Pine Mountain Preserve and Conservation Easements: A Victory in Disguise for Taxpayers?

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Despite its main holding, a recent Tax Court decision shows progress for taxpayers in obtaining charitable contributions for conservation easements.

Tax Court litigation focused on conservation easements is becoming more prevalent, and the reasons for this phenomenon depend on who you ask. What is undeniable, though, is that the IRS is now aggressively challenging partnerships involved in easement transactions. The tactics commonly used by the IRS include negatively characterizing easements as "listed transactions," starting a large number of audits, taking extreme positions that tax deductions related to easements should be $0 and large penalties should apply (regardless of the facts in a particular case or the strength of the relevant appraisals), presenting long lists of legal, tax, and technical theories to the Tax Court in hopes of getting a total victory based on one or more "foot faults," and filing multiple Motions for Summary Judgment with the Tax Court, arguably with the purpose of skirting the pivotal valuation issue, creating division among the partners, obligating partnerships to incur large fees to defend themselves, and chilling the donation of conservation easements overall.

Consistent with the IRS's stance, some groups and individuals are quick to classify nearly every Tax Court opinion involving conservation easements as a triumph for the IRS. The problem, particularly for those who actually take the time to read the entire opinion and have a more comprehensive understanding of the issues, is that such pronouncements are misleading, at best. A good example is a recent case, *Pine Mountain Preserve LLLP*,[1] which arguably contains more favorable results for the easement community than for the IRS, despite the main holdings by the Tax Court.

This article examines the principal rules related to conservation easement

donation deductions, the main facts and rulings in *Pine Mountain*, and the important, yet obscure issues, raised by this case.

Overview of Conservation Easements and Pertinent Issues

In order to understand *Pine Mountain* and some of its interesting issues, one must first have a basic understanding of the applicable rules and terminology.

What is a Qualified Conservation Contribution?

Taxpayers generally may deduct the value of any charitable contribution that they make during a year.[2] However, taxpayers are not entitled to deduct donations of property, if they consist of less than their entire interest in such property.[3] One important exception is that taxpayers can deduct a donation of a partial interest in property (instead of an entire interest), provided that it is a "qualified conservation contribution."[4] To meet this critical definition, taxpayers must show that they are (1) donating a qualified real property interest (QRPI), (2) to a qualified organization, (3) exclusively for conservation purposes.[5]

What is a QRPI?

One of the main issues in *Pine Mountain* was whether Pine Mountain Preserve, LLLP ("Partnership") donated a QRPI. This can be one of several things, including a restriction, granted in perpetuity, on the use of a particular piece of real property.[6] These can be known by many names, among them "conservation easement," "conservation restriction," and "perpetual conservation restriction."[7] Regardless of what you call them, QRPIs must be based on legally enforceable restrictions (such as those memorialized in a Deed of Conservation Easement) that will prevent uses of the property, forever, which are inconsistent with the conservation purpose of the contribution.[8]

For What Purposes Can Land Be Conserved?

A contribution has a "conservation purpose" if it meets one of the following requirements:

1. It preserves land for outdoor recreation by, or the education of, the general public.
2. It preserves a relatively natural habitat of fish, wildlife, or plants, or a similar ecosystem.
3. It preserves open space (including farmland and forest land) for the scenic enjoyment of the general public and will yield a significant public benefit.
4. It preserves open space (including farmland and forest land) pursuant to a federal, state, or local governmental conservation policy, and will yield a significant public benefit.
5. It preserves a historically important land area or a certified historic structure.[9]

Such conservation purposes must be protected forever in order to trigger the tax deduction. Indeed, a contribution is not treated as "exclusively for conservation purposes," unless the conservation purposes are "protected in perpetuity."[10]

Can Taxpayers Reserve Rights in the Protected Property?

A taxpayer can retain certain "reserved rights," still make a qualified conservation contribution, and thus qualify for the tax deduction. However, in keeping something for themselves, taxpayers must ensure that the reserved rights do not unduly conflict with the conservation purposes.[11] The IRS openly recognizes, in its Conservation Easement Audit Techniques Guide (ATG), that reserved rights are ubiquitous. The ATG states the following about taxpayer holdbacks:

> *All conservation easement donors reserve some rights to the property.* Depending on the nature and extent of these reserved rights, the claimed conservation purpose may be eroded or impaired to such a degree that the contribution may not be allowable. A determination of whether the reserved rights defeat the conservation purpose must be determined based on all the facts and circumstances.[12]

The ATG later provides some examples for IRS personnel about reserved rights, including the following:

> Taxpayers are permitted to reserve some development rights on a portion of the property, such as construction of additional homes or structures, installation of utilities, and building of fences or roads, provided that the conservation purposes are protected. Depending on the facts and circumstances, retention of these rights may result in disallowance [of the charitable contribution tax deduction related to the easement].[13]

The regulations provide more specifics about reserved rights and uses that might be inconsistent with the conservation purpose of an easement.

> [A] deduction will not be allowed if the contribution would accomplish one of the enumerated conservation purposes but would permit destruction of other significant conservation interests.... However, this requirement

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1. 151 TC No. 14 (2018), which addresses the "technical" issues regarding 2005, 2006, and 2007; *Pine Mountain Preserve, LLLP*, TCM 2018-214, which addresses only the easement valuation issue for 2007.
2. Section 170(a)(1); Reg. 1.170A-1(a).
3. Section 170(f)(3)(A); Reg. 1.170A-7(a)(1).
4. Section 170(f)(3)(B)(iii); Reg. 1.170A-7(a)(5).
5. Section 170(h)(1). The issue of whether the land trust in *Pine Mountain* was a "qualified organization" was not in dispute, so it is not discussed here.
6. Section 170(h)(2); Regs. 1.170A-14(a) and 1.170A-14(b)(2).
7. Reg. 1.170A-14(b)(2).
8. Reg. 1.170A-14(g)(1); *Turner*, 126 TC 299, 311 (2006).
9. Section 170(h)(4)(A); Reg. 1.170A-14(d)(1); S. Rept. 96-1007, at 10 (1980).
10. Section 170(h)(5)(A); Reg. 1.170A-14(e)(1).
11. Reg. 1.170A-14(b)(2).
12. IRS, *Conservation Easement Audit Techniques Guide* (Rev. 11/4/2016), page 23.
13. *Id*. at page 63.

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is not intended to prohibit uses of the property, such as selective timber harvesting or selective farming if, under the circumstances, those uses do not impair significant conservation interests.... A use that is destructive of conservation interests will be permitted only if such use is necessary for the protection of the conservation interests that are the subject of the contribution.... A donor may continue a pre-existing use of the property that does not conflict with the conservation purposes of the gift.[14]

What Is an Easement Worth?

Generally, a deduction for a charitable contribution is allowed in the year in which it occurs.[15] If the contribution consists of something other than money, then the amount of the contribution normally is the fair market value (FMV) of the property at the time the taxpayer makes the donation.[16] For these purposes, the term FMV ordinarily means the price on which a willing buyer and willing seller would agree, with neither party being obligated to participate in the transaction, and with both parties having reasonable knowledge of the relevant facts.[17]

Reg. 1.170A-14(h)(3) ("Easement-Valuation-Methods Regulation") provides special rules for calculating a deduction stemming from the donation of a conservation easement, which is a partial (not a full) interest in property. The relevant portion of the Easement-Valuation-Methods Regulation, broken down to enhance readability and to conform to the Tax Court's analysis in *Pine Mountain*, is set forth below:[18]

> [Sentence 1] The value of the contribution under Section 170 in the case of a charitable contribution of a perpetual conservation restriction is the [FMV] of the perpetual conservation restriction at the time of the contribution.
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> [Sentence 2] If there is a substantial record of sales of easements comparable to the donated easement (such as purchases pursuant to a governmental program), the [FMV] of the donated easement is based on the sales prices of such comparable easements.
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> [Sentence 3] If no substantial record of market-place sales is available to use as a meaningful or valid comparison, as a general rule (but not necessarily in all cases) the [FMV] of a perpetual conservation restriction is equal to the difference between the [FMV] of the property it encumbers *before* the granting of the restriction and the [FMV] of the encumbered property *after* the granting of the restriction.
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> [Sentence 4] The amount of the deduction in the case of a charitable contribution of a perpetual conservation restriction covering a portion of the contiguous property owned by a donor and the donor's family (as defined in Section 267(c)(4)) is the difference between the [FMV] of the entire contiguous parcel of property before and after the granting of the restriction.
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> [Sentence 5] If the granting of a perpetual conservation restriction ... has the effect of increasing the value of any other property owned by the donor or a related person, the amount of the deduction for the conservation contribution shall be reduced by the amount of the increase in the value of the other property, whether or not such property is contiguous.

