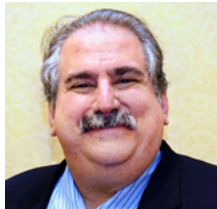


# GIVE IT AWAY NOW: AN UPDATE ON CONSERVATION EASEMENTS, CHARITABLE DEDUCTIONS, AND SUBSTANTIAL COMPLIANCE (PART 1)



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## I. CONSERVATION EASEMENT OVERVIEW

### HISTORY, PURPOSE AND PUBLIC BENEFITS OF CONSERVATION EASEMENTS

Owners of real property in the United States have the right to use their property in many different ways and to use traditional real estate strategies to maintain or change the character and use of their land. Accordingly, landowners employing such traditional strategies can construct or replace existing buildings (for residential or industrial use) on their land, or may use land for agricultural purposes (to grow crops or forests,

or to raise livestock). In the alternative, landowners may employ strategies to maintain property in its current condition, whether developed or not, and the owners may decide to give away, sell, lease and otherwise transfer their rights in such property to others.

Much is known and written about such traditional real estate strategies and this discussion will not expand on that body of knowledge. Instead, this composition explains how landowners can employ conservation strategies for real estate in ways that preserves significant open spaces, vistas, natural habitats, forest land and farm lands and historical structures for future generations. Such conservation strategies arose from

Congress's recognition of the importance and benefit of such preservation activities, and Congress's determination that it was in the country's best interest to encourage landowners to preserve land of ecological or historic importance in a manner that protects or preserves the conservation values identified by Congress as being important.

To accomplish this goal, Congress provides substantial tax benefits for taxpayers who voluntarily restrict their property in a manner which preserves such conservation values on such property in perpetuity. These restrictions are commonly known as conservation easements. The income tax benefits provided by Congress for these restrictions are found in section 170(a) and (h) of the Internal Revenue Code. Estate tax benefits are found in sections 2031(c) and 2055(f) of the Code. Many states have also enacted tax benefits for donating landowners, usually in the form of a tax credit.

The concept is timely and important, and we have had numerous requests from landowners and others for information about conservation easements and how they can be used to accomplish various tax and real estate goals. These requests have prompted us to write this article which covers the basics of conservation easement planning. Points covered include:

- The history, purpose and public benefits of conservation easements;
- The technical requirements that must be satisfied before a land owner will be entitled to a federal tax deduction for the contribution of a conservation easement; and
- Valuation of conservation easements, which determines the amount of any deduction.

### **WHAT IS A CONSERVATION EASEMENT?**

A conservation easement (also called a conservation restriction or restrictive covenant) is a legal conveyance between a landowner and a third party whose role is to monitor the easement and enforce it if necessary. This third party must be a governmental entity or, more commonly, a special kind of tax-exempt Section 501(c)(3) organization known as a "land trust." Land trusts are viewed by the conservation community and Congress as the "gate keepers" for conservation easements. Land trusts accept easements on property with appropriate conservation values, and they monitor and enforce the legal restrictions on the property in

perpetuity. The landowner will continue to own the land and may use the land for various purposes that do not impair the conservation values of the property. The landowner may also sell the land or pass it on to heirs. However, the conservation easement must give the land trust the right and power to permanently restrict the uses of the land to those uses allowed by the easement.

Conservation easements offer great flexibility and can contain a variety of restrictions and of permissible uses. For example:

- An easement might apply to all or to only a portion of a landowner's property;
- It might allow recreational uses, such as hunting, fishing and water sports;
- It can, but need not (in most cases), allow public access to the eased property; and
- Landowners sometimes reserve sites on the easement on which to build homes and other structures.

On the other hand, conservation easements necessarily place limitations on some uses of the property. For example:

- A conservation easement typically prohibits any intense development of the property for residential or commercial uses;
- Particular conservation values associated with the property must be perpetually protected. For example, significant wildlife or plant habitat, streams and lakes, or in some cases a scenic vista;
- Lenders may be unwilling to loan funds secured by restricted property, and existing mortgages must be subordinated to the conservation easement; and
- The Tax Court has recently explained that the conservation easement must permanently encumber the specific real property upon which it is granted, and the encumbered real property cannot be "substituted" for different real property.

### **POTENTIAL TAX BENEFITS FOR DONATION OF CONSERVATION EASEMENTS**

To encourage the preservation (in perpetuity) of land with significant conservation values, Congress has provided substantial tax benefits to landowners donating

qualifying conservation easements. The primary incentive is an income tax deduction under Section 170(a) and (h) of the Internal Revenue Code. A landowner who donates a “qualified” conservation easement to a qualified governmental entity or land trust, and who satisfies the technical requirements of the regulations issued under section 170, is eligible for a federal income tax deduction equal to the value of the donated easement. However, the value of restrictions placed on real property is a difficult question. The Treasury regulations require the taxpayer to first attempt to value the conservation easement by looking at sales of other “comparable” easements. In practice, however, such comparable easements rarely exist, so the value of a conservation easement donation generally is measured by the difference between the fair market value of the property before the easement takes effect and the fair market value after the easement takes effect.

Other potential tax benefits to donors of qualifying conservation easements include an estate tax deduction for donations made at the time of death (section 2055(f)) and an estate tax exclusion for eased property included in a decedent’s estate (section 2031(c)).

## **TECHNICAL REQUIREMENTS FOR INCOME TAX BENEFITS**

To qualify for the income tax deduction under Section 170, a conservation easement must meet several requirements:

### **The Easement Must Be Perpetual**

In order to be eligible for an income tax deduction, the donation must be perpetual. What this means is that the conservation restrictions will be recorded and will forever prohibit the uses of the property described in the conservation easement deed. The perpetuity requirement manifests itself in various ways, and the scope of this requirement is only partly explained in the regulations. The scope of the perpetuity requirement is a common source of IRS controversy and litigation.

Congress intended that conservation easements perpetually encumber the land on which the easement is granted. For this reason, any outstanding mortgages, liens, encumbrances or other rights of third parties must be subordinated to the rights of the land trust to enforce the conservation easement restrictions. The subordination must be obtained and be effective before the easement is granted. Also, if the eased

property were to be condemned, the land trust must receive a proportionate share of the proceeds from condemnation. There are unsettled questions about the impact on perpetuity of such things as amendment or modification of an easement. However, the courts have recently determined it is impermissible for a donor to retain the right to modify the boundary lines of an easement. Whether the nature and extent of the restrictions within the eased property (such as the location of reserved “development areas”) can be moved, is subject to ongoing litigation.

### **The Easement Must Be Held by a Qualified Governmental or Non-Profit Organization**

A conservation easement must be donated to a qualified governmental entity or to a qualified tax-exempt organization. Tax-exempt donee organizations are generally referred to as “land trusts” and they must be a tax-exempt entity that is qualified to receive tax-deductible contributions. It was the intent of Congress to have land trusts function as the regulators of conservation easements. A land trust will monitor conservation easement property periodically to assure that the property is in compliance with the terms of the conservation easement and that the conservation values of the property are being preserved. If a land owner violates the terms of a conservation easement, the land trust must be willing and able to take appropriate enforcement actions that are available under the law.

### **Valid Conservation Purpose**

The easement must serve a valid “conservation purpose,” meaning the property must have a significant ecological, scenic, historic, scientific, recreational, or open space value. Congress has specified four types of property that it wishes to be preserved, and these types of property are enumerated in the Internal Revenue Code and are further defined in the Treasury Regulations. The four conservation values that Congress has allowed as a basis for a deduction are:

- Preservation of land areas for outdoor recreation by, or education of, the general public;
- Protection of a significant, relatively natural habitat of fish, wildlife, or plants, or similar ecosystem;
- Preservation of open space, including farmland and forest land, for the scenic enjoyment of the general public, or preservation of open space pursuant to a clearly defined governmental conservation policy,

provided such preservation will yield a significant public benefit; and

- Preservation of a historically important land area or certified historic structure.

The conservation easement must secure one, but only one, of the four types of preservation values. If land is suitable for such a purpose, the donor and the land trust must agree on, and implement, a set of restrictions which will preserve the identified characteristics of the property in perpetuity. These restrictions become the core of the conservation easement document, together with specified uses reserved to the landowner. The IRS is currently taking the position that a land owner cannot protect one type of conservation purpose, while allowing a use that would impair a separate conservation purpose. For this reason, all potential conservation purposes should be evaluated in light of the easement restrictions and uses reserved by the donor.

### **The Easement Donation Must Be Substantiated and Reported in Specific Ways**

An appraisal of the value of the donated conservation easement must be obtained within a certain time period and must be performed by a qualified appraiser whose work satisfies standards set out in the Treasury Regulations, as discussed more fully below. The landowner must obtain a written acknowledgement from the land trust prior to the earlier of filing his tax return or the due date (including extensions) thereof, that confirms the donation and that makes certain certifications required by the Regulations. A document called the baseline documentation must be obtained which details the condition of the property and the conservation values associated with it. The fundamental documentation of the conservation easement must be carefully drawn, and the execution and recording of the documents must be done in the proper time and manner. In addition, the donor's tax return must include an appraisal summary (Form 8283) that is signed by the appraiser and by the land trust and that sets out certain information about the donation and the donated property. The IRS carefully scrutinizes Forms 8283, and will deny a deduction if it determines a Form 8283 is incomplete.

## **THE INCOME TAX DEDUCTION**

### **Enhanced Incentives for Conservation Easement Donations Available to Individuals**

Under current law, individuals may deduct conservation easement donations up to 50 percent of the individual's contribution base, and the unused portion the donation may be carried forward for up to 15 additional tax years. This enhanced incentive applies to deductions for conservation easement donations made directly by an individual taxpayer directly as well as those "passed through" from an entity such as a partnership or S-Corporation (as discussed in the following subsection, separate limitations apply to donations made by C-Corporations). Further, an individual that is a "qualified farmer or rancher" (defined as a taxpayer that earns 50 percent or more of its annual gross income from the trade or business of farming) may deduct a conservation easement donation of property used in, or made available for use in, the production of agriculture or livestock production ("agricultural property") up to 100 percent of the qualified farmer or rancher's contribution base provided that the easement includes a restriction that such agricultural property remain available for such production.

