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Conservation Easements: Tax Shields with Philanthropic Means. Glass v. Commissioner

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CONSERVATION EASEMENTS: TAX SHIELDS WITH PHILANTHROPIC MEANS

Glass v. Commissioner[1]

I. INTRODUCTION

Conservation Easements have been a part of the Internal Tax Code since at least 1986, but in recent years, they have become a favorite way to preserve relatively natural tracts of land and claim a tax deduction – up to half of adjusted gross income in some cases – at the same time.[2] Using these easements, private individuals have found a way to be green, philanthropic, and tax-savvy in one publicly recorded deed. As the popularity of the conservation easement has increased, the Internal Revenue Service ("I.R.S.") has started looking at the easements to make sure that they really are protecting a relatively significant natural habitat.[3] One couple created two conservation easements – one in 1992 and another in 1993 – that drew the I.R.S.'s attention.[4] When the I.R.S. demanded back-taxes, claiming that the taxpayers really were not entitled to deduct the easements as charitable contributions, the taxpayers sued in the tax court, and the tax court sided with them against the I.R.S.[5]

II. FACTS & HOLDING

Charles and Susan Glass bought ten acres of land in Emmet County, located in the northern end of Michigan's Lower Peninsula in 1988.[6] The western end of the property bordered Lake Michigan.[7] This border was approximately 460 feet wide, from north to south.[8] The

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[1] 471 F.3d 698 (6th Cir. 2006) ("*Glass II*").
[2] *See, e.g.,* Rachel Emma Silverman, *Tax Break with a View*, THE WALL STREET JOURNAL, Feb. 7, 2007, at D1.
[3] *See, e.g.*, Turner v. Comm'r, 126 T.C. 299 (T.C. 2006).
[4] *See Glass II*, 471 F.3d 698.
[5] *Id.* at 699.
[6] *Glass II*, 471 F.3d at 700.
[7] Glass v. Comm'r of Internal Revenue ("*Glass I*"), 124 T.C. 258, 261 (T.C. 2005).
[8] *Id.*

property was also 1,055 feet from the lake to the eastern edge of the property, which bordered Highway M-119.[9] In 1990, 1992, and 1993, they made three contributions of conservation easements to the Little Traverse Conservancy ("LTC") trust.[10] Subsequently, on their 1992 and 1993 tax returns, they claimed those easements as charitable deductions, totaling $99,000 and $214,800, respectively.[11] On August 27, 1999, the I.R.S. issued the Glasses a notice of deficiency for tax years 1992 and 1993 because it had determined that they were not entitled to the deductions from the easements.[12]

A. LTC

LTC is a nonprofit organization in Michigan that is exempt from paying federal income taxes under section 501(c)(3) of the Internal Revenue Code ("I.R.C.").[13] Its purpose was to ensure that future generations would be able to enjoy the natural beauty and scenery in northern Michigan, [14] and part of how it tried to achieve that goal was by obtaining conservation easements, either through gift or through outright purchase.[15] In the early 1990s, LTC actively sought conservation easements in and around Emmet County because the organization believed that overdevelopment of the land in the area would destroy the natural beauty of the bluffs over Lake Michigan, the Bald Eagles that were returning to the area, and the recent growth of endangered plants near the area's beaches.[16]

Furthermore, LTC typically sought cash from donors of conservation easements.[17] LTC did this to help monitor and enforce the terms of its easements.[18] Although LTC did not regularly or annually

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[9] *Glass II*, 471 F.3d at 700.
[10] *Id.* at 702. The 1990 easement was not at issue in this case. *Id.*
[11] *Id.* at 705-706.
[12] *Id.* at 706.
[13] *See* 26 U.S.C. § 501(c)(3) (2000).
[14] *Glass I*, 124 T.C. at 274.
[15] *Id.*
[16] *Glass II*, 471 F.3d at 702.
[17] *Id.*
[18] *Id.*

monitor each of its easements, it did "occasionally monitor[ ] them informally" for compliance,[19] and it would enforce the easement if it found violations of the easement's terms.[20] Additionally, although LTC would not value any easement that it received, it would help landowners find appraisers to value the encumbered land and it would inform landowners about the tax ramifications of donating a conservation easement.[21] It would also acknowledge receipt of such easements by signing a "Noncash Charitable Contributions" form.[22]

B. The 1992 Conservation Easement

The Glasses and LTC signed a document titled "Conservation Easement" on December 28, 1992.[23] The Glasses also gave LTC a cash contribution of $2,000 at the time the easement was signed.[24] The 1992 Conservation Easement covered the northwestern edge of the property, extending south 150 feet from the northern edge of the property, and extending east 120 feet from the ordinary high water mark of the lake.[25] According to the document, the encumbered shoreline contained a "relatively intact forested ecosystem" with a habitat for wildlife and old growth pine trees;[26] the property on the lake was "under intense development pressure," thereby harming protected wildlife and plants such as piping plover and Huron Tansy.[27] The Glasses and LTC, recognizing the scenic value of the property, wanted to conserve the land in perpetuity to protect the land from any development that would conflict with the natural resources and scenic beauty that the property possessed.[28] The 1992 Conservation Easement further stated that it was intended to

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[19] *Id.*
[20] *Glass I*, 124 T.C. at 275 ("The cash contribution is meant to help LTC monitor and, if necessary, enforce the terms of the easement.").
[21] *Id.*
[22] *Id.*
[23] *Glass II*, 471 F.3d at 703.
[24] *Id.*
[25] *Id.*
[26] *Glass I*, 124 T.C. at 268.
[27] *Id.*
[28] *Id.*

"prevent the use or development of the Property for any purpose or in any manner which conflicts with the perpetual maintenance of these scenic and natural resources," and that it was written to "ensure the scenic and natural resource values of the Property will be retained forever."[29]

To achieve those objectives, the 1992 Conservation Easement forbade any activity inconsistent with those purposes and it included a non-exhaustive list of restricted uses including mining activities and, unless otherwise excepted, "development, construction, improvement, or similar acts that would destroy" any part of the land.[30] The 1992 Conservation Easement also specifically forbade the Glasses or any succeeding owner of the land from partitioning or dividing the land for any purpose; granting rights-of-way or easements of ingress or egress; constructing or maintaining a driveway or a road; storing or placing trash, garbage, toxic or hazardous waste or unsightly materials on the land; using all-terrain vehicles on the land; cutting or removing plants on the land except as allowed in the easement; and altering or manipulating the "natural water courses" on the land.[31]

