

1992

Agricultural Preservation: Protesting the Application of Revenue Ruling 78-384

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Recommended Citation

William T. Hutton, *Agricultural Preservation: Protesting the Application of Revenue Ruling 78-384*, 3 *Back Forty* 12 (1992).

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Author: William T. Hutton

Source: Back Forty

Citation: 3 BACK FORTY 12 (Sept./Oct. 1992).

Title: *Agricultural Preservation: Protesting the Application of Revenue Ruling 78-384*

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relinquished property is allocated between the bargain and exchange portions of the transaction. The landowner's realized gain equals the amount realized (the fair market value of the property and boot received) less the adjusted basis allocated to the exchange portion. As in any other §1031 exchange, the landowner recognizes this gain to the extent of any boot.

Example. Bob's farm has a fair market value of \$300,000 and an adjusted basis of \$60,000. In a transaction that qualifies under §1031, Bob exchanges the farm for a smaller farm owned by the Land Trust and worth \$190,000. Bob also receives \$10,000 in cash. Bob has made a \$100,000 charitable contribution (the fair market value of the relinquished property minus the fair market value of the property and boot received). The adjusted basis allocable to the sale element is \$40,000, so Bob realizes \$160,000 of gain. Bob recognizes gain to the extent of boot received, thus Bob recognizes \$10,000 in gain. His basis in the new, smaller farm will be \$40,000, that is, the adjusted basis allocable to the sale portion (\$40,000) minus the boot received (\$10,000) plus the gain recognized (\$10,000).

As with any donation of appreciated property, the donor needs to be aware of the percentage limitation on charitable deductions and the possibility of the alternate minimum tax. See Hutton, "Donations of Appreciated Property — Income Tax Consequences," *The Back Forty*, September 1991 [Primer #3]; Wedlake, "Alternative Minimum Tax," *The Back Forty*, November 1991 [Primer #4]. For more on bargain sales, see Hutton, "Bargain Sales," *The Back Forty*, February 1991 [Primer #1].

Conclusion

Given the tax-exempt status of land trusts, the possibilities for structuring §1031 exchanges beneficial to both a land trust and an individual are infinite. If used effectively, §1031 can be a highly useful tool. Section 1031, however, is highly technical. It has many requirements and time restraints. A slight error by one who is ill-informed may destroy the tax-deferred exchange. Moreover, the most commonly used transaction, the Starker exchange, can also be extremely time-consuming for the parties involved. The exchange itself, not including preparation, may stretch over several months. So when embarking on a §1031 exchange, it is wise to consult an experienced advisor familiar with both tax and land conservation issues.

Maureen Kelly is a recent graduate of Hastings College of the Law.

Agricultural Preservation: Protesting the Application of Revenue Ruling 78-384

by William T. Hutton

When a land trusts asserts an intention to engage in agricultural preservation in its application for recognition of tax-exempt status, it is apt to have its application denied. The Internal Revenue Service's objections to farmland preservation as a proper exempt purpose are grounded in Revenue Ruling 78-384, which maintains that agricultural preservation is not a proper charitable function. In the view of this writer, the opinion expressed in that ruling, even if originally valid, was vitiated by the enactment of the conservation easement legislation (IRC §170(h)) in 1980.

The arguments advanced in the following "Protest" letter have, in several actual cases, been sufficient to persuade the Service to reverse its position. Although the letter pertains to a fictional California land trust, and thus cites various California governmental policies in support of its argument, the general thrust of the presentation would appear to be applicable in any jurisdiction where agricultural preservation is supported by state, county, and/or local policies. Accordingly, unless and until the Service revokes the 1978 ruling, this letter may serve as a useful model for an agricultural land trust which faces initial denial or subsequent challenge to its exempt status. (The Protest also deals with a separate but frequently troublesome issue — the possibility that the resources of the land trust may be used for the benefit of private persons; i.e., the "private benefit" issue.)

