.* at 1370. Taxpayer's challenge was limited to the pre donation value of the easement. *Id.*

86. *Id.* at 1370–71. When determining the fair market value of a conservation easement in the absence of comparable market sales, the "before-and-after" method of valuation is generally used. Treas. Reg. § 1.170A-14(h)(3)(i). This method determines the fair market value of the easement by comparing the "difference between the fair market value of the property pre and post encumbrance" based on the highest and best use of the property in each instance. Pine Mtn. Pres. v. Comm'r, 978 F.3d 1200, 1211 (11th Cir. 2020). The highest and best use of a property is one that is a "reasonable and probable use that supports the highest present value," focused on "the highest and most profitable use for which the property is adaptable and needed or likely to be needed in the reasonably near future." *TOT Prop. Holdings II*, 1 F.4th at 1369 (quoting *Palmer Ranch*, 812 F.3d at 987 (quoting Symington v. Comm'r, 87 T.C. 892, 897 (1986))). When the parties propose different uses, courts consider chances that the property will achieve the proposed use in the near future, the risk of the use, and hypothetical buyers' willingness to pay. *Id.* at 1369–70 (citing *Palmer Ranch*, 812 F.3d at 1000).

87. *TOT Prop. Holdings I,* 2019 WL 11880554 at *7.

88. *TOT Prop. Holdings II*, 1 F.4th at 1368.

89. *Id.*

and best use both before and after donation was for recreation and timber revenue and that the pre and post-donation values were $1,128,000 and $632,000, respectively, representing a fair market value of $496,000 for the easement.[90]

The tax court found the IRS expert more credible, characterizing some of the conclusions presented by Taxpayer's expert as improbable.[91] The tax court also noted that other evidence, particularly the PES Transaction—of which the IRS expert was not aware—corroborated the IRS expert's conclusions.[92] Accordingly, the tax court adopted the IRS's valuation and upheld the assessment of accuracy-related penalties.[93]

The court concluded that the tax court's valuation was not clearly erroneous.[94] First, the PES Transaction provided overwhelming support for the tax court's valuation.[95] The IRS's expert had no knowledge of the PES Transaction, yet his valuation was only $78,297 greater than the value implied in the PES Transaction.[96] In contrast, Taxpayer's expert valued the property $2,863,297 higher than the value implied in the PES Transaction. Neither party challenged the PES Transaction as being other than an arm's-length sale.[97] Thus, the existence of an arm's-length sale only seventeen days before the donation of the conservation easement provided strong support for both the highest and best use and the dollar valuation.[98]

Additionally, the property was located in an undeveloped rural area.[99] The property lacked mountains and large bodies of water, containing only two streams which were frequently dry. There was no hospital in the county, the nearest highway was over thirty miles away, and the property did not have public water access. Moreover, other proposed developments in the area had failed. This evidence led the tax court to determine that Taxpayer's proposed highest and best use as a low-density mountain resort was "highly unlikely."[100] The Eleventh Circuit agreed, noting that "ample evidence" supported the tax court's findings and that Taxpayer "fail[ed] woefully to demonstrate clear

90. *TOT Prop. Holdings I*, 2019 WL 11880554 at *6.
91. *Id.* at *8–9.
92. *Id.* at *8.
93. *Id.* at *11.
94. *TOT Prop. Holdings II*, 1 F.4th at 1368.
95. *Id.* at 1371.
96. *Id.* at 1370.
97. *Id.* at 1371.
98. *Id.*
99. *Id.* at 1370.
100. *Id.*

error."[101] Accordingly, the Eleventh Circuit concluded that the tax court's valuation was not clearly erroneous and that the tax court appropriately upheld the imposition of accuracy-related penalties.[102]

D. Did the Supervisor's Cover Letter Satisfy the Supervisory Approval Requirement?

Finally, the court addressed Taxpayer's argument that the IRS failed to comply with the approval requirements for the imposition of penalties.[103] Under section 6751 of the Code,[104] the IRS cannot assess a penalty absent written approval of the recommending individual's immediate supervisor, or such appropriately designated superior officers. No particular form is required; rather, all that the statute requires is that the assessment be approved (1) in writing and (2) by a manager—namely, the recommending individual's immediate supervisor or higher.[105]

