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Conservation Easement— Perpetuity Requirements



A charitable organization is one party to a conservation easement. As such, the charity should have a general understanding of the tax issues a donor faces when granting the easement. The following discussion includes a general explanation of the donor's requirements for qualified conservation easements, including recent guidance announced by the IRS.

A qualified conservation easement (QCE) is a restriction on the use of real property granted *in perpetuity* to a qualified charitable donee exclusively for conservation purposes [IRC Secs. 2031(c)(8)(B) and 170(h)(1)]. The donor typically executes a written agreement granting an easement to a qualified organization. This agreement specifies the types of uses that will be restricted and any prohibited activities. The purpose of the easement is to protect some aspect of the land that has conservation value. The perpetuity rules require that the conservation easement both be: (1) granted in perpetuity under IRC Sec. 170(h)(2)(C), and (2) protected for the conservation purpose in perpetuity under IRC Sec. 170(h)(5)(A). The perpetuity requirements are a key component of the general rules governing QCEs.

The Benefits of Contributing a QCE

Making a charitable contribution of a QCE offers the donor a number of benefits, including the following:

1. Assurance that the property will keep its current use (e.g., preservation of wildlife or forestland) and that it stays in the family. (This is because the easement discourages the sale and development of the property.) It may be possible to place an easement on the property without any change in how the donor or donor's family uses the property.
2. The knowledge that the contribution provides a benefit to the environment (e.g., by protecting wildlife, forests, fish habitat, preserving a historic structure).
3. A donor's contribution during his or her lifetime is eligible for an income tax charitable deduction for the difference between (a) the value of the highest and best use of the property and (b) the value of the property with the limited use.
4. The potential for an estate tax deduction or exclusion.

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The IRS is concerned about overstated charitable deductions using conservation easements; it closely reviews these transactions and has implemented several compliance strategies targeting them. Planners should carefully review the terms and restrictions of the easement and the appraisal to help ensure that the charitable contribution will not be disallowed.

The Requirements for a QCE

A QCE is defined as one that would qualify as a qualified conservation contribution under IRC Sec. 170(h). It must be a contribution—

1. of a *qualified real property interest*,
2. to a *qualified organization*, and
3. exclusively for *conservation purposes*.

Because the property contribution is real estate, there must be a deed signed by the donor transferring the property, accepted by the qualifying organization, and recorded in the public record. Additionally, the transfer cannot be conditional and the transfer must be substantiated under the rules of Regs. 1.170A-13 and -14. Requirements may include a contemporaneous written acknowledgment, a fully completed Form 8283 (Non-cash Charitable Contributions), and a qualified appraisal.

Defining a Qualified Real Property Interest. A qualified real property interest includes any of the following: (1) a donor's entire interest, other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction, *granted in perpetuity*, on the use that may be made of the real property. The restriction must include a prohibition on more than a *de minimis* use for commercial recreational activity. To be a qualified real property interest, the interest must be an identifiable, specific piece of property. Retaining the right, however minor, to change the boundaries of the land subject to the easement will not satisfy this requirement even if the acreage of the donated land cannot be decreased by the changes.

Qualified Organization. A contribution of a qualified conservation easement must be made to a charity (or other qualified organization) and used exclusively for conservation purposes. Qualified organizations include the following:

1. The United States, a possession of the United States, a state (or the District of Columbia), or a political subdivision of them, as long as the gift is for exclusively public purposes.
2. A domestic entity that qualifies as a public charity under IRC Sec. 170(c)(2) and that generally receives a substantial amount of its support from a government unit or from the general public.
3. Any entity that qualifies under IRC Sec. 170(h)(3)(B).

Private foundations are not considered qualified organizations for purposes of deducting conservation easements.

