IRS Takes Extreme Position Regarding "Commercial Forestry" in Conservation Easement Disputes: Getting to the Root of the Matter

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Hale E. Sheppard examines the conservation easement donation process and potential flaws with the IRS's stringent position on "commercial forestry."

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I. Introduction

The IRS continues to attack partnerships that donate conservation easements and pass the corresponding charitable tax deductions to their partners. One of its favorite methods is to raise a number of "technical" arguments, which ordinarily focus on alleged problems with a deed of conservation easement ("Deed"). A victory on a technicality creates a windfall for the IRS in the sense that it eliminates all the tax benefits for the partners without obligating the IRS to address thornier substantive issues, like easement valuation.

In light of this reality, the IRS continues to introduce new "technical" arguments, such as a blanket assault on "commercial forestry." In a recent Tax Court case, *TOT Property Holdings, LLC*, the IRS took the position that conservation easements and commercial forestry are "inherently inconsistent" and simply "cannot coexist."[1] The Tax Court did not rule on the matter, as the case was resolved on other grounds. Therefore, this important issue remains open. This article explains the conservation easement donation process, categories of attacks typically employed by the IRS, main issues in *TOT Property Holdings*, and potential flaws with the IRS's stringent position on "commercial forestry."

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II. Overview of Conservation Easement Donations

Taxpayers who own undeveloped real property have several choices. For instance, they might (i) hold the property for investment purposes, selling it when it appreciates sufficiently, (ii) determine how to maximize profitability from the property and do that, regardless of the negative effects on the local environment, community, and economy, or (iii) donate an easement on the property to a charitable organization, such that it is protected forever for the benefit of society.

The third option, known as donating a "conservation easement," not only achieves the goal of environmental protection, but also triggers another benefit, tax deductions for donors. Taxpayers generally must donate their entire legal interest in a particular piece of property, not just part of their interest, in order to qualify for a tax deduction.[2] This is a critical concept, as taxpayers who own all attributes of a piece of real property (*i.e.*, they own it in "fee simple") do not donate the property outright to a charitable organization in the easement context. Instead, they retain ownership of the property, but convey an easement on such property to an independent, nonprofit organization with the ability, capacity, willingness, and resources to safeguard the property forever. This is usually a land trust. Provided that the easement, which is just a partial interest in property, constitutes a "qualified conservation contribution," taxpayers are entitled to the tax deduction.[3]

As one would expect, taxpayers cannot donate an easement on any old property and claim a tax deduction; they must demonstrate that the property is worth protecting. A donation has an acceptable "conservation purpose" if it meets at least one of the following requirements: (i) It preserves land for outdoor recreation by, or the education of, the general public; (ii) It preserves a relatively natural habitat of fish, wildlife, or plants, or a similar ecosystem; (iii) It preserves open space (including farmland and forest land) for the scenic enjoyment of the general public and will yield a significant public benefit; (iv) It preserves open space (including farmland and forest land) pursuant to a federal, state, or local governmental conservation policy, and will yield a significant public benefit; or (v) It preserves a historically important land area or a certified historic structure.[4]

Taxpayers memorialize the donation to charity by filing a public Deed. In preparing the Deed, taxpayers often coordinate with the land trust to identify certain limited activities that can continue on the property after the donation, without interfering with the Deed, without prejudicing the conservation purposes, and, hopefully, without jeopardizing the tax deduction.[5] These activities are called "reserved rights." The IRS openly recognizes, in its Conservation Easement Audit Techniques Guide ("ATG") and elsewhere, that reserved rights are ubiquitous in Deeds.[6]

The IRS will not allow the tax deduction stemming from a conservation easement unless the taxpayer provides the land trust, before making the donation, with "documentation sufficient to establish the condition of the property at the time of the gift."[7] This is called the Baseline Report. It may feature several things, including, but not limited to (i) the survey maps from the U.S. Geological Survey, showing the property line and other contiguous or nearby protected areas, (ii) a map of the area drawn to scale showing all existing man-made improvements or incursions, vegetation, flora and fauna (*e.g.*, locations of rare species, animal breeding and roosting areas, and migration routes), land use history, and distinct natural features, (iii) an aerial photograph of the property at an appropriate scale taken as close as possible to the date of the donation, and (iv) on-site photographs taken at various locations on the property.[8]

The value of the conservation easement is the fair market value ("FMV") of the property at the time of the donation.[9] The term FMV ordinarily means the price on which a willing buyer and willing seller would agree, with neither party being obligated to participate in the transaction, and with both parties having reasonable knowledge of the relevant facts.[10] The IRS explains in its ATG that the best evidence of the FMV of an easement would be the sale price of other easements that are comparable in size, location, usage, *etc*. The ATG recognizes, though, that it is difficult, if not impossible, to find comparable sales.[11] Consequently, appraisers often must use the before-and-after method instead. This means that an appraiser must determine the highest and best use ("HBU") of the property *and* the corresponding FMV twice. First, the appraiser calculates the FMV if the property were put to its HBU, which generates the "before" value. Second, the appraiser identifies the FMV, taking into account the restrictions on the property imposed by the easement, which creates the "after" value.[12] The difference between the "before" value and "after" value, with certain other adjustments, produces the value of the easement donation.

