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In this article, Sheppard identifies the main facts and issues from a recent conservation easement donation dispute, *Little Horse Creek Property*, explains several taxpayer-favorable holdings by the Tax Court in the case, explores the strategic use of qualified offers, and argues that easement cases can be resolved — reasonably and without costly litigation — when the IRS focuses on valuation instead of supposed technical flaws in documents.

Sheppard and Chamberlain Hrdlicka represented the taxpayer in *Little Horse Creek Property*.

I. Introduction

Most tax disputes can be settled on reasonable terms, as long as the parties behave reasonably. This is true even in the context of so-called syndicated conservation easement transactions (SCETs).

The IRS has believed since late 2016 that partnerships that engage in SCETs are claiming excessive tax deductions based on inflated appraisals. The partnerships, of course, disagree. They cite congressional support for easement donations for over 50 years, the significant amount of pre-donation due diligence performed for each property, full disclosure to the IRS, and reliance on a long list of experts in various fields. The IRS and the partnerships have opposing views, and the dollars at stake are high, which is a recipe for intense disputes. These battles typically entail prolonged audits, Appeals Office conferences, Tax Court trials, and appellate litigation. All this fighting comes at a large cost to the partnerships, the IRS, and the judicial system.

A SCET case, *Little Horse Creek Property*,[1] recently settled before trial in the Tax Court. Using that case as the backdrop, this article provides an overview of the rules and procedures related to conservation easement donations, identifies supposed technical flaws that the IRS tends to attack, describes several critical holdings by the Tax Court beneficial to all partnerships involved in SCETs, explores the use of qualified offers, and demonstrates that SCET cases can be resolved when the IRS acts reasonably by focusing on the real issue — valuation.

II. Overview of Conservation Easements

Some background on the conservation easement process is necessary to appreciate the significance of *Little Horse Creek Property*.

Taxpayers that own undeveloped real property have several choices. For instance, they might (1) hold the property for investment purposes, selling it when it appreciates sufficiently; (2) determine how to maximize profitability from the property and do that, regardless of the negative effects on the local environment, community, or economy; or (3) voluntarily restrict future uses of the property, such that it is protected forever for the benefit of society. The third option, known as donating a conservation easement, not only achieves environmental protection but also triggers tax deductions for donors.[2]

[1] *Little Horse Creek Property LLC v. Commissioner*, No. 7421-19 (T.C. stipulated decision Sept. 22, 2021).

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

Taxpayers cannot donate an easement on just any property and claim a tax deduction; they must demonstrate that the property has at least one acceptable conservation purpose.[3]

Taxpayers memorialize the donation by filing a public deed of conservation easement or similar document. In preparing that deed, taxpayers often coordinate with the donee land trust to identify limited activities that can continue on the property after the donation without interfering with the deed, prejudicing the conservation purposes, or, hopefully, jeopardizing the tax deduction.[4] These activities are called reserved rights.[5]

The IRS will not allow the tax deduction stemming from a conservation easement unless, before making the donation, the taxpayer obtains "documentation sufficient to establish the condition of the property at the time of the gift."[6] This is referred to as the baseline report.[7]

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 willing seller would agree if neither party were obligated to participate in the transaction and if both parties had reasonable knowledge of the relevant facts.[9] The best evidence of the FMV of an easement would be the sale price of other conserved properties that are comparable in size, location, etc. The IRS recognizes that it is difficult, if not impossible, to find comparable easement sales.[10] Consequently, appraisers often must use the before-and-after method instead. This means that the 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 conservation easement, which creates the "after" value.[11] The difference between the "before" and "after" values of the property, with some adjustments, produces the amount of the donation.

A property's HBU is the most profitable use for which it is adaptable and needed in the reasonably near future.[12] The HBU must also be physically possible, legally permissible, financially feasible, and maximally productive.[13] Importantly, valuation in the easement context does not depend on whether the owner has actually put the property to its HBU in the past.[14] The HBU can be *any* realistic potential use of the property.[15] Common HBUs are construction of a residential community, creation of a mixed-use development, mining (of all types), and establishment of a solar energy facility.

Properly claiming the tax deduction from an easement donation is surprisingly complicated. It involves a significant number of actions and documents. Among other things, the taxpayer must (1) obtain a qualified appraisal from a qualified appraiser; (2) demonstrate that the land trust is a qualified organization; (3) obtain a baseline report adequately describing the condition of the property and the reasons why it is worthy of protection; (4) complete a Form 8283, "Noncash Charitable Contributions"; (5) assuming that the taxpayer is a partnership, file a timely Form 1065, "U.S. Return of Partnership Income," enclosing Form 8283 and the qualified appraisal; and (6) receive from the land trust a contemporaneous written acknowledgement, both for the easement and for any stewardship fee donated to finance perpetual protection of the property.[16]

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[3] Section 170(h)(4)(A); reg. section 170A-14(d)(1); and S. Rep. No. 96-1007, at 10 (1980).