Although names, dates, and places have been altered to obscure connection to any real-life situation, in all substantive respects the letter is unexpurgated.

June 11, 1992

Internal Revenue Service
1111 Constitution Avenue
Washington, DC 20224
Attn: OP:E:EO:R:1

Mr. _____

Re: Hardscrabble County Land Conservancy
— Protest to Proposed Denial of Recognition
of Exempt Status

Dear _____:

This letter constitutes a Protest to the determination proposed in your letter of April 22, 1992, with respect to the Hardscrabble County Land Conservancy's (the "Conservancy's") application for recognition of status as an organization described in section 501(c)(3) of the Internal Revenue Code. In response to a letter of Zane Swardley, president of the Conservancy, dated May 9, 1992, your office extended the time for filing this Protest by thirty days, to June 13, 1992.

PROTEST

1. Request For Reconsideration. By the filing of this Protest the Conservancy expresses its intention to seek reconsideration of the denial of entitlement to tax-exempt status as an organization described in section 501(c)(3) of the Internal Revenue Code. Such denial is proposed in a letter dated April 22, 1992 (OP:E:EO:R:1) and signed by Rolf McLickens, Chief, Exempt Organization Rulings Branch.

2. Organization's Name And Address: The Hardscrabble County Land Conservancy, 1431 Dry Gulch Boulevard, Welfare, California 95172.

3. Discussion Of Intended Purposes. The Conservancy's Articles of Incorporation and Bylaws define the proposed scope of its operations in respect of the conservation and preservation of historic properties and agricultural lands. Under its Articles, the Conservancy is specifically empowered to acquire, hold, manage and dispose of

"land and interests in land in a manner designed to preserve, protect and enhance the agricultural, historical, environmental, natural wildlife habitat, scenic and recreational values of such lands in conformance with the requirements of Section 501(c)(3) of the Internal Revenue Code and Sec-

tions 23701(d) and 214 of the California Revenue and Taxation Code . . ." Article III, B, (2).

The Bylaws echo that language, and those intended purposes are elaborated upon in the Conservancy's application for exempt status on Form 1023 and subsequent correspondence with your office.

The focus of the issue in this case is upon the propriety of agricultural preservation as a charitable purpose within the meaning of section 501(c)(3) of the Code and relevant regulations. The Conservancy does not maintain that mere preservation or conservation of agricultural lands, without limitation, meets the requirements of the statute. Rather, it is the position of the Conservancy that such programs, if designed to advance a clearly delineated governmental policy, constitute activities appropriately "charitable" within the meaning of the Code and regulations.

The definition of the term "charitable," as used in section 501(c)(3), is hardly static. Over the past two decades all manner of organizations, not previously considered as candidates for exempt status (nor, in some cases, envisioned at all), have attained exemption under that provision, among them public interest law firms, organizations promoting education in feminist concerns, and organizations intended to educate the public on current issues arising out of technological innovation and change. In those cases the Internal Revenue Service has shown a sensible willingness to treat charitability as an evolutionary concept, capable of embracing emerging causes organized for the common good. It is respectfully submitted that, in the instant case, we have just such a situation, a cause born out of the realization that one of our nation's most important resources, its productive farm and ranch lands, is threatened by multiple economic forces — principally degradation through incompatible (but momentarily lucrative) practices and conversion to non-agricultural uses. Concern over the permanent loss of our agricultural resource base has been expressed in recent years in nearly every legislature of the United States, and some states, California among them, have provided significant incentives toward the preservation of agricultural lands and production, and disincentives to the termination of agricultural uses.

It is the position of this Protest, quite simply, that an organization which seeks to conserve and to preserve agricultural properties, pursuant to clearly delineated governmental policies favoring such programs, is now entitled to exempt status under section 501(c)(3) as a charitable organization. The principal reason for the denial of that status, according to Mr.