The 1992 Conservation Easement provided that the landowner of the encumbered property was not forbidden from selectively pruning, moving, or cutting trees and other vegetation, either to preserve the view of Lake Michigan or for safety; maintaining the footpath to the beach or constructing and maintaining new footpaths to the beach; constructing or maintaining a patio, deck, or storage shed or wooden boat house, "in a manner and location which minimizes interference with the scenic and natural resource value of the Property;" and to make "wildlife habitat improvements."[32] The 1992 Conservation Easement also addressed the cottage, even though it was outside the area of the easement.[33] The Glasses retained the right to build additions onto the existing structure so long as those additions were "only incidental to the existing cottage's overall size and location," and the square footage of the cottage with any additions did not exceed five thousand square feet.[34] If the cottage was

[29] *Id.*
[30] *Glass II*, 471 F.3d at 703.
[31] *Id.* at 703-704.
[32] *Id.* at 704.
[33] *Id.*
[34] *Id.*

replaced, the replacement structure had to be in "substantially the same location as the existing cottage," "the encroachment of the replacement structure onto the Property [could only be a] replacement of the structure's overall size and location," and the new structure's square footage [could] not exceed five thousand square feet.[35]

The 1992 Conservation Easement also granted LTC certain rights to enforce compliance with the terms of the document.[36] LTC was allowed to enter the encumbered property to document its condition; to monitor compliance; to perform investigations; to prevent any activity on the property which would be inconsistent with the easement; to restore any part of the property that was damaged by inconsistent actions; and to otherwise take "corrective action" if there was a violation of the easement.[37] Additionally, the easement specified that its terms should be "liberally construed in favor of the purpose of th[e] Conservation Easement, the [LTC]," and state law.[38]

Conversely, the easement restricted LTC's right to transfer its interest in the easement only to "a qualified conservation organization" which would agree to enforce the easement "in accordance with the regulations established by the Internal Revenue Service governing such transfers and the laws of the State of Michigan."[39] If LTC ceased to exist, the easement provided an order in which the rights and obligations of the easement would be assigned: The Nature Conservancy, then the Michigan Department of Natural Resources, then any other appropriate organization which "qualifies under Section 170(h)(3) of the [Internal Revenue] Code, has conservation purposes, and is qualified to accept and hold this Conservation Easement either voluntarily or through an award of such right by a court of competent jurisdiction under the doctrine of *cy pres*."[40]

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[35] *Id.*
[36] *Id.*
[37] *Id.*
[38] *Id.* at 710.
[39] *Id.* at 704.
[40] *Id. Cy pres* is a tool that courts can use to remove restrictions in a trust, easement, or other document. WILLIAM M. MCGOVERN, JR. & SHELDON F. KURTZ, WILLS, TRUSTS AND ESTATES 399 (3d ed. 2004). Courts have used it to remove racial restrictions, accommodate changes to the tax code, and replace a defunct beneficiary with a different one. *Id.* at 400-01. To apply *cy pres*, however, the court must find that the donor had a

The Glasses had the encumbered land appraised and attached the appraisal letter to their 1992 tax returns.[41] The letter said that the 1992 Conservation Easement had been appraised at a fair market value of $99,000.[42] The appraiser, in the letter, also said that he estimated the encumbered land had a fair market value of $249,000 before the easement was imposed, and $99,500 after the easement was imposed.[43] The appraiser also said that the easement improved the fair market value of the unencumbered land by $50,500.[44] Thus, the value of the 1992 Conservation Easement was $99,000.[45] The Glasses claimed the easement, as well as the $2,000 cash contribution to LTC, as a charitable contribution on their 1992 tax returns.[46] In 1992, they claimed a total of $9,957 in cash contributions and the $99,000 from the Conservation Easement;[47] they used $95,569 of the contributions in 1992 and the remaining $13,388 was carried over to 1993.[48]

C. The 1993 Conservation Easement

The Glasses, again at the end of 1993, signed another "Lakefront Conservation Easement" with LTC.[49] At the time of the signing, the Glasses also gave LTC a $2,000 cash donation.[50] The 1993 Conservation Easement covered the southeast end of the Glass' property, extended north 260 feet from the southern property line and eastward 120 feet from the lake's ordinary high water mark.[51] The purpose of the 1993 easement was the same as the 1992 easement and similarly forbade any activity that

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"charitable purpose," which can be difficult. *See id.* at 401-04. For a discussion of *cy pres* and how courts have applied it, *see generally id.* at 399-405. *See also* MO. REV. STAT. § 456-004.413 (2000).

[41] *Glass I*, 124 T.C. at 269.

[42] *Id.*

[43] *Id.*

[44] *Id.*

[45] *Id.*

[46] *Glass II*, 471 F.3d at 705.

[47] *Id.*

[48] *Id.*

[49] *Id.*

[50] *Id.*

[51] *Id.*

violated those purposes.[52] The non-exhaustive list of restricted uses was the same, and the permitted uses were the same except that in the 1993 easement, there was no right to build, maintain, or replace any footpath and the right to add on to or replace the existing cottage was restricted so that the existing cottage with additions, or any new cottage, could not exceed 2,500 square feet.[53] Under the 1993 easement, however, there was no restriction on the landowner regarding developing any part of the property not covered by the easement.[54] Furthermore, the 1993 Conservation Easement also gave LTC the same rights of enforcement and also restricted LTC's right to assign the easement as the 1992 Conservation Easement did.[55]

The Glasses had the 1993 encumbered property appraised and attached the appraisal to their 1993 tax returns.[56] The appraiser said that he estimated the value of the encumbered land at $483,600 before the 1993 Conservation Easement was signed, and that the fair market value of the land after the easement was granted was $193,400.[57] He also said that fair market value of the unencumbered property increased by $48,400 due to the easement.[58] Thus, the overall fair market value of the 1993 Conservation Easement itself was valued at $241,800.[59] They claimed the easement, as well as the $2,000 cash contribution to LTC, as a charitable contribution on their 1993 tax returns.[60] On their tax returns, they claimed a total of $11,414 in cash contributions, the $13,388 carryover from 1992, and the $241,800 from the Conservation Easement.[61] They used $128,473 on their 1993 return and carried over the balance to 1994 and 1995.[62]

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[52] *Id.*
[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] *Glass I*, 124 T.C. at 271-272.
[57] *Id.* at 272.
[58] *Id.*
[59] *Id.*
[60] *Glass II*, 471 F.3d at 705-706.
[61] *Id.*
[62] *Id.* at 706.