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

[5] IRS, "Conservation Easement Audit Techniques Guide," at 23 (rev. Jan. 24, 2018) (ATG); *see also* reg. section 1.170A-14(e)(2) and (3).

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

[7] *Id.*

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

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

[10] ATG, *supra* note 5, at 42.

[11] *Id.* at 43-44.

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

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

[14] *Id.* at 657.

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

[16] *See* ATG, *supra* note 5, at 24-31; IRS Publication 1771, "Charitable Contributions — Substantiation and Disclosure Requirements"; IRS Publication 526, "Charitable Contributions"; section 170(f)(8) and (11); reg. section 1.170A-13; Notice 2006-96, 2006-2 C.B. 902; and T.D. 9836.

III. IRS Enforcement Actions

For the past several years, the IRS has been attacking partnerships that engaged in SCETs. In doing so, it has used a list of aggressive tactics.[17] This article highlights only the two actions most relevant to *Little Horse Creek Property*.

The IRS has consistently stated that the main problem with SCETs is inflated valuations. However, its primary focus in tax disputes thus far has been on "technical" flaws — that is, supposed problems with the deed, baseline report, qualified appraisal, Form 8283, or other documents affiliated with donations. The Conservation Easement Audit Techniques Guide published by the IRS contains a list of technical duties that IRS personnel are encouraged to challenge.[18]

The IRS has implemented a practice of issuing audit reports and notices of final partnership administrative adjustment claiming that *all* partnerships that participated in SCETs should get a charitable deduction of $0 and be severely penalized — regardless of the amount of pre-donation due diligence performed by the partnership, the strength of the conservation values, the existence of multiple independent appraisals, etc. Particularly galling to taxpayers is the IRS's refusal to specify the factual, legal, or tax reasons for its attacks. Indeed, the IRS often limits itself in the FPAA notices to alleging that the partnership should get a tax deduction of $0 because "it has not been established that all the requirements of I.R.C. Section 170 have been satisfied for the non-cash charitable contribution of a qualified conservation contribution." In addition to fully disallowing the deduction without providing justifications, the IRS proposes several alternative penalties ranging in severity. The IRS ordinarily leads with a gross valuation misstatement because it triggers the highest penalty, equal to 40 percent of the ultimate tax liability.[19]

[17] *See* Hale E. Sheppard, "30 Wrongs Do Not Make a Right: Revealing Extraordinary IRS Actions in Conservation Easement Disputes," 33 *Tax'n Exempts* 8 (2021), republished in 135 *J. Tax'n* 21 (2021).

[18] ATG, *supra* note 5, at 86, Exhibit 12-1.

[19] Sections 6662 and 6662A.

IV. Case Study

Little Horse Creek Property is an educational case. The most important aspects are explained below.[20]

A. Charitable Donation

Horse Creek Partners LLC (the original landowner) made a series of purchases of real property, the last of which occurred in June 2010. It amassed significant acreage close to Savannah, Georgia, and held it for several years.

The original landowner and another entity formed Little Horse Creek Property LLC (PropCo) on September 21, 2014. The original landowner contributed approximately 645 acres in exchange for a 99 percent interest in PropCo. The other entity owned the remaining 1 percent.

Little Horse Creek LLC (InvesCo) was also formed on September 21, 2014. Various individuals made capital contributions and executed subscription agreements in mid-December 2014 to become partners in InvesCo.

On December 23, 2014, the original landowner sold a 97 percent interest in PropCo to InvesCo. After that transaction, ownership of PropCo was as follows: The original landowner held 1 percent, another entity held 2 percent, and InvesCo held 97 percent.

On December 23, 2014, PropCo obtained an opinion letter from a reputable law firm indicating that PropCo had met or would meet all requirements under section 170(h), related regulations, and other tax authorities.

PropCo conducted a vote of the partners ending December 26, 2014, with the majority instructing PropCo to donate a conservation easement.

[20] The following documents were reviewed in preparing the case summary: the IRS appraiser's "Review With an Opinion of Value" (Apr. 17, 2017); the IRS's summary report (Mar. 20, 2018); PropCo's Tax Court petition (May 10, 2019); the IRS's answer (July 3, 2019); PropCo's reply to the answer (Aug. 19, 2019); the IRS's motion for partial summary judgment (MPSJ) and memorandum of law in support (Mar. 5, 2020); PropCo's qualified offer letter to the IRS (June 11, 2020); the IRS's offer letter to PropCo for the settlement initiative (July 9, 2020); PropCo's opposition to the IRS's MPSJ (Apr. 8, 2020); PropCo's MPSJ and memorandum of law in support (Aug. 5, 2020); the IRS's letter taking the position that the qualified offer was invalid (Sept. 4, 2020); the Tax Court's order denying both MPSJs (Mar. 2, 2021); and the decision document (Sept. 16, 2021).