McLickens's letter of April 22, 1992, is that farmland preservation justifies exempt status only if limited to the preservation of "ecologically significant land," a standard evidently drawn from Revenue Ruling 76-204, 1976-2 C.B. 152. Developed farmland is apparently considered to lack such ecological significance, and, therefore, where the protection of such lands constitutes a substantial part of an organization's program, it is deemed to fail to meet the requirements of section 501(c)(3) on account of its pursuit of a noncharitable purpose. The proposed negative ruling concludes on this issue that "[t]he protection of farmland is not a charitable purpose and this activity of yours is substantial in nature."

The argument proposing the denial of exempt status relies heavily upon Revenue Ruling 78-384, 1978-2 C.B. 174. In that case a nonprofit organization which owned farmland and restricted the use of that land to farming or other uses deemed ecologically suitable was held not to be a "charitable" organization in the "generally accepted sense" of that term. Preservation alone, without a showing of ecological significance, is found insufficient to meet the statutory standard, and the public benefit derived from the organization's "self-imposed restriction on its own land" is neither so direct nor so significant as to meet the requirements of the regulations defining charitable purposes. Reg. §1.501(c)(3)-1(d)(2).

It is submitted, first, that the proposed activities of the Conservancy are clearly distinguishable from the proposed function of the organization described in Revenue Ruling 78-374, and second, that Congressional action subsequent to the promulgation of that ruling undermines its validity. As amply described in prior correspondence (see, especially, Mr. Sturdley's letter of December 6, 1991), the Conservancy is not seeking merely to place restrictions upon land it already holds in order to insure the perpetuation of agricultural activities, but rather to achieve, through various legal mechanisms, the protection of highly productive agricultural lands pursuant to clearly delineated local and state governmental conservation policies. The crucial distinction between the situation of the Conservancy and that of the organization described in Revenue Ruling 78-374 is that the Conservancy will determine the feasibility and propriety of its protective programs and transactions pursuant to external standards, the application of which insures the public benefit essential to status as a section 501(c)(3) organization. The application of such external standards, in the form of clearly delineated governmental policies, was specifically sanctioned by Congress in 1980 with the enactment of P.L. 96-541.

That legislation, which defined and clarified the charitable contribution requirements applicable to "qualified conservation contributions," makes it clear that the public interest is considered to be served by the preservation of farmland pursuant to "clearly delineated" governmental standards. Code section 170(h)(4), defining "conservation purpose," reads in part:

"(A) IN GENERAL — For purposes of this subsection, the term "conservation purpose" means —

(iii) the preservation of open space (including farmland and forest land) where such protection is —

(I) for the scenic enjoyment of the general public, or

(II) pursuant to a clearly delineated Federal, State, or local governmental conservation policy, and will yield a significant public benefit . . ." (Emphasis added).

Since the recipient of a qualifying easement over open-space land must be a governmental entity or a section 501(c)(3) organization, the Congressional intent to allow section 501(c)(3) organizations to engage in open-space preservation, including efforts aimed at conserving our agricultural resources, is patently clear. IRC §170(h)(3). It may have been possible to maintain, prior to the enactment of P.L. 96-541, that substantial agricultural preservation activities provided a ground upon which the Service might categorically deny exempt status. But with the enactment of the statute quoted above, Congress has forced a refinement of the issue: Do the Conservancy's proposed agricultural preservation activities advance a sufficiently well-defined governmental policy favoring farmland conservation and preservation?

Attached to this Protest are eight Exhibits representing California and Hardscrabble County legislation relevant to that issue. The highlights of those provisions as they bear upon the present inquiry may be briefly summarized as follows:

Exhibit 1 — California Constitution, Article XIII, Section 8. This provision unequivocally states a public policy in favor of, among other purposes, the "use or conservation of natural resources, or production of food or fiber . . ."

