COMMITTEE REPORT:
VALUATIONS

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An Oldie But Not a Goodie

Putting a new conservation easement case into perspective

Manipulation of information is remarkably easy these days thanks to the Internet, and tax issues aren't immune to this phenomenon. Essentially all parties, including the Internal Revenue Service, tend to describe events in the manner most favorable to themselves, with hopes of influencing opinion, controlling the narrative or creating reality.

The Tax Court recently issued *Brooks v. Commissioner*,[1] a conservation easement case in which the taxpayers suffered a tax deduction of $0 and large penalties thanks to flawed documents and appraisals. Logic dictates that the IRS will portray this case as a major victory, a sign of resurgence amid recent defeats. It isn't. Let's review the easement donation process, the initial attacks by the IRS, a series of victories by taxpayers and the true significance of *Brooks*.

Conservation Easement Donations

Taxpayers who own undeveloped real property have several choices, one of which is voluntarily restricting future uses for the benefit of society as a whole. This is called "donating a conservation easement," and it often triggers tax deductions for donors.[2]

Protected property needs to be special. Taxpayers must demonstrate that the property placed under easement has at least one acceptable "conservation purpose."[3] These include preserving land for public recreation or education, safeguarding a relatively natural habitat for plants and animals, maintaining open space for public enjoyment or using property pursuant to a government conservation policy.[4]

Taxpayers memorialize a donation by filing a Deed of Conservation Easement or similar document (Deed). In preparing the Deed, taxpayers often identify limited activities that they can continue on the property after the donation, without prejudicing the conservation purposes (Reserved Rights).[5]

An appropriate party must receive the conservation easement in order to trigger the tax deduction. This means certain types of governmental, private or tax-exempt entities, which are committed to protecting the conservation purposes and which possess sufficient resources to enforce the restrictions in the Deed (Qualified Organization).[6] A land trust often serves as the Qualified Organization, for logical reasons.

The IRS won't allow the tax deduction stemming from a conservation easement unless the taxpayer obtains documentation establishing the condition and characteristics of the property around the time of the donation (Baseline Report).[7] Given its purpose, expertise, personnel and policy of only accepting conservation-worthy projects, a land trust frequently prepares the Baseline Report.

Taxpayers donate the conservation easement to the land trust, along with money so that the land trust has sufficient resources to oversee and enforce the Deed forevermore (Stewardship Fee). The land trust uses the Stewardship Fee to inspect the property regularly, generate monitoring reports, take legal actions to halt transgressions and more.[8] The land trust must provide taxpayers a so-called "contemporaneous written acknowledgment" (CWA) to confirm receipt of both the conservation easement and the Stewardship Fee.

The value of the conservation easement is the fair market value (FMV) of the property at the time of

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the donation.[9] The term "FMV" ordinarily means the price on which a willing buyer and willing seller would agree, if neither party were obligated to participate in the transaction and if both parties had reasonable knowledge of the relevant facts.[10] The best evidence of the FMV of an easement is the sale price of other easements of comparable size and location. The IRS recognizes that it's difficult, if not impossible, to find them.[11]

Consequently, appraisers often must use the before-and-after method instead. This means that they need to determine the highest and best use (HBU) of the property *and* the corresponding FMV twice. First, appraisers calculate the FMV as if the property had been put to its HBU, which generates the "before" value. Second, appraisers identify the FMV, taking into account the serious restrictions on the use of property imposed by the conservation easement, which creates the "after" value.[12] The difference between the "before" and "after" values of the property, with certain adjustments, produces the amount of the donation.

Claiming the tax deduction from an easement donation is surprisingly complicated; it involves several actions and documents. Among other things, taxpayers must obtain a Qualified Appraisal, demonstrate that the land trust is a Qualified Organization, obtain an adequate Baseline Report, prepare and file the Deed, complete Form 8283 (Noncash Charitable Contributions), receive CWAs verifying the donations and file a timely tax return with all necessary enclosures and disclosures.[13]

Initial Attacks by the IRS

In December 2016, the IRS announced in Notice 2017-10 that it intended to challenge what it coined "syndicated" conservation easement transactions on the grounds that they supposedly constitute "tax-avoidance transactions" characterized by serious overvaluations.[14] One effect of Notice 2017-10 was that many easement donations by partnerships became "listed transactions." All participants, therefore, had to enclose a Form 8886 (Reportable Transaction Disclosure Statement) with their tax returns for every year of participation, as well as send a copy for the first year to the Office of Tax Shelter Analysis.[15] The IRS used the data on Forms 8886 to identify easement donations and begin audits.