These enhanced incentives, signed into law by President George W. Bush as part of the Pension Protection Act of 2006, were enacted to encourage and reward conservation easement donations. Prior to the enactment of these incentives, conservation easement donations by individuals were subject to the general 30 percent contribution base limitation and the five-year carryover period. While the enhanced incentives for conservation easement donations were originally scheduled to expire at the end of 2007, these incentives were subsequently (and, as necessary, retroactively) extended by Congress for each year between 2008 and 2014, thereby making this one of the most confusing areas of conservation easement law.

Fortunately, the pro-easement incentives were finally (and retroactively for 2015) made permanent when President Barack Obama signed into law the Protecting Americans from Tax Hikes Act of 2015 (the "2015 PATH Act") on December 18, 2015. Accordingly, the 50 percent contribution base limitation and 15 year carryover period apply to conservation easement donations made in every tax year beginning on or after January 1, 2006. While some of the uncertainty surrounding this topic was eliminated when the enhanced incentives

were made permanent in 2015, these limitations remain complex and particular to each taxpayer, so anyone considering a conservation easement donation should consult with a tax advisor prior to making the decision to pursue a conservation easement donation.

### **Enhanced Incentives for Conservation Easement Donations by Certain Corporations**

Under current law, C-Corporations may deduct conservation easement donations up to 10 percent of the C-Corporation's taxable income and the unused portion the donation may be carried forward for up to five additional tax years. However, like the incentives for individuals, some pro-easement incentives are available for conservation easement donations made by certain C-Corporations. First, much like the similar incentive for individuals, a non-publicly traded corporation that is a qualified farmer or rancher may deduct a conservation easement donation of agricultural property up to 100 percent of the corporation's taxable income, and any unused deduction may be carried over for up to 15 subsequent tax years, provided that the easement includes a restriction that such agricultural property remain available for such production. Like the pro-easement incentives for individuals, this provision was originally enacted by the Pension Protection Act of 2006 and was subsequently made permanent by the 2015 PATH Act. Accordingly, this incentive applies to tax years beginning on or after January 1, 2006.

In addition to making the incentive for corporate farmers and ranchers permanent, the 2015 PATH Act also added a new (and permanent) pro-easement incentive for certain Alaskan "Native Corporations" (generally defined as entities, whether for-profit or not, organized under the laws of the State of Alaska for the purpose of holding, managing, investing or distributing funds, land or other property and rights on behalf of Native Alaskans). Under this new incentive, a Native Corporation may deduct a conservation easement donation of property conveyed under the Alaska Native Claims Settlement Act up to 100 percent of the Native Corporation's taxable income, and any unused deduction may be carried over for up to 15 subsequent tax years. Unlike the other pro-easement incentives discussed above, this new incentive applies only to donations made in tax years beginning on or after January 1, 2016.

### **VALUING A CONSERVATION EASEMENT**

The amount of the charitable deduction available for a donation of property is the fair market value of the property donated. In the case of a conservation easement, however, the donation involves a landowner placing restrictions on land he will still own after the donation. The land trust receives the right to enforce the restrictions. The value of these rights and restrictions would be difficult to appraise under normal appraisal methods. In some cases, there are actual sales and purchases of conservation easements that can be compared to the donated easement. In these cases, a standard appraisal method can be employed based upon the comparable sales. However, in most cases, such "comparable sales" of easements either do not exist or they are insufficient to perform a valid appraisal.

When there is no substantial record of marketplace sales of comparable easement rights, the Treasury Regulations provide that the fair market value of the conservation easement is deemed to be the difference between the fair market value of the property the easement encumbers immediately before granting the easement (the "Before Value") and the fair market value of the encumbered property after granting the easement (the "After Value"). Under Section 1.170A-14(h)(3)(ii), this "before-and-after" valuation must take into account the "highest and best" use of the property in question, based upon an objective assessment of how immediate or remote the likelihood is that such property, absent the restriction, would in fact be put to that use. The analysis must also take into account realistically the impact of zoning laws, conservation or historic preservation laws, and other issues related to feasibility of the property's potential highest and best use. The following example illustrates a before-and-after valuation scenario:

Mr. Jones owns 100 acres of ecologically important, undeveloped land. It is feasible and reasonably probable that Mr. Jones could develop the land into a residential community, and if so then the fair market value of the land at its highest and best use is \$10 million. However, Mr. Jones wants to donate to Land Trust a conservation easement over the land, which will eliminate in perpetuity his right to develop the land. A qualified appraiser determines that the value of the land after the restrictions are in place (thus eliminating any development potential) is only \$1 million. Assuming Mr. Jones meets

all of the technical requirements applicable to conservation easement donations, Mr. Jones will be entitled to a \$9 million deduction.

If the amount claimed or reported as a charitable contribution deduction exceeds \$5,000, the deduction must be substantiated by a “qualified appraisal” performed by a “qualified appraiser” under Section 1.170A-13(c) of the Regulations. This is often a complicated and relatively expensive process which requires an appraiser with special skills and experience. As a result of this complexity and of the inherent subjectivity of property appraisal, tax controversies involving conservation easements are often embroiled in valuation concerns and issues. Moreover, the 2006 Pension Protection Act and subsequent guidance have expanded on the requirement of a “qualified appraisal” and “qualified appraiser.” The IRS is frequently raising issues about what these terms mean and require in light of the changes.

## **OTHER TAX BENEFITS OF CONSERVATION EASEMENTS**

There are other benefits beyond the federal income tax deduction that are available for conservation easement donations. Two of the more important benefits are discussed below.

### **Reducing Estate Taxes**

A conservation easement can facilitate passing undeveloped land on to the next generation. By removing the land’s development potential, the easement typically lowers the property’s fair market value, which in turn lowers the potential estate tax. Whether the easement is donated during life or by will, it may make a critical difference to the heirs’ ability to keep the land intact. If “eased” property is included in a decedent’s estate at the reduced value of the property post-easement, the estate’s estate tax liability may be reduced, and the need to sell the eased property to raise funds to pay estate taxes may be eliminated. Accordingly, the absence of development potential may make it more likely that the property will stay in the family, and in its current use, for generations.

Another incentive for conservation easement donations is an estate tax exclusion of up to 40 percent of the restricted value (the “after value”) of land protected by a conservation easement. That exclusion is capped at \$500,000 and is further reduced in cases where the easement reduces a property’s value by less than 30 percent.

## **State Tax Benefits**

In 1983, North Carolina became the first state to establish a state income tax program which provides donors of qualified conservation easements with credits that can be used to pay state income tax. In 1999 four state legislatures enacted state tax credit programs (Virginia, Delaware, Colorado, and Connecticut). South Carolina and California followed in 2000. Several other states, including Georgia, have followed since, although there have been subsequent restrictions on the availability and prerequisites to obtaining such state tax benefits.

For landowners with little income subject to state taxation, a tax credit can be of little benefit. In response to this problem, Colorado in 2000 made their state tax credit transferable—that is, the donor/landowner can sell her/his credit to other parties; the buyers can then use the purchased tax credit to pay their Colorado income tax. Virginia followed by enacting transferability in 2002. Other states, including Georgia, have followed since. However, the amount of credit an easement can generate is often capped, and other restrictions limit the scope of the state tax credit programs in various ways.

In the states where the credit for conservation land donations is transferable, free markets for such credits have formed. Brokers assist landowners with excess credits to identify buyers. The brokers often handle payments and paperwork to protect the principals and to ensure that transfers are fully reported to the state tax authorities.

## **CONSERVATION EASEMENTS AND REAL ESTATE PARTNERSHIPS**

A conservation easement can be a valuable alternative for deriving real property value. In certain instances, the tax benefits that may be realized from a conservation easement donation will make such a donation attractive when compared to alternative uses for a property. Partnership structures that allow investors to become members of a land-owning partnership that is considering the development or conservation of such land can allow, under the right circumstances, multiple landowners to benefit from the tax benefits resulting from a conservation easement donation if that approach is chosen. This may result in the permanent preservation of land that might not otherwise be protected due to the significant profit potential to be extracted from the highest and best use of the

property for development purposes. Ultimately, the decision of whether to develop or conserve the property, or to commit the property to some other use, will be made by the landowner(s) or their designee, regardless of how the property is held or owned.

Thus, the tax incentive for conservation easements found in Section 170(h) will achieve its purpose, even in a partnership setting, by encouraging the donation of a conservation easement on property and by protecting the conservation values Congress wants to preserve in perpetuity for future generations. While some partnership ownership structures can be complex, it appears that they are ideally designed to allow the tax incentives of Section 170(h) to be used as Congress originally intended; that is to incentivize the permanent protection of valuable lands by private landowners. An example of how this might work is provided below:

Assume that Mr. Jones (from the example above) owns the property with his son, Casey, in a partnership, and assume that Mr. Jones and Casey each have an annual adjusted gross income of only \$50,000. If Mr. Jones and Casey were to donate a conservation easement over their property, they would likely be unable to fully utilize the \$9 million deduction attributable to an easement donation because of the deduction limitations discussed above (Mr. Jones and Casey would each be limited to deducting \$25,000 of the \$9 Million deduction in the year of donation, and roughly the same amount for each carryover year afterward). However, if Mr. Jones and Casey admitted other high-income investors into their partnership by selling the LLC interests, and the partnership subsequently elected (among several alternative decision) to donate an easement over the property, the investors would be able to share in the deduction.

### **IRS NOTICE 2017-10 (LATER MODIFIED BY NOTICE 2017-29)**

In late December, 2016, the IRS published Notice 2017-10 (as later modified by Notice 2017-29) (the "Notice"), which designates donations of certain conservation easements (and substantially similar transactions) that arise out of certain syndication transactions as "reportable" or "listed" transactions. In simple terms, the Notice requires any individual (a "Participant") who participates in a so-called syndicated conservation easement (that generally took place since 2010) that

produces a deduction greater than 250 percent of the Participant's investment amount in the transaction to file IRS Form 8886, Reportable Transaction Disclosure Statement, provided that the applicable statute of limitations remains open for the year in which the investment was made. Additionally, so-called Material Advisors to such transactions must file Form 8918, Material Advisor Disclosure Statement.