On December 29, 2014, PropCo donated a conservation easement on approximately 642 acres of the 645 total acres to a charitable organization (the land trust). At the time of the donation, the property was already zoned for "planned unit development," it was free from mortgages, and it had entitlements to build more than 2,500 units of residential and multifamily housing. According to the deed, the donation had several conservation purposes, including preserving open space in accordance with a clearly delineated governmental policy, preserving a relatively natural habitat, and preserving open space for scenic enjoyment by the general public. The land trust prepared a baseline report to document the condition and characteristics of the property at the time of the donation.

On December 29, 2014, the day of the donation, the land trust issued two contemporaneous written acknowledgements. One pertained to the conservation easement, while the other confirmed the stewardship funds gifted by PropCo.

PropCo obtained a timely appraisal (the original appraisal). The original appraisal concluded that the HBU of the property would have been to construct a mixed-use development, featuring a master planned community, in accordance with the zoning already in effect. Taking into account the HBU, the original appraisal indicated that the FMV of the property *before* the donation of the conservation easement was $22,264,000, that the FMV *after* the donation was $645,000, and that no adjustments for enhancements to neighboring properties were warranted. This formula yielded a FMV of $21,619,000. PropCo also hired another appraiser to scrutinize the original appraisal, identify any material errors or omissions, and ensure that it complied with all requirements (the review appraisal).

Because PropCo donated only a conservation easement on the property to the land trust and did not outright donate the property in fee simple, it remained the owner of the property after 2014. Thus, PropCo had the ability to continue using the property as long as that use was done in accordance with the reserved rights expressly fixed in the deed.

B. Filings With the IRS

Relying on a reputable accounting firm, PropCo filed a timely 2014 Form 1065 with several attachments. Among them were the original appraisal, a completed and executed Form 8283, and a document titled "Supplemental Attachment" to Form 8283. Together, these showed that PropCo was claiming a conservation easement deduction of $21,619,000.

C. Summary of IRS Audit

The IRS started an audit in February 2017. It applied the special rules introduced in the 1982 Tax Equity and Fiscal Responsibility Act. Under the TEFRA rules, instead of auditing each of the partners separately, the IRS audits the relevant partnership, and then, at the very end of the process, any adjustments (such as a reduction in the amount of the charitable deduction and the imposition of penalties) resulting from this partnership-level dispute are passed through to the partners based on their ownership percentage.

PropCo, through its representatives, fully cooperated in the audit process. Among other things, it timely responded to three information document requests, granted an interview of the tax matters partner, and offered a site visit. Although not required, PropCo voluntarily extended the assessment period by executing Form 872-P, "Consent to Extend the Time to Assess Tax Attributable to Partnership Items."

The audit team consisted of a revenue agent and an IRS senior real estate appraiser. The latter had over 45 years of appraisal experience and held various certifications with the Appraisal Institute and designations with the Society of Real Estate Appraisers. He reviewed the original appraisal enclosed with the 2014 Form 1065, conducted his own independent analysis, and concluded that the conservation easement was worth $18,355,000. The professionals who prepared the original appraisal for PropCo then held a face-to-face meeting with the IRS appraiser to convince him that their value of $21,619,000 was more accurate. The IRS appraiser stuck to his guns, so to speak, sending a letter the following day to the revenue agent affirming his opinion that the conservation easement should be valued at $18,355,000. Notably, the figure presented by the IRS appraiser was only 15 percent below the amount initially claimed by PropCo in its original appraisal. Stated conversely, the IRS appraiser determined that the original appraisal was 85 percent correct.

The IRS appraiser came to several important conclusions in his written report. For instance, he agreed with PropCo's original appraisal regarding the HBU, zoning, the lack of enhancement to nearby properties, the time required to market and sell the properties in a master-planned community, the valuation method used, and the value of the property after the conservation easement donation. The only material disagreement, which was relatively slight, was the value of the property before PropCo donated the easement. The original appraisal fixed that value at $22,264,000, while the IRS appraiser thought it should be $19 million.

The environment changed when the case was elevated to the IRS attorneys. They refused to allow the revenue agent to conclude the case based on a 15 percent decrease in valuation, and the IRS issued a summary report with new legal and tax theories designed to give PropCo a tax deduction of $0. The IRS's primary position in the summary report was that the conservation easement was not protected in perpetuity, as required, because the clause in the deed concerning the allocation of sales proceeds upon future extinguishment of the easement allegedly failed to meet the standards set forth in the applicable regulations. The IRS's secondary position in the summary report was that, consistent with the determination by the IRS appraiser, PropCo was entitled to a deduction of no more than $18,355,000.

PropCo then participated in a closing conference. The IRS personnel in attendance were unwilling to alter their stance as set forth in the summary report, so the battle persisted.

