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Thank you, Mr. Chairman, Ranking Member Baucus, and distinguished Members of the Committee, for the opportunity to discuss the law relating to the deductibility of contributions for conservation easements, and the steps the Internal Revenue Service is taking to enforce the law in this area. Congress has allowed an income tax deduction for owners of significant property who give up certain rights of ownership so that their land or structures might be preserved for future generations.

The conservation contribution provisions of the Internal Revenue Code play a vital role in the preservation of property with unique public value. However, conservation easements – dependent as they are on issues of public benefit and the appropriate valuation of tangible and intangible assets – warrant our attention. In our work to date in this area, the IRS has seen abuses that compromise the policies and the public benefit that Congress intended to promote. Later, I will discuss these problems in more detail, and explain what we are doing about them. But first, let me explain how the tax provisions relating to conservation easements work.

Legal Requirements for Deductions for Conservation Easements

In general. First, let me distinguish between donations of ownership of real property and donations of conservation easements. Under general income tax rules, to be eligible for a deduction for a charitable contribution, a taxpayer must give his or her entire interest in the property to the charity that receives the gift. For example, if I own a parcel of land, or a boat, or anything else, I must give up all rights of ownership to the charity, and can reserve no substantial rights for myself. Under these rules, when ownership of real property is transferred to a charity, the donor gives up all title and interest in the property and the recipient charity becomes the new owner. The donor generally may take a charitable contribution deduction for the fair market value of the property. In these cases, as with other gifts of property, our main concern generally is whether the donor has valued the gift correctly.

Conservation Easements. There are only a few exceptions to this general rule, and a conservation easement is one of them. Section 170(f)(3)(B)(iii) allows a deduction for a qualified conservation contribution, even though it is only a gift of a partial interest in property.

Section 170(h) defines a "qualified conservation contribution." It is a contribution:

- Of a qualified real property interest, including an easement granted in perpetuity that restricts the use that can be made of the property. Section 170(h)(2)(C).

- To a qualified organization. Generally, these are public charities and governmental units. Section 170(h)(3). Importantly, the recipient charity must have the resources and commitment to monitor and enforce the restrictions.

- Exclusively for conservation purposes.

With respect to the last requirement, there are four allowable conservation purposes. Section 170(h)(4). A conservation contribution must be for:

- The preservation of land areas for outdoor recreation or education of the general public;

- The protection of a relatively natural habitat of fish, wildlife, plants, or similar ecosystem;

- The preservation of open space (including farmland and forest land) for either the scenic enjoyment of the general public, or pursuant to a clearly delineated governmental conservation policy. In either case, the conservation contribution must yield a significant public benefit; or

- The preservation of an historically important land area or a certified historic structure.

From discussions with your staff, I understand that the Committee is concerned today primarily with easements that address the third conservation purpose, the preservation of open space, and my remarks will focus on such easements.[1] I

[1]The following is a brief description of the other allowable conservation purposes:
a). **Easements for recreational or educational purposes.**
The donation of easements to preserve land areas for the recreational use of the general public or for the education of the public is a recognized conservation purpose. Examples include the preservation of a water area for public recreation such as boating or fishing, or the preservation of land for a nature trail or hiking trail. Unlike easements for the other conservation purposes listed

would also note that, as we move forward, we are doing considerable work in the area of façade easements. In addition, as we work on what we believe are open space issues, we expect to find that some easement donations fall into other categories, e.g., easements for recreation and for the protection of a relatively natural habitat.

Specific rules relating to open space easements. Easements for the preservation of open space must either be for the scenic enjoyment of the general public, or pursuant to a clearly delineated governmental conservation policy. In either case, they must also yield a significant public benefit.

Scenic enjoyment of the public.