Exhibit 2 — California Revenue and Taxation Code. California has seen fit to accord tax relief in respect of the creation of "agricultural preserves" as defined in Section 421(a). Note particularly in this connection the rebuttable presumption of Section 430 that "the present use of open-space land which is

enforceably restricted and devoted to agricultural use is its highest and best agricultural use."

Exhibit 3 — California Government Code, Open-Space Easement Act of 1974. This legislation provides the means by which any county or city may acquire or approve an open-space easement in perpetuity or for a term of years "for the purpose of preserving and maintaining open space." Section 51070. The legislative findings leading to this Act include concern that "the rapid growth and spread of urban development is encroaching upon, or eliminating open-space lands which are necessary not only for the maintenance of the economy of the state, but also for the assurance of the continued availability of land for the production of food and fiber . . ." Section 51071. In order to amplify the effects of this legislation, nonprofit, nongovernmental organizations approved by cities or counties are qualified recipients of open-space easements. Section 51083.5.

Exhibit 4 — California Government Code §65560(b) and 65561. These Government Code provisions, defining "open-space land," again evidence the legislature's concern for the maintenance of agriculturally productive resources, and its intention to discourage "premature and unnecessary conversion of open-space land to urban uses" as "a matter of public interest." Section 65561(a), (b).

Exhibit 5 — California Government Code, The "Williamson Act". Property tax relief under California's Williamson Act has been availed of by thousands of farmers and ranchers who contract to maintain their properties in agricultural use in exchange for property tax assessments based upon agricultural values. Few states have made such a substantial funded (via tax relief) commitment to agricultural preservation. The policy which generated that commitment is reflected in the legislative findings at Section 51220, including recognition of the dangers to agricultural lands in a "rapidly urbanizing society." Section 51220(c), (d). The legislature has also found that "agricultural land trusts represent a promising method of preserving productive agricultural lands without the direct intervention of state or local land use regulations." Section 51296.

Exhibit 6 — California Government Code, Scenic Easement Deed Act of 1959. This relatively early Act evinces the same concern for the preservation of open space as do the later and more specific acts constituting the previous exhibits. Even in this early legislation, it was contemplated that governmental interests might be served by the acquisition of property in fee, with a conveyance or leaseback to an original owner, under an arrangement limiting the use

of the subject property. The Conservancy's expressed intention to acquire threatened agricultural lands in fee, to attach perpetual conservation restrictions, and then to lease such properties at their agricultural fair rental value is precisely consonant with the legislative declaration in 1959. Section 6953.

Exhibit 7 — California Civil Code, Conservation Easements. In 1979 the legislature passed enabling legislation recognizing the conservation easement as a valid and perpetual interest in land, not requiring appurtenant fee ownership or affirmative use rights. Section 815.2. The definitional provision, Section 815.1, contains specific approval of conveyances of conservation easements for the retention of land "predominantly in its . . . agricultural . . . condition."

Exhibit 8 — County of Hardscrabble General Plan Amendments. The Service has previously been furnished, as an attachment to Mr. Sturdley's letter of December 6, 1991, excerpts from the Hardscrabble County General Plan, as amended. Those excerpts amply demonstrate extreme governmental sensitivity to the environmental issues to which the Conservancy's programs will be addressed. On December 4, 1990, the Board of Supervisors for Hardscrabble County adopted certain amendments to the General Plan, specifically intended to strengthen and support agricultural preservation efforts, particularly as to legally subdivided lands the development of which would be incompatible with the County's General Plan. Private conservation organizations are prominently mentioned in these amendments as alternative recipients of voluntary donations and purchasers of development rights; see Section 29.2.5.

The governmental policies recited in the statutory Exhibits to this Protest provide overwhelming evidence of the concern of the State of California and the County of Hardscrabble for the conservation and preservation of its natural resources, among them its agriculturally productive lands. These are not mere general expressions of aspirational programs, but rather a coherent and complementary statutory scheme providing statements of policies, incentives, and descriptions of mechanisms intended to effectuate the legislative objectives described. It is hardly conceivable that a private land trust, operating within guidelines established by those clearly delineated governmental policies, could be found not to provide a significant public benefit through its activities.