The Notice requires Participants and Material Advisors to maintain certain records with respect to such transactions. These new filing requirements are intended to generate information the IRS may use to audit such syndicated conservation easement transactions. Clearly, however, the Notice does not change the law governing conservation easements and does not mean that a transaction that has been disclosed by Participants (using Form 8886) and Material Advisors (using Form 8918) will be denied. The focus of the Notice appears to be on the valuation claimed by taxpayers with respect to affected conservation easements. Unfortunately, penalties for failing to comply with Notice 2017-10 (as modified by Notice 2017-29) can be draconian, so compliance with the requirements of such Notice is advisable. Whether or when Notice 2017-10 (as modified) will be amended, revoked or rescinded is uncertain.

### **CONCLUSION**

Conservation easements can provide land owners with significant tax and non-tax benefits. Congress has repeatedly expressed its desire for the preservation of private property for public benefit by enacting Section 170(h) of the Code and by repeatedly expanding or extending the tax benefits available for conservation easement donations.

Despite Congress's clear intent to promote easement transactions, however, the IRS has been active trying to weed out what they perceive as "bad" easements. Unfortunately, these efforts by IRS to find and to disallow bad easements have resulted in many good easements being examined and often deductions being disallowed due to technical problems, inaccurate paperwork or simple disagreements over value issues. The courts have often drawn hard lines on certain technical issues, so it is more important than ever to make sure easement donations are carefully scrutinized by competent and experienced tax counsel and that all of the many procedural and technical requirements are satisfied.

## II.

### IRS AREAS OF ATTACK ON CONSERVATION EASEMENTS

#### TECHNICAL ISSUES

##### Qualified Real Property Interests (I.R.C. § 170(h)(2)(C))

Under the Code, a qualified conservation contribution must be “a restriction (granted in perpetuity) on the use which may be made of the real property.”

IRS argues that an easement is not a qualified real property interest (on the grounds that the boundaries are not fixed) if:

- Contains floating homesites and/or the right to carve-out out- parcels, which the IRS treats as movement of boundaries;
- Contains amendment clause (right of the parties to amend the easement, which could include moving boundaries); and
- Allows the land trust and owner to agree to move the boundaries of the easement.

##### Protection of Conservation Purposes in Perpetuity

Under the Code, a qualified conservation contribution is not exclusively for conservation purposes “unless the conservation purpose is protected in perpetuity.” I.R.C. § 170(h)(5)(A). The Treasury Regulations contain several requirements that must be met to ensure that the conservation purposes are protected in perpetuity. The IRS will attack easements that do not meet these strict requirements.

##### Mortgage Subordination

Pursuant to Treas. Reg. § 1.170A-14(g)(i)(2), a mortgagee must subordinate its rights in the property to the land trust.

If the subordination agreement is not signed and filed at the time of the easement, the IRS will argue that the conservation purposes are not protected in perpetuity.

If the mortgagee does not subordinate its rights to insurance proceeds that the mortgagor/donor carries on the encumbered property, the IRS will argue that the conservation purposes are not protected in perpetuity.

##### Extinguishment Rights

Pursuant to Treas. Reg. § 1.170A-14(g)(i), in cases where the conservation purposes can no longer be served, the conservation purposes can nonetheless be treated as protected in perpetuity if the restrictions are extinguished by judicial proceeding.

If the deed allows the parties to *agree to extinguish* the easement (or provides a method of extinguishment other than by judicial proceeding) the IRS will argue the conservation purposes are not protected in perpetuity.

##### Extinguishment Proceeds

Pursuant to Treas. Reg. § 1.170A-14(g)(6)(ii), the donee must be entitled to a portion of the proceeds (in the case of a judicial condemnation or sale) at least equal to the donee’s proportionate interest in the property at the time of the easement donation.

- The IRS will argue that any extinguishment clause that does not precisely track the Treasury Regulation’s formula does not protect conservation purposes in perpetuity.
- The IRS will argue that proceeds with respect to improvements added to the property post-easement are subject to the same proportionality rule.
- The IRS will argue the land trust must have a vested interest in proceeds from third party contracts, such as insurance contracts.

##### Reserved Rights/Inconsistent Use

Pursuant to Treas. Reg. § 1.170A-14(e)(2) “a deduction will not be allowed if the contribution would accomplish one of the enumerated conservation purposes but would permit destruction other significant conservation purposes.”

Similarly, Treas. Reg. § 1.170A-14(g) provides “[i]n the case of any donation under this section, any interest in the property retained by the donor ... must be subject to legally enforceable restrictions ... that will prevent uses of the retained interest inconsistent with the conservation purposes of the donation.”

The IRS consistently argues that reserved rights in the easement deed are inconsistent with the conservation purposes. (Glass, Butler and Atkinson) The response: Taxpayer must show that (1) reserved rights are not inconsistent with the conservation purposes, and (2)



the land trust has authority and ability to enforce the restrictions in the deed and preclude exercise of inconsistent reserved rights. (Butler)

### Baseline Documentation

With respect to conservation easements in which the donor reserved certain rights with respect to the eased property, Treasury Regulation § 1.170A-14(g)(5) outlines the requirements for the baseline documentation, including photographs, maps, and surveys, that must be provided by the donor to the donee prior to the time the donation is made. The IRS will argue that baseline documentation is insufficient or was not provided prior to the date of donation. (Bosque Canyon)

### Qualified Appraisal / Qualified Appraiser

IRS will argue that the appraisal fails to comply with the regulations and that it fails to comply with USPAP. IRS will argue that the appraiser is not a qualified appraiser and/or that the appraisal is not a qualified appraisal.

### Incomplete Appraisal Summary (Form 8283)

IRS will argue that the Form 8283 is not complete and does not accurately describe the eased property. IRS will argue that the taxpayer did not provide its basis on Form 8283. There is, however, a Reasonable Cause exception.

### Contemporaneous Written Acknowledgement (CWA)

The IRS will argue that Section 170(f)(8) letter was not provided by Donee.

### Conservation Purpose (I.R.C. 170(h)(4))

Under the Code, a qualified conservation contribution must be made “exclusively for conservation purposes.” I.R.C. 170(h)(1)(C). There are four conservation purposes, any one of which can be met, under I.R.C. § 170(h)(4):

- Preservation of land areas for outdoor recreation by, or the education of, the general public;
- Protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem;
- The preservation of open space...where such preservation is: (1) for the scenic enjoyment of the general public; or (2) pursuant to a clearly delineated Federal, State, or local governmental conservation policy, and will yield a significant public benefit;

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

The IRS argues that conservation purposes are not met as follows:

- **Outdoor recreation or education for general public:** The general public does not have access to the property at the time of the easement grant, or at some subsequent time;
- **Relatively natural habitat:** (a) habitat is too small, (b) the wildlife, fish, or plants are not “significant”, or (c) the habitat has been altered to such an extent that it is no longer “natural”;
- **Preservation of Open Space:** (a) general public cannot view the open space, (b) the preservation is not made in connection with a specific policy, (c) no significant public benefit; and
- **Historically important land area or certified historic structure:** Restrictions imposed by the easement are not more restrictive than applicable restrictions under existing local law.

## VALUATION ISSUES

### Highest and Best Use

- Zoning does not permit proposed development plan. Zoning in place does not have to permit the proposed development, but a zoning change to accommodate such development must be reasonably probable (Palmer Ranch).
- Local opposition would preclude development. Does not impact highest and best use, but might impact value (Palmer Ranch).
- Must prove based on reasonable probability standard that the use is legally possible, physically possible, financially feasible and maximally productive.

### Comparables

- Previous purchase price of the property is best indicator of value.
- If property was worth what taxpayer claimed on return, the taxpayer would have developed and/or sold the property.
- Comparable analyzed by adjusting for differences between the subject and comparable properties. IRS will argue analysis provided by taxpayer’s qualified appraiser and other experts is incomplete or wrong.

### **Syndicated Deals**

- Amount investors paid to be in the deal is the indicator of the value of the property.

### **Income Approach**

- Compensable sale approval is preferred.
- Too many variables in an income approval valuation makes the approval unreliable.

## **III.**

### **IMPORTANT CONSERVATION EASEMENT CASES/RELEASES (ORGANIZED BY ISSUE)**

#### **CONSERVATION PURPOSE — INCONSISTENT USE**

##### **Glass v. Comm’r**

- 471 F.3d 698 (6th Cir, 2006), affirming 124 T.C. No. 16, in 1992 and 1993 (Judge Laro)

#### **Overview**

Charles and Susan Glass donated two conservation easements to the Little Traverse Conservancy (LTC). The conservation easements protected 410 feet out of the taxpayers’ 460 feet shore frontage on Lake Michigan, and comprised just over one acre in total. The shore frontage consisted of beach and a steep bluff. This type of bluff and beach were known to be habitat for bald eagles, piping plovers, and two endangered plant species. The easements restricted most development along the beach and bluff but did allow certain reserved rights to establish a boathouse, storage shed, day shelter, and a scenic viewing platform, as well as cutting vegetation for safety and view purposes and for walking paths. The Glasses claimed deductions for the charitable contributions, based on independent appraisals. The IRS initially challenged the valuation of the easements, and the case worked its way through administrative channels for several years. Eventually, the IRS also contended that the easements did not qualify under the conservation purposes test of I.R.C. section 170(h) because they failed to protect habitat or open space. A trial was held in August 2004, at which the court bifurcated the valuation issue and the 170(h) qualification issue, and determined to rule first on the qualification issue. After the trial, the parties settled the valuation issue.

