taxnotes federal

Volume 183, Number 7 ■ May 13, 2024

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Reprinted from *Tax Notes Federal*, May 13, 2024, p. 1213

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In this article, Sheppard explains how the Tax Court, in three recent conservation easement disputes, has weighed various factors in concluding that the relevant property constituted inventory in the hands of the taxpayer, rather than an investment.

I. Introduction

To prevail in conservation easement donation cases, the IRS has trotted out many different arguments in recent years. Some were rejected by the Tax Court upon arrival, others gradually disappeared as taxpayers improved pre-donation documentation to avoid "technical" flaws exploited by the IRS, and a few still exist. One of the lingering challenges centers on the character, for federal tax purposes, of the property on which an easement is placed. This argument has been dubbed the "inventory issue," and the IRS is now raising it with a vengeance. These efforts have resulted in three recent Tax Court victories for the IRS: *Glade Creek Partners*, *Mill Road 36 Henry*, and *Oconee Land Holdings*. This article examines pivotal concepts in easement disputes, key characters, legal support for the inventory issue, and the three pivotal cases thus far.[1]

II. Conservation Easement Donations

Taxpayers who own undeveloped real property have several choices. They might hold the property for investment purposes and then sell when it appreciates sufficiently. Another option is to determine how to maximize profitability from the property immediately and do that, regardless of negative effects on others. One more possibility is voluntarily restricting future uses of the property to benefit society as a whole. The last option, known as donating a conservation easement, often triggers tax deductions for donors.[2]

Congress has offered tax incentives for donating conservation easements for more than five decades, starting in 1969.[3] It codified the notion as section 170(h) in 1980.[4] Four years later, Congress introduced legislation to sweeten the pot. It wanted to expand the rewards for protecting land, mindful of increasing development pressures and decreasing federal budgets for land acquisition. A hearing about the legislation left no doubt that Congress was

[1] *See* Hale E. Sheppard, "Valuation Loss in Recent Easement Case Obscures Silver Linings," *Tax Notes Federal*, Dec. 4, 2023, p. 1741; and Sheppard, "IRS Shifts Focus to Original Landowners in Easement Disputes," *Tax Notes Federal*, Aug. 14, 2023, p. 1077.

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

[3] Tax Reform Act of 1969, section 201; H.R. Rep. No. 91-782 (Dec. 21, 1969); *see also* TRA 1976, section 2124(e); and Tax Reduction and Simplification Act of 1977, section 309.

[4] Tax Treatment Extension Act, section 6(a) (1980); S. Rep. No. 96-1007 (Sept. 30, 1980).

providing an incentive for private land preservation — and that donors were largely motivated by tax benefits.[5]

Taxpayers cannot donate easements on just any old piece of property and claim a tax deduction; they must demonstrate that the property is worth protecting, meaning that it has one or more acceptable conservation purposes.[6]

Taxpayers memorialize the donation by filing a deed of conservation easement. In preparing the deed, taxpayers often coordinate with a land trust to identify limited activities that can continue on the property after the donation without interfering with the deed and without prejudicing the conservation purpose.[7] These activities are called "reserved rights."[8]

The IRS will not allow the tax deduction stemming from a conservation easement unless, before making the donation, the taxpayer provides the land trust with "documentation sufficient to establish the condition of the property at the time of the gift."[9] This is called the baseline report. It frequently contains surveys, pictures taken from various locations, and a detailed map showing man-made improvements, plants, animals, distinct natural features, and more.[10]

The value of the conservation easement is the fair market value at the time of the donation.[11] The term "fair market value" 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.[12] The best evidence of the FMV of an easement would be the sale price of other easements that are comparable in size, location, usage, and so on. However, even the IRS recognizes that it is difficult, if not impossible, to find comparable sales.[13] Thus, 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 as 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.[14] The difference between the before value and after value, with certain other adjustments, produces the value of the easement donation.

