Appraisals supporting conservation easements are in the crosshairs of the IRS - by David Wilkes

October 15, 2024 - Owners Developers & Managers

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Restrictions placed on the use of land or buildings for conservation purposes have for many years been driven in part by syndicated conservation easements, in which a pass-through business entity acquires real property on behalf of investors, makes a conservation contribution to a qualified organization, and then allocates the associated tax benefits among the investors. Congress began encouraging such conservation easements in the Pension Protection Act of 2006. Total deductions for conservation easement contributions by taxpayers went from $971 million in 2012 to $6.5 billion in 2018. Not long after this period, concerns began to be raised about abuses of the deduction, along with a demand by lawmakers for stronger enforcement of appraisal standards.

The underlying valuation of these and other forms of conservation easements is today a recurring issue that falls among the “Dirty Dozen” list of tax scams identified by the Internal Revenue Service based on the government’s allegation that these transactions may rely on inflated property appraisals that generate excessive tax deductions.

While Congress took steps in recent years that effectively negate much of the tax benefit by enabling the IRS to disallow the deduction at a defined level of value, the Department of Justice continues to aggressively investigate and collect evidence of conservation easements that it asserts used inflated appraisals. Typically, the government asserts that the appraisal makes unreasonable conclusions about the development potential of the property, and therefore the value given up by the donor.

Unfortunately, in pursuing these cases, the government casts an over-broad net that may ensnare many legitimate and properly supported appraisals, causing both appraisers and the transacting parties – even for deals completed many years in the past – to litigate to prove their innocence where the IRS effectively presumes guilt.

The two principal sources of prosecution, often pursued in tandem, are investments that were based on questionable appraisals, according to the IRS, or where the property owners modified the easement terms to fall outside the Code’s “perpetuity” definition, or developed the land in a manner inconsistent with the easement’s restrictions. To qualify for the deduction, the legal agreement to restrict the development or use of the land forever must meet the test of IRC Section 170(h) and associated Treasury regulations. In some instances, tribunals have determined that the easement fails to meet the legal standards for conservation, disallowing the charitable contribution deduction, but then imposed massive penalties based on an evaluation of the appraisals underlying the valuation.

In a pair of 2022 Tax Court cases, some of the wind was taken out of the government’s sails when the court invalidated certain Treasury regulations pertaining to these syndicated easements on grounds related to the process used to enact them, and thereby negated some of the IRS’s ability to assess penalties.

Nonetheless, the Department of Justice continues to prosecute appraisers and related parties based on the underlying appraisals. It goes without saying that no matter how legitimate the valuation practices used may have been, the U.S. Government is a behemoth for any appraiser to confront. In the Tax Court, the appraiser’s methods of determining fair market value at the time the contribution was made (a “before and after” approach) will be scrutinized on a variety of grounds. The tribunal has the discretion to accept the appraisal expert’s opinion in its entirety or may be selective about which portions of testimony it will rely upon, and may determine fair market value based on its own examination of the record. This of course creates great uncertainty, cost, and loss of productivity for many appraisers whose work product was performed with integrity and adhered to recognized appraisal standards. Aside from advocacy provided by counsel, engagement of a well-regarded review appraiser is often an essential component of the defense.

For many appraisers across the U.S., the IRS’ efforts to ensnare a group of bad actors has become an extremely costly examination of their legitimate and appropriate valuations and exposure to penalties and other consequences involved in rebutting the government’s charges.

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