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IRS Shifts Focus to Original Landowners in Easement Disputes

by Hale E. Sheppard

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In this article, Sheppard examines *Glade Creek Partners* and explains how the IRS is shifting its sights from donors to the original landowners when determining whether property satisfies easement deduction requirements.

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I. Introduction

Most battles over "syndicated" conservation easement transactions focus on the partnership that made the donation. This is logical because it is the entity that took the key actions, claimed the tax deductions, and then allocated them to the partners. A recent case, *Glade Creek Partners*,[1] shows that the IRS might concentrate on other parties instead.

Those parties include the original landowners who contribute to the partnership the property on which the easement is later donated. Why would the IRS scrutinize original landowners? How long they held the property and for what purpose directly affect the size of the charitable tax deduction that the partnership can claim for donating.

This article explains the easement donation process and its main characters, significance of property characterization, three-round battle in *Glade Creek Partners*, and prior IRS positions centered on original landowners. This article concludes that the IRS is now looking to original landowners to determine whether easement property is both "long-term" and "capital gain" in nature, as required to maximize the tax deduction.

II. Overview of Easement Donations

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

Protected property must 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 in accordance with a government conservation policy.[4]

Taxpayers memorialize a donation by filing a deed of conservation easement or similar document. In preparing the deed, taxpayers often identify limited activities that they can continue to perform on the property after the donation, without prejudicing the conservation purposes.[5]

An appropriate party must receive the conservation easement in order to trigger the tax deduction. This includes governmental, private, or tax-exempt entities, which are committed to protecting the conservation purposes and possess

[1] *Glade Creek Partners LLC v. Commissioner*, T.C. Memo. 2023-82.

[2] Section 170(f)(3)(B)(iii); reg. section 1.170A-7(a)(5); section 170(h)(1); section 170(h)(2); reg. section 1.170A-14(a); reg. section 1.170A-14(b)(2).

[3] Section 170(h)(4)(A); reg. section 170A-14(d)(1); S. Rep. 96-1007, at 10 (1980).

[4] Section 170(h)(4)(A); reg. section 170A-14(d)(1).

[5] IRS, "Conservation Easement Audit Techniques Guide," at 23 (rev. Nov. 4, 2016); *see also* reg. section 1.170A-14(b)(2); reg. section 1.170A-14(e)(2) and (3).

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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 will not 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 accepting only conservation-worthy projects, a land trust frequently prepares the baseline report.

The value of the conservation easement is the fair market value of the property at the time of the donation.[8] FMV ordinarily means the price on which a willing buyer and seller would agree if neither party were obligated to participate in the transaction, and if both parties had reasonable knowledge of the relevant facts.[9] The best evidence of an easement's FMV would be the sale price of other easements of comparable size, location, etc. The IRS recognizes that it is difficult, if not impossible, to find them.[10]

Thus, 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 restrictions on the use of property imposed by the conservation easement, which creates the "after" value.[11] 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"; and file a timely tax return with all necessary enclosures and disclosures.[12]

III. Key Characters

There is no typical conservation easement donation because the properties, charitable motives, conservation features, valuation methods, HBUs, and other circumstances are unique in each case. For this article, the key characters in a so-called syndicated transaction might be described as follows:

- the original landowner, who initially holds the property on which a conservation easement is ultimately placed;
- the organizer, who locates the potential property held by the original landowner, hires multiple experts to conduct due diligence regarding the property and its possible uses, engages a laundry list of specialized professionals to complete various projects, and finds partners willing to invest;
- the transactional attorney, who forms the necessary entities; analyzes legal, tax and regulatory issues; prepares opinion letters; drafts private placement memoranda or similar materials describing the potential investment; and creates legal documents to effectuate transactions;
- the appraiser, who prepares the qualified appraisal, often with input from construction, mining, zoning, environmental, transportation, cost, and other experts;
- the land trust, which frequently prepares the baseline report, deed, and Form 8283, receives the easement donation, and then protects the property forever;

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[6] Section 170(h)(3); reg. section 1.170A-14(c)(1).

[7] Reg. section 1.170A-14(g)(5)(i).

[8] Section 170(a)(1); reg. section 1.170A-1(c)(1).

[9] Reg. section 1.170A-1(c)(2).

[10] IRS, "Conservation Easement Audit Techniques Guide," at 43 (rev. Jan. 24, 2018).

[11] *Id.* at 43.

[12] *See id.* at 24-31; IRS Publication 1771, "Charitable Contributions — Substantiation and Disclosure Requirements" (Mar. 2016); IRS Publication 526, "Charitable Contributions" (2022); section 170(f)(8); section 170(f)(11); reg. section 1.170A-13; Notice 2006-96, 2006-2 C.B. 902; T.D. 9836.