The pivotal concept in easement valuation is HBU, and all parties are supposed to take this into account.[15] A property's HBU is the most profitable use for which it is adaptable and needed in the near future.[16] The term also means the use of property that yields maximum economic benefit, while also being physically, legally, and financially feasible.[17] Importantly, valuation in the easement context does not depend on whether the owner has actually put the property to its HBU in the past.[18] The HBU can be *any* realistic potential use of the property.[19]

Claiming an easement-related deduction is surprisingly complicated. It involves numerous actions and documents, including the following: The taxpayer must obtain a qualified appraisal from a qualified appraiser, demonstrate that the land trust is a qualified organization, obtain an acceptable baseline report, receive a "contemporaneous written acknowledgement" of

[5] Joint Committee on Taxation, "Description of S. 1675 (Public Land Acquisition Alternatives Act of 1983)," JCX-1-84, at 10 (Feb. 4, 1984) (statement by Sen. Malcolm Wallop).

[6] Section 170(h)(4)(A); reg. section 170A-14(d)(1); S. Rep No. 96-1007, at 10.

[7] Reg. section 1.170A-14(b)(2).

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

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

[10] *Id.*

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

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

[13] IRS, *supra* note 8, at 41.

[14] *Id.*

[15] *The Stanley Works v. Commissioner*, 87 T.C. 389, 400 (1986); reg. section 1.170A-14(h)(3).

[16] *Olson v. United States*, 292 U.S. 246, 255 (1934).

[17] *Esgar Corp. v. Commissioner*, 744 F.3d 648, 659 n.10 (10th Cir. 2014).

[18] *Id.* at 657.

[19] *Symington v. Commissioner*, 87 T.C. 892, 896 (1986).

the donation, and file a timely tax return reporting the charitable tax deduction, enclosing Form 8283, "Noncash Charitable Contribution," and the qualified appraisal.[20]

III. Some Key Characters

There is no typical conservation easement donation because all properties, conservation features, valuation methods, HBUs, and other circumstances are unique to each case. Nevertheless, some of the normal characters in a so-called syndicated transaction might be described as follows. First, the original landowner initially holds the relevant property. Second, the property holding partnership receives the property as a contribution from the original landowner in exchange for significant ownership in the property holding partnership. Third, the investment partnership, generally funded by cash contributions from individuals, purchases nearly all the membership interests in the property holding partnership from the original landowner. Finally, after the property holding partnership donates the conservation easement, the individual partners in the investment partnership are allocated most of the resulting tax deduction.[21]

IV. Importance of Character

As explained above, the value of the conservation easement is the FMV at the time of the donation.[22] That figure must be reduced, however, by the amount of gain that would not have been characterized as long-term capital gain if the taxpayer had sold the property.[23] 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 of these rules in the context of a syndicated easement transaction is that the tax deduction is limited to the property holding partnership's adjusted basis in the donated property. Stated differently, the property holding partnership is prevented from claiming a higher tax deduction deriving from the HBU of the property.

On a related note, if a taxpayer contributes property to a partnership that is considered inventory in the taxpayer's hands, 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.[24] Congress enacted this rule to prevent partners from converting ordinary income property into capital gain property simply by contributing it to a partnership (with a different purpose for owning the property) and then having the partnership sell it.[25]

As explained in the introduction of this article, the IRS has started raising this inventory issue in many conservation easement cases. The Tax Court has rejected this argument in some cases, concluding that it has no applicability. However, the IRS has achieved judicial success on this issue three times thus far. Those victories are analyzed below.

V. First Case

The first case, *Glade Creek Partners*,[26] showed the importance of the character of the property on which a conservation easement is placed.

A. 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, called Tract I, Tract II, and Tract III.

The property was undeveloped when ILC bought it. Therefore, ILC spent about $6 million more to complete various infrastructure projects

[20] *See* IRS, *supra* note 8, at 24-30; IRS Publication 1771, "Charitable Contributions — Substantiation and Disclosure Requirements" (Mar. 2016); IRS Publication 526, Charitable Contributions (2022); section 170(f)(8) and (f)(11); reg. section 1.170A-13; Notice 2006-96, 2006-2 C.B. 902; and T.D. 9836.