D. Tax Court Litigation Begins

The IRS then issued the FPAA in February 2019, taking the primary position that PropCo was entitled to a charitable deduction of $0 (instead of $21,619,000). The sole legal/tax ground for this complete disallowance was that "the deduction . . . does not meet the requirements of Section 170 of the Internal Revenue Code." The alternative position by the IRS was that the deduction should be $18,355,000, consistent with the determination of the IRS appraiser. The FPAA also asserted accuracy-related penalties.

The FPAA provided no specific facts, legal theories, tax theories, or analysis for the disallowance of the conservation easement deduction or the imposition of penalties. Remarkably, after the IRS conducted an audit lasting approximately two years, the document attached to the FPAA proposing a multimillion-dollar tax liability plus sanctions and interest consisted of just one page.

PropCo filed a petition with the Tax Court in May 2019 disputing the FPAA.

E. IRS Tries to Win Without a Trial

The IRS filed a motion for partial summary judgment (MPSJ) in March 2020. The IRS essentially tried to convince the Tax Court to hold that PropCo was entitled to a charitable deduction of $0 based on two supposed technical flaws. According to the IRS's logic, if the Tax Court were to rule in its favor on the MPSJ, the only issue left unresolved would be whether PropCo should be penalized.

1. Key parts of the deed.

The most relevant portions of the deed were as follows.[21] (The critical language has been italicized to facilitate the analysis.)

- Paragraph 18 provided that if the conservation easement were terminated in the future by way of a judicial proceeding, "any and *all prior claims* shall first be satisfied by [PropCo's] portion of the proceeds before [the land trust's] portion is diminished in any way."
- Paragraph 20 explained that "the parties stipulated to have a current fair market value [of the conservation easement] determined by multiplying the fair market value of the property unencumbered by this Conservation Easement (*minus any increase*

[21] The IRS also challenged the so-called state law exception issue in its MPSJ. Paragraph 18 of the deed stated that if the conservation easement were terminated in the future by way of a judicial proceeding, "the amount of the proceeds to which [the land trust] shall be entitled shall be determined in accordance with the Proceeds paragraph below, unless state law provides otherwise." This issue was not fundamental to the Tax Court's order or to the settlement of the case; therefore, it is not addressed in this article.

in value after the date of this Conservation Easement attributable to improvements) by the ratio of the value of the Conservation Easement at the time of this conveyance to the value of the property at the time of this conveyance without deduction for the value of the Conservation Easement."

- Paragraph 20 also said that "the value of this Conservation Easement at the time of this conveyance, and the value of the property at the time of this conveyance without deduction for the value of the Conservation Easement, s*hall be determined according to that certain property appraisal report*, on file at the office of [the land trust], prepared on behalf of [PropCo] to establish the value of this Conservation Easement for purposes pursuant to section 170(h) of the Code."

2. First argument by the IRS.

The IRS argued that the preceding aspects of the deed were problematic for several reasons. It based nearly all its arguments on the Tax Court's decision in *Coal Property Holdings*.[22]

a. Context for understanding the IRS's attacks.

Conservation easements must be donated in perpetuity, but does anything really last forever? No, the IRS has recognized. The regulations explain that an unexpected post-donation change in the conditions surrounding the relevant property can make it either impossible or impractical to continue using it for conservation purposes.[23] This occurs, for instance, when the government approaches a taxpayer years after it donates a conservation easement, offers to purchase a portion of the protected land for purposes of installing a power line or constructing a road and, if the taxpayer refuses, forces the sale through a process called condemnation. The government effectively "takes" the property but must supposedly pay FMV for it. The question thus becomes, who gets the sales proceeds — the taxpayer, which still owns the property; the land trust, which holds the conservation easement on the property; or both under some formula? The regulations mandate use of a formula, which, based on a long list of Tax Court cases focused solely on this issue, is far from clear.[24]

For purposes of this article, it is enough to understand that the regulations state that a conservation easement is a property right held by the land trust that is worth at least the "proportionate value that the [conservation easement] at the time of the gift bears to the value of the property as a whole at that time."[25] The regulations go on to explain that if a condemnation or similar legal action occurs through which the government forcibly buys some or all of the property that is covered by the conservation easement, the land trust "must be entitled to a portion of the [sales] proceeds at least equal to that proportionate value of the [conservation easement], unless state law provides that the [taxpayer] is entitled to full proceeds . . . without regard to the terms of the prior" conservation easement.[26]

b. Subargument 1A.

The IRS alleged in its MPSJ that the deed filed by PropCo failed to guarantee the land trust a proportionate share of the proceeds from a future forced sale of the conservation easement "based on actual fair market value." The IRS maintained that paragraph 20 of the deed pegged the value of the conservation easement to the value claimed on the original appraisal — not the value ultimately determined by the IRS or the Tax Court, not its actual FMV, and not its "proportionate value" as that term is used in the regulations. The IRS claimed that using the original appraisal as the starting point could create a windfall for PropCo.

