

**Remarks of Steven T. Miller
Commissioner, IRS Tax Exempt and Government Entities Division
Before the American Society of Appraisers
Friday, October 22, 2004
Conservation Easements**

I appreciate your invitation to come this morning to discuss the IRS's approach to the donation of conservation easements. As you are aware, the issue has become a matter of concern, and our reaction and the reaction of Capitol Hill should be of concern to you.

I am a lawyer by trade, if not current occupation, but I think I should make it clear that I am not a specialist in conservation easements. In my current position, I have oversight responsibility for the charities that are to receive and protect these easements. Responsibility for education and enforcement of the donation rules in this area resides elsewhere in the Service.

So I will of necessity not delve into nor dwell upon the legal specifics other than to outline some general requirements. After I do that, I want to discuss what some of the issues are in this area and finish with what we at the Service are intending to do about the problems we have seen. By the end of this discussion, I hope you also have a sense of what we plan and what you can do to help both your profession and the Service.

I believe I am talking to people who want to comply with the rules. But you know as well as I that there has been a growth in troublesome transactions in the tax area generally. Since Mark Everson became Commissioner, the Service has stepped up its enforcement against tax shelters and other abusive tax transactions. Now, many of these have been corporate shelters, but a remarkable number of them fall outside of that realm into the wealthy investor category.

My function has been engaged in some front-line work with respect to some of those schemes, including the misuse of donor advised funds and supporting organizations. **We have seen questionable promotions in your area as well. I have personally been provided information on two promotions in your area. Let me not be subtle as to why I am here. We need your help.** I will start by reading what the Commissioner had to say in connection with Notice 2004-41, which we issued on July 12 and which deals with charitable contributions and conservation easements:

[W]e have uncovered instances where the tax benefits of preserving open space and historic buildings have been twisted for inappropriate individual benefit. Taxpayers who want to game the system and the charities that assist them will be called to account.

I am sure other speakers today will make the same point I am about to make. You, as professional appraisers, are key players in determining whether the United States has a **conservation easement donation program that serves its intended, and laudable, purposes**. Or whether, in the alternative, we have a program that is marked by abuse, resulting in disallowed deductions, penalties, professional and promoter referrals and even criminal prosecutions.

Commissioner Everson, whom I am privileged to represent here this morning, noted early in his tenure as Commissioner of Internal Revenue, that much of the scandal and the erosion of standards that have occurred in the areas of corporate governance, in accounting, and in adherence to the tax laws of the country, arises from an unwillingness of professionals to live up to the standards of their professions. These problems are the result of a growing willingness of professionals to sacrifice established standards and independent professional judgment to clients' goals, even when the goals are questionable or illegitimate.

I will talk later of what the Service is doing in the area of professional responsibility. And Howard and Jeff will take the discussion even further. But you and I both know that each of you has an important role to play in ensuring that donations for conservation easements are appropriately used.

When the tax benefits granted for easement donations are appropriately used, we can all expect that they will bring real and enduring benefits to the American public. Conservation easements can help, and have helped, safeguard fragile ecosystems, critical watersheds, lands bordering national parks, and stunning views. We value this use of conservation easements, and we want to do nothing to hinder the continued and appropriate donations of conservation easements to provide these gifts to the public.

So let me talk a little about some general requirements, not because I believe you don't know them better than I, but because I was told by my lawyers and my agents that some transactions don't seem to meet them. Now is that the appraiser's responsibility? Maybe it is, but regardless of whether you agree that that's the answer to the question, I want to sensitize you to these rules so you better understand what you are getting into as you offer your services in this area. This is key, because the cost of being found to have aided in an abusive transaction is high.

Our regulation of the area begins, of course, with the Internal Revenue Code: Easements are unusual within the context of philanthropy. Ordinarily, gifts of partial interests in property are not deductible as charitable contributions, and an easement is only a partial interest in property. However, the Code provides an

exception to the partial interest rule for qualified conservation contributions such as conservation easements.

As you know, conservation easements are generally permanent deed restrictions that limit some type of development.

Landowners donate the easement to a government or a conservation organization, and the donor seeks a federal income tax deduction for the reduction in the land's value. A reduction that you all are in the business of valuing. Often, the donor also benefits from reduced estate taxes and reduced real property taxes. The government agency or conservation organization that receives the easement is supposed to enforce it, to make sure the easement's terms are adhered to.

To be deductible, the transfer of a conservation easement must meet the requirements of the Code and the very detailed rules of the Income Tax Regulations.

There seems to be a popular perception that valuation of the easement is the only issue of concern under the regulations, and it is the primary issue we face in examination, but in fact there are many requirements having nothing to do with valuation that must be complied with before we have a deductible charitable contribution.