[21] Notice 2017-10, 2017-4 IRB 544, section 1.

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

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

[24] Section 724(b).

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

[26] *Glade Creek Partners LLC v. Commissioner*, T.C. Memo. 2023-82, *on remand from* No. 21-11251 (11th Cir. Aug. 22, 2022) (unpublished), *vacating in part* T.C. Memo. 2020-148.

and to 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 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 departure occurred when Hawks Bluff Investment Group Inc. acquired the remaining unsold lots in Tract I, along with all of Tract II and Tract III, in exchange for assuming ILC's liabilities. One of the three shareholders of Hawks Bluff was James Vincent, a local real estate investor, who had provided services in connection with the ILC project.

In his quest for 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, were inconsistent with the vision marketed to early purchasers of lots in Tract I, and would negatively affect development of the remaining lots in Tract I. Vincent decided to pursue a conservation easement on tracts II and III.

Vincent, through an individual experienced with real estate projects and conservation easements, formed two entities in connection with the proposed transaction: Glade Creek Partners LLC (PropCo) and Sequatchie Holdings LLC (InvesCo). The individual then hired various professionals to complete the pre-donation actions, among them a brokerage firm, securities and tax lawyers, 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; (2) InvesCo would use a portion of the proceeds from its private offering to buy nearly all of Hawks Bluff's interests in PropCo; (3) Hawks Bluff would use the funds from InvesCo to satisfy its debt; and (4) if the partners in PropCo voted to donate an easement, nearly all the charitable deductions would be allocated to InvesCo. It would then pass them along to the individual partners.

The partners voted for the conservation easement option, after which PropCo donated an easement to a land trust and claimed a charitable tax deduction of just over $17.5 million for 2012.

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

B. Legal Analysis

In its initial opinion, the Tax Court held that PropCo was entitled to a charitable deduction of $0 because the conservation easement was not "protected in perpetuity." More specifically, the deed filed by PropCo expressly stated that any increase in value of the property 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 attributable to the land trust.[27] The Tax Court determined that the formula violated the applicable regulation.

PropCo appealed to the Eleventh Circuit. Time was on its side. Things drastically changed after the Tax Court ruled that the deed filed by PropCo failed to protect the conservation easement in perpetuity. The Eleventh Circuit held in another case, *Hewitt*,[28] that the IRS's interpretation of the regulation was arbitrary, capricious, and in violation of the Administrative Procedure Act. Because it had invalidated the regulation, the Eleventh Circuit vacated that portion of the Tax Court's earlier judgment.[29] In other words, the Eleventh Circuit held that the Tax Court could not give PropCo a deduction of $0 based on supposed noncompliance with an invalid regulation. It thus remanded *Glade Creek Partners* to the Tax Court, instructing it to reconsider the case without giving credence to the IRS's argument about the deed.

PropCo was riding high, having convinced the Eleventh Circuit that the IRS's basis for allowing a charitable deduction of $0 was invalid and forcing the Tax Court to take another look. That euphoria was short-lived. The Tax Court

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

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

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

highlighted key facts from the first two rounds and supplemented them, as follows:

- When Hawks Bluff contributed property to PropCo in exchange for a 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 successfully sell lots on Tract I after it contributed the relevant property to PropCo.
- The tax attorney hired by InvesCo explained, during a meeting attended by Vincent and others, the negative tax effect of having the property classified as inventory.
- InvesCo used a private placement memorandum to raise money from potential partners. 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 its adjusted basis in the property.
- The tax return for 2012 that Hawks Bluff filed with the IRS indicated that it was a real estate dealer and that the relevant property was inventory. Attached to that return was a Form 4797, "Sale of Business Property," describing the transaction as a "sale to Glade Creek" and claiming an ordinary loss on that sale.