As indicated above, in calculating the FMV of property, appraisers and courts must take into account not only the current use of the property, but also its HBU.[13] A property's HBU is the most profitable use for which it is adaptable and needed in the reasonably near future.[14] The term HBU has also been defined as the use of property

that is physically possible, legally permissible, financially feasible, and maximally productive.[15] Importantly, valuation in the easement context does not depend on whether the owner has actually put the property to its HBU in the past.[16] The HBU can be *any* realistic potential use of the property.[17] Common HBUs are construction of a residential community, creation of a mixed-use development, or mining.

Properly claiming the tax deduction stemming from an easement donation is surprisingly complicated. It involves a significant amount of actions and documents. The main ones are as follows: The taxpayer must (i) obtain a "qualified appraisal" from a "qualified appraiser," (ii) demonstrate that the land trust is a "qualified organization," (iii) obtain a Baseline Report adequately describing the condition of the property at the time of the donation and the reasons why it is worthy of protection, (iv) receive from the land trust a "contemporaneous written acknowledgement," both for the easement itself and for any endowment/stewardship fee donated to finance perpetual protection of the property, (v) complete a Form 8283 (*Noncash Charitable Contributions*) and have it executed by all relevant parties, including the taxpayer, appraiser, and land trust, (vi) assuming that the taxpayer is a partnership, file a timely Form 1065, enclosing Form 8283 and the qualified appraisal, and (vii) send all the partners their Schedules K-1 (Partner's Share of Income, Deductions, Credits, *etc*.) and a copy of Form 8283.[18]

III. Categories of Challenges by the IRS

The IRS has been advancing a series of arguments to attack partnerships donating conservation easements, and the list continues to expand. The contentions by the IRS can be divided into the following categories.

A. Common "Technical" Arguments

The IRS has published an ATG concerning conservation easement donations, which Revenue Agents and other IRS personnel follow when conducting examinations.[19] The ATG contains a "Conservation Easement Issue Identification Worksheet." It sets forth a large number of technical challenges (*i.e.*, those not related to the valuation of the conservation easement) that the IRS might raise, including the following reasons for completely disallowing an easement-related tax deduction:

- The donation of the easement lacked charitable intent, because there was some form of quid pro quo between the partnership and the land trust;
- The donation of the easement was conditional upon receipt by the partnership of the full tax deduction claimed on its Form 1065;
- The land trust failed to give a proper "contemporaneous written acknowledgement" letter;
- The appraisal was not attached to the Form 1065 filed by the partnership;
- The appraisal was not prepared in accordance with the Uniform Standards of Professional Appraisal Practice;
- The appraisal fee was based on a percentage of the easement value;
- The appraisal was not timely, in that it was not sufficiently proximate to the making of the donation or the filing of the Form 1065 by the partnership;
- The appraisal was not a "qualified appraisal";
- The appraiser was not a "qualified appraiser";
- The Form 8283 was missing, incomplete, or inaccurate;
- The partnership's cost basis or adjusted basis in the donated property, as listed on Form 8283, was improperly calculated;
- The manner in which the partnership obtained the relevant property was incorrectly described as a "purchase" instead of a "contribution" by one of the partners;
- Not all appraisers who participated in the analysis signed Form 8283;
- The Baseline Report insufficiently described the condition of the property;
- The conservation easement was not protected in perpetuity;
- Any mortgages or other encumbrances on the property were not satisfied or subordinated to the easement before the donation;
- The Deed contains an improper clause regarding how the proceeds from sale of the property upon extinguishment of the easement would be allocated among the partnership and the land trust;
- The Deed contains an amendment clause, which, in theory, might allow the parties to modify the donation, after taking the tax deduction, in such a way to undermine the conservation purposes;
- The Deed contains a merger clause, as a result of which the fee simple title and the easement might end up in the hands of the same party, thereby undermining the ability to protect the property forever;
- The Deed was not timely filed with the proper court or other location;
- The land trust was not a "qualified organization";
- The land trust was not an "eligible done"; and

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- The property lacks acceptable "conservation purposes" for any number of reasons, including the habitat is not protected in a relatively natural state, there are insufficient threatened or endangered species on the property, the habitat or ecosystem to be protected is not "significant," the public lacks physical or visual access to the property, the property lacks historical significance, the conservation purposes do not comport with a clearly-delineated government policy, the easement allows uses that are inconsistent with the conservation purposes, the partnership has certain "reserved rights" that interfere with or destroy the conservation purposes, *etc*.[20]

B. Standard IRS Positions in Litigation

After conducting a multi-year audit, the IRS generally issues a notice of Final Partnership Administrative Adjustments ("FPAA") in all easement cases on the following generic terms.

1. Obscure Grounds for Disallowance of Tax Deduction

The standard approach by the IRS is to disallow the easement-related deduction based on one or more of the "technical" arguments under Code Sec. 170 described above. In other words, the IRS initially claims that the partnership is entitled to a deduction of $0 because of supposed flaws in the hundreds, if not thousands, of pages prepared in connection with a typical conservation easement. Then, as a backup plan, the IRS fully disallows the deduction for supposed valuation problems. Below is the language from an FPAA in a recent Tax Court case, which is representative of the stance that the IRS is taking in essentially all easement cases:

> It has not been established that all the requirements of I.R.C Section 170 have been satisfied for the non-cash charitable contribution of a qualified conservation contribution. Accordingly, the charitable contribution deduction is decreased by [the entire amount claimed by the partnership on its Form 1065].
>
> Alternatively, if it is determined that all the requirements of I.R.C Section 170 have been satisfied for all or any portion of the claimed non-cash charitable contribution, it has not been established that the value of the contributed property interest was greater than zero for the [relevant year]. Accordingly, the charitable contribution is decreased by [the entire amount claimed by the partnership on its Form 1065].