### **Tax Court Decision**

The Tax Court (Judge Laro) held that the conservation easements were granted for conservation purposes within the meaning of I.R.C. § 170(h)(4). In particular, the easement’s purpose and effect was to protect bald eagle and endangered plant habitat, therefore qualifying as a “conservation purpose” under section 170(h)(4)(A)(ii), the “protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem.” According to the court, the Glasses presented credible evidence that the easement would protect and preserve the bald eagles’ habitat and communities of threatened plant species on the land. Because the easements qualified under the habitat prong of the conservation purposes test, the court did not address the open space prong.

The Tax Court further held that the easements were granted “exclusively for conservation purposes” within the meaning of section 170(h)(5), noting that the easement was perpetual and legally enforceable, and also recognizing the Holder’s commitment and financial resources to enforce the easement.

### **Sixth Circuit Affirms**

In its December 21, 2006 opinion, the Sixth Circuit resoundingly affirmed the Tax Court’s decision in all respects. In particular, the Circuit Court held that the easements protected significant habitat because threatened and endangered species were documented on the encumbered property and because, even without such documentation, there was ample evidence that such species could potentially inhabit the encumbered property.

The Circuit Court also held that the easement’s reserved rights were not inconsistent with the easement’s habitat protection purposes. Third, the Circuit Court upheld the Tax Court’s analysis of § 170(h)(5).

### **Analysis**

The Tax Court opinion was very thorough, included a review of the legislative history of § 170(h), and held for the donors on every account. The court’s conclusion that the easements met the §170(h)(4) conservation purposes tests seemed well-founded, given the strong evidence of the existence of endangered animals and plants on the protected property. The analysis of §170(h)(5) was also an important part of the case, for it suggests certain basic criteria for a conservation easement holder to observe in order to demonstrate

that it will hold the easement “exclusively for conservation purposes.” These criteria include: (a) the holder has the organizational commitment to land conservation; (b) the holder has adequate financial resources to enforce the easement; (c) the holder’s enforcement of the easement is directly related to its purposes for tax-exemption; and (d) the easement contains language requiring that any subsequent holder be an entity fully committed to enforcing the easement.

The Sixth Circuit’s opinion was a significant victory for the land conservation community, as several aggressive arguments set forth by the IRS were rejected out of hand.

On appeal, one of the Government’s thematic arguments was that the easements should be held to a higher standard (both for significant habitat purposes and inconsistent reserved rights purposes) because of their relatively small size. The Sixth Circuit soundly rejected this approach, citing as persuasive authority IRS Private Letter Ruling 8546112 (recognizing the deductibility of an open space easement on  $\frac{3}{4}$  of an acre) and noting that the quality of the habitat and the actual effect of the reserved rights, not the size of the protected property, is what matters.

Another aggressive, perhaps even radical, argument presented by the Government was that potential development on nearby properties (not owned by the Glasses) would undermine the habitat protection purposes of the conservation easements and therefore the easements should not qualify for a deduction. Again, the Sixth Circuit dismissed this reasoning, recognizing that easement donors have no legal right to control what development may or may not occur on these nearby properties.

One issue on appeal was whether the taxpayers had to show actual evidence that endangered or threatened species inhabit the property, or instead whether it was enough to demonstrate that such species could *potentially* live, feed, or roost on the property. The Sixth Circuit, citing IRS Private Letter Ruling 200403044 as persuasive authority, held that a showing of potential habitat is sufficient in certain instances. Presumably, declaring a property potential habitat must be based on valid scientific data or reasoning and not simply pulled out of thin air. And despite this favorable ruling, easement donors and holders would be wise to carefully document which particular species or ecological

communities are protected by their easements, both in the easements themselves and in the baseline data.

The Circuit Court distinguished this case from *Turner v. Commissioner*, 126 T.C. No. 16 (May 16, 2006) by noting that the easements in *Glass* essentially doubled the setback provisions under the existing zoning ordinances, whereas in *Turner*, the easement simply mirrored the existing zoning protections.

Although the donors won on the reserved rights issue, the opinion suggests that easement drafters pay particular attention to reserved rights to ensure that they do not allow uses inconsistent with the conservation purposes of the easement. The Circuit Court conducted a careful analysis of the reserved rights and their likely effects. For example, the taxpayer’s right to cut vegetation for safety and view maintenance purposes was deemed not to harm the threatened plant species because these plants grow only a few feet high and would not pose a safety or view concern. In addition, the right to build structures such as a boathouse and storage shed was acceptable because it was expressly limited to be conducted “in a manner and location which minimizes interference with the [Protected Property’s] scenic and natural resource values” Finally, the right to cut vegetation for walking paths was found to enhance habitat protection by concentrating human use to a narrow corridor instead of allowing the widespread trampling of plants or disturbance of animals. An implicit conclusion of the opinion is that a loosely drafted easement that allowed overly generous reserved rights might not pass the “inconsistent uses” standard found in the federal regulations.

The Tax Court in *Butler v. Comm’r*, T.C. Memo 2012-72, expanded on the *Glass* analysis of inconsistent use.

### **Butler v. Comm’r**

T. C. Memo 2012-72 (Judge Wells)

#### **Overview**

*Butler* related to easements on land near Columbus, Georgia that were intended to satisfy the requirements of Section 170(h)(4)(A)(ii) (preservation of a relatively natural habitat) and (iii) (preservation of open space).

#### **The Court’s Analysis**

The IRS in *Butler* contended that the rights the taxpayers retained in the relevant conservation deeds are inconsistent with such conservation purposes. The

Court in *Butler* found that the taxpayer satisfied 170(h)(4)(a)(ii) (relatively natural habitat) so did not address the open space issue. In doing so the Court recited the definitions of relatively natural habitat from the Regulations (1.170A-14(d)(3) which first defines in -14(d)(3)(i) what significant habitats and ecosystems include and then noted under -14(d)(3)(ii) that a habitat is an area or environment where an organism or ecological community normally lives or occurs, or the place where a person or thing is most likely to be found (citing *Glass v. Comm’r*, 124 T.C. 258).

Thus the court stated that a “conservation easement will satisfy the conservation purpose of protecting a relatively natural habitat if it protects and area: (1) that is an environment where a rare, endangered, or threatened species is normally found; (2) that is a “high quality” example of an ecosystem; or (3) that contributes to the ecological viability of a park or other conservation area.”

The Court goes on to state: Any interest retained by donor “must be subject to legally enforceable restrictions that will prevent uses of the retained interest inconsistent with the conservation purposes of the donation. 1.170A-14(g)(5). When the donor reserves rights that, if exercised, would have the potential to impair conservation interests, the donor must provide the donee with “documentation sufficient to establish the condition of the property at the time of the gift (what we call the baseline report). The donee must also be given the right to periodically inspect the property to enforce the conservation restrictions, including the right to require the restoration of the property to its condition at the time of the donation.

The Court stated that in deciding whether the conservation easement deeds preserve the conservation purposes in perpetuity, we must first decide the extent to which the conservation easement deeds permit the eased properties to be altered from their current states, and second, if the properties were developed to the extent permitted by the conservation easement deeds, would the conservation purposes still be preserved.

The case involved two sets of easements, the first one related to properties in Muscogee County and the second set related to Kolumoki Plantation. In looking at those easements, the Court reviewed the numerous reserved rights in the conservation easement deeds, noting that such rights were all subject to the

overarching language of the conservation easement Deeds preserving the conservation purposes.

### **Reserved Rights in Muscogee Easements**

The following reserved rights relating to the Muscogee County property were noted:

- Right to partition into smaller tracts of 36 acres each, each of which would include a 2-acre building site on which a home and a garage could be constructed;
- Right to build roads or driveways to access such buildings;
- Right to operate small-scale farms, for keeping livestock and raising crops. On such farms agrichemicals can be used to eliminate “noxious weeds” provided the use of the chemicals minimize the impact on non-noxious foliage and vegetation;
- Right to construct dams to create ponds for recreation or irrigation, and to construct docks, gazebos and “related recreational structures”;
- Right to clear timber for agricultural uses, clear brush and remove trees for “aesthetic” purposes and plant nonnative trees or plants; and
- The deeds permitted a wide variety of other uses that do not result in “demonstrable degradation of Conservation Values,” including construction of fences, roads other than those that access building sites, unlimited number of barns and sheds for agricultural or recreational use on any portion of the property (not just the two-acre building sites), and commercial timber harvesting under an approved timber management plan.

The conservation easement deeds permitted the land trust to periodically enter and inspect the property to ensure compliance with the conservation easement deeds and to require the landowner to restore the property if there is damage to the conservation values.

The Court included some discussion of whether the baseline documents, which identified the location of the building sites and was incorporated by reference into the conservation easement deed, was effective to do so. The court said that under Georgia law it did so by having the map in the baseline incorporated by reference. *That seems to mean that the building sites in Butler did not float.*

The Court then reviewed the evidence presented on whether the properties that were eased contained protectable conservation purposes and concluded that the properties include habitats where some rare, endangered, or where threatened species normally live. That said, the issue to be determined was whether the conservation easement deeds preserve such conservation purposes in perpetuity in light of the retained rights in the conservation easement deed (if there are no retained rights, proving the existence of the conservation purposes is all that would be required).

What was most interesting is that the only testimony offered by the taxpayers regarding the retained rights were a few exchanges between their counsel and the taxpayer's environmental consultants who were expert witnesses in the case concerning the two acre building sites. The Court quoted one of the experts who generally talked about how the setting of the property is so special because of where it is and how it looks. She also was quoted as stating that 400 acres were being preserved for wildlife and that for "400 acres to be preserved and guided by conservation principles is really priceless."

She was also asked about another portion of eased property that was 12 acres, ten of which were perpetually preserved: how does that serve conservation of a relatively natural habitat for wildlife? She concluded that the reservation of 2 of the 12 acres were the same as the larger tract mentioned above as to its benefit as a natural habitat for wildlife.

*The court then noted that such testimony was only directed at the issue of whether the reserved rights to build on the home sites are consistent with the conservation purposes and no other of the reserved rights were addressed.* The Court also noted that the taxpayers contended that the land trust's enforcement rights were important in showing that the reserved rights were so consistent with conservation purposes because if they or later owners used the retained rights improperly, the land trust would have the right to enforce the conservation easement deed and cause the land to be restored.