For example, the recipient charity cannot be just any charity but must be what the regulations call a "qualified organization." Generally, the statutory reference to a qualified organization means public charities and governments. Importantly, the recipient charity must have both the commitment to enforce the easement, that is, the intent to enforce, as well as the resources to enforce it. That is where my function comes in.

The Code provides that a conservation contribution must satisfy one of four purposes to be deductible. A conservation contribution must be for:

1. The preservation of land areas for outdoor recreation or education of the general public.
2. The protection of a relatively natural habitat of fish, wildlife, plants or similar ecosystem.
3. The preservation of open space (including farmland and forest land) for either the scenic enjoyment of the general public, or pursuant to a clearly delineated governmental conservation policy, or
4. The preservation of an historically important land area or a certified historic structure.

Each of these purposes is spelled out in greater detail in the Regulations. I'll let others more qualified outline this in greater detail.

Let me turn now to some of the problems and abuses we have seen with conservation easements.

In this regard we need to talk about Notice 2004-41, issued in July of this year. Notice 2004-41 is not the end of what we are likely to say or to do about improper donations of conservation easements. We are not finished in this area.

Notice 2004-41, sends what I hope is a clear message. In it, we issue a warning about the transactions outlined in the notice – in this case that we have begun looking closely at improperly claimed charitable deductions, and that we intend to disallow such deductions, where they have been wrongly taken, and that we may impose penalties and excise taxes.

The notice also advises promoters and appraisers that the Service intends to review promotions of transactions involving improper deductions, and that the promoters and appraisers may be subject to penalties. More on that later.

From a technical viewpoint, Notice 2004-41 provides a brief primer on conservation easements, and if you have not read it, I urge you to do so. It is only slightly over a page long, but it touches on a number of important points that everyone who works with conservation easements should know about.

For example, the Notice reiterates that a conservation easement involves a restriction on the use of real property that is granted in perpetuity.

It also points out that, in the case of an open space easement, the public benefit of the open space easement must be significant. If it is not, the charitable deduction will be disallowed.

It notes that the deduction may not exceed the fair market value of the contributed property.

The Notice points out that if the donor reasonably can expect to receive financial or economic benefits greater than those that will inure to the general public as a result of the donation of the easement, no deduction is allowable.

Further, if the donation of a conservation easement has no material effect on the value of real property, or if it enhances rather than reduces the value of real property, no deduction is allowable.

The Notice warns against so-called conservation buyer programs. In one type of conservation buyer program, the conservation organization buys property, places an easement on it, and then sells the property to a taxpayer for two payments. The first payment is designated a “purchase price,” and the second is characterized by the parties as a “charitable contribution.” However, in some cases, the second payment is really part of the negotiated purchase price of the property and therefore is not a contribution. Undervaluation of a property in this fashion can be just as much a problem as overvaluation, and you as appraisers

have a professional role to play here. In any event, the Notice tells us that the Service will treat these transactions in accordance with their substance rather than their form.

The warnings and reminders of the Notice stem from some of what we have seen. Other problems also have been found.

One problem shows up with some regularity in requests for private letter rulings. The problem is that some applicants do not pay sufficient attention to the regulations that spell out the requirements that must be met to establish one of the four conservation purposes. We find that an applicant will identify one or more conservation purposes that apply to his or her easement, but the applicant stops too soon and does not go through the regulations carefully enough to make sure that all the elements of the conservation purpose at issue are met.

Let me give you an example concerning open space easements. One type of open space easement is an easement that is pursuant to a “clearly delineated governmental conservation policy.” The other type of open space easement is for the scenic enjoyment of the general public. For both types, there must be a “significant public benefit.”

The regulations list eleven factors to be taken into consideration. They also tell us to consider all facts and circumstances, and they say that some of the 11 factors may not be relevant to a particular property. One of the listed factors is the “opportunity for the general public to use the property or to appreciate its scenic values.” If a taxpayer donates a scenic easement on land that is not visible to the public, there is no scenic benefit to the public. For example, there have been proposals to place conservation easements on small parcels of land that lie between the holes of a golf course. More recently there have been proposals for easements in space between houses in a development, property in gated communities, and so on.

Another problem that is showing up arises in connection with historic easements. The problem here is that taxpayers are taking improperly large deductions for façade easements. These taxpayers have houses listed in the National Register, or houses located in a registered historic district. They purport to agree not to modify the façade of their historic house, and give an organization an easement to this effect. But if the façade was already subject to restrictions under zoning rules, the taxpayers may not be giving up anything at all. A taxpayer cannot get a charitable contribution if he or she has nothing to give up. The taxpayer can't give up a right to change the façade of a building if he or she doesn't hold that right in the first place.

We also are hearing of charities that tell their historic easement donors that they are entitled to claim, as a façade easement deduction, a fixed percentage of the fair market value of their property.

This, of course, is not accurate, since the rules on the valuation of historic property are based on the facts and circumstances of each case, including prior restrictions on the use or modification of the property.