2. Equally Obscure Grounds for Asserting Penalties

In addition to fully disallowing the easement-related deduction based on a combination of alleged technical and valuation issues, the IRS ordinarily proposes in the FPAA several alternative penalties against the partnership, ranging in severity. These include (i) negligence, (ii) substantial understatement of income tax, (iii) substantial valuation misstatement, (iv) gross valuation misstatement, or (v) reportable transaction understatement penalty.[21] This is consistent with the ATG, which explains that an FPAA "will generally include a tiering of proposed penalties with multiple alternative positions."[22]

C. Theories Announced in IRS Notices

The IRS has been threatening for years to raise various theories for attacking conservation easements. For example, the IRS announced in Notice 2017-10, which was issued back in December 2016, that it intended to challenge certain easement transactions on grounds that they supposedly constitute "tax-avoidance transactions" and involve overvaluations.[23] The IRS further stated in Notice 2017-10 that it might challenge easements based on the partnership anti-abuse rules, the economic substance doctrine, and/or other unspecified rules and doctrines.[24]

D. Contentions in Injunction Lawsuit

In the Complaint filed by the Department of Justice ("DOJ") in District Court in December 2018 seeking an injunction against various persons in the easement industry, the DOJ alleged that the relevant partnerships are not true partnerships for federal tax purposes, they exist solely as a conduit to "sell" tax deductions, they are "shams," and they "lack economic substance."[25] Specifically, the DOJ claimed that the defendants either knew, or should have known, that (i) the partnerships that they organized, promoted, sold, and/or opined on had no business purpose other than tax avoidance, (ii) the partners did not join together for the purpose of carrying on a business and sharing in the profits or losses of such business, and (iii) the partnerships lack economic substance and are shams.[26]

E. Arguments Advanced in Earlier Tax Court Case

The IRS showed its willingness to raise novel positions in an ongoing case, *Champions Retreat Golf Founders, LLC*.[27] Despite the long list of initial challenges, the IRS eventually decided to drop many of them. In particular, the IRS conceded the following arguments that it raised in the FPAA or elsewhere: (i) The land trust was not a

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"qualified organization"; (ii) The partnership made a "disguised sale" of tax deductions; (iii) The allocation of the easement-related deduction to the partners did not have substantial economic effect and thus should not be respected; (iv) Each partner's deduction should be limited to the amount of his capital contribution to the partnership; and (v) The allocations of income and loss from the partnership were incorrect and inconsistent with the terms of the pertinent partnership agreements.[28]

IV. Studying the Relevant Case—*TOT Property Holdings*

As explained above, the ATG provides Revenue Agents and other IRS personnel with an extensive checklist of "technical" arguments that they should consider in auditing partnerships that donate conservation easements. The ATG seems to encourage creativity, explaining to IRS personnel that the checklist should not serve as a limitation. Indeed, it states that "[t]his worksheet is not an all-inclusive list of potential issues for donations of conservation easements [and] users should review IRC Section 170, DEFRA Section 155, the corresponding Treasury Regulations, Notice 2006-96, and case law." Taking this to heart, the IRS recently adopted the position in *TOT Property Holdings* that any Deed, allowing any amount of "commercial forestry," under any circumstances, should result in a complete disallowance of the tax deduction. Issues associated with this new IRS position are examined below.

A. Summary of Facts and Tax Court Determination

The original landowner bought the relevant property in 2005 for about $486,000. In November 2013, he indirectly contributed the property to the partnership ("PropCo") in exchange for a significant ownership interest. A month later, in December 2013, a partnership comprised of numerous individual investors ("InvesCo") purchased 99 percent of PropCo from the original landowner for $1,039,200. Extrapolating from this data, the price for 100 percent of PropCo would have been about $1,050,000.

The PropCo donated a conservation easement on the property to a land trust later in December 2013 and then claimed a tax deduction of $6.9 million on its 2013 Form 1065. The IRS eventually audited the PropCo and disallowed the deduction. Tax Court litigation ensued. The valuation expert presented by the IRS opined that (i) the HBU for the property before the donation was recreational use and timber harvesting, (ii) the HBU after the easement would be the same as before the donation, and (iii) the easement value was $496,000. The expert introduced by the PropCo disagreed with the IRS, of course. He indicated that (i) the HBU before the donation was a "low density, destination mountain resort residential development," (ii) the HBU after the donation was recreational use and timber harvesting, and (iii) the easement value was $2.7 million.

In addition to the value of the easement, the IRS challenged three "technical" issues related to the Deed, namely, the extinguishment clause, merger clause, and commercial forestry clause. With respect to the first issue, the Tax Court ruled that the "extinguishment clause" violated Reg. §1.170A-14(g)(6) ("Proceeds-Upon-Extinguishment Regulation"), and that the so-called "savings clause" in the Deed did not salvage matters for PropCo. Consequently, the Tax Court determined that PropCo was entitled to a tax deduction of $0.

Because the Tax Court completely resolved *TOT Property Holdings* by ruling in favor of the IRS regarding the Proceeds-Upon-Extinguishment Regulation, it did not address the second two issues. Thus, the Tax Court did not analyze or rule on the IRS's position that permitting any degree of "commercial forestry" in a Deed automatically triggers a tax deduction of $0. Considering that Deeds commonly contain provisions about timbers rights, and the likelihood that the IRS will trot out this position in future disputes, it is critical to analyze it further.