While the Government contended (I suppose by briefs) that the reserved rights were inconsistent with the conservation purposes, they offered NO EXPERT TESTIMONY to support that contention. Moreover, while the Government contended that the conservation easement deeds fail to address how the reserved rights can

be exercised so as not to thwart the conservation purposes and that the reserved rights could be exercised in ways that would destroy the habitats and high quality ecosystems on the property, *they did not introduce any evidence in support of that argument or any evidence that the land trust would be likely to fail to enforce its rights under the conservation easement deed or otherwise permit the taxpayers or their successors to use the land in a manner inconsistent with the conservation purposes.*

### **Court's Conclusion on Muscogee Conservation Easements**

The Court concluded that the taxpayers presented credible evidence, in the form of expert testimony noted above, the overarching rights granted to the land trust in the conservation deeds themselves, and the annual monitoring conducted by the land trust, that the conservation easement deeds preserve the conservation purpose, and the burden of proof shifted to the Government. Since the Government offered no contrary expert witness testimony and pointed to no evidence that would suggest that the land trust is likely to abandon its right to enforce the conservation easement deed, the Court concluded that the Government failed to establish that the conservation easement deeds do not protect significant habitat, holding that the conservation easement deeds satisfy the requirements of 170(h)(4)(A)(ii) and 1.170A-14(d)(3).

### **Kolomoki Plantation Conservation Easements**

A second portion of Butler involved a conservation easement granted over the Kolomoki Plantation, which has been used for decades as a shooting plantation. The Plantation already included a main lodge with guest house (overlooking at 25-acre pond), a headquarters office, a maintenance barn, a manager's house, a grain storage facility, four tenant houses, two equipment shelters, kennels, a hay field cabin, a 30 acre hayfield including fenced pasture land for horses that is also used as a landing strip. Most of the property in Kolomoki Plantation was eased in two easements.

### **Reserved Rights in Kolomoki Conservation Easement Deeds**

The conservation easement deeds restricted the use of the property but reserved a number of rights. The conservation easement deed permits existing agricultural, grazing and horticultural uses to continue and permitted areas that were once fields but on which

timber was then growing to be reclaimed for agricultural use at any time. That included up to 75 percent of the eased area. The conservation easement deed allows the use of agrichemicals provided that such use does not have a demonstrable detrimental effect on the Conservation Purposes. The deed prohibits certain industrial agricultural practices and prohibits importation of game farm animals other than whitetail deer or game birds. It permits commercial timber harvesting under an approved timber management plan that is not detrimental to the scenic, historic, natural area and rare species habitat protection, wildlife and game habitat protection and sustainable forestry purposes.

The conservation easement deed allows the Kolomoki Plantation to be subdivided into up to 15 tracts of at least 200 acres. The owner of any subdivided portion of less than 500 acres can build the following structures on a five-acre building envelope: single family residence, unlimited number of garages, gazebos, sheds, boat houses, and other recreational facilities; a secondary residential building for each 100 acres beyond the first 100 acres; and farm building of not more than 4500 square feet under roof. The residential buildings can be leased and with permission from the land trust, the owner may construct any such nonresidential agricultural and recreational structures as may be reasonably necessary for the uses permitted.

Moreover, the owner of any subdivided acreage of over 500 acres can construct a headquarters site of up to 15 acres, with up to two residential dwellings, one lodge for temporary guests, three guest houses, any number of sheds, barns, kennels, garages, picnic shelters, and barns “reasonably necessary to conduct permitted activities”. The total ground coverage under roof at each headquarters site cannot exceed 15,000 square feet. *The location of all headquarter sites and building envelopes is subject to approval by the land trust (so the building envelopes may float it seems).*

The conservation easement deed allowed construction of permeable roads and driveways to access any permitted structure. The owner was permitted to construct and maintain a private grass airstrip and to construct new ponds and lakes in locations subject to approval by the land trust.

The conservation easement deed prohibited all other development and prohibited any use that would impair or destroy significant conservation values.

The land trust was granted the right to enter the property periodically to inspect the property and ensure compliance with the conservation easement deed. The land trust did that regularly (twice a year) and the land trust had the right to require the owners to restore the property if there has been a violation of the conservation easement Deed.

The baseline reports in all easements and supplemental reports provided at the time of trial described various aspects of the properties and what was found there, including listing of species found on the property and species that normally would be found on the property which were rare, endangered or threatened.

In its discussion of the Kolomoki Plantation easement, the court followed a similar analysis to that outline above for the Muscogee properties. Under the heading: “Does the Conservation Deed Preserve the Conservation Purposes in Perpetuity”, the Court noted that the record was sparse concerning whether the conservation easement deed preserves the conservation purpose in perpetuity *and that although the environmental and supplemental reports from the taxpayer’s experts show that the property as it existed in the relevant years provide significantly relatively natural habitat, the reports do not establish that the conservation easement deed effectively preserves such relatively natural habitat.*

The Court also quotes a couple of statements made by the Taxpayer’s experts in their testimony that confirmed that allowing for the reserved rights kept people on the property that are of a mind to protect the conservation values on the property. That meant that having such like-minded (conservation oriented I suppose) people on the property kept or prevented other (evil or non-conservation minded) people from destroying the property or the conservation values on the property (with the example given using eased areas as a dumping ground).

The largest quote was: “You know, if we have—if we put a structure in a spot on 500 acres—one structure, two structures, five structures—verses going in and mowing the whole thing down and putting in half-acre, one-acre lots, that’s a huge difference. So, you know, it’s not going to affect that significantly with that small amount of structures on a 500-acre parcel.”

## Conclusion on Kolomoki Conservation Easements

Like before, the court concluded that the taxpayers had presented credible evidence—in the form of expert testimony described above, the overarching rights granted to the land trust in the conservation easement deed, and the evidence that the land trust regularly monitors the property—that the conservation deed preserves the conservation purpose, and therefore the burden of proof shifted to the Government. Because the Government offered no contrary expert witness testimony and pointed to no evidence that would suggest that the land trust is likely to abandon its right to enforce the conservation easement deed, the court concluded that the taxpayers established that the conservation easement deed protect significant habitat and satisfies 170(h)(4)(A)(i) and 1.170A-14(d)(3).

It is noteworthy that in *Butler*, the Muscogee conservation easement deeds, the building sites did not seem to float, but in the Kolomoki CEs they did. Judge Wells did not seem to think this was an issue. It was not even mentioned.

### Atkinson v. Comm’r

145 T.C. 13 (2015) (Judge Wells)

#### Overview

The decision in *Atkinson* involved two easements—one contributed in 2003 and another in 2005—for which the taxpayers claimed deductions totaling \$7.88 million. Portions of each easement encumbered property that was being operated as a golf course both before and after the easement. The golf courses are part of the St. James Plantation community near Wilmington, NC. The golf courses and the area they are in are described in the case. Judge Wells rejected both easements on the grounds that they did not satisfy conservation purpose requirement. In a minor taxpayer victory, no penalties were assessed based on reasonable cause and good faith review.

#### Decision Summary

Judge Wells points out up front that “we were presented with similar issues in *Kiva Dunes*” but “were not required to decide the issue of compliance with conservation purpose requirement of 170(h) because the commissioner had conceded the issue on brief.” This makes one wonder if Judge Wells might have ruled in *Kiva* the same way he ruled in *St. James*.

In his description of the two easements at issue, Judge Wells included a chart that breaks down by percentage the various areas of the easement areas into (a) tees, bunkers, fairways and greens, (b) rough, (c) ponds, (d) other (e) wetlands, and he makes clear that the easement areas are divided into portions and that the percentages do not include the golf cart paths. The court notes that the areas outside of the manicured part of the golf course only add up to 24 percent.

Wells notes in the discussion of the 2003 easement that a subsequent easement was covered by the nearby Middle Swamp and in his discussion of the 2005 easement he notes a second easement over Wetlands II that borders the eastern edge of the 2005 easement area.

In his review of the terms of the easements, he notes the retained rights to operate a golf course and of all the things that the golf course could continue to do as long as “the best environmental practices then prevailing in the golf industry were used and applied.” *This will later be used against the taxpayer as the court notes in the opinion that the standard of protecting according to golf course standards is misplaced...should be based on best conservation practice in general, not just in the context of the operation of a golf course.* In that regard, Wells notes the right to dig in various ways, ability to relocate cart paths, right to construct shelters, rest stations, food concessions, stands and other structures not in excess of 2500 square feet and the right to increase the surface area of the golf course with NALT consent if there is not a material adverse effect on conservation purpose. He also notes in a separate paragraph the right to cut and remove trees on the golf course or within 30 feet of the course if “appropriate for proper maintenance of the golf course”, and to build a restroom, rain shelter, rest station or food concession stands. *This right to remove trees hurt the taxpayer in the opinion as it showed a lack of concern for the trees, what was claimed to be a reason that the property had conservation purpose.*

Wells went into great detail about the ability to maintain the course by applying chemicals on the course and to maintain turf grass and other vegetation.

The Judge noted that the 2003 easement area was in the Cape Fear Arch and that it is close to, but not in, the Boiling Springs Lakes Complex. He noted that the 2005 easement partially borders the Boiling Springs Lake Complex. Being close or partially bordering was

not good enough. Wells also reviewed the NALT baseline report and discussed the species of animals noted as being found on the course or likely to be found on the course, including the Red-Cockaded Woodpecker. *That said, he notes that the baseline does not reference any specific sighting or evidence of migration of the Red-Cockaded Woodpecker. Wells seems to want more detailed sightings. This proved problematic for nocturnal animals...how do you show that animals exist and visit the property at night?*

Wells describes the photos of the property in the baseline noting that it mostly depict open areas of mowed grass, ponds surrounded by mowed grass and a line of trees with dense foliage surrounding houses. He also notes a picture of a pond with the densest foliage surrounding it, where Mr. Wilson heard a large southern leopard frog chorus, which pond was labeled a “temporary pool habitat.” The “temporary” nature of that pond was cited later as a problem. The photos seemed to be a real problem...worth a thousand words.