The tax court concluded that the transmittal letter accompanying the revenue agent's report satisfied the approval requirement, and the Eleventh Circuit agreed.[106] The transmittal letter stated that a copy of the revenue agent's report was enclosed and that "the report [contains] all proposed adjustments including facts, law, and conclusion," and the revenue agent's supervisor signed the transmittal letter.[107] The reasonable inference here was that the supervisor who signed the letter approved the adjustments and penalties proposed in the report.[108] Taxpayer could point to no caselaw in support of its argument that the transmittal letter was insufficient or that alternative documentation was required.[109] Accordingly, the Eleventh Circuit affirmed the tax court's decision on this issue.[110]

E. Conclusion

The court's decision in *TOT Property Holdings* provides a preview of what participants in conservation easement transactions can expect to

101. *Id.* at 1371.
102. *Id.* at 1372.
103. *Id.*
104. I.R.C. § 6751(b)(1).
105. *Id.*; *see also PBBM-Rose Hill*, 900 F.3d at 213.
106. *TOT Prop. Holdings II*, 1 F.4th at 1372.
107. *Id.* (alteration in original).
108. *Id.* at 1372–73.
109. *Id.* at 1373.
110. *Id.* at 1374.

experience. The IRS will examine these transactions with close scrutiny, seeking to strictly apply the law.[111] The court has demonstrated a commitment to narrow construction of the conservation easement provisions, so taxpayers should expect little wiggle room in these transactions. Although it remains to be seen how the conservation easement arena will play out,[112] taxpayers can expect this outcome to embolden the IRS in its efforts to combat attempted abuses.

III. HEWITT V. COMMISSIONER

In *Hewitt v. Commissioner*,[113] the Eleventh Circuit was again called upon to determine whether the tax court properly denied taxpayers' deductions arising from donation of a conservation easement.[114] Given that the same regulation at issue in *TOT Prop. Holdings II* had a major role in this case, one would have expected a similar result. This time, however, the taxpayers challenged the validity of the applicable regulation.[115] Concluding that the regulation was invalid, the Eleventh Circuit reversed the tax court and remanded the case for further proceedings.[116]

A. Factual Background

David and Tammy Hewitt were residents of Randolph County, Alabama.[117] Beginning in 1997, David Hewitt acquired approximately 232 acres of his family's farmland from his sister in a series of three transactions. In 2001, David acquired an additional 25 acres of land adjacent to the acres acquired from his sister. David used a portion of these 257 acres (the Property), the total acreage, as a cattle ranch. The remainder of the Property consisted of wooded areas with steep terrain. On December 28, 2012, David donated an easement on the Property to Pelican Coast Conservancy, Inc. The deed granting such easement contained restrictions aimed at forever retaining the Property "predominately in its natural condition," but the Hewitts were permitted to construct certain improvements on the Property.[118]

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111. *See generally TOT Prop. Holdings II*, 1 F.4th 1354.
112. *See infra* Part III.
113. 21 F.4th 1336 (11th Cir. 2021).
114. *Id.* at 1338.
115. *Id.* at 1338–39.
116. *Id.* at 1353.
117. *Id.* at 1339.
118. *Id.* at 1339–40.

The deed contained a section governing judicial extinguishment of the easement.[119] Section 15.1 of the deed provided that the easement could only be extinguished by appropriate judicial proceedings. If the easement was appropriately terminated, the donee was entitled to receive a portion of the extinguishment proceeds "at least equal to the perpetual conservation restriction's proportionate value," which was to be determined according to section 15.2.[120] Section 15.2 of the deed stated that the donee's share of the extinguishment proceeds was to be calculated by subtracting out the value attributable to improvements, then multiplying the reduced amount by the ratio of the easement's value at the time of the grant to the unencumbered Property value at the time of the grant.[121]

On their jointly filed federal income tax return for tax year 2012, the Hewitts reported a charitable contribution deduction for donation of the easement totaling $2.788 million.[122] Due to limitations on charitable contribution deductions,[123] only a portion of the $2.788 million deduction was properly deductible in tax year 2012.[124] The remaining balance was to be carried forward and deducted in tax years 2013 and 2014, as appropriate.[125] The Hewitts' returns were selected for examination. In August 2017, the IRS issued a statutory notice of deficiency disallowing the claimed charitable contribution deduction for tax years 2012, 2013, and 2014, as well as assessing accuracy-related penalties under section 6662 of the Code.[126]

The Hewitts timely petitioned the tax court, challenging the disallowance of the charitable contribution deductions related to the donation of the easement.[127] In the tax court proceedings, the Commissioner argued that the deed granting the easement did not comply with the requirements of Treasury Regulation § 1.170A-14(g)(6) (the Extinguishment Regulation), because the formula in section 15.2 of the deed provided for subtracting the value of improvements when

