Eleventh Circuit Deals IRS Defeat In Conservation Easement Struggle

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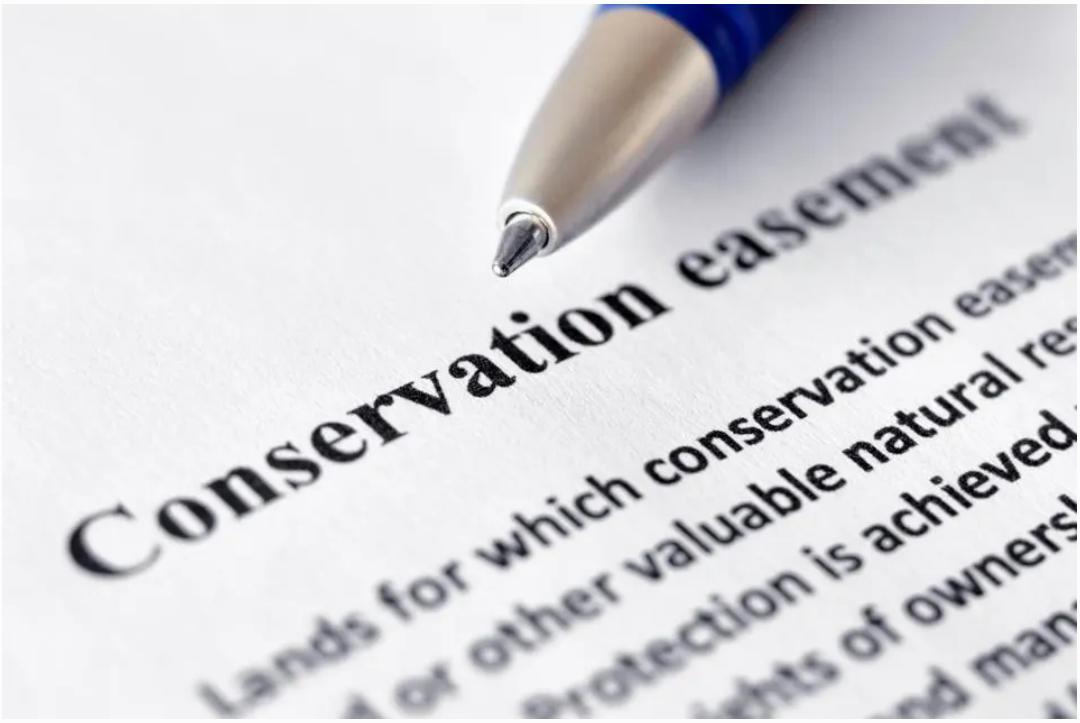

Close-up of Conservation easement with pen GETTY

The Eleventh Circuit has thrown a monkey wrench into the IRS machinery grinding away at abusive conservation easement deductions. Judge Barbara Lagoa, a Trump appointee, wrote the

opinion in David and Tammy Hewitt v Commissioner of IRS issued on December 29, 2021.

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The Hewitts were appealing a 2020 Tax Court decision by Judge Goeke. The Hewitts had claimed a $2.8 million deduction on their 2012 return. Somehow the 2012 return got by, but the IRS was disallowing carryovers in 2013 and 2014. Judge Goeke agreed with the disallowance resulting in deficiencies of $336,894 and $347,878 for 2013 and 2014 respectively, but passed on valuation and accuracy penalties.

The Perpetuity Problem

Judge Goeke based total disallowance of the deduction on the failure of the easement document to meet the perpetuity requirement (Section 170(h)(5)(A)). The problem was with the clause in the agreement as to what would happen in the event that the easement was extinguished by judicial action (such as a taking of the property by eminent domain).

Regulation 1.170A-14(g)(6)(ii) requires that the percentage split of proceeds be set at that the time of the donation and remain fixed. The donee's share has to be at least the proportionate value the gift bears to the whole at that time. The Hewiitt easement had a clause allowing five one acre homesites on the 257 acre property and provided that in the event of judicial extinguishment that the value of any post easement improvements would come off the top and go to the donors.

Ancient History

The Hewitts took a new tack in challenging the regulation based on the process that Treasury went through in approving it. The argument is that Treasury did not tow the line of the Administrative

Procedures Act when the regulation was under consideration in the early eighties. There were a couple of germane comments that Treasury did not respond to most notably one from the New York Landmarks Conservancy that encouraged Treasury to delete the proposed proceeds regulation. Believe it or not that is what did it for the taxpayers:

Because Treasury, in promulgating the extinguishment proceeds regulation, failed to respond to NYLC's significant comment concerning the post-donation improvements issue as to proceeds, it violated the APA's procedural requirements. We thus conclude that the Commissioner's interpretation of § 1.170A-14(g)(6)(ii), to disallow the subtraction of the value of post-donation improvements to the easement property in the extinguishment proceeds allocated to the donee, is arbitrary and capricious and therefore invalid under the APA's procedural requirements.