Identifying Conservation Purposes. To be eligible for the income tax deduction or the estate tax exclusion, the easement must be exclusively for a conservation purpose [IRC Sec. 170(h)(1)(C)]. A contribution is used exclusively for conservation purposes if the conservation purpose is *protected in perpetuity* [[IRC Sec. 170(h)(5)]. A conservation purpose is [IRC Sec. 170(h)(4)(A)]—

1. preservation of land areas for outdoor recreation for use by, or for the education of, the general public;
2. protection of a relatively natural habitat of fish, wildlife, plants, or a similar ecosystem;
3. preservation of open space (including farmland and forestland) for scenic enjoyment by the general public or pursuant to a governmental conservation policy; or
4. preservation of historically important land or a certified historic structure.

Note: The preservation of a certified historic structure is not a conservation purpose eligible for the estate tax exclusion; although it can qualify for the income and estate tax charitable deductions.

Protected in Perpetuity. For the conservation purpose to be protected in perpetuity, any interests retained by the donor must be subject to legally enforceable restrictions (e.g., by recording in the land records of the applicable jurisdiction) that prevent the donor from using the retained interest inconsistently with the conservation purpose.

If a subsequent unforeseen change in the conditions makes it impossible or impractical to use the property for its continued conservation purpose(s), the restrictions required to protect the conservation purpose can be extinguished by judicial proceedings. If this occurs, all of the donee's proceeds from the property's sale or exchange must be used by the donee in a manner that is consistent with the contribution's original conservation purpose. As such, the conservation purpose can still be treated as being protected in perpetuity.

Any extinguishment formula, determining the charity's share of proceeds in the event of a sale following extinguishment of the easement, must be carefully developed. The Tax Court has denied several charitable contribution deductions of conservation easements due to a flawed formula for determining the charity's share of the sale proceeds following an easement's extinguishment.

Recent Guidance

Generally, for a contributed conservation easement to be protected in perpetuity, the grantee must be entitled to a proportionate share of extinguishment proceeds under the rules set forth in Reg. 1.170A-14(g)(6)(ii). A judicial proceeding is the exclusive manner in which a perpetual conservation restriction may be extinguished, and only if a subsequent unexpected change in the conditions

surrounding the property that is the subject of this easement has made the continued use of the property for conservation purposes impossible or impractical.

In the past, donors have been denied a charitable deduction when the deed granting a conservation easement contains language that violates the perpetuity rules upon the easement's extinguishment. Language in a conservation easement deed that closely adheres to the language of Reg. 1.170A-14(g)(6)(ii) generally will not cause a deed to violate the enforceability in perpetuity requirements. In a recent Chief Counsel Advice (CCA 202130014), the IRS has provided the following sample conservation easement deed language:

Donor agrees that the donation of the perpetual conservation restriction described in this deed gives rise to a property right, immediately vested in the donee organization, with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction, at the time of the gift, bears to the fair market value of the property as a whole at that time. For purposes of this paragraph, the proportionate value of the donee organization's property rights shall remain constant.

On a subsequent sale, exchange, or involuntary conversion of the subject property, the donee organization will be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction.

All of the donee organization's proceeds from a subsequent sale or exchange of the property must be used by the donee organization in a manner consistent with the conservation purposes of the original contribution.

Caution: While the guidance in a CCA cannot be relied upon, it does give insight into the IRS's current thinking and perhaps some handy language.

Looking Ahead

While the perpetuity requirements are just one technical area upon which a QCE may be challenged, it's apparently a favorite area for an IRS challenge. The National Taxpayer Advocate's 2020 Annual Report to Congress noted the IRS could help avoid litigation by providing model language taxpayers could use in deeds conveying conservation easements. The specific recommendation suggested the IRS "develop and publish additional guidance that contains sample easement provisions to assist taxpayers in drafting deeds that satisfy the statutory requirements for qualified conservation contributions, particularly the perpetuity requirement for those conservation easements that incentivize land preservation for future generations" to reduce the high number of litigated cases.

Practical Consideration:

CCA 202130014 indicates the IRS heard the Taxpayer Advocate's message and perhaps more sample language for QCEs will be forthcoming. However, given the long wish list and the IRS's tight resources, that may not be likely in the near future.