To determine that an easement will protect the scenic enjoyment of the public, it must be shown that development of the land would result either in an impairment of the scenic character of the landscape, or would interfere with a scenic view that can be enjoyed from a public place. Scenic enjoyment is determined by a flexible facts and circumstances test, which takes into account regional variations in topography, geology, biology, and cultural and economic conditions. Section 1.170A-14(d)(4)(ii) of the Income Tax Regulations sets out factors to be considered in determining scenic enjoyment. These include the following:

- The compatibility of the land use with other land in the vicinity;
- The degree of contrast and variety produced by the visual scene;
- The openness of the land;

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here, these easements necessarily require regular and substantial physical access by the general public.

b). **Easements for the protection of wildlife and habitat.**
The second category of conservation easements is to protect a significant natural habitat or ecosystem in which fish, wildlife, or plants live in a relatively natural state. Significant natural habitats include the habitats of rare, endangered, or threatened species of animals, fish, or plants, or natural areas that represent high quality examples of a terrestrial or aquatic community, or natural areas that contribute to the ecological viability of a park, nature preserve, wildlife refuge, or wilderness area. Limitations on public access to these areas will not render an easement donation nondeductible. For example, a restriction on access to the habitat of a threatened species is consistent with the conservation purpose of the easement.

c). **Easements for historic land or structures.**
Historical preservation easements are intended to preserve historically important land areas or historic structures. This provision contemplates properties listed in the National Register of Historic Places, or a land area that is independently significant historically, or that is located in a registered historic district, or that contributes to the historic or cultural integrity of a registered historic district. Easements to preserve historic land or buildings will not qualify as qualified conservation contributions unless there is at least some visual access by the public.

- The degree to which the land use maintains the scale and character of the urban landscape; and

- The consistency of the view with state programs and landscape inventory.

At a minimum, visual access to or across the property is required. Under the terms of an open space easement on scenic property, the entire property need not be visible to the public, although the public benefit from the donation may be insufficient to qualify for a deduction if only a small portion of the property is visible to the public.

Significant public benefit.

There must also be a significant public benefit that arises from an open space easement. The regulations contain a non-exclusive list of eleven factors that may be considered. Section 1.170A-14(d)(iv)(A). Some of these factors involve the uniqueness of the land; the intensity of current or foreseeable development; the likelihood of development that would lead to the degradation of the scenic, natural, or historic character of the area; the opportunity for the general public to use the property or appreciate its scenic values; and the importance of the property in maintaining a local or regional landscape or resource that attracts tourism or commerce to the area. These factors indicate the kind of open space contemplated as having a significant public benefit.

The preservation of an ordinary tract of land will not in and of itself yield a significant public benefit, but the preservation of ordinary land areas in conjunction with other factors that demonstrate significant public benefit or the preservation of a unique land area for public enjoyment will yield a significant public benefit. For example, the preservation of a vacant downtown lot will not by itself yield a significant public benefit, but the preservation of the downtown lot as a public park will, absent other factors, yield such a benefit.

The following are other examples of contributions with a significant public benefit: the preservation of farmland pursuant to a state program for flood prevention and control; the preservation of a unique natural land formation for the enjoyment of the general public; the preservation of woodland along a public highway pursuant to a government program to preserve the appearance of the area so as to maintain the scenic view from the highway; and the preservation of a stretch of undeveloped property located between a public highway and an ocean in order to maintain the scenic ocean view from the highway.

A deduction will not be allowed for the preservation of open space if the terms of the easement permit a degree of intrusion or future development that will interfere with the essential scenic quality of the land.

I have mentioned that, as we expand our work in this area, we may find that we have issues with respect to the deductions claimed for gifts of conservation easements for purposes other than open space. For example, issues may arise regarding the degree of development that is consistent with conservation purposes. We recently lost a case in Tax Court in which the taxpayer claimed a deduction for donating a conservation easement to limit development on two sections of a parcel of lakeshore property. Access to the property was not available to the public. The taxpayer provided testimony that bald eagles had been sighted on the property and that at least one species of endangered indigenous plants could be found there. The court upheld the taxpayer's position that a deduction was allowable, not on the basis that it was a qualified open space easement, but on the alternative ground that the easement protected a relatively natural habitat of wildlife and plants. The IRS had argued that the deduction failed on this basis as well. *Glass v. Commissioner*, 124 T.C. No. 16, Docket No. 17878-99 (May 25, 2005). No decision has been made whether the IRS will appeal or seek reconsideration.

Amount of the deduction - Valuation rules. If the contribution meets all requirements of section 170, and qualifies as a conservation contribution, then the question becomes how to value the easement. Generally, the amount of the deduction may not exceed the fair market value of the easement on the date of the contribution (reduced by the fair market value of anything received by the donor in return). Fair market value is the price at which the contributed property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and each having reasonable knowledge of relevant facts.