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- the property-holding partnership, which receives the relevant property as a capital contribution from the original landowner in exchange for a large percentage of the ownership interests in the property-holding partnership, and which ultimately donates the conservation easement to the land trust and claims a charitable tax deduction;
- the investment partnership, which purchases nearly all the membership interests in the property-holding partnership from the original landowner before the property-holding partnership donates the conservation easement to the land trust;
- the direct individual partners, often the organizers, who own a small percentage of membership interests in the property-holding partnership from the outset, do not sell such interests, and receive minor allocations of the charitable tax deduction because of their interests in the property-holding partnership;
- the indirect individual partners, who buy interests in the investment partnership with cash, watch the investment partnership use their funds to buy nearly all the interests in the property-holding partnership from the original landowner before the property-holding partnership donates the easement, and receive most of the allocations of the charitable tax deduction thanks to their indirect interest in the property-holding partnership; and
- the accountants, who prepare and file all required tax and information returns for the property-holding partnership, investment partnership, direct individual partners, and indirect individual partners.

IV. Importance of Land Characterization

As explained above, the value of the conservation easement is its FMV at the time of the donation.[13] That figure must be reduced, however, by the amount of the gain that would not have been characterized as long-term capital gain if the taxpayer had sold the property for its FMV.[14] In other words, if the sale of the property would have generated either ordinary income or short-term capital gain (instead of long-term capital gain), the charitable deduction must be reduced by that amount. The effect is that the charitable deduction is limited to the taxpayer's adjusted basis in the donated property. Thus, character counts, in life *and* in taxes.

On a related note, if a partner contributes property to a partnership that is considered inventory in the partner's hands at the time of the contribution, and if the partnership then sells or otherwise disposes of the property within five years, the resulting gain or loss is treated as ordinary, not capital.[15] Congress enacted this rule to prevent partners from converting ordinary-income property into capital-gain property by simply contributing it to a partnership that has a different purpose for owning it.[16]

V. Three-Round Easement Fight

The recent three-round battle with the IRS in *Glade Creek Partners* illustrates the importance of the characterization of the property on which an easement is donated.

A. Round One: Tax Court

1. Key facts.

In 2006 International Land Company (ILC) purchased about 2,000 acres in Tennessee for approximately $9 million through a seller-financed arrangement. In other words, ILC put down some cash and agreed to pay the remainder over time, with interest. ILC intended to create and sell lots in three phases to out-of-state buyers who wanted to build vacation homes. The phases were called Tract I, Tract II, and Tract III.

The property was undeveloped when ILC bought it. Therefore, ILC spent about an additional $6 million to complete various infrastructure projects and obtain necessary permits and approvals. In 2007, ILC recorded the lots on Tract I, marketed them, and made some sales. ILC ran out of money in 2009, though, so

[13] Section 170(a)(1); reg. section 1.170A-1(c)(1).

[14] Section 170(e)(1)(A).

[15] Section 724(b).

[16] *Jones v. Commissioner*, 560 F.3d 1196, 1199 (10th Cir. 2009), *aff'g* 129 T.C. 146 (2007).

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marketing ceased and sales plummeted. ILC faced a depressed real estate market, slow sales, substantial debt, and considerable uncertainty. Some of its members wanted out.

Their departures occurred when Hawks Bluff Investment Group Inc. (Hawks Bluff) acquired the remaining unsold lots in Tract I, along with all of Tract II and Tract III, in exchange for assuming ILC's liabilities. The debts largely consisted of the unpaid amount of the purchase price still owed to the owner, along with the costs of building infrastructure. One of the three shareholders of Hawks Bluff was James Vincent, a local real estate investor with government contacts who had provided services in connection with the ILC project.

Because of troubles servicing the ongoing debt, one of the shareholders in Hawks Bluff exited. The remaining two shareholders obtained his shares in exchange for assuming his one-third of the debt. In 2011 Hawks Bluff entered into a mortgage modification agreement, which resulted in a decrease of the total amount owed. Even after this reduction, Hawks Bluff was still on the hook for about $3.3 million. Vincent was concerned that the one remaining shareholder would be unwilling or unable to continue paying his portion of the debt, especially because Vincent had personally guaranteed some of the loans.

In his quest to find a financial solution, Vincent entertained various options, including selling the property to a developer, timbering, or donating a conservation easement. He ultimately dismissed the first two possibilities because they would not protect the environment, they were inconsistent with the vision marketed to early purchasers of lots in Tract I, and they would negatively affect development of the remaining lots in Tract I. Vincent pursued a conservation easement on Tract II and Tract III.

Vincent approached an experienced individual (organizer), who understood that "the goal was to raise enough money to repay the Hawks Bluff debt and [he] designed the easement transaction with that goal in mind."[17] The organizer formed two entities in connection with the proposed transaction, Glade Creek Partners LLC (PropCo) and Sequatchie Holdings LLC (InvesCo). The organizer hired many professionals to complete the pre-donation actions, including a brokerage firm, securities lawyer, tax lawyer, and two appraisers.