The IRS provides the following summary and hints about valuation to its personnel in the ATG. It explains that the best evidence of FMV of an easement is the sale price of easements comparable to the easement in question, but, "in most instances, there are no comparable easement sales."[19] Appraisers, therefore, often must use the before-and-after method. The ATG acknowledges that this effectively means that an appraiser must determine the highest and best use (HBU) *and* the corresponding FMV of the relevant property twice:

1. Without regard to the easement, which generates the before value.
2. Taking into account the restrictions on the property imposed by the easement, which creates the after value.[20]

As indicated in the preceding paragraph, in deciding the FMV of property, appraisers and courts must take into account not only the current use of the property, but also its HBU.[21] A property's HBU is the highest and most profitable use for which it is adaptable and needed, or likely to be needed, in the reasonably near future.[22] The term HBU has also been defined as the reasonably probable use of vacant land or improved property that is physically possible, legally permissible, financially feasible, and maximally productive.[23] Importantly, valuation does not depend on whether the owner has actually put the property to its HBU.[24] The HBU can be any realistic, objective potential use of the property.[25]

The Easement-Valuation-Methods Regulation provides additional guidance in situations where the appraiser uses the before-and-after method, described in Sentence 3, above. It states the following:[26]

> If before and after valuation is used, the [FMV] of the property before contribution of the conservation restriction must take into account not only the current use of the property but also an objective assessment of how immediate or remote the likelihood is that the property, absent the restriction, would in fact be developed, as well as any effect from zoning, conservation, or historic preservation laws that already restrict the property's potential highest and best use.
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> In the case of a conservation restriction that allows for any development, however limited, on the property to be protected, the [FMV] of the property after contribution of the restriction must take into account the effect of the development.
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14 Regs. 1.170A-14(e)(2) and (3).
15 Section 170(a)(1).
16 Section 170(a)(1); Reg. 1.170A-1(c)(1).
17 Reg. 1.170A-1(c)(2).
18 Reg. 1.170A-14(h)(3)(i).
19 *Conservation Easement Audit Techniques Guide*, *supra* note 12, at page 41.
20 *Id*.
21 *Stanley Works & Subs.*, 87 TC 389, 400 (1986); Regs. 1.170A-14(h)(3)(i) and (ii).
22 *Olson*, 292 U.S. 246, 255 (1934).
23 *Esgar Corp.*, 744 F.3d 648 (CA-10, 2014).
24 *Id*.
25 *Symington*, 87 TC 892 (1986).
26 Reg. 1.170A-14(h)(3)(ii).
27 See *Conservation Easement Audit Techniques Guide, supra* note 12, at pages 24-30; IRS Publication 1771, *Charitable Contributions—Substantiation and Disclosure Requirements*; IRS Publication 526, *Charitable Contributions*; Sections 170(f)(8) and (11); Reg. 1.170A-13; Notice 2006-96, 2006-2 CB 902; TD 9836.

> Additionally, if before and after valuation is used, an appraisal of the property after contribution of the restriction must take into account the effect of restrictions that will result in a reduction of the potential [FMV] represented by [HBU] but will, nevertheless, permit uses of the property that will increase its [FMV] above that represented by the property's current use.

How Do Taxpayers Claim an Easement-Related Tax Deduction?

Properly claiming the tax deduction triggered by an easement donation is, well, complicated. It involves a significant amount of actions and documents. The main ones are that the taxpayer must:

1. Obtain a "qualified appraisal" from a "qualified appraiser."
2. Demonstrate that the easement recipient is a "qualified organization."
3. Obtain a "baseline report," generally from the organization receiving the easement, describing the condition of the property at the time of the donation and the reasons for which it is worthy of protection.
4. Complete a Form 8283 (Noncash Charitable Contributions) and have it executed by all relevant parties, including the taxpayer, appraiser, and easement recipient.
5. Assuming that the taxpayer is a partnership, file a timely Form 1065, enclosing the Form 8283 and qualified appraisal.
6. Receive from the easement recipient a proper contemporaneous written acknowledgement, both for the easement itself and for any endowment/stewardship fee donated to finance the perpetual protection of the property.
7. Ensure that all mortgages on the relevant property have been subordinated to the easement.
8. Send to all the partners their Schedule K-1 (Partner's Share of Income, Deductions, Credits, etc.) and a copy of the Form 8283.[27]

Analysis of *Pine Mountain*

The main facts, legal/tax positions, and decisions by the Tax Court in *Pine Mountain* are discussed below.

Main Events

Starting in 2004, and running through late 2007, a father and son team with significant experience in real estate development ("Individuals") acquired tracts of land near Birmingham, Alabama, close to the most affluent part of the city. Individuals eventually cobbled together ten contiguous parcels of land consisting of approximately 6,200 acres, which were transferred to Pine Mountain Property ("Partnership").

During 2004 and 2005, Partnership negotiated with representatives of two smaller cities, Westover and Chelsea, regarding which might annex the Pine Mountain Property and on what terms. Partnership ultimately decided to go with Westover, the basic terms of annexation were agreed in early 2005, the parties signed an agreement in September 2006, and the four-month annexation process started soon thereafter, in November 2006.

Partnership made an initial offering in August 2005 permitting investors to buy interests. The investors paid about $30 million for 300 limited partnership interests, which entitled them to 50% of the profits, losses, etc. from Partnership. Another entity owned by Individuals owned the other 50%.

In December 2005, Partnership granted the first of three conservation easements ("2005 Easement") to the North American Land Trust ("Land Trust").

Partnership made another offering in December 2006 to its existing limited partners, whereby each could buy another half-interest for a certain price. As a result of this second offering, the limited partners paid approximately $15 million more for 300 half interests.

Also, in December 2006, Partnership applied with the City of Westover to rezone the Pine Mountain Property from an "agricultural preserve" to a planned unit development (PUD). The relevant zoning ordinance, however, dictated that property annexed into a city must initially be zoned as an agricultural preserve.

Later in December 2006, Partnership conveyed to the Land Trust the second conservation easement ("2006 Easement") covering additional parcels.

Westover enacted an ordinance in April 2007 that rezoned the Pine Mountain Property from an agricultural preserve to a PUD. Thus, at the time that Partnership granted the 2005 Easement and the 2006 Easement, the relevant land was still zoned for agricultural purposes.

Completing the trilogy, in December 2007, Partnership conveyed to the Land Trust the third conservation easement ("2007 Easement") covering additional parcels.

A taxpayer can retain certain "reserved rights," still make a qualified conservation contribution, and thus qualify for the tax deduction.

Details About the Three Easements

Each of the three easements is described below.

2005 Easement. The conservation purposes for the 2005 Easement were to preserve a relatively natural habitat and open space. Article 2 of the conservation easement deed ("2005 Deed") generally prohibited residential, commercial, and industrial development. However, certain exceptions, called reserved rights, were located in Article 3. Among others, Partnership or its successors could build one single-family dwelling (along with a shed, garage, gazebo, vehicle parking area, and pool) within each of ten different one-acre "Building Areas" located within the area protected by the 2005 Easement. The 2005 Deed did not specify the location of the 10 Building Areas, but these were shown in an exhibit.

