

## Legal Viewpoint

# Easement Audits in Colorado: What Can We Learn from Them?

by Bill Silberstein

### IRS Initiates Audits in Colorado

In the eyes of many of us in the land trust community in Colorado, the IRS appears to have declared war on conservation easements. According to briefings of the Colorado congressional delegation by the IRS, there are approximately 250 audits of conservation easements that were conveyed in Colorado in 2003 and 2004. Because some of these easements are on properties with multiple owners, there may be as few as 100 conservation easements involved in these 250 audits. The exact numbers are uncertain.

The audits arose in response to issues relating to the Colorado state conservation easement income tax credit that were brought to the attention of the Colorado Department of Revenue (DOR). The Colorado state income tax credit program began in 2000 and in the following years was made more generous. A number of tax credits were claimed based on exaggerated and possibly fraudulent appraisals. Some of these cases were identified by DOR; some were identified by the land trust community.

DOR, believing that it lacked the resources and experience to enforce the law, requested that the IRS investigate the federal tax returns of easement donors. The problem is that neither the state nor the IRS seems willing or able to separate good easements from bad, and a number of legitimate transactions have been caught up in the IRS's effort to disallow abusive transactions.

I feel quite confident in stating that a large percentage of the conservation easements under audit involve easements well within the mainstream of generally accepted practices of the land trust community, and that they were appraised by experienced and well-re-

spected appraisers. Many of the easements under audit involved public funding such as grants issued by the Colorado funding agency, Great Outdoors Colorado, as well as federal funding from the United States Department of Agriculture and county and municipal open space programs.

Reportedly, DOR turned over 5,000 state tax returns to the IRS and the IRS eventually sifted these down to the 250 tax returns that are the subject of the pending audits. Despite the fact that many of these easements had been appraised and approved by state and federal agencies, the IRS has stated that only three of the 250 conservation easement audits were acceptable—and that all the rest had problems.

The Colorado Coalition of Land Trusts has been active in obtaining this information, gathering additional information about the conservation easements under audit, and providing education to land trusts, landowners and their advisers about the audit process.

### Current Status

The first few audits are coming to a close and the landowners and their advisers are just beginning to see the revenue agent reports and engineering reports. "Engineering report" is IRS terminology for what might be considered a review appraisal, except the engineering reports are not appraisals (for example, they do not follow Uniform Standards of Professional Appraisal Practice) and they are not done by appraisers, but rather by IRS engineers. The first few landowners are receiving "30 day letters," which contain a statement of the IRS position as a result of the audit and a calculation of the deficiency and tax owed. The taxpayer has 30 days after the issuance of the 30 day letter (hence its name) to protest

and to file an appeal with the IRS Office of Appeals. No payment is due if a protest and appeal is filed in a timely manner. In some cases, the IRS has taken the position that the conservation easement does not meet the conservation purposes test of Internal

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Revenue Code (IRC) §170(h). In most cases the IRS is challenging the conservation easement appraisal, often taking the position that the conservation easement has zero value.

A common theme is emerging in the few engineering reports that have been issued. The reports include a discussion of sales of easement-encumbered property and conclusions about Property Reduction Value (PVR), a term apparently invented by the IRS engineers. Two hundred easement-encumbered property sales are stated to have been identified in Colorado, and 35 analyzed. The reported results are that over 70 percent of the 35 analyzed transactions reflect a PVR of between 0 percent and 20 percent; nearly 80 percent reflect a PVR of 30 percent or less; and fewer than 10 percent reflect a PVR of greater than 50 percent. Also, for conservation easements that allow for at least one building envelope, the PVR was "relatively small." One thing is clear—this 35-property sample bears little resemblance to the value reductions we in the land trust community

expect to see in conservation easements in Colorado.

### Lessons Learned to Date

The IRS is a large bureaucracy, with many divisions. The Land Trust Alliance has been working long and hard to have a dialogue with, and to educate the regulatory side of the IRS. I fully support those efforts. But the enforcement side of the IRS—the folks who audit taxpayers—is very different. I would strongly advise land trusts that cooperation with IRS auditors does not help your donors.