The basic idea was that (1) Hawks Bluff would contribute the relevant property to PropCo in exchange for 98 percent of the ownership interests in PropCo, (2) InvesCo would use a portion of the proceeds from its private offering to buy nearly all of Hawk Bluff's interests in PropCo, (3) Hawks Bluff would use the funds from InvesCo to satisfy its debts, and (4) if the partners in PropCo voted to donate a conservation easement instead of developing the property or holding it for appreciation, nearly all the charitable deductions would be allocated to InvesCo, which, in turn, would pass them along to its individual partners.

The partners voted for the conservation easement option, after which PropCo donated an easement to a land trust and claimed a charitable deduction of just over $17.5 million on its Form 1065, "U.S. Return of Partnership Income," for 2012.

The IRS audited. It concluded, as it invariably does, that PropCo should get a charitable deduction of $0 and pay the highest possible penalty, equal to 40 percent of the tax underpayment. PropCo disagreed with the IRS, filing a petition with the Tax Court to get litigation underway.[18]

2. First issue.

The Tax Court sided with the IRS on the first issue, holding that PropCo was entitled to a charitable deduction of $0 because the conservation easement was not "protected in perpetuity."

Here is what led to that conclusion. Taxpayers must donate conservation easements in perpetuity, but nothing really lasts forever. Mindful of this, the regulations explain that a post-donation change in conditions surrounding the relevant property can make it impossible or impractical to continue using it for conservation purposes at some future point.[19] This occurs, for

[17] *Id.* at 9.

[18] *Glade Creek Partners LLC v. Commissioner*, T.C. Memo. 2020-148, *vacated and remanded*, No. 21-11251 (11th Cir. filed Aug. 22, 2022).

[19] Reg. section 1.170A-14(g)(6)(i).

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instance, when the government approaches a taxpayer, like PropCo, years after it donates a conservation easement, offers to purchase part of the protected land for purposes of installing a power line or constructing a road. If the taxpayer refuses, the government can force the sale through a process called condemnation. The government effectively "takes" the property but must pay for it. The question thus becomes: Who gets the sale proceeds? The taxpayer, which still owns the property; the land trust, which holds the conservation easement on the property; or both in accordance with some formula? The regulations mandate use of a formula that, based on a long list of Tax Court cases, is far from clear.[20]

The deed filed by PropCo in *Glade Creek Partners* expressly stated that any increase in value of the property *after* the donation resulting from post-donation improvements, made and paid for by PropCo, should be subtracted from the total value of the property before calculating the proportionate share of sales proceeds owed to the land trust.[21] The Tax Court determined that the formula violated the applicable regulations, triggering a deduction of $0 for PropCo.

3. Second issue.

The second issue ostensibly addresses penalties, but it is really about valuation. Readers might be asking themselves why the Tax Court addressed valuation at all, when it had already decided that PropCo deserved a charitable deduction of $0. The answer is that the Tax Court was obligated to ascertain the value, despite its initial decision, to determine whether PropCo should be penalized.

a. Penalties asserted.

The IRS's primary penalty argument was that there was a "gross valuation misstatement," which would have occurred if the value of the conservation easement claimed by PropCo on its Form 1065 was 200 percent or more of the correct amount, as ultimately determined by the Tax Court. This makes more sense when one inserts figures. PropCo claimed a deduction of about $17.5 million on its Form 1065. Therefore, if the Tax Court were to conclude that the conservation easement was really worth $8.75 million or less, a "gross valuation misstatement" would exist, and PropCo would suffer a hefty penalty equaling 40 percent of the tax underpayment.

The IRS further argued that, if the case did not involve a "gross valuation misstatement," surely PropCo should suffer penalties for submitting a "substantial valuation misstatement." That would apply if the value declared by PropCo on its Form 1065 was between 150 percent and 200 percent of the correct amount, as calculated by the Tax Court.

The opinion issued by the Tax Court in *Glade Creek Partners* exceeds 60 pages, much of which is devoted to valuation methods, flaws, and disparities. It is unnecessary to do a deep dive; the key aspects are described below.

b. IRS expert.

At trial, the IRS presented an appraisal by, and testimony from, a local real estate appraiser with some 40 years of experience (government expert appraiser). He used a comparable sales method; stated that the HBU of the property was rural residential, agricultural, and recreational; and calculated the before value at about $1.5 million.

The Tax Court was unimpressed with the government expert appraiser, to put it lightly. It harshly criticized many aspects of his appraisal, characterized it as "unreliable," "not helpful," "of little relevance," and, in some ways, "clearly wrong." Importantly, the Tax Court admonished the purported comparable sales selected by the government expert appraiser, emphasizing that they were dissimilar in many ways, and even if they were comparable, he "was not evaluating [them] for their development potential."[22]

c. PropCo experts.

