Musings in Agricultural Law and Taxation - of Conservation Easements, IDGTs and Takings

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May 2024
Agricultural Law and Taxation Blog, by Roger McEowen: https://lawprofessors.typepad.com/agriculturallaw/
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Overview

The ag law and tax world continues to go without rest. It's amazing how frequently the law intersects with agriculture and rural landowners. It really is "where the action is" in the law. From the U.S. Supreme Court all the way to local jurisdictions, the current developments just keep on rolling.

More recent developments in ag law and tax – it's the topic of today's post.

An Easement is Not Worth More than the Underlying Property

Oconee Landing Property, LLC, et al. v. Comr., T.C. Memo. 2024-25

In the latest round of the continuing saga involving donated conservation easement tax fraud, the Tax Court uncovered another abusive tax shelter. IRS guidelines make it clear that a conservation easement's value is the value of the forfeited development rights based on the land's highest and best use. To qualify as a highest and best use, a use must satisfy four criteria: (1) the land must be able to accommodate the size and shape of the ideal improvement; (2) a property use must be either currently allowable or most probably allowable under applicable laws and regulations; (3) a property must be able to generate sufficient income to support the use for which it was designed; and (4) the selected use must yield the highest value among the possible uses.

Note: A tract's highest and best use is merely a factor in determining fair market value. It doesn't override the standard IRS valuation approach – that being the price at which a willing buyer and a willing seller would arrive at. *See, e.g., Treas. Reg. §1.170A-1(c)(2). See also Boltar LLC v. Comr., 136 T.C. 326 (2011).*

In this case, the taxpayer donated 355 acres of undeveloped land to a land trust. The 355-acre tract was part of a larger tract that was a nationally recognized golf resort with associated developments. When the larger tract wouldn't sell, the taxpayer became interested in the possibility of granting a conservation easement on the 355 acres. Ultimately, the taxpayer valued the 355 acres at about $60,000 per acre and claimed a charitable deduction for the entire amount - $20.67 million. The IRS disallowed the deduction due to lack of donative intent – the entire scheme involved a pre-determined agreement to secure inflated appraisals so that investors would be able to deduct more than their respective investments.

Note: The amount of the deduction that can be claimed is subject to a limitation based on a percentage of the taxpayer's contribution base. *I.R.C. §170(b)(1)(H).* However, if the donor is a "qualified farmer or rancher" and the donated property is used in agricultural or livestock production, the deduction may be up to 100 percent of the donor's contribution base. *I.R.C. §170(b)(1)(E)(iv).* For corporate farms and ranches, see I.R.C. §170(b)(2)(B) and for the definition of a "qualified farmer or rancher" see I.R.C. §170(b)(1)(E)(v) and Rutkoske v. Comr., 149 T.C. 133 (2017).

While the Tax Court determined that the donated easement had value, it agreed with the IRS that the value of the tract was approximately $5 million. However, the lack of a *qualified* appraisal as the regulations require be attached to the return wiped out any associated deduction. Simply setting a target value for the appraiser to hit coupled with the taxpayer's knowledge that the value was overstated is not a qualified appraisal.

Note: Form 8283, Section B, as an appraisal summary must be fully completed and attached to the return for noncash donations greater than $5,000.

In addition, the Tax Court pointed out that the 355-acre tract had been transferred to a developer (a partnership) who then donated the easement. That meant that the donation was of ordinary income property which limited any deduction to the basis in the property. Because there was no evidence offered as to the basis of the property, the deduction was zero. *I.R.C. §170(e)(1)(A).*

For good measure, the Tax Court tacked on a gross overstatement penalty of 40 percent. In determining the penalty, the Tax Court agreed with the IRS position that the highest and best use of the tract was as a "speculative hold for mixed-use development" and the easement was worth less than $5 million. The Tax Court also tacked on a 20 percent penalty on the portion of the underpayment that wasn't associated with the erroneous valuation.

