PLANNING FOR AND DEFENDING CONSERVATION EASEMENTS IN AN ADVERSE IRS ENVIRONMENT

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PART ONE
CONSERVATION EASEMENT OVERVIEW

A. 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.
- Valuation of conservation easements, which determines the amount of any deduction.
B. 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.
- 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.
- 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.
C. 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)).

D. TECHNICAL REQUIREMENTS FOR INCOME TAX BENEFITS

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

1. **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.

2. **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.

3. **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.

4. **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.

On July 30, 2018, the IRS issued final regulations (83 FR 36417-01, TD 9836) concerning substantiation and reporting requirements for cash and noncash charitable contributions. The final regulations direct taxpayers regarding certain provisions of the American Jobs Creation Act of 2004 and the Pension Protection Act of 2006. Below is an outline of the issue headings in the “Explanation of Provisions and Summary of Comments” issued by the Treasury Department with respect of the final regulations.

I. Cash, Check, or Other Monetary Gift Substantiation Requirements
   A. Contributions made to a distributing organization
      1. *Blank Pledge Card is Not Substanitation*
      2. *Name of Donee for Purposes of CFC*
   B. Compliance with 170(f)(8) and 170(f)(17) in a Single Document

II. Noncash Substanitation Requirements
   A. Reasonable Cause Exception
   B. Appraiser privacy concerns
   C. Form 8283 is not a contemporaneous written acknowledgement
   D. Form 8283 (Section B) provided to donee
   E. Attaching appraisal to carryover year returns

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III. New Requirements for Qualified Appraisals and Qualified Appraisers
   A. Transitional Rule
   B. Definition of generally accepted appraisal standards
   C. Education and experience requirement for qualified appraisers
   D. Parity between “designation” and “education and experience”
   E. Satisfying verifiable education requirement
   F. Education provided by trade organization
   G. Examples of generally recognized professional appraiser organizations

IV. Additional Comments

E. THE INCOME TAX DEDUCTION

1. Enhanced incentives for conservation easement donations available to individuals.

Under current law, individuals may deduct conservation easement donations up to 50% 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% 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% 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% contribution base limitation and the 5-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% 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.

2. **Enhanced incentives for conservation easement donations by certain corporations.**

Under current law, C-Corporations may deduct conservation easement donations up to 10% of the C-Corporation’s taxable income and the unused portion the donation may be carried forward for up to 5 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% 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 remains 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% 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.
F. 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.
G. 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.

1. 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% 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%.

2. 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.
H. 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.

I. 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% 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.

J. CONSERVATION EASEMENT AUDIT TECHNIQUES GUIDE

On January 24, 2018, the IRS issued a revised version of the “Conservation Easement Audit Techniques Guide” providing guidance for the examination of charitable contributions of conservation easements. The guide includes examples of examination techniques, an overview of the valuations processes for conservation easements, and a discussion on penalties.

The issue headings for the “Conservation Easement Audit Techniques Guide” are provided below:

- Chapter 1: Introduction to Conservation Easements
- Chapter 2: Statutory Requirements for All Charitable Contributions
- Chapter 3: Qualified Conservation Contribution
- Chapter 4: Qualified Organization
- Chapter 5: Conservation Purpose
- Chapter 6: Substantiation
- Chapter 7: Qualified Appraisal Requirements
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K. 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.
A. TECHNICAL ISSUES.

1. 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.”

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

      (i) Contains floating homsites and/or the right to carve-out out-parcels, which the IRS treats as movement of boundaries.

      (ii) Contains amendment clause (right of the parties to amend the easement, which could include moving boundaries).

      (iii) Allows the land trust and owner to agree to move the boundaries of the easement.

2. 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.

   a. 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.

      (i) 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. (Minnick, Mitchell, RP Golf)

      (ii) 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. (Kaufman I, Palmolive Building)

   b. Extinguishment Rights. Pursuant to Treas. Reg. § 1.170A-14(g)(6)(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.
(i) 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.

c. **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.

(i) 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. (Carroll)

(ii) The IRS will argue that proceeds with respect to improvements added to the property post-easement are subject to the same proportionality rule. (PBBM-Rose Hill)

(iii) The IRS will argue the land trust must have a vested interest in proceeds from third party contracts, such as insurance contracts. (Palmolive Building)

d. **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.”

(i) The IRS consistently argues that reserved rights in the easement deed are inconsistent with the conservation purposes. (Glass, Butler and Atkinson)

(ii) **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)

e. **Deemed Consent.** With respect to conservation easements in which the donor reserved certain rights with respect to the eased property and those reserved rights are conditioned on consent (usually written) of the land trust, the same Treasury Regulations cited in d. above are applicable.
(i) The IRS will argue that the easement deed could permit an inconsistent use of the property (notwithstanding the easement deed’s other restrictive provisions) if the land trust is deemed to consent when it fails to respond to an owner’s request for permission to exercise a conditional reserved right within some time frame. IRS argues deemed consent strips the land trust of ability to protect conservation values. (Hoffman)

(ii) Response:

(a) Easement deed does not permit an inconsistent use of the property pursuant to any conditional right.

(b) The Deemed Consent Provision does not prevent the land trust from enforcing the conservation easement and protecting the conservation values in perpetuity.

(c) The IRS position ignores the congressional intent, as reflected in case law, that land trusts were the gate keepers for conservation easements.

f. Baseline Documentation. Donors of conservation easements must document the condition of the property at the time of donation via a “baseline report.” Treas. Reg. § 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.

(i) IRS will argue that baseline documentation is insufficient or was not provided prior to the date of donation. (Bosque Canyon)

3. Qualified Appraisal / Qualified Appraiser.

a. IRS will argue that the appraisal fails to comply with the regulations and that it fails to comply with USPAP.

b. IRS will argue that the appraiser is not a qualified appraiser and/or that the appraisal is not a qualified appraisal.

4. Incomplete Appraisal Summary (Form 8283).

a. IRS will argue that the Form 8283 is not complete and does not accurately describe the eased property.

b. IRS will argue that the taxpayer did not provide its basis on Form 8283. (RERI Holdings, I)
c. Reasonable cause exception.

5. **Contemporaneous Written Acknowledgement (CWA).**

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


   a. There are four conservation purposes, any one of which can be met, under I.R.C. § 170(h)(4).

   (i) “preservation of land areas for outdoor recreation by, or the education of, the general public,

   (ii) “protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem.”

   (iii) “the preservation of open space…where such preservation is

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

          (b) pursuant to a clearly delineated Federal, State, or local governmental conservation policy, and will yield a significant public benefit”

   (iv) “the preservation of a historically important land area or a certified historic structure.”

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

   (i) 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.

   (ii) 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.”

   (iii) 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.

   (iv) Historically important land area or certified historic structure: Restrictions imposed by the easement are not more restrictive that applicable restrictions under existing local law.
B. VALUATION ISSUES

1. Highest and Best Use.
   a. Zoning does not permit proposed development plan.
      (i) 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).
   b. Local opposition would preclude development
      (i) Does not impact highest and best use, but might impact value (Palmer Ranch).
   c. Must prove based on reasonable probability standard that the use is legally possible, physically possible, financially feasible, and maximally productive.

2. Comparable Sales.
   a. Previous purchase price of the property is best indicator of value.
   b. If property was worth what taxpayer claimed on return, the taxpayer would have developed and/or sold the property.
   c. 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.

3. Syndicated Deals.
   a. Amount investors paid to be in the deal is the indicator of the value of the property.

   a. Comparable sale approval is preferred.
   b. Too many variables in an income approval valuation makes the approval unreliable.
PART THREE
IMPORTANT CONSERVATION EASEMENT CASES/RELEASES
(ORGANIZED BY ISSUE)

A. CONSERVATION PURPOSE — INCONSISTENT USE.


   a. **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 protected 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.

   b. **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.

c. **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).

d. **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 ¾ 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.


a. 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).

b. 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.

c. **Reserved Rights in Muscogee Easements.** The following reserved rights
relating to the Muscogee County property were noted:

(i) 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.

(ii) Right to build roads or driveways to access such buildings.

(iii) 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.

(iv) Right to construct dams to create ponds for recreation or irrigation,
and to construct docks, gazebos and “related recreational structures.”

(v) Right to clear timber for agricultural uses, clear brush and remove
trees for “aesthetic” purposes and plant nonnative trees or plants.

(vi) 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.

d. **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).

e. **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 hayfield cabin, a 30 acre hayfield including fenced pastureland for horses that is also used as a landing strip. Most of the property in Kolomoki Plantation was eased in two easements.

f. **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% 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 5-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, in 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.


   a. **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.

   b. **Decision Summary.**

      (i) 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.

      (ii) 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 adds up to 24%.
(iii) 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 boarders the eastern edge of the 2005 easement area.

(iv) 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.

(v) 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.

(vi) 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 a 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).

(xii) 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.

(xiii) 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.

(xiv) 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.

(xv) 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.

(xvi) 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 Flytrap 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.

(xvii) 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.

(xviii) The court noted that “it is clear from the testimony of the IRS expert that the chemicals…promote the nonnative flora without regard for any conservation purpose,” noting that the operation of the golf course results in the replacement of a natural area with nonnative 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”).

(xix) 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.

(xx) The Court’s detailed analysis of the 2005 easement mirrored the Court’s analysis of the 2003 easement.
c. **Tax Court’s Conclusion.**

(i) 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)(I). 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.

(ii) The court rejects 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 Greenacre).

(iii) The court summarily addressed Open Space and rejected its application. That was not a surprise.

(iv) Retained rights and value were rendered irrelevant by the court’s holding on lack of conservation purpose.

(v) 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.


a. **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.

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.

b. **IRS Position.** 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% gross valuation misstatement penalty, or alternatively, the 20% 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.

c. **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.

d. **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) and because the easement failed to preserve a conservation purpose.

e. **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% gross valuation misstatement penalty.


a. **Appeal to Fifth Circuit.** The 5th Circuit Court of Appeals reversed the Tax Court holding that PBBM’s conservation easement failed to protect a conservation purpose. However, the 5th Circuit affirmed the Tax Court’s other findings, including that the improvements clause rendered the easement deed noncompliant with the extinguishment regulation in Treasury Regulation Section 1.170A-14(g)(6). See PBBM Rose Hill, LLC, No. 17-60276.

b. The 5th Circuit’s recent opinion will impact thousands of conservation easement deductions. Three aspects of the 5th Circuit’s opinion are significant: (1) the opinion invalidates a common easement deed provision allocating proceeds from judicially extinguished conservation easements; (2) the opinion contradicts existing law governing whether the IRS must comply with the managerial approval of penalties requirement under Code section 6751(b); and (3) the good news for taxpayers is that the 5th Circuit reversed the Tax Court and determined that protection of conservation purpose is
based on the language of the easement deed, disregarding the actions of a subsequent owner of the eased property.

**Improvements Clause Ruling**

c. The Code clearly requires that a conservation easement must be “perpetual.” Yet the statute is silent as to its application, which has caused the IRS to issue regulations implementing the mandate. One aspect of the perpetuity requirement is addressed in Treasury regulation section 1.170A-14(g)(6) (the “Extinguishment Regulation”). The Extinguishment Regulation provides, in relevant part, that “[i]f a subsequent unexpected change in the conditions surrounding the property … make impossible or impractical the continued use of the property for conservation purposes” the perpetuity requirement can still be satisfied so long as the easement deed provides the land trust with its proportionate share of proceeds from the subsequent extinguishment or condemnation.” The Extinguishment Regulation also provides a formula for calculating the land trust’s proportionate share of any extinguishment proceeds. See Treas. Reg. § 1.170A-14(g)(6)(ii).

d. In PBBM, the easement deed excluded from such proceeds “an amount attributable to the improvements constructed … pursuant to the Reserved Rights.” This provision had the effect of reserving any proceeds attributable to post-easement improvements for the land owner. The balance of the proceeds were allocated between the land trust and land owner in proportion to their respective interests under the easement deed. The 5th Circuit agreed with the Tax Court that the definition of proceeds in PBBM’s easement deed violated the Extinguishment Regulation and therefore the perpetuity requirement. The 5th Circuit held that the Extinguishment Regulation “does not indicate that any amount, including that attributable to improvements, may be subtracted out” prior to allocating proceeds between the land trust and land owner.

e. Prior to the Tax Court’s ruling, numerous easement deeds containing “improvements clauses” had passed IRS and court scrutiny in audits and court cases. Indeed, in the one private ruling letter in which the IRS directly addressed and analyzed an improvements clause, the IRS determined that the clause was appropriate. Nonetheless, the 5th Circuit refused to consider the private letter ruling because the 5th Circuit concluded that the “regulation [was] not ambiguous.” The determination leads one to question how the same government agency can construe the same regulatory language two different ways if the regulation was not “ambiguous.”
f. Reserving proceeds attributable to post-easement improvements on the landowners is necessary, so that landowners can protect the improvements that they construct pursuant to the rights they reserved in an easement deed. Land trusts prefer reserved rights, so that on-site landowners can watch over the land and help steward the conservation values. Indeed, many model conservation easement agreements contain improvements clauses similar to the one the Tax Court and 5th Circuit determined violated the perpetuity requirement. And in PBBM, NALT filed an Amici Brief that expressed its belief that it had no interest in proceeds attributable to post-easement improvements. NALT, similar to other land trusts, determined it did not have (and did not want) an economic interest in houses, gazebos and barns built by a landowner on easement property.

Penalty Approval Issue

g. There are statutory requirements that the IRS must follow before it can assert penalties against a taxpayer. One is found in Code section 6751(b), which 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.” The IRS is barred from asserting penalties if this section is not complied with. There is a detailed discussion of the managerial approval issue in the section on Penalties, infra.

h. The specific abuse Congress sought to curb with section 6751(b)(1) was IRS agents improperly wielding penalties as a club to beat taxpayers into settlement: “The [Senate Finance] Committee believes that penalties should only be imposed where appropriate and not as a bargaining chip.” S. Rep. No. 105-174, at 65 (1998). Congress felt strongly about this abuse, so it imparted, as a statutory pre-requisite to penalty assertion, an obligation that IRS agents obtain their immediate supervisor’s signature prior to bringing penalties “into the conversation.” Graev III, 149 T.C. No. 23, at *10 (Lauber, J., concurring) (emphasis added).

i. Prior to PBBM-Rose Hill, the 2nd Circuit, in Chai, addressed “at what point the IRS’s obligation to comply with the written-approval requirement [in section 6571(b)(1)] kicks in.” The Tax Court had previously found that the IRS could obtain supervisory approval at any time prior to assessment of the penalty. The 2nd Circuit, however, found that the legislative history of Code section 6751(b)(1) “strongly rebuts … that written approval may be accomplished at any time prior to, even if just before, assessment.” Assessment of a penalty normally occurs at the very end of a tax deficiency proceeding. The court reasoned that permitting “an unapproved initial
determination of the penalty to proceed through administrative proceedings, settlement negotiations, and potential Tax Court proceedings, only to be approved sometime prior to assessment would do nothing to stem the abuses § 6751(b)(1) was meant to prevent.” Indeed, “the supervisor’s Johnny-come-lately approval of the “initial determination” would add nothing to the process.”

j. In Graev v. Commissioner, 149 T.C. No. 23, at *5 (December 20, 2017) (“Graev III”) the Tax Court reversed, in part, its prior determination in Graev v. Comm’r, 147 T.C. 460 (2017) (“Graev II”) and adopted the 2nd Circuit’s reasoning in Chai. Importantly, the Tax Court adopted the 2nd Circuit’s reasoning as its own rather than deciding the case “under the Golsen rule and liv[ing] to fight another day in another circuit.” Graev III, 149 T.C. No. 23, at **11, 24 (Holmes, J., concurring). Accordingly, it remains unclear what precedential weight the Tax Court will give to the contradictory opinion of the 5th Circuit in PBBM-Rose Hill.

k. In Graev III, Judge Lauber explained (in a concurring opinion) that section 6751(b)(1) requires supervisory approval the first time an IRS agent introduces penalties “into the conversation” as a means of protecting taxpayers against the “improper wielding” of penalties as a bargaining chip in settlement negotiations:

The Court adopts a more sensible approach. It treats the “initial determination of such assessment” as referring to the action of the IRS official who first proposes that a penalty be asserted. This is a reasonable construction of the statute, giving primacy to the word “initial” (a term that appears in the statute) rather than to the penalty-assister’s scope of authority (a term that does not appear). And by requiring supervisory approval the first time an IRS official introduces the penalty into the conversation, the Court’s interpretation is faithful to Congress' purpose by affording maximum protection to taxpayers against the improper wielding of penalties as bargaining chips. Graev III, 149 T.C. No. 23, at *10 (Lauber, J., concurring) (emphasis added).

l. In spite of Chai and Graev III, the 5th Circuit found the IRS complied with section 6751(b)(1), even though, the only evidence set forth on the issue was a “cover letter” to a “summary report” that was signed by a “manager.” The 5th Circuit reasoned that the summary report reflected the IRS examiner’s
prior determination to assert the gross valuation and that the manager approved the assertion.

m. The 5th Circuit's opinion in PBBM appears to contradict Congress' intent that section 6751(b)(1) prevent IRS agents from using penalty assertion as a bargaining chip in negotiations during an audit. In nearly every audit, the “manager” assigned to supervise the IRS agent will review the formal “summary report” and issue it under a similar cover letter. A summary report is issued, in most examinations, after the IRS agent completes the examination, not when the agent makes its “initial determination.” Penalties would be “brought into the conversation” much earlier if they were being improperly wielded as a club. Thus, the 5th Circuit's opinion renders the protections Congress sought to provide taxpayers in section 6751(b)(1) illusory.

n. The timeline for the opinions discussed herein is important and worth noting. Judge Morrison of the Tax Court entered a bench opinion in PBBM-Rose Hill on September 9, 2016 that determined the IRS had complied with section 6751(b)(1). Subsequently, on December 20, 2017, the Tax Court issued Graev III in which it adopted the 2nd Circuit’s reasoning in Chai as its own. Graev III, 149 T.C. No. 23, at **11, 24 (Holmes, J., concurring). Accordingly, by the time the 5th Circuit affirmed the determination that the IRS had complied with section 6751(b)(1), the Tax Court had expressly adopted an interpretation of section 6751(b) that conflicted with Judge Morrison’s prior determination in PBBM-Rose Hill. This is evidenced by Judge Morrison joining the dissenting opinion in Graev III. It appears that what the 5th Circuit affirmed would be decided differently if tried before the Tax Court post-Graev III.