The IRS, unsurprisingly, took the position that Hawks Bluff held the relevant property as inventory and that such character carried over to PropCo when the property was donated. Consequently, 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, the property was investment property in the hands of Hawks Bluff, not inventory. Second, the activities and intentions of ILC were relevant to determining the character of the property; ILC acquired all the property as an investment, and only Tract I was later converted to inventory. Third, PropCo contended that even if the Tax Court were to decide that ILC held the easement property (tracts II and III) as inventory originally, that inventory transformed into 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.

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 his trade or business, but does *not* include several things. Among the items excluded are "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 customers in the ordinary course of his trade or business."[30]

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 his business. In answering those three questions, the Tax Court explained that it had to consider the following factors: (1) the purpose for acquiring the property and the duration of ownership; (2) the extent and type of efforts the taxpayer made to sell the property; (3) the number, continuity, and substantiality of sales; (4) the use of developing, 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. The Tax Court said that it was placing significant weight on the manner in which Hawks Bluff reported the property and related transactions. Hawks Bluff indicated on its tax return for 2012 that it was a real estate dealer, that the property was inventory, and that the inventory was reduced when it transferred the

[30] *Glade Creek Partners*, T.C. Memo. 2023-82, at 9-10 (citing sections 724(b), 751(d), and 1221(a)).

property. 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 any event, 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 tax return was not the sale of the property but rather the sale of its ownership interests in PropCo to InvesCo. It explained 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 noted that Congress created that special rule to stop taxpayers from organizing partnerships solely to access capital gain treatment (and thus reduce 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."[31]

The Tax Court also rejected PropCo's allegation that Hawks Bluff had a tax motive for characterizing as inventory the property it contributed. 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 code expressly states that the character of the donated property in the hands of Hawks Bluff is relevant to PropCo later.[32] The Tax Court acknowledged that the tax return filed by Hawks Bluff did not legally bind PropCo, but insisted that the return should be given significant weight in light of the partnership antiabuse rules enacted by Congress. It then observed that "the only evidence in the record that objectively establishes how Hawks Bluff characterized the easement property" was its tax return for 2012.[33]

The Tax Court returned to the seven factors enumerated above, devoting attention to just three of them. First, the Tax Court centered on the purposes for holding a property. It noted that Hawks Bluff indicated on its tax return that it was a real estate dealer and that it continued selling lots on Tract I after donating the easement. Moreover, Vincent did not testify at 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. Accordingly, the Tax Court held that Hawks Bluff was a real estate broker.

PropCo countered that even if Hawks Bluff were in the real estate business, it could still hold certain properties for investment purposes. The Tax Court agreed with this duality in theory, but explained that taxpayers claiming such 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. After reviewing the relevant facts, the Tax Court ruled 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

[31] *Id.* at 12.

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

[33] *Id.* at 14.

unsold inventory to Hawks Bluff although it may not have been actively engaged in that business.[34]

The second factor analyzed by the Tax Court was the sales effort. The court acknowledged that no lot sales occurred on Tract II or Tract III, but it clarified that this, alone, did not mandate a holding that the property was held for investment. The Tax Court emphasized that ILC's plan from the outset was to develop the *entire* property in three phases, using the cash flow from Tract I to fund Tract II and Tract III. ILC was not holding the latter two for investment purposes initially; its plan was to make a decision about whether to develop them only after Tract I had been completed.

The third and final factor was development. The Tax Court explained that the development activities completed by ILC weighed against a finding that ILC purchased the easement property for investment purposes or adequately segregated it from Tract I. The Tax Court conceded that Hawks Bluff did not undertake additional development after acquiring the property from ILC, but that had little meaning 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 had financed the infrastructure projects. Second, ILC had already finished the work needed to sell lots on Tract I, such that additional development by Hawks Bluff was unnecessary.