PropCo presented two experts at trial, namely, a land-use professional (planning expert) and an appraiser (taxpayer expert appraiser). The planning expert prepared a market study of economic trends, housing demand, target market,

[20] Reg. section 1.170A-14(g)(6)(i) and (ii); *see, e.g., Belk v. Commissioner*, 774 F.3d 221 (4th Cir. 2014), *aff'g* 140 T.C. 1 (2013); *PBBM-Rose Hill Ltd. v. Commissioner*, 900 F.3d 193 (5th Cir. 2018); *Carroll v. Commissioner*, 146 T.C. 196 (2016); *Coal Property Holdings LLC v. Commissioner*, 153 T.C. 126 (2019); and *Oakbrook Land Holdings LLC v. Commissioner*, 154 T.C. 180 (2020).

[21] *Glade Creek Partners*, T.C. Memo. 2020-148, at 14-15.

[22] *Id.* at 37-38.

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regional attractions, and amenities. He concluded that the HBU of the property, before donation of a conservation easement, would have been residential development. He envisioned a resort-style community featuring outdoor activities, which would appeal both to multi-generational families and those seeking vacation homes. He identified five types of lots on the property and calculated an average price for each using figures from seven "benchmark" residential communities already in existence.

The planning expert put his ideas on paper, supplying "a Concept Plan for a hypothetical development similar to ILC's [original] project with slight alterations."[23] He acknowledged that development would necessitate aggressive marketing, a significant upfront investment to build community amenities, and additional costs to construct a model home and several speculative homes ready for immediate purchase. The planning expert estimated that, even with all the efforts and investment, it would take seven years to sell out the lots, and the number of annual sales (that is, the absorption rate) during this period would follow a bell curve, with sales trailing off toward the end.

The taxpayer expert appraiser largely incorporated the data from the planning expert. He agreed with the hypothetical development described in the concept plan, average lot prices, need to make upfront expenditures, and absorption rate. The taxpayer expert appraiser then incorporated additional development costs, including a 15 percent profit for the hypothetical developer that might buy the property, provided that it was not encumbered with an easement. He also applied a so-called discount rate of 11.25 percent to account for the time value of money.

In short, to calculate the before value, the taxpayer expert appraiser "performed a discounted cash-flow analysis from the sale of lots in [the planning expert's] hypothetical development."[24] After reducing the before value to consider the after value and enhancement to neighboring property, he stated that the easement was worth about $16.2 million. That was slightly lower than the $17.5 million originally claimed by PropCo on its Form 1065 for 2012.

d. Tax Court analysis.

The Tax Court began by providing foundational information about valuation in the context of conservation easements. It concluded the following about the HBU of the property in *Glade Creek Partners*:

> Residential development was physically and financially feasible on the easement date. In light of the improved real estate market [in 2012] and the significant infrastructure work and approvals previously granted, a hypothetical buyer would have reasonably purchased the property for the development of a vacation or residential community. Accordingly, we hold that residential development is the unencumbered property's [HBU].[25] [Internal citations omitted.]

While the Tax Court accepted the HBU advanced by PropCo, a huge victory by itself, it indicated that the taxpayer expert appraiser overvalued the property for a few reasons. Specifically, the Tax Court believed that the planning expert, and by extension the taxpayer expert appraiser, had overestimated the average prices of the lots in the hypothetical development because several of the benchmark properties that they considered in fixing prices were superior in various ways. The Tax Court further explained that the taxpayer expert appraiser did not adequately account for the large degree of uncertainty and risk affiliated with any hypothetical residential development when he created his discounted cash-flow analysis.

The Tax Court also explained that, although the taxpayer expert appraiser conducted sufficient due diligence to support his projected development costs, he neglected to adjust for inflation over the seven-year absorption period. The Tax Court next criticized the taxpayer expert appraiser for omitting the costs of building the model home and speculative homes from his financial analysis. Finally, the Tax Court

[23] *Id.* at 17.

[24] *Id.* at 19.

[25] *Id.* at 34.

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disapproved of the distinct manner in which the taxpayer expert appraiser applied the 15 percent profit margin for the hypothetical developer and the 11.25 percent discount rate.[26]

The Tax Court held that, based on the planning expert, taxpayer expert appraiser, a concession by the IRS, and some machinations of its own, the FMV of the conservation easement donated by PropCo was about $8.88 million.

Because the deduction of $17.5 million claimed by PropCo on its Form 1065 for 2012 did *not* exceed the amount determined by the Tax Court by 200 percent or more, the "gross valuation misstatement" penalty did not apply. It was close, though, with the threshold at $8.75 million.[27]

PropCo did not escape completely, however. The Tax Court held that the "substantial valuation misstatement" penalty applied for two reasons. First, the difference between the value claimed by PropCo on its Form 1065 and the correct value set by the Tax Court was between 150 percent and 200 percent. Second, PropCo, based on the actions or inactions of the organizer, lacked reasonable cause, failed to reasonably rely on the original appraisers, and did not conduct its own good faith investigation into the value of the conservation easement.[28]

B. Round Two: Court of Appeals

Unhappy about the Tax Court's decision that it was entitled to a charitable deduction of $0 and penalties apply, PropCo sought relief from the Eleventh Circuit.[29] Only the pertinent aspects of round two are evaluated below.