Conservation Purpose Ruling.

o. The Fifth Circuit, in a bit of good news for the Taxpayer, held that the terms of the recreation easement satisfied the public-access requirement in § 170(h)(4)(A)(i), thereby satisfying the conservation purpose requirement. The Court construed the deed by giving greater weight to the deed’s specific terms providing that “the Property is and shall continue to be and remain open for substantial and regular use by the general public for outdoor recreation,” finding that the terms of the deed created an obligation to operate the Property in such a way that provides access to the public for “substantial and regular” recreation use. In effect, the Fifth Circuit ignored the fact that a subsequent purchaser of the Property was not abiding by the terms of the easement and that the land trust donee was not enforcing such terms. Thus, the Fifth Circuit reversed the Tax Court on this issue and determined that
protection of conservation purpose is based on the language of the easement deed, disregarding the actions of a subsequent owner.

B. VALUATION.


   a. **Overview.** On 6/22/09, 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 12/31/02, 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.

b. **Tax Court Litigation.** 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.

c. **Tax Court Determination.** 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% 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.

d. **Comment.** 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.


a. **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).

b. **Tax Court Analysis.** 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 an HBU of recreational use).

c. **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.


a. **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.

b. **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.


a. **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.

b. **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% penalty to apply anytime a taxpayer overvalues property by more than 200%, as opposed to prior law which required a 400% 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% or 400%) 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% 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.

c. **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.


a. **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.”

b. **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 2 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.

c. **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.

d. **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.
e. **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.

f. **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).

g. **Penalties.** With respect to the proposed accuracy related penalty, because the diminution in value was less than 40%, but greater than 20%, 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.

h. **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% 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”.

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i. **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.

j. **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.

a. **Overview.** The Whitehouse saga reached its final resting place following the second decision by the Fifth Circuit (Whitehouse IV) upholding the Tax Court's valuation finding on remand (Whitehouse III), but vacating the Tax Court's decision to impose gross valuation misstatement penalties due to lack of reasonable cause. While expressing sympathy for the taxpayer's arguments that the Tax Court got “highest and best use” wrong, the Fifth Circuit concluded that the Tax Court's decision did not rise to the high standard of “clear error”, thus the Fifth Circuit could not overturn the Tax Court's decision to reduce the value of the façade easement by $5.5 million. For a thorough summary of the Whitehouse trilogy of opinions, see “Conservation Easement Confusion in the Tax Court and Fifth Circuit”, 25 Taxation of Exempts, No. 1 (September/October 2013) at 32.

b. **Penalties.** The Fifth Circuit's decision will be helpful to many taxpayers seeking penalty relief in the conservation easement context. Typically, taxpayers donating an easement undertake extensive due diligence to determine the proper value of the easement, including consulting with tax professionals and obtaining a qualified appraisal from a qualified appraiser. While these actions should be sufficient to establish reasonable cause (a defense to accuracy related penalties in most cases), the Tax Court in Whitehouse III said that this was not enough because there was no evidence that the taxpayer made an independent good faith investigation of value or asked its professionals to investigate value. In addition, the Tax Court said that such an investigation was warranted because the taxpayer should have known that value reached in the appraisals it relied upon was too high. The Fifth Circuit disagreed, stating “that the tax court imposed an excessively high standard of proof for actual reliance on the advice of competent professionals with respect to this statutory defense.” Instead, establishing “reliance on tax professionals was enough.” The Fifth Circuit observed that valuing assets is a difficult task, and especially so in the context of an easement where “the valuation is divorced from a negotiated transaction between buyer and seller. . . . The easement was a gratuitous transfer; the [charity] did not haggle over price and did not pay a final sale price.”

Notably, the Fifth Circuit was “particularly persuaded” by the argument that the Commissioner, the Commissioner's expert and the Tax Court all reached different conclusions. Looking at all the facts and circumstances, the Fifth Circuit held that “[o]btaining a qualified appraisal, analyzing that appraisal, commissioning another appraisal, and submitting a professionally-prepared tax return is sufficient to show a good faith investigation” as required by the reasonable cause exception.
c. **HBU or Second HBU?** However, the Fifth Circuit's failed to discredit the Tax Court's unusual “highest and best” use analysis in Whitehouse III. The Whitehouse III “second-best use” decision appears to be contrary to the law and the regulations. The taxpayer contended that the Tax Court's unusual decision that second highest and best use could determine fair market value violated the Fifth Circuit's previous instruction that a determination of highest and best use other than a luxury hotel must be clearly justified. While the Tax Court's highest and best use remand finding appeared to run afoul of the Fifth Circuit's previous guidance that determination was left undisturbed on review. “Though we did call [the IRS's expert's] opinion ‘implausible,’ we did not instruct the tax court that it was forbidden to accept it.” The Fifth Circuit concluded that “we remanded for the Tax Court to establish explicitly the highest and best use of the parcel for valuation purposes. . . . it did make the finding we requested.” While the Fifth Circuit certainly did not condone the Tax Court's highest and best use determination, it refused to go the extra step of finding clear error. Certainly this “second highest and best use” is something that taxpayers will need to be concerned about in the future, as we anticipate the IRS will be using this standard in earnest to drastically reduce conservation easement deductions.

d. **Comment.** The Whitehouse IV decision will be hailed by both taxpayers and the IRS. Taxpayers now have another weapon in their arsenal to defend against penalties, while the IRS will attempt to use the Whitehouse III decision to undermine highest and best use claims by taxpayers.


a. **Overview.** Schmidt v CIR, (T.C. Memo 2014-159), will be hailed as a “win” for taxpayers due to the court's explicit approval of the discounted cash flow approach (“DCF Approach”) to valuing the highest and best use of property subject to a conservation easement. Schmidt relates to a conservation easement granted by Leroy Schmidt on property located in northern Colorado in close proximity to forests and mountains. Mr. Schmidt had purchased the property in May, 2000, as raw land with no development entitlements, but had considered possible development opportunities in the years prior to the granting of the easement.

b. **DCF Used.** Schmidt seems to be a significant taxpayer victory and will likely prove important for a few reasons. First, Schmidt is another in a line of cases, which includes, Kiva Dunes T.C. Memo 2009-145, where the Tax Court recognizes and adopts the DCF Approach to value a conservation easement. Not only did the Tax Court in Schmidt approve of the DCF Approach, but the Court decided to apply the approach as it saw fit, rejecting
the analyses of both the taxpayer and the IRS. In calculating its own value under the DCF Approach, the Court adopted and rejected elements of each party's DCF model.

The Schmidt opinion is also important to taxpayers because it outlines a framework for how the Tax Court (or, at least, Judge Marvel) would like to see the DCF Approach applied. The Schmidt opinion contains an extensive analysis of the various factors that go into the DCF Approach, including number of lots, retail lot selling prices, retail lot price appreciation rate, timing to obtain entitlements, lot absorption, development costs, marketing/administrative costs and discount rate. This analysis may serve as a blueprint for appraisers, taxpayers and their representatives when valuing future easements. Applying the DCF Approach using the evidence and stipulations submitted by the parties, the Tax Court arrived at an easement value of $1,152,445, which was about $400,000 less than the taxpayer's value and $600,000 greater than the Service's value. However, given Judge Marvel's extensive analysis, this result should be viewed as anything but a mere “compromise.”

c. **HBU Determined by Expert.** Finally, Schmidt provides another tool in the arsenal of demonstrating the feasibility of highest and best use. Here, the taxpayer, and his advisors and consultants successfully demonstrated that development was reasonably probable. Specifically, the taxpayer hired an expert to prepare a development plan and the expert provided the taxpayer with a letter confirming that proper zoning would likely be obtained if the taxpayer decided to proceed with development. The Tax Court found that new applications for such subdivision plans would have to be resubmitted to the county, but that the need to resubmit did not impair the feasibility of the proposed development plan. This is in direct contrast to Mountanos v. Commissioner, T.C. Memo 2013-138, where the Tax Court was not able to find that the taxpayer had proven that the proposed highest and best use of the property as a vineyard was reasonably probable.

d. **Unaddressed Issues.** While the Service apparently raised issues with the taxpayer's compliance with the technical requirements of section 170(h), those issues were not discussed in the Court's opinion and were presumably conceded by the IRS. In addition, the Court's opinion did not discuss conservation purposes of the easement, which must have likewise been conceded by the IRS.
8. **SWF Real Estate, LLC**, T.C. Memo 2015-63 (Judge Wells).

a. **Overview.** On April 2, 2015, Judge Wells issued his opinion in *SWF Real Estate, LLC*. The case involved a conservation easement donated in late December, 2005 by the taxpayer to Albemarle County Public Recreational Facilities Authority. (The conservation easement deed was recorded in Albemarle County, Virginia. The case was written up in Checkpoint as a disguised sale case along the lines of Virginia Historic Tax Credit Fund 2001, LP, 107 AFTR 2d 2011-1523 (CA4 2011) and the recent Route 231, LLC, T. C. Memo 2014-30. In this case (following the other two cases just mentioned), the Tax Court found that the taxpayer had engaged in a disguised sale relating to the sale of Virginia tax credits to partners for cash.

b. **Court Addresses Valuation Issues.** *SWF Real Estate* will be seen by the conservation easement world as a big taxpayer win. The facts are not too different from what is normally seen and ended up being a battle of experts. Of interest is how Judge Wells addresses a number of valuation related issues.

(i) While normally it is not logical to start at the end, the taxpayer claimed a conservation easement deduction of $7,398,333, Judge Wells concluded that there was an overstatement of only $48,333, resulting in a deduction of $7,350,000, which is a reduction of only .65%.

(ii) The Court noted the normal rules set forth in the regulations on how to value conservation easements, including as a first step determining if there is a substantial record of sales of easements comparable to the donated easement. The Court found, however, that in *SWF Real Estate* there was no established market for similar easements. Accordingly, the Court properly moved on to the before and after analysis to determine the value of the donated easement.

(iii) Wells then began to review the valuation reports of the parties. Both of the appraisers were very experienced and used similar approaches in their valuation analysis. Since the case is fairly fact specific, the actual analysis is not extremely important, but the Court did have to address a few notable issues:

(a) IRS argued that the Taxpayer’s expert appraiser could not be independent and therefore his report was not credible because the taxpayer had given the taxpayer’s expert the appraisal report that had been prepared at the time of the easement (by
Mr. Stephen G. Williams) and because there was less than 1% difference between the results of the two appraisals as to the ultimate value of the easement. The Court rejected that argument stating:

We disagree with respondent. Respondent mistakenly presumes impropriety without proving it, i.e., that Mr. Jones must have been improperly influenced by Mr. Williams' appraisal because he had access to it and because their ultimate results were similar. As petitioner points out, Mr. Jones used different valuation methods and different comparable properties, applied different amounts of adjustments, and determined different values for Sherwood Farm before and after the easement. Moreover, Mr. Jones credibly testified that he referred to Mr. Williams' appraisal only for its description of Sherwood Farm as of December 2005. Accordingly, we conclude that Mr. Jones was not improperly influenced by Mr. Williams' appraisal.

(b) IRS argued that Taxpayer’s expert report was not credible because the report did not comply with the Uniform Standards of Professional Appraisal Practice (USPAP). The Court noted the following:

Uniform Standards of Professional Appraisal Practice (USPAP) are promulgated by the Appraisal Standards Board of the Appraisal Foundation, a nonprofit organization comprising other nonprofit organizations that represent appraisers and users of appraisal services. Whitehouse Hotel Ltd. P’ship v. Commissioner, T.C. 112, 126 n.4 (2008) (citing The Appraisal Foundation, Frequently Asked Questions: https://www.appraisalfoundation.org, rev’d on other grounds, 615 F.3d 321 [106 AFTR 2d 2010-5759] (5th Cir. 2010). USPAP is widely recognized and accepted as containing standards applicable to the appraisal profession. Adherence to those standards is evidence that the appraiser is applying methods that are generally accepted within the appraisal profession.

Specifically, respondent contended that petitioner failed to list the proper hypothetical conditions of an appraisal completed after an easement is placed on property and that
petitioner failed to list several details required for self-contained appraisal reports. The Court disagreed stating:

We have previously held that “[f]ull compliance with professional standards [e.g., USPAP] is not the sole measure of an expert's reliability” and that “a noncompliant valuation report is not per se unreliable.” Whitehouse Hotel Ltd. P’ship v. Commissioner, 131 T.C. 112, 127 (2008), rev’d on other grounds, 615 F.3d 321 [106 AFTR 2d 2010-5759] (5th Cir. 2010); see also Schwartz v. Commissioner, 348 Fed. Appx. 806, 809 [104 AFTR 2d 2009-6808] (3d Cir. 2009), aff’g T.C. Memo. 2008-117 [2008 RIA TC Memo ¶2008-117]. In the instant case, we decline to accept the merits of respondent's contentions because, as petitioner notes, respondent has not demonstrated how the alleged technical errors render the Jones report unreliable or that the alleged technical errors are reflective of more significant substantive errors. Accordingly, we decline to find that the Jones report is unreliable solely for any alleged failures to comply with USPAP requirements. Instead, we independently review both reports to evaluate the reliability of each and determine the proper valuation of the easement.

(iv) Both appraisers described market conditions that impacted their analyses, and the Court found that the taxpayer’s expert did a better job substantiating the adjustments that he assumed. The lack of support provided by the IRS expert was noted as follows:

The reports applied different rates of adjustment to account for the market conditions at the time of the easement. The Pape report adjusted comparable property sales prices by 10% per annum to account for changes in market conditions, but did not provide any support for the 10% rate. The Jones report adjusted comparable property sales prices by 12% per annum to account for changes in market conditions; Mr. Jones based this rate on a price index released by the Office of Federal Housing Enterprise Oversight stating that home prices increased nearly 13% from the end of 2004 to the end of 2005. Moreover, the 12% per annum rate comports with credible testimony from Mr. Jones and Mr. Lewis regarding the rising real estate market in and around Albemarle County during the end of 2005. Because of great demand and pressure to develop large farm lands into subdivisions, real estate prices in Albemarle County were
high and increasing rapidly. Accordingly, we conclude that the Jones report used a more accurate rate of adjustment for market conditions and therefore more accurately adjusted the values of comparable properties than the Pape report to account for improving market conditions.

(v) The Court’s analysis of comparable sales was not very instructive to us because of the factual nature of that analysis. However, the Court did note the importance of the proximity of comparable properties to the subject property, the relative size of the comparable properties to the subject property, the similarity or not of the topography of the comparable properties (including slope issues and existence of a floodplain) and the difference in time of sale between comparable properties and the subject property.

(vi) Additionally, the Court went into great detail about the types of adjustments and the methods of adjusting the values of the comparable properties, noting specifically a number of errors made by the IRS expert (Pape) that caused the Court to question the overall reliability of the IRS expert’s report.

(vii) In contrast, the Court did not note any significant material errors during its review of the taxpayer’s appraiser’s report.

(viii) The Court also noted that the IRS contends that Mr. Jones (taxpayer’s expert) also made inconsistent adjustments in the Jones report with respect to the sizes of some of his comparable properties.

In particular, respondent contends that Mr. Jones failed to adjust the value of Blenheim Road downward even though he adjusted the value of Route 612 and Greenmont Farm downward and the three properties are roughly similar in size. We disagree. As petitioner contends, Mr. Jones properly determined that for purposes of the before-easement valuation analysis Blenheim Road would be included in the same size category as Sherwood Farm because both had similar development potential. However, for purposes of the after-easement analysis, a size adjustment was necessary because there was a significant difference between the marketability of Sherwood Farm, which was a 674.65-acre tract of land that could be used only for farming, and the much smaller Route 612 and Greenmont Farm properties, which could possibly be sold to estate home-buyers. Accordingly, we find no inconsistency in Mr. Jones' adjustments.
This analysis shows the Court’s disdain for errors, omission and inconsistencies, which the Court found in spades in the IRS report and generally not existent in the Taxpayer’s expert report.

c. **Tax Court’s Conclusion.** The Court’s conclusion regarding how it viewed the two expert reports cannot be improved:

The Jones report properly accounted for the restrictive nature of the easement and the market conditions at the time of the easement; used more numerous and more accurate comparable properties than the Pape report; and avoided other errors and inconsistencies when adjusting the values of those comparable properties. While we find the Pape report, to be burdened by multiple errors and inconsistencies, we find no reason to question the credibility of Mr. Jones or the reliability of the Jones report. Accordingly, we conclude that the Jones report provided an accurate valuation of the easement on Sherwood Farm and, therefore, that the value of the easement for purposes of a charitable contribution deduction is $7,350,000.