D. Subsequent Developments

In 1999, the Internal Revenue Service issued the Glasses a notice of deficiency for tax years 1992 through 1995.[63] The I.R.S. claimed that they were not entitled to deduct the 1992 and 1993 Conservation Easements because they were not "qualified conservation contributions" within the meaning of the Internal Revenue Code ("I.R.C.").[64] In the alternative, the I.R.S. argued that even if they were entitled to deduct the easements, their appraised values were inflated above their fair market value.[65]

The Glasses filed a petition in the tax court for a redetermination of the deficiencies of $26,539; $40,175; $26,193; and $22,771 asserted against them for 1992, 1993, 1994, and 1995, respectively.[66] The tax court separated the issues of whether the 1992 and 1993 Conservation Easements constituted "qualified conservation contributions" from the issue of their fair market values.[67] The tax court held that their contributions were qualified conservation contributions because they protected a relatively natural habitat of wildlife and plants, and were held exclusively for conservation purposes.[68]

The I.R.S. appealed the tax court's decision, claiming that the lower court read the word "significant" out of the Treasury Regulations

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[63] *Id.*

[64] *Id. See* 26 U.S.C. ("I.R.C.") §§ 170(h), (h)(4)(A), & (h)(4)(C).

[65] *Id.*

[66] *Id.* The Tax Court has jurisdiction to hear cases involving a dispute over the amount of money that a taxpayer owes the government. I.R.C. § 7442 (2000) ("The Tax Court and its divisions shall have such jurisdiction as is conferred on them by this title, by chapters 1, 2, 3, and 4 of the Internal Revenue Code of 1939, by title II and title III of the Revenue Act of 1926 (44 Stat. 10-87), or by laws enacted subsequent to February 26, 1926."). The Internal Revenue Code of 1986 replaced the Internal Revenue Code of 1939 and the Revenue Act of 1926, but pursuant to section 7851(e) the Court stills retains its jurisdiction over the Code by reference to those superceded statutes. *See* I.R.C. § 7851(e) ("For the purpose of applying the Internal Revenue Code of 1939 or the Internal Revenue Code of 1986 to any period, any reference in either such code to another provision of the Internal Revenue Code of 1939 or the Internal Revenue Code of 1986 which is not then applicable to such period shall be deemed a reference to the corresponding provision of the other code which is then applicable to such period.").

[67] *Glass II*, 471 F.3d at 706.

[68] *Glass I*, 124 T.C. at 284.

and thereby erred in concluding that the encumbered property satisfied the I.R.C.;[69] that the encumbered properties were too small, left the Glasses with too many rights, and failed to restrict the building rights of neighboring properties, thereby precluding the easements from serving their purposes;[70] and that the easements were not protected in perpetuity and "exclusively for conservation purposes" as required by both the I.R.C. and the Treasury Regulations.[71] The U.S. Court of Appeals for the Sixth Circuit, ruling for Taxpayers, held that any habitat for rare, endangered, or threatened species of animals or plants are, *ipso facto*, "significant" under the I.R.C.;[72] that under the circumstances, the rights of the Glasses were restricted enough to meet the Conservation Easements' purposes; and that the easements protected their purposes in perpetuity, in accord with the requirements of the I.R.C. regarding charitable conservation easements.[73]

III. LEGAL BACKGROUND

A. Charitable Contributions Generally

Charitable contributions are deductible from adjusted gross income under section 170 of the I.R.C.[74] In order for a taxpayer's contribution to be considered "charitable," the contribution may be a contribution or gift to, or for the use of, a trust, fund, or foundation which is created in the United States or under its laws, the laws of any state, the District of Columbia, or any U.S. possession,[75] which is organized and operated

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[69] *Glass II*, 471 F.3d at 707.
[70] *Id.* at 707-708.
[71] *Id.* at 708.
[72] *Id.*
[73] *Id.* at 713.
[74] I.R.C. § 170(a)(1) (2000). The court used the 1988 I.R.C. but here statute citations reference the 2000 because the language has not changed between the two versions and because the 2000 version is currently applicable to tax planners and other practitioners who may be interested in drafting conservation easements. *Compare* I.R.C. § 170(h) (1988) *with* I.R.C. § 170(h) (2000).
[75] *Id.* § 170(c)(2)(A). The charitable organization must be "a corporation, trust, or community chest, fund, or foundation created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States." *Id.*

exclusively for charitable purposes,[76] which does not engage in political lobbying or campaigns,[77] and which does not distribute any part of its net earnings to any individual member of the group.[78] If an individual taxpayer's contribution is considered charitable, then the taxpayer is allowed to deduct the value of the contribution from his "contribution base" for the year in which the contribution is made; the taxpayer is limited, however, from deducting more than half of his contribution base with charitable contributions in the year he makes the contribution.[79] For

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[76] *Id.* § 170(c)(2)(B). The organization must be "organized and operated exclusively for religious, charitable, scientific, literary, or education 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." *Id.*

[77] *Id.* § 170(c)(2)(D). The organization cannot be "disqualified for tax exemption under [I.R.C.] section 501(c)(3) by reason of 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." *Id.*

[78] *Id.* § 170(c)(2)(C). "[N]o part of the net earnings [of the organization may] inure[ ] to the benefit of any private shareholder or individual." *Id.*

