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Unsettled questions surround tax breaks for conservation easements

By Benny L. Kass
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Q: My neighbor just gave an easement in her property to some company and claims that she will get a huge tax benefit when she files her next income tax return. What is that, and are there really any tax benefits available?

A: An easement is often defined as giving someone other than the property owner the right to use the property (or a portion of it) without actually owning the property. For example, say you own land by a lake, and I own adjoining land by a road. The only way you can get to the road is through my land. You have an easement by necessity to cross my property to get to the road.

Public utilities have their pipes and conduits running under my land. They have an easement -- recorded on local land records -- allowing them to access my property to make repairs or correct problems.

Oversimplified, an easement (whether voluntarily granted by the homeowner or created by law -- such as the easement by necessity) is a restriction on your use of your property. Your neighbor is referring to a conservation easement (often called a facade or preservation easement). This means that your neighbor has given an easement to a legitimate conservation organization, and as a result your neighbor is restricted from making changes to the exterior of her house without first obtaining permission from the organization that holds the easement.

Why should you consider granting an easement placing significant restrictions on what you can do with your house in the future? There are two basic reasons.

First, you want to preserve the historic nature of your house -- and your neighborhood. You are troubled with the many commercial or condominium buildings popping up all over your area, and you want to do your part to protect the architectural integrity of your house. Second, if you do it right, you will get a tax credit.

How does it work? You must make arrangements with a qualified, legitimate organization that accepts such easements. According to the IRS, a qualified organization is either a governmental unit; a publicly supported charitable, religious, scientific or literary organization; or "an organization that is controlled by and operated for the exclusive benefit of a governmental unit or a publicly supported charity." (See IRS Publication 526, "Charitable Contributions," available from <http://irs.gov>.)

Several years ago, it was discovered that many fly-by-night organizations were claiming they could assist homeowners with these easements. It turned out that those groups were only interested in taking consumers' money and were not qualified to accept easements. Congress tightened the law, and now the IRS will carefully scrutinize any tax return that contains a credit for the easement.

However, the L'Enfant Trust, a recognized and reputable organization in the Washington area, tells property owners: "Be careful about promoters who steer you to a particular easement holding group, and make sure you find out how and by whom the promoter is paid."

Not all houses will qualify for tax benefits. Your property either has to be specifically listed on the National Registry of Historic Places or located in a registered historic district such as Greater U Street, 14th Street Historic, Anacostia or Georgetown, and be more than 50 years old.

There are additional requirements. The restriction must preserve the entire exterior of the building, including its front, sides, rear and height. You must enter into a written agreement with the organization receiving the easement, certifying under

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penalty of perjury, that the organization is qualified. Finally, your tax return must include a qualified appraisal, pictures of the building's entire exterior and a description of all restrictions on development of the property such as zoning laws. If you claim a deduction of more than \$10,000, you will also have to pay a \$500 filing fee to the IRS.

In April, the U.S. Tax Court threw a wrench into the deductibility of these conservation easements. According to the tax code, the interest conveyed by an easement must be protected in perpetuity. This means that it is permanent and that unless the charitable organization consents, it can never be changed.

In the case before the tax court, the easement was conveyed to a legitimate organization after the homeowners had a mortgage on their house. The tax court was concerned that should the house be destroyed by a fire or other casualty, the mortgage lender would be entitled to any insurance proceeds. Since the tax laws require that the charitable organization is absolutely entitled to these proceeds, the court held that the facade easement contribution "fails as a matter of law to comply with the enforceability in perpetuity requirements." (Kaufman v. IRS, decided April 26.)

Does this mean the end of conservation easements? No. There is a simple way of resolving this, namely by getting your mortgage lender to subordinate its rights to the charitable organization. This means that a document is filed with the land records where the house is located, stating that the organization's interest in the easement is superior to that of the lender's interest -- in other words "subordinated" to the organization.

L'Enfant Trust, on its Web site, distinguishes its practices from those in the Kaufman case, because its documents do, in fact, contain a subordination approved by the mortgage lender. Whether lenders in today's market will be willing to subordinate any of their interests is a question that remains to be answered.

What are the tax benefits available should you have a successful easement approved by the IRS? If you contribute qualified property to a qualified organization, the amount of your charitable contribution is generally the difference between the value of the property before the easement is recorded and the value of the property afterward. The IRS cautions, however, that if your property increases in value as a result of the easement, you will not be entitled to any tax credit.

An earlier tax court case is helpful as we attempt to determine the true value of the easement. In *Simmons v. IRS*, decided on Sept. 15, 2009, the court made it clear that "no established market exists for determining the fair market value of an easement." After a thorough evaluation of the appraisals submitted by both sides, the court granted a 5 percent reduction to the homeowners.

Whether the IRS will continue its campaign against conservation easements is an open question. There is no litmus test, no safe harbor, as to what tax benefits you will get should you decide to donate a conservation easement.

It's a complex process, and you should consult not only a qualified charitable organization but also your tax and legal advisers.

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