Venus Flytraps were noted as being in both the 2003 and 2005 easement areas, but the location was not clearly identified. He notes that the Flytraps were designated “federal species of Concern”, meaning it is more stable than endangered (highest designation) or threatened (second highest designation). He also reviews other ways to rank its status as between imperiled globally because of rarity and apparently secure. *Wells seems to make clear that protected animals and plants need to be considered endangered and not just threatened.*

The discussion of the 2005 easement was mostly the same as for the 2003 easement except for the existence according to the baseline report for the 2005 easement of “old growth” forests and the identification of the American alligator as a threatened species and the shortleaf yellow eyed grass, yellow pitcher plant and purple pitcher plant, which are recognized as “significantly rare- peripheral” or “exploited plants.” The baseline also similarly to the 2003 report notes species to be potentially found in the 2005 easement including the Red-Cockaded woodpecker.

The Judge notes that the photos in the baseline for the 2005 easement (and Wetland II area) show: a pond surrounded by mowed grass up to the edge and trees in the distance, undeveloped wetlands, a concrete bridge over undeveloped wetlands with space trees in the distance, a picture of the golf course, shown ringed

by a line of trees and an mowed open field transected by rougher shrubs and grasses and ringed by a concrete path and trees. *The pictures in the baseline seem to matter to the Judge.*

To begin his discussion of the easements, it is noteworthy that the court concludes that the petitioners produced credible evidence with respect to whether the easements satisfied the “protecting natural habitat” (Brambrell and NALT testimony and Luken as expert). That with other findings of cooperation lead to the Court’s holding that burden of proof was shifted under 7491 on the issue of whether the easements satisfy “protecting natural habitat” purpose under 170(h)(4)(A)(ii).

In addressing whether the easements satisfied conservation purpose, the court addressed each easements conservation significance, its contributory role (a big part of taxpayer’s case was the contributory impact each easement had to the Cape Fear Arch and the Boiling Springs Lake Complex) and the effect of retained rights, noting shifting of the burden. These positions were part of the original plans by NALT and the taxpayer.

Judge Wells found that the 2003 easement did not protect forests, ponds or the wetland and that none of these features provide a relatively natural habitat for applicable plants or animals. In the analysis, *Wells notes that the long leaf pine trees on the property are not protected because they can be removed and that the number and type of longleaf remnants were not “in a relatively natural state worthy of conservation” and that none constituted “old growth.”* He noted that there was no management plan to ensure that the longleaf pine will reach and maintain a relatively natural state (discussing the lack of controlled burning). The court seemed to focus on the right to remove trees as being a real problem.

As to the ponds being a relatively natural habitat, the court was critical of the lack of natural edges on the ponds and the impact of pesticides on the ponds concluding that “when a pond in this ecosystem has no edge, it does not provide even a “relatively” natural habitat...” The Court also noted the IRS expert’s water studies of the impact of chemicals on the ponds. *The Court pointed out that while taxpayer’s expert testified generally that the various ponds in the 2003 easement provide critical habitat for amphibians, fish, reptiles and birds, but the expert did not observe any specific plants or wildlife in the pond edges.*



The court also discusses that the easement property provides poor habitat for plants and wildlife, noting no natural fruits and seeds for foraging and no cover. He notes that animal migration is deterred by the residential development around the easement areas and that human activity in the area and frequent watering made the area not animal friendly. He also noted that petitioner could not provide testimony on what happens on the property at night or how the property could be used for roosting, feeding or breeding. The species listed in the baseline were found to be common and there was no indication that the species noted are rare, endangered or threatened.

As to the argument that the easement area provides a habitat for one threatened or endangered species to satisfy the conservation purpose test (citing Venus Fly-trap and Pitcher Plants), the court distinguished Glass on the grounds that the area protected in Glass was mostly undisturbed land because the subject was not in a “natural undeveloped state”. In other words, the court limits Glass’s application and does not extend. He also noted that the communities of the plants found in Glass were much more robust.

The Court also noted that the 2003 easement property was not ideal for the Venus Flytrap, that they were not found in a large enough area of the eased property to qualify the entire area and that the species at issue in Glass were threatened or endangered, noting that the Pitcher Plants and Venus Flytraps in the 2003 and 2005 easement areas are rare but not designated threatened or endangered.

The court noted that “it is clear from the testimony of the IRS expert that the chemicals...promote the non-native flora without regard for any conservation purpose,” noting that the operation of the golf course results in the replacement of a natural area with non-native grasses. The Court was critical of allowing the operation of the golf course and the use of chemicals to do so could injure or destroy the local ecosystem and therefore runs counter to the provisions of 1.170A-14(e)(2) (IRS guidelines regarding the use of pesticides that imposes the following standard: “if under the terms of the contribution a significantly naturally occurring ecosystem could be injured or destroyed by the use of pesticides”).

Thus, the Court concluded that the use of pesticides and other chemicals could injure or destroy the

ecosystem. On that basis the court concluded that the wildlife and plants are not “most likely” to be found and do not normally live on the easement properties.

The Court’s detailed analysis of the 2005 easement mirrored the Court’s analysis of the 2003 easement.

### **Court’s Conclusion**

Without going into detail, the Court found that the easement areas do not satisfy conservation purpose by contributing to other protected areas under 1.170A-14(d)(3)(l). The easement areas were not “natural areas” (too much non-native grasses), ponds not in relatively natural state and native forests do not remain and are at risk. The Court also noted that the easement areas do not act as a wildlife corridor or sink and there are no natural fruits or seeds for foraging or cover from humans and predator and that there are barriers to migration such as homes, people and nightly watering. Because of all these issues, the easement areas could not contribute to other protected areas.

The court rejected petitioner’s argument that the easement area acts as a buffer to a nearby significant habitat, noting that example 2 of 1.170A-14(f) is distinguishable (easement on Farmacre to preserve Green-acre). The court summarily addressed Open Space and rejected its application. That was not a surprise. Retained rights and value were rendered irrelevant by the court’s holding on lack of conservation purpose.

In a minor win for the taxpayer, the court found that the proposed valuation and accuracy related penalties were not applicable as petitioners showed reasonable reliance on NALT and the Qualified Appraisals, and good faith based on Mrs. Wills’ testimony of good faith investigation.

### **Appeal to Two Circuits**

On September 21, 2016, the taxpayers filed a Notice of Appeal in both the Fourth Circuit and the Eleventh Circuit Courts of Appeal.

#### **PBBM-Rose Hill, Ltd. v. Comm’r**

No. 26096-14 (Oct. 7, 2016)  
(bench opinion Judge Morrison)

### **Overview**

On 09/09/2016 the Judge Morrison of the Tax Court issued a bench opinion in PBBM-Rose Hill. Ltd. that

denied a taxpayer's charitable deduction due to perpetuity and conservation purpose deficiencies. The precedential value of this opinion is limited because it is a bench opinion rather than a memorandum or en banc Tax Court opinion. The PBBM-Rose Hill, Ltd. appeal is currently pending before the Fifth Circuit Court of Appeals.

In 2002, PBBM bought a 241-acre parcel that included a golf course (consisting of 27 holes) from Rose Hill County Club, Inc. for approximately 2.4 million dollars. In January of 2006, PBBM ceased operation of the golf course. On March 2, 2006, First Carolina Bank filed for foreclosure with respect to the golf course property. On March 21, 2006 PBBM voluntarily filed a Chapter 11 Bankruptcy protection petition.

On December 28, 2007 PBBM granted a conservation easement to the North American Land Trust (NALT), which generally prohibited development of the property. In January of 2008, PBBM sold the golf course property for 2.3 million dollars. Sometime thereafter in 2008, PBBM filed its income tax return for the 2007 tax year and claimed a charitable deduction for the conservation easement of approximately 15.2 million dollars.

The IRS determined that PBBM was not entitled to a deduction for the contribution of the easement to NALT, and PBBM was subject to either the 40 percent gross valuation misstatement penalty, or alternatively, the 20 percent understatement penalty.

The IRS argued that the easement failed to satisfy the perpetuity requirements of Code sections 170(h)(2)(C) and 170(h)(5)(A) because the bankruptcy trustee could have voided the easement. The court was "unclear whether the transfer of the easement could have been avoided" by the trustee as the IRS alleged. Ultimately, the court did not make a ruling on the bankruptcy issue because it determined that PBBM was not entitled to a deduction on other grounds.

On appeal, the Fifth Circuit affirmed the Tax Court's decision. The Fifth Circuit agreed with the Tax Court's conclusion that the contribution was not "protected in perpetuity" as required by section 170(h)(5)(A) because the easement deed contained an extinguishment provision that did not satisfy the perpetuity requirement. The Fifth Circuit also held that the Tax Court did not err in its valuation of the easement or regarding its determination that a valuation-related penalty applied.

## Conservation Purpose

The court also determined that the easement failed to preserve a valid conservation purpose within the meaning of Code section 170(h)(4)(A). The court made two findings with respect to the conservation values that will be ripe for appeal. First, the respondent alleged that the easement failed to preserve a valid recreational open space for the general public because the subsequent purchasers of the property from PBBM were apparently denying access to the general public. The court agreed with the respondent that PBBM was not entitled to a deduction because a subsequent purchaser of the property was not abiding by the terms of the easement and NALT was not enforcing the terms of the easement. It is unclear what PBBM could have done to enforce such access, as it had divested itself of all interest in the property at the time of sale. Second, the court determined that the property did not possess a habitat for rare, endangered or threatened species despite the presence of two species of concern: the wood stork and the American alligator. The court explained that "[a]lthough wood storks forage on the property, this foraging activity does not convince us that the property is habitat for the wood stork." The court also explained that the American alligator was "a relatively unimportant species ecologically." There is no further analysis as to why the presence of these species does not evidence a habitat for them.

The court held that PBBM was not entitled to a deduction both because the easement deed failed to comply with the extinguishment requirement in Treasury Regulation section 1.170A-14(g)(6).