The IRS has consistently stated that the main problem with easement donations is inflated valuations. However, the primary focus of the IRS in tax disputes for many years was on "technical" flaws; that is, issues *unrelated* to valuation. These ordinarily consisted of alleged shortcomings with the Qualified Appraisal, Deed, Baseline Report, Form 8283, CWA or other documents affiliated with the donations.[16] To the dismay of taxpayers, the Tax Court ruled in favor of the IRS on technical issues in several early cases.[17]

> *Hewitt v. Comm'r* held that the IRS broke the law when it came to the regulation addressing the proper division of sales proceeds when an easement is extinguished.

A Shift in Momentum

Things changed over time, with taxpayers marking several significant victories. For example, the U.S. Court of Appeals for the Eleventh Circuit held in *Hewitt v. Comm'r* that the IRS broke the law when it came to the regulation addressing the proper division of sales proceeds (between the owner of the property and the land trust) when an easement is extinguished. This occurs, for instance, when a government forcibly purchases eased property via condemnation or eminent domain proceedings to build a road, locate phone towers, run power lines, etc. The Eleventh Circuit ruled that the IRS violated the Administrative Procedures Act (APA) in construing the relevant regulation.[18]

The IRS then incurred a series of APA-related losses, two of which centered on conservation easements. First, the government filed an answer in a district court case admitting that Notice 2017-10 is a legislative rule, the IRS didn't follow the notice-and-comment procedures of the APA and the IRS wasn't exempt from such procedures; therefore, Notice 2017-10 is invalid.[19] The district

court agreed with the government's concession, declaring Notice 2017-10 "unlawful" and setting it aside with respect to the particular taxpayer in that case.[20] Second, the Tax Court held in *Green Valley Investors, LLC v. Comm'r* that the IRS violated the APA in issuing Notice 2017-10 labeling "syndicated" easements listed transactions.[21] Regarding the broad scope of its decision, the Tax Court expressly stated that it "intends to apply this decision setting aside Notice 2017-10 *to the benefit of all similarly situated taxpayers who come before us.*"[22]

Finally, several courts have accepted easement valuation methods advanced by taxpayers. One example is *Glade Creek Partner, LLC v. Comm'r*, in which both the Tax Court and Eleventh Circuit held that one should value an easement donation by identifying the HBU of the property, using the before-and-after method and applying a discounted cash-flow analysis.[23] The Tax Court also agreed with the taxpayer's manner of gauging value in *Champions Retreat Golf Founders, LLC v. Comm'r*.[24] In that case, the Tax Court ultimately held that the easement was worth about $7.8 million or 75% of the charitable tax deduction originally sought by the partnership.

> The conservation easement donation in *Brooks* suffered from numerous technical flaws, including a non-existent or deficient CWA, Deed, Baseline Report and Form 8283.

Two Steps Forward, One Step Back

After suffering the defeats described above, the IRS likely will try to characterize *Brooks*, a Tax Court case released in December 2022, as a sign that it's back on track.[25] Here are the key aspects of the case.

The taxpayers, husband and wife, purchased about 85 acres through a partnership in which they were the only two members. They bought the land on Dec. 15, 2006 for $1.35 million. They subdivided the property that same day, creating one parcel of 44 acres and another of 41 acres. They then waited more than one year, such that the property met the requirement of being a long-term capital asset.

The taxpayers donated a conservation easement on the 41 acres (Relevant Parcel) to Liberty County, Ga., a Qualified Organization, on Dec. 27, 2017. The taxpayers memorialized the donation in a Deed, to which they attached a half-page description of the land, two basic maps and a five-page Baseline Report.

The partnership filed its Form 1065 (U.S. Return of Partnership Income) for 2007 claiming a charitable tax deduction of $5.1 million. The partnership attached a Form 8283, which mistakenly showed the cost basis in the Relevant Parcel as $1.35 million. That figure represented the purchase price in December 2006 of the *entire 85 acres*, not just the amount allocable to the 41 acres comprising the Relevant Parcel. The tax deduction of $5.1 million flowed from the partnership to its only two partners, the taxpayers. They claimed only a small portion of the tax deduction on their Form 1040 (U.S. Individual Income Tax Return) for 2007, carrying forward the remaining deduction for use in future years.

The IRS audited the Forms 1040 of the taxpayers for 2010, 2011 and 2012, years after the easement donation in 2007 to which the taxpayers had carried forward the tax deduction. The IRS eventually issued a Notice of Deficiency to the taxpayers, disallowing all deductions claimed in the later years and imposing the highest possible penalty because the Form 1065 filed by the partnership allegedly contained a "gross valuation misstatement." The taxpayers disputed the Notice of Deficiency by filing a Petition with the Tax Court.