The IRS supplied the following hypothetical to make its point. It underscored the figures found in the original appraisal (that is, conservation easement value of $21,619,000 and pre-donation property value of $22,264,000, yielding 97.1 percent). If the government were to take the property in the future by condemnation and pay $1 million, the land trust would receive $971,000

[22] *Coal Property Holdings LLC v. Commissioner*, 153 T.C. 126 (2019).

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

[24] 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); and *Coal Property Holdings*, 153 T.C. 126.

[25] Reg. section 1.170A-14(g)(6)(ii).

[26] *Id.*

using the requirements in paragraph 20 of the deed. The IRS suggested that the result would be altered if one were to assume that the numbers in the original appraisal are incorrect and were later changed by the Tax Court to the following: conservation easement value of $23.6 million and pre-donation property value of $24 million, yielding 98.3 percent. Thus, concluded the IRS, using the formula required by the regulations, the land trust would get $983,000, whereas applying the language in the deed, the land trust would get only $971,000.

It is important to note that the example proffered by the IRS presupposes that PropCo *undervalued* the conservation easement by using the original appraisal; that is, it claimed a deduction that was too low. This scenario is laughable to anyone who has read any IRS publications, listened to any IRS statements, or defended any partnerships in SCET cases, because the IRS's unwavering accusation is that the partnerships significantly *overvalued* their donations based on inflated appraisals.

c. Subargument 1B.

The IRS contended that the deed allows an improper reduction in the future sales proceeds to the land trust because the value of any improvements made on the property *after* the date on which PropCo donated the conservation easement goes to PropCo, not the land trust. This argument is founded on the language in paragraph 20 of the deed, stating that the FMV of the property before the donation would be calculated "minus any increase in the value after the date of this Conservation Easement attributable to improvements." In making this argument, the IRS conveniently neglects to note that those improvements likely would be paid by PropCo.

d. Subargument 1C.

The IRS suggested that paragraph 18 of the deed allows an inappropriate decrease in the future sales proceeds to the land trust because of the language about satisfying "any and all prior claims." The IRS offered essentially no support for this argument.

3. Second argument by the IRS.

The IRS, after taking several shots at the deed, turned to the Form 8283.

a. Context for understanding the IRS's attacks.

Again, a little background is necessary to understand what upset the IRS. To claim the deduction related to a conservation easement donation, taxpayers must do several things, including attaching a "fully completed" Form 8283 to the tax return on which the deduction is first claimed.[27]

b. Subargument 2A.

PropCo enclosed a timely, complete, and executed Form 8283 with its 2014 Form 1065. Nevertheless, the IRS asked the Tax Court to determine that the Form 8283 was fatally flawed for two reasons. The IRS began by highlighting that the box asking for the date on which PropCo acquired the property stated "June 2010" instead of September 21, 2014. It argued that the "failure to disclose its correct date of acquisition in Form 8283 . . . in combination with a contradictory date being buried in the Supplemental Attachment, evince an intent to obscure [PropCo's] actual date of acquisition and avoid [the IRS] scrutinizing the transaction."

The IRS also suggested that PropCo had not "strictly complied" or "substantially complied" with the Form 8283 requirements, such that PropCo failed regardless of which legal standard the Tax Court were to apply. In advancing this argument, the IRS heavily relied on *RERI Holdings I*,[28] a Tax Court case from 2017 in which the taxpayer intentionally refused to provide the cost of the property or its adjusted basis in the property on Form 8283. The IRS also relied on *Belair Woods*,[29] a Tax Court decision issued in 2018 in which the taxpayer again intentionally refused to provide its cost or adjusted basis in the property on Form 8283.

c. Subargument 2B.

The box on Form 8283 asking how PropCo acquired the property said "purchase" instead of "capital contribution." What occurred with the Form 8283 was evident: The data provided were from the perspective of the original landowner,

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[27] Reg. section 1.170A-13(c)(2)(i).

[28] *RERI Holdings I LLC v. Commissioner*, 149 T.C. 1 (2017).

[29] *Belair Woods LLC v. Commissioner*, T.C. Memo. 2018-159.

not PropCo. However, the supplemental attachment to Form 8283 correctly stated that PropCo acquired the property on September 21, 2014, through a capital contribution. The supplemental attachment further explained that the original landowner had obtained the property through a series of three separate purchases, the last of which took place in June 2010.

The IRS argued that "omission of the complete manner of acquisition from the Form 8283 intentionally obfuscated the nature and complexity of the transaction in order to circumvent" the IRS's scrutiny. It added that "the Supplemental Attachment does not cure this defect."

F. PropCo Opposes the MPSJ

In March 2020 PropCo filed with the Tax Court its opposition to the MPSJ previously filed by the IRS.