[79] *Id.* at § 170(b)(1)(A). A taxpayer's "'contribution base' means adjusted gross income (computed without regard to any net operating loss carry back to the taxable year under section 172). *Id.* § 170(b)(1)(F). "Adjusted gross income" is gross income minus the following deductions: trade or business deductions (*Id.* § 62(a)(1)); certain trade and business deductions of employees (*Id.* § 62(a)(2)); loss from the sale or exchange of property (*Id.* § 62(a)(3)); deductions attributable to rents and royalties (*Id.* § 62(a)(4)); certain deductions of life tenants and income beneficiaries of property (*See id.* § 62(a)(5)); pension, profit-sharing and annuity plans of self-employed individuals (*See id.* § 62(a)(6)); retirement savings (*See id.* § 62(a)(7)); penalties forfeited because of premature withdrawal of funds from time savings accounts or deposits (*See id.* § 62(a)(9)); alimony (*See id.* § 62(a)(10)); reforestation expenses (*See id.* § 62(a)(11)); some required repayments of supplemental unemployment compensation benefits (*See id.* § 62(a)(12)); remissions of jury pay to the taxpayer's employer in consideration for employment compensation for the period when the taxpayer had jury duty (*See id.* § 62(a)(13)); clean-fuel vehicles deductions (*See id.* § 62(a)(14); *see also id.* § 179A); moving expenses (*See id.* § 26(a)(15); *see also id.* § 217); Archer MSAs (*See id.* § 62(a)(16); *see also id.* § 220); interest paid on qualified education loans (*See id.* § 62(a)(17); *see also id.* § 221); qualified higher education tuition and related expenses (*See id.* § 62(a)(18); *see also id.* § 222); the amount paid in cash for a qualified individual's health savings account (*See id.* § 62(a)(19); *see also id.* § 223); and attorneys fees and court costs paid by the taxpayer in connect with any action involving a claim of unlawful

contributions of property, the deduction that the taxpayer takes on his tax returns for the donation is the fair market value of the property at the time the taxpayer contributes it.[80]

Subsection (f) of section 170, however, places a limit on the kinds of property interests that can be transferred as charitable contributions.[81] One such limitation is that a taxpayer generally cannot claim a deduction on a contribution of less than his entire interest in a piece of property.[82] This exception does not apply to "qualified conservation contributions."[83]

B. Qualified Conservation Contributions[84]

A qualified conservation contribution is a contribution of a "qualified real property interest"[85] to a "qualified organization,"[86] "exclusively for conservation purposes."[87] A qualified real property interest includes a restriction, granted in perpetuity, on the uses which the taxpayer may make on the land.[88] A qualified organization includes certain nonprofit organizations[89] and organizations which are either: (1)

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discrimination (*See id.* § 62(a)(20)). *Id.* § 62(a). "Gross income" generally means "all income from whatever source derived." *Id.* § 61(a).

[80] 26 C.F.R. § 1.170A-1(c)(1) (2006) ("Treas. Reg."). References in the article are to the 2006 Code of Federal Regulations even though the case referenced 1992 & 1993 regulations, for the same reasons stated in note 74. *See supra* note 74. *Compare* Treas. Reg. § 1.170A-14 (1992) & (1993) *with* Treas. Reg. § 1.170-14 (2006).

[81] I.R.C. § 170(f).

[82] *Id.* § 170(f)(3)(A). *See also* Treas. Reg. § 1.170A-14(a) (2006) ("A deduction under section 170 is generally not allowed for a charitable contribution of any interest in property that consists of less than the donor's entire interest in the property. . . .").

[83] I.R.C. § 170(f)(3)(B)(iii).

[84] See C. Timothy Lindstrom, "A Guide to the Tax Aspects of Conservation Easement Contributions," 7 WYO. L. REV. 441 (2007), for a detailed discussion of the requirements of a Conservation Easement Contribution, their potential tax benefits, and their potential tax burdens on the donor and donee, with examples.

[85] *Id.* § 170(h)(1)(A).

[86] *Id.* § 170(h)(1)(B).

[87] *Id.* § 170(h)(1)(C).

[88] *Id.* § 170(h)(2)(C). Other qualified real property interests are the entire interest of the taxpayer other than a "qualified mineral interest" and a remainder interest in the property. *Id.* § 170(h)(2)(A)-(B).

[89] *Id.* § 170(h)(3)(B). These organizations, described in I.R.C. § 501(c)(3), must meet the

governmental units[90] or (2) trusts, funds, or foundations organized and

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requirements of section 509(a)(2) or, alternatively, meet the requirements of section 509(a)(3) and be controlled by either a § 509(a)(2) organization, a governmental unit, or a charitable organization. A governmental unit is a state, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia. *Id.* § 170(c)(1). The qualifications of a charitable organization are discussed in notes 75-78, *supra*. A § 509(a)(2) organization is:

> (2) an organization which
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> (A) normally receives more than one-third of its support in each taxable year from any combination of
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> (i) gifts, grants, contributions, or membership fees, and
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> (ii) gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities, in an activity which is not an unrelated trade or business . . . , not including such receipts from any person, or from any bureau or similar agency of a governmental unit . . . , in any taxable year to the extent such receipts exceed the greater of $5,000 or 1 percent of the organization's support in such taxable year, from persons other than disqualified persons . . . with respect to the organization, from governmental units . . . , or from organizations described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)), and
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> (B) normally receives not more than one-third of its support in each taxable year from the sum of—
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> (i) gross investment income . . . and
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> (ii) the excess (if any) of the amount of the unrelated business taxable income . . . over the amount of the tax imposed by section 511.

Id. § 509(a)(2). A § 509(a)(3) organization is:

> (3) an organization which—
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> (A) is organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in [subsections (a)(1) or (2) of section 509],
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> (B) is operated, supervised, or controlled by or in connection with one or more organizations, described in [subsections (a)(1) or (2) of section 509], and
>
> (C) is not controlled directly or indirectly by one or more disqualified persons . . . other than foundation managers and other than one or more organizations described in [subsections (a)(1) or (2) of section 509].

Id. § 509(a)(3).