On its 2005 Form 1065, SWF reported a charitable contribution of $7,398,333 for its donation of the easement to Albemarle County PRFA, on the basis of a valuation prepared by Mr. Williams. Mr. Williams did not testify at trial, and petitioner relies only on the Jones report for the proper valuation of the easement. Consequently, we conclude that SWF overstated its charitable contribution deduction for its 2005 tax year by $48,333.


a. **Overview.** The facts of this case are long and convoluted, involving multiple owners coming into ownership at different times, assuming various roles, and multiple government entities with different points of view towards the deal. For purposes of this outline, the following facts will suffice:

The taxpayer, Cave Buttes, LLC, consisted of three partners and owned 11 acres in somewhat close proximity to Cave Buttes Dam in the Phoenix, Arizona area. One of the partners, Wolfe, had previously purchased the land sight unseen for the “unbelievable” price of $100,000 in February of 2004 prior to the other partners obtaining an interest. Due to each partner’s somewhat differing opinions on how to develop the land, Cave Buttes, LLC, divided those 11 acres into three parcels to expedite dissolution of the partnership, if that proved necessary. The taxpayer became frustrated at the various red tape and other local government push-back it was receiving for its plans to develop the subject parcel. Apparently, local and state authorities
were fighting the development over safety concerns for the dam, as well as other zoning and access rights issues.

Eventually, the taxpayer had enough of the fight and started looking at options for the property other than development. Cave Buttes, LLC came to the conclusion that a bargain-sale to the local Maricopa County Flood Control District was its best course of action. The District obtained an appraisal in October 2006, which valued the 11 acres at $765,000. Importantly, that appraisal determined—based on a phone call with a local government employee—that the property was legally and physically inaccessible home-site.

The taxpayer found this determination “absurd” and sought its own appraisal. In May 2007, it hired two MAI appraisers to reappraise the 11 acres and with the intention of acting prudently decided to use the lower of those two appraisals ($1.5 million rather than $2 million) to substantiate its claimed charitable deduction. The taxpayers completed this transaction receiving $735,000 in cash and taking a charitable deduction for the “bargain” aspect of the transaction ($765,000). The IRS challenged the deduction claiming both technical deficiencies and overvaluation concerns. Subsequently, the taxpayer obtained a third appraisal in preparation for trial, which valued the property at $2.16 million.

b. Substantiation Issues. The Commissioner raised five substantiation issues regarding the appraisal Cave Buttes utilized to value its deduction for the bargain sale transaction: (1) The appraisal was not prepared by a qualified appraiser and did not include the qualification of the appraiser who prepared the report, (2) the appraisal did not include a sufficiently detailed or accurate description of the property, (3) the appraisal did not include a statement that the appraisal was prepared for income-tax purposes, (4) the date of value is not the date of the purported contribution, and (5) the appraisal utilized a definition of fair market value that was different than the definition provided by Treasury Regulations. The Tax Court addressed each of these claims in turn.

(i) The Appraisal was not prepared by a Qualified Appraiser and did not include the Qualifications of the Appraiser Who Prepared the Report.

The Commissioner took a hard line regarding a certain factual anomaly in this case. The appraisal that Caves Buttes chose to utilize for its tax return was actually prepared by two individuals; however, only one of those two people signed the appraisal summary (i.e.,
Form 8283). The Tax Court took issue with the Commissioner’s position in large part because in 2007 when that appraisal was prepared the instructions to Form 8283 did not address who should sign in the case of multiple appraisers. Those instructions were amended in 2012 and now express that in the case of multiple appraisers both must sign the appraisal and Form 8283.

The Tax Court noted that while these instructions were changed in 2012, Form 8283 “to this day includes only one signature line.” The court acknowledged that instructions do not carry the weight of law, but explained that “they are useful in illustrating understandable taxpayer confusion.” The court reasoned that taxpayers must have been getting confused by these instructions: “Why else would the IRS have changed the instructions to be more clear?” Accordingly, the Tax Court found that Caves Buttes, LLC had substantially complied with the appraisal summary requirements; notwithstanding the failure of one of the appraisers to sign Form 8283. It seems unlikely that the Tax Court would reach a similar decision if the appraisal summary had similar deficiencies under the new instructions to Form 8283.

The Tax Court similarly found substantial compliance with the Regulation when that same appraiser—who failed to sign Form 8283—did not attach his resume to the actual appraisal. The court found that the taxpayer clearly did not strictly comply with Regulation, which requires the appraiser’s qualifications to be attached to the qualified appraisal. However, likening the case to its prior holding in Bond, the court found that the taxpayer had substantially complied with the Regulation because the other appraiser’s “qualifications were included in the appraisal, and the Commissioner never previously questioned whether [the omitted appraiser] was a qualified appraiser.”

(ii) The Appraisal did not include a Sufficiently Detailed or Accurate Description of the Property.

The Commissioner made what the court characterized as a “Gotcha” argument by asserting that the property was improperly described because it was not—in the Commissioner’s view—three-separate lots when transferred. Notwithstanding that Caves Buttes validly recorded the properties division into three lots in February 2007, received stipulations from the District that the property was in fact three lots when transferred in April 2007, and submitted an appraisal
of the three-lot property in May 2007, the Commissioner attempted to deny the claimed deduction because it interpreted Arizona law to only effectuate a property split “when the county assessor completes his identification and valuation of the resulting parcels”, which did not occur until August 2007.

The court was quick to dismiss the Commissioner’s argument pointing out that the statute it relied on pertained to property-tax valuation, which in no way affects the property’s value, and that the property division was legally enforceable when recorded in February 2007. This issue should have been resolved much earlier in the proceedings.

The Commissioner raised other concerns regarding the accuracy of the property’s description in the appraisal because of the appraiser’s characterization of certain evaluative factors. Specifically, the Commissioner took issue with an apparently inaccurate description (difference in ¼ mile and ¾ mile) of the proximity of utilities to the property, as well as the access afforded to the property. The court disagreed with IRS over the purpose of the regulation’s requirement that a qualified appraisal adequately describe the property. “We also think these arguments about utilities and access miss the point of the regulation’s requirement that an appraisal describe the property. . . . Since the purpose of this requirement is to let the IRS know what’s being donated, a description by address and characteristics is enough to strictly comply with the regulation.”

(iii) The Appraisal did not include a Statement that the Appraisal was prepared for Income-Tax Purposes.

The most enigmatic argument put forth by the Commissioner in its all-out attack on this particular appraisal’s qualifications was that the appraisal failed to include a statement that it was prepared for income tax purposes. The qualified appraisal contained the following language, “[t]he purpose of this appraisal is to estimate the current Market Value of the fee simple interest in the subject as of the date of the valuation for filing with the IRS.” (Emphasis added). The court quickly dismissed the IRS contention “that there are magic words required to fulfill this requirement.” The court stated that “for filing with the IRS” certainly substantially complied, if not strictly complied, with the regulation’s requirement that the appraisal state it was prepared for income tax purposes.
(iv) **The Date of Value is not the Date of the Purported Contribution.**

The Commissioner claimed that the appraisal was not qualified because the deed was signed, delivered, and accepted at least 11 days and possibly as many as 21 days prior to the date of valuation for the appraisal. The taxpayer’s relied on the Tax Court’s holding in *Dunlap* for the proposition that the appraisal substantially complied with the regulation.

In *Dunlap*, the appraisal’s valuation date was merely one day prior to the date of donation, whereas the taxpayers in *Cave Buttes* were at least 11 days and possibly 21 days after the date of the bargain sale. In what can only be described as a win for taxpayers, the court found that the substantial compliance doctrine cured the technical noncompliance, because this deal had “a number of moving parts and a somewhat vague closing date.”

The court reasoned that “[w]ithout any significant event that would obviously affect the value of the property in those two or three weeks, we agree with *Cave Buttes* that it substantially complied with the regulation.”

(v) **The Appraisal Utilized a Definition of Fair Market Value that was Different than the Definition Provided by Treasury Regulations.**

The Commissioner contested the taxpayer’s experts definition of fair market value, which utilized a definition of fair market value established under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. The court quickly disposed of this assertion as the definition in the 1989 Act covered all of the requirements of the Regulation’s definition of fair market value.

The court noted that the Commissioner only argued that this definition did not strictly comply with the regulation, which the court interpreted as a concession to the taxpayer’s claim of substantial compliance. Ironically, the contested fair market value definition that the taxpayer’s appraiser used was the very same definition that the Commissioner’s own expert used in its appraisal report.

c. **Valuation.** *Cave Buttes* is a taxpayer friendly decision on the issue of valuation and highest and best use. The relevant issue before the Tax Court was “the fair market value of the property. If *Cave Buttes* is right, that value
is greater than what it claimed on the return; if the commissioner is right, that value is less.”

The court disagreed with the Commissioner’s expert-appraisal because it erroneously claimed that the taxpayer’s lacked legal or physical access to the property. Instead, the court found that the taxpayer had “an exceptionally strong claim” to access rights via at least three separate legal rights: After establishing that Cave Buttes, LLC had access to the property, the court shifted its analysis of value to the properties highest-and-best-use based on various zoning restriction. As mentioned, above, the reason for the bargain-sale transaction was the government push back and other red-tape that the taxpayer was experiencing in its efforts to develop the property. The taxpayer argued “that the property was improperly downzoned, and the ease of rezoning should have been considered in the highest-and-best-use analysis.”

The Commissioner argued that the property’s value should not incorporate development of the property that the taxpayers decided not to undertake due its pursuance of the bargain-sale transaction in lieu of development. Essentially, the Commissioner implies that Cave Buttes, LLC would have to actually develop the property to be able to take a deduction equal to value under such a use. In rejecting the Commissioner, the court was emphatic that current use does not define or restrict the potential highest-and–best-use and that value must consider that potential highest-and-best-use assuming such a use is substantiated. “The steps that [the taxpayer] could reasonably and probably take within a reasonable proximity to the valuation date must be factored into the valuation.” (Emphasis added).


C. **SUBSTANTIAL COMPLIANCE—8283—QUALIFIED APPRAISAL/APPRASIER.**

   a. **Overview.** Scheidelman involved an architectural easement on a townhouse in Brooklyn.
b. **Tax Court Holding.** In T.C. Memo 2010-151, the Tax Court found that the appraisal was not a “qualified appraisal.” The Tax Court also denied deductions for the cash contribution made by the taxpayers, but concluded that the taxpayer acted in good faith and with reasonable cause, and therefore was not liable for penalties.

c. **Second Circuit vacated Tax Court Holding.** Second Circuit Court of Appeals vacated the Tax Court holding, finding the appraisal was a qualified appraisal because it: (1) adequately specified the appraiser's method of determining the easement's fair market value and (2) adequately specified the basis for determining the easement's fair market value. The Second Circuit also allowed the deduction for the cash contribution and found that an incomplete Form 8283 “substantially complied” with the requirements.

d. **Tax Court Remand.** On remand, T.C. Memo. 2013-18, Tax Court assigned zero value to the easement.


   a. **Overview.** In supplemental Opinion, Tax Court acknowledged that the 2nd Circuit’s opinion in Scheidelman was controlling precedent (Golsen Rule) (Judge Laro).

   b. **Tax Court Opinion.** Tax Court vacated its previous finding that taxpayer’s appraisal was not a qualified appraisal because of the two “qualified appraisal” requirements (statement of method and basis of value) previously addressed by the 2nd Circuit. However, Tax Court nonetheless found the appraisal to be unqualified, based on failures to meet other requirements for qualified appraisals.


   a. **Overview.** In Dunlap, the easement encumbered the Cobblestone Loft Condominium, which is a seven-story loft building in the Tribeca North Historic District of New York, New York. All of the petitioners owned units within Cobblestone during 2003. The Cobblestone board of managers (the “Cobblestone Board”) had general oversight over the property and consisted of five people who are elected at an annual meeting.

   In 2003, the Cobblestone Board was introduced to the National Architectural Trust (“NAT”) regarding the potential for a conservation easement over the façade of the Cobblestone Loft Condominium. The Cobblestone Board
granted the façade conservation easement to NAT in December of 2003. The facade easement deed restricts the Cobblestone Board's ability to undertake any alteration, construction, or remodeling of Cobblestone's façade without the express written consent of NAT.

The IRS raised many technical and value related contentions with respect to the easement donation, including:

1. the Cobblestone Board did not have power to grant a facade easement to NAT
2. the façade easement deed was not recorded until 2004, rendering the deductions claimed in 2003 invalid.
3. Petitioner’s Form 8283 failed to adequately substantiate the charitable deductions
4. The façade easement granted is invalid under section 170(h) and the related regulations
5. Even if the façade easement were valid, it had no value
6. Cash payments to NALT were not deductible gifts, and
7. The petitioner was subject to accuracy related penalties

b. **Tax Court Opinion.** The court did not address most of these contentions because it determined that the easement had no value, rendering an analysis of the other IRS contentions unnecessary: “Because we find that the facade easement donated to NAT had no value, we only address that argument, the cash contribution issue, and the accuracy-related penalties.”

Important to the court’s analysis was a determination that the burden of proof would not shift from the petitioners to the respondent under Code section 749(a)(1). The court made this determination because the “petitioners failed to introduce credible evidence with respect to the fair market value of the facade easement donated to NAT and, as a result, section 7491(a)(1) does not shift the burden of proof to respondent with respect to that issue.”

The court refused to give “any probative weight” to the petitioners’ expert reports because it determined that their experts’ conclusions as to value lacked credibility. Therefore, the court determined that the petitioners failed to produce sufficient credible evidence with respect to the easement’s fair market value and disallowed the petitioners’ deduction. “Considering the
expert reports and other evidence, we find that petitioners have failed to meet their burden of proving that the value of the Cobblestone facade easement was greater than zero. We conclude that petitioners are not entitled to any deductions resulting from donation of the Cobblestone facade easement.”

The court did find that the taxpayers substantially complied with their appraisal summary—Form 8283—requirements, even though the Form 8283 omitted the taxpayers’ cost basis in the donated easement, when the donor acquired the property it donated, and how the donor acquired the property it donated. The court reasoned the petitioners had filled “in the most pertinent information on their Forms 8283.” The court also noted that the instructions to Form 8283 indicate that the portions omitted by the petitioners “are not absolutely necessary,” and the regulations provide for reasonable cause exceptions for omissions. This seems to conflict with the Tax Court’s *en banc* opinion in *RERI Holdings, I*, discussed *infra*.

4. **Friedberg v. Comm’r.** T.C. Memo 2013-224 (Judge Wells).
   
a. **Overview.** The Tax Court held that an appraisal submitted by the taxpayer was a “qualified appraisal” as defined in Treasury Regulation Section 1.170A-13(c)(3) and rejected the IRS’s claim that the appraisal was not qualified because it was not reliable and improperly applied the methodology used to value the property. In doing so, the Tax Court reversed its earlier decision to grant a summary judgment in favor of the IRS.

b. **Second Circuit Impact.** Taxpayer had filed a motion for reconsideration following the Second Circuit’s decision in *Scheidelman v. Comm’r* (682 F.3d 189 (2d. Cir. 2012)). In *Scheidelman* the Court of Appeals held “it is irrelevant that the…[Commissioner] believes that the method employed was sloppy or inaccurate, or haphazardly applied.” Applying the standard, the Tax Court held, “any evaluation of accuracy is relevant for purposes of deciding whether the appraisal is qualified.” Whether the appraiser properly applied the methodology was not relevant, so long as the appraisal provided the IRS with sufficient information to evaluate the underlying methodology. Finally, Tax Court held that (under *Scheidelman*) the analysis in the appraisal need not support its conclusion, so long as “it was ‘incontestably there.’”

Tax Court also rejected the IRS’s attempt to disqualify the appraiser. Service presented evidence from a deposition in which the appraiser admitted that he had never valued certain development rights that were part of his valuation of the easement. The Tax Court held that under the plain language of the regulation, the appraiser need only make a declaration that he or she is qualified to make the appraisal: “the regulation does not direct the
Commissioner to analyze the appraiser’s qualifications to determine whether he or she has sufficient education, experience, or other characteristics.” Therefore, even if the appraiser’s declaration is “unconvincing” the appraiser still meets the qualified appraiser standard under the Treasury Regulations as long as the requisite declaration is present.

In sum, an appraisal constitutes a qualified appraisal under this case as long as it meets the technical requirements of the regulations, regardless of accuracy or reliability. In Friedberg, the Tax Court held that the appraisal qualified because it stated the methodology applied by the appraiser and outlined the specific basics for its conclusion, despite the fact that the court “questioned whether the appraisal is reliable or properly applied methodology to reach its conclusions” and that the court explicitly disagreed with the appraiser’s analysis. Similarly, the appraiser qualified because his declaration met the requirements of the treasury regulations, even if statements in the declarations were unsupported by facts discovered by the IRS.


   a. **Overview.** The Tax Court ruled on “Qualified appraisal” issue similar to Scheidelman; and also in 2d Circuit). In responses filed August 24, 2012, IRS denied that Scheidelman was controlling precedent (notwithstanding the Golsen Rule).

   b. **Comment.** More detailed requirements for qualified appraisals were enacted beginning with the 2006 tax year (PPA of 2006). IRS claimed that these rules create a functionally different “statutory scheme” under which a “qualified appraisal” is evaluated. The Tax Court in Gorra seems to have rejected that claim of a new statutory scheme as a result of the PPA of 2006.