The Tax Court ultimately concluded that neither ILC nor Hawks Bluff held the relevant property for investment purposes and that the ordinary income character carried over to PropCo. Therefore, the tax deduction stemming from the easement donation was capped at PropCo's adjusted basis in the property. PropCo originally claimed a charitable tax deduction of $17.5 million but ended up with a $3.7 million deduction.

VI. Second Case

The second case involving the inventory issue, *Mill Road 36 Henry*,[35] is long by any measure. This article focuses only on the key facts and the inventory issue, using simplified terms to identify the main characters.

A. Key Facts

The original landowner contributed 40 acres of undeveloped real property to a partnership (the property holding company). The property was located on the south side of Atlanta, in an area experiencing heavy commercial and residential development. The only asset of the property holding company was the property itself, which the company held for purposes of selling to a developer. With this goal in mind, the initial managing member obtained topography, soil, rock, and wetland surveys. He also secured a "concept plan" from an independent consulting firm, which contemplated development of an assisted living facility on the property.

The property holding company, through its managing member, filed an application in July 2016 to develop an assisted living facility. The county planning and zoning board then issued a conditional use evaluation report. The report recommended approval by the zoning advisory board, subject to a few conditions. Approving construction of an assisted living facility or leaving an application pending could hurt the county's overall development plan. Specifically, it could disrupt the blessing of other potential assisted living facilities because the county would reach a limit. The staff at the county planning and zoning board therefore asked the managing member to withdraw his application after getting conditional approval if he believed actual development would not occur. He obliged.

Later, another entity was formed: the traditional investment partnership. It used $1 million of the funds contributed by multiple partners to purchase a 97 percent ownership interest in the property holding company in September 2016. That entity voted three months

[34] *Id.* at 22.

[35] *Mill Road 36 Henry LLC v. Commissioner*, T.C. Memo. 2023-129.

later to donate a conservation easement on most of the property.

The property holding company hired the original appraiser to determine the value of the conservation easement. His appraisal stated that the property had been approved for construction of 677 assisted living units. The reality was that only conditional approval had been obtained for the property, after which the application was withdrawn. The appraiser concluded that the HBU of the property before donating an easement would have been development of an assisted living facility. Next, the appraiser used the sales comparison approach, using a price-per-unit theory. He concluded that each unit was worth $13,500, a figure he then multiplied by 677 units. That product, minus the cost for connecting public sewer to the property and a small post-donation value, yielded an appraisal of approximately $8.9 million for the easement. The property holding company claimed this amount on its tax return for 2016.

The IRS audited, of course. It eventually issued its final notice asserting, as it invariably does, that the property holding company should get a tax deduction of $0 and should pay a large penalty because of a gross valuation misstatement. The property holding company challenged the IRS by submitting a timely petition with the Tax Court. Litigation ensued, and the Tax Court issued its opinion in late 2023.

B. Legal Analysis

The IRS raised the inventory issue as part of the Tax Court litigation. Referencing *Glade Creek Partners*, the Tax Court explained that the character of a particular property 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 sale anticipated by the taxpayer was ordinary in his business.

The Tax Court explained that the original owner was engaged in the business of buying and selling real estate, both before and after contributing the property to the property holding company. It also noted that the original owner acquired the parent tract of which the property was a part "in furtherance of the real estate business" and later contributed the property "in furtherance of the real estate business." Moreover, the fact that the original owner later sold 97 percent of its interest in the property holding company did not alter the fact that the property was contributed by partners "who were real estate professionals within five years of donating the conservation easement."[36]

The Tax Court concluded that the easement was *not* worth about $8.9 million, as initially claimed by the property holding company. The correct value was about $420,000. That was because the original owner held the property as inventory, it contributed the property to the property holding company when it had a basis of about $420,000 in the relevant acres, and the donation was made within five years of the contribution.

VII. Third Case

The most recent Tax Court case focusing on the inventory issue is *Oconee Landing Property*.[37] Several interesting items arose in the case, but this article centers on just one.