[90] *Id.* § 170(h)(3)(A).

operated for exclusively charitable purposes[91] and which normally receive a substantial part of their support from a governmental unit or from direct or indirect contributions from the general public.[92]

The I.R.C. defines a "conservation purpose," for purposes of a qualified conservation contribution, as: (1) the preservation of land areas for outdoor recreation by, or the education of, the general public;[93] (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem;[94] (3) the preservation of an historically important land area or a certified historic structure;[95] or (4) the preservation of open space (including farmland and forest land) where such preservation is for the scenic enjoyment of the general public or is pursuant to a clearly delineated federal, state, or local governmental conservation policy, and will yield a significant public benefit.[96] For example, in a Private Letter Ruling,[97] the I.R.S. said that a property which was the "actual habitat for numerous plants and animal species" and was "potentially the habitat for several endangered, threatened, or rare plant and animal species" qualified as a "donation for the protection of an environmental system."[98]

A conservation purpose must be protected in perpetuity, [99] and it must be enforceable in court.[100] To this end, the contribution must be

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[91] *Id.* § 170(h)(2). For the full description of these organizations, see *supra* notes 75-78.
[92] *Id.* § 170(b)(1)(B)(vi).
[93] *Id.* § 170(h)(4)(A)(i).
[94] *Id.* § 170(h)(4)(A)(ii).
[95] *Id.* § 170(h)(4)(A)(iv).
[96] *Id.* § 170(h)(4)(A)(iii).
[97] A Private Letter Ruling is a formal response to a question from a private taxpayer about how a specific transaction would be taxed if it were executed. They are considered "private" because they are a response to a specific private individual and are officially confidential, but I.R.C. § 6110 requires the I.R.S. to make public as many of them as possible. *See* I.R.C. § 6110. They may not be cited to or used as precedent. I.R.C. § 6110(k)(3).
[98] I.R.S. Priv. Ltr. Rul. 2004-03-044 (Oct. 9, 2003).
[99] *Id.* § 170(h)(5)(A). The regulations under section 170 say that a restriction in perpetuity must be "on the use which may be made of real property—including, an easement or other interest in real property that under state law has attributes similar to an easement (e.g., a restrictive covenant or equitable servitude)." Treas. Reg. § 1.170A-14(b)(2).
[100] Treas. Reg. § 1.170A-14(g)(1).

"exclusively for conservation purposes"[101] and "[t]he terms of the donation must provide a right of the donee to enter the property at all reasonable times for the purpose of inspecting the property to determine if there is compliance."[102] Furthermore, "the terms of the donation must provide a right of the donee to enforce the conservation restrictions by appropriate legal proceedings, including but not limited to, the right to require the restoration of the property to its condition at the time of the donation."[103]

The regulations do, however, allow for some flexibility. Uses of the property which are inconsistent with the terms of the conservation contribution may be acceptable if, under the circumstances, those uses "do not impair significant conservation interests."[104] Also, conflicting uses of the property which pre-exist the conservation contribution are permitted so long as they do not "conflict with the conservation purposes of the gift."[105]

To calculate the value of conservation easements, the regulations state that a taxpayer must reduce the cost of the easement by the value of any financial or economic benefit that he gets from the easement contribution.[106] Furthermore, the taxpayer cannot take any deduction if the financial or economic benefit that he receives from the easement is greater than the financial or economic costs that the easement imposes.[107]

A taxpayer who challenges an I.R.S. assessment of deficiency must prove that the assessment was wrong to prevail in court.[108] A petitioner must prove his entitlement to deductions; because deductions are strictly a matter of legislative grace, a petitioner must satisfy the specific statutory

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[101] I.R.C. § 170(h)(5)(A).
[102] Treas. Reg. § 1.170A-14(g)(5)(ii).
[103] *Id.*
[104] Treas. Reg. § 1.170A-14(e)(2).
[105] Treas. Reg. § 1.170A-14(e)(3).
[106] Treas. Reg. § 1.170A-14(h)(3)(i).
[107] *Id.*
[108] Welch v. Helvering, 290 U.S. 111, 115 (1933). Section 7491 of the I.R.C. says that sometimes the burden of proof is shifted when a taxpayer introduces credible evidence with respect to a factual issue that relates to his or her tax liability. *See* I.R.C. § 7491(a). That provision is only available in examinations that began after July 22, 1998. *See* Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685, 726 (1998). Because the instant case began before July 22, 1998, that section did not apply to this case. *Glass I*, 124 T.C. at 276 n.14.

requirements for his claimed deductions.[109] A tax court's findings of fact are reviewed by an appellate court for clear error, and its application of the law is reviewed *de novo*.[110]

IV. INSTANT DECISION

The Sixth Circuit Court of Appeals had one issue before them: whether the 1992 and 1993 Conservation Easements were qualified conservation contributions.[111] The I.R.S. contested the tax court's holding that the easements were qualified conservation contributions on three grounds.[112] First, the I.R.S. argued that the tax court's construction of the regulations[113] was erroneous because it read the word "significant" out of the Treasury Regulations and thus erred in concluding that the Glass' property satisfied the I.R.C. rules for conservation easements.[114] Second, the I.R.S. said that the tax court's findings that the encumbered property fit the I.R.C.'s definition of a "charitable conservation easement" were clearly erroneous because the property was too small, retained the Glasses too many rights, and failed to restrict the building rights of neighboring property owners.[115] Finally, the I.R.S. claimed that the tax court erred in finding that the easements' conservation purpose was protected in perpetuity.[116]

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[109] Deputy v. DuPont, 308 U.S. 488, 493 (1940) ("[A]llowance of deductions from gross income does not turn on general equitable considerations. It 'depends upon legislative grace; and only as there is clear provision therefor [sic] can any particular deduction be allowed.' (quoting New Colonial Ice Co., Inc. v. Helvering, 292 U.S. 435, 440 (1934))).
[110] Ekman v. Comm'r, 184 F.3d 522, 524 (6th Cir. 1999).
[111] *Glass II*, 471 F.3d 698, 707 (6th Cir. 2006) (citing.I.R.C. § 170(h)(1) (2000)).
[112] *Id.*
[113] Specifically, the I.R.S. argued that the Tax Court misinterpreted Treas. Reg. § 1.170A-14(d)(3)(i)-(ii). *Id.*
[114] *Id.*
[115] *Id.* at 707-708.
[116] *Id.* at 708.