B. Review of Relevant Authorities

Reviewing tax provisions and regulations can be tedious, even for tax professionals. However, doing so is essential to understanding the significance of *TOT Property Holdings*. The main authorities raised by the parties are set forth below:

- Code Sec. 170(h)(4)(A) generally provides that the term "conservation purpose" means several things, including "the preservation of open space (including farmland and forest land) where such preservation is (I) for the scenic enjoyment of the general public, or (II) pursuant to a clearly delineated federal, state, or local governmental conservation policy, and will yield a significant public benefit."
- Reg. §1.170A-14(d)(1) and (4) echo the general rule, above, confirming that the term "conservation purpose" normally covers the "preservation of certain open space (including farmland and forest land)" under certain conditions.
- Reg. §1.170A-14(d)(4)(iv)(B) indicates that the following situations generally will meet the standard: "The preservation of farmland pursuant to a state program for flood prevention and control [and] the

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preservation of woodland along a public highway pursuant to a government program to preserve the appearance of the area so as to maintain the scenic view from the highway."

- Reg. §1.170A-14(d)(4)(v) creates a limitation, stating that a tax deduction for preservation of open space will not be allowed if the terms of the Deed permit "a degree of intrusion or future development that would interfere with the essential scenic quality of the land or with the governmental conservation policy that is being furthered by the donation."
- Reg. §1.170A-14(e)(2) provides that a tax deduction will not be allowed if the donation accomplishes one of the acceptable "conservation purposes" identified by the IRS, but at the same time "would permit destruction of other significant conservation interests." As an example, the regulation states that conservation of farmland pursuant to a governmental program for preventing or controlling floods would not qualify for a tax deduction if "a significant naturally occurring ecosystem could be injured or destroyed by the use of pesticides in the operation of the farm." It clarifies, however, that the prohibition against "inconsistent uses" of the property "is not intended to prohibit uses of the property, *such as selective timber harvesting or selective farming* if, under the circumstances, those uses do not impair significant conservation interests."

C. Relevant Provisions in the Deed

In addition to grasping the applicable tax provisions and regulations, one must also appreciate the pertinent portions of the Deed in *TOT Property Holdings* in order to understand the divergent positions presented by the PropCo and the IRS. These portions are detailed below:

- The Preamble identifies several conservation purposes, including the following: "Preservation of open space for the scenic enjoyment of the general public, and pursuant to a clearly delineated government conservation policy which provides significant public benefit from both open space (including farmland and forest land) and agricultural use."
- Clause 1 indicates potential forestry uses, provided that they are not inconsistent with the conservation purposes: "Grantor intends that this Easement will allow the use of the Property for such activities that are not inconsistent with the purposes of this Easement, including, without limitation, those involving permitted agricultural uses, forest management and protection, fire management and control, wildlife habitat improvement, and other permitted recreational uses that are not inconsistent with the purposes of this Easement."
- Clause 3 sets limits on the types of forestry allowed, stating that (i) no trees can be cut, unless such cutting is done pursuant to a forest management plan approved by the Tennessee Division of Forestry ("TDF") and the Best Management Practices published by the TDF, (ii) no trees can be cut in any area identified by the land trust, at any time, as a "sensitive natural area," and (iii) no trees can be cut if doing so would significantly impair or interfere with, materially threaten, or be inconsistent with the conservation purposes stated in the Deed.
- Clause 4 outlines the "reserved rights." It states that PropCo can conduct forest management and commercial forestry, in accordance with (i) a written forest management plan, reviewed and approved by the land trust, (ii) the Best Management Practices issued by the TDF, and (iii) other applicable county, state and federal forestry laws and regulations. It further confirms that no timbering of any sort can occur in "sensitive natural areas." It also contains many statements attempting to ensure that the exercise of any reserved rights, including timbering, will not undermine the conservation purposes. In this regard, Clause 4 states that the PropCo cannot engage in any reserved rights without first submitting written notice to the land trust and getting prior approval, which the land trust will not grant unless it is convinced that the proposed activities will not harm the conservation values.
- Finally, Clause 11 confirms that the conservation easement is transferable, but emphasizes that the land trust can only transfer it to another "qualified organization," which is authorized by state law to hold easements, and which takes the easement subject to all restrictions set forth in the Deed, including those related to timbering.

D. Arguments by the IRS Regarding Commercial Forestry

The IRS's position in *TOT Property Holdings* regarding "commercial forestry" derives from two principal sources, the Pre-Trial Memorandum and the Report Regarding Reserved Commercial Timbering Rights ("Expert Report") by an IRS forester.[29]

1. Pre-Trial Memorandum

The IRS took the position that the problem primarily emanated from Clause 4, which listed the reserved rights of PropCo, including the ability to engage in "commercial forestry" under certain conditions. The IRS acknowledged that the Deed established restrictions, such as only allowing forestry when it is done in accordance with a written

forest management plan, the Best Management Practices issued by the TDF, and other applicable forestry laws and regulations. Nonetheless, the IRS made the following blanket statement in its Pre-Trial Memorandum: "*Even where commercial forestry is conducted responsibly, it is inherently inconsistent with significant conservation interests*."[30]

