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IRS Issues Regulations on Conservation Easement Reporting

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A taxpayer is generally allowed an income tax deduction for a charitable contribution of a conservation easement. To qualify for a deduction, the conservation easement must protect either land or a historic building from development in perpetuity and must meet numerous other requirements. Despite apparent congressional intent to encourage the donation of conservation easements, the IRS has been extremely aggressive in challenging such deductions, particularly in the case of certain syndicated transactions that the IRS views as highly abusive.

In many of such transactions, a sponsor would sell interests in a partnership to various investors, after which the partnership would donate a conservation easement on property that it owned. In connection with such sales, the sponsor would sometimes issue promotional materials promising investors tax deductions that significantly exceed the amount of their cash invested.

As part of these efforts, in December 2016, the IRS issued Notice 2017-10, which designated certain of these syndicated conservation easement transactions as "listed transactions" and had significant retroactive effect. The consequence of engaging in a listed transaction is that a taxpayer must disclose information relating to such transaction on its tax return. If a taxpayer fails to make such a disclosure, significant penalties apply, and the statute of limitations generally remains open until at least a year after such information is provided to the IRS. In addition, any material advisor with respect to a listed transaction (such as an attorney or an accountant) is required to file a disclosure with the IRS, and if such a disclosure is not made, the advisor is also subject to significant penalties.

Under the Administrative Procedure Act (APA), federal agencies must follow certain procedures before adopting legally binding regulations. Among other things, the APA requires that agencies provide notice of proposed regulations and an opportunity for the public to comment on the proposed regulations before they become law. In issuing Notice 2017-10 (and numerous other notices identifying listed transactions), the IRS did not follow these notice-and-comment procedures, on the theory that the issuance of such a notice was exempt from the APA. However, in *Green Valley Inv., LLC v. Commissioner*, 159 T.C. 80 (2022), the Tax Court disagreed and held that Notice 2017-10 was invalid for failure to follow APA requirements. A district court in Alabama subsequently reached a similar conclusion, which was recently affirmed by the U.S. Court of Appeals for the Eleventh Circuit in *Green Rock, LLC v. IRS,* 104 F.4th 220 (11th Cir. 2024).

In light of this litigation, the IRS issued proposed regulations in December 2022 designating certain syndicated conservation easements as listed transactions. After a notice-and-comment process designed to comply with the APA, the IRS finalized those regulations on October 8, 2024.

The final regulations provide that a deduction for a charitable contribution claimed through one or more pass-through entities in which a taxpayer acquired an interest is a listed transaction if certain requirements are met. Generally, such a transaction will be considered a listed transaction if the taxpayer received promotional materials (broadly defined) that offered investors in a pass-through entity the possibility of being allocated charitable deductions at least equal to 2.5 times the amount of the taxpayer's investment in the pass-through entity. The regulations also provide that substantially similar transactions are considered listed transactions, and provide that certain charitable contributions of fee simple interests in properties, rather than conservation easements, may be considered substantially similar under this rule.

Although most highly abusive deductions would be considered listed transactions under the final regulations, the regulations are broad enough to cover some legitimate transactions that would otherwise be permitted. Moreover, just two weeks after the issuance of the proposed regulations, Congress enacted changes to the charitable contribution rules that prohibit certain conservation easement deductions where the value of the deduction exceeds 2.5 times the sum of each partner's relevant tax basis. The statute contains several exceptions, including for certain family partnerships and for contributions outside of a three-year holding period. These statutory changes largely restrict the most abusive transactions, so the need for the listed transaction regulations is now greatly reduced compared to prior law.

The IRS noted in its response to comments that the listed transaction regulations are generally broader than the new statutory prohibitions, so they are still needed to protect the government against abusive transactions not covered by those rules. Yet the IRS regulations seem to go beyond congressional intent and create the added confusion of having two similar but not identical sets of rules.

In addition, the regulations are problematic in that they could have significant retroactive effect. Taxpayers and material advisors are generally required to file disclosures for conservation easements covered by the regulations that relate to tax years for which the statute of limitations is still open, even if those transactions occurred prior to 2024. This creates a trap for the unwary, as many taxpayers and advisors may be unaware of the new regulations, and old transactions may have been forgotten. The regulations are also part of a troubling trend of IRS guidance that is increasingly aggressive in its retroactive scope.

The regulations are further evidence of the confused nature of the law governing conservation easements. On the one hand, the statute evidences congressional intent to encourage conservation easements and in some instances treats conservation easements more favorably than other charitable donations. On the other hand, the IRS has been extremely aggressive in challenging conservation easements and these new regulations are just a small part of that stance. Thus, to protect against IRS challenges, taxpayers need to be extremely cautious in ensuring that charitable contributions meet all applicable requirements.

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