1. First issue.

Time was on PropCo's side. Things drastically changed after the Tax Court held that the deed filed by PropCo failed to protect the conservation easement in perpetuity, as required, because it did not comport with the regulation addressing how to divide sales proceeds in situations involving post-donation extinguishment actions. Specifically, the Eleventh Circuit held in another case, *Hewitt*,[30] that the IRS's interpretation of the regulation was arbitrary, capricious, and in violation of the Administrative Procedure Act.

Because it had subsequently "invalidated the regulation on which the Tax Court relied in disallowing [PropCo's] charitable deduction," the Eleventh Circuit vacated that portion of the Tax Court's earlier judgment.[31] In other words, it held that the Tax Court cannot give PropCo a deduction of $0 based on supposed noncompliance with an invalid regulation.

The Eleventh Circuit thus returned *Glade Creek Partners* to the Tax Court, instructing it to reconsider the case, without giving credence to the IRS's argument about the deed. The Eleventh Circuit warned, though, that this would not be the proverbial slam dunk for PropCo. It underscored that the IRS had raised "several other arguments" for giving PropCo a deduction of $0, all of which the Tax Court would need to analyze in round three of the dispute.

2. Second issue.

PropCo did not fare as well on the second issue. The Eleventh Circuit refused to alter the earlier decision by the Tax Court about applicability of the substantial valuation misstatement penalty.[32]

C. Round Three: Back to the Tax Court

PropCo was riding high, having persuaded the Eleventh Circuit that the IRS's basis for allowing a charitable donation of $0 was invalid and forcing the Tax Court to take another look.[33] That euphoria was short lived.

1. Expanded facts.

The Tax Court summarized the key facts from the first two rounds and supplemented them, as follows:

- When Hawks Bluff contributed property to PropCo by quitclaim deed in exchange for a

[26] *Id.* at 41-54.

[27] *Id.* at 54-55.

[28] *Id.* at 55-59.

[29] *Glade Creek Partners*, No. 21-11251; *see also* Kristen A. Parillo, "Appeals Court Vacates Denial of Easement Deduction," *Tax Notes Federal*, Aug. 29, 2022, p. 1505.

[30] *See Hewitt v. Commissioner*, 21 F.4th 1336 (11th Cir. 2021).

[31] *Glade Creek Partners*, No. 21-11251, at 6.

[32] Parillo, *supra* note 30.

[33] *Glade Creek Partners*, T.C. Memo. 2023-82.

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98 percent interest in PropCo, it reduced the value of its inventory by about $2.9 million.

- The operating agreement for PropCo described neither the character of the property (that is, as inventory or investment property) nor how Hawks Bluff and PropCo would report the transaction on their respective tax returns.
- Hawks Bluff continued to sell lots on Tract I, successfully, after it contributed the relevant property to PropCo.
- The tax attorney hired by InvesCo explained during a meeting that Vincent and others attended the negative tax effect of having the property classified as inventory.
- InvesCo used a private placement memorandum to raise money from potential partners. Among other things, it explained that, if the property transferred by Hawks Bluff to PropCo were considered inventory in the hands of PropCo, the amount of the charitable donation would be limited to PropCo's adjusted basis in the property. The private placement memorandum also stated that InvesCo believed that the property would be treated as a capital asset of PropCo so that the value of the donation would be based on FMV using its HBU, unrestrained by PropCo's adjusted basis in the property.
- The Form 1120-S, "U.S. Income Tax Return for an S Corporation," for 2012 that Hawks Bluff filed with the IRS indicated that it was a real estate dealer and the transferred property was inventory. Attached to that Form 1120-S was a Form 4797, "Sale of Business Property," describing the transaction as a "sale to Glade Creek" and claiming on ordinary loss upon the sale.

2. Framing the issue and positions.

This article previously explained that the value of a conservation easement generally is its FMV at the time of the donation, but that amount decreases if the sale of such property would have yielded ordinary income or short-term capital gain, as opposed to long-term capital gain. The charitable deduction amount in those situations equals the taxpayer's adjusted basis in the donated property, which often is less than its FMV. This article also indicated that when a partner contributes property to a partnership, such property is considered inventory, and the partnership sells it within the following five-year period, the resulting gain is considered ordinary income, not capital gain.[34]

Applying those foundations to *Glade Creek Partners*, the Tax Court underscored that if the property that Hawks Bluff transferred to PropCo was inventory in its hands, this characterization would transfer to PropCo, and the amount of the easement donation would be limited to PropCo's adjusted basis in the property.[35]

The IRS, unsurprisingly, took the position that Hawks Bluff held the property as inventory, and such treatment carried over to PropCo when the property was donated. Thus, PropCo's charitable deduction could not surpass its adjusted basis, which the IRS calculated at $3.7 million.