The IRS then expanded on this point, focusing on the common treatment of pine trees:

> The subject property's stock of trees is largely pine, and the most common management practice for pine plantations is simultaneous growth with occasional thinning until the remaining trees are ready for harvest, when they are clear-cut. As [the IRS's] expert witness notes, while this may be permissible under forestry best management practices, it is inconsistent with several other significant conservation interests.[31]

As an example of supposed damage to other conservation purposes, the IRS referenced in its Pre-Trial Memorandum the fact that the Baseline Report says there is an at-risk bat species protected by the conservation easement, which lives under the bark of dead and dying trees. According to the reasoning of the IRS, if the PropCo were to engage in "commercial forestry" by cutting certain pine trees on a portion of the property, it would undermine conservation purposes by eliminating some of the bat habitat.[32]

The IRS summarized its position in the Pre-Trial Memorandum as follows:

> [B]ecause the allowance of commercial forestry on the property is a use inconsistent with significant conservation interests, the contribution is not exclusively for conservation purposes as required by Section 170(h)(1)(C), and the claimed deduction should be disallowed.[33]

2. Expert Report by IRS Forester

In an effort to legitimize its extreme position, the IRS presented the Expert Report to the Tax Court. To be clear, we are not talking about an independent, financially disinterested, third party providing an objective opinion to the Tax Court, but rather a person who has worked for the IRS for many years. It is not surprising, with this backdrop, that the Expert Report reached the conclusions that it did.

The Expert Report emphasized the fact that the Baseline Report and Deed used the phrase "sustained yield of forest products," which supposedly "implies active and aggressive timber management."[34] The Expert Report contained the following broad conclusions:

- "Commercial forestry permits destruction of, and impairment to, significant conservation interests,"
- "The tension between forestry and conservation values arise when restrictions are placed on the land, restrictions that are inconsistent with commercial forestry," and
- "Conservation easements and commercial forestry cannot coexist because their goals are in direct conflict."[35]

V. Hurdles Facing IRS's Position on Commercial Forestry

The fact that the IRS continues to expand its list of "technical" arguments to raise in conservation easements cases is predictable; it is considerably easier for the IRS to dispense with entire cases on minor infractions than it is to address complicated substantive issues, like valuation, which might go the taxpayer's way. However, in its zeal to prevail, the IRS surely wants to avoid taking positions that the Tax Court might reject and that taxpayers might cite as favorable precedent. This segment of the article examines some shortcomings of the IRS's stringent position on "commercial forestry."

A. Tax Court Testimony Exposes Debilities

As explained above, the Expert Report by the IRS forester featured the unyielding position that conservation easements and commercial forestry are incompatible, period. The Expert Report could not have been clearer on this point, stating that "[c]onservation easements and commercial forestry cannot coexist because their goals are in direct conflict."[36]

A potential problem for the IRS is that the trial testimony by its forester revealed some shortcomings with this position. First, the forester admitted that he never reviewed, considered, or analyzed in his Expert Report the portion of the Deed requiring that the PropCo obtain written approval from the land trust before exercising any reserved rights, including timbering.[37] Second, the forester acknowledged that he never even entered the relevant property in connection with preparing his Expert Report.[38] Third, the forester had to recognize that commercial forestry could only be conducted pursuant to an approved forest management plan, and in a manner consistent with the conservation purposes stated in the Deed.[39] Fourth, the forester agreed that the Deed did not specifically allow

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clear-cutting of trees.[40] Fifth, the forester indicated that his position was based partly on the fact that the land trust might later transfer the easement to a party that "doesn't care" about clear-cutting of trees, but this ignores both the pertinent tax regulations and Clause 11 of the Deed, which expressly limits transfers to "qualified organizations" that are authorized to hold easements under state law.[41] Finally, one exchange with the Tax Court, set forth below, might be interpreted as a degree of judicial skepticism toward the IRS's stance that "commercial forestry" necessarily means massive, destructive clear-cutting:

> **Tax Court:** "If we were to suppose that there is no commercial forestry activity in the current property that's the subject of the easement, I think it's your testimony that eventually, over a long period of time, this reverts to a hardwood forest."
> **Forester:** "Over time, yes."
>
> **Tax Court:** "And I am going to put together some pieces of your testimony but I ask you to correct me."
> **Forester:** "Yes, sir."
>
> **Tax Court:** "I am supposing that means that eventually over a long period of time, this property becomes hardwood forest of the sort in which selective cutting might commercially make sense. So that while today you think it's unlikely that anyone would have a commercial interest in entering the property, for instance this is cutting down a tree, it would be a relatively cheap pine tree, not wood for profit. At some distant time in the future when this forest has become mature and reverted to its natural order, it might reach the point where some selective cutting of trees would be a commercially feasible activity; is that right?"
> **Forester:** "That would be correct, your honor."[42]

B. Congressional Support from the Outset

Congress has placed special emphasis on conservation of agricultural land, including timbering land, since the beginning. For example, in the Tax Reform Act of 1969, Congress introduced the concept of charitable deductions for donations of the use of property. The law stated that a deduction would be allowed only where the taxpayer made "an outright gift of an undivided interest in property," but the related legislative history clarified that Congress intended that "a gift of an open space easement in gross is to be considered a gift of an undivided interest in property where the easement is in perpetuity."[43]

About a decade later, Congress enacted the Tax Treatment Extension Act of 1980, thereby making permanent the tax deduction for conservation easements and modifying the existing provisions in several respects. The legislative history expressly states that conservation purposes encompass protection of open space "including farmland and forest land," as long as certain conditions were met.[44] The legislative history also indicates that, with respect the requirement that property be used exclusively for conservation purposes, Congress did not intend to prevent uses of the property, "such as selective cutting of timber or farming, if under the circumstances they are not destructive of significant conservation interests."[45] These special rules directed at "farmland and forest land" have existed for many decades, unchanged.