A. Argument One: The Tax Court Misinterpreted the Definition of a "Significant Relatively Natural Habitat"

The Court first evaluated the I.R.S.'s claim that the 1992 and 1993 Conservation Easements were not qualified conservation easements because the habitat protected by the easements were not "significant" per the regulations under I.R.C. § 170(h).[117] According to the I.R.S., because the easements were not significant, they failed to meet the third requirement for a qualified conservation contribution: "exclusively for conservation purposes."[118] The tax court held that the regulations under section 170(h) define the phrase "significant relatively natural habitat" in such a way to include general fish, wildlife, or plant communities or ecosystems.[119] The tax court also pointed to examples in the regulations as evidence that "habitats for rare, endangered, or threatened species" are in fact significant habitats and ecosystems.[120] Because there was credible evidence that the encumbered property was a relatively natural habitat for Lake Huron tansy, pitcher's thistle, bald eagles, and other endangered species, the tax court ruled that the properties were conservation easements which qualified for tax deductions.[121]

The court of appeals held that the tax court did not err in its interpretation of the I.R.C. and the regulations.[122] Reviewing the tax

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[117] *Id. See* Treas. Reg. § 1.170A-14(d)(3)(i)-(ii) (2006).

[118] *Glass I*, 124 T.C. 258, 280 (T.C. 2005).

[119] *Id.* "[A] qualified real property interest will meet the conservation purpose test, and thus satisfy the third requirement . . ., if that interest is contributed 'to protect a significant relatively natural habitat in which a fish, wildlife, or plant community, or similar ecosystem, normally lives.'" *Id.* (quoting Treas. Reg. § 1.170A-14(d)(3)(i)).

[120] *Id.* (citing Treas. Reg. § 1.170A-14(d)(3)(ii)).

[121] *Id.* at 281-82. LTC's executive director testified that the property was a "'famous' roosting spot for bald eagles and that the conservation easements established a proper place for the growth and existence of Lake Huron tansy and pitcher's thistle. *Id.* at 282. The court, using a layman's definition of "habitat" as an area or environment where an organism or ecological community normally lives or occurs, *id.* (quoting AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 786 (4th ed. 2000), then held that the encumbered property fit the definition of a habitat and therefore were qualified for the conservation easement deductions created by Congress. *Id.* at 282.

[122] *Glass II*, 471 F.3d at 708.

court's interpretation of the law *de novo*,[123] the court of appeals said that habitats for rare, endangered or threatened species or animals or plants are clearly identified in the regulations as significant.[124] With a definition of what a significant relatively natural habitat was, the Sixth Circuit next asked whether or not the encumbered property was significant.[125]

B. Argument Two: The Tax Court Erred in Finding that the Encumbered Property Was a Significant Relatively Natural Habitat

The I.R.S. gave three alternative arguments why the encumbered property was not a significant relatively natural habitat.[126] First, it argued that, absent testimony that Lake Huron tansy, Bald Eagles, and other threatened or endangered species were actually sighted living on the encumbered property at the time of the donation, the tax court was wrong to say that the property was a significant relatively natural habitat.[127] Second, the I.R.S. advocated that, even if Lake Huron tansy and Bald Eagles inhabited the property when the easements were donated, the property still wasn't a significant relatively natural habitat because it was too small.[128] Third, the I.R.S. said that the tax court erred when it failed to consider the building rights of the neighboring property owners.[129]

The Sixth Circuit rejected the I.R.S.'s first point, that endangered species were not actually seen on the property when the easements were granted, and thus, the encumbered properties were not significant relatively natural habitats, on two grounds.[130] First, the court said that the I.R.S. was ignoring testimony from Ms. Glass that she had observed bald eagles and Lake Huron tansy on the encumbered property.[131] Second, the court held that neither the statutory nor the plain meanings of the words "habitat" or "community" supported the argument that endangered species

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[123] *Id.* at 706.
[124] *Id.* at 708.
[125] *Id.* at 708-12.
[126] *Id.*
[127] *Id.* at 709.
[128] *Id.*
[129] *Id.* at 711.
[130] *Id.* at 709.
[131] *Id.*

had to be living on the property when the easements were granted.[132] As support for this argument, the court referenced a Private Letter Ruling from the I.R.S. that a conservation easement can have a mere potentiality to be a habitat for endangered, threatened, or rare plant and animal species, to qualify as a tax-deductible donation under the I.R.C.[133]

The court also rejected the I.R.S.'s argument that the encumbered property was too small and reserved too many rights for the Glasses, to qualify as a significant relatively natural habitat.[134] Instead, the court held that the easements were carefully drawn to prohibit any activity or use of the encumbered property that would undermine their stated conservation purpose.[135] Citing a lack of any evidence that LTC was unwilling or unable to monitor the encumbered property, and noting that the easements were carefully drafted to protect the identified endangered habitats, the court decided that the property owners' reserved rights were not sufficient to say that the easements did not protect a significant relatively natural habitat.[136] In the court's opinion, the Glasses' reserved right to prune or cut vegetation to preserve the view of Lake Michigan or to maintain safety on the property was actually a significant limitation on their rights as property owners.[137] Additionally, the court said that this limitation was enhanced by LTC's power to bring legal action to enforce it.[138]

The Sixth Circuit also found unpersuasive the argument that the physical size of the encumbered properties was too small.[139] According to the court, the I.R.S. failed to present any evidence or testimony to support the assertion that, coupled with the Glasses' retained rights in the property, the specifically identified wildlife and plant-life could not exist in the

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[132] *Id.*

[133] *Glass II*, 471 F.3d 698, 709 (citing I.R.S. Priv. Ltr. Rul. 2004-03-044 (Oct. 9, 2003)).

[134] *Id.*

[135] *Id.* at 710-11.

[136] *Id.* at 711.

[137] *Id.*

[138] *Id.* Although the court does not explain the importance of LTC's power to bring a lawsuit against the property owners, it probably thought that power was significant because it would place a check on the property owners and create a disincentive, i.e. the threat of a lawsuit, for the property owners to engage in conduct proscribed by the easements.