PropCo disagreed for four reasons. First, it argued that the property was investment property in the hands of Hawks Bluff, not inventory. Second, the activities and intentions of ILC are relevant to determining the character of the property: It acquired Tract I, Tract II, and Tract III as investment property, and only Tract I was later converted to inventory. Third, PropCo contended that, if the Tax Court were to decide that ILC held the easement property (that is, Tract II and Tract III) as inventory originally, it later became investment property in 2009 when ILC abandoned its plans to develop because of the recession and insufficient funding. Finally, putting ILC aside, PropCo maintained that Hawks Bluff was organized for purposes of holding the donated property as investment property and did so.

3. Meaning of inventory.

The Tax Court began with the definition of inventory. It explained that a capital asset is property held by the taxpayer, regardless of whether it is connected with its trade or business, but does *not* include several things. Among the items excluded are "stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer" or "property held by the taxpayer for sale to

[34]Section 724(b).

[35]*Glade Creek Partners*, T.C. Memo. 2023-82, at 8-9.

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customers in the ordinary course of his trade or business."[36]

Citing standards developed by the Eleventh Circuit, the Tax Court explained that whether the sale of a particular property will generate ordinary income or capital gain depends on whether the taxpayer was engaged in a trade or business, whether the taxpayer held the property primarily for sale in that business, and whether the sales anticipated by the taxpayer were ordinary in the business.

In answering those three questions, the Tax Court explained that it had to consider the following factors: (1) purpose for acquiring the property and duration of ownership, (2) extent and type of efforts a taxpayer made to sell the property, (3) the number, continuity and substantiality of sales, (4) the use of advertising and other methods to increase sales, (5) the degree of supervision or control that the taxpayer exercised over any representative selling the property, (6) the use of a business office to sell the property, and (7) the time and effort the taxpayer habitually devoted to sales. Who said tax law is not great: Three questions answered by delving into seven factors?

The Tax Court acknowledged that most of the factors centered on sales and marketing, there were no lot sales on the easement property (that is, Tract II or Tract III), and this reality might favor characterization as a capital asset. The Tax Court minimized that, however, by underscoring that the factors do not constitute a "balancing test," no one factor is controlling, some factors can be ignored, and the Tax Court is free to consider and attribute importance to factors that are not even on the list. With that said, the Tax Court revealed that it was placing "significant weight" on the manner in which Hawks Bluff reported the property and related transactions.

4. Reporting by Hawks Bluff.

Hawks Bluff indicated on its Form 1120-S for 2012 that it was in business as a real estate dealer, the property was inventory, and inventory was reduced when it transferred the property to PropCo.

PropCo claimed that what Hawks Bluff reported was incorrect for two reasons. First, Hawks Bluff made a nontaxable contribution of property to PropCo in exchange for ownership interests; it did not sell anything. Second, PropCo alleged that Hawks Bluff characterized the property as inventory intentionally so that it could claim an ordinary loss in 2012. In all events, PropCo emphasized, it should not be legally bound by the tax reporting done by Hawks Bluff.

The Tax Court disagreed, clarifying that what Hawks Bluff was really reporting on its Form 1120-S was not the sale of the property, but rather the sale of its ownership interests in PropCo to InvesCo. It went on to explain that the sale of a partnership interest normally is treated as the sale of a capital asset, resulting in a capital gain or loss. An exception exists in situations in which a partnership has inventory, though. In those cases, the taxpayer is deemed to have sold an interest in the assets (that is, inventory) of the partnership, which would trigger ordinary income.

The Tax Court explained that Congress created that special rule to stop taxpayers from organizing partnerships solely for purposes of accessing capital gain treatment (and thus reduced taxes) on the sale of inventory. The Tax Court reasoned as follows: "Assuming that the easement property was inventory, it would have been proper for Hawks Bluff to treat the sale of its [PropCo] interest as the sale of an interest in inventory, and thus Hawks Bluff would have been required to report the sale as generating ordinary income or loss."

The Tax Court also rejected PropCo's allegation that Hawks Bluff had some tax motive for characterizing the property it contributed as inventory. Why? Hawks Bluff was already reporting an ordinary loss on its Form 4797 unrelated to the sale of its interests in PropCo, and it claimed a charitable contribution deduction of about $1.5 million for 2012 thanks to its remaining interests in PropCo. In short, Hawks Bluff was already in a significant loss position.

Next, the Tax Court refused to allow PropCo to distance itself entirely from Hawks Bluff. It pointed out that the Internal Revenue Code expressly states that the character of the donated

[36] *Id.* at 9-10 (citing section 724(b), section 751(d), and section 1221(a)).

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property in the hands of Hawks Bluff is relevant to PropCo subsequently.[37] The Tax Court conceded that the Form 1120-S filed by Hawks Bluff does not legally bind PropCo, but insisted that it should be afforded "significant weight" in light of the partnership antiabuse rules enacted by Congress.