Article 3.16 of the 2005 Deed stated that the boundaries of the Building Areas could be modified by mutual agreement between Partnership and the Land Trust.

However, this language was softened by the fact that modifications cannot increase a Building Area and they cannot negatively impact any of the conservation purposes, in the reasonable judgment of the Land Trust. Article 3 contained a list of additional reserved rights.

Article 6.7 of the 2005 Deed stated that Partnership (or its successors) and the Land Trust "shall mutually have the right, in their sole discretion, to agree to amendments to [the 2005 Easement] which are not inconsistent with the conservation purposes," but the Land Trust had "no right or power to agree to any amendments ... that would result in the [2005 Easement] failing to qualify ... as a qualified conservation contribution under Section 170(h) of the Internal Revenue Code and applicable regulations." This is generally known as an amendment clause in the easement world.

2006 Easement. The 2006 Deed identified essentially the same conservation purposes as the 2005 Deed. It also generally prohibited residential, commercial, and industrial development, with exceptions for certain reserved rights.

Article 3.1 of the 2006 Deed stated that Partnership or its successors could build one single-family dwelling (along with a shed, garage, gazebo, and pool) within each of six different one-acre "Building Areas" within the area covered by the 2006 Easement. The 2006 Deed did not specify the location of the Building Areas and placed no limitations on locations, other than stating that they must be approved in advance by the Land Trust, and the Land Trust cannot issue such approval if the locations would negatively affect the conservation purposes.

Article 3.2 of the 2006 Deed allowed Partnership to construct a water tower within the area covered by the 2006 Easement, along with underground pipelines to the areas served by the water tower, including the ten Building Areas contemplated by the 2005 Easement, the six Building Areas contemplated by the 2006 Easement, and any development on the 79% of the Pine Mountain Property that was not protected by a conservation easement. The Land Trust had to approve in advance the design and location of the water tower and underground pipelines.

The 2006 Deed had an identical amendment clause to the 2005 Deed.

2007 Easement. The 2007 Deed has conservation purposes akin to those in the 2005 Deed and the 2006 Deed. Article 2 generally prohibited residential, commercial, and industrial development, and had certain exceptions for reserved rights. The 2007 Deed had some critical differences, though. Namely, there were no Building Areas anywhere on the property.

The 2007 Deed allowed Partnership to construct a water tower within the area covered by the 2007 Easement, along with underground pipelines to the areas served by the water tower. However, there were no Building Areas on the property safeguarded by the 2007 Easement, and the 2007 Deed stated that the pipelines could run only to the six Building Areas contemplated by the 2006 Easement and to any development on the 79% of the Pine Mountain Property unprotected by easement. The Land Trust must approve in advance the design and location of the water tower and underground pipelines.

The 2007 Deed had the same amendment clause as the 2005 Deed and the 2006 Deed.

Notices and Start of Litigation

After what must have been a long audit, the IRS issued in January 2013 three separate notices of final partnership administrative adjustment (FPAAs) covering 2005, 2006, and 2007. The IRS, following its normal *modus operandi* in conservation easement cases, fully disallowed the multi-million-dollar deductions, without the courtesy of providing any details as to why. Partnership, through its tax matters partner, filed a timely Petition with the Tax Court to challenge the three FPAAs.

Four Issues Addressed by the Tax Court

Ultimately, the Tax Court issued its Opinion in *Pine Mountain* in December 2018 focused on four issues:

1. Whether the three easements are QRPIs.
2. Whether the easements were made "exclusively for conservation purposes."
3. Whether the amendment clauses in the 2005 Deed, 2006 Deed, and 2007 Deed cause the Pine Mountain Property not to be protected "in perpetuity."
4. What was the value of the 2007 Easement.

These four issues are addressed in detail below.

First issue—Are the easements QRPIs? The IRS argued that none of the three easements were a QRPI because the restrictions on the Pine Mountain Property were not granted in perpetuity as a result of the reserved rights for Partnership, particularly the ability to build up to 16 one-acre residences in the 2005 Easement area and the 2006 Easement area, plus surrounding structures.

Summary of Tax Court precedent. The Tax Court, in analyzing this argument, discussed three prior cases: (1) *Belk*,[28] (2) *Balsam Mountain Investments, LLC*,[29] and (3) *Bosque Canyon Ranch, LP*.[30]

The taxpayer in *Belk* donated to a land trust a conservation easement over a golf course, which was surrounded by a single-family residential development. The relevant deed allowed the parties, by mutual agreement, to change the specific property subject to the easement. According to the deed, land could be removed from the easement, provided that (1) the taxpayer substituted a contiguous piece of land that was of equal or larger size, value, and ecological quality, (2) the land trust approved the substitution, and (3) the substitution had no negative effect on the conservation purposes of the easement. The deed did not contain any limitations on when the substitution could occur or how much of the protected land could be affected. The Tax Court held that the easement was not a QRPI because it was not perpetual in that it contained a substitution clause.

The Tax Court arrived at the same conclusion in its response to the Motion for Reconsideration filed by the taxpayer, emphasizing that taxpayers must donate an interest in an "identifiable, specific piece of real property." The Fourth Circuit Court of Appeals, likewise, held against the taxpayer based on the substitution

clause and the fact that the relevant provision requires a perpetual use restriction on a defined piece of property, rather than on some, any, or interchangeable pieces of property.

In *Balsam Mountain*, the Tax Court indicated that terms of the deed were similar to those in *Belk*, except that the taxpayer's ability to substitute land was different. The deed permitted "minor alterations to the boundary" of the property protected by easement, as long as (1) the land trust approved the substitution, (2) the substitution had no negative effect on the conservation purposes of the easement, (3) the substitution occurred within five years of the original easement date, and (4) no more than 5% of the original easement area could be substituted. The Tax Court did not find these distinctions from the deed in *Belk* decisive. For the same reasons set forth in *Belk*, the Tax Court in *Balsam Mountain* held that the easement was not a QRPI.

The Tax Court indicated that the deed in *Bosque Canyon* contained terms "very similar" to those in the 2005 Deed, 2006 Deed, and 2007 Deed related to Partnership. In both situations, the taxpayer donated an easement, reserved a certain portion for development of residential home sites, and had numerous reserved rights. According to the deed in *Bosque Canyon*, land could be removed from the easement on the condition that (1) the taxpayer substituted land, (2) the size of each home site could not be expanded, (3) the land trust approved the substitution, and (4) the substitution had no negative effect on the conservation purposes. Unlike the deeds in *Belk* and *Balsam Mountain*, the deed in *Bosque Canyon* did not allow the substitution to change the exterior boundaries of the property under easement.

The Tax Court held consistently with its earlier decisions, in that the ability to substitute property, even within the conservation area and not affecting the exterior boundaries, still means that the property originally under easement could lose its protection. The Tax Court held that the easement in *Bosque Canyon* was not a QRPI because it was not perpetual as a result of the substitution clause. However, upon appeal by the taxpayer, the Fifth Circuit Court of Appeals disagreed with the Tax Court and vacated its decision, holding in favor the taxpayer. The key for the Fifth Circuit Court of Appeals was that, unlike in *Belk* and *Balsam Mountain*, the substitution clause in *Bosque Canyon* did not permit modification of the exterior boundaries of the easement.

Application of Precedent to Pine Mountain. The Tax Court in *Pine Mountain*, based on its review of *Belk*, *Balsam Mountain*, and *Bosque Canyon*, presented the following analysis with respect to Partnership. It began by thumbing its nose at the earlier decision by the Fifth Circuit Court of Appeals, which had decided *Bosque Canyon* in favor of the taxpayer, because *Pine Mountain*, if appealed, would be reviewed by the Eleventh Circuit Court of Appeals, not the Fifth Circuit Court of Appeals.[31] The Tax Court then declared that, "[u]pon careful consideration of our precedents and the relevant appellate opinions, we are not persuaded to abandon our earlier view."