If there is a substantial record of sales of easements comparable to the donated easement (such as purchases pursuant to a governmental program), the fair market value of the donated easement is based on the prices of the comparable sales. If no substantial record of marketplace sales is available to use as a meaningful or valid comparison, as a general rule (but not in all cases) the fair market value of a conservation restriction is equal to the difference between the fair market value of the property before the granting of the restriction and the fair market value of the encumbered property after the granting of the restriction.

Under the regulations, if such before-and-after valuation is used, the fair market value of the property before contribution must take into account not only the current use but also an objective assessment of how immediate or remote is the likelihood that the property, absent the restriction, would in fact be developed. The valuation also must take into account the effect of any zoning, conservation or historic preservation laws that already restrict the property's potential highest and best use. Additionally, if before-and-after valuation is used, an appraisal of the property after contribution of the restriction must take into account the effect of restrictions that reduce the potential fair market value represented by highest

and best use but will, nevertheless, permit uses of the property that will increase its fair market value above that represented by the property's current use.

If the donor reasonably can expect to receive financial or economic benefits greater than those to be obtained by the general public as a result of the donation of a conservation easement, no deduction is allowable. If development is permitted on the property to be protected, the fair market value of the property after contribution of the restriction must take into account the effect of the development.

The recipient of the easement - Qualified Organizations. To be qualified to receive a conservation easement, an organization must be a governmental unit, or one of several types of public charities. In order to be a qualified organization, the organization also must be committed to protect the conservation purposes of the donation, and must have the resources to enforce the restrictions. However, it need not set aside funds for this purpose.

As with any charity, a qualified organization is subject to certain rules described in section 501(c)(3); the organization must operate exclusively for charitable, educational, or other tax-exempt purposes. It cannot serve private interests unless such interests are only incidental to its exempt purposes, and it cannot serve a substantial nonexempt purpose. If the organization becomes derelict in its duties to ensure that donated easements continue to serve an exempt purpose, or if the organization subordinates the interests of the public to the interests of the donor, the organization's tax exemption may be open to question.

Internal Revenue Service Enforcement of Open Space Conservation Easements

Overview. In this portion of my testimony I will outline the enforcement actions the IRS has taken in this area, and what we have found to date. First, I will discuss the reporting requirements for exempt organizations and their donors, and steps the IRS is taking to improve such reporting. Then, I will discuss our examination activity in the area.

Reporting. As we moved from dealing with these issues on a case-by-case basis to approaching them in an organized, comprehensive fashion, we recognized that we needed to enhance the capacity to determine systematically which organizations and individuals have been involved in conservation easement transactions. To address this, we are modifying our tax forms to gather more information about organizations with conservation easement programs, and their donors. We recently modified Form 1023, "*Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code,"* to add new questions that will help us identify organizations with conservation easement donation programs in order to ensure that they meet the requirements for exemption, including the ability to meet conservation responsibilities.

Charities and other tax-exempt organizations annually file Form 990, *"Return of Organization Exempt From Income Tax",* an information return that reports income, expenses, assets, and liabilities of these organizations, along with specific information about their operations and programs**.** We are concerned that the public is not getting enough information from Form 990 to understand what activities many of our charities are engaged in**.** As an interim step, the 2005 Form 990 will be modified so that both the IRS and the public have a better understanding of which organizations receive easements. We expect that this will be in the form of a new checkbox that will identify those organizations that received a conservation easement donation during the year.

All exempt organizations can now file their annual returns electronically. Electronic filing was available for Form 990 and 990EZ filers in 2004, and is available this year for private foundations, which file Form 990-PF. We want to encourage e-filing because it reduces taxpayer errors and omissions and allows us, and ultimately the public, ready access to the information on the return. For this reason, we have required e-filing in certain cases. Under proposed and temporary regulations, by 2007 we will require electronic filing for larger public charities and all private foundations.

We also are working on larger scale improvements to the Form 990. The current form could be more "user-friendly" and elicit more information that we need. We anticipate that the revised form will have specific questions or separate schedules that focus on certain problem areas. For example, filers should not be surprised to find specific schedules or detailed questions relating to credit counseling activities, supporting organizations, compensation practices, and organizational governance. The easement area is also under consideration. The timing of the revision of the Form 990 is dependent on our partners, including the states, 37 of which use the Form 990 as a state filing, and software developers.