A. Key Facts

The land at issue consisted of about 355 acres located roughly 70 miles east of Atlanta, near Lake Oconee, in an area that has become a vacation and retirement destination (the subject property). It was part of a larger piece of land consisting of approximately 1,100 acres (the parent tract). Various members of a family, directly or through entities, acquired the parent tract in 2003 (the landowners).

The landowners hired professionals to create maps, surveys, and potential plans for the parent tract. They ultimately opted for a mixed-use development scenario, made up of various "town centers" surrounded by homes at different price points. They then applied for, and received, the necessary zoning. Soon thereafter, the landowners installed roads, water access points, and utility access points. The next step was selling portions of the parent tract, generally for projects that would be "synergistic" with the mixed-use development. These included construction of a

[36] *Id.* at 56.

[37] *Oconee Landing Property LLC v. Commissioner*, T.C. Memo. 2024-25.

fire station, church, school, hospital, and assisted living facility. The landowners sold portions of the parent tract to other home developers, too.

The overall economy was struggling in 2011, and the real estate market was hit hard. Therefore, the landowners began marketing the parent tract to potential investors, hoping to find a joint venture partner that could supply the funds required to advance the project. Negotiations occurred from 2012 through 2014, but no deal was finalized.

In 2014, the landowners formed Carey Station LLC and contributed 980 of the remaining acres of the parent tract to it. They continued their marketing efforts thereafter, with little success. One bright spot was that Carey sold approximately 15 acres to a third party in 2014, which it developed into a residential subdivision.

In 2015, Carey entered into an agreement with a real estate broker, giving him the right to sell the entire parent tract for a particular price. The broker advertised the property, showed it to a prospective buyer, and introduced the buyer to the landowners. These efforts did not result in a transaction, though. In the absence of sales proceeds or investment capital from a joint venture partner, the landowners began exploring other options, including the possibility of donating a conservation easement.

As part of that process, Oconee Landing Property LLC was formed. Carey then contributed a portion of the parent tract, the subject property, to Oconee in exchange for almost complete ownership of Oconee. Next, various individuals, through an investment partnership, purchased from Carey nearly its entire interest in Oconee. In December 2015, Oconee donated an easement on the subject land, claimed a charitable deduction of about $20.7 million, and passed those tax benefits through to its direct and indirect partners.

The IRS audited and concluded that Oconee was entitled to a deduction of $0 and that penalties were in order. Oconee disagreed, of course, and initiated litigation in the Tax Court.

B. Legal Analysis

In setting the scene, the Tax Court described the applicable rules in much the same way it did earlier in *Glade Creek Partners* and *Mill Road 36 Henry*. There is no point in duplicating that background here.

In describing the tax character of the subject property, the Tax Court explained that the landowners held their interests in the parent tract for sale to customers in the ordinary course of business. The Tax Court listed several facts that, from its perspective, "point inescapably to that conclusion." They included the following:

- The landowners have been real estate developers for more than three generations.
- The landowners acquired the parent tract for development purposes, completed plans to convert it into a mixed-use residential community, and obtained the necessary zoning.
- The landowners completed initial infrastructure work on the parent tract, such as adding roads, water access points, and utility access points.
- The landowners obtained a concept plan and a master sewer plan contemplating various residential communities on the parent tract.
- The landowners "persistently marketed" the parent tract.
- The landowners conducted their sales and marketing activities directly, as well as through their office staff and related entities.
- From 2012 through 2014, the landowners engaged in negotiations with two potential joint venture partners to develop the parent tract.
- The landowners sold 10 parcels from the parent tract, normally with the objective of enhancing the chances of developing the entire parent tract. Those sales were "substantial" in that they involved over 150 acres and generated more than $3.6 million.
- When the landowners sold the parcels, they reported those events on their federal income tax returns as generating ordinary income, not capital gain. The Tax Court emphasized that it placed "great weight" on

that reporting, "which shows that the Landowners (and their entities) regarded the Parent Tract as being held for sale to customers in the ordinary course of their real estate business."[38]

- Carey sold about 15 acres of the parent tract to a third party and reported the proceeds as ordinary income on its tax return, consistent with characterization of that property as inventory.
- In 2015, the landowners were working with a real estate broker, who was authorized to sell what remained of the parent tract at a particular price. The broker advertised the property, gave a tour to a prospective buyer, and introduced him to the landowners to discuss a potential deal.