The Tax Court went on to borrow a Swiss cheese metaphor, used previously by Judge Dennis in his dissent in *Bosque Canyon* of the taxpayer-favorable opinion issued by the Fifth Circuit Court of Appeals. Judge Dennis explained that the entire easement property is a hunk of Swiss cheese, the holes in such cheese represent portions reserved for future development by the taxpayer, and Section 170(h)(2)(C) "bars the [taxpayer] from putting any new holes in the cheese."

The Tax Court explained that the deed in *Belk* contemplated putting new holes in the cheese and then adding an equal amount of new, previously-unprotected land to the conservation area, whereas the deed in *Bosque Canyon* entailed inserting new holes in the cheese and then plugging the same number of holes elsewhere in the conservation area. The Tax Court indicated that the deeds for Partnership were similar to those in *Bosque Canyon*, but reasoned that the conclusion would be the same, even if the deeds were more akin to those in *Belk:*

> [The Partnership] has achieved the impermissible objective of putting new holes in the cheese, *i.e.*, subjecting to commercial or residential development land that was supposed to be protected in perpetuity from such development.... [W]e are unable to discern any meaningful legal distinction between these two paths to the same bottom line. In both scenarios, the developer has retained the right to develop a portion of the conservation area by substituting other property. The only difference among *Belk*, *Bosque Canyon*, and [*Pine Mountain*] is whether the other property lies inside or adjacent to the conservation area. We do not see why it matters where the other property lies. What matters is whether there is a perpetual use restriction on 'the real property' covered by the easement at the time the easement is granted. We will accordingly adhere in this case to the approach we embraced in *Belk* and *Bosque Canyon*.

In any event, the key point under Section 170(h)(2)(C) is that both easements have the same defect. By permitting the homesite parcels to be relocated to other sections of the conservation area, the deed allows the developer to subject to residential development land that was supposed to be protected in perpetuity from any form of development.

The Tax Court, building on its general conclusions described above, reviewed the situation on a year-by-year basis. With respect to 2005, the Tax Court explained that, in addition to allowing relocation of the Building Areas, the 2005 Deed permits Partnership to build other structures and facilities in connection with the residential homes. It does not specify where they may be located, the location can change if the Building Areas change, pre-approval by the Land Trust is not necessary for all items, and, to-

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[28] 140 TC 1 (2013), *Belk*, TCM 2013-154, supplementing the first Tax Court decision in response to a Motion for Reconsideration filed by the taxpayer, and *Belk*, 774 F.3d 221 (CA-4, 2014), which affirmed the earlier decisions by the Tax Court.

[29] TCM 2015-43.

[30] TCM 2015-130, which was overturned by *BC Ranch II, LP*, 867 F.3d 547 (CA-5, 2017).

[31] *Golsen*, 54 TC 742 (1970) (holding that the Tax Court must follow the precedent of the court of appeals to which a case would be elevated for further review).

gether, they have the effect of increasing the residential development well beyond the ten acres comprising the Building Areas. Applying the Swiss cheese metaphor, the Tax Court explained that the reserved rights in the 2005 Deed allow Partnership "not only to put new holes in the cheese for the ten residences, but to put 20 acres of extra holes in the cheese for structures appurtenant to these residences." The Tax Court concluded that, because the 2005 Easement is not a QRPI, Partnership cannot claim the charitable deduction; it got $0 for 2005.

Regarding 2006, the Tax Court explained that it was impossible to define, at the time that the 2006 Easement was granted to the Land Trust, which property would actually be restricted from development forever because the six Building Areas could have been placed anywhere within the conservation area. Consequently, the perpetual restriction on use did not attach from the outset to a single, defined, immutable parcel of property, and this is not changed by the fact that the Land Trust must approve any placement beforehand to ensure that the conservation values are protected. As with the first year, the Tax Court held that the 2006 Easement did not constitute a QRPI, such that Partnership was entitled to a deduction of $0 for 2006.

The 2007 Deed, unlike those for the other two years, did not allow for any Building Areas or structures nearby. This changed the Tax Court's perspective entirely. It held that the 2007 Easement was a QRPI because it "does not permit [Partnership], under any circumstances, to place any new holes in the cheese.

Second issue—Are the easements solely for conservation purposes? As explained above, a contribution is made for a conservation purpose if it preserves land for outdoor recreation by, or education of, the general public, a relatively natural habitat of fish, wildlife, or plants, or similar ecosystems, open space for the scenic enjoyment of the general public, land pursuant to a federal, state, or local governmental conservation policy, or a historically important land area or a certified historic structure.[32]

The IRS argued in *Pine Mountain* that the tax deductions generated by the three easements should be fully rejected because they were not made "exclusively for conservation purposes." This turned out to be a non-issue at trial. Partnership presented testimony from a biologist with the Land Trust that none of the reserved rights would impair the conservation purposes or prevent them from being protected in perpetuity. The IRS did not present any contrary evidence whatsoever; therefore, the Tax Court held in favor of Partnership.

Third issue—Does potential amendment ruin perpetual protection? The IRS challenged the amendment clauses in the 2005 Deed, 2006 Deed, and 2007 Deed, which were identical. The amendment clauses recognized that, when dealing with perpetuity, circumstances might arise that would justify modification of certain restrictions contained in easements, such that Partnership and the Land Trust "shall mutually have the right, in their sole discretion, to agree to amendments to this Conservation Easement which are not inconsistent with the Conservation Purposes."

The IRS contended that the amendment clause would allow the parties to violate the perpetuity requirement, which necessarily means that the Land Trust would "be unfaithful to the charitable purposes on which its exemption rests." This line of reasoning comports with the general guidance that the IRS provides to all its personnel in the ATG. It states that "[a]n easement deed will fail the perpetuity requirements ... if it allows *any amendment or modification* that could adversely affect the perpetual duration of the restriction or conservation purposes."[33]

Citing to various cases in the facade easement and conservation easement arena, the Tax Court stated that it and various Courts of Appeal have rejected similar arguments by the IRS in the past. The Tax Court explained that easements involve a conveyance, which is a form of contract. Normally, parties to a contract can amend it, regardless of whether they explicitly reserve the right to amend in the contract itself. The Tax Court, grounded in the notion of the amendable contracts, explained that the amendment clause in the 2007 Deed should be interpreted as "*a limiting provision*, confining the permissible subset of amendments to those that would not be 'inconsistent with the Conservation Purposes.'" (Emphasis in original.) The Tax Court went on to point out how the IRS's far-reaching position would lead to absurd results; it would "prevent the donor of *any easement* from qualifying for a charitable deduction under Section 170(h) if the easement permitted amendments [and] we find no support for that argument in the statute, the regulations, the decided cases, or the legislative policy under the statute." (Emphasis added.)

The recent decision in *Pine Mountain* finds support in two earlier Tax Court cases, where the relevant deeds not only contained amendment clauses, but the parties had actually amended the deeds pursuant to such clauses before the dispute with the IRS began. First, in *Strasburg*,[34] the taxpayer granted an open space easement to a land trust. The deed allowed the taxpayer to maintain and repair the existing structures on the property, and to construct two additional single-family residences. In 1994, the taxpayer filed an amendment to the deed of conservation easement, whereby the taxpayer relinquished the right to build one of the two single-family residences. Consequently, the taxpayer claimed an additional charitable contribution deduction in 1994 for the development right relinquished. The issues raised by the IRS in *Strasburg* were the FMV of the conservation easement donated in 1993 and the FMV of the amendment to the deed in 1994. Although *Strasburg* focused solely on valuation issues, it indicates that an amendment may be made to a deed of conservation easement, as long as it protects the conservation purposes of the easement.

Likewise, in *Butler*,[35] the taxpayer granted a conservation easement to a land trust in 2003, which encumbered 1,780 acres. The deed significantly re-

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[32] Section 170(h)(4)(A); Reg. 1.170A-14(d)(1); S. Rept. 96–1007, at 10 (1980).

[33] *Conservation Easement Audit Techniques Guide*, *supra* note 12, at page 13 (emphasis added).

[34] TCM 2000-94.