The taxpayers lost decisively, with the Tax Court identifying several problems. First, it appears that the recipient of the conservation easement (that is, Liberty County, Ga.) failed to provide a CWA. In light of this oversight, the taxpayers argued that the language in the Deed, by itself, adequately demonstrated that they didn't receive any goods or services from Liberty County in exchange for the donation. The Tax Court rejected this contention because the Deed contained only boilerplate language about the type of consideration received, and it lacked a so-called merger clause stating that

the Deed constituted the entire agreement between the parties. Moreover, the Tax Court rebuffed the taxpayers' explanation that they relied on their attorneys and accountant to do everything correctly because the law doesn't feature a "reasonable cause" exception to the CWA requirement.[26]

Second, the Tax Court held that the Baseline Report was insufficient in that it failed to explain adequately the condition of the Relevant Parcel at the time of the donation. The Tax Court offered several criticisms in this regard, including that the Baseline Report lacked survey maps, photographs and detailed descriptions of the vegetation, forests, wetlands, access roads and improvements.[27]

Third, the Tax Court determined that the Form 8283 was fatally flawed. As explained above, instead of showing the cost basis for just the 41 acres constituting the Relevant Parcel, the Form 8283 reflected the basis of the partnership in the entire 85 acres, or $1.35 million. The IRS argued that reporting a cost basis twice its actual size prevented it from scrutinizing the extent of the potential easement overvaluation, which is the purpose of the requirement. The taxpayers, for their part, suggested that the inaccurate basis data on Form 8283 was merely a scrivener's error, which created no problems for the IRS because the partnership disclosed all relevant facts about the easement donation elsewhere in its Form 1065 for 2007 and attachments. The Tax Court sided with the IRS. It explained that Congress introduced the heightened substantiation requirements, including completion of Form 8283, to prevent the IRS from having to "sleuth through the footnotes of millions of returns."[28] The Tax Court concluded that stating a cost basis double the accurate amount didn't constitute strict or substantial compliance with the Form 8283 duty.[29]After deciding that the taxpayers should get a tax deduction of $0 because of technical problems, the Tax Court turned to sanctions. It had to determine the true value of the easement donation to identify which penalty to impose. The partnership claimed a value of $5.1 million on its Form 1065 for 2007, which means that the "gross valuation misstatement penalty" would apply automatically if the Tax Court were to find the easement was really worth $2.55 million or less.

The case, as with all conservation easement disputes, triggered a battle of the appraisers. The partnership's expert and the IRS' expert agreed that the HBU of the property, *before* donation of the easement, was construction of a residential subdivision. Concurrence stop there, though. The partnership's expert claimed that the easement was worth $3.63 million, while his IRS counterpart suggested that the appropriate figure was only $470,000. The Tax Court agreed with the latter and identified shortcomings with the former. It explained, in particular, that the partnership's expert failed to support several of the assumptions on which he based his calculations, such as that the partnership could obtain a zoning change and the neighboring property owners would grant access from the Relevant Parcel to the public road.

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The Tax Court went on to indicate that, even if residential development were plausible, the appraisal by the partnership's expert contained "significant errors" that inflated the valuation. The appraisal supposedly cited incorrect zoning, confused the location of the Relevant Parcel in relation to the nearest highway, mischaracterized the surrounding neighborhood, insufficiently accounted for differences among comparable developments, employed inferior cost projections, overstated the maximum number of lots capable of development, relied on data from transactions that occurred many years earlier and ignored the price that the taxpayers paid for the entire 85 acres essentially one year before they donated an easement on the Relevant Parcel.

The Tax Court agreed with the IRS' expert. Given

the significant difference between the tax deduction claimed on the Form 1065 for 2007 (that is, $5.1 million) and the amount decided by the Tax Court (that is, $470,000), the taxpayers were stuck with the tax liabilities, plus the gross valuation misstatement penalty equal to an additional 40% of such liabilities, plus interest charges accruing over many years.[30]

Differentiating *Brooks*

The conservation easement donation in *Brooks* suffered from numerous technical flaws, including a non-existent or deficient CWA, Deed, Baseline Report and Form 8283. It had serious valuation problems, too, with the Tax Court ruling that the easement was worth less than 10% of the amount originally claimed. This led to imposition of the highest possible penalty, with no chance for the taxpayers to avoid it based on reasonable cause.

The IRS likely will try to characterize *Brooks* as a sign that it's regained control in the easement space, but that's simply not the case, pun intended. That dispute involved a conservation easement made in 2007, a decade *before* the IRS issued Notice 2017-10 identifying certain transactions as problematic, a decade *before* the IRS launched a full-scale compliance campaign focused on easements and a decade *before* the Tax Court began publishing opinions alerting taxpayers to technical pitfalls.