Tax Briefs

Employee Retention Credit (ERC) Extended and Modified. The May 2021 issue of this newsletter included an "Employee Retention Credit Update" addressing IRS Notices 2021-20 and 2021-23. The American Rescue Plan Act of 2021 codified the ERC under IRC Sec. 3134 for calendar quarters beginning after June 30, 2021. Recently, IRS Notice 2021-49 (2021-34 IRB) was released providing additional guidance. The notice (1) extends the ERC to wages paid between July 1 and December 31, 2021, (2) modifies the definition of *applicable employment taxes* to mean the employer's share of Medicare tax (or RRTA equivalent) reduced by certain qualified sick and family leave wages, and (3) extends and modifies the maximum ERC and provides a separate credit limit for recovery startup businesses. Revenue Procedure 2021-33 (2021-34 IRB 327) provides additional guidance on the interaction between forgiven Paycheck Protection Program (PPP) loans and the ERC.

Procedural Change Due to Mayo Ruling. The July 2021 issue of this newsletter included an article "Hold the Mayo" about the Eighth Circuit Court of Appeals' reversal and remand of the Mayo Clinic case. Because of the ongoing litigation in the Eighth Circuit regarding Reg. 1.170A-9(c)(1), the IRS's Tax-Exempt and Government Entities (TEGE) division has issued interim guidance (TEGE-07-0821-0019). The guidance provides that EO Determinations specialists will coordinate with division counsel to process a determination request when (1) an applicant is seeking classification or reclassification as an educational organization under IRC Secs. 509(a)(1) and 170(b)(1)(A)(ii), and (2) the applicant's primary function is *not* the presentation of formal instruction. This procedural guidance will be incorporated into the Internal Revenue Manual.

Note: Specialists do not need to coordinate the processing of such requests if the applicant does not satisfy the requirements of IRC Sec. 501(c)(3).



Charity Navigator Adds New Rating System

Charity Navigator, the world's largest independent and most-used evaluator of nonprofit organizations, has rolled out the *Encompass Rating System* (Encompass Rating or the system), a new system that gives donors access to a significantly higher number of evaluations of nonprofit organizations. It gives donors a new ratings tool and gives organizations a new way to raise awareness and promote themselves to current and prospective donors. Charity Navigator launched the new system in July 2020 and additional phases will continue to roll out over time.

Encompass Rating expands evaluation eligibility to organizations who are smaller nonprofits and are less established than those that meet the eligibility requirements for Charity Navigator's Star Rating System, which includes a minimum number of years in operation and minimum revenue amounts. Adding Encompass Rating has increased the number of charities rated by Charity Navigator from 9,000 to 170,000. The new system doesn't affect organizations who are Star-rated.

Encompass Rating uses technology to automatically analyze 501(c)(3) organizations' tax forms for three consecutive years. The system scores nonprofit organizations on a scale from zero to 100, with a score of 75 or higher indicating effectiveness in the assessed areas. Charity Navigator recommends an organization rated 75 or above and gives it a "Give with Confidence" designation on the nonprofit organization's page on the Charity Navigator website. The organization can display a badge on its own website, and it can access promotional tools from Charity Navigator to use to highlight the Encompass Rating.

Practical Consideration:

Rating systems such as Encompass Rating highlight the need for nonprofit organizations to ensure that the information in their Form 990 is complete and accurate.

Four Key Beacons

Encompass Rating looks at an organization's total impact in achieving outcomes and considers attributes that enable future and sustained success. The system analyzes performance using four "beacons," which are key indicators of a nonprofit's total impact:

Finance & Accountability. Measures financial health, stability, efficiency, and sustainability. The system

utilizes nine metrics when assessing this beacon. Of these, the three highest point values are based on the percentage spent on program expenses out of total expenses (25 points); board composition and independence (25–35 points); and if the organization had an independent audit, review, or compilation (20 points).

Impact & Results. Assesses cost effectiveness of an organization's programs and evaluates delivery of the nonprofit's mission and outcomes. The system bases the scoring on estimated impact on the lives of those served and how the nonprofit uses donor resources.

