

## Lien and Mortgage Subordination

The Alliance recommends that land trusts obtain comprehensive subordinations of mortgages and other liens on conservation property that give the land trust an absolute priority to proceeds associated with easement extinguishment and condemnation as well as complete protection of the first priority position for the conservation easement or other right. This pointer will focus on subordinations and partial interests but, as a reminder, with respect to land ownership, title should be fully cleared of all liens prior to the land trust accepting a deed of the full fee simple title. (For more information, see narrative for *Land Trust Standards and Practices* [9F2](#)).

### Subordination

U.S. Tax Court cases underscore the importance of comprehensive subordination of lenders' rights to proceeds, including insurance and condemnation proceeds arising from extinguishments of easements or other partial interests. This also applies to 1) all other liens and 2) where the grantor is not seeking a federal tax deduction. Land trusts must obtain clear title and a first priority position in all conservation holdings in order to ensure the land trust's continued legal right to monitor, enforce and defend its conservation interest. Such subordinations are especially important to establish land trusts' first priority rights to proceeds after conservation easement terminations and extinguishments (including condemnations) and to show compliance with T.R. 1.170A-14(g)(2) and T.R. 1.170A-14(g)(6).

The Tax Court has decided several important cases pertaining to subordinations. In particular, the history of *Kaufman v. Commissioner* is important (and complex), because the First Circuit Court of Appeals disagreed with the IRS and the Tax Court about the necessary scope of lenders' subordination agreements, requiring less stringency in [Kaufman v. Commissioner](#), 687 F.3d 21 (1<sup>st</sup> Cir. 2012) ([Kaufman III](#)). That First Circuit decision recognized the difficulties landowners have in requiring lenders to agree to an absolute proceeds priority in favor of the land trust on easement termination, and accordingly, thought that a strict interpretation of T.R. 1.170A-14(g)(6) requiring such "absolute priority" did not reflect congressional intent.

The Tax Court disagrees, however, and does not follow the decision in Kaufman III anywhere outside of the First Circuit (Maine, New Hampshire, Massachusetts Rhode Island, and Puerto Rico). See, e.g., *Palmolive Building Investors, LLC, v. Commissioner*, 149 T.C. 380 (2017) (declining to follow First Circuit decision in Kaufman in other federal circuits); *901 South Broadway Limited Partnership v. Commissioner*, U.S.T.C. No. 14179-17 (unpublished Order, Apr. 27, 2021). The IRS also insists that if the property has a mortgage or lien in effect at the time the easement is recorded, the easement contribution is not deductible unless the mortgagee or

lien holder subordinates its rights in the property to the rights of the land trust to enforce the conservation purposes of the easement in perpetuity. (See [IRS' Conservation Easement Audit Technique Guide](#).)

## Recording

The Tax Court and the IRS also require recording of subordination agreements before or contemporaneously with the recording of the conservation easement. The Alliance recommends recording the subordination prior to the conservation easement even if you record all documents simultaneously and obtain a time stamped copy of each.

*Even if the conservation easement is purchased or exacted, the land trust still must obtain and record lien subordinations with all conservation easements to assure that the conservation easement will be protected in perpetuity. Substantial compliance does not apply to failure to properly subordinate. See, [Mitchell v. Commissioner](#), 775 F.3d 1243 (10<sup>th</sup> Cir. 2015)(Mitchell III), [affirming](#) 138 T.C. No. 16 (U.S.T.C. 2012)(Mitchell I); T.C. Memo. 2013-204 (U.S.T.C. 2013)(Mitchell II); [Minnick v. Commissioner](#), 775 F.3d 1243 (9th Cir. 2015)(Minnick, [aff'g](#) T.C. Memo 2012-345 (U.S.T.C. 2012).*