[139] *Id.*

property because of its small size.[140] The court also pointed out that neither the I.R.C. nor the Treasury Department's regulations required an encumbered property to meet a minimum size criterion in order to qualify for the tax deduction.[141] Instead, the court focused on the Private Letter Ruling, which held that a smaller parcel of encumbered property did qualify for the deduction, as evidence that there is no minimum size criterion.[142]

Next, the court rejected the argument that the tax court erred when it failed to consider the building rights of neighboring property owners.[143] To this argument, the Sixth Circuit had two responses.[144] First, the court noted that there is nothing in either the I.R.C. or the Treasury Department's regulations which requires parties to a qualified conservation contribution to take into account, when drafting an easement, the building rights of adjacent property owners.[145] Furthermore, the court believed that accepting the I.R.S.'s argument would unnecessarily preclude conservation donations which would otherwise be permitted under the I.R.C.[146] Specifically, such an interpretation of the statute and the regulations would "preclude larger conservation benefits achieved by aggregate donations of relatively small conservation easements."[147] Thus, the court said that the intent of conservation easements generally would be better served by not requiring encumbered property to satisfy some criterion of minimum physical size or to impair the rights of owners of adjacent properties over their own parcels.[148]

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[140] *Id.*

[141] *Id.* (citing I.R.C. § 170(h)).

[142] *Id.* ("A Private Letter Ruling from the Internal Revenue Service allowing the deduction under I.R.C. § 170(h) for a conservation easement on a 3/4 acre parcel with a state conservation purpose of preserving 'scenic enjoyment of the general public' provides persuasive authority to the contrary.'") (quoting I.R.S. Priv. Ltr. Rul. 85-46-112 (Aug. 21, 1985).

[143] *Id.*

[144] *Id.* at 712.

[145] *Id.* The court suggested that the reason Congress did not require such consideration is because of the "common sense truth that Taxpayers/Donors cannot realistically limit building on property outside of their control." *Id.*

[146] *Id.*

[147] *Id.*

[148] *See id.* at 711-12.

C. Argument Three: The Tax Court Erred in Finding that the Easements Were Protected in Perpetuity.

The Sixth Circuit rejected the argument, posited by the I.R.S., that the easements were not protected in perpetuity.[149] The court acknowledged that a "contribution shall not be treated as exclusively for conservation purposes unless the conservation purpose is protected in perpetuity,"[150] but it went on to point out that the regulations did not disallow the deduction for a contribution when "inconsistent uses" of the property "'do not impair significant conservation interests.'"[151] Summarily, the court then announced that the tax court "correctly concluded that Taxpayers' contributions" were held in perpetuity because of LTC's power to enter the land, to bring legal action to protect the terms of the easement, and to pass off those powers to another conservation group or agency if LTC ceased to function or exist.[152] The court concluded by affirming the decision of the tax court on all grounds.[153]

V. COMMENT

The Sixth Circuit upheld the tax court's decision that the taxpayers were entitled to deduct the "net cost" of granting a charitable conservation organization an easement which allowed a group, LTC, to monitor the use of the taxpayer's land and protect endangered plants and wildlife which may grow there.[154] The court, in doing so, forced the I.R.S. to abide by its own private administrative rulings and by the statutes and regulations which establish the conservation easement.[155] Furthermore, the court

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[149] *Id.* at 712-13.
[150] I.R.C. § 170(h)(5)(A).
[151] *Glass II*, 471 F.3d at 712 (quoting Treas. Reg. § 1.170A-14(e)(2)).
[152] *Id.* at 713. The Tax court had said that LTC "is a legitimate, longstanding nature conservancy dealing at arm's length with petitioners, and LTC has agreed (and has the commitment and financial resources) to enforce the preservation-related restrictions included in [the easements] in perpetuity." *Glass I*, 124 T.C. at 283.
[153] *Glass II*, 471 F.3d at 713.
[154] *Id.*
[155] *See, e.g., id.* at 711 (using a Private Letter Ruling as evidence that the I.R.S. in other similar situations had not required a minimum size for charitable contributions).

acknowledged practical and economic realities which make conservation easements practical for smaller landowners and others.[156]

This decision was consistent with prior decisions from the tax court and courts of appeals as well as I.R.S. administrative decisions.[157] In Private Letter Rulings, the I.R.S. had said that areas which were "potentially the habitat for several endangered, threatened or rare plant and animal species" qualified as tax-deductible charitable donations.[158] In another ruling, the I.R.S. stated that a conservation easement on a parcel of land which was smaller than an acre qualified as a qualified charitable contribution.[159] Thus the court's decision in *Glass* mirrored previous I.R.S. decisions that were factually similar to the one presented in *Glass*.

Furthermore, the decision advances several goals. First, if the court had agreed with the I.R.S. that the land was too small to qualify for the tax deduction, then owners of parcels of land which were even smaller than the Glasses' would have no incentive to create conservation easements. The Glasses' entire property was a little over eleven acres, and if the I.R.S. had won their argument, many small tracks of land would be ineligible for donation; indeed, under the I.R.S.'s rationale, every tract under twelve acres would have been ineligible. Owners of small parcels would have no incentive to preserve their land in its natural state rather than sell it to developers. Furthermore, only farmers and wealthy owners of large pieces of land would have any incentive to preserve their property through conservation easements. While individual family farmers would be one type of taxpayer that Congress would probably prefer to use the deduction, large corporate farms and wealthy private individuals are less sympathetic characters.[160] Yet, the I.R.S.'s argument would have made them the

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[156] *See id.* at 712 ("Congress likely recognized the common sense truth that Taxpayers/Donors cannot realistically limit building on property outside of their control. Adoption of the Commissioner's position would unnecessarily preclude conservation donations permitted under the Tax Code.").

[157] *See supra* note 155.

[158] *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2004-03-044 (Oct. 9, 2003).

[159] *See* I.R.S. Priv. Ltr. Rul. 85-46-112 (Aug. 21, 1985).

[160] According to the U.S. Department of Agriculture, "small family farms" make up ninety-one percent of all farms in the United States. U.S. DEPT. OF AGRIC., ECONOMIC RESEARCH SERVICE, U.S. FARMS: NUMBERS, SIZE, AND OWNERSHIP 6 (2005), *available at* http://www.ers.usda.gov/publications/EIB12/EIB12c.pdf. (last visited Apr. 6, 2007). They hold seventy percent of all farm lands, and they account for eighty-two percent of

primary beneficiaries of the tax deductions for conservation easements. The tax code should not be manipulated to create advantages for only taxpayers in the higher tax brackets, but the I.R.S. advocated an interpretation that would have had just that result. The Sixth Circuit was correct, then, to reject the argument that the parcel was too small to qualify.

