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## **An Uncharitable Regulation: Tax Court Invalidates Conservation Easement Regulation**

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A taxpayer is generally allowed a deduction for a charitable contribution of a conservation easement over undeveloped land or a historic building if the easement protects the property in perpetuity and meets certain other requirements. However, in recent years, the IRS has been extremely aggressive in challenging such deductions. Rather than focusing on the value of an easement, which is a highly fact-specific inquiry, in many cases the IRS has sought to disallow charitable deductions as a result of technical flaws with conservation easement deeds.

For a donation of a conservation easement to be eligible for a charitable deduction, the Internal Revenue Code requires that the easement be “a restriction (granted in perpetuity)” on the use of the property and that the easement’s conservation purpose be “protected in perpetuity.” Treasury regulations interpreting these requirements, which were finalized in 1986, provide that if subsequent changes in the conditions surrounding the property “make impossible or impractical the continued use of the property for conservation purposes,” then the perpetuity requirement is still satisfied if the easement is extinguished by a judicial proceeding and the donee’s share of any resulting proceeds is used in a manner consistent with the easement’s conservation purposes. In addition, the regulations provide that the donee must receive a share of any proceeds from such a judicial extinguishment in the same proportion as the value of the easement at the time of the donation bears to the value of the entire property at the time of the donation.

In a recent Tax Court case, *Valley Park Ranch, LLC v. Commissioner*, 162 T.C. No. 6 (2024), the taxpayer had conveyed a conservation easement over land in Oklahoma. The easement deed had provided that if future circumstances render the conservation purpose of the easement obsolete or impossible to accomplish, then the easement may be extinguished by judicial proceeding. The deed provided that, after the satisfaction of prior claims, the donee’s share of any proceeds from the sale, exchange, or voluntary conversion of the property would be as determined by the court.

On its 2016 income tax return, Valley Park Ranch, LLC claimed a deduction for a charitable contribution of \$14.8 million. The IRS disallowed the deduction, on the grounds that the easement was not “protected in perpetuity” as required by the applicable statutory provisions and did not comply with the extinguishment proceeds regulation. The taxpayer argued that the easement complied with these provisions, and that, even if the easement did not comply with the extinguishment proceeds regulation, the regulation was invalid under the Administrative Procedure Act (APA). The APA is a federal law governing the procedures agencies must follow to adopt legally binding regulations.

A number of courts had previously considered whether the extinguishment proceeds regulation was invalid under the APA. The Tax Court itself had previously held the regulation valid, and that decision was affirmed by the Sixth Circuit. However, the Eleventh Circuit had subsequently held the regulation invalid under the APA. In light of the Eleventh Circuit's opinion, the Tax Court stated that it had a duty to reconsider its prior holding, and since the *Valley Park* case was appealable to the Tenth Circuit, the Tax Court was not bound by either the Sixth Circuit or Eleventh Circuit opinions.

The Tax Court in *Valley Park* ultimately held that the extinguishment proceeds regulation was invalid under the APA. The APA requires that, prior to finalizing a regulation, an agency must consider and respond to all significant comments received during the period for public comment. When the extinguishment proceeds regulation was first proposed in 1983, the Treasury Department received numerous comments. In particular, one commentator had noted that the regulation may deter prospective donors, because it does not give the donor credit for the value of any improvements constructed on the property by the donor after the easement was donated. The commentator also felt that the regulation was unnecessary given the remote likelihood of extinguishment. Other commentators expressed similar views. However, when the Treasury Department ultimately finalized the regulation, it made only minor editorial changes and never addressed those comments. The Tax Court held that, because the Treasury Department failed to respond to these significant comments, the extinguishment proceeds regulation was procedurally invalid under the APA.

Having held the regulation invalid, the Tax Court went on to hold that the easement satisfied the statutory "in perpetuity" requirements. The court reasoned that the easement clearly imposed restrictions on the use of the land, and that those restrictions were granted in perpetuity because nothing in the grant envisioned a "reversion of the easement interest to the landowner, its heirs, or assigns."

This case is significant because it illustrates the Tax Court's willingness to invalidate a longstanding regulation based on procedural flaws that occurred almost 40 years ago. It is possible that there are other tax regulations outside the conservation easement area that suffer from the same procedural flaws, and taxpayers seeking to challenge tax regulations would do well to consider this type of attack. Moreover, this case is yet another example of the extreme lengths to which the government will go to challenge conservation easement deductions based on technical flaws, despite the clear congressional intent to encourage such donations.

The practical effect of this particular ruling on new easements is likely to be limited. As a result of a statutory mandate enacted in 2022, the IRS released safe harbor language for taxpayers to use in easement deeds to ensure that they comply with the extinguishment proceeds regulation. Nevertheless, there are many other technical requirements to claim a deduction for a conservation easement, and any taxpayer seeking to donate a conservation easement should exercise extreme caution to ensure that all applicable statutory and regulatory requirements are met.

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