119. *Id.* at 1340.
120. *Id.*
121. *Id.*
122. *Id.* at 1340–41.
123. I.R.C. § 170(b)(1)(E)(i).
124. *Hewitt*, 21 F.4th at 1340–41.
125. *Id.* at 1341.
126. *Id.*; I.R.C. § 6662.
127. *Hewitt*, 21 F.4th at 1341.

allocating extinguishment proceeds to the donee.[128] The Hewitts argued that the Extinguishment Regulation was invalid.[129]

The tax court upheld the Commissioner's disallowance of the Hewitts' charitable contribution deductions.[130] It explained that the Extinguishment Regulation does not permit for the value of post-donation improvements to be subtracted when allocating extinguishment proceeds to the donee.[131] Thus, the court quickly determined that the requirements for a deduction were not satisfied because section 15.2 of the deed provided for subtraction of the value of post-donation improvements before determining the donee's share of extinguishment proceeds.[132] Moving on to the validity of the Extinguishment Regulation, the tax court rejected the Hewitts' challenge.[133]

B. Was the Extinguishment Regulation Arbitrary and Capricious for Failing to Comply with the Administrative Procedure Act Procedural Requirements?

Because the tax court found that the Hewitts were not liable for accuracy-related penalties,[134] the sole issue before the Eleventh Circuit was the validity of the Extinguishment Regulation. [135] The Hewitts argued that the U.S. Department of Treasury (Treasury) received significant comments in response to its proposed version of the Extinguishment Regulation, and that the Treasury's failure to respond to those comments rendered the Extinguishment Regulation invalid. The Commissioner asserted that none of the comments mentioned by the Hewitts were significant and the Treasury was not required to respond because those comments did not "cast[] doubt on the regulation's reasonableness."[136]

After giving a brief primer on the Administrative Procedure Act (APA),[137] the court began by examining the history of the

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128. *Id.*

129. *Id.*

130. *Hewitt v. Comm'r*, 119 T.C.M. (CCH) 1593, T.C. Memo. 2020-89, at *14–15 (2020).

131. *Id.* at *14.

132. *Id.*

133. *Id.* at *24.

134. *Id.* at *44.

135. *Hewitt*, 21 F.4th at 1347.

136. *Id.*

137. *Id.* at 1342–43. The APA generally requires that federal agencies follow prescribed procedures when issuing regulations that have the force and effect of law. 5 U.S.C. § 551. Agencies must first publish a "notice of proposed rulemaking," generally in the Federal Register. *Hewitt*, 21 F.4th at 1342 (citing Perez v. Mortg. Bankers Ass'n, 575

Extinguishment Regulation. The Treasury proposed the Extinguishment Regulation on May 23, 1983.[138] The Treasury received comments from ninety organizations and individuals through more than 700 pages of commentary.[139] Of the ninety commenters, thirteen commented on the proposed extinguishment provisions.[140]

The most detailed comment came from the New York Landmarks Conservancy (NYLC).[141] NYLC urged the Treasury to scrap the extinguishment proceeds regulation altogether. Specifically, NYLC claimed that it would thwart the congressional intent behind section 170(h) of the Code by discouraging charitable donations of easements and noting that the remote possibility of extinguishment rendered the proposed language unnecessary. NYLC also expressly commented on the issue of whether the value of post-donation improvements should be considered when allocating extinguishment proceeds to the donee. NYLC observed that the proposed language contemplates that the ratio value used in the allocation formula will remain fixed forever. Accordingly, this language ignores an appropriate circumstance for modification of the ratio. NYLC presented mathematical examples illustrating how the proposed language "would obviously be undesirable to the prospective donor and would constitute a windfall to the donee organization."[142]

Although NYLC's comment was the most extensive—and the only comment to address the post-donation improvement language adopted in section 1.170A-14(g)(6)(ii)—several other commenters expressed

U.S. 92, 96 (2015)). After giving notice, the agency must provide the public with an opportunity to provide comments to the rule by submitting written data, arguments, and other responses. *Mortg. Bankers Ass'n*, 575 U.S. at 96. The agency must consider the comments received, and significant comments require an agency response. *Id.* Finally, the agency must provide a concise statement of the basis for the rule and its purpose when promulgating the final rule. *Id.* This statement must provide enough detail to "enable the reviewing court to see the objections and why the agency reacted to them as it did." *Hewitt*, 21 F.4th at 1342 (quoting Lloyd Noland Hosp. & Clinic v. Heckler, 762 F.2d 1561, 1566 (11th Cir. 1985)). Together, this rulemaking framework provides "'affected parties fair warning of potential changes in the law and an opportunity to be heard on those changes' while 'affording the agency a chance to avoid errors and make a more informed decision.'" *Id.* at 1343 (quoting Azar v. Allina Health Servs., 139 S. Ct. 1804, 1816 (2019)) (alteration in original).