Exercising what seemed to be common sense, the Colorado Coalition of Land Trusts at first cooperated with DOR and the IRS and invited them to participate in its statewide land trust conference. The subjects of this conference were water rights and mineral rights in land conservation transactions. The result of this cooperation and education was that shortly after this conference, landowners received a new round of questioning from the IRS asking the taxpayer to explain how the conservation easement transaction dealt with water rights and mineral rights.

My advice to Colorado land trusts is that they should not voluntarily provide information to the IRS about landowner transactions. The negative consequences include the possibility of exposing the land trust to liability to landowners by voluntarily providing confidential information.

A land trust (or a donor) involved in an audit will need to learn about the rules of the game, and you should require the IRS to follow proper procedures such as issuing formal “information document requests” (IDRs). Notify the landowner when you receive an IDR. Do not reply to the IDR until after the time has expired for the landowner to file an objection to the IDR with the IRS and you request and receive a letter from the IRS stating that the landowner has not objected to the IDR. The IDR is not self-executing. If you fail or choose not to respond to all or part of an IDR, the IRS has the power to issue a summons. If a summons is issued, follow the same procedure as for the IDR before complying.

Notify the landowner, wait until the landowner period to object expires, and obtain a letter from the IRS that the landowner has not objected before providing information requested in the summons. The summons is not self-executing. If you choose not to or fail to reply to the summons, the IRS may elect to enforce the summons in federal court. This is a very brief description of a highly technical area.

This is not a level playing field. The IRS will *not* tell you about the rules and most lawyers, CPAs and other landowner advisers do not know them. Lawyers that specialize in advising 501(c)(3) organizations, or about conservation easements, are unlikely to know the rules. Only lawyers that specialize in tax disputes with the IRS know these rules. Find one of these lawyers and obtain his or her advice before responding to the IRS regarding an audit of one of your donors.

The IRS is asking land trusts and conservation easement donors to demonstrate that the land trust has the resources and commitments to enforce the terms of the easement and is therefore a qualified recipient of the conservation easement, as defined in the IRS regulations. Your land trust should be prepared to answer this question for your donors.

This is a time when the completeness of the land trust’s file will be scrutinized. Your file should be complete, including up to date annual property inspection reports and a copy of the letter required by IRC §170(f)(8) to be sent to the conservation easement donor acknowledging receipt of the conservation easement (the “goods and services” letter).

Land trusts can and should help the landowners defend their conservation easements. Land trusts are prohibited from providing private inurement or private benefit to their donors. However, the land trust mission revolves around land conservation, and it falls within that mission to defend legitimate conservation transactions and to educate landowners, the public, legislators, regulators and other policymakers about land conservation transactions.

If the value of the conservation

easement is the only issue in the audit, lawyers that have experience with IRS disputes will understand very quickly that this is a valuation dispute and will likely know how to deal with it.

The first contact from the IRS notifying the landowner of commencement of the audit will usually include a request for extension of the statute of limitations. The general statute of limitations to challenge a tax deduction is three years from the filing of the tax return on which the deduction is claimed, including tax returns on which any carry-forward of the deduction is claimed. Landowners should consider very carefully with knowledgeable and

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experienced advisers whether they wish to grant the extension to the IRS.

Granting an extension to the IRS gives the IRS more time to build its case, and to build pressure on the donor. These cases drag on for many years. In the *Glass* case, the conservation easements were donated in 1992 and 1993, the notice of deficiency was issued in 1999, the Tax Court trial was conducted in August 2004, and the Tax Court decision was issued in December 2005. This is a much longer time frame than average, but illustrates the point. In the end, interest on the tax deficiency asserted by the IRS and penalties can be as great as the tax deficiency itself.

The 250 Colorado audits are only at the very early stages. The IRS war on these conservation easements will drag on for many years and the outcomes will have consequences for the entire land trust community. 

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