Note: The rules associated with donated conservation easements are technical and must be precisely complied with. While large tax savings can be achieved by donating a permanent conservation easement (especially for farmers and ranchers), carefully following all of the rules is critical. Predetermining a valuation is a big "no-no."

IRS Changes Position on Gift Tax Treatment of IDGT Tax Reimbursement Clauses

C.C.A. 202352018 (Nov. 28, 2023)

An Intentionally Defective Grantor Trust, or IDGT, is a tool used in estate planning to keep assets out of the grantor's estate at death, while the grantor is responsible for paying income tax on the trust's earnings. Those tax payments are not gifts by the grantor to the beneficiaries. If that tax burden proves to be too much it has been possible to give an independent trustee discretion to distribute funds from the trust to the grantor for making those tax payments. The IRS said in 2016 that also wouldn't trigger any gift or income tax consequences for the grantor. *Priv. Ltr. Rul. 201647001 (Aug. 8, 2016).* But now IRS says that a reimbursement clause in an IDGT does trigger gift tax when the trustee distributes trust funds to the grantor. IRS now deems such a clause to result in a change in the beneficial interests in the trust rather than constituting merely being administrative in nature.

Note: While the IRS did not address the issue, it would seem that if state law authorizes the trustee to reimburse the grantor, as long as the trust doesn't prohibit reimbursement, no gift tax should be triggered.

"Takings" Cases at the U.S. Supreme Court

Devillier v. Texas, 144 S. Ct. 938 (2024)

Sheetz v. El Dorado County, 144 S. Ct. 893 (2024)

***Devillier* – Is the Fifth Amendment "self-executing"?** The family involved in *Devillier* has farmed the same land for a century. There was no problem with flooding until the State renovated a highway and changed the surface water drainage. In essence, the renovation turned the highway into a dam and when tropical storms occurred, the water no longer drained into the Gulf of Mexico. Instead, the farm was left flooded for days, destroying crops and killing cattle. The family sued the State of Texas to get paid for the Taking.

Note: Constitutional rights don't usually come with a built-in cause of action that allows for private enforcement in courts – in other words, "self-executing." They're generally invoked defensively under some other source of law or offensively under an independent cause of action.

The family claimed that the Takings Clause is an exception based on its express language – "nor shall private property be taken for public use, without just compensation." The case was removed to federal court and the family won at the trial court. However, the appellate court dismissed the case on the basis that the Congress hadn't passed a law saying a private citizen could sue the state for a constitutional taking. In other words, the federal appellate court determined that the Fifth Amendment's Takings Clause isn't "self-executing."

The U.S. Supreme Court agreed to hear the case with the question being what the procedural vehicle is that a property owner uses to vindicate their right to compensation against a state. The U.S. Supreme Court unanimously reversed the lower court, although it did not hold that the Fifth Amendment is "self-executing." Texas does provide an inverse condemnation cause of action under state law to recover lost value by a Taking. The Supreme Court noted that Texas had assured the Court that it would not oppose the complaint being amended so that the case could be pursued in federal court based on Texas state law.

***Sheetz* - traffic impact mitigation fee and government extortion.** Sheetz claimed that a local ordinance requiring all similarly situated developers pay a traffic impact mitigation fee posed the same threat of government extortion as those struck down in *Nollan v. California Coastal Commission, 483 U.S. 825 (1987)*, *Dolan v. City of Tigard, 512 U.S. 374 (1995), and Koontz v. St. Johns River Water Management District, 570 U.S. 595 (2013).* Those cases, taken together, hold that if the government requires a landowner to give up property in exchange for a land-use permit, the government must show that the condition is closely related and roughly proportional to the effects of the proposed land use.

In this case, Sheetz claimed that test meant that the county had to make a case-by-case determination that the $24,000 fee was necessary to offset the impact of congestion attributable to his building project - a manufactured home on a lot that he owns in California. He paid the fee, but then filed suit to challenge its constitutionality under the Fifth Amendment. The U.S. Supreme Court unanimously ruled in his favor. The Court determined that nothing in the Takings Clause indicates that it doesn't apply to fees imposed by state legislatures.

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