[35] TCM 2012-72.

stricted the use of the property, but reserved a number of rights for the taxpayer, including the right to subdivide the property into five separate tracts. In 2004, the taxpayer filed an amendment to the deed, thereby enlarging the property protected by the easement by 2,450 acres, and permitting the property to be subdivided into 15 tracts, instead of only five. Neither the IRS nor the Tax Court challenged whether this amendment violated the perpetuity requirement, as it furthered the conservation purposes of the original deed of conservation easement.

Fourth issue—What is the 2007 easement worth? As indicated above, the Tax Court determined that the 2005 Easement and the 2006 Easement did not involve QRPIs, such that Partnership was not allowed to claim any charitable deduction related to these two transactions. As a result, it was unnecessary for the Tax Court to address valuation issues for 2005 and 2006. It focused only on the 2007 Easement in this regard, devoting an entire separate Opinion to this one issue.

Preliminary comments about valuation. The Tax Court started with four comments that hinted at a low valuation. First, it said that Partnership was seeking a total charitable deduction, as determined by the valuation expert used at trial, of approximately $97 million for restrictions on property for which Partnership paid around $24 million. Second, the Tax Court noted that the combined easements for 2005, 2006, and 2007 protect less than 21% of the total Pine Mountain Property, thereby leaving about 79% for future development by Partnership or its successors. Third, the Tax Court explained that the limited partners paid $45 million for their 50% interest in Partnership, they would get a total tax deduction of about $48.7 million if the Tax Court were to accept the figures proffered by Partnership at trial, and they would still own a 50% interest in the unprotected portion (constituting about 79% of the total Pine Mountain Property), which could later be used for profitable development. Fourth, the Tax Court commented on the rapid appreciation in value, stating that "[b]ecause the easements were placed on the various parcels within two years of their acquisition, [Partnership's] valuations presuppose a large increase in value over a very short time."

These initial observations notwithstanding, the Tax Court ultimately determined that Partnership was entitled to a deduction even larger than the one that it had originally claimed on its Form 1065 for 2007. The Tax Court's analysis is outlined below.

Overview of valuation rules and regulations. An earlier portion of this article described the Easement Valuation-Methods Regulation, which features special rules for calculating a deduction that involves donating a conservation easement. The Tax Court divided the Easement-Valuation-Methods Regulation into parts, consisting of Sentence 1 (general rule), Sentence 2 (comparable-sales method), Sentence 3 (before-and-after method), Sentence 4 (contiguous property rule), and Sentence 5 (enhancement rule).

Properly claiming the tax deduction triggered by an easement donation is, well, complicated. It involves a significant amount of actions and documents.

Differing opinions of the expert appraisers. The Tax Court was concerned only with the value of the 2007 Easement, because it determined that the values of the 2005 Easement and the 2006 Easement were irrelevant, as Partnership was not entitled to any deduction for these two years because they did not entail QRPIs. Nevertheless, the Tax Court examined the calculation of the 2005 Easement as an example, which it then extrapolated to the 2007 Easement.

Partnership's expert at trial valued the 2005 Easement using Sentence 3 of the Easement-Valuation-Methods Regulation, subtracting the value of the relevant acres after the donation of the easement from the value of the same acres before the easement. This is commonly known as the before-and-after method.

To determine the *before* value, Partnership's expert used two methods:

1. The sales-comparison approach, looking at other properties that likely would be developed, and concluding that the value was $55,950,000.
2. The discounted cash flow (DCF) method, assuming that the property could have been developed into a residential subdivision with 865 houses, and concluding that Partnership could have earned cash flows of $55,900,000.

To determine the *after* value, Partnership's expert used only the sales-comparison approach. Partnership's expert divided the acres subject to the 2005 Easement into two categories, namely, land within the ten Building Areas, which he said was worth $700,000, and land outside the ten Building Areas, which he claimed was equal to $560,000. Although the 2005 Easement covered only approximately 560 acres of a total of about 2,880 acres, Partnership's expert concluded that the granting of the easement on 560 acres had no positive effect on the unprotected property, such that the before and after values were the same, and there was no "enhancement" that needed to be subtracted from the easement value. In conclusion, Partnership's expert determined that the total *before* value for all the 2,880 acres was $93,680,000 and the *after* value was $38,990,000, rendering a difference of $54,690,000.

Partnership's expert used a similar method for the 2007 Easement, concluding that it was worth $9,110,000. The Tax Court expressly noted that the "value is greater than the value originally reported by [Partnership] on its partnership return [for 2007]."

The IRS's expert disagreed with Partnership's expert, of course. He used two methods. Applying the sales-comparison method, he considered the sales price of rural land with little potential for development in concluding that the value

of the 560 protected acres would be $1,119,000. Then, using the before-and-after method, the IRS's expert assumed that the HBU for the Pine Mountain Property (i.e., land on a hillside, annexed by Westover, zoned for PUD, near one of the most affluent parts of Birmingham, and overlooking the city) would be undeveloped open space. As undeveloped land, the IRS's expert assigned a total value of $15,080,000. Comparing the sales of supposedly comparable land already encumbered by easements, the IRS's expert determined an after value of $1,120,000 for the 560 acres. For the remaining, unprotected acres of the total of 2,880, he said that it had the same per-acre value as the pre-easement value of the 560 acres, thus rendering a value of $12,168,000.

Using the before-and-after method, the IRS's expert ultimately concluded a value of $2,912,000 (i.e., $15,080,000 for the 2,880 acres minus $12,168,000 for the approximately 2,320 acres). The IRS's expert opined that the sales-comparison method was a better indicator of value than the before-and-after method, thereby going with a total value of $1,190,000 for the 2005 Easement.

The IRS's expert used the same methodology for 2007, concluding that the value for that year was just $449,000.

Analysis by the Tax Court—Splitting the baby. The Tax Court, equally critical of both sides, stated that neither Partnership's expert nor the IRS's expert used a method accepted by the Easement-Valuation-Methods Regulation.

Sentence 1 simply contains the general rule and was not part of the analysis.

The Tax Court held that the IRS's expert violated Sentence 2 of the Easement-Valuation-Methods Regulation because he compared the Pine Mountain Property to the wrong type of property in performing his sales-comparison analysis. Sentence 2 dictates that, if a substantial record of sales of easements comparable to the donated easement exists, then the FMV is based on the sales price of such comparable easements. The Tax Court pointed out that, because the Pine Mountain Property had development potential, the sales of rural land with little development potential on which the IRS's expert relied were not comparable.

Partnership's expert did not escape criticism either. The Tax Court indicated that he violated Sentence 3 of the Easement-Valuation-Methods Regulation, which says that, if there is no substantial record of marketplace sales, then "as a general rule (but not necessarily in all cases)" the FMV of a conservation easement is determined using the before-and-after method. The Tax Court underscored that Sentence 3 contains only the general rule, and the situation in *Pine Mountain* justified a departure because the before-and-after method, as applied by Partnership's expert, resulted in an overestimate of the value of the 2007 Easement. The Tax Court raised two potential reasons for this overvaluation. First, Partnership's expert did not take into account any "enhancement" of the surrounding land. Second, the high development potential of the property made the easement difficult to value using the before-and-after method.

The Tax Court next turned to Sentence 4 of the Easement-Valuation-Methods Regulation, which says that an easement covering a portion of the contiguous property that is owned by the taxpayer or a related party is the difference between the FMV of the entire contiguous property before and after the granting of the easement. The Tax Court explained that Sentence 4 is designed to obligate an appraiser to take into account the beneficial effects of an easement on contiguous property that is not restricted by the easement. Partnership's expert assumed that the

EXHIBIT 1

Positions of the Various Parties

Year	2005	2006	2007
Price originally paid by Partnership for the property	$5,345,550	$13,363,145	$15,448,555
Easement value claimed by Partnership on Forms 1065	$16,550,000	$12,726,000	$4,100,000
Easement value claimed by IRS in the three FPAAs	$0	$0	$0
Easement value claimed by Partnership's expert at trial	$54,690,000	$33,570,000	$9,110,000
Easement value claimed by the IRS's expert at trial	$1,119,000	$998,000	$449,000
Easement value determined by Tax Court in *Pine Mountain*, 151 TC No. 14 (2018)	$0	$0	Not Applicable
Easement value determined by Tax Court in *Pine Mountain*, TCM 2018-214	$27,904,500	$0	$4,779,500

easements contributed by Partnership, including the 2007 Easement, did not have any effect on the value of the portions of the property not restricted by an easement. However, the Tax Court pointed out that the 2007 Easement had "positive external effects" on the contiguous property, which Partnership's expert failed to properly consider.