On appeal, the Fifth Circuit concluded that the easement was "for conservation purposes" as required by section 170(h)(1)(C). Nevertheless, concluded that the contribution was not "protected in perpetuity" as required by section 170(h)(5)(A).

## Extinguishment

The court held that easement did not protect the conservation values in perpetuity because it did not comply with the extinguishment requirement in Treasury Regulation section 1.170A-14(g)(6). The court found that the formula for dividing proceeds following a hypothetical extinguishment of the easement did not comply with the regulation because it did not guarantee that NALT would receive the minimum proportionate share required by section 1.170A-14(g)(6). The alleged

flaw in the easement deed was the fact that it reserved the value attributable to improvements made by PBBM subsequent to the easement's grant for PBBM before dividing the remaining proceeds with NALT prorata.

Adopting the interpretation accepted by the Tax Court, the Fifth Circuit held that all proceeds resulting from an extinguishment of a conservation easement must be divided using the formula of the regulations. The Fifth Circuit determined the land trust must be granted an economic interest in, and any "proceeds" attributable to, improvements (e.g., a house, barn, etc.) built on easement encumbered property.

### **Gross Valuation Penalty**

Because the conservation easement failed to protect a valid conservation purpose, the court also determined that PBBM was subject to the 40 percent gross valuation misstatement penalty. Here, we note that Section 6751(b) states that "[n]o penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate." An interesting aspect of the Fifth Circuit's opinion is its conclusion that the IRS satisfied its burden of production under section 6751(b) (1), even though, the only record evidence of compliance with this mandatory statutory condition precedent to penalty assertion was a "cover letter" to a "summary report." The summary report was sufficient for the Court to conclude that the IRS satisfied its obligations under section 6751(b).

## **VALUATION**

### **Kiva Dunes Conservation, LLC v. Comm'r**

T.C. Memo. 2009-145. (Judge Wells)

On June 22, 2009, the Tax Court issued its opinion in *Kiva Dunes Conservation, LLC*, which addressed an issue that had previously been hotly debated among the conservation easement community—whether or not a conservation easement can be granted on golf course property. In its decision, the court also addressed several other important issues, including valuation methods applicable to conservation easements. The decision is a valuable guide for taxpayers seeking to make conservation easement contributions

*Kiva Dunes* involved a taxpayer's gift of a conservation easement over certain property (which included a golf course) to an eligible land trust. The taxpayer in the case was a limited liability company (LLC) taxed as a partnership for federal income tax purposes. On December 31, 2002, the taxpayer donated the conservation easement to the North American Land Trust (NALT) by a grant (the easement declarations). The conservation easement was granted on 140.9 acres (the property), which was located on the Ft. Morgan Peninsula in Baldwin County, Alabama.

The property lies between, but does not abut, the Gulf of Mexico on the south, and Mobile Bay and Bon Secour Bay on the north. The conservation easement is located between two nearby segments of the Bon Secour National Wildlife Refuge (Refuge) (approximately 0.85 miles west/northwest of the easement, and approximately 1.55 miles east of the easement). The property includes the Kiva Dunes Golf Course. However, it has many unique natural attributes that made it well suited for a conservation easement.

The easement declarations restricted development of the property, the practical effect of which was to limit the use of the property to a golf course, a park, or a low-density agricultural enterprise. Specifically, the easement declarations limited the use of the property to protect relatively natural habitats for fish, wildlife, and plants, and to preserve open space for scenic enjoyment of the general public and for the advancement of governmental conservation policies. The easement declarations also preserved the property's land areas for outdoor recreational use by the general public.

The LLC claimed two charitable contribution deductions on its partnership return for the tax year. One was a deduction for a \$35,000 cash contribution to NALT. The other was for the qualified conservation contribution of a conservation easement on the property to NALT in the amount of \$30,588,235.

The case was tried before Judge Thomas B. Wells. The week-long trial brought forth evidence including 103 exhibits, testimony of 18 witnesses, and numerous charts, photographs and videography. Despite challenging conservation purpose throughout the week-long trial, the IRS conceded conservation purpose in the first line of its post-trial brief. After the IRS conceded that a conservation purpose existed, the primary issue left before the court was the fair market value of the easement.

The court issued an opinion highly favorable to the taxpayer and to the use of conservation easements generally. Specifically, the court found that the taxpayer was entitled to a charitable deduction of \$28,656,004, which was 94 percent of the deduction the taxpayer claimed on its income tax return. The valuation methods and variables taken into account by the taxpayer's appraiser and the IRS appraiser were critical to the court's determination of value.

Kiva Dunes appears to indicate, as the IRS conceded, that golf course property can be property acceptable for conservation easement. For more information about Kiva Dunes and the valuation analysis employed by the courts, see Kiva Dunes, "Making and Substantiating the Value of Conservation Easements," *Journal of Taxation*, November 2009, and Tax Court Analysis of Land Conservation Easements Values - Developments Since Kiva Dunes," *Taxation of Exempts Vol. 2/No.6*, 2011.

### **Mountanos v. Comm'r**

T.C. Memo 2013-138. (Judge Kroupa)

#### **Overview**

The Tax Court analyzed whether a conservation easement encumbering ranch property in Lake County, California, which the IRS conceded was a qualified conservation contribution had any value that was deductible under Section 170(h).

What makes Mountanos interesting is the Tax Court's determination of the value of the easement under the before-and-after method. Under this approach, the Tax Court had to determine the highest and best use of the subject property before and after the grant of the easement.

In its analysis, Tax Court defined the HBU as the highest and most profitable use for which the property is adaptable or needed or likely to be needed in the reasonably near future. The Government successfully argued that the conservation easement resulted in no charitable contribution because the Taxpayer did not satisfy his burden of proof that the HBU of the property was other than recreation both before and after the easement was granted.

The Taxpayers were unable to show that before the grant of the easement, it was reasonably probable that the property could be used partially as a vineyard and partially for residential development (which would

have had a higher value than property with a HBU of recreational use).

### **Motions to Reconsider and Appeals Denied**

Subsequently, the Tax Court (in T.C. Memo 2014-38) denied motions to reconsider, vacate or revise its initial opinion in Mountanos, and in a very brief unpublished opinion, the 9th Circuit affirmed the Tax Court's original decision, U.S. Court of Appeals, 9th Circuit, No. 14-71580, June 1, 2016.

In affirming the Tax Court, the 9th Circuit explained that "the Commissioner may impose a 40 percent accuracy-related penalty for underpayment of income tax due to a gross valuation misstatement. Prior to 2006, taxpayers could claim a reasonable cause defense. The Pension Protection Act of 2006 ("PPA"), Pub. L. No. 109-280, 120 Stat. 780, *eliminated the defense for gross valuation misstatements filed after August 17, 2016*. PPA § 1219(a)(3), 120 Stat. at 1084 (codified as amended at 26 U.S.C. § 664(c)(3)).

### **Esgar v. Comm'r**

113 AFTR 2d 2014-583, Tenth Circuit, (March 7, 2014), aff'g T.C. Memo 2012-35. (Judge Wherry)

#### **Overview**

Taxpayer donated easements on land adjacent to land that taxpayer had used for gravel mining. Taxpayers argued that HBU of the eased property prior to easement was gravel mining. IRS argued that the HBU was agriculture. Tax Court considered expert reports and determined that it would have been physically possible to mine the property, but there was no demand in the near future.

Using comparable sales of agricultural lots, the Tax Court in T.C. Memo 2012-35 determined easement values equal to less than 1/10th of what the taxpayers originally claimed on returns.

#### **Tenth Circuit Review**

The taxpayers argued in its appeal to the Tenth Circuit Court of Appeals that the Tax Court erred in determining the highest and best use value by looking at current use rather than future development. The Court of Appeals disagreed, finding that the Tax Court properly applied the legal standard, which is to objectively assess the pre-easement highest and best use. Any determination of what that highest and best use was (i.e., agriculture or future development) could

only be reversed for clear error, a difficult standard to meet. In this case, the Tax Court did not clearly err because there was evidence to support its conclusion that gravel mining was not reasonably foreseeable in the future. The Court of Appeals also rejected the taxpayer's claim that the Tax Court improperly relied on eminent domain cases, which look at the "highest and most profitable use" of the property prior to a taking, noting that several other easement cases have likewise relied on the eminent domain precedent. Court of Appeals concluded that requirements of Treas. Regs in determining HBU value of a conservation easement do not materially differ from calculation of property value in the eminent domain context.

### **Chandler v. Comm'r**

T.C. 142 T.C. No. 16. (Judge Goeke)

#### **Overview**

The Tax Court's opinion in *Chandler v. Comm'r* is consistent with a string of cases denying deductions for preservation easements in the Northeast. Nevertheless, it is worth a second glance due to its statements about the application of "gross valuation" penalties. The case involved two façade easements granted on two single-family residences in Boston. The first issue before the court was the value of the easements. In determining that the value of the easements was zero, the court analyzed the appraisal reports submitted by both parties. The court found the taxpayers' appraisal to be flawed, in part because it analyzed "comparable" properties that were located outside of Boston. Although, the court similarly found the report submitted by the IRS to be unpersuasive, it still found the value of the easements to be zero. In so concluding, the court relied on the rationale of *Kaufman v. Comm'r*. In *Kaufman*, the court determined that when there are relatively minor differences in local property restrictions and the requirements imposed by an easement, such differences normally do not reduce the value of the property.

#### **Application of Penalties**

The court next turned to the application of penalties. Importantly, the carryovers (taken in 2005 and 2006) generated by the donations (made in 2004) resulted in multiple years being at issue in the case. This, in turn, raised questions about how (and when) the 2006 Pension Protection Act (PPA) changes to the penalty provisions applied to tax returns filed after the effective date of the statute (July 25, 2006), but which contained

carryover deductions attributable to a donation made prior to the PPA changes. The PPA changes to the penalty provision are important to the "gross valuation" penalty for two reasons: (1) The PPA changes caused the 40 percent penalty to apply anytime a taxpayer overvalues property by more than 200 percent, as opposed to prior law which required a 400 percent overvaluation; and (2) the PPA changes made the gross valuation penalty a "strict liability" penalty by eliminating the "reasonable cause and good faith" exception to the penalty.