The types of actions and issues addressed in *Brooks* are, as they say, ancient history. By contrast, recent easement cases feature significant pre-donation due diligence, few potential technical problems and appraisals prepared in accordance with the methods expressly approved by the Tax Court in *Glade Creek Partner, LLC*, *Champions Retreat Golf Founders, LLC,* and elsewhere. When gauging the status of conservation easement disputes, taxpayers and their advisors should be cautious to avoid making an apples-to-oranges comparison based on *Brooks*.

Endnotes

1. *Brooks v. Commissioner*, T.C. Memo. 2022-122.
2. Internal Revenue Code Section 170(f)(3)(B)(iii); Treasury Regulations Section 1.170A-7(a)(5); IRC Section 170(h)(1); IRC Section 170(h)(2); Treas. Regs. Section 1.170A–14(a); Treas. Regs. Section 1.170A–14(b)(2).
3. IRC Section 170(h)(4)(A); Treas. Regs. Section 170A–14(d)(1); S. Rept. 96–1007, at p. 10 (1980).
4. IRC Section 170(h)(4)(A); Treas. Regs. Section 170A–14(d)(1).
5. Internal Revenue Service Conservation Easement Audit Techniques Guide (Rev. Nov. 4, 2016), at p. 23; *see also* Treas. Regs. Section 1.170A-14(b)(2); Treas. Regs. Section 1.170A-14(e)(2) and (3).
6. Section 170(h)(3); Treas. Regs. Section 1.170A-14(c)(1).
7. Treas. Regs. Section 1.170A-14(g)(5)(i).
8. Treas. Regs. Section 1.170A-14(c)(1); Treas. Regs. Section 1.170A-14(g)(5)(ii).
9. IRC Section 170(a)(1); Treas. Regs. Section 1.170A-1(c)(1).
10. Treas. Regs. Section 1.170A-1(c)(2).
11. IRS Conservation Easement Audit Techniques Guide (Rev. Jan. 24, 2018), at p. 43.
12. *Ibid.,* at p. 43.
13. *Ibid.,* at p. 43.
14. *See ibid.,* at pps. 24-31; IRS Publication 1771, Charitable Contributions —Substantiation and Disclosure Requirements; IRS Publication 526, Charitable Contributions; Section 170(f)(8); Section 170(f)(11); Treas. Regs. Section 1.170A-13; Notice 2006-96; TD 9836.
15. Notice 2017-10, Preamble and Section 1.
16. *See, e.g.,* Hale E. Sheppard, "20 Recent Enforcement Actions in Conservation Easement Disputes: Awareness and Preparation Are Key," *Journal of Taxation* at p. 15 (2021).
17. *See, e.g, Dasher's Bay at Effingham, LLC v. Comm'r*, Tax Court Docket No. 4078-18 (Dec. 10, 2019); *Ogeechee River Preserve, LLC v. Comm'r*, Tax Court Docket No. 2771-18 (Dec. 10, 2019); *River's Edge Landing, LLC v. Comm'r*, Tax Court Docket No. 1111-18, (Dec. 10, 2019); *TOT Property Holdings, LLC v. Comm'r*, Tax Court Docket No. 5600-17 (Dec. 13, 2019).
18. *Hewitt v. Comm'r*, 21 F.4th 1336 (11th Cir. 2021).
19. "Government Concedes in Conservation Easement Reporting Notice Case," 2022 *Tax Notes Today Federal* 100-23 (May 20, 2022).
20. *GBX Associates, LLC v. United States*, Case No. 1:22cv401, Memorandum Opinion and Order, District Court Ohio (Nov. 14, 2022).
21. *Green Valley Investors, LLC v. Comm'r*, 159 T.C. No. 5 (2022).
22. *Ibid.*, at footnote 22 (2022) (emphasis added).
23. *Glade Creek Partner, LLC v. Comm'r*, T.C. Memo. 2020-148; *Glade Creek Partner, LLC v. Comm'r*, No. 21-11251 (11th Cir. Aug. 22, 2022),
24. *Champions Retreat Golf Founders, LLC v. Comm'r*, T.C. Memo. 2018-146; *Champions Retreat Golf Founders, LLC v. Comm'r*, 959 F.3d 1033 (11th Cir. 2020); *Champions Retreat Golf Founders, LLC v. Commissioner*, T.C. Memo 2022-106.
25. *Supra* note 1.
26. *Ibid.,* at pps. 10-13.
27. *Ibid.,* at pps. 13-15.
28. *Ibid.,* at p. 17.
29. *See supra* note 27.
30. *Ibid.*, at pps. 5-8, 18-22.