C. Conservation of Agricultural Land

Congress introduced special rules for farmers and ranchers in the Pension Protection Act of 2006 ("PPA"). Specifically, those considered "qualified farmers or ranchers" could claim for the year of the charitable donation 100 percent of their contribution base, whereas others could only claim 30 percent or 50 percent, depending on the type of property contributed. The special rules in the PPA were temporary at first, only covering donations made in 2006 and 2007. Congress extended the rules several times over the years, before finally making them permanent in 2015.[46]

In discussing the potential passage of PPA, one senator explained why the legislation would be vital to farmers and clarified that Congress expected farmland placed in conservation to be utilized in ongoing farming activities:

> Let me give you an example of how it works. *A farmer who owns 100 acres of undeveloped lands decides that he wants his land to stay as productive farmland forever and not allow the land to be developed or subdivided*. The farmer appreciates the open space that is created by his farm and wants to pass the farm on to his children or grandchildren. *One way that the farmer or rancher can accomplish this goal is to donate a conservation easement that prohibits future generations from building or subdividing the farm*. The farmer would be required to donate the easement to either a qualified organization, like a land trust, or an arm of the government, federal, state or local. *The value of the deduction would reflect how much the restriction on development and subdivision reduced the price of the farm* …. Now, the law requires the farmer to have a qualified appraisal for any donation of more than

$5,000. Finally, in order to qualify, the farmer must prove that the restrictions placed on the farm serve a real conservation purpose. It is not a qualifying conservation purpose to allow just 15 subdivisions instead of 20, nor is it a qualifying conservation purpose to place an easement over a golf course. In order to meet a conservation purpose for an open space easement, the farmer needs to show the easement benefits the scenic enjoyment of the public or is pursuant to a federal, state or local conservation policy. In either case, the farmer has to show that the easement will yield a significant benefit to the public. *The laws allow the farmer to continue using the farmland productively, as long as the productive use is consistent with conservation goals. This policy has allowed thousands of farmers to maintain the great American tradition of the family farm*.[47]

Code Sec. 170(b)(1)(E)(iv)(I), resulting from the PPA, generally provides that a "qualified farmer or rancher" who makes a qualified conservation easement donation can claim a tax deduction in the first year up to 100 percent of his contribution base. The exception to the general rule indicates that, if the conserved property was used in agriculture before the donation, it must continue such use. In particular, it states that the preferential tax treatment will not apply to any contribution involving property "which is used in agriculture or livestock production (or available for such production) unless such contribution is subject to restriction that such property remain available for such production."[48]

For purposes of these rules, the term "qualified farmer or rancher" means a taxpayer whose gross income from the trade or business of "farming" is more than 50 percent of his total gross income for the pertinent year.[49] The concept of "farming" is broadly defined to cover, among other things, "the planting, cultivating, caring for, or cutting of trees, or the preparation (other than milling) of trees for market."[50]

The IRS published Notice 2007-50 explaining the new rules established by the PPA for "qualified farmers and ranchers." The IRS provided guidance, in a question-and-answer format, which clarifies repeatedly that agricultural property subjected to conservation must remain open for agriculture, including timbering. The most relevant items from Notice 2007-50 are highlighted below:

Q-7. Is income from the *sale of timber* included in the individual's gross income from the trade or business of farming?

A-7. *Yes. The planting, cultivating, caring for, or cutting of trees, or the preparation (other than milling) of trees for market are activities described in §2032A(e)(5). Therefore, income from the sale of timber is included in the individual's gross income from the trade or business of farming*, and is also included in the individual's gross income.

Q-10. *If a qualified farmer or rancher makes a qualified conservation contribution of property used or available for use in agriculture or livestock production, must the contribution be subject to a restriction that the property remain available for such use in order to qualify for the 100 percent limitation*?

A-10. *The answer depends on the date of the contribution. If the contribution was made after August 17, 2006, the contribution must be subject to such a restriction in order to qualify for the 100 percent limitation*. The contribution may qualify for the 50 percent limitation if the contribution lacks such a restriction. If the contribution was made on or before August 17, 2006, no such restriction is required in order to qualify for the 100 percent limitation.

Q-12. How may a qualified farmer or rancher comply with the requirement that a qualified conservation contribution of property used or available for use in agriculture or livestock production be subject to a restriction that the property (including the portions of the property upon which improvements described in Q-11 of this notice are located) remain available for such production?

A-12. *The qualified conservation contribution must include a restriction that the property remain available for agriculture or livestock production, and must ensure that the property is protected from any use that would interfere with agriculture or livestock production*. For example, a qualified conservation contribution of property used or available for use in agriculture or livestock production might include in the document of conveyance prohibitions against construction or placement of buildings (except those used for agriculture or livestock production purposes, or dwellings used for family living by the qualified farmer or rancher, a lessee that operates the property, or their employees); removal of mineral substances in any manner that adversely affects the property's agriculture or livestock production potential; and other uses detrimental to retention

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of the property for use in agriculture or livestock production.