## Points to Consider in All Subordination Agreements:

1. Identify the purpose for the subordination (also known as a lender agreement), particularly the intention to comply with the perpetuity requirements of the Tax Code and Treasury Regulations for donated easements *and for the land trust's compliance with its mission and Section 501(c)(3) requirements.*
2. Include an affirmative agreement that the lender is subordinating its rights in the property to the rights of the land trust to enforce the easement in perpetuity, not merely consenting.
3. Include a lender acknowledgement of the property right vested in the land trust and an express agreement that any exercise of the lender's rights in the property may not diminish or affect the conservation rights of the land trust as stated in the conservation easement.
4. Include an acknowledgement that upon termination, extinguishment, or condemnation of the conservation easement, in whole or in part, that the lender shall not have a priority claim over the right of the land trust to receive any insurance payments, condemnation awards, or other proceeds paid upon, or subsequent to, judicial extinguishment of the conservation easement.
5. In the event of a foreclosure *after* a judicial extinguishment, protect the priority interest of a land trust's lien to secure its right to subsequent property sale proceeds *before* payment is made to lenders to satisfy their interests in the property.
6. Include a statement that the lender agreement should be interpreted for purposes of qualifying the easement as a Qualified Conservation Contribution under section 170(h).
7. Watch out for lenders insisting on limitations on land trusts' right to obtain or charge the landowner or other responsible parties for restoration or mitigation of easement violations, including the lenders themselves if they are in possession of the property after foreclosure and are responsible for the violation.
8. Develop relationships with local lenders rather than the large national lenders. Educate local lenders.
9. Record the subordination before the conservation easement. Be prepared for IRS objections if they find a tardy subordination on audit.

## Clause Suggestions for the Lender Agreement

(See *Land Trust Standards and Practices* [9F](#) for more sample language for mortgage subordination agreements and statements available on The Learning Center):

1. Mortgagee hereby acknowledges that the Easement vests in Donee a real property interest in the Property and the right to receive a proportionate share of any proceeds of a sale, exchange or involuntary conversion subsequent to an extinguishment of the Easement or condemnation as provided in paragraph \_\_\_\_\_ of the Easement. Lender agrees that extinguishment proceeds, casualty insurance proceeds, and condemnation proceeds shall be divided as and when received so that Donee receives its full proportionate share, before any other claims are paid or satisfied.
2. Section 1.170A-14(g)(2) of the Treasury Regulations requires that, in order for the Mortgagor's donation of the Easement to be treated as a "qualified conservation contribution," the mortgagee of any mortgage outstanding on property subject to such a donation must agree to subordinate its rights in the property to the right of the qualified organization to enforce the conservation purposes of the donation in perpetuity. The Mortgagor has asked that the Mortgagee subordinate its rights in the Property to the Easement in order to comply with these regulatory requirements, and to insure that the Easement will, in fact, protect the Property in perpetuity, as required by Section 170(h)(5) of the federal Income Tax Code and Treasury Regulations 1.170A-14(g)(2) and 1.170A-14(g)(6).
3. Mortgagee does hereby subordinate its rights to the rights of the \_\_\_\_\_ [Trust] to the Easement and the right of the \_\_\_\_\_ [Trust] to enforce the conservation purposes, as set forth in the easement, in perpetuity. No sale of the Property by Mortgagee, or by, through or under the powers vested in Mortgagee pursuant to the Mortgage, shall occur except under and subject to the Easement. In the event of foreclosure or deed in lieu of foreclosure, the Easement may not be extinguished and must remain in full force and effect.
4. Lender hereby agrees that the sale or transfer of the Property pursuant to a foreclosure, condemnation, or any proceeding or settlement in lieu thereof shall not extinguish any lien to secure Donee's entitlement to its proportionate share of extinguishment proceeds as provided in paragraph \_\_\_ of the Easement.

### Contact us:

- Leslie Ratley-Beach (802) 262-6051 | [lrbeach@lta.org](mailto:lrbeach@lta.org)
- Diana Norris (202) 816-0221 | [dnorris@lta.org](mailto:dnorris@lta.org)

**Date last revised:** September 10, 2021

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