The Tax Court also indicated that PropCo partially brought this problem upon itself. For instance, the operating agreement could have explicitly stated that Hawks Bluff was donating investment property and it needed to classify it as a capital asset on its Form 1120-S and elsewhere. The Tax Court pointed out that PropCo knew the importance of donating a long-term capital asset, as this was discussed in meetings with its tax attorney and in the private placement memorandum given to potential partners. The Tax Court concluded that "the only evidence in the record that objectively establishes how Hawks Bluff characterized the easement property" was its Form 1120-S for 2012.

5. Back to the questions and factors — purposes for holding property.

At this point, the Tax Court turned back to the seven factors enumerated above, devoting attention to just a few. One factor of interest was Hawk Bluff's purpose for owning the property on which the easement was ultimately placed. The Tax Court, citing applicable precedent, conceded that a taxpayer's reason for holding property is not fixed; it can change over time.

The Tax Court then noted that Hawks Bluff indicated to the IRS on its Form 1120-S for 2012 that it was a real estate dealer, and it continued selling lots on Tract I after donating the easement. Moreover, Vincent did not testify during the trial that the property was held for investment purposes and did not dispute classification as a real estate dealer. He said, in fact, that lots were not being sold during an earlier period because of a weak economy and inadequate marketing, not because Hawks Bluff was not trying. Thus, the Tax Court held that Hawks Bluff was a real estate broker.

PropCo countered that, even if Hawks Bluff was in the real estate business, it could nonetheless hold some properties for investment purposes. The Tax Court retorted that this duality is feasible, but taxpayers claiming that status have the burden of adequately segregating inventory from investments. The Tax Court must consider various items when analyzing the segregation issue, including whether the taxpayer treated the relevant property differently, made improvements on it, subdivided it, advertised it, otherwise held it out for sale, solicited the offer that led to its sale, or held it in the name of a separate entity.

a. Why ILC held the property.

PropCo suggested that ILC bought the easement property (that is, Tract II and Tract III) as an investment, segregated that property from Tract I to preserve its character, and treated the property differently in that it did not record platted lots there. The Tax Court held that, to the extent that ILC's purpose for holding the easement property is even relevant to the analysis, ILC held it as inventory.[38] The Tax Court cited the quick turnaround of the development as critical. ILC bought the entire property in 2006, hired Vincent to analyze it for residential development potential, retained an engineer to create a concept plan for one community, placed restrictive covenants on the property in accordance with the plan, obtained governmental approvals, and invested millions in infrastructure.

Moreover, the Tax Court explained that the real reason for not platting lots on Tract II and Tract III early in the process was to avoid an increase in property taxes; it had nothing to do with investment status. The Tax Court eventually held as follows:

> ILC was a failed real estate developer that held the entire ILC property out for sale to customers in the ordinary course of its business as a master-planned community. ILC continued to hold the ILC property in that business when it transferred its unsold inventory to Hawks Bluff although it may not have been actively engaged in that business.[39]

[37] *Id.* at 13 (citing section 724(b)).

[38] *Id.* at 19.

[39] *Id.* at 22.

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b. Why Hawks Bluff held the property.

PropCo argued that Hawks Bluff was formed to stop development, marketing, and sales activities, and to formulate a broader plan for long-term investment of Tract I, Tract II, and Tract III. The Tax Court was not buying it, period. It said that PropCo's position was speculative, unsupported by the record, inconsistent with Vincent's testimony at trial, and contrary to the supposed facts in its own legal briefs. Ultimately, the Tax Court determined that Hawks Bluff "was organized to take over a failing real estate development with Vincent as a part owner, find a solution for the ongoing financial problems, and continue to sell the lots to customers in the ordinary course of business."[40]

6. Back to the questions and factors — sales and marketing.

The Tax Court stated that nearly all seven factors listed above deal with sales and marketing in some manner and that those activities are the "most important" in determining the character of property. The Tax Court acknowledged that no lot sales occurred on Tract II or Tract III, but clarified that this alone does not mandate a holding that the property was held for investment. It went on to punctuate that ILC's plan from the outset was to develop the entire property in three phases, using the cashflow from the Tract I to fund Tract II and Tract III. ILC was not holding the latter two for investment purposes initially, with a plan to make a decision about whether to develop them only after Tract I had been completed.[41]

7. Back to the questions and factors — development.

Not making improvements to real property, such as installing infrastructure, can serve as support for the position that a taxpayer held property for investment purposes. The Tax Court pointed out that (1) PropCo argued as part of the original trial that ILC spent about $6 million in infrastructure related to Tract I and the easement property (that is, Tract II and Tract III), (2) it previously agreed that the HBU of the property was residential development thanks in part to the infrastructure, and (3) the infrastructure, comprehensive plan, and governmental approvals all affected the Tax Court's earlier decision about the value of the easement.[42] In other words, creating significant infrastructure and taking other steps helped PropCo initially in terms of establishing the HBU of the property and its value.