6. **IR 2014-31.** News release announces that the IRS office of Professional Responsibility (OPR) has reached a “settlement” with a group of appraisers accused of participating in the understatement of federal tax liabilities by overvaluing façade easements given pursuant to Section 170(h) of the Code. Under this settlement, the appraisers admitted to violating Sections 10-22(1) and (2) of Circular 230, which means they admitted to a failure to exercise due diligence in the preparation of documents relating to IRS matters and failing to determine the correctness of written representations made to the Treasury Department. The appraisers agreed to a 5 year suspension from valuing façade easements and “undertaking any appraisal services that could subject them to penalties under the Code”.

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a. **Overview.** In Zarlengo, et al v. Comm’r (T.C. Memo. 2014-161), the Tax Court issued a limited “win” for the taxpayer, holding that substantial compliance with the substantiation regulations was sufficient to support the taxpayer's claim for a façade easement donation. The Tax Court did, however, disallow the charitable deductions claimed in the year the easement was granted because the easement deed was not recorded until the following year, holding that the perpetuity requirement was not met until the deed was recorded, thus only a portion of the carryover deductions could be claimed. In addition, the Tax Court slashed the value of the easement and imposed penalties for gross valuation misstatement in the later years.

The taxpayers, a divorced couple, donated a façade easement on a townhouse that they jointly owned to the National Architectural Trust (the “Trust”). The husband deducted the full amount of his half of the charitable contribution in 2004, the year the taxpayers donated the property to the Trust. The wife deducted only a portion of the charitable contribution in 2004 and carried the remainder over into 2005 through 2007. Though the conservation easement deed was signed in September 2004, the Trust did not record the deed until January 2005. The IRS claimed the “contribution date” of the conservation easement was not until January 2005, when the deed was recorded. The IRS also argued that the taxpayers failed to properly substantiate the value of their donation pursuant to the Treasury Regulations.

Applying New York law, the Tax Court held that the contribution did not occur until the following year when the deed was recorded (and therefore legally enforceable against subsequent purchasers) because prior to that time the easement was not protected in perpetuity. As a result, the deductions taken in 2004 were disallowed. The Tax Court then concerned whether deductions carried over into 2005 through 2007 could be taken by the wife taxpayer.

The IRS argued that the deductions in the later years should be disallowed because the appraisal filed with the return failed to comply with several of the substantiation requirements outlined in the Treasury Regulations, including (1) the appraisal was prepared more than 60 days prior to the contribution (2) the appraisal failed state the date or expected date of the contribution, (3) the appraisal failed to provide the terms of any agreement or understanding, (4) the appraisal failed to determine the “fair market value,” and (5) the appraisal was not prepared by a qualified appraiser because an employee of the appraisal assisted in the drafting of the report.
b. **Substantial Compliance.** While the appraisal arguably failed to comply with each of these requirements, the Tax Court held that the appraisal substantially complied with the requirements in Treasury Regulation 1.170A-13(c)(3) where (1) the date of the appraisal was within 60 days of the signing of the deed in September 2004 (as opposed to the January 2005 recording date), (2) in the appraisal summary the Trust acknowledged that it received the easement on September 22, 2004, (3) the appraisal report attached a copy of a sample deed, (4) the term “market value” as defined in the appraisal report was close to the definition of “fair market value” in the regulations, and (5) there was no indication that the opinions or conclusions in the appraisal report were those of anyone other than the appraiser who signed the report. Accordingly, the taxpayer satisfied the requirement to substantiate her conservation easement.

c. **Value.** The Tax Court then considered the expert testimony as to value, finding that both experts were not completely reliable and that each expert report served as more of an advocacy piece. Of note, the Tax Court dismissed the Service's expert, finding that his “conclusory analysis demonstrates his preconceived notion that conservation easements have no value.” Instead of adopting the value proposed by either expert, the Tax Court chose a value between the two, finding that the easement caused a 3.5% diminution in value of the property, reducing the claimed easement value from $660,000 to $157,500.

d. **Penalties.** With respect to penalties, the Tax Court found that the taxpayers established reasonable cause for the claimed deduction, thus penalties did not apply for the 2004 and 2005 tax years. However, the 2006 changes to the penalty provisions by the Pension Protect Act converted the gross valuation misstatement penalty (i.e., claiming the value of property is 200% or more than the amount determined to be correct) to a strict liability penalty. As a result, any understatement in the wife's 2006 and 2007 return was subject to the 40% gross valuation misstatement penalty. This is a good reminder to taxpayers that valuation problems in post-2005 returns can lead to hefty penalties.


a. **Overview.** In Gemperle, two pro se taxpayers quickly learned the harsh complexities of conservation easement law firsthand while defending a façade easement granted over their Chicago residence. The taxpayers' appraiser, who was selected from a list provided by the donee, valued the easement contribution at $180,000. The taxpayers failed to attach a copy of the appraisal report to their return and failed to fully complete the Form 8283.
appraisal summary as required by law. Further complicating the situation, the taxpayers also failed to include the appraiser on their witness list for trial.

b. **The Trial.** At trial, the court granted the IRS's motion to exclude the taxpayers' appraisal from evidence, holding that the taxpayers' failure to produce their appraiser as a witness for trial deprived the IRS of its right to cross-examine the expert witness at trial. The court then disallowed the deduction entirely because of the taxpayers' failure to comply with the technical requirement that a qualified appraisal be attached to the filed return on which the easement deduction was claimed. After reaching these two conclusions, the issue of accuracy-related penalties was all that remained.

In addition to testifying themselves, the taxpayers called three other witnesses at trial. However, none of these witnesses were qualified as experts nor did any of the witnesses purport to value the easement. Instead, the only evidence of value in the record came in the form of an IRS appraisal that concluded the façade easement “had a value in the range of zero to $35,000.” Noting that the taxpayers “failed to furnish admissible evidence that their façade easement had any determinable value,” the court concluded that the value of the façade easement was $35,000 which represented the “the high end” of the range established by the IRS's appraisal. Based on this value, the court concluded that the taxpayers overvalued the easement by more than 200% on their returns and were therefore liable for the 40% gross valuation misstatement penalty.

c. **Penalties Applied.** Like the decision in *Bosque Canyon Ranch*, T.C. Memo. 2015-130 this case represents another instance in which accuracy-related penalties have been applied where a charitable deduction was disallowed for purely technical reasons. While the *Bosque Canyon Ranch* court applied accuracy-related penalties without ever addressing value, the court in *Gemperle* made a value determination in order to assess the gross valuation misstatement penalty. As long as the gross valuation misstatement penalty is in play, we anticipate that the IRS will continue to make valuation an issue in future cases where the deduction is disallowed on purely technical grounds.


a. **Overview.** The Tax Court dealt a blow to taxpayers in *RERI Holdings I, LLC v. Comm’r*, 149 T.C. No. 1 (2017) ("RERI Holdings"). The taxpayer—
RERI Holdings I, LLC—purchased a remainder interest in an LLC owning real property (a web hosting facility in Hawthorne, California leased by AT&T) for 2.95 million dollars and donated the remainder interest to the Regents of the University of Michigan three days later claiming a charitable deduction in excess of 33 million dollars. In RERI Holdings, the Tax Court disallowed a taxpayer’s $33 million charitable deduction in total because the donor did not report the cost or adjusted basis of the donated property on IRS Form 8283.

**Tax Court Holding.** When completing IRS Form 8283 (an attachment to the tax return), the taxpayer (or likely, its tax professional) left blank the space for “Donor's cost or other adjusted basis.” The Tax Court determined that omitting the donor-taxpayer's cost or adjusted basis from IRS Form 8283 caused the donation to fail to comply with Treasury regulation section 1.170A-13(c)(4)(ii)(E). Accordingly, the taxpayer's entire deduction was disallowed. To add insult to injury, the Tax Court also imposed a harsh penalty for a “gross valuation misstatement.”

b. **Comment.** RERI Holdings is surprising in light of the Instructions to IRS Form 8283, which indicate that the cost or adjusted basis may be left blank if the taxpayer has reasonable cause for not completing the form and attaches an explanation of that reasonable cause. Moreover, the Instructions to Form 8283 indicate that taxpayers' deductions will not be disallowed for failing to complete Section B of IRS Form 8283, if the taxpayers provide the IRS a complete IRS Form 8283 within 90 days of IRS request. The court's holding does not indicate if the taxpayer attached an explanation for why the basis was not provided or subsequently provided the basis within 90 days of IRS request.

The taxpayer in RERI Holdings donated a remained interest in property, not a conservation easement. And while the IRS Form 8283 substantiation requirement applies generally to all contributions of property, there are specific provisions in the Instructions to IRS Form 8283 (Rev. 2014) for contributions of conservation easements. The IRS provides specific provisions in the Instructions to Form 8283 to clarify how donors should complete IRS Form 8283 for property possessing unique characteristics, such as conservation easements. It is arguable that RERI Holdings should not apply in the conservation easement context because the specific provisions impart different regime of rules for completing IRS Form 8283.

   a. **Overview.** In Mecox, the taxpayer donated an open space and architectural façade easement over a historic building in the Greenwich Village Historic District. The taxpayer and the National Architectural Trust (the “NAT”) executed a document entitled “Conservation Deed of Easement” in December 2004. The taxpayer claimed a deduction on its 2004 1065 tax return claiming a $2.21 million deduction, which was filed in July 12, 2005. However, the Deed of Easement was not recorded with the New York City Department of Finance, Office of the City Register until the following calendar year, on November 17, 2005.

   b. **District Court Holding.** In granting the government’s motion for summary judgment, the Southern District of New York held “[a]s a matter of law, Mecox did not make a “qualified conservation contribution” in 2004, because the Conservation Deed of Easement was not effective until it was recorded on November 17, 2005.” The consequence of this recording error was a total disallowance of the taxpayer’s $2.21 million deduction.

   The district court explained that “in a federal tax controversy, state law governs the taxpayer’s interest in the property while federal law determines the tax consequences of that interest.” The case deals a great deal with recording laws in New York—an analysis of which is beyond the scope of this outline—but to summarize the courts analysis it determined that “[u]nder New York law, an instrument purporting to create, convey, modify, or terminate a conservation easement is not effective unless recorded.”

   The court also supported its decision with references to the Tax Court’s opinion in Zarlengo, discussed supra.

D. **PERPETUITY.**

1. **Foreword on Perpetuity.** The perpetuity requirement is, likely, the most abstract and malleable requirement imposed on conservation easement donations. This indefinite nature has provided the IRS with significant flexibility to engineer various avenues to attack conservation easements as failing the perpetuity requirement. This section is organized to demonstrate the various ways in which the IRS will challenge perpetuity during an audit.

2. **Perpetuity — Duration of Time.**

(i) **Overview.** The Tax Court agreed with the IRS that a conservation easement in North Dakota was disqualified for a charitable contribution deduction because the North Dakota law under which the easement was granted limits easements to a maximum duration of 99 years. The IRS determined, and the Tax Court agreed, that the 99 year limit kept the easement from protecting its conservation purposes “in perpetuity.”

3. **Perpetuity — “The” Property.**


   (i) **Overview.** The Fourth Circuit handed down its decision in Belk v. Comm’r, which is the first Appellate court opinion to interpret the Section 170(b)(2) requirement of a “qualified real property interest” in the context of donating a conservation easement. The Fourth Circuit held that to be a “qualified real property interest,” an easement must cover a fixed parcel of land. Consequently, it held that a provision allowing a substitution of the underlying land violated a perpetuity component of “qualified real property interest.” The Fourth Circuit also refused to give effect to a savings clause in the easement deed that prohibited the Land Trust from agreeing to any amendment (including an amendment to substitute the underlying land) if the amendment would cause the easement to fail to qualify as a charitable donation under Section 170(h). This decision will have far-reaching implications for taxpayers considering donation of conservation easements, and also for tax planners who use savings clauses in various contexts to protect the anticipated tax treatment of agreements.

   (ii) **Right to Substitute.** The easement in Belk was donated to the Smokey Mountain National Land Trust (now Southeast Regional Land Conservancy; the “Land Trust”) in 2004 on 410 acres. The easement deed allowed the Belks and the Land Trust to mutually agree to substitute a portion of the land covered by the conservation easement with an adjacent parcel of land of equal or greater in size, value and ecological features (the “Substitution Clause”). Because the parties could agree to substitute easement property, the Tax Court disallowed the charitable deduction because it found that the easement was not a perpetual restriction on the use of real property, and therefore was not a “qualified real property interest” under I.R.C.
§ 170(h)(2)(C). The interpretation of this provision had never been addressed by any court or in any IRS guidance.

On Appeal, the Belks claimed that Congress intended for easements themselves to be perpetual, and to perpetually protect the conservation purposes of the easement, but that Congress did not intend to require that the specific land underlying the easement be fixed in perpetuity. Such a requirement would deny land trusts flexibility to address most future changes and events. The Fourth Circuit disagreed. It found that Congress' use of the term “the” in the phrase “a restriction (granted in perpetuity) on the real property” meant Congress required the easement to attach to a defined parcel of real property that could never be changed by an agreement of the land trust and landowner.

Notably, the Fourth Circuit limited the holdings of Simmons and Kaufman, two Court of Appeals decisions holding that an easement deed meets the perpetuity requirements of the Code, even if it gives the donee the right to abandon the easement altogether. The Fourth Circuit reasoned that Simmons and Kaufman concerned only perpetual protection of the conservation purpose (§ 170(h)(5)(A)) and did not address perpetuity of the use restrictions (§ 170(h)(2)(C)). Under Simmons and Kaufman, a deduction did not fail merely because the land trust could choose not to enforce the easement. But under the Fourth Circuit's decision in Belk, a deduction fails if the landowner and land trust can agree to relocate the easement to other property.

(iii) Savings Clause. The second notable aspect of the Belk opinion is the discussion of savings clauses. A savings clause is a tool used by tax planners to protect the anticipated tax consequences of an agreement in the event a provision of the agreement would defeat that preferred tax treatment. The Fourth Circuit previously rejected certain savings clauses that were triggered by “conditions subsequent” that nullify a transaction if there is an adverse determination by a Court or the IRS. However, the savings clause in Belk prohibited the Land Trust prospectively from agreeing to any amendment that would cause the easement to fail to qualify for a charitable deduction under I.R.C. § 170. If the tax law developed such that a particular amendment would negate the deduction, the Land Trust was prohibited from agreeing to it.
The Fourth Circuit disagreed with the Belks' claim that the clause was “interpretive,” serving to guide the Land Trust concerning types of amendments that were appropriate. Instead, the Fourth Circuit found that no interpretive assistance was needed where the deed included a provision such as the Substitution Provision that, in its view, was so evidently inconsistent with I.R.C. § 170(h)(2)(C). The Fourth Circuit disregarded the fact that an adverse decision was not necessary for the savings clause to be operative, saying this was a “distinction without a difference.” The Court found that the easement deed plainly permitted substitutions, and concluded that the only time the savings clause would be invoked to prohibit offending substitutions would be following an adverse determination by the IRS or a Court. The Court apparently did not consider to be sufficient the Land Trust’s exercise of its judgment not to amend. In this context, the Fourth Circuit opinion can be viewed as broadening the types of savings clauses that will be deemed void for tax purposes.


   (i) **Overview.** The Tax Court issued its opinion in another Conservation Easement case, **Balsam Mountain Investments, LLC v. Commissioner**, T.C. Memo 2015-43 (J. Morrison) that involves an easement given in Jackson County, NC relating to a 22 acre tract of property. The Easement deed reserved to the landowner rights to make minor alterations of boundary lines. The Tax Court agreed with the IRS contention that the easement property was not a qualified real property interest because the easement agreement permits the grantor to change what property is subject to an easement, citing Belk. The Tax Court found that the easement did not apply to an “identifiable, specific piece of real property” and that the gift did not constitute a gift of a “qualified real property interest.” The taxpayer tried to distinguish Belk because the case did not involve substitution for other lands and only allowed substitution for 5% of the land initially subject to the easement. The Tax Court said that difference does not matter as the easement was not an interest in an “identifiable, specific piece of property.”


   (i) **Overview.** On August 11, 2017, the Fifth Circuit issued an important decision in **BC Ranch II, L.P. v. Comm’r** 867 F.3d 547 (5th Cir. 2017) (“BC Ranch II”). **BC Ranch II** is significant for the land trust
community because the Fifth Circuit, severely limited the breadth (at least in the Fifth Circuit) of Belk v. Comm’r, 140 T.C. 1 (2013), aff’d, 774 F.3d 221 (4th Cr. 2014).

(ii) **Facts.** BC Ranch involves a conservation easement granted by two limited partnership, which were intended to protect and preserve certain Texas ranch land that provides habitat for gold-cheeked warblers. The easement also protected watershed, scenic vistas and mature forest. The partnerships were owned by investors (in the partnerships), who were given the right to build ranch homes on select 5-acre sites (“homesite parcels”), with the rest of the land reserved for conservation, recreation and agricultural use. To be clear, the homesite parcels were not part of the conserved area, but were contiguous to it. The easements could only be amended with the land trust’s consent and then only to modify the boundaries of the homesite parcels, but not to increase the size of the homesite parcels to more than five acres. In addition to the homesite parcels conveyed to the various investors for their investment in the partnerships, the investors also received a membership interest in a to-be-formed Bosque Canyon Ranch Association, which would own all the other property other than the homesite parcels.