G. PropCo Submits a Qualified Offer

In June 2020 PropCo filed with the IRS a so-called qualified offer under section 7430 emphasizing that (1) the IRS's arguments focused on the deed were weak because the limited reserved rights in the deed preclude PropCo from making any post-donation improvements that could or would materially alter the value of the property; (2) at worst, PropCo expected the Tax Court to rule in response to the pending MPSJ that there were genuine issues of material fact and to force the parties to trial; and (3) PropCo was prepared to litigate issues in the Tax Court, and a decision favorable to PropCo regarding the deed would seriously undermine the IRS's past judicial victories regarding clauses governing the allocation of sales proceeds upon future extinguishment of the easement.

PropCo offered to settle the case for a charitable deduction of $18,354,999, which was $1 less than the value of $18,355,000 determined by the IRS appraiser. PropCo further put the IRS on notice that if it was forced to go to trial, and if the Tax Court determined a value of $18,355,000 or higher, PropCo would be filing a motion to recoup costs and fees from the IRS from the date of the qualified offer forward.[30]

H. Settlement Initiative Offer

Uplifted by some recent Tax Court victories on technical issues in conservation easement disputes, and cognizant of the enormous number of additional cases headed its way in the coming years, the IRS announced a settlement initiative in June 2020.[31] Shortly thereafter, the IRS attorneys sent PropCo an offer letter inviting it to participate in the settlement initiative.

Not all partners are treated the same under the settlement initiative. The offer letters from the IRS describe two types of partners: Category 1 partners are those who engaged in any various activities related to SCETs, such as organizing them, promoting them, supplying tax advice, providing return preparation services, or otherwise serving as so-called material advisers. By default, category 2 partners are those who are *not* category 1 partners.

Partnerships must pay the following toll to conclude matters under the settlement initiative: (1) federal income taxes, which are different amounts for category 1 partners and category 2 partners; (2) penalties, which vary depending on the type of partner, the return-on-investment ratio, and whether all parties filed timely Forms 8886, "Reportable Transaction Disclosure Statements," with the IRS; and (3) interest charges.

PropCo declined to participate in the settlement offer because doing so would have reduced the charitable tax deduction well below the $21,619,000 indicated in the original appraisal or the $18,355,000 determined by the IRS appraiser during the audit.

I. PropCo Files Its Own MPSJ

In August 2020 PropCo countered with its own MPSJ, asking the Tax Court to rule that paragraphs 18, 19, and 20 of the deed comply with applicable law and regulations. Before filing the MPSJ, PropCo retained an expert appraiser with

[30] *See* Tax Court Rule 231, "Claims for Litigation and Administrative Costs."

[31] IR-2020-130; CC-2021-001; IR-2020-228.

30 years of experience, who determined that any post-donation improvements that PropCo might make in accordance with the reserved rights in the deed would not increase the value of the property.

J. IRS Rejects Qualified Offer

In September 2020 the IRS sent a letter taking the position that the qualified offer submitted by PropCo back in June 2020 was invalid because a partnership involved in a TEFRA proceeding simply cannot meet the standards of section 7430. The IRS's dubious reasoning, which is contrary to judicial precedent on point, was as follows:

> A partnership cannot make a Qualified Offer in a partnership-level proceeding under TEFRA because the Qualified Offer rule requires that the judgment of the court address the "liability of the taxpayer" [and] the partnership is not a taxpayer, rather tax liabilities flow through to the partners, but [their] liabilities are not at issue in the TEFRA proceeding.

K. Tax Court Renders a Decision

In March 2021, the Tax Court rendered its decision, published as an order.

1. Decision regarding deed issues.

a. Response to subargument 1A.

As discussed earlier, the IRS argued that paragraph 20 of the deed violated the applicable regulations because it used as a starting point the value of the conservation easement as determined by the original appraisal, instead of the "actual FMV," whatever that might be. To fortify its position, the IRS presented to the Tax Court an illustration in which the taxpayer had *undervalued* the easement, not *overvalued* it, using the original appraisal. Thus, suggested the IRS, situations in which taxpayers aim too low initially and use language like that in paragraph 20 could yield a financial windfall for the taxpayer.

The Tax Court rejected the IRS's contentions, emphasizing that they are impractical and unlikely:

> In summary judgment posture [like here], we have no way of knowing the actual FMVs of the easement or the encumbered land, because there has been no trial. And in the large universe of cases that never get litigated, it would be very difficult to determine — where an easement was extinguished (say) 50 years after it was granted — what the easement and the unencumbered land were worth 50 years previously. The only practical approach, which is perfectly consistent with the text of the regulation, is to treat the values as equal to the values claimed by the taxpayer [in the original appraisal] unless other values have been judicially determined. This mode of calculation ensures that [the land trust] will get at least its full proportionate share of the proceeds because the [partnership] is very unlikely to have *understated* the numerator, i.e., the claimed value of the easement.

b. Response to subargument 1B.