However, things changed when the case was remanded by the Eleventh Circuit to the Tax Court, and the IRS raised the argument that the amount of the charitable donation should be limited to PropCo's adjusted basis because it did not involve long-term capital gain property. The Tax Court explained that the development activities completed by ILC weigh against a finding that it purchased the easement property for investment purposes or adequately segregated it from Tract I. It conceded that Hawks Bluff did not undertake additional development after acquiring the property from ILC, but this had little meaning for the Tax Court for two reasons. First, Hawks Bluff intervened for a specific purpose, namely, to take over ILC's failing business, give Vincent an ownership interest, and satisfy the bank that financed the infrastructure projects. Second, ILC had already finished the work needed to sell lots on Tract I, so that additional development by Hawks Bluff was unnecessary.[43] The Tax Court also highlighted the fact that PropCo did not present any evidence showing whether, or to what extent, any increase in the value of the property during the relevant period was attributable to market appreciation, as opposed to the addition of infrastructure.[44]

8. Conclusion.

The Tax Court's ultimate conclusion was that neither ILC nor Hawks Bluff held the relevant property for investment purposes, and this character carried over to PropCo. Therefore, the charitable deduction stemming from the donation of this property was capped at PropCo's adjusted basis therein.[45]

[40] *Id.* at 17.

[41] *Id.* at 22-23.

[42] *Id.* at 23-25.

[43] *Id.* at 25.

[44] *Id.* at 26.

[45] *Id.* at 26-27.

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The deduction to which PropCo was entitled changed drastically over the course of this long dispute, with PropCo saying $17.5 million on its Form 1065, the IRS saying $0 during the audit, PropCo's expert saying $16.2 million at trial, the Tax Court initially saying $0 because of the deed problem, the Eleventh Circuit provisionally saying $8.88 million, and the Tax Court saying $3.7 million on remand.

VI. Prior Focus on Original Landowners

Readers may not realize *Glade Creek Partners* is *not* the first time that the IRS has scrutinized original landowners in the context of conservation easement disputes. Indeed, the IRS often contacts them during audits in an effort to gather data about the ownership history of the property, its traditional uses, previous attempts to sell, zoning or permitting matters, encumbrances, existence of previous valuations for any purpose, property tax assessments and challenges, communications with organizers, their understanding of whether they were selling or contributing property to PropCo, and more.

Another major line of inquiry by the IRS is how long the original landowner held the property before contributing it to PropCo because PropCo often "tacks," or adopts, this holding-period to ensure that the property on which it donates an easement meets the "long-term" requirement. Why is this important? As explained above, the charitable deduction decreases by the amount of gain that would *not* have been characterized as "long-term" capital gain if the taxpayer had actually sold the property for its FMV.[46] Put differently, if the sale of the property would have generated ordinary income or short-term capital gain, the charitable deduction must be reduced accordingly. A summary of the rules follows.

If a capital asset is held for more than one year, gain or loss upon disposition normally is treated as long-term capital gain or long-term capital loss.[47] The holding-period rules generally provide that the period during which the contributed property was held *before* its transfer to a partnership is added to (1) the partner's holding-period in its partnership interest, *and* (2) the partnership's holding-period in the property received.[48] The regulations describe this concept, commonly known as "tacking," as follows:

> The basis to the partnership of property contributed to it by a partner is the adjusted basis of such property to the contributing partner at the time of the contribution. Since such property has the same basis in the hands of the partnership as it had in the hands of the contributing partner, *the holding-period of such property for the partnership includes the period during which it was held by the partner*.[49] [Emphasis added.]

The IRS has long recognized the reliance on tacking by partnerships making easement donations and its critical function. For example, Notice 2017-10, 2017-4 IRB 544, classified tacking of the holding-period as one of the hallmarks of a "syndicated" transactions. It described this concept in the following manner: "Investors who hold their direct or indirect interests in the pass-through entity for one year or less may rely on the pass-through entity's holding period in the underlying real property to treat the donated conservation easement as long-term capital gain property."[50] The IRS's Audit Technique Guide, likewise, cautioned that "the partnership structure and partnership agreement are of particular importance in a syndicated conservation easement case because the partnership relies on the contributing partner's holding period to generate the deduction."[51]

VII. Conclusion

This article explains that taxpayers must donate long-term capital gain property to a charitable organization to maximize the related tax deduction. In the past, the IRS looked to original landowners solely to see if the property donated by PropCo was long-term, thanks to the

[46] Section 170(e)(1)(A).

[47] Section 1222(3).

[48] Section 1223(1).

[49] Reg. section 1.723-1.

[50] Notice 2017-10, section 1.

[51] IRS Pub. 5464, "Conservation Easement Audit Technique Guide," at 96 (rev. Nov. 9, 2020).

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tacking rules. As *Glade Creek Partners* shows, the IRS is now scrutinizing original landowners regarding whether an item is "capital gain" property or ordinary income property, too. The IRS's goal is to persuade the Tax Court that the original landowners held the property as inventory or for development purposes, not as an investment, and that such character carried over to PropCo. That, as *Glade Creek Partners* demonstrates, could lead to a significant decrease in the charitable deduction. ■

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