(iii) **What Happened in the Tax Court?** In Bosque Canyon Ranch, L.P. v. Comm’r, T.C. Memo 2015-550 (Judge Foley), the IRS disallowed the charitable deduction on various grounds, claimed that the distribution of the homesite parcels constituted disguised sales (resulting in income or gain to the partnership; the sales price in the disguised sale being equal to the amount contributed by each investor for his interest in the partnership) and asserted accuracy-related penalties, including the gross valuation misstatement penalty. After a four week trial, the Tax Court (Judge Foley) agreed with the IRS and disallowed the deductions in full, holding that (1) the conservation easements were not granted in perpetuity because the ability to make amendments to the boundary lines of the homesite parcels violated the perpetual restriction requirement under Belk, (2) the donors failed to make appropriate baseline documentation available to the land trust at the time of the grant of the easements under Reg. Section 1.170A-14(g)(5)(i) (discussing documentation necessary to allow the land trust to properly monitor the protected properties), and (3) the gross valuation misstatement penalty was applicable because the disallowance of the deductions caused the value of the deductions to be zero. Additionally, the Tax Court held that the facts in Bosque constituted a disguised sale transaction and
that the partnerships' receipt of the limited partners' entire contributions to the partnerships were receipts from such disguised sales.

(iv) **Fifth Circuit Vacates and Remands.** All of these issues were appealed to the Fifth Circuit, which had a completely different view of the world than the IRS and Judge Foley. Specifically, the Fifth Circuit (1) vacated the Tax Court's holding regarding the perpetuity of the easements and the baseline documentation (in other words finding that the taxpayers were correct on those issues), and remanded to the Tax Court for it to consider other grounds asserted by the Commissioner to support the disqualification of the easements as charitable deductions but not addressed by the Tax Court (outlined in footnote 30 of the decision), (2) vacated the Tax Court's determination that the entirety of the partners' contributions were disguised sales and remanded for the Tax Court to determine the correct amount of any taxable income resulting from the disguised sales, and (3) vacated the imposition of the gross valuation misstatement penalty and remanded to the Tax Court to determine the value of the contribution and whether the gross valuation misstatement penalty is applicable, and if so, the proper amount of such penalty.

(v) **Belk Conflation and Floating Homesites.** Bosque involved conservation easements granted by two limited partnerships that were intended to protect thousands of acres of Texas ranch land that provides habitat for gold-cheeked warblers and to protect watershed, scenic vistas and mature forest. The partnerships were owned by investors (in the partnerships) who were given the right to build ranch homes on select 5-acre sites ("homesite parcels"). The rest of the land was reserved for conservation, recreation and agricultural use. To be clear, the homesite parcels were not part of the conserved area, but were located contiguous to it.

The easements in Bosque could only be amended with the land trust's (in this case, the North American Land Trust, or NALT) consent and then only to modify the boundaries of the homesite parcels, but not to increase the size of the homesite parcels to more than five acres. One of the main issues in the case was whether the ability to amend the easements, with the land trust's approval, to modify the boundary of the homesite parcels, violated the perpetuity requirement of Section 170(h)(2)(C). In that regard, the IRS argued and the Tax Court agreed that such a right to amend to change the boundary of an
easement disqualified the easement, citing Belk. The Fifth Circuit found Belk distinguishable and held that reliance on Belk was misplaced.

Before analyzing the facts, the Fifth Circuit explained that Congress has consistently and historically provided bipartisan support for the use of conservation easements (citing legislative history from 1980) to protect important lands. The Fifth Circuit recognized that the easements at issue did indeed protect certain land in perpetuity, subject only to a few reserve rights that both the land trust and the land owner agreed could be exercised without having an adverse effect on the protected conservation purposes. The Court also recognized that an amendment to make minor modifications of boundary lines of the homesite parcels, all within the four corners of the ranch property, could only be made with the approval of the NALT. In distinguishing Belk, the court noted that (1) NALT had to approve any such amendments (giving a nod to the importance of land trusts in conservation easement operations), and (2) the homesite parcels could not be increased in size and that the external boundaries of the easement area nor the total acreage of the easement could change.

The Fifth Circuit observed that in Belk the easement could be moved, lock, stock and barrel, to a tract or tracts different and remote from the original easement property, allowing the donor to change the nature of the eased property and possibly undermining the appraisal of the property. But in the present case, the Court noted that those problems did not exist, comparing Bosque more favorably to the facts in Commissioner v. Simmons, 646 F. 3d 6 (D.C. Cir. 2011) and Kaufman v. Shulman, 687 F. 3d 21 (1st Cir. 2012). The Fifth Circuit noted that its sister circuits (in those cases) ruled that the conservation easements were perpetual even though the trust (in such cases) could consent to the partial lifting of certain restrictions. Highlighting the common sense reasoning in Simmons and Kaufman, the Fifth Circuit recognized “that an easement may be modified to promote the underlying conservation interests and that the need for flexibility to address changing or unforeseen conditions on or under property subject to a conservation easement clearly benefits all parties, and ultimately the flora and fauna that are their true beneficiaries.”

The Fifth Circuit's final lasso regarding perpetuity is found in its final point: “Most IRC provisions that intentionally create narrow
‘loopholes’ to cover narrowly specific situations are deemed to have been adopted in an exercise of legislative grace, and thus are subject to strict construction.” But the Fifth Circuit recognized that Section 170(h) was adopted at the insistence of conservation activists (not property-owning, potential donor taxpayers), by an overwhelming majority of Congress, with the hope that adding thousands of acres of primarily rural property for various conservation purposes would never be developed. Accordingly, the Fifth Circuit found that the usual strict rules of construction of tax loopholes “is not applicable to grants of conservation easements made pursuant to Section 170(h).” Indeed, it appears that the Fifth Circuit does not believe that a conservation easement is even a tax loophole, but instead is a tax incentive Congress overwhelmingly created to encourage conservation.

The Fifth Circuit's final comments regarding loopholes demonstrates that the Fifth Circuit does not agree with the hyper technical approach we have seen the IRS and some courts take in analyzing whether a conservation easement grant satisfies the requirements of Section 170(h). While this case applies that point of view to the perpetuity requirement of Section 170(h)(2)(c) and clearly distinguishes how Belk has been applied in the past, the theory would also apply to other issues that the IRS uses as a hammer to deny deductions with respect to grants of conservation easements where good conservation, which Congress clearly supports, is taking place.


(ii) Majority Opinion – Floating Homesites Problematic. The majority opinion, written by Judge Lauber, denied the deductions claimed in 2005 and 2006 because the partnership had retained the right to locate ten homesites on the 550-acre parcel underlying the 2005 easement and six homesites on the 499-acre parcel underlying the 2006 easement. Because the location of the homesites might move (though only with the land trust’s approval), Judge Lauber said that the easement was not protected in perpetuity as required by §
170(h)(2)(C) (easement must protect a specific parcel of property in perpetuity).

The majority opinion relied heavily on the Fifth Circuit dissent in BC Ranch II. The dissent opined that a floating outparcel that is not subject to the restrictions of the easement alters the boundaries of the easement-protected property. However, the majority opinion in BC Ranch II rejected the dissent’s position and allowed the easement deduction.

In Pine Mountain, the Tax Court’s majority allowed the deduction for the 2007 easement. It allowed a floating water tower, but no homesites. And the Court allowed a deduction for 2007 of $4,700,000, significantly more than originally deducted.

(iii) Amendment Clause Not A Problem. The Pine Mountain majority also addressed the IRS’s argument that a general right to amend an easement deed should result in loss of a deduction because the parties could subsequently amend the deed to alter the property subject to the easement. Lauber and the concurring judges rejected this IRS argument. The Tax Court concluded that a land trust charged with stewardship of an easement could not properly consent to such an amendment.

(iv) Morrison Dissent. Judge Morrison, the trial judge who heard the evidence in the Pine Mountain case, issued a dissenting opinion stating he would have allowed a deduction for 2005 for an amount that was more than twice what was originally claimed. He rejected the majority’s conclusion that a reserved right to relocate a homesite alters the property protected by the easement. Judge Morrison observed that the IRS has on numerous occasions allowed easement donors to reserve homesites even if the location of the homesite is not fixed as the time of donation. Judge Morrison also distinguished the Tax Court opinion reversed by BC Ranch II, which involved homesite outparcels that are no subject to the restrictions of the conservation easement. The homesites in Pine Mountain remained subject to the restrictions of the easement even if relocated.

Judge Morrison’s dissent concluded that, in addition to allowing a deduction for the 2007 easement, the 2005 conservation easement should qualify for deduction in the amount of $27,000,000. However, Judge Morrison would have denied the deduction for the 2006 easement, as the majority did, but for a different reason. In his
opinion, the floating homesites on the 2006 easement compromised the conservation purpose of the easement.

(v) **Valuation Determined by Morrison.** The majority view in Pine Mountain was determined by Judges who did not hear the case; but the valuation determination of the deduction allowed for in 2007 was made by the Trial Judge in the case, Judge Morrison, under T.C. Memo 2018-214. In this “valuation” decision, Judge Morrison found that while aspects of both expert opinions were useful in valuing the 2007 easement, each of these experts made critical errors. Morrison found that the Taxpayer’s expert ignored the beneficial effects the easement had on other non-eased property, resulting in an overvaluation of the easement. In addition, Morrison found that the IRS expert incorrectly assumed that the eased property would not be developed, resulting in an under-valuation of the easement. Judge Morrison found that by giving each appraisal equal weight, the errors of each would be corrected. Interestingly, the total deduction thereby allowed for 2007, $4,779,500, exceeded the deduction originally claimed for 2007, $4,100,000. In doing so Judge Morrison seems to adopt a new valuation approach to conservation easements, leading to some uncertainty as to how valuation rules for conservation easements will apply in the future.

4. **Perpetuity — Proceeds Clause and Extinguishment.**


   (i) **Overview.** The easement deed permitted the easement to be extinguished by mutual consent of the donor / taxpayer and the donee / land trust. In a motion for summary judgment, the IRS argued that extinguishment by mutual consent violated the protected in perpetuity requirement of Code section 170(h)(5)(A) and Treasury Regulation section 1.170A-14(g)(1).

   (ii) **IRS Argument.** The IRS took the position that the Code and regulations only permit extinguishment pursuant to a condemnation or other judicial proceeding. The Tax Court held that the easement was not enforceable in perpetuity and therefore the taxpayer’s deduction was disallowed in total.

   (iii) **Judicial Extinguishment.** The court reasoned that the “restrictions [in a deed] are supposed to be perpetual in the first place, and the
decision to terminate them should not be solely by interested parties. With the decision-making process pushed into a court of law, the legal tension created by such judicial review will generally tend to create a fair result.”

(iv) **So-Remote-As-To-Be-Negligible.** The court rejected the taxpayers argument that the possibility of extinguishment was so-remote-as-to-be-negligible, and adopted the principle expressed in Kaufman II, 139 T.C. 294 (2011) that “the so-remote-as-to-be-negligible standard does not affect the taxpayers obligations under Treasury Regulation section 1.170A-14(g)(6)(i).”

(v) **Kaufman III had no Impact.** On a motion for reconsideration, the Tax Court in T.C. Memo 2013-172 rejected the taxpayer’s position that the subsequent reversal of Kaufman II by the First Circuit Court of Appeals in Kaufman III affected its holding in Carpenter. The court stated: “we find that the holding in Kaufman III does not apply to this case and thus does not constitute an intervening change in law which would justify granting the motion to reconsider. Kaufman discussed at page 81 below.


(i) **Overview.** The Tax Court in Carroll denied a taxpayer's deduction for a conservation easement donated in 2005. The donated easement protects approximately 20 acres of land near Baltimore, Maryland. The taxpayer donated the easement in December 2005, and claimed a deduction of $1.2 million. The Court disallowed the deduction due to poor wording of the easement deed concerning the distribution of proceeds if the easement is extinguished, e.g., by condemnation. The Court ruled that the extinguishment language must track the language of the regulation exactly; otherwise the easement fails to meet the requirements of section 170. It is an unfortunate result for the taxpayer because the error probably was inadvertent and could have easily been avoided by a minor edit of the easement deed.

(ii) **Proceeds Clause Problem.** The Court concluded that the easement's conservation purpose was not protected in perpetuity because the language regarding extinguishment proceeds was inconsistent with the regulations. Treasury Regulation § 1.170A-14(g)(6) discusses unexpected changes in the conditions surrounding donated property. If the easement is extinguished, and the property is sold, the amount of proceeds that go to the donee must be equal to “the proportionate
value that the perpetual conservation restriction at the time of the gift bears to the value of the property as a whole at the time.” The easement deed in this case stated that the numerator in this fraction would be the “deduction for federal income tax purposes allowable by reason of this grant,” rather than the fair market value of the conservation restriction on the date of the gift. The Court viewed this as allowing a “potential windfall” for the landowner if the easement was extinguished and the deduction was disallowed for reasons other than value. The Court also held that the requirements in Treasury Regulation § 1.170A-14(g) must be strictly complied with, despite the fact than any potential extinguishment was highly unlikely.

(iii) Comment. Even though the Court ultimately disallowed the deduction, there are several positive findings in the decision. First, the Court found that the easement was a qualified real property interest based on the land trust's testimony that it would enforce the restrictions in the easement. In addition, the Court found that the donation satisfied the conservation purpose requirement because the easement was accepted by a State agency after a thorough review process and the land was in a highly populated area that benefited from the easement.


5. Perpetuity — Mortgage Subordination.

a. Minnick v. Comm’r. T.C. Memo. 2012-345 (Judge Morrison), aff’d 796 F.3d 1156 (9th Cir. 2015).

(i) Overview. In September of 2006, the taxpayers donated a conservation easement on their 74-acre parcel of land in the foothills near Boise, Idaho to the Land Trust of Treasure Valley, Inc. On or about December 26, 2007, taxpayers filed an amended income-tax return for 2006. On the amended return, they reported that the value of the easement was $941,000.

The deed of conservation easement granted by the taxpayer contained the following warranty regarding their ownership of the property: “Grantor [i.e. Minnick] warrants that * * * [he] owns the Property in fee simple and has conveyed it to no other person, and that there are no outstanding mortgages, tax liens, encumbrances, or other interests
in the Property that have not been expressly subordinated to the Easement.”

Contrary to the warranty provision in the easement deed, there was a mortgage encumbering the property at the time of the donation, which was held by U.S. Bank. U.S. Bank did not subordinate its interest to the land trust by the time the easement was granted.

(ii) **Tax Court Opinion.** The taxpayers argued that a subordination agreement executed in September of 2011 (nearly 5 years after the donation) satisfied the mortgage subordination requirement in Treasury Regulation 1.170-14(g)(2). The Tax Court found this “argument [to be] unavailing” based on its prior decision in *Mitchell v. Commissioner*, 138 T.C. 324, 332, (2012), which held that a mortgage subordination agreement must be in place at the time that the conservation easement is granted to satisfy the regulation’s perpetuity requirements.

The court also rejected the taxpayers argument that the perpetuity concerns furnished by the lack of mortgagee subordination to the land trust should be disregarded, because the likelihood of default by the taxpayer was so-remote-as-to-be-negligible. The court relied again on *Mitchell* wherein the Tax Court determined that “the likelihood of default is irrelevant.”

The court assessed an accuracy related penalty equal to 20% of the understatement. The court found that the taxpayers did not exercise reasonable cause because (1) the taxpayers did not obtain timely mortgage subordinations, which the warranty provision in the deed would have alerted the taxpayers to if a good faith investigation had been made, (2) while taxpayers solicited general advice about conservation easements from their CPA, they did not solicit or receive advice with respect to the deductibility of the particular easement they granted, and (3) that the taxpayers hiring of an appraiser to determine the value of the easement did not constitute reasonable cause for the accuracy-related penalty.


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1 But see, discussion of *Palmolive Building*, 149 T.C. No. 18 (2017) infra.
(i) **Overview.** Façade easement on townhouse in Boston. This case went through four decisions.

(ii) In *Kaufman I* (134 T.C. 182 (2010)), the Tax Court granted partial summary judgment finding mortgage subordination inadequate. Specifically, the Tax Court found that IRC §170(h)(5)(A) (perpetuity requirement) violated because subordination gave the lender a priority claim to proceeds from condemnation or casualty. The court ruled that the donee must be entitled to a proportionate share of proceeds if the easement is extinguished under Treas. Reg. §1.170A-14(g)(6)(ii) (extinguishment provision). The court interpreted donee’s rights to proceeds from the extinguishment of the easement to include proceeds from third-party contracts, such as insurance contracts.

(iii) In *Kaufman II*, 136 T.C. 94 (2011), the Tax Court reconsidered its ruling and elaborated on the “enforceability-in-perpetuity” requirements of IRC §170(h)(5)(A). It clarified that the easement failed not because the mortgage was not protected from foreclosure (i.e., not subordinated) but because the easement was not protected in the event of judicial condemnation or other casualty loss. It allowed deduction of cash contributions and denied application of penalties. The court also disallowed a portion of the cash donations and imposed a negligence penalty on that donation (but not on the easement).

(iv) In *Kaufman III*, the 1st Circuit rejected the Tax Court’s reasoning on the extinguishment provision holding the interpretation to be an unreasonable “impromptu reading that is not compelled and would defeat the purpose of the statute.” The 1st Circuit also rejected arguments that the donee might abandon the easement, or that the taxpayer failed to meet substantiation requirements by not including a summary appraisal or fully completing Form 8283. The 1st Circuit vacated the Tax Court’s decision on this point.

(v) In *Kaufman IV*, T.C. Memo 2014-52, the Tax Court determined value of easement to be zero and penalties were imposed. Tax Court criticized the taxpayer’s appraiser and concluded that the appraisal method used was not reliable. The court further stated that it was convinced that the restrictive provisions in the Preservation Agreement were duplicative of local zoning ordinance and related...
restrictions, thus the easement did not materially diminish the value of the row house that is subject of the easement.