The IRS took the stance that paragraph 20 of the deed also violated the pertinent regulation because it indicated that the value of any improvements on the property made after the easement donation would go to PropCo.

The Tax Court acknowledged that it previously held in *Coal Property Holdings* that reducing the land trust's share of the proceeds by the value of post-donation improvements violated the obligation that a conservation easement be granted in perpetuity. However, the Tax Court underscored that the property in *Coal Property Holdings* had extensive improvements at the time of the easement donation; that the deed in that case contained many reserved rights, including those to make significant future improvements; and that the "existing and contemplated future improvements had obvious value."

By contrast, when it comes to PropCo and its deed, the Tax Court indicated that the existing improvements and permitted future ones consist almost entirely of structures related to noncommercial kenneling of hunting dogs. The Tax Court observed that if the case were to go to trial, PropCo might be able to prove that (1) any improvements on the property at the time of the donation were unlikely to appreciate in value and that (2) any post-donation improvements allowed by the deed would unlikely increase the value of the property in any meaningful way, if at all. The Tax Court went on to say that if PropCo could demonstrate that any post-donation increase in value attributable to improvements would be de minimis, PropCo could plausibly contend that the improvements language in paragraph 20 of the deed would not cause the land trust to receive less than its proportionate share if condemnation were to occur. Thus, the Tax Court held that there was a genuine issue of material fact, thereby preventing resolution of this issue by way of an MPSJ.

c. Response to subargument 1C.

The IRS argued that paragraph 18 of the deed might result in the land trust's getting less than the proper amount as a result of the requirement of paying first "any and all prior claims."

The Tax Court acknowledged that it has held for the IRS in some prior cases involving carveouts for prior claims. However, the language in the deed related to PropCo is significantly different, said the Tax Court. Instead of benefiting PropCo, it favors the land trust. The Tax Court explained that a literal interpretation of paragraph 18 would mean that PropCo's share of the future sales proceeds would be used to pay not only claims caused by its actions, but also claims triggered by the land trust's actions. Despite this, the IRS contended that the land trust's share of the proceeds might somehow be invaded if PropCo's sales proceeds were insufficient to pay all prior claims. The Tax Court, nonplussed, said that this created questions of contract interpretation and state law, which made a ruling on MPSJ inappropriate.

2. Decision regarding Form 8283 issues.

The Tax Court acknowledged that it previously held, in *Belair Woods*, that a taxpayer's failure to disclose on Form 8283 its cost or adjusted basis can be fatal to claiming the charitable deduction. However, the Tax Court emphasized that the IRS did not contend that PropCo omitted anything. The IRS suggested, instead, that PropCo failed to adequately disclose the date on which it acquired the property and the manner of acquisition. The Tax Court explained that it did not need to decide the consequences of skipping those items on Form 8283 because PropCo "was guilty of no such failure."

The Tax Court pointed out that PropCo inserted "June 2010" and "purchase" in the pertinent boxes on Form 8283. It also noted that PropCo affixed the supplemental attachment to Form 8283, which correctly explained that it obtained the property on September 21, 2014, by way of a capital contribution from the original landowner. The supplemental attachment went on to explain how the original landowner had accumulated acreage, which included the property, through three separate purchases, the last of which took place in June 2010. The Tax Court concluded this issue as follows:

> [The IRS] does not contend that any of the information [in the supplemental attachment] was incorrect. But [it] urges that all of this information needed to appear on the Form 8283 itself, rather than as an attachment to that form. This argument is wholly unpersuasive: The boxes [on Form 8283] are extremely small, and portions of the property were acquired at different times in different ways from different persons. While it is true that the numbers in the boxes told only part of the story, the full story appeared in the [supplemental attachment]. That is what attachments are for.

L. Parties Settle Case

In light of the Tax Court's order, buttressed by the qualified offer submitted by PropCo, the IRS reconsidered its position. It ultimately agreed to settle the case without the need for a costly trial. The corresponding decision document filed with the Tax Court in September 2021 indicated that PropCo was entitled to a charitable deduction of $18,362,500, which consisted of the conservation easement donation of $18,355,000 (that is, the amount determined by the IRS appraiser during the audit) plus the cash stewardship donation to the land trust of $7,500. Moreover, the decision document featured a minor penalty, equal to 10 percent of the reduced tax liability. PropCo believed that the imposition of any penalty was unwarranted, but it ultimately accepted the small sanction solely to conclude the case. Interestingly, the IRS insisted that the decision document explicitly state that the IRS and PropCo "will bear their own costs."

V. Conclusion

As with most tax cases, *Little Horse Creek Property* offers some learning opportunities. Perhaps the most noteworthy aspects of the case are as follows.