Based on the preceding, the Tax Court held that the parent tract, including the subject property, was ordinary income property. Therefore, when Carey contributed the subject property to Oconee, that tax character went with it. Following that logic, when Oconee later donated a conservation easement, the tax deduction was limited to Oconee's basis in the property. Oconee, in other words, could not claim a larger value rooted in the HBU of the subject property.

Oconee disagreed with the Tax Court. First, it argued that the landowners always held the parent tract as an investment and that such characterization was intact when they contributed it to Carey. Oconee further suggested that the landowners were not personally engaged in the real estate business because the relevant work was carried out by affiliated entities. The Tax Court rejected those notions, stating that the trial record "leaves no doubt" that the landowners were developers. It underscored that the landowners created numerous holding, investment, development, and construction companies to conduct their business. The Tax Court then concluded:

> In determining the character of the Parent Tract, it is immaterial which of these entities ultimately performed the development and construction work. The critical question is whether *the owners* of the Parent Tract held that land for sale to customers in the ordinary course of their real estate business. [The landowners] were the owners of the Parent Tract, and the facts establish that they held this land for sale to customers from 2003 onwards.[39]

Next, Oconee contended that even if the landowners initially held the parent tract as inventory, it was later converted into investment property in 2011 when the nationwide financial crisis and lack of funding caused the landowners to abandon their development plans. The Tax Court rebuffed this assertion, too. It pointed out that the economic realities during the relevant period might have obligated the landowners to shift their method but not their overarching goals. The Tax Court noted that the landowners simply decided to seek a joint venture partner possessing the necessary cash instead of forging ahead alone. The Tax Court described their new concept as follows: The landowners would provide the land, the joint venture partner would supply the capital, development would occur, and they would divide the profits. The Tax Court also underscored that this type of arrangement was not merely theoretical; the landowners actually accomplished that goal in 2014 for 15 acres of the parent tract.

Lastly, Oconee maintained that it should prevail, regardless of whether the subject property was ordinary income property, because the Tax Court should be focused on the character of the easement instead. Oconee reasoned that the tax provisions imposing the basis limitation did not apply because it donated a conservation easement on the subject property (not the subject property itself); the provisions refer to inventory held for sale to customers; and an easement is not tangible property falling into that category. The Tax Court was unpersuaded by that line of reasoning, stating that it "has little appeal to common sense." It explained that an easement "is a real property interest corresponding to a subset of the property rights possessed by Oconee, the fee simple owner." The Tax Court also relied on its

[38] *Id.* at 52.

[39] *Id.* at 54 (emphasis in original).

two earlier decisions supporting application of the inventory issue to conservation easement donations — *Glade Creek Partners* and *Mill Road 36 Henry*.

VIII. Conclusion

The good news is that after many years of the IRS obligating taxpayers and the Tax Court to center on what felt like every conceivable "technical" issue under the sun, many conservation easement disputes are finally focused on valuation. The bad news is that many questions of worth are still not deep dives into the special valuation rules for conservation easements, various HBUs for particular properties, the accuracy of inputs, the reasonableness of assumptions, and so on. Rather, they are exercises in tax character, reaching back to the purposes for which historical parties, including the original landowners, held the property. Given the frequency with which the IRS is raising this claim, the detrimental effect of the basis limitation on charitable tax deductions, and the three recent Tax Court cases covered in this article, taxpayers should be prepared to defend themselves against the inventory issue. ■