Tax Court determined that the taxpayers’ reported value, where the claimed façade easement exceeded the correct value by 400% or more, constituting a gross valuation misstatement and, further, that the 40% gross valuation misstatement penalty should be imposed.

While finding that the easement value was based on a qualified appraisal made by a qualified appraiser (forced by the Circuit Court of Appeals decision) the Tax Court ultimately found that the taxpayers’ reliance on their accountant and appraiser did not satisfy their burden to show that they conducted a good faith investigation of value or acted with reasonable cause.

Underlying the Court’s determination (as well as the Court’s value determination) was unfortunate evidence that came to light during trial. The donee of the easement had represented to Mr. Kaufman (the donor), a sophisticated MIT Emeritus Professor of Statistics, that the easement would not reduce the value of the underlying property. Despite these written communications, the Kaufmans proceeded, without further investigation, to claim the charitable deduction based on the appraisers estimate.


   (i) **Overview.** The Tenth Circuit upheld the Tax Court's decisions in Mitchell v. Comm’r, 138 T.C. No. 16 (2012), mot. for reconsideration denied, T.C. Memo 2013-204, to completely deny the taxpayer's deduction for the donation of a conservation easement where the donor failed to subordinate the mortgage on the property to the conservation easement.

   The taxpayer in Mitchell donated a conservation easement over 180 acres of unimproved land to a local land trust. Tenth Circuit was to decide whether donated conservation easement was protected “in perpetuity”. Because “perpetuity” is not defined in the Code, IRS issued regulations outlining the requirements for perpetual protection. One of these requirements is that a mortgage on any property subject to the conservation easement must be subordinated to the easement (to prevent the mortgage lender from foreclosing on the property and extinguishing the easement). See 26 C.F.R. §

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1.170A-14(g). The Treasury Regulations further provide that a deduction will not be disallowed based on some potential future event that could defeat the donee's interest if the possibility of such future event “is so remote as to be negligible.”  

(ii) **Tax Court.** The taxpayer in Mitchell did not subordinate the mortgage at the time of the easement; and instead subordinated the mortgage two years later. The Tax Court denied the deduction in full, determining that the Regulations require subordination “at the time of the donation” for the donation to meet the requirements of a “qualified conservation contribution.”

(iii) **Tenth Circuit.** On appeal, the taxpayer argued she was entitled to the deduction despite failing to strictly comply with the subordination requirement because (1) the regulations do not require subordination at the time of the contribution, and (2) the possibility that the bank would foreclose on the mortgage was so remote as to be negligible.

The Tenth Circuit disagreed, strictly interpreting the regulation to require subordination **prior to** claiming the deduction and also agreed with the Commissioner's interpretation that the regulation requires that the mortgage be subordinated “at the time of the donation.” The Tenth Circuit also held that the “so remote as to be negligible” standard did not apply to mortgage foreclosures, which are not such “remote” future events. In addition, the “so remote as to be negligible” standard could not include mortgage foreclosures because the Regulations explicitly contemplated the possibility of foreclosure and included a requirement that mortgages be subordinated. In so holding, the Tenth Circuit limited the D.C. Circuit's application of this standard in Simmons, 646 F.3d 6 (D.C. Cir. 2011), explaining that, unlike a mortgage foreclosure, the possibility that a donee would abandon its rights under an easement is a remote future event where the donee had never abandoned its rights previously.

(iv) **Comment.** The Tenth Circuit's decision in Mitchell, like the Fourth Circuit's holding in Belk, reflects a harsh view by the courts when it comes to strict compliance with the Treasury Regulations. In both cases, the taxpayers donated a very valuable restriction on their property to a charitable organization. And the donated restrictions in both cases were, as a practical matter, protected in perpetuity. However, the deductions were denied in full because the
taxpayers failed to technically comply with the Treasury Regulations and the Code.


(i) **Overview.** The Tax Court in *RP Golf* disallowed a $16 million deduction for a conservation easement donation where the taxpayer failed to subordinate two mortgages prior to the donation of the conservation easement. The donation at issue in *RP Golf* covered 277 acres of property, which included a golf course. The original purchase of the property in 1997, which included the easement property, was financed by a bank, which received a security interest in the underlying property. The owner subsequently obtained a second loan, which was also secured by the property. On December 29, 2003, the taxpayer donated an easement to the local land trust. The banks did not sign the consents to subordinate their mortgage interest until April 14, 2004 – though the consents by their terms were effective as of December 30, 2003. This case is another example of how both the IRS and the Tax Court are harshly punishing taxpayers who fail to comply with highly technical rules and regulations associated with gifts of conservation easements.

(ii) **Positions of the Penalties.** The IRS claimed that because the mortgages were not subordinated at the time of the easement donation, the conservation purposes were not protected in perpetuity, as required by Section 170(h)(5)(A). The taxpayer claimed that the banks had orally agreed to the subordination at the time of the easement, but didn't execute that subordination until later.

(iii) **Tax Court Holding.** The Tax Court followed a recent line of cases strictly construing the mortgage subordination requirement in the regulations, and requiring that the mortgage be subordinated at the time of the easement donation. The Tax Court also looked at Missouri law, as well as the mortgage agreements themselves, to determine whether the claimed oral agreement to subordinate was sufficient to protect the land trust's rights in the easement. The Court concluded that any oral agreement was not enforceable as between the parties, and certainly not enforceable against third parties.

(iv) **Comments.** The *RP Golf* case follows the Tax Court and Court of Appeals precedent strictly construing the requirement to subordinate mortgages before the easement is donated, despite the fact that all of these cases involve easements that had no adverse events occur...
between the date of donation and date of subordination. While these decisions appear to fly in the face of Congress's continued support of the conservation easement program, they have shaped the landscape of easement donations where taxpayers must ensure that every “i” is dotted and every “t” is crossed. Even a small misstep may have dire consequences.


In affirming the Tax Court’s opinion in **RP Golf v. Comm’r**, T.C. Memo 2016-80 (Judge Paris), the Eighth Circuit joined the Ninth and the Tenth Circuits in holding that Treasury regulation section 1.170A-14(g)(2) requires a mortgage to be subordinated at the time of the gift. **Minnick v. Comm’r**, 796 F.3d 1156, 1159 (9th Cir. 2015) (nearly five-year gap between easement's conveyance and subordination); **Mitchell v. Comm’r**, 775 F.3d 1243, 1248 (10th Cir. 2015). (Two-year gap).

In both **Minnick** and **Mitchell**, the taxpayers argued —like the taxpayers in **RP Golf**—that the Code's silence about the timing of subordination allows it after the conveyance of the easement. The Eighth Circuit agreed with its sister circuits that the plain language of Treasury regulation section 1.170A-14(g)(2) requires subordination prior to the donation in order for the deduction to be allowable.

The Eighth Circuit held that “the regulations ‘do not permit a charitable contribution deduction unless any existing mortgage on the donated property has been subordinated, irrespective of the likelihood of foreclosure.’” (citing **Mitchell**, 775 F.3d at 1255.)


(i) **Overview.** In 2004, the taxpayer, Palmolive Building LLC, donated a façade easement to a land trust encumbering the Palmolive Building on North Michigan Avenue in Chicago, Illinois, which it had purchased in May 2001 for approximately 58.5 million dollars. The taxpayer would claim a charitable deduction in the amount of approximately 33.4 million dollars on its 2004 tax return pursuant to the easement donation.
The IRS argued that the easement deed did not protect the conservation values in perpetuity, as required by Code section 170(h)(5)(A) and Treasury Regulation section 1.170A-14(g)(6)(ii), because the deed provided the taxpayer’s mortgagees with prior claims to insurance proceeds.

The IRS also argued that the mortgages on the building were not fully subordinated to the easement as required by Treasury Regulation section 1.170A-14(g)(2) because of the mortgagees’ rights to any insurance proceeds in preference of the land trust.

(ii) **Tax Court Does Not Follow Kaufman III.** In Palmolive Building, LLC, the Tax Court’s *en banc* opinion adopted its prior holding in *Kaufman I* (discussed supra) that taxpayers fail to satisfy the protected in perpetuity requirement of Code section 170(h)(5) if the donee/land trust is not entitled to a proportionate share of any proceeds, including those from third-party contracts—such as insurance contracts.

The court held that allocating insurance proceeds in preference to a mortgagee violated the mortgage subordination requirement. The court explained that the mortgage subordination requirement “is not satisfied simply by including in the Deed a section captioned ‘Subordination of Mortgages,’ without regard to what the Deed actually provides and what the mortgagee actually agrees to. Rather, the mortgagee must actually subordinate its interest.” Providing the mortgagees a preference to insurance proceeds (which the mortgagees required the taxpayer to maintain) violated the mortgage subordination requirement.

(iii) **Golsen Rule.** The Tax Court acknowledged that it was taking a position already rejected by the 1st Circuit Court of Appeals in *Kaufman III*. It was able to do this because of the Golsen Rule, which allows a Tax Court to adopt case law from the circuit court of appeals that would hear the taxpayer’s appeal (if such an appeal occurred). The taxpayer’s appeal would lie in the 7th Circuit Court of Appeals, while *Kaufman III* was an opinion from the 1st Circuit, so the court determined “we are not bound by the opinion of the U.S.

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Court of Appeals for the First Circuit in [Kaufman III] … and we will follow [Kaufman I].”

6. **Perpetuity – Deemed Consent.**


   (i) **Overview**: On July 12, 2017, Judge Nega of the Tax Court granted the IRS Partial Summary Judgement finding that a conservation easement failed to protect the conservation purposes in perpetuity because the easement could permit the taxpayer to use the eased property in a manner inconsistent with the conservation purposes protected by the easement.

   (ii) **Deemed Consent Provision.** In Hoffman, the taxpayer granted an easement encumbering the façade of a historically significant building and the air rights above the building and above an adjacent parcel of historically important land. The taxpayer reserved various rights under the easement deed. Certain of those rights were only exercisable on the condition that the taxpayer obtained consent from the land trust. The easement deed provided that the land trust would be deemed to consent to any written request to exercise a conditional right if the land trust failed to respond within 45 days (the “Deemed Consent Provision”).

   (iii) **Tax Court Opinion.** The Tax Court determined that the Deemed Consent Provision violated the perpetuity requirement because it could permit the taxpayer to use the property in a manner inconsistent with the conservation purposes. The Tax Court reasoned that following a deemed consent, the land trust would be without recourse to fix any degradation of the conservation purposes caused by the exercise of the conditional reserved right because the easement deed only permits the land trust to seek remedy for a breach of the easement deed’s terms. The court determined that the Deemed Consent Provision trumped any competing provision imparting obligations on the taxpayer, so the taxpayer would not be in breach of the easement deed’s terms if the land trust’s inaction caused a deemed consent.

The Tax Court recognized that taxpayers can reserve conditional rights that may affect the conservation purposes, in this case the ability to alter the exterior of the historic building. However, the
court indicated that such reserved rights are only permissible “where
the easement’s conditions provide the qualified organization with
unlimited discretionary authority to approve or deny changes arising
from those reserved rights.” The Deemed Consent Provision
curtailed the land trust’s discretion; therefore, the court determined
that the taxpayer was not entitled to a deduction because the taxpayer
reserved a right inconsistent with the conservation purposes.

7. **Perpetuity – Amendment Clause.**

a. **Pine Mountain Preserve, LLP v. Comm’r.** 151 T.C. No. 14 (Dec. 27,

E. **PENALTIES.**

1. **Kaufman v. Shulman.** T.C. Memo 2014-52, 687 F.3d 21 (1st Cir. 2012) aff’g in
case summary on page 81.

2. **Chandler v. Comm’r.** T.C. 142 T.C. No. 16 (Judge Goeke). See case summary on
page 42.

3. **Zarlengo v. Comm’r.** T.C. Memo 2014-161 (Judge Vasquez). See case summary
on page 65.

4. **Seventeen Seventy Sherman Street v. Comm’r.** T.C. Memo 2014-124 (Judge
Marvel). See case summary on page 96.


a. **Overview.** Legg is a conservation easement deduction case centered around
the issue of accuracy-related penalties. The taxpayers in Legg claimed
deductions totaling more than $1.4 million for an easement they contributed
to the Colorado Natural Land Trust. After a timely examination of the
taxpayers' returns, the IRS examiner issued an “initial report” that took the
primary position that the deduction be disallowed entirely for failure to
satisfy certain legal requirements and the alternative position that the
 easement's value was $0. The initial examination report computed penalties
at 20% but also took the alternative position that the taxpayers were liable
for the 40% gross valuation misstatement penalty under § 6662(h).

b. **Resolved Issues.** Following examination, the taxpayers entered into a partial
settlement order with the IRS agreeing that: (1) the taxpayers were entitled
to a charitable deduction; (2) the value of the conservation easement was

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$80,000; and, (3) the taxpayers satisfied the reasonable cause defense requirements for the 20% substantial valuation misstatement penalties under §§ 6662(a) and (b)(3) but that the taxpayers could not invoke the reasonable cause defense against the 40% gross valuation misstatement penalty under § 6662(h).

c. **Penalties Determined.** At trial, the taxpayers argued that the 40% penalty was not properly assessed because the IRS did not satisfy the procedural requirement of § 6751(b) which, in relevant part, provides that no penalty 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.” The taxpayers argued that asserting penalties as an alternate position in the examination report was not an “initial determination” as required by the statute. In rejecting the taxpayers' arguments, the Court explained that, “Congress enacted section 6751(b) to ensure that taxpayers understood the penalties that the IRS imposed upon them” and, by raising the 40% penalty as an alternative position in the examiner's initial examination report, the procedural requirements of § 6751(b) were satisfied. Accordingly, the Court sided with the IRS and held that the taxpayers were subject to the 40% gross valuation misstatement penalty.


a. **Section 6662 Penalties and Supervisory Approval Required by Section 6751(b).**

To justify imposing accuracy-related penalties under section 6662 the IRS is required to comply with section 6751(b), which provides:

> No 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 local official as the Secretary may designate. IRC § 6751(b).

The meaning “initial determination of such assessment” was hotly contested by the taxpayers in Graev and the IRS. An en banc opinion from the Tax
Court held that the written approval under section 6751(b) could be validly obtained at any time before the penalty is assessed. See Graev v. Comm’r, 174 T.C. No. 16, 2016 WL 6996640, at *10 & n.13 (2016). This opinion was troubling because it essentially rendered 6751(b) a nullity, as the IRS had up until the very moment of assessment to get the managerial approval, which undermined the purposes behind section 6751(b).  

b. The Second Circuit clarified the “supervisory approval” requirement in section 6751(b)(1) after the tax court issued its en banc opinion in Graev.  

Six months after the tax court issued its en banc opinion in this case, the Second Circuit thoroughly analyzed section 6751(b) and its legislative history, rejected the divided en banc tax court’s construction of that statute in Graev, and buttressed the mandate set forth by section 6751(b)(1). See Chai v. Comm’r, 851 F.3d 190 215-23 (2d Cir. 2017). Specifically, the court in Chai held that section 6751(b) “requires written [supervisory] approval of the initial penalty determination no later than the date the IRS issues the notice of deficiency (or files an answer or amended answer) asserting such penalty.” Id. at 221 (emphasis added).  

As the Second Circuit explained, allowing “an unapproved initial determination of the penalty to proceed through administrative proceedings, settlement negotiations, and potential tax court proceedings, only to be approved sometime prior to assessment would do nothing to stem the abuses § 6751(b) was meant to prevent.” Id. at 219.  

The Second Circuit further held that “compliance with § 6751(b) is part of the Commissioner’s burden of production and proof in a deficiency case in which a penalty is asserted” and “therefore part of the IRS’s prima facie penalty case.” Id. at 221; see also id. at 222 n.26 (“The written-approval requirement -- as a mandatory, statutory element of a penalty claim -- is distinct from affirmative defenses … which need be raised by the taxpayer.”).  

Finally the Second Circuit clarified that the term “personal[] approv[al]” in section 6751(b)(1) means something more than a general bureaucratic forwarding of an initial assessment. In so doing, the court observed that “the IRS’s current administrative practice requires a supervisor’s approval to be noted on the form reflecting the examining agent’s penalty determination or

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3 There are exceptions to this rule for additions to tax under section 6651, 6654, or 6655 or penalties automatically calculated through electronic means.
otherwise be documented in the applicable workpapers.”  Id. at 220 (emphasis added). 4

The Second Circuit also referenced other sections of the IRM which state that “managerial review and approval must be documented in writing in the case file.”  Chai, 851 F.3d at 220 (quoting IRM 20.1.1.2.3(7) (Aug. 5, 2014)). The court found these procedures, issued by the Commissioner, were “a persuasive signal of the IRS’s reading of § 6751 to require, as Congress intended, supervisory approval prior to the issuance of a notice of deficiency.”  Id.

With respect to Congressional intent for 6751(b), the Chai court explained that Congress enacted section 6751(b) to ensure penalties are imposed fairly and to preclude the Commissioner from threatening the imposition of penalties as a tactic to strong-arm settlements.  See S. Rep. No. 105-174, at 65 (1998) (“The Committee believes that penalties should only be imposed where appropriate and not as a bargaining chip.”).

The Tax Court’s application of section 6751(b) in Graev appears to thwart that purpose. Under the interpretation set forth by the Second Circuit Court of Appeals in Chai, the Commissioner has the burden to establish, among other elements, that the initial determination of the penalty was personally approved, in writing, by the immediate supervisor of the person making such determination.

c.  **Tax Court reverses course regarding the burden of production for penalties under section 7491(c) in Dynamo.**

(i) **Overview.** Dynamo Holdings Limited Partnership v. Comm’r, 150 T.C. No. 10 (2018) is not a conservation easement case; however, it is important because of its holding regarding the burden of production with respect to penalties imposed on partnerships during an IRS audit.