138. *Hewitt*, 21 F.4th at 1343 (citing Qualified Conservation Contribution; Proposed Rulemaking, 48 Fed. Reg. 22940 (May 23, 1983)).

139. *Id.* at 1345.

140. *Id.*

141. *Id.*

142. *Id.*

concern with the proposed proceeds regulation.[143] These comments ranged from warnings that the regulations would "create a potential disincentive to the donation of easements," to concerns that the regulations would "unnecessarily restrict" the amounts payable to charitable easement holders.[144]

In total, seven commenters either criticized or urged caution with respect to the proposed extinguishment regulations.[145] Although the preamble to the final regulations stated that the Treasury had "considered . . . all comments regarding the proposed amendments," the final rule did not discuss or respond to the NYLC or other commenters concerning the extinguishment proceeds regulation.[146]

The Eleventh Circuit then proceeded to discuss the tax court's decision in *Oakbrook Land Holdings, LLC v. Commissioner*,[147] which the tax court relied heavily upon in rejecting the Hewitt's arguments regarding the validity of the Extinguishment Regulation.[148] In *Oakbrook*, the tax court considered a similar challenge to the validity of the Extinguishment Regulation.[149] There, the tax court found the Treasury's statement in the preamble that it considered all comments to be sufficient evidence that the relevant matters were appropriately considered.[150] The tax court characterized NYLC's comments as a "supposition that [the] Treasury may reasonably have discounted," pointing out that NYLC did not offer a proposed alternative rule and that its comment specifically addressing post-donation improvements only accounted for one paragraph out of more than 700 pages of written commentary received.[151] According to the tax court, the broad purpose statements in the preamble to the final regulations were sufficient to allow the court to "obvious[ly]" infer the reason for the Treasury's actions.[152]

The *Oakbrook* decision, however, was not unanimous. [153] In an opinion concurring in the result, Judge Toro found that the Treasury failed to respond to all significant comments received in the rulemaking

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143. *Id.* at 1345–46.
144. *Id.* at 1346.
145. *Id.* at 1345–46.
146. *Id.* at 1346.
147. 154 T.C. 180 (2020).
148. *Hewitt*, 21 F.4th at 1347 (citing *Oakbrook*, 154 T.C. at 192).
149. *Oakbrook*, 154 T.C. at 193.
150. *Id.* at 191–92.
151. *Id.* at 192–93.
152. *Id.* at 194–95.
153. *Id.* at 223 (Toro, J., concurring).

process. He noted that the Treasury's response to comments received required only two pages in the Federal Register despite receiving more than 700 total pages of comments.[154] Judge Toro also stated that NYLC's comments expressly addressing specific proposed language and detailing how the purpose of the statute would be thwarted by that language were significant because they "'challenge[d] a fundamental premise' underlying the proposed [regulation]."[155] Similarly, Judge Holmes found the Treasury's explanation to be inadequate, noting that agency responses with even greater detail have been deemed invalid.[156]

Upon consideration of the agency record, the tax court's decision in *Oakbrook*, and various other precedent, the Eleventh Circuit concluded that the Extinguishment Regulation was rendered invalid as an arbitrary and capricious agency action because the Treasury failed to respond to significant comments in the final rule.[157] In doing so, the court found its decision in *Lloyd Noland Hospital and Clinic v. Heckler*[158] to be instructive.[159]

In *Lloyd Noland*, the plaintiff argued that a regulation promulgated by the Department of Health and Human Services (HHS) was invalid because HHS failed to respond to comments questioning the reliability of a study upon which HHS relied in promulgating the regulation.[160] The court held that HHS's broad purpose statements in the rule's preamble were insufficient, explaining that such statements must provide enough detail for a reviewing court to understand why the agency responded the way it did.[161]

The court quickly concluded that the NYLC's comment to the proposed Extinguishment Regulation was significant.[162] NYLC's comments noted that the proposed regulation would thwart congressional intent and actually discourage donations. The comments also presented mathematical evidence demonstrating that the proposed extinguishment proceeds formula would "obviously be undesirable to the prospective donor and would constitute a windfall to the donee

154. *Id.* at 221 (Toro, J., concurring).