Yet another problem arises in cases in which the donor, or the donor's successor in interest, takes an action inconsistent with the easement without adverse consequences. This strikes me as an issue that you, as appraisers, should bear in mind. Does the document creating the easement allow a use inconsistent with the ostensible purpose of the easement? A questionable provision of this sort might render a proposed conservation easement worthless, and if it does, our view is that the appraisal should reflect that. Moreover, a failure to enforce these restrictions raises issues about the recipient organization.

I am sure that having a good nose is helpful to an appraiser, as it is to anyone, and so I encourage you to use it, and pay attention to it when, from the outset, something seems unlikely to pass a smell test.

So I have outlined some of the problems we are seeing. What are we going to do about this? Well, Notice 2004-41 outlines the penalties, excise taxes and consequences to donors, promoters, and exempt organizations that will arise if improper deductions are taken as part of the granting of a conservation easement. We may impose accuracy related penalties under section 6662. We intend to assess the excise tax for excess benefit transactions under section 4958 against disqualified persons of the charity who receive excess benefits, and against charitable organization managers who knowingly participate in the transactions.

And, in appropriate cases, we may challenge the tax-exempt status of the organization, based on the organization's operation for a substantial nonexempt purpose.

Promoters and other persons involved in these transactions may be subject to penalties under sections 6700, 6701 and 6694.

More particularly for you as a group is the issue of practice before the Service. I mentioned that the Commissioner is attacking the problem of professionalism head on. The Service's Office of Professional Responsibility is at work. Vigorously at work. We are revising Circular 230; and we are putting out the word that we will hold professionals -- all professionals who influence the tax system -- to the highest standards. Of course, this includes appraisers.

Each of you should be familiar with Circular 230. It regulates the practice of appraisers before the Internal Revenue Service. At section 10.50(b) it provides that the Secretary of the Treasury may disqualify from practice before the Service any appraiser against whom a penalty has been assessed under section 6701 of

the Code. Section 6701 imposes a penalty for aiding and abetting an understatement of tax liability.

A disqualified appraiser is barred from presenting evidence or testimony in any administrative proceeding before the Department of the Treasury or the IRS. And any appraisal made by a disqualified appraiser will have no probative effect in administrative proceedings before Treasury or the Service. You will hear more about Circular 230 and appraisers later this morning from Howard and Jeff, and I think what you hear will be of great interest to you.

What else are we doing?

Well, I think you can assume that we will be modifying some current tax forms. First, the Form 990, the information form for nonprofits, including qualified recipients of donated easements, may be modified so that my function and the public have a better understanding of which organizations take easements and what they do with them. The Form 1023, the application for tax exemption for charities, will also require additional information in this area. As importantly, the donor's form, the 8283, may be modified to both provide better instructions on what is permissible and to disclose better information on the type of property donated.

This will allow better targeting of our enforcement efforts in the future. However, I need to note that we are not waiting. The Service is already in the process of reviewing promotions of transactions involving improper deductions for conservation easements, some recipient organizations and a number of contributors. We have audits across the conservation easement area, including façade easements. Further, we are awaiting a Tax Court decision in a case that was tried in August of this year.

I would be remiss if I did not mention the interest in Capitol Hill on this issue. The Senate Finance Committee has undertaken a review of a key stakeholder in the community, and part of its hearings on abuses in the charitable area in June was directed squarely at gifts of property and easements. There is no indication that Senate Finance is done in this area.

Let me wind up.

Ultimately, there is no inconsistency between appreciating conservation easements and being aware that they can be misused. What we have to recognize is that if we are to preserve the benefit of conservation easements for the public for the future, we all have a solemn and continuing obligation to see that the conservation easement donation program stays within its lawful and intended boundaries now. I therefore solicit your cooperation, and appeal to your professionalism, to help preserve a

viable, appropriately disciplined program of conservation easement donations, for the benefit of the public.

What does the Service expect of you? We need your help in policing the area. I think it's fair to say that we expect you to do at least three things. First, I would ask that you walk away from a transaction that looks like it is on the wrong side of the line. Please use your eyes and your nose. Second, if you can see your way clear to do so, let us know when something obviously abusive crosses your desk. Finally, we expect you to exercise all the diligence necessary to come to well reasoned opinions on value. You will level the competitive playing field and you will benefit your profession.

We see today a real concern, across the Service, Congress, and throughout the great majority of the tax and appraisal community, about the misuse, the distortion, by some, of important provisions of the Code intended to foster and promote the philanthropic and charitable impulses of the American people.

Conservation easements have not escaped this concern, and no one should expect them to escape increasing scrutiny in the future. In this new environment, I think each of you can play an important role in insuring that conservation easement donations are appropriately used and thereby preserved. Thank you for your attention; thank you for your professionalism; and thank you for your invaluable, day-in and day-out contribution to a sound, fair, and smoothly functioning tax system.