The Conservancy requests, therefore, that reconsideration be given to the Service's proposed finding that the preservation and conservation of agricultural lands cannot be considered a charitable purpose. The 1980 conservation easement legislation, in conjunc-

tion with the well-defined legislative purposes sought to be advanced by the Conservancy's intended programs, sanction those programs as indubitably charitable in nature. It would be an anomaly indeed if, where Congressional concern for open-space agricultural preservation is buttressed by strong and precise local policies, private conservation organizations were not permitted to function for lack of a perceived traditional charitable nature.

Mr. McLickens's letter of April 22 also indicates that the Conservancy's programs may create more than an "indirect or incidental benefit" to farmers "involved in" the Conservancy's programs. Although the Conservancy certainly intends to engage in agricultural preservation efforts, as described above, it has no intention whatsoever of creating situations in which the private inurement of farmers or ranchers is effected.

Agricultural landowners who transfer properties, or interests in properties, to the Conservancy will receive no more than fair market value. In acquiring lands in fee by purchase, the Conservancy will pay no more than fair market value, and for the Service to conclude on the basis of such a proposed transaction that the transferor was improperly advantaged would be to deny, by analogy, the right of an art collector to sell a painting to an exempt museum at fair market value, or the right of an urban landowner to sell his property to a school or hospital for a fair price. The "inurement" rule contains no such proscription, and in no case or ruling has it ever been suggested that a publicly supported charitable organization could not deal at fair market value and at arms' length with owners of property sought to be acquired for its proper charitable purposes.

The confusion on this issue may involve a somewhat different transaction, the donation or purchase from an agricultural landowner of an easement restricting the uses of the subject property. That situation is not conceptually different from the purchase in fee, but since the acquisition is of rights essentially negative in character (i.e., the power to proscribe certain defined uses but not affirmatively to use the subject property), it may appear that the transferor has received an unwarranted benefit.

The perception is illusory. Regulations adopted under the conservation easement legislation (P.L. 96-541) discussed above permit a charitable contribution deduction in the amount of the diminution in value of the property subject to the easement. Reg. §1.170A-14(h)(3). In the contribution situation, the regulations properly recognize that the donor has conveyed a bundle of property rights properly valued according

to the property's reduction in value. Where the Conservancy receives an easement by donation over land legally subdividable into one-acre lots, for example, and the easement restricts the subsequent use of the property to exclusively agricultural pursuits, the landowner has clearly parted with value, and the cited regulation accords him an income tax deduction. Similarly, were the landowner to have sold such a proscriptive easement, he would be entitled to receive, and the Conservancy entitled to pay, an amount representing the fair market value of that transferred interest — again the diminution in value of the property. Private inurement in such a scenario simply does not arise; the activities of the Conservancy are exclusively aimed at the production of public benefit, and acquisitions from landowners through donations or via purchases not in excess of fair market value can hardly be said to confer any unwarranted benefit to participating landowners. Purchase of a conservation easement at fair market value does not enhance the personal balance sheet of the selling farmer whatsoever, it merely transforms one or more attributes of land (e.g. development rights) into a different asset (the consideration received). In no sense have the assets or the income of the organization been used for the seller's benefit, but merely to acquire an asset to be used to advance the organization's proper exempt purposes.

Finally, Mr. McLickens's letter addresses the possibility of qualification under Section 501(c)(3) as an organization which "lessens the burdens of government." Reg. §1.501(c)(3)-1(d)(2). That letter recites that there is "no information to indicate that Hardscrabble County and/or the State of California is involved in the active operation of farms," and the Conservancy certainly does not base its application upon any such contention. But the ruling goes on to state that "[f]arming or the preservation of farmland is not a traditional governmental function," and that "[the Conservancy is] therefore not lessening the burdens of government."