155. *Id.* at 216 (Toro, J., concurring) (quoting MCI WorldCom, Inc. v. FFCC, 209 F.3d 760, 765 (D.C. Cir. 2000)).

156. *Id.* at 245–48 (Holmes, J., dissenting) (discussing Dominion Res., Inc. v. United States, 681 F.3d 1313, 1319 (Fed. Cir. 2012)).

157. *Hewitt*, 21 F.4th at 1349–50.

158. 762 F.2d 1561 (11th Cir. 1985).

159. *Hewitt*, 21 F.4th at 1350.

160. *Id.* (citing *Lloyd Noland*, 762 F.2d at 1563).

161. *Id.* (citing *Lloyd Noland*, 762 F.2d at 1566).

162. *Id.* at 1351.

organization."[163] This comment challenged the fundamental premise of the proposed regulation, thereby requiring a response from the Treasury. In rejecting the Commissioner's argument that the comments were not significant because they did not "cast doubt on the reasonableness of the [regulation]," the court observed that NYLC's comments warned that the proposed extinguishment proceeds language would discourage the very donations that Congress sought to encourage when enacting section 170(h) of the Code.[164] By highlighting how the proposed regulations would counteract the congressional intent, which was purportedly "reflected" in the final regulations, NYLC did, in fact, cast doubt upon the reasonableness of the regulation.[165]

Additionally, the court rejected the Commissioner's final argument that the statement in the preamble that "all comments" had been considered coupled with some minor revisions to the proceeds language was sufficient and concluded that the revision did not "provide any indication that [the] Treasury was responding to NYLC's significant comment about the post-donation improvements issue."[166]

C. Conclusion

Hewitt is an interesting plot twist in the conservation easement saga. Given the Treasury's historical position that its regulations were merely interpretive and, therefore, outside the scope of the APA,[167] it is possible that more Treasury Regulations could be susceptible to challenge. Will *Hewitt* serve as an invitation for future taxpayer attacks on Treasury Regulations? Or will it merely embolden participants in conservation easement transactions?

IV. CONCLUSION

Because the Code was amended to allow charitable contribution deductions for qualified conservation contributions, Congress was aware that the conservation easements presented the potential for

163. *Id.*
164. *Id.* at 1351–53.
165. *Id.* at 1352.
166. *Id.* at 1353.
167. *Id.* at 1346–47 ("[A]lthough a notice of proposed rulemaking which solicited public comments was issued, the Internal Revenue Service concluded when the notice was issued that the regulations are interpretive and that the notice and public comment procedure requirement of 5 U.S.C. § 553 [of the APA] did not apply.") (quoting Income Taxes; Qualified Conservation Contributions, 51 Fed. Reg. 1496-01, 1498 (Jan. 14, 1986) (codified at 26 C.F.R. pt. 1, 20, 25, 602)).

taxpayer abuse.[168] Sure enough, promoters swooped in, marketing conservation easements as a way for taxpayers to easily reduce their taxable income. But rather than conserving natural resources and cultural heritage for public benefit, the syndication-run-amok environment has caused significant erosion of public trust in private land conservation, earning conservation easements a spot on the IRS's "Dirty Dozen" list of tax scams since 2019.[169] In response, the IRS has since designated certain syndicated conservation easements as listed transactions which taxpayers must disclose to the IRS;[170] announced increased enforcement activity with "extensive enforcement tools that employ advanced techniques";[171] and established a new Office of Promoter Investigations to "coordinate efforts across multiple business divisions to address abusive syndicated conservation easements."[172] Accordingly, it appears that the IRS will continue to deploy vigorous enforcement activity in this area.

Faced with increased IRS enforcement activity, how will participants in conservation easement transactions fare? Will the IRS continue to enjoy resounding victory as it did in *TOT Property Holdings*? Or will the taxpayers find more success, perhaps even borrowing a page from the *Hewitt* playbook and challenge the validity of other regulations of the Commissioner?

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168. S. REP. NO. 96-1007, at 9 (1980).
169. IRS, *supra* note 3.
170. I.R.S. Notice 2017-10, 2017-4 I.R.B. 544.
171. IRS, *supra* note 3.
172. I.R.S. News Release IR-2021-88 (Apr. 19, 2021).