To the extent that any doubt remains after reviewing Notice 2007-50 about the need for conserved agricultural property to remain available for similar use, the legislative history confirms the matter:

> *As an additional condition of eligibility for the 100 percent limitation, with respect to any contribution of property in agriculture or livestock production, or that is available for such production, by a qualified farmer or rancher, the qualified real property interest must include a restriction that the property remain generally available for such production*. (There is no requirement as to any specific use in agriculture or farming, or necessarily that the property be used for such purposes, merely that the property remain available for such purposes.) Such additional condition does not apply to contributions made after December 31, 2005, and on or before the date of enactment.[51]

VI. Conclusion

TOT Property Holdings demonstrates that the IRS will continue to unveil new "technical" arguments in its efforts to disallow charitable tax deductions, including the position that conservation easements and commercial forestry, even when conducted responsibly, are "inherently inconsistent" and "cannot coexist." This article identifies several possible defects with this rigid stance, and others exist. Among other things, the IRS might have trouble reconciling its current argument with the fact that Congress and the IRS introduced rules many years ago providing that (i) "farming" encompasses planting, cultivating, caring for, and cutting trees, (ii) "qualified farmers," including those involved in timbering, are entitled to special tax treatment for donations of conservation easements, and (iii) agricultural property placed in easement must remain available for agricultural use. The Tax Court did not rule on the "commercial forestry" issue in *TOT Property Holdings*, and the IRS has not publicly conceded it.[52] Taxpayers and their advisors, therefore, should remain aware of this important issue as conservation easement battles persist.

ENDNOTES

* Hale defends businesses and individuals in tax audits, tax appeals, and Tax Court litigation, focused on both domestic and international issues. You can reach Hale by phone at (404) 658-5441 or by email at *hale.sheppard@chamberlainlaw.com*.

1 *TOT Property Holdings, LLC*, Tax Court Docket No. 5600-17, Order (Dec. 13, 2019). Importantly, this ruling came in the form of a Bench Opinion, which, according to the Internal Revenue Code and Tax Court Rules, has no precedential value. The Order recognized its limitations on page 3, stating that "[t]his Bench Opinion is made pursuant to the authority granted in Section 7459(b) of the Internal Revenue Code (26 U.S.C.), and Tax Court Rule 152; and it shall not be relied on as precedent in any other case."

2 Code Sec. 170(a)(1); Reg. §1.170A-1(a); Code Sec. 170(f)(3)(A); Reg. §1.170A-7(a)(1).

3 Code Sec. 170(f)(3)(B)(iii); Reg. §1.170A-7(a)(5); Code Sec. 170(h)(1); Code Sec. 170(h)(2); Reg. §1.170A-14(a); Reg. §1.170A-14(b)(2).

4 Code Sec. 170(h)(4)(A); Reg. §1.170A-14(d)(1); S. Rept. 96-1007, at 10 (1980).

5 Reg. §1.170A-14(b)(2).

6 Internal Revenue Service. Conservation Easement Audit Techniques Guide (Rev. 11/4/2016), at 23; *see also* Reg. §1.170A-14(e)(2) and (3).

7 Reg. §1.170A-14(g)(5)(i).

8 Reg. §1.170A-14(g)(5)(i).

9 Code Sec. 170(a)(1); Reg. §1.170A-1(c)(1).

10 Reg. §1.170A-1(c)(2).

11 Internal Revenue Service. Conservation Easement Audit Techniques Guide (Rev. 11/4/2016), at 41.

12 Internal Revenue Service. Conservation Easement Audit Techniques Guide (Rev. 11/4/2016), at 41.

13 *Stanley Works & Subs.*, 87 TC 389, 400, Dec. 43,274 (1986); Reg. §1.170A-14(h)(3)(i) and (ii).

14 *Olson*, SCt, 292 US 246, 255 (1934).

15 *Esgar Corp.*, CA-10, 2014-1 USTC ¶50,207, 744 F3d 648, 659 n.10.

16 *Esgar Corp.*, 744 F3d 648, 657.

17 *J.W. Symington*, 87 TC 892, 896, Dec. 43,467 (1986).

18 *See* Internal Revenue Service. Conservation Easement Audit Techniques Guide (Rev. 11/4/2016), at 24–30; IRS Publication 1771, Charitable Contributions—Substantiation and Disclosure Requirements; IRS Publication 526, Charitable Contributions; Code Sec. 170(f)(8); Code Sec. 170(f)(11); Reg. §1.170A-13; Notice 2006-96; T.D. 9836.

19 Internal Revenue Service. Conservation Easement Audit Techniques Guide. (Rev. 11/4/2016).

20 Internal Revenue Service. Conservation Easement Audit Techniques Guide. (Rev. 11/4/2016), at 78–81.

21 Code Sec. 6662; Code Sec. 6662A.

22 Internal Revenue Service. Conservation Easement Audit Techniques Guide (Rev. 11/4/2016), at 77.

23 Notice 2017-10, Preamble and Section 1.

24 Notice 2017-10, Section 1.

25 *Nancy Zak, Claud Clark, EcoVest Capital Inc., Alan N. Solon, Robert M. McCullough, and Ralph R. Teal*, Case No. 1:18-cv-05774, D.C. N.D. Ga, Complaint filed Dec. 18, 2018, at 47.