Where Does That Leave Us?

It is worth noting that this is not one of the abusive syndicated transactions that have been the main focus of IRS fury. Much of the property had been in the family since the 1950s. There is some indication that Mr. Hewitt got involved in syndicated deals subsequently. Judge Goeke, although somewhat concerned, dismissed that as not relevant in looking at accuracy penalties, which he did not sustain.

The proceeds language was the easiest avenue of attack, but not the only one raised by the IRS. The Hewitts claimed a deduction of $2,787,500 of which they had only used $57,738 in 2012. The IRS appraiser placed a value of $190,000 on the easement judging that the highest and best use of the property was the sort of use allowed by the easement. The taxpayer experts argued that it was great site for a mobile home park. Judge Goeke was only looking at valuation for purposes of the valuation penalty. He ruled that the easement was worth at least $1.4 million. It looks like he will have to take another look.

The Sixth Circuit is looking at a full dress Tax Court opinion on the validity of the regulations - Oakbrook Land Holdings. The Tax Court upheld them, but there was an impassioned dissent by Judge Holmes which leaned on the New York Landmark's Conservancy comments. Even if the Sixth goes with the Tax Court, a disproportionate number of easement cases probably arise in the Eleventh.

Judge Holmes recommends that the IRS focus on valuation rather than using technical flaws. It will be interesting to see what happens.

Comments

I heard from David W Foster, one of the lawyers for the Hewitts, he wrote:

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Under the APA, regulations receive deference because they are the product of a robust exchange with the regulated public. The Eleventh Circuit's opinion in Hewitt demonstrates that the courts will not defer to regulations that circumvented the required process.

With this decision, taxpayers now will have the opportunity to demonstrate the merits of their transactions in Tax Court.

Lew Taishoff wrote me:

Mr Reilly, I was expecting this outcome. "Highly contestable readings of what it means to be perpetual" were bound to fail. Judge Holmes was right.

Stephen J. Small pointed out that the holding in the opinion is a little confusing in that it does not explicitly invalidate the regulation, just IRS interpretation of it.

I would be tempted to say to the court, no, that's not right. The rule has been issued. You can either say the rule is invalid under the APA or, no, IRS, your argument on this particular very specific interpretation of the rule is not consistent with the reg, so you can't deny a deduction solely on this issue.

He continued:

We have not heard the last of this. We have to wait and see what IRS does or says or doesn't do. I do not think this opinion is enough to give anyone "comfort" at the moment; maybe "a little bit of hope," but not comfort.

Other Coverage

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Jack Townsend at *Federal Tax Procedure* has *11th Cir. Invalidates Proportionate Sharing Regulations As Procedurally Arbitrary and Capricious for Failing to Address a Significant Comment*, Mr. Townsend, like Stephen Small noted ambiguity in the opinion:

It is not clear to me whether the opinion as written is a final disposition on the issue of the validity of the interpretation. The Hewitt court seems only to have held that the regulation was invalid because it failed the procedural regularity test. The Court never engaged with the issue of whether the interpretation (as opposed to the regulation) was a valid interpretation of the governing statute, § 170(h)(5)(A). There is thus the possibility that the IRS could or should still prevail if the interpretation is the best interpretation of the statute.

An interesting hit on the decision comes from LIF (lawsinflorida) - *Here's the Tax Deductible 11th Cir. Opinion Judge Jill Pryor Has Been Bayin' Her Colleagues For*. Apparently Judge Pryor has an interest in two LLCs that are in Tax Court litigating conservation easements. I am skeptical of LIF's claim that this is "corruption at its highest level', but I am intrigued enough to try to find out more. The cases are River's Edge Landing LLC and Dasher's Bay at Effingham LLC. They both lost on motions for summary judgement on the perpetuity issue.

Ed Zollars on *Current Federal Tax Developments* has *Eleventh Circuit Holds IRS Regulation on Judicial Extinguishment Formula for Conservation Easement Deductions Invalid*.

Lew Taishoff has Taking The Bookies' Money. He was pleased with himself for having predicted the outcome. I had asked him about LIF's article. He was not impressed.

But Mr. Reilly turned up some political commentary, claiming judicial misconduct. Arrant nonsense; proof once again that Lord Chief Justice Campbell was right: "There is nothing so dangerous as for one not of the craft to tamper with our freemasonry."
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