The Tax Court then explained that Sentence 5 of the Easement-Valuation-Methods Regulation was not relevant because the method described there applies only when the unprotected property is not contiguous, which was not the case with the 2007 Easement.

Because neither Partnership nor the IRS presented an appraisal that comported with the Easement-Valuation-Methods Regulation, the Tax Court was essentially left valueless. The Tax Court pointed out this anomaly, explaining that it could, and would, take valuation matters into its own hands:

> In summary both [Partnership] and the IRS favor valuation opinions that are based on methods that do not meet the requirements of the [Easement-Valuation-Methods Regulation]. Now consider the legal significance of this. In a case of unilateral noncompliance, where one party's proffered method complies with the regulation but the other's does not, it might be appropriate, or even mandatory, for a court to adopt the opinion of the expert whose method complies with the regulation. In this case, however, neither expert's methods complies. Nothing in the [Easement-Valuation-Methods Regulation] counsels one expert's method over the other in this case of bilateral noncompliance …. Because the [Easement-Valuation-Methods Regulation] does not require us to accept one expert's conclusion over the other's, this case is like any other case in which experts offer competing estimates of fair market value. The Court decides what weight to give those estimates by, among other things, examining the factors they considered in reaching their conclusions. The Court is not bound by the opinion of any expert witness, and it may accept or reject expert testimony in the exercise of its sound judgment. The Court may selectively use a portion of the opinion of an expert. The Court may also reach a decision as to the value of property that is based on its own examination of the evidence in the record.

The Tax Court ultimately decided to give equal weight to the improper values proposed by Partnership's expert and the IRS's expert. Speaking colloquially, the Tax Court opted to "split the baby." This rendered the following value for the 2007 Easement: (1) 50% of the value by Partnership's expert of $9,110,000, (2) plus 50% of the valuation by the IRS's expert of $449,000, (3) equals $4,779,500.

Summary of Positions by the Parties and the Tax Court

The positions of the IRS, Partnership, various experts, and the Tax Court are set forth in Exhibit 1 for ease of understanding.

Interesting and Obscure Issues

Pine Mountain, like most cases, is full of interesting aspects, most of which are missed by those who limit themselves to reading quick summaries published by electronic tax news services, countless blogs by self-professed experts, spin pieces by various interest groups, and superficial articles published by certain industry journals. Identified below are some of the important issues that are likely to be overlooked.

The FPAAs Give No Clues

After conducting a multi-year audit of three multi-million dollar conservation easement deductions, the FPAAs issued by the IRS provide absolutely no clue as to the *specific* issues that the IRS really intends to challenge in Tax Court litigation. The FPAAs issued by the IRS in *Pine Mountain* illustrate the standard approach by the IRS in easement cases, which is to fully disallow the deduction based on "technical" arguments under Section 170 and its corresponding regulations, and then, as a backup plan, fully disallow the deduction for supposed valuation failures. The FPAA for Partnership for 2005 contains the following general claims, and the FPAAs for 2006 and 2007 follow suit:

> It is determined that the requirements of Internal Revenue Code Section 170 have not been met for the contribution of a conservation easement which was deducted on the Form 1065 for [Partnership] for the tax year ending December 31, 2005. Accordingly, the deduction on Schedule K [of $16,550,000] … for a contribution is decreased in the amount of $16,550,000 for the tax year ending December 31, 2005.
>
> Alternatively, to the extent that it is determined the requirements of Internal Revenue Code Section 170 have been met for the noncash contribution of a qualified conservation contribution, it has not been established that the value of the contributed property interest is as claimed on Schedule K … for a contribution in the amount of $16,550,000 for the tax year ending December 31, 2005. Accordingly, the deduction on Schedule K [of $16,550,000] … for a contribution is decreased in the amount of $16,550,000 for the tax year ending December 31, 2005.

To be clear, the IRS took the position in the FPAAs that the three easements granted by Partnership should be entitled to a combined deduction of $0, notwithstanding that the original appraisal contemplated a total deduction/value of approximately $33 million, and that Individuals paid about $34 million in the aggregate for the Pine Mountain Property. Moreover, in doing so, the IRS did not clarify for Partnership the factual, legal, tax, or procedural grounds on which the full disallowances were made.

For those readers who do not get involved in Tax Court litigation often, this behavior by the IRS is particularly problematic because (1) there is a legal presumption that what the IRS claims in the FPAA is correct, (2) taxpayers normally cannot "go behind the FPAA" and present evidence to the Tax Court related to the audit (such as the Examination Report, Summary Report, or Notice of Proposed Adjustments), which contain detail about the IRS's positions, and (3) taxpayers ordinarily have the burden of proof during a Tax Court trial, meaning that they have the duty to present sufficient evidence to overcome the

presumed correctness of the IRS, as reflected in its FPAA.[36]

Thus, the reality is that, unless the IRS later identifies or narrows the issues that it is truly contesting via responses to discovery requests issued by the taxpayer during Tax Court litigation, a Stipulation of Facts, a Stipulation of Settled Issues, or a Pre-Trial Memorandum, the taxpayer is obligated to present evidence at trial that it satisfied every single requirement on an extremely long list to be granted a deduction for a "qualified conservation contribution" under Section 170. The magnitude of this endeavor is illustrated by the ATG, which contains a chart spanning four pages called the "Conservation Easement Issue Identification Worksheet."[37] This represents an enormous evidentiary burden on Partnership, as well as an inefficient use of Partnership, IRS, and Tax Court resources.

EXHIBIT 2

Valuations of Easements

Year	2005	2006	2007
Easement value claimed by Partnership on Forms 1065 based on appraisals by Mr. Clark	$16,550,000	$12,726,000	$4,100,000
Easement value claimed by Partnership's expert at trial	$54,690,000	$33,570,000	$9,110,000
Easement value determined by Tax Court in *Pine Mountain*, 151 TC No. 14 (2018)	$0	$0	Not Applicable
Easement value determined by Tax Court in *Pine Mountain*, T.C. Memo 2018-214	$27,904,500	$0	$4,779,500

Acceptance of HBU Without Zoning

The regulations under Section 170 provide that the FMV of the property before granting of the easement must take into account not only the current use of the property, but also an objective assessment of how immediate or remote the likelihood is that the property, absent the easement, would be developed.[38] The regulations also provide that the before value must consider "any effect from zoning, conservation, or historic preservation laws that already restrict the property's potential highest and best use." In other words, in determining the FMV before the granting of the easement, which involves an analysis of the HBU, all existing local, state, and federal restrictions on development and use of the pertinent property must be considered.

Interestingly, in *Pine Mountain*, the Tax Court accepted the opinion of Partnership's expert and other witnesses that the HBU would be residential development, even though zoning for such development was not in place at the time that the 2005 Easement and the 2006 Easement were granted. This issue was triggered by the fact that the IRS's expert compared values of land that had little development potential, whereas Partnership's expert examined developable land. The Tax Court noted that the values for the Pine Mountain Property suggested by Partnership's expert are proper only if it was reasonably probable that the property would be developed at the time that it was donated to the Land Trust.