The Sixth Circuit also ruled that the easement was valid as a charitable contribution even though the easement did not place any restrictions on adjacent properties.[161] If the court had ruled in favor of the I.R.S. on this argument, the entire purpose of the deduction would have been lost, because a donor-taxpayer simply does not have the power to grant easements for land he or she does not own. Doing so would violate the rights of the proper owner of the land the donor-taxpayer seeks to control, and an easement which tried to encumber land outside the control of the granting party could not be enforced. While the I.R.S. may worry about the developments on neighboring parcels and their effects on endangered species on the encumbered land, neither the taxpayer nor the recipient of a conservation easement are required by the I.R.C. or its regulations to consider the rights of others when drafting a conservation easement. To require them to make such considerations would be to impose impractical and unfair extra-statutory obligations that in practice would ruin the conservation easement scheme Congress created.

Finally, the Sixth Circuit allowed the Glasses to deduct the cost of the easement from their adjusted gross income in 1992 and 1993 as an itemized deduction, because the easements were permissible contributions under the I.R.C.[162] Acknowledging the deduction as an itemized deduction has benefits for state income taxpayers. For example, in Missouri, a resident taxpayer who calculates his or her federal taxes with itemized deductions such as conservation easements generally can use those same deductions to offset income in calculating his or her state taxes as well.[163]

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the land enrolled in the Conservation Reserve Program and Wetlands Reserve Program. *Id.* at 7.

[161] *Glass II*, 471 F.3d at 712.

[162] *Id.* at 713.

[163] *See* MO. REV. STAT. § 143.141 (2000). *See also* Curchin v. Mo. Indus. Dev. Bd., 722 S.W.2d 930 (Mo. 1987) (en banc) ("In large part the deductions provided by the Internal Revenue Code are also allowable for the benefit of Missouri residents to decrease their

In Missouri, a taxpayer's "Missouri itemized deduction" includes all allowable *federal* deductions except for those used to calculate adjusted gross income or which are personal or dependency exemptions.[164] Since contributions to certain qualified organizations of conservation easements are taken after adjusted gross income has been calculated, Missouri law allows its resident taxpayers to deduct those costs from their state income taxes as well. This "legislative grace"[165] amounts to an advantageous double dipping for those who decide to protect the environment with a conservation easement.

Other states also allow taxpayers to deduct conservation easements from their state income tax liabilities.[166] Some states even allow tax credits, rather than deductions, for conservation easements.[167] Credits are stronger tools than deductions because they are dollar-for-dollar reductions for tax liabilities, so taxpayers in states which offer credits get even bigger rewards on their state income tax rewards.[168]

VI. CONCLUSION

The Sixth Circuit's decision in *Glass* protects and reaffirms the taxpayer's right to deduct the net cost of a conservation easement from his or her adjusted gross income.[169] Conservation easements allow a taxpayer to protect up to half of his or her adjusted gross income from taxation by

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state income tax liability.").

[164] *Id.* For a list of deductions used to calculate adjusted gross income, *see supra* note 79.

[165] "[D]eductions are a matter of legislative grace, and the taxpayer must satisfy the specific statutory requirements claimed to reduce a tax liability." *Glass II,* 471 F.3d at 706 (quoting Ekman v. Comm'r, 184 F.3d 522, 524-525 (6th Cir. 1999)).

[166] *See, e.g.,* Code of Ala. § 40-18-15(a)(10) (2007), 36 Me. Rev. Stat. § 5125, Mont. Code. Anno. § 15-30-121 (2007).

[167] *See, e.g.,* Colo. Rev. Stat. § 39-22-522 (2006).

[168] The I.R.S. in January 2007 circulated an attorney memorandum which said that income would not be imputed to a taxpayer which got a credit for granting a conservation easement, even though technically such credits would be income under I.R.C. § 61. I.R.S. A.M. 2007-002 (Jan. 11, 2007). The memo did point out that the credits would reduce overall tax liability to the state which allows it and thus the amount of tax credit granted by the federal government for taxes paid to states would be lower. *Id.* Thus, a state tax credit lowers state tax liability but increases federal tax liability.

[169] *Glass II,* 471 F.3d at 699-700.

the federal government. If the cost of the easement exceeds that limit, the taxpayer can carry forward the balance of the cost into future years and continue to deduct it from adjusted gross income, until either the cost has been fully deducted from income or fifteen years have passed since granting the easement, whichever is sooner. Not only can the easement reduce a taxpayer's tax burden in the present, but it can create benefits in future years when he or she sells the land, since the land will be less valuable with an easement on it. [170] Because the land will be less valuable with the easement on it, the taxpayer will have less gain from the sale of the land, and thus will report less income to the government; then, he or she will be taxed less than he or she otherwise would have if the easement had not been granted. The descendants of the taxpayer would also benefit, albeit to a lesser extent, because the basis they would take in the property would be the fair market value of the land at transfer (i.e., when the taxpayer died), not the basis the taxpayer had in the land right before he or she died.

Conservation easements are also good for the environment because they slow the rate of development and encourage citizens to consider making donations that help the environment. Land that is encumbered with an easement which allows a conservation organization to sue whoever tries to develop the land is worth less than unencumbered land and also cannot be converted into a subdivision or a shopping center. Thus, land on the outskirts of cities, especially cities that are experiencing large urban sprawl, loses some monetary value to developers but retains value in terms of its environmental benefits and is preserved as a natural sanctuary and not paved over.

Conservation easements also encourage citizens to help the environment because they create a presently recognizable and personal benefit to the taxpayer granting the easement for protecting the environment. Because the easement lowers the value of the property, and in many situations makes the land unavailable for commercial or residential development, the economic incentive to the taxpayer to sell the land disappears, or at least drops. However, economically it is offset by a present realization of benefits in the form of tax deductions. These

[170] Rachel Emma Silverman, *Tax Break with a View*, THE WALL STREET JOURNAL, Feb. 7, 2007, at D1.

deductions save taxpayers money by shielding them from taxation at the federal level and possibly at the state or local level as well. Without a presently recognizable economic benefit, a taxpayer would not have a large incentive – other than pure philanthropy – to protect his or her land in perpetuity from development. By coupling environmental protection to economic incentives, the tax code protects endangered species and undeveloped land so that future generations of Americans may enjoy open spaces and those plants and animals whose habitats are threatened by overdevelopment.

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