To receive a score in this category, there are several eligibility criteria. The entity must deliver at least two thirds of its activities (measured by program service expenses) directly to beneficiaries and the impact must be reasonably measurable. Also, the nonprofit organization must provide a service at low or no cost to beneficiaries distinct from its donors. The organization must receive private charitable contributions.

Leadership & Adaptability. Assesses leadership capacity and development, strategic planning and goal setting, and the ability to be innovative and respond to changes in demand and other external changes to achieve the mission of the organization.

Culture & Community. Evaluates the organization's engagement in feedback with beneficiaries of its programs and other constituents. This beacon includes rating feedback practices to achieve mission impact and community benefit. Organizations must fill out a profile section and answer specific questions to receive a rating for this beacon.

Updates and Future Changes

Charity Navigator will update ratings three times a year. Nonprofit organizations can receive an overall Encompass Rating only if the system has rated the organization on Finance & Accountability, Impact & Results, or both. Donors can focus on overall scores or consider one or more beacons that are important to their individual decision-making.

Charity Navigator may change these beacons and add or change metrics and methods in the future based on stakeholder feedback. They are also continuing to explore technology, including artificial intelligence and machine learning, to provide the highest quality information to users.

The Encompass Rating System will have three releases every year. The August 2021 release launched the Leadership & Adaptability beacon and completed the beta phase of Encompass Rating. Charity Navigator plans its next release for October 2021.

Practical Consideration:

Additional information about the Encompass Rating System is available on Charity Navigator's website at www.charitynavigator.org.



2021 Compliance Supplement Released

In recent years, the Office of Management and Budget (OMB) has struggled when it comes to releasing the annual Compliance Supplement edition in a timely manner. Adding to that, the COVID-19 pandemic has continued to cause delays for almost every aspect of the economy. On August 12, 2021, the OMB released the initial version of the 2021 edition of the *OMB Compliance Supplement*. On August 25, 2021, the OMB released an updated version. The 2021 Compliance Supplement is effective for audits of fiscal years beginning after June 30, 2020 and supersedes the 2020 Compliance Supplement.

Practical Consideration:

The Compliance Supplement can be accessed at https://www.whitehouse.gov/wp-content/uploads/2021/08/OMB-2021-Compliance-Supplement_Final_V2.pdf. Please download the updated version if you downloaded prior to August 25, 2021.

Highlights

Appendix V lists the changes made to the 2021 Compliance Supplement in detail. The following paragraphs highlight some of the key changes.

2021 Compliance Supplement and COVID-19. Because of the timing of development and approval of Compliance Supplement changes and the evolving nature of the COVID-19 pandemic and related legislation and programs, the 2021 Compliance Supplement does not contain new COVID-19-related programs that resulted from the American Rescue Plan Act of 2021 (ARP). Furthermore, the COVID-19 pandemic has led to extensive changes to the 2021 Compliance Supplement compared to the past several years and auditors need to be aware that the OMB plans to release two addendums to the Compliance Supplement. The first addendum,

expected to be issued early this fall, will likely include the Coronavirus State and Local Fiscal Recovery Fund (21.027) and updates to the Education Stabilization Fund (84.425) section 1. A second addendum, expected to be issued later this fall, will likely include three Treasury programs (1) Capital Projects Fund (no Assistance Listing number yet), (2) Homeownership Assistance Fund (21.026), and (3) the Local Assistance and Tribal Consistency Fund (no Assistance Listing number yet). Additionally, these addendums may include additional new programs.

Because the initial 2021 Compliance Supplement does not contain new COVID-19 related programs that resulted from ARP and related compliance requirements, many practitioners (and organizations receiving federal awards) have questioned whether they can appropriately complete a single audit and issue their reports before the addendums are available. The Compliance Supplement states that reports issued prior to the publication of an addendum are not required to adhere to its requirements. However, due to the critical nature of the information expected in the addendums, AICPA representatives, industry opinion leaders, and our authors are strongly urging auditors of organizations that received COVID-19-related awards that resulted from ARP (whether through new or existing programs, or had changes made to existing programs due to ARP) not to complete and report on their June 30, 2021 or later single audits until the addendums have been released and analyzed.