The IRS contended that it would have been unreasonable to assume, at the time that the three easements were granted, that the Pine Mountain Property would be developed. The IRS first observed that when the 2005 Easement and the 2006 Easement were granted, county zoning regulations in effect prohibited development of the Pine Mountain Property; it was considered agricultural land. Next, with respect to the 2007 Easement, the IRS argued that development of the Pine Mountain Property could only have occurred if it were in the hands of Individuals, because of their proven experience in developing real estate. Unfortunately for Partnership, argued the IRS, the regulations and caselaw indicate that, in valuing the 2007 Easement using the before-and-after method, an appraiser must assume that the Pine Mountain Property is in the hands of hypothetical persons, not Individuals.

The Tax Court rejected the positions advanced by the IRS on the following rationale:

> Although the Pine Mountain property was *not* zoned for development by the town of Westover until April 2007, [Individuals] and the mayor of Westover convincingly testified that they reasonably assumed early in the process of negotiating the annexation of the Pine Mountain property that [it] would eventually be zoned for development.
>
> Despite [Individuals'] significant personal role in getting the land zoned for residential development, a third party could also have accomplished this. The Pine Mountain property was between the city of Chelsea and the town of Westover. These two municipalities had an incentive to compete with each other for development. Even without [Individuals'] personal influence, one of these municipalities would have been convinced to annex the Pine Mountain property and allow it to be developed. Thus, it was reasonably probable that the Pine Mountain property would eventually be zoned for development.

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36 Tax Court Rule 142(a); *Greenberg's Express, Inc.*, 62 TC 324 (1974).

37 *Conservation Easement Audit Techniques Guide*, *supra* note 12, at pages 78-81.

38 Reg. 1.170A-14(h)(3)(ii).

39 Reg. 1.170A-1(c)(1).

40 2017-4 IRB 544.

41 *United States v. Nancy Zak, Claud Clark, EcoVest Capital Inc., Alan N. Solon, Robert M. McCullough, and Ralph R. Teal*, Case No. _______ D.C. N.D. Ga, Compliant filed 12/18/2018.

> Although [Individuals] also played a crucial role in assembling the property that made up the Pine Mountain property, and although [they] accomplished the purchase of three parcels ... that provided access to the highways from the rest of the property, and although without these parcels the Pine Mountain property could not be made into a residential development, by the time Pine Mountain had granted the 2005 easement, it had already purchased the three parcels. Access to the highways had been achieved by this purchase. Thus, as we find, it was reasonably probable that the Pine Mountain property would be developed. [Internal citations omitted.]

Focus on the Date of the Easement; No Hindsight Allowed

The regulations generally provide that, in the case of a charitable donation other than money, the contribution is the FMV "at the time of the contribution."[39] Of course, in disputes before the Tax Court, both the IRS and taxpayers often attempt to introduce evidence of valuation in later years, using hindsight, depending on whether the market has declined or improved. The Tax Court in *Pine Mountain* was having none of that, explaining that the easement values claimed by Partnership should not change as a result of the precipitous fall in the real estate market in Alabama after the granting of the 2007 Easement or the fact that the Pine Mountain Property was never actually developed.

> The question of whether there was a reasonable probability the property would be developed is resolved according to the circumstances existing as of the dates of valuation, which are the dates the easements were donated.... [Partnership] kept buying land during each of the three years in which the easements were donated. The last of the 10 parcels of the Pine Mountain property was bought in the year 2007. The continual buying of property showed that the [Individuals] still thought that the Pine Mountain property would be developed. Two sales of partnership interests [in Partnership] suggested that outside investors also thought that the Pine Mountain property would be developed. The basic facts affecting the prospects of developing the Pine Mountain property—the access from the property to highways, the likelihood that one of the municipalities would approve a real-estate subdivision, and the changing state of the real-estate market—are facts that would be known to third parties or could easily be learned by third parties. These considerations lead us to believe that when the 2007 easement was granted, the Pine Mountain property could be sold to a third-party buyer and the buyer would have paid a relatively high price that corresponded to the development potential of the property.

Tax Court Determines That the Original Appraisal Was Low

Some contend that certain agencies of the U.S. government have been trying to administratively eradicate the conservation easement industry for years, because Congress appears steadfast in its commitment to support protection of land and the corresponding charitable deduction under Section 170. The steps have been numerous, but perhaps the two most notable are the IRS issuing Notice 2017-10[40] in December 2016, identifying certain easements as "listed transactions," and the U.S. Department of Justice (DOJ) filing in December 2018 a Complaint with a district court, asking it to enjoin various entities and individuals from any involvement with easements, impose a long list of penalties, obligate those accused to disgorge the gross receipts that they made in connection with easements, and more.[41]

The Tax Court held that the easement was not a QRPI because it was not perpetual in that it contained a substitution clause.

Most charging documents filed by the DOJ are filled with hyperbole, and the recent Complaint is no exception. It alleges, among other things, that an appraiser, Claud Clark, valued at least 187 conservation easements between 2009 and 2016, repeatedly relied on extraordinary assumptions, used inappropriate methodologies, and used various techniques to "improperly inflate the value of the conservation easements." The Complaint further claims that Mr. Clark generated "grossly overvalued appraisals" that led to taxpayers "grossly overstating their tax deductions," overstated the FMV of easements "by hundreds of thousands, if not millions, of dollars," and knew that the manner in which he was valuing easements violated U.S. tax law and the professional standards for real estate appraisers.

What is interesting about the Complaint is that it is undermined by concessions by the IRS, and certain rulings by the Tax Court, in *Pine Mountain.* Mr. Clark prepared the original appraisals supporting the 2005 Easement, 2006 Easement, and 2007 Easement. The IRS conceded that Mr. Clark was a "qualified appraiser" and that his products were "qualified appraisals." The Tax Court made this point clear:

> The value reported by Pine Mountain on its partnership return was $4,100,000 for the 2007 easement. Attached to the return was an appraisal by Claude Clark III that stated that the value of the easement was the same as the value reported for that easement. The IRS has stipulated that the Clark appraisal was a "qualified appraisal" as that term is defined by sec. 170(f)(11)(E)(i). This stipulation means that Pine Mountain has met the requirement, found in sec. 170(f)(11)(A)(i) and (D), that a taxpayer must attach a qualified appraisal to the return when claiming a charitable-contribution deduction of more than $500,000.

Moreover, the IRS did not even propose penalties in the three FPAAs issued to Partnership, presumably because the Revenue Agent determined that Partnership had relied in good faith on qualified professionals, including Mr. Clark. Finally, Partnership's expert at trial and, to a certain degree, the Tax Court agreed that Mr. Clark had actually undervalued, not overvalued, the easements. This is reflected in Exhibit 2.

The table in Exhibit 2 shows that (1) Partnership's expert concluded that Mr. Clark had significantly undervalued the

easements, and (2) the Tax Court determined, likewise, that Mr. Clark had undervalued the 2005 Easement and the 2007 Easement by a total of approximately $12.2 million. If the Tax Court had not fully disallowed the 2006 Easement based solely on a "technical" issue under Section 170, it stands to reason that it would have concluded that Mr. Clark undervalued all three easements, particularly since he used the same valuation method every year.

Tax Court Acknowledges Possibility of Diamond in the Rough

A common tactic of the IRS in conservation easement cases is to try to drive down the value by focusing the Tax Court's attention on items that often have little to do with the true issue, such as the tax-assessment value of the property or the original price paid for the property by Partnership. The IRS pointed toward the latter in *Pine Mountain*, but the Tax Court rejected the notion that the Pine Mountain Property could not be the proverbial diamond in the rough.

> The IRS also attacks [Partnership's expert] valuations of the Pine Mountain property before the easements because he did not consider the relatively low actual prices Pine Mountain paid for the property. We are not persuaded that the ... method was flawed for this reason. [Partnership's expert] opined that the value of the Pine Mountain property was much higher than its purchase price because he thought that when the easements were granted, it was reasonably probable that the land could be developed. We agree with this assumption. The purchase price of the Pine Mountain property did not reflect the value of the land as a commercial and residential subdivision. This is because the land was assembled parcel by parcel. The low price for each parcel did not reflect, for example, that the fully assembled property would have access to the highway system. This access was necessary for the fully assembled property to be developed into a subdivision.