First, the IRS followed its traditional, unhelpful habit of attacking all supposed technical flaws. In *Little Horse Creek Property*, this meant arguing that paragraphs 18 and 20 of the deed, which describe the allocation of sales proceeds in the event of a post-donation forced sale of the property, supposedly violated the applicable regulation for four reasons. It also included challenging the content of the timely, complete, and executed Form 8283 while trying to simultaneously ignore the supplemental attachment affixed to Form 8283, which contained the data.

Second, the IRS further adhered to its normal procedures by issuing an FPAA offering absolutely no details about the factual, legal, or tax justifications for proposing a charitable deduction of $0, despite having conducted an audit lasting approximately two years. This practice by the IRS is problematic for *all* taxpayers, not just partnerships that participated in SCETs, because there is a general presumption in federal tax disputes that determinations made by the IRS during an audit are correct.[32] In other words, when the IRS alleges in an FPAA that a taxpayer owes additional taxes, penalties, and interest, the Tax Court starts with the notion that what the IRS claims is true.[33] The IRS's practice of issuing FPAAs devoid of substance is also troublesome because the starting point of a tax dispute, at least from the perspective of the Tax Court, is when the IRS issues the FPAA. What occurred before that time, such as during the audit with the revenue agent or administrative review with the Appeals officer, normally is irrelevant to the Tax Court.[34]

Third, the Tax Court made some significant rulings in its order that might prove beneficial to *all* partnerships defending themselves in SCET disputes. The order (1) denied the IRS's request to dispense with matters without a trial, (2) rejected the idea that pegging the value of the easement donation to the original appraisal was problematic, (3) suggested that post-donation improvements that create little or no additional value might be acceptable, (4) implied that language in a deed about payment of prior claims that benefits the land trust instead of PropCo is copacetic, and (5) indicated that, as long as a Form 8283 is timely and complete, supplying key information to the IRS on a supplemental attachment to a Form 8283 is fine.

Fourth, one might surmise that *Little Horse Creek Property* shows that the IRS is concerned about litigating valuation issues in the SCET context, despite innumerable public statements and actions to the contrary. This supposition stems from the fact that the IRS fought aggressively during the audit and early litigation phases but rapidly agreed to settle the case shortly after the Tax Court issued its order undermining essentially all the IRS's technical challenges to the deed and Form 8283.

Fifth, *Little Horse Creek Property* underscores the strategic use of qualified offers. Section 7430 generally provides that the prevailing party in any administrative proceeding before the IRS, or in any litigation against the IRS, may be awarded reasonable costs.[35] A taxpayer is treated as the prevailing party if its liability, as ultimately determined by a court, is the same as or less than it would have been if the IRS had just accepted the qualified offer in the first place.[36] Stated differently, if the IRS ignores or rejects a qualified offer, the case goes to trial, and the court rules that the taxpayer's liability is equal to or below the qualified offer amount, the IRS ordinarily is on the hook for reasonable administrative and/or litigation costs. Only two cases have addressed whether partnerships subject to TEFRA

[32] Tax Court Rule 142(a)(1).

[33] H.R. Rep. No. 105-364, at 55 (Oct. 31, 1997); and S. Rep. No. 105-174, at 43 (Apr. 22, 1998).

[34] *Greenberg's Express Inc. v. Commissioner*, 62 T.C. 324, 327-328 (1974).

[35] Section 7430(a).

[36] Section 7430(c)(4)(E)(i); and reg. section 301.7430-7(a) and (b)(1).

proceedings are able to make qualified offers.[37] Just one case yielded a decision with precedential value, and it explained that TEFRA partnerships are entitled to file qualified offers.[38] Despite this, the IRS has been entrenched in its traditional position, arguing in *Little Horse Creek Property* that TEFRA partnerships are ineligible to file qualified offers, period. Curiously, though, when preparing the decision document for the Tax Court, the IRS insisted that it expressly state that the IRS and PropCo "will bear their own costs." Including this type of language in a decision document is rare and leads to the conclusion that the IRS, in the end, is quite concerned about the possibility of getting stuck paying defense costs in SCET disputes.

Finally, *Little Horse Creek Property* is a positive development all around. It shows, above all else, that if the parties are rational, cases can get resolved on reasonable terms without forcing taxpayers, the IRS, and the courts to expend excessive resources. Of course, this level of rationality would require the IRS to halt its current practice of initially claiming in every single SCET case that the value of the conservation easement is $0. ■

[37] *BASR Partnership v. United States*, 130 Fed. Cl. 286 (2017), *aff'd*, 915 F.3d 771 (Fed. Cir. 2019); *Hurford Investments No. 2 Ltd. v. Commissioner*, No. 23017-11 (T.C. order Dec. 21, 2018); and No. 23017-11 (T.C. order Sept. 11, 2019).

[38] *See* Sheppard, "Partnerships, Qualified Offers, and Conservation Easement Disputes: Analyzing Problems With the IRS's Positions, Now and Later," 22 *J. Tax Prac. & Proc.* 33 (2020).