(ii) **Tax Court.** In Dynamo, the Tax Court addressed the burden of production under I.R.C. section 7491(c) and determined that the automatic burden of production that the IRS bears with respect to penalties only applies when the IRS seeks to impose penalties against individuals. Accordingly, the court determined that section 7491(c) does not require that the IRS bear the burden of production for

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4 The Internal Revenue Manual (“IRM”) provides that workpapers document the procedures applied, texts performed, information obtained, and conclusions reached. IRM 4.46.6.2(2) (Dec. 29, 2009).
penalties in a corporate or partnership level proceeding, so long as the penalties are raised in the notice of deficiency. The court indicated that the IRS bears the burden or production for any penalty raised in an answer.

(iii) **Comment.** Dynamo does not void the requirement that the IRS obtain supervisory approval of penalties; however, non-individual taxpayers need to take special caution to raise the supervisory approval requirement as a defense to penalties asserted by the IRS.

d. **Fifth Circuit Muddies the Waters Regarding Section 6751(b).**

(i) See supra section on 5th Circuit’s opinion in PBBM-Rose Hill for a discussion of how the managerial approval requirement is being interpreted in the 5th Circuit Court of Appeals.


a. **Overview.** On October 25, 2016, the Southern District of New York granted a motion for partial summary judgment that was filed by the United States. See Partita Partners LLC v. United States, 216 F.Supp.3d 337 (S.D.N.Y. 2016) (“Partita I”). The court concluded that, as a matter of law, Partita's donation of the façade easement did not preserve the building's entire exterior, as required by IRC § 170(h)(4)(B), and that Partita therefore was ineligible for the $4,186,000 deduction that it claimed.

The taxpayer then moved for summary judgment contending that the valuation misstatement penalty was inappropriate, because Partita I concluded that the charitable deduction did not satisfy the criteria of Code section 170(h)(4)(B)(i)(I) and disallowed the deduction in total for technical noncompliance. According to the taxpayer, its 2008 underpayment was not “attributable to” a valuation misstatement because the deduction was disallowed on entirely separate grounds that are not related to valuation—i.e., a technical violation.

b. **District Court Opinion.** The Southern District of NY relied on United States v. Woods, 134 S.Ct. 557, 561–62, (2013) in concluding that the gross valuation misstatement penalty was applicable even when the gross understatement results from a total disallowance of the charitable deduction on technical grounds. The court rejected the taxpayer’s reliance on a pre-Woods line of cases providing that valuation misstatement penalties were not appropriate following a technical disallowance when the court does not
otherwise determine a value for the easement. Todd v. Comm’r, 862 F.2d 540 (5th Cir. 1988).

The posture of the parties—i.e., the taxpayer’s motion for summary judgment—somewhat limited the court’s analysis on the valuation misstatement penalty. While the court indicated that valuation misstatement penalties could be applied following a technical violation, it is unclear if the disallowance is enough to trigger the penalty or if the court would also have to make a determination regarding the easement’s value to apply a valuation misstatement penalty.

The court seemed to indicate that more litigation was necessary to determine the appropriateness of a valuation misstatement penalty. “The government's successful motion for summary judgment as to the deduction's disallowance does not preclude it from continuing to litigate Partita's challenge to the underpayment penalties, which will be decided at trial.”

c. **Comment.** If a successful disallowance by the IRS is enough to trigger the penalty, then the effect of Woods and Partita is that a gross valuation misstatement penalty will always be at the IRS’s disposal following the disallowance of a taxpayer’s deduction due to noncompliance with a technical requirement imposed on qualified conservation easement contributions.

**F. QUALIFIED FARMER STATUS.**


This case involved a 2009 conservation easement encumbering 355 acres of land. The taxpayer conveyed the conservation easement as part of a bargain sale transaction with a qualified organization. The taxpayer conveyed the conservation easement to a qualified organization in exchange for $1,504,960, and claimed a charitable deduction of $1,335,040 for the “bargain” aspect of the conveyance.

There was no dispute that the taxpayers, who were brothers, “were in the business of farming. Through numerous entities they owned seven parcels of land in Maryland and Delaware, totaling 1,455 acres in 2009… During 2009
the brothers each rendered at least 2,500 hours of physical labor and management services in growing and harvesting corn, barley, wheat, and soybeans on all of their properties. They borrowed money when necessary and joined the U.S. Department of Agriculture's Farm Service Agency subsidy programs. In fall 2008, the brothers, through Rutkoske Farms, planted wheat on the property and reserved to themselves its harvesting and the proceeds derived from the sale thereof.”

The classification as a qualified farmer or rancher has great importance because such individuals are able to deduct a higher percentage of their yearly income for contributions of conservation easements.

b. **Percentage of Contribution Base Limits.** Subparagraph (E) of section 170(b)(1) governs the deductibility of a “qualified conservation contribution” by an individual. Section 170(b)(1)(E)(i) generally limits the deduction from such a donation to 50% of the donor’s “contribution base”, defined by section 170(b)(1)(G) as the taxpayer's adjusted gross income (computed without regard to any net operating loss carryback for the taxable year) less the value of his/her other charitable contributions for the year.

Section 170(b)(1)(E)(iv) provides a special rule for contributions of property used in agriculture or livestock production. If the individual is a “qualified farmer or rancher” for the taxable year for which the contribution is made, then that individual may deduct the value of the donation up to 100% of the his/her contribution base, less the amount of all other charitable contributions allowable under section 170(b)(1) made during the year. Section 170(b)(1)(E)(v) defines the term “qualified farmer or rancher” as an individual whose gross income from the trade or business of farming (within the meaning of section 2032A(e)(5)) is greater than 50% of the individual's gross income for the taxable year.

Section 2032A(e)(5) sets forth activities, the revenues of which constitute income from the trade or business of farming:

(A) cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, shearing, feeding, caring for, training, and management of animals) on a farm;

(B) handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant,
or operator of the farm regularly produces more than one-half of the commodity so treated; and

(C) (i) the planting, cultivating, caring for, or cutting of trees, or (ii) the preparation (other than milling) of trees for market.

To determine whether the contribution of the conservation easement qualifies for the special rule of section 170(b)(1)(E)(iv), a fraction must be created, the numerator of which is the income derived from the trade or business of farming, and the denominator of which is the donor's gross income. See IRC § 170(b)(1)(E)(v).

c. **Trade or Business of Farming.** The issue before the Tax Court was how much of the taxpayer’s income was derived from the trade or business of farming. The taxpayer took the position that the sale of the conservation easement and the sale of property used in the business of farming constituted income derived from the trade or business of farming.

d. **Tax Court Holding.** The court acknowledged that the purchase and sale of farming property was necessary activity of a farming business, but was quick to point out that it was not determining the validity of “operational expense deductions or any other provision of the Code that relates to a business' general operations.” Rather the court was interpreting “a narrowly tailored provision intended to provide a tax benefit for a specific action, namely, the contribution of conservation easements by qualified farmers.” The court refused to expand the scope of what interpreted to be a narrowly tailored Code section.

The Tax Court held that income derived from the sale of a conservation easement encumbering farmland or ranchland is not income derived from the trade or business of farming. Additionally, Tax Court determined that income derived from the sale of property (real and personal) used in the business of farming or ranching is not income derived from the trade or business of farming.

G. **QUID PRO QUO, ENHANCEMENT, AND SUBSTANTIAL BENEFIT.**


   a. **Overview.** In Seventeen Seventy Sherman Street v. Comm'r (T.C. Memo 2014-124), the Tax Court held that an understanding between the taxpayer
and a development company under which the taxpayer would grant certain conservation easements if the development company assisted in obtaining variances constituted a *quid pro quo*, resulting in a complete loss of the deduction for such conservation easement.

The property at issue included the El Jebel Shrine, a structure in Denver, Colorado which was completed in 1907 and designated as a landmark. The property also includes an adjacent parking lot. The taxpayer (a Colorado LLC) intended to turn the structure into condominiums. To that end, the taxpayer needed a change to the PUD to allow such development and a variance to allow for the building of a structure on the parking lot. In 2002, the taxpayer began negotiating with Community Planning and Development Agency (“CPDA”) regarding the (1) the proposed PUD change, (2) the imposition of interior and exterior easements, (3) the application for a variance, and (4) rehabilitation of the property. The taxpayer and CPDA entered into a development agreement, under which the CPDA would recommend approval of the proposed PUD and variance request and, if the PUD change was approved, the taxpayer would donate interior and exterior easements to Historic Denver, Inc., a charitable organization. In addition, the taxpayer agreed to undertake certain rehabilitation projects if the variance request was granted. The PUD change would have to be approved by the Denver City Council, and the variance would have to be obtained from the Denver Planning Board.

The taxpayer donated the interior and exterior easements to Historic Denver in December 2003, after obtaining the PUD change and the variance, and claimed a deduction of $7,150,000 as the value of the easements.

b. **Tax Court’s Decision.** The Tax Court held that the charitable deduction must be completely disallowed because the taxpayer received a *quid pro quo* for the donation of the easements. The Tax Court explained that the consideration need not be financial; it can be any other benefit that vitiates charitable intent. The Tax Court further explained that the taxpayer bears the burden of demonstrating that he or she intended to make a charitable contribution in excess of any consideration received.

The Tax Court held that the development agreement as a whole demonstrated that the taxpayer received CPDA's recommendation as to both the PUD change and the variance request in exchange for the easement. In so holding, the Tax Court dismissed the taxpayer's argument that only the value of the PUD change should be viewed as “consideration” for the easement, which the taxpayer valued at just over $2 million. The Tax Court observed that the nature of the negotiations between the taxpayer and CPDA showed that both
recommendations should be viewed as consideration for the easements, despite the fact that CPDA could not approve either the PUD change or the variance. The Tax Court further held that since the taxpayer failed to demonstrate or identify the value of the consideration received in the transaction, the taxpayer was not entitled to any deduction.

c. **IRS Contentions.** At trial, the IRS contended that because the taxpayer received consideration in exchange for the easement, which the taxpayer failed to disclose, the charitable contribution had no value. The IRS further argued that the interior easement served no conservation purpose and the value claimed by the taxpayer of the easements was overstated. The taxpayer contended that the consideration received was limited to the PUD change, which was only worth $2,025,000, thus the taxpayer was entitled to a deduction of $5,125,000. The taxpayer further contended that it was not required to disclose the consideration received because the consideration was not received from the donee organization – instead it was received from the city of Denver in the form of a PUD change.

d. **Penalties and Burden of Proof.** As the case related to penalties, like in many other recent cases, the burden of proof impacted the Tax Court's decision. While the FPAA mailed to the taxpayer challenged the deductibility of the subject conservation easements, the Commissioner asserted in an amendment to his answer that even if the easements were deductible, the fair market value of the easements was only $400,000 (compared to $7,150,000 claimed by the taxpayer). The amended answer further asserted that an accuracy related penalty applied to the underpayment in the form of a gross valuation misstatement, or, alternatively, (i) because of negligence or disregard of rules or regulation under Section 6662(b)(1), (ii) a substantial understatement of income tax under Section 6662(b)(2), or (iii) a substantial valuation misstatement under Section 6662(b)(3).

Since the assertion of penalties was raised in an amended answer, the Tax Court assigned the burden of proof on the “new matter” under Rule 142(a) to the Commissioner. As to the proposed gross valuation misstatement, the Tax Court did not accept the Commissioner's expert's opinion that the subject easements had no value, which testimony was refuted at trial by representatives from both the City of Denver and Historic Denver, the recipient of the easement. While concluding that one of the easements at issue had value, the Tax Court found that the Commissioner failed to meet his burden of establishing that the value of the subject conservation easements exceeded 400% of the correct value of the easements, meaning that the gross valuation misstatement penalty could not apply.
With respect to the other (non-valuation) accuracy related penalties asserted in the amended answer, the Tax Court found that, because the deductions were disallowed, the Commissioner had met his burden of establishing that the taxpayer acted negligently or with disregard to Section 170 and the regulations thereunder.

e. **Reasonable Cause and Good Faith.** To prove that the taxpayer had acted with reasonable cause and good faith through reliance on professional advice, the evidence offered at trial included testimony from the taxpayer's tax advisor that he had advised the taxpayer that he had to reduce the value of the claimed deduction by the consideration received in the quid pro quo exchange. Of course, the taxpayer failed to follow that advice. Accordingly, the Tax Court found the Taxpayer's disregard of the advisor's advice was not reasonable and in good faith.

f. **Comment.** This case is instructive to developers and property owners who are considering the grant of a conservation easement in connection with a request for zoning changes to develop property underlying or adjacent to the eased property. Carefully structuring and reporting these transactions can avoid the unfortunate result where the easement is disallowed in total and the property owner is hit with penalties.

Seventeen Seventy Sherman Street also is important because it illustrates the confusing differences between the application of the valuation misstatement penalties and the accuracy related penalties and shows how important the burden of proof can be in a court's determination of whether these very potent penalties are applicable.


a. **Overview.** In McGrady, the taxpayers claimed a noncash charitable contribution in 2007 and claimed a deduction of $4.7 million. This contribution comprised two distinct gifts, which were components of a complex conservation plan in Bucks County, Pennsylvania undertaken by the township, Heritage Conservancy, the taxpayers, and other private individuals. This resulted in several transactions between numerous parties. See McGrady v. Comm’r, T.C. Memo. 2016-233 at *2-4.

Taxpayers donated to the township in which they lived a qualified conservation easement on their 25-acre homestead property, and they donated to a tax-exempt conservation organization a fee simple interest in an adjoining 20-acre parcel of undeveloped land.
The IRS disallowed these deductions in full. It raised several contentions, including (1) that the taxpayers overvalued the donated property and were subject to penalties; and (2) that the taxpayers received return benefits in exchange for their gifts ("quid pro quo").

b. **Quid Pro Quo.** The IRS claimed that the taxpayers received quid pro quo benefits pursuant to the transactions, which adequately compensated the taxpayers for the property they conveyed. According to the IRS, these quid pro quo benefits negated “[t]he sine qua non of a charitable contribution [i.e.,] a transfer of money or property without adequate consideration.” United States v. Am. Bar Endowment, 477 U.S. 105, 118 (1986) (emphasis added).

The IRS did not identify any specific benefit that the Taxpayers received in the negotiations. Instead, the IRS lobbed vague aspirations regarding the taxpayers’ “supposed ability to steer the entire set of transactions in a way that benefited them. [The taxpayers] were motivated by a desire to protect their privacy and to prevent suburban development from spoiling the attractive views from their residence. … if not ceding petitioners actual control, [Heritage and the Township] allowed them to guide the transactions in a direction that achieved [the taxpayers’] personal goals.

c. **Tax Court Decision.** The Tax Court rejected the IRS quid pro quo argument in what should be considered a major taxpayer victory. The Tax Court held that even though taxpayers were involved in negotiations with and benefited somewhat (buffer to homestead) from the development plan the Township agreed to in those negotiations, that there was no quid pro quo because the taxpayers were mere incidental beneficiaries. In rejecting the IRS’s quid pro quo argument, the Tax Court explained that:

> Whenever a homeowner places a conservation easement over his property, or a neighbor places a conservation easement over neighboring property, the homeowner in a sense “benefits” by having natural landscapes rather than suburban sprawl in his immediate surroundings. When the Township approved a conservation subdivision on the Rorer Tract, petitioners may be said to have “benefited” because the Rorer Tract surrounded their property. **But petitioners were mere incidental beneficiaries of this action.** Heritage and the Township executed these transactions not to benefit petitioners or the Creeks Bend homeowners but to accomplish their charitable purposes of conserving rural and agricultural land. See McLennan v. United States, 24 Cl. Ct.
102, 107 (1991) (upholding charitable contribution deduction where “[a]ny benefit which inured to * * * [the taxpayer] from the conveyance was merely incidental to an important, public spirited, charitable purpose”), aff’d, 994 F.2d 839 (Fed. Cir. 1993).

Ultimately the court was “unpersuaded by [the IRS] characterization of these events. [The taxpayers] were indeed involved in the negotiations from the outset, but this was inevitable…. There is no evidence that [the taxpayers] had the power to manipulate these negotiations or that the other parties made meaningful concessions to them. The Township and Heritage were single-mindedly dedicated to accomplishing the maximum degree of environmental conservation consistent with the financial realities they confronted.”

d. **Penalties and Good Faith Defense.** The Tax Court agreed with the IRS that the Taxpayers overvalued the conservation easement contribution, but it did not agree with the alternative value provided by the IRS, so it determined that the “the appropriate values lie in between “the values provided by the taxpayers and the IRS. The Tax Court determined that the value claimed by the taxpayers for the fee simple gift was appropriate.

With respect to the conservation easement, the value determined by the court created the potential for both a negligence and substantial understatement of tax penalty and a substantial valuation misstatement penalty. See IRC 6662(a), (b)(1), (b)(3).

The Tax Court held that the taxpayer was not liable for the negligence and substantial understatement of tax penalty because the taxpayer acted in good faith and had reasonable cause for the understatement. The taxpayer relied in good faith on the appraisals performed by Mr. Quinn and on the advice of the tax return preparer who had competently represented them for many years. Mr. Quinn had significant experience valuing real estate in Bucks County. … [The taxpayers’] return preparer was likewise knowledgeable about property donations, including conservation easements. [The taxpayers] made full disclosure of all relevant facts to them both.”