Because the court determined the value of the preservation easements to be zero, the overvaluation threshold (200 percent or 400 percent) was irrelevant. However, the court determined that the taxpayers made a good faith attempt to determine the values of the donated easements, *allowing the taxpayers to avoid the 40 percent penalty under the law in place prior to the PPA 2006 changes*. The court then determined which years the reasonable cause exception applied to. The application of the reasonable cause exception to the 2004 and 2005 tax years at issue in the case was easy because the deductions were *claimed and reported* prior to the 2006 changes. The 2006 year was a bit trickier because, although it reported a deduction taken prior to the PPA 2006 changes, it was filed after the PPA changes. The IRS argued the strict liability changes should apply due to the filing date of the return. The taxpayers argued the reasonable cause exception under the prior law should apply because the easements were granted and the deductions were originally taken prior to the PPA 2006 changes. The court found for the IRS, determining that the filing of the 2006 return amounted to a "reaffirmation" of the value originally claimed by the taxpayers.

#### **Comment**

The Tax Court's decision is significant. Due to the slow pace at which tax disputes move through the courts and the frequency at which large easement donations result in carryover deductions, there are many unresolved cases involving easements (and other donations) which will be impacted by the decision. The IRS now has support for the position that any return filed after July 25, 2006 is subject to the post-PPA changes to the penalty provisions, regardless of when a charitable contribution claimed on such returns was made.

## **Palmer Ranch Holdings, Ltd. V. Comm’r**

T.C. Memo 2014-79 (May 6, 2014) (Judge Goeke)

### **Overview**

In Palmer Ranch, the Tax Court considered whether the taxpayer’s claimed highest and best use which was based on changing the zoning designation was “reasonably probable.”

### **Zoning Issue**

The IRS argued that it was not reasonably probable that zoning on the subject property could be changed to increase density from 70 to 100 dwelling units up to a maximum of 352 dwelling units. The Tax Court considered and rejected the four impediments to rezoning asserted by the IRS: (1) the taxpayer’s failed rezoning history on property adjacent to the subject property; (2) environmental concerns regarding the property; (3) limited access to outside roads; and (4) neighborhood opposition.

The Judge disagreed with the IRS argument that the prior zoning failure indicated that denser development would not be approved. The Tax Court distinguished cases where zoning history was similarly used; noting that the denial was two years prior to the grant of the easement and that the final order involved a different parcel, not the subject property. The Tax Court also noted that the previous denial was made by a 3-2 vote, suggesting the board’s decision could have changed over time. Finally Tax Court observed that significant development had been permitted on other adjoining parcels and that the IRS’s own land use planner recognized that there are significant developable areas in the wildlife corridor that run through the property.

### **Conservation Purpose**

The wildlife corridor and the existence of an eagle’s nest and other important animal life in the wildlife corridor made this property a good candidate for a conservation easement. The conservation purpose was not challenged in the case. Interestingly, the Tax Court found that the existence of the wildlife corridor did not decrease the reasonable probability of successful zoning.

### **Access**

The Tax Court also addressed whether the IRS’s argument that road access was not readily available and that neighborhood opposition would have limited

such access to emergency use only. The Tax Court disagreed with the IRS for a number of reasons. As stated in the decision, neighborhood opposition alone will not preclude development. Moreover, the IRS position required three assumptions: (1) that the residents would object to ingress and egress on the property; (2) that any possible objection would be a factually based argument strong enough to preempt such access; and (3) the Board of County Commissions would find merit in the argument. The Tax Court was not prepared to make these assumptions.

As to road access, the IRS argued that an applicable access point to the property was not possible without an additional cost to the hypothetical willing buyer to purchase an access easement. The Tax Court noted that since the taxpayer controlled that access point on the adjoining property, the additional costs of granting an easement to himself (the ultimate friendly seller!) would not have been significant. Accordingly, the Tax Court found that the factor did not decrease the probability that the property could have been rezoned.

### **Neighborhood Opposition**

Finally, the IRS contended that neighborhood opposition is another factor that would prevent the parcel from being rezoned. For support, the IRS pointed to neighborhood opposition to the taxpayer’s attempt to rezone different land parcel. The Tax Court noted that even if one were to assume rezoning the parcel at issue would face neighborhood opposition, to find such opposition effective the Tax Court would have to make the same three assumptions mentioned above. Since the Tax Court was not interested in making those assumptions, it found that potential neighborhood opposition did not bar the reasonable probability of a successful rezoning.

### **Tax Court Holds for Taxpayer**

Accordingly, the Tax Court found that there is reasonable probability that the subject property could have been successfully rezoned to allow for the development of multi-family dwellings at the higher density level assumed in the taxpayer’s appraisal evaluation analysis.

The taxpayer did take a haircut on value because the Tax Court found that the inflation rate assumed by the taxpayer in determining its value was too high, especially given the deterioration of the real estate market and the softening of demand in the applicable tax year (2006).

## Penalties

With respect to the proposed accuracy related penalty, because the diminution in value was less than 40 percent, but greater than 20 percent, the Tax Court had to determine whether the taxpayer was entitled to avoid the accuracy-related penalty under the reasonable cause exception found in Section 6664(c). The IRS's principle argument was that the taxpayer did not inform its appraiser or tax return preparer of an ordinance that would have affected valuation. However, the Tax Court found that the omission did not show a lack of good faith and that the omission would not have affected the tax return preparation. The Tax Court noted that the taxpayer retained a tax attorney to advise it on how to donate the easement in compliance with the Code and that the attorney had retained a licensed appraiser and a land planner. While the Tax Court identified flaws in the appraisal, the Court concluded that these flaws were not due to information contained in the omitted ordinance. Accordingly, the Tax Court: (1) found that the actions taken by the taxpayer represented a good faith attempt to determine the easement's value; (2) concluded that Palmer Ranch had reasonable cause and acted in good faith with respect to its underpayment for 2006; and (3) held that taxpayer was not liable for the accuracy-related penalty.

## Appeal to Eleventh Circuit

The Eleventh Circuit issued its highly- anticipated decision in *Palmer Ranch Holdings Ltd. v. Comm'r*, No. 14-14167, 2016 WL 453975 (11th Cir. Feb. 5, 2016). For different reasons, the Tax Court's decision was appealed by both the IRS and the taxpayer. The IRS argued that the Tax Court erred in agreeing with the taxpayer that the highest and best use of the property was for moderate density residential (MDR) development. While the taxpayer was satisfied with the adoption of its highest and best use argument, the taxpayer appealed the approximately 20 percent discount the Tax Court applied to the value reached by the taxpayer's appraiser.

Rejecting the IRS's highest and best use argument, the Eleventh Circuit agreed with the Tax Court that it was reasonably probable that the highest and best use of the property was MDR because the property could be rezoned (even though prior attempts to do so had failed). Despite finding that the Tax Court erred in failing to consider whether the development was "needed or reasonably likely to be needed" (a mandatory element of the highest and best use test), the Eleventh Circuit

concluded the error was harmless because the local "market clearly demanded MDR-level development."

The Eleventh Circuit also rejected the IRS's argument that the property's history of failed rezoning attempts showed that the property had a different highest and best use. Instead, the court explained that "the test for highest and best use already bakes in some adjustment for development risk" because "[i]f there is too high a chance that the property will not achieve the proposed use in the future, then the use is too risky to qualify" as the highest and best use of the property. So in spite of the history of the Zoning Board rejecting previous rezoning attempts, the Court noted the County's specific action, which noted what was necessary to secure the zoning change approval. Thus, the Eleventh Circuit found that the best evidence of the Zoning Board's determination ended up being their official statement. Hearing minutes of prior decisions were rejected as hearsay.

After affirming the Tax Court's highest and best use conclusion, the Eleventh Circuit found error both in the Tax Court's reliance on evidence not in the record and in its failure to explain why it departed from the comparable-sales analysis used by both parties' experts to value the easement. The Eleventh Circuit instructed that to the extent the court chooses to use different methods or data from that set forth in the appraisals, the departure must be explained and the court's analysis and any adjustments to the values reached by the appraisers should be based solely on facts in the record. Because the Tax Court discounted the value based on evidence outside of the record and failed to explain its departure from the method of valuation used by both parties, the case was remanded with instructions to "stick with the comparable-sales analysis or explain its departure."

## Comment

Palmer Ranch is important as it provides clarity about the reasonable probability standard and suggests how to corroborate and substantiate reasonable probability. This case also makes clear that, when coming up with highest and best use, an appraiser needs to consider the future, which does not always mean the immediate future. The Court indicated that the reasonably near future can be several years down the road, without using 20-20 hindsight.

## Remand to Tax Court

In remanding this case back to Tax Court, the 11th Circuit instructed the Tax Court to determine whether the taxpayer's "valuation should otherwise be reduced because of a declining real estate market in 2006." The 11th Circuit held that the adjustment made by the Tax Court in Palmer Ranch I was flawed, so the Tax Court instructed, "that an alternative basis must be found to support any adjustment for the market decline or the adjustment should be abandoned."

On remand, the Tax Court in T.C. Memo 2016-190 (October 13, 2016), ordered a supplemental brief from each party. The IRS struggled to provide a rationale for a reduction in the value of the charitable contribution that was consistent with the 11th Circuit's mandate on remand, which required that any adjustment to the easement's value attributable to a declining market be based upon evidence of comparable sales or other evidence in the record.

The Tax Court found in favor of the taxpayer, and determined that IRS failed to produce comparable sales or other data that demonstrated a market softening during the relevant time period:

*The problem is a simple one; respondent failed to demonstrate the market-softening effect at trial using sales or other data for 2006 and 2007. The Court of Appeals accepted petitioner's qualitative adjustment argument, and no data in the record shows the impact of the market downturn. Therefore, respondent's latest proposed method provides no basis to compute an adjustment that conforms with the mandate. Given the state of the record, we will adopt petitioner's expert's position and sustain the value that petitioners claimed at trial.*

Id. at 1. 📌



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