Practical Consideration:

For COVID-19 related programs that are not included in the addendums, the framework in Part 7 of the Compliance Supplement should be applied.

Part 2—Matrix of Compliance Requirements. Certain changes and corrections to the matrix were made for 2021. Changes are shown with yellow highlights; and corrections are shown with blue. The six-compliance requirement mandate that was introduced in the 2019 Compliance Supplement remains in effect. *This six-compliance requirement mandate does not apply to programs not included in the Compliance Supplement.*

Part 3—Compliance Requirements. Changes include:

- Part 3 of the 2021 Compliance Supplement has been updated to reflect changes in the revised Uniform Guidance issued in August 2020. Two provisions of the new Uniform Guidance were effective immediately while the remainder was effective for awards received after November 12, 2020. For 2021, the revisions are not called out separately as they have been in the

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past and auditors will need to check the award terms and conditions to determine the correct version of the Uniform Guidance to follow when testing awards subject to audit.

- The 2020 Uniform Guidance revisions also include updates to certain purchase thresholds for procurement included in Part 3.
- Part 3 of the 2021 Compliance Supplement has fully incorporated requirements of the Federal Funding and Accountability and Transparency Act (FFATA) that was originally included in the 2020 Addendum along with guidance concerning when auditors must test FFATA.

Part 4—Agency Program Requirements and Part 5—Clusters of Programs. Updates reflect program additions and deletions, program title changes, COVID-19 and statutory requirement updates, reference updates, and technical changes and corrections.

Appendix IV—Internal Reference Tables. Appendix IV adds a number of COVID-19-related programs to federal programs that have been designated as “higher risk.” The upcoming addendums are expected to include additional ARP programs that will be designated as “higher risk.” Appendix IV indicates that, generally, new ARP Type A programs must be audited as a major program because, in most cases, new ARP programs will not have been audited in one of the two most recent audit periods. However, it further states, that an auditor is not precluded from determining that a “higher risk” non-ARP Type A program or cluster qualifies as a major program if both of the following criteria are met:

- The program otherwise meets the criteria for a low-risk Type A program under 2 CFR 200.518; and
- The percentage of COVID-19-related funding in the program is immaterial to the program or cluster.

Lastly, the inclusion of COVID-19-related funding within the Research and Development (R&D) cluster does not create a “higher risk” for the R&D Cluster.

Appendix VII—Other Audit Advisories. Updated section I, Novel Coronavirus (COVID-19), includes additional guidance on COVID-19 funding and addresses OMB’s plans to publish two addendums to the Supplement in Fall 2021. Subsections include: Definition of COVID-19 funding; Single audit due dates—Additional Extension; Treatment of donated personal protective equipment (PPE) on the Schedule of Expenditures of Federal Awards (SEFA); Agency Guidance Document References; Identification of COVID-19 related awards and single audit applicability; Identification of COVID-19 related awards on the SEFA and SF-SAC; Identification of COVID-19 related awards in audit findings; Identification of compliance requirements for COVID-19 related awards; Responsibilities for informing subrecipients; and Additional audit guidance for COVID-19 programs to be issued in follow-up addendum.

Section I gives instructions to auditors that COVID-19 related awards should again be identified separately on the SEFA and the Data Collection Form as well as for audit findings. Section I also gives additional details concerning the facts and circumstances that precluded the initial Compliance Supplement from including new COVID-19 related programs funded under ARP or the Coronavirus Response and Relief Supplemental Appropriations Act (CRRSAA) and further outlines the programs to be included in the addendums that will be issued this fall. Lastly, Section I highlights that there will be no new clusters formed by ARP or CRRSAA Assistance Listing numbers nor will any ARP or CRRSAA Assistance Listing numbers be added to existing other clusters.