When donors make gifts of property in one year that exceed $500, they file Form 8283, *"Noncash Charitable Contributions*", with their income tax returns. On the form donors list the property they are donating. For most donations that exceed $5,000, the form requires a written appraisal and the identity and signature of the appraiser, along with a signed acknowledgement of the gift by an officer of the charity that receives the gift.

We are modifying Form 8283 to provide a new checkbox to identify donors of conservation easements, and we are modifying the form's instructions to better describe what is permissible and to obtain better information on the type of property donated. The revised form also will reflect new qualified appraisal requirements enacted by Congress last year in section 170(f)(11). Where the donation is in excess of $500,000, the form will require taxpayers to attach the complete appraisal to the return.

Once implemented, these changes will enable us to better identify the universe of organizations and donors who are involved in conservation easement transactions, and they will allow us to better target our future enforcement efforts. In the meantime, we will pursue the active enforcement program we have in place now.

Examination activity in the area of conservation easements - Review and findings to date.

Formation of a cross-functional team. Earlier this year, we formed a cross-functional team to attack all aspects of the problem of conservation easements, including any conservation buyer programs as described in Notice 2004-41, discussed below. The team includes members from three IRS business units (Large and Midsize Business, Small Business and Self-Employed, and Tax Exempt and Government Entities), as well as representatives from the IRS Appeals Office, Chief Counsel, and the Office of Professional Responsibility.

Our team has set workload priorities. It has trained and is continuing to train IRS agents and appraisers on conservation easement issues, and will serve as a resource for legal questions for our field personnel.

We are looking not only at donors and recipient charitable organizations, but also at promoters. The team will be alert for developing patterns of abuse and will identify promoters of potentially abusive easement donations. In the course of our examinations we are finding appraisers that appear to be associated with abusive promotions on a recurring basis. We are going to shine a searchlight in their direction, and will use all civil and criminal tools at our disposal to combat abuses.

Inventory of cases and findings to date.

Donor Audits.

Currently we have over 240 donors under audit because they have taken an open space easement deduction. These are high dollar cases. An additional 100 donors are being considered for audits as well. As indicated, we also have façade easement cases, both residential and commercial, under way, though the number currently active is lower.

While our audits are under way, it is still too early to draw reliable conclusions or make clear findings about taxpayer practices in this area. Nonetheless, I am comfortable in offering some comments and expressing some concerns. In the open space easement area, valuation can be difficult and can present opportunities for abuse and manipulation. As I have said, the value of a donated easement generally is the difference in the value of the underlying property before and after the donation. This essentially means the property must be

valued twice, based on what a willing buyer would pay to a willing seller before and after the donation of the easement.

In these cases, we are seeing several issues. In terms of whether the donation meets the threshold requirements for deductibility, we have seen cases where we do not believe there is any public access (visual or otherwise), where the tract appears to be ordinary in nature and where there does not appear to be a conservation purpose being served (for example, there are cases involving the donation of easements on pieces of a golf course).

Valuation issues are even more difficult because we must review and critique underlying assumptions that do not appear reasonable. The rules on valuation are based upon the facts and circumstances of each case, including prior restrictions on the use or modification of the property, as well as upon the restrictions detailed in the easement, and each case is unique. In some cases, the easement restrictions may have no effect on the value of the property.

Assumptions concerning future development have been particularly problematic. Generally, the owner of the property restricts the amount of development to a degree that is less than that allowed by local zoning or regulatory policy. However, in some cases, development is assumed that takes into account major zoning changes, and in other cases, non-existent water rights have been assumed. The economic feasibility of the development may not be adequately considered, and there may be other unrealistic assumptions.

Audits of the recipient charity.

We are also looking at a number of charities that are engaged in the receipt of conservation easements. This includes some charities that we believe may have been involved in particular abuses. Currently, we have seven organizations under examination, and four more examinations will begin shortly.

In Notice 2004-41, 2004-28 I.R.B. 31, we outlined another abuse. In this situation, a charitable organization purchases property and places a conservation easement on the property. The charity then sells the property subject to the easement for a price that is substantially less than the price paid by the charity for the property. As part of the sale, the buyer makes a second payment designated as a charitable contribution to the charity. The total of the payments fully reimburses the charity for its cost. In some cases, the second payment is really part of the negotiated purchase price of the property and therefore is not a contribution. The Notice says that the IRS will treat these transactions in accordance with their substance rather than their form, and will look at the operations of the charity.