The Tax Court found that the Taxpayers also satisfied the additional requirements to have a good faith defense to a substantial valuation misstatement penalty. The IRS did not dispute that Mr. Quinn was a qualified appraiser or that the appraisal provided by Mr. Quinn was a qualified appraisal. The taxpayers demonstrated that they made a good faith investigation into the value of the donated conservation easement because they were involved from the outset in the negotiations to formulate a
conservation plan for the area, they worked with the township and Heritage Conservancy, were aware of demand for land in the Township, and relied on experts to determine the appropriate method to accomplish the parties conservation goals.


a. **Overview.** In Wendell Falls, the Tax Court seemed to determine that there is no deduction allowable for a conservation easement that “enhances” the value of other property owned by a donor taxpayer or provides the taxpayer with a substantial benefit. The case involved a developer that placed a conservation easement over certain property located within one of its ongoing development projects. The developer then sold the easement-encumbered property (which was restricted to use as a park) to Wake County at what it claimed was a “bargain price.”

b. **Enhancement.** At trial, none of the expert reports provided by the IRS nor the taxpayer determined that the contribution of the conservation easement “enhanced” the value of any other property owned by the taxpayer. However, disregarding the experts’ opinions, the Tax Court concluded that the conservation easement enhanced the value of other property owned by the taxpayer—because the court inferred that the presence of a park benefited the yet-to-be-sold, adjacent lots. The Tax Court then took the unprecedented step of determining the presence of such enhancement caused the entire conservation easement donation to be nondeductible, citing U.S. v. American Bar Endowment, 477 U.S. 105, 116 (1986). The Tax Court’s holding in Wendell Falls could be construed to invalidate the “Enhancement Regulation.” Treas. Reg. § 1.170A-14(h)(3)(i)(fifth sentence).

The Tax Court’s decision marks a radical departure from prior conservation easement jurisprudence, as well as the Treasury regulations pertaining to the valuation of conservation easement donations. The regulations specifically dictate how any increase in the value of other property owned by a taxpayer or related person is to be handled in the context of a “before and after” conservation easement valuation. The regulations account for this possibility by requiring any appraisal to account for the value of any such “enhancement,” by reducing the amount of the charitable deduction by such enhancement value.

c. **Substantial Benefit.** The taxpayer’s representative emailed the donee of the conservation easement—Wake County North Carolina—that it “need[ed] to ensure that the County uses the [contributed] park for its intended use.”
intended use of the eased acres was to be maintained as a park. The Tax Court determined that the email “confirmed” that the donor had an “expectation of receiving a substantial benefit.”

The Tax Court states that, “[n]o deduction for a charitable contribution is allowed if the taxpayer expects a substantial benefit from the contribution.” The Tax Court’s opinion in Wendell Falls appears to also, by implication, invalidate the Substantial Benefit Regulation. Treas. Reg. § 1.170A-14(h)(3)(i) (sixth and seventh sentences).

The Substantial Benefit Regulation does not provide that donor receipt of any substantial benefit automatically disallows the charitable deduction, as opinion in Wendell Falls indicates. Rather, the Substantial Benefit Regulation directs that the value of financial or economic benefits received by a donor, even if substantial, reduces (rather than disallows) a donor’s charitable deduction. If the value of the benefits received by the donor exceed the value of the contributed property, then the Substantial Benefit Regulation would render the contribution valueless.

d. **Opinion.** The Tax Court focuses on the taxpayer’s apparent “expectation” of substantial or enhancement benefits when donating the conservation easement. The expectation being that the property would continue to be utilized as a park once encumbered by the conservation easement and owned by Wake County. The court’s opinion seems to blur the line between expectation of a post-contribution use that may result in enhancement value to other property owned by the taxpayer (which reduces the value of a charitable deduction), receipt of substantial benefits received by the taxpayer in conjunction with the contribution (which reduces the value of a charitable deduction), and quid pro quo (which disallows a charitable deduction altogether). Indeed, the Tax Court reasons that the taxpayer’s deduction “is not allowable because of this expectation.” It is likely that many other donors could have the same or a similar expectation with respect to their properties once eased.

In Wendell Falls, the experts for the taxpayer and the IRS all agreed that the conservation easement did not enhance the value of the taxpayer’s other property. The Tax Court, however, disagreed with both experts, finding that the donation of the conservation easement created an (unspecified amount of) enhancement to the value of other property owned by the taxpayer. Although this disregard of the unanimous conclusion of the experts was itself notable, the Tax Court’s ruling that the presence of such enhancement caused the entire contribution to be nondeductible is significantly more consequential.
It is difficult to ascertain the full implications of the court’s decision. Taken to its logical conclusion, it could mean the presence of any “enhancement” in value to a taxpayer’s property or substantial benefit received causes a conservation easement donation to be nondeductible—Treasury regulations notwithstanding. We expect the IRS will now take this position during audit.

It is unclear if the Tax Court intended it’s opinion to invalidate both the Substantial Benefit Regulation and the Enhancement Regulation. However, the opinion in Wendell Falls can easily be construed as implicitly invalidating both regulations. Irrespective of the Tax Court’s intent, unless the opinion in Wendell Falls gets appealed, vacated, or otherwise revised, donors of conservation easements (and other types of charitable property) should be weary of incidental or consequential benefits that they may receive in conjunction with a charitable deduction.


   a. **Overview.** In Triumph, the taxpayer was a developer of a large-mixed use planned unit development in Lehi, Utah. The developer was producing a new plan for the development in order to take advantage of additional development credits that it had acquired. To take advantage of these development credits the developer was required to get city council’s approval of the development plans.

   The city of Lehi imposes requirements on planned unit developments such as a maximum density of 4.2 lots per acre and a minimum of 10% of open space. The city’s preference is for the open space to be contributed to the city. Before submitting development plans to the city council, the taxpayer had the city’s Development Review Committee and the Planning Commission review the plans.

   The Development Review Committee indicated that the city of Lehi wanted all of the open space to be dedicated to the city concurrent with the new plan’s approval. The Planning Commission agreed to approve and recommend that the city council approve the development plan if the open space areas were to be dedicated to the city. The city council approved the development plan on condition that the open area be dedicated to the city as recommended by the Development Review Committee and Planning Commission.
b. **Tax Court Holding** The Tax Court described the issue as whether the taxpayer “actually made a charitable contribution or whether the transfer was part of a quid pro quo arrangement as the Commissioner alleges.” The Court also mentions the *U.S. v. American Bar Endowment*, 477 U.S. 105, 116 (1986) case, which disallows a charitable contribution when the taxpayer receives substantial benefits that have a value in excess of the value of what was contributed.

The Tax Court determined that the contribution to the city was part of a quid pro quo arrangement. It found that the taxpayer donated the property in exchange for the city council’s approval of the development plan. Moreover, the court determined that the taxpayer did not prove that the contributed open space was worth more than the substantial benefit it received (i.e., city council approval). The court rejected the taxpayer’s argument that the benefits received were merely incidental to the contribution. Accordingly, the court disallowed the taxpayer’s $11,040,000 deduction associated with the contribution of the open space to the city of Lehi.

c. **Commentary.** *Triumph* is not a conservation easement case. However, it provides guidance to taxpayers making charitable deductions, such as conservation easements, to be wary of representations made when negotiating with government officials. The taxpayers in *Triumph* had a deduction of $11,040,000 disallowed merely for following the customary protocols for planned unit developments with the city of Lehi. Indeed, the taxpayer was following the express recommendations of the Development Review Committee and Planning Commission.

H. **BASELINE.**


I. **CONTEMPORANEOUS WRITTEN ACKNOWLEDGEMENT.**


   a. **Overview.** The taxpayer donated a conservation easement and claimed a charitable contribution deduction of $64,490,000 on its partnership return for the 2007 tax year. This case involved the substantiation requirement imposed on a donor of charitable property. “In order to substantiate a charitable contribution deduction of $250 or more, a taxpayer must secure and maintain in its files a “contemporaneous written acknowledgment” (CWA) from the donee organization. I.R.C. sec. 170(f)(8)(A). The CWA
must state (among other things) whether the donee provided the donor with any goods or services in exchange for the gift. I.R.C. sec. 170(f)(8)(B)(ii).”

The substantiation requirements of section 170(f)(8)(A) do not apply to a contribution “if the donee organization files a return, on such form and in accordance with such regulations as the Secretary may prescribe,” that includes the information specified in subparagraph (B). I.R.C. § 170(f)(8)(D). As of the date of the opinion (and of this writing), Treasury has not issued regulations to implement the donee-reporting regime referred to in subparagraph (D).

b. **IRS Audit Amended Form 990 Filed.** The IRS audited the LLC’s 2007 partnership return and determined that the charitable contribution deduction should be disallowed in its entirety. Subsequent to the audit and the case being docket in Tax Court, the donee—Trust for Architectural Easements (“Trust”)—filed an amended Form 990, Return of Organization Exempt from Income Tax, that included the information required by section 170(f)(8)(B). The LLC thereafter filed a motion for partial summary judgment, contending that this action by the Trust eliminated, as a matter of law, the need for a CWA.

On its initial Form 990, Return of Organization Exempt from Income Tax, for calendar year 2007, the Trust did not report receipt of a charitable contribution from the LLC. Nor did it report whether it had provided any goods or services to the LLC in exchange for the easement.

c. **Tax Court Decision.** The court was faced with a familiar inquiry: whether a Code section “is self-executing in the absence of implementing regulations.”

This case thus requires us to address a question that has arisen with some frequency: How should a court respond when a taxpayer or the IRS desires to have a particular tax treatment apply in the absence of the regulations to which the statute refers? In some cases, the Secretary may have affirmatively declined to issue regulations, having concluded that they are unnecessary or inappropriate. In other cases, the Secretary may intend to issue regulations but may have encountered delays because of subject matter complexity or the press of other business. **Courts have described the question presented here as whether the statute is “self-executing” in the absence of regulations. …**
The courts have struggled to define the proper judicial response in these scenarios. In each case, Congress has delegated to an executive branch agency the task of using its expertise to craft appropriate regulations. Under the Administrative Procedure Act and familiar separation-of-powers principles, a court's usual role is to review the regulations an agency has issued, not to conjure what regulations might look like had they been promulgated. On the other hand, if it is absolutely clear that Congress intended that a particular tax benefit or tax treatment should be available, a legitimate question arises as to whether the IRS may prevent that outcome by declining to engage in rulemaking. Commentators have described this scenario as one of “spurned delegations” and the resulting judicial dilemma as one of crafting “phantom regulations.”

Tax court ruled that 170(f)(8)(D) was not self-executing and not operative without Treasury regulations. This led the court to conclude that the 990 returns filed by the land trust did not provide valid substitutes for the CWA.

   
a. **Overview.** In French, the taxpayer did not receive from the donee organization a timely letter of the sort that normally acts as a “contemporaneous written acknowledgment” (CWA) within the meaning of section 170(f)(8)(B). Taxpayer contended that it nevertheless satisfied the statutory substantiation requirements relying on two documents.

   The first was the letter from an MLR representative to Davy and Priscilla French dated June 6, 2006. Because the taxpayers filed their 2005 amended return on or before April 15, 2006, the court determined that the letter was not contemporaneous with petitioners’ 2005 return and could not satisfy the substantiation requirements.

   The second was the conservation deed recorded on December 29, 2005. The IRS and the taxpayers disputed whether the conservation easement deed satisfies the contemporaneous written acknowledgment” (CWA) imposed by Section 170(f)(8)(B)(ii), which requires that a CWA state whether the donee organization provided goods or services in exchange for the donor's charitable contribution.

b. **Did CE Deed meet § 170(f)(8).** The Court described the test for determining if a conservation easement deed satisfied the CWA requirement:
“We have held that a deed of conservation easement may satisfy the substantiation requirements of section 170(f)(8), including subparagraph (B)(ii). … Generally, to satisfy the requirement of section 170(f)(8)(B)(ii), the deed must contain a statement about whether the donee provided goods or services for the contribution. … When a deed does not contain an explicit statement, this Court has looked to the deed as a whole to determine whether the donee provided goods or services.”

The Tax Court determined “that the conservation deed did not state whether the donee provided goods or services in exchange for the charitable contribution. Therefore we must analyze whether the deed taken as a whole shows compliance with section 170(f)(8)(B)(ii).”

In analyzing the conservation easement deed as a whole, the court noted that it “includes provisions stating that the intent of the parties is to preserve the property.” However, the conservation easement deed did not include “a provision stating that it is the entire agreement of the parties” (i.e., a merger/integration clause).

The lack of a merger clause led the tax court to conclude “that the conservation deed taken as a whole is insufficient to satisfy section 170(f)(8)(B)(ii), because without a merger clause, the IRS could not have determined by reviewing the conservation deed whether [taxpayers] received consideration in exchange for the contribution of the conservation easement.”


   a. **Overview.** In 310 Retail, the taxpayer did not receive from the donee organization a timely letter of the sort that normally acts as a “contemporaneous written acknowledgment” (CWA) within the meaning of section 170(f)(8)(B). Taxpayer contended that it nevertheless satisfied the statutory substantiation requirements relying on three documents.

   The first two documents were the donee’s 990, Return of Organization Exempt from Income Tax. After the time the taxpayer filed its motion for summary judgment but before the court had issued its opinion, the Tax Court released its en banc opinion in **15 West 17th Street LLC v. Comm’r**, 147 T.C. No 19 (2016), which held that subsequently filed partnership returns do not satisfy the CWA requirement. The taxpayer acknowledged that the Tax
Court’s en banc opinion in 15 West 17th Street was dispositive of his contention with respect to the land trust’s return.

b. **Tax Court Holding.** The Tax Court did find that the easement deed qualified as a CWA: “The deed of easement in the instant case is similar in all material respects to the deed in RP Golf, LLC, and we reach here the same result we reached there. The deed of easement was properly executed by LPCI’s president and recorded by the Cook County Recorder of Deeds on December 30, 2005. It thus constituted a “contemporaneous” acknowledgment. See I.R.C. § 170(f)(8)(C).”

   
a. **Overview.** In Big River, the taxpayer did not receive from the donee organization a timely letter of the sort that normally acts as a “contemporaneous written acknowledgment” (CWA) within the meaning of section 170(f)(8)(B). The taxpayer contends that it nevertheless satisfied the statutory substantiation requirements because the deed of easement constituted a de facto CWA.

   After reviewing relevant case law, the Tax Court “concluded that the deed of easement [in Big River], like the deeds of easement in Averyt and RP Golf, LLC, qualified as a CWA because it included an affirmative indication that the donee organization had supplied no goods or services to the taxpayer in exchange for its gift. ... the deed of easement involved here resembles in material respects the deeds of easement involved in 310 Retail, LLC, and RP Golf, LLC . . . It thus constituted a “contemporaneous” acknowledgment.”

b. **Tax Court Holding.** In granting the taxpayer’s motion for summary judgment, the Tax Court determined, as a matter of law, that the easement deed satisfied the CWA requirement. The court relied on its prior case law: “We have previously held that a deed of easement may constitute a CWA. See 310 Retail, LLC v. Comm’r, T.C. Memo. 2017-164; RP Golf, LLC v. Comm’r, T.C. Memo. 2012-282; Averyt v. Comm’r, T.C. Memo. 2012-198.” (internal citations abbreviated).

J. **QUALIFIED ORGANIZATION.**

1. **IRS Release 20140518.**
   
a. **Overview.** IRS Release 20140518 tells a tale of woe in which an organization that considered itself a qualified organization, and had previously received an advanced ruling from the IRS that the organization...
was exempt from tax under Section 501(a) of the Code as a 501(c)(3) organization, lost its status as an exempt organization under Section 501(c)(3) because it was not being operated for exempt purposes.

In revoking tax exempt status, IRS concluded that the organization was simply a conduit for the entity’s president who is described as having vast knowledge and experience in the field of public accounting as demonstrated by his being one of less than 250 non-lawyers nationwide admitted to practice before the US Tax Court to help his clients obtain sizable deductions.

In its analysis, the IRS reviewed in detail three land transactions that the entity had entered into that were deemed to be connected to the president and show that the president’s intent and goals were not concerned with environmental or conservation issues, but rather that the president used the organization as a vehicle for enrichment of his clients.

b. **Comment.** This Release illustrates that the role of the land trust in conservation easement transactions is very important and that a key to successfully donating a conservation easement includes making sure that the donee of such a grant truly is a “qualified organization.” The Release puts all on notice to carefully review each potential donee of a conservation easement to be certain that it satisfies the Code’s requirement for being a “qualified organization.”
Ronald A. Levitt is a shareholder at the law firm of Sirote & Permutt, P.C. Mr. Levitt handles federal and state controversy matters, and charitable deduction planning, including planning and defending conservation easements. He also counsels clients in business planning, succession planning, estate planning, entity formation, specifically the formation of S Corporations, limited liability companies, and other flow-through entities, mergers and acquisitions, purchases and sales of businesses and healthcare law through the representation of physician practices.

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An AV rated Martindale-Hubbell attorney, Levitt was recognized by Best Lawyers in America as Birmingham's "2012 Best Lawyer of the Year" for Tax Law. Best Lawyers in America has recognized Mr. Levitt for more than 20 years in the areas of Tax, Litigation & Controversy-Tax, Corporate Law and Health Care Law. Additionally, Mr. Levitt has been recognized by Mid-South Super Lawyers for Tax from 2008 to Present, and by the Birmingham Magazine as Top Attorney, Tax for 2009-10.

Mr. Levitt earned his JD from the University of Alabama School of Law, his BS and MBA from the University of Alabama and his LLM in Taxation from University of Florida School of Law.