Although farming per se is assuredly not either a traditional or current governmental function, the preservation of agricultural land is certainly viewed as a high governmental priority in the State of California and in Hardscrabble County, as the statutory evidence referenced in the attached exhibits amply demonstrates. The 1990 amendments to the Hardscrabble County General Plan, in particular, envision a symbiosis between governmental planning and private non-profit effectuation which is designed to produce a public benefit in the form of the maintenance of open-space lands and agricultural productiv-

ity. While perhaps not "traditional," the efforts of the Conservancy to further the governmental objectives of the State of California and of Hardscrabble County will undeniably serve to produce a public benefit and thus to lessen the obligations of government to shoulder the entire burden of land use planning through zoning, eminent domain, and other non-cooperative devices.

Times change. So too, must the concept of charitability, as reflected in the Internal Revenue Service's frequent recognition of exempt status for organizations outside the nonprofit "mainstream." Fortunately, as the evolution of American philanthropy well proves, the Service has shown an admirable capacity to recognize emerging public concerns and to accord exempt status to organizations formed to address them.

The Conservancy asks for no more than a careful reconsideration of its proposed programs and objectives in light of the views expressed above. We believe that upon such reconsideration you will conclude that: (1) the conservation of agricultural lands pursuant to clearly delineated governmental policies may indeed constitute a proper charitable purpose, within the meaning of section 501(c)(3); (2) no impermissible private benefit will be conferred upon any landowner who transfers property, or interests in property, to the Conservancy for an amount not exceeding the fair market value of that property or those interests; and (3) through the pursuit of its intended land preservation activities, the Conservancy will advance the interests of the State of California and the County of Hardscrabble, and thus lessen the burdens of government.

If, upon reconsideration, you conclude that a favorable ruling cannot be issued, a conference in your office is respectfully requested. A power of attorney authorizing the undersigned and one other to represent the Conservancy in this matter is enclosed herewith.

Sincerely yours,

Beowulf Q. O'Shaunessey

From the Bench

The Advantage of a Local Appraiser

As a taxpayer attempting to maximize the value of a donated conservation easement, does it pay to hire a land use expert who is from the local area, to determine the value of the easement? In *Clemens v. Commissioner*, 64 T.C.M. 351 (1992), the fact that the taxpayer hired a planner who was familiar with local land use practices resulted in the Tax Court substantially agreeing with the taxpayer's appraisal of the value of the easement.

The taxpayer's dispute with the IRS arose out of the "before" value of the taxpayer's property. The property was a 140-acre undeveloped plot of land located on Martha's Vineyard, an island off the coast of Cape Cod, Massachusetts. The taxpayer donated development rights on forty to fifty acres of the property to various qualified conservation organizations. After the imposition of the easement, the property was to be subdivided into twenty-three housing lots. The taxpayer, in attempting to maximize the assessed "before" value of the property, asserted that the property's highest and best "before" use would have been a 40-lot subdivision, were it not for the imposition of the easement.

The IRS argued that the taxpayer's valuation of the "before" value of the property was grossly overstated. It asserted that twenty-three lots, or at most thirty, would have constituted the highest and best possible "before" use of the property, because local approval of a 40-lot subdivision on the property was not at all certain. The property was located in a district of "critical planning concern," with regulations prohibiting construction on hilltops or near roadways. Additionally, local regulations required a functioning well on each lot. During preliminary drilling, there had been considerable difficulty in finding adequate water supplies on the property. For these and other reasons, the IRS asserted that the taxpayer had overstated the "before" fair market value of his property, and thus had overstated the value of his donated easement.

In ruling for the taxpayer, the Tax Court gave substantial weight to the fact that the taxpayer's valuation was supported by the testimony of a local planner and former director of the local planning commission. The IRS's valuation expert, on the other hand, had offices in Seekonk, Massachusetts, and Pawtucket, Rhode Island, thirty to forty miles to the