Promoter Referrals and Audits. We are seeing promoted investor syndications seeking to profit from conservation easements. This may be more prevalent in

certain states that allow transfers of tax credits. Some of these states have provided referral information to us on questionable easement donations. In a typical case, investors pool funds to buy a property. After one year, a conservation easement will be placed on the property using an appraised value for the property before the contribution that is much higher than the purchase price. The result is an easement deduction that is many times the value of the original purchase price.

We are currently looking or have looked at the activities of more than twenty promoters, and five promoters involved in easements have been recommended for investigation. Promoters and other persons involved in these transactions may be subject to penalties under sections 6700, 6701, and 6694, or an injunction under section 7408.

Sanctions against Appraisers. Before 1984, attorneys and accountants, but not appraisers, could be barred from practice before the IRS. In 1984, Congress modified the law, and Circular 230 was modified to include appraisers. Circular 230 currently requires that the section 6701 penalty, aiding and abetting in the understatement of tax, be imposed before action may be taken against the appraiser. The IRS must demonstrate, by a preponderance of the evidence, that the appraiser had actual knowledge that the taxpayer would rely on a document that would lead to an understatement of tax by the taxpayer.

When a section 6701 penalty is asserted against an appraiser, an information referral to the Office of Professional Responsibility is mandatory. We have alerted the Director, Office of Professional Responsibility, of possible referrals of three appraisers arising out of questionable valuations of donated easements.

IRS Challenges

Although the conservation contribution provisions of the Internal Revenue Code play a vital role in the preservation of our open spaces, we are concerned with valuations of property that appear to be primarily influenced by tax considerations rather than actual property values. In challenging such valuations, our outstanding but small staff of appraisers (48 in all, 20 of whom work wholly or in part on 170(h) cases) must perform the detailed appraisal work using accepted and recognized valuation standards. It is not easy or quick work. Our work to date raises the question of whether rules governing appraiser qualifications, appraisal standards, and the standards for referral to the Office of Professional Responsibility are sufficient.

As you discuss changes in this and other areas involving the tax exempt sector, I also ask you to recall and consider the focus areas outlined in Commissioner Everson's testimony before this Committee on April 5. You may recall that these focus areas include whether there are gaps in the statutory or regulatory framework; whether the IRS has the flexibility it needs to respond appropriately to

compliance issues; whether more should be done to promote transparency; and whether we have the resources we need to do the job. In this regard, please consider the intermediate sanction recommended by the Administration when taxpayers claim charitable contribution deductions for contributions of perpetual conservation restrictions, but the charities that receive those contributions fail to monitor and enforce the conservation restrictions for which the charitable contribution deductions were claimed.

The Administration has made this recommendation in its FY 2006 budget proposals.[2] Specifically, the proposal would impose significant penalties on any charity that removes or fails to enforce a conservation restriction for which a charitable contribution was claimed, or transfers such an easement without ensuring that the conservation purposes will be protected in perpetuity. The amount of the penalty would be determined based on the value of the conservation restriction shown on the appraisal summary provided to the charity by the donor.

The Secretary would be authorized to waive the penalty in certain cases, such as if it is established to the satisfaction of the Secretary that, due to an unexpected change in the conditions surrounding the real property, retention of the restriction is impossible or impractical, the charity receives an amount that reflects the fair market value of the easement, and the proceeds are used by the charity in furtherance of conservation purposes. The Secretary also would be authorized to require such additional reporting as may be necessary or appropriate to ensure that the conservation purposes are protected in perpetuity.

In conclusion, the IRS remains committed to doing all it can to make the land donation and conservation easement provisions of the tax code work in the manner Congress intended. Legitimate conservation easements serve an important role in the preservation of our open lands and our cultural heritage. However, what began as a laudable program to save our open space, natural habitats, and historic sites may have become distorted. We are committed, as we progress through our enforcement program, to determine the size of this distortion and to take all steps necessary to stem abuse. Clearly, the public should be able to expect that only those land donations that result in an identified public good will result in favorable tax treatment.

[2] *General Explanations of the Administration's Fiscal Year 2006 Revenue Proposals*, Department of the Treasury, February, 2005, pp. 112 - 113.