26 *Nancy Zak, Claud Clark, EcoVest Capital Inc., Alan N. Solon, Robert M. McCullough, and Ralph R. Teal*, Case No. 1:18-cv-05774, D.C. N.D. Ga, Complaint filed Dec. 18, 2018, at 48–50.

27 *Champions Retreat Golf Founders, LLC*, 116 TCM 262, Dec. 61,260(M), TC Memo. 2018-146; *reversed and remanded* 125 AFTR 2d 2020-2057 (11th Cir. 2020).

28 *Champions Retreat Golf Founders, LLC*, TC Memo. 2018-146, at 21 and fn 1.

29 The IRS's Pre-Trial Memorandum is dated November 4, 2019, and the "Report Regarding Reserved Commercial Timbering Rights" by the IRS forester, David Senn, is dated October 8, 2019.

30 IRS's Pre-Trial Memorandum dated November 4, 2019, at 12.

31 IRS's Pre-Trial Memorandum dated November 4, 2019, at 12.

32 IRS's Pre-Trial Memorandum dated November 4, 2019, at 12.

33 IRS's Pre-Trial Memorandum dated November 4, 2019, at 13.

34 Report Regarding Reserved Commercial Timbering Rights by the IRS forester, David Senn, dated October 8, 2019, at 13.

35 Report Regarding Reserved Commercial Timbering Rights by the IRS forester, David Senn, dated October 8, 2019, at 20.

36 Report Regarding Reserved Commercial Timbering Rights by the IRS forester, David Senn, dated October 8, 2019, at 20.

37 Tax Court transcript from November 19, 2019, at 290, 301–302.

38 Tax Court transcript from November 19, 2019, at 315.

39 Tax Court transcript from November 19, 2019, at 316–317.

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[40] Tax Court transcript from November 19, 2019, at 317.

[41] Tax Court transcript from November 19, 2019, at 319.

[42] Tax Court transcript from November 19, 2019, at 322–323.

[43] U.S. House of Representatives. Tax Reform Act of 1969. 91st Congress, 1st Session. Report No. 91-782 (Dec. 21, 1969), at 294.

[44] U.S. Senate, Committee on Finance. Tax Treatment Extension Act of 1980. 96th Congress, 2nd Session. Report No. 96-1007 (Sept. 30, 1980), at 11–12.

[45] U.S. Senate, Committee on Finance. Tax Treatment Extension Act of 1980. 96th Congress, 2nd Session. Report No. 96-1007 (Sept. 30, 1980), at 13.

[46] *See, e.g.*, U.S. Joint Committee on Taxation. Technical Explanation of H.R. 4, the Pension Protection Act of 2006, as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006. JCX-38-02 (Aug. 3, 2006), at 274–277; U.S. Joint Committee on Taxation. Description of Revenue Provisions Contained in the President's Fiscal Year 2008 Budget Proposal. JCS-2-07 (March 2007), at 64–67; Temporary Tax Relief Act of 2007, 110th Congress, 1st Session, House Report 110-431 (Nov. 6, 2007), at 42–45; U.S. Joint Committee on Taxation. Technical Explanation of the Revenue Provisions Contained in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, scheduled for Consideration by the U.S. Senate. JCX-55-10 (Dec. 10, 2010), at 91–94; Conservation Easement Incentive Act of 2015, 114th Congress, 1st Session, House Report 114-17 (Feb. 9, 2015), at 2–7; U.S. Joint Committee on Taxation. Description of H.R. 641, The Conservation Easement Incentive Act of 2015. JCX-8-15 (Feb. 4, 2015), at 2–5; U.S. Joint Committee on Taxation. Description of H.R. 2807, the "Conservation Easement Incentive Act of 2013," JCX-53-14 (May 27, 2014); Jane G. Gravelle & Molly F. Sherlock. Recently Expired Charitable Tax Provisions ("Tax Extenders"), Congressional Research Service Report 7-5700, R43517 (Jan. 15, 2016), at 5–6, Tax Analysts Doc. No. 2016-1389.

[47] U.S. Senate, Committee on Finance. *Hearing: The Tax Code and Land Conservation: Report on Investigations and Proposals for Reform*, June 8, 2005. Tax Analysts Doc. No. 2005-13563 (statement by Senator Max Baucus of Montana) (emphasis added).

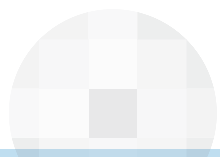
[48] Code Sec. 170(b)(1)(E)(iv)(II).

[49] Code Sec. 170(b)(1)(E)(v). This provision states that the term "farming" has the definition found in Code Sec. 2032A(e)(5).

[50] Code Sec. 2032A(e)(5)(C).

[51] U.S. Joint Committee on Taxation. Technical Explanation of H.R. 4, the Pension Protection Act of 2006, as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006. JCX-38-02 (Aug. 3, 2006), at 277 (emphasis added).

[52] The IRS has publicly relinquished other "technical" arguments that it was previously advancing. For example, in Generic Legal Advice AM-2020-001 (March 17, 2020), the IRS announced that (i) the IRS would no longer take the broad position that the existence of an "amendment clause" in a Deed, by itself, causes the conservation values not to be protected in perpetuity, (ii) the IRS must review each "amendment clause" within the context of the entire Deed, as well as the facts and circumstances of each case, and (iii) the mere fact that the Deed contains an "amendment clause" does not necessarily mean that it fails to meet Code Sec. 170.



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