No Mention of Listed Transaction Issue

The term "listed transaction" means a reportable transaction that is the same as, or substantially similar to, a transaction identified by the IRS (by notice, regulation, or some other form of published guidance) as a tax-avoidance transaction.[42] Pursuant to Notice 2017-10, issued by the IRS in December 2016, all syndicated conservation easement transactions (SCETs) that occurred on or after 1/1/2010, are considered listed transactions, such that participants, material advisors, and others are subject to additional reporting, due diligence, and record-keeping requirements.

Description of the targeted transaction. Notice 2017-10 broadly defines an SCET as follows:

> An investor receives promotional materials that offer prospective investors in a pass-through entity [such as a partnership] the possibility of a charitable contribution deduction that equals or exceeds an amount that is two and one-half times the amount of the investor's investment. The promotional materials may be oral or written....[43]
>
> The investor purchases an interest, directly or indirectly (through one or more tiers of pass-through entities), in the pass-through entity that holds real property.
>
> The pass-through entity that holds the real property contributes a conservation easement encumbering the property to a tax-exempt entity and [then] allocates, directly or through one or more tiers of pass-through entities, a charitable contribution deduction to the investor.
>
> Following that contribution, the investor reports on his or her federal income tax return a charitable contribution deduction with respect to the conservation easement.

Forms 8886, Forms 8918, and substantially similar transactions. Notice 2017-10 requires taxpayers who "participate" in an SCET or a substantially similar transaction to file Form 8886 (Reportable Transaction Disclosure Statement). Notice 2017-10 also requires persons who are "material advisors" to an SCET or a substantially similar transaction to file Form 8918 (Material Advisor Disclosure Statement). In this context, the term "substantially similar" includes any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on similar tax strategy.[44] The regulations indicate that the term "substantially similar" must be broadly construed in favor of disclosure to the IRS.[45]

Concept of participation. As indicated above, Notice 2017-10 requires taxpayers who "participate" in an SCET or in a substantially similar transaction to file Form 8886. For these purposes, a taxpayer has "participated" in an SCET if the taxpayer's tax return reflects the tax consequences or a tax strategy described in Notice 2017-10. For instance, a partner who receives a Schedule K-1 from a partnership that has engaged in an SCET is considered to have "participated" in the transaction.[46] Notice 2017-10 indicates that "participants" in SCETs include:

1. Investors/partners.
2. The pass-through entity that actually engaged in the transaction, which includes any tier if the transaction is conducted through a tier-entity structure.
3. Any other person whose tax return reflects tax consequences or a tax strategy described as an SCET.

The regulations clarify that if a reportable transaction results in a loss that is carried back to a previous year, then the taxpayer must enclose Form 8886 with the application for tentative refund or amended return for the previous year.[47] By extension, if a taxpayer participates in an SCET in one year and carries forward a portion of the relevant charitable deduction to later years, then the taxpayer would be "participating" in the SCET in the later years and would thus need to file Forms 8886, as appropriate.

Potential penalties. Notice 2017-10 contains multiple threats about potential downsides of non-compliance. Participants in SCETs could get hit in two main ways.

Notice 2017-10 warns that "participants" who are required to disclose an SCET by filing a Form 8886 but fail to do so will be subjected to penalties under Section 6707A. These come in two forms. First, if participants fail to file timely,

complete Forms 8886, then the IRS generally can assert a penalty equal to 75% of the tax savings resulting from their participation.[48] In the case of a listed transaction, like an SCET, the maximum penalty for individual taxpayers is $100,000, while the maximum for entities is $200,000.[49] The minimum penalty is $5,000 for individuals and $10,000 for entities.[50] Importantly, in the case of a listed transaction, like an SCET, the IRS does not have authority to rescind or abate it.[51] Also, there is no "reasonable cause" exception to this penalty.

Second, if a taxpayer participates in a reportable transaction (including listed transactions) and the IRS later disallows the benefits claimed, then the IRS can assess a penalty equal to 20% of the tax increase.[52] This penalty rate increases to 30% if the participant fails to file a Form 8886.[53]

Notice 2017-10 also indicates that, if a "participant" fails to enclose a Form 8886 with a tax return, then the assessment period with respect to the tax return remains open until one year after, the earlier of, when the participant later files Form 8886, or when the material advisor provides the IRS with the required list of data about the SCET in response to the written request from the IRS.[54] The regulations explain the types of taxes, penalties, and interest that the IRS might assess situations involving an SCET and unfiled Forms 8886:

> If the period of limitations on assessment for a taxable year remains open under [Section 6501(c)(10)], the [IRS] has authority to assess any tax with respect to the listed transaction in that year. This includes, but is not limited to, adjustments made to the tax consequences claimed on the return plus interest, additions to tax, additional amounts, and penalties that are related to the listed transaction or adjustments made to the tax consequences. This also includes any item to the extent the item is affected by the listed transaction even if it is unrelated to the listed transaction....[55]

Inapplicability to *Pine Mountain*. The transactions at issue in *Pine Mountain* consisted of the 2005 Easement, 2006 Easement, and 2007 Easement, all of which occurred *before* 1/1/2010, which is the key date identified by the IRS in Notice 2017-10. Accordingly, they were not considered "listed transactions" and none of the downsides of such classification (including filing duties, record-keeping obligations, and potential penalties) applied in *Pine Mountain*. These issues are sure to arise, though, in easement cases of more recent vintage.

The IRS Did Not Assert Penalties Against Partnership

In a normal conservation easement case, where the IRS issues an FPAA arguing that a taxpayer is entitled to a deduction of $0 based first on "technical" arguments, and then on valuation issues, the IRS ordinarily proposes a long list of alternative penalties, ranging in severity. These often include:

1. Negligence or disregard of rules and regulations.
2. Substantial understatement of income tax.
3. Substantial valuation misstatement.
4. Gross valuation misstatement.
5. Reportable transaction understatement penalty.[56]

Indeed, one of the "audit tips" provided to IRS personnel in the ATG is that an FPAA "will generally include a tiering of proposed penalties with multiple alternative positions."[57]

Some penalties can be avoided if the taxpayer can demonstrate that there was "reasonable cause" for the violation.[58] Others will not be asserted if the value was based on a qualified appraisal by a qualified appraiser and the taxpayer made a good faith investigation of the value of the property.[59] Finally, under current law, certain penalties, like the one for making a gross valuation misstatement, cannot be overcome by evidence of "reasonable cause." It is mathematical in nature; that is, if the value of the easement/deduction originally claimed by the taxpayer on the Form 1065 (and enclosed Form 8283) exceeds the value ultimately determined by the Tax Court by a certain percentage, then the penalty applies, period.[60] For these reasons, the IRS routinely asserts a laundry list of potential penalties in the FPAA, regardless of how diligent the taxpayer was in conducting the easement transaction, obtaining appraisals, consulting specialized professionals, etc.

In an attempt to ward off penalties whose parameters allow for consideration of "reasonable cause," taxpayers often seek refuge behind the reasonable-reliance-on-a-qualified-informed-disinterested-tax-professional defense.[61] The Supreme Court has emphasized that the IRS must liberally construe this defense:

> When an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a "second opinion," or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place.[62]

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42 Section 6707A(c)(2); Reg. 1.6011-4(b)(2).

43 For purposes of Notice 2017-10, promotional materials include "written materials, including tax analyses or opinions, relating to each reportable transaction that are material to an understanding of the purported tax treatment or tax structure of the transaction that have been shown or provided to any person who acquired or may acquire an interest in the transactions, or to their representatives, tax advisors, or agents, by the material advisor or any related party or agent of the material advisor." Reg. 301.6112-1(b)(3)(iii)(B).

44 Reg. 301.6011-4(c)(4).

45 *Id.*

46 Reg. 1.6011-4(e)(1).

47 Regs. 301.6707A-1(c)(1) and (c)(2), Example 3.

48 Section 6707A(a), (b); Reg. 301.6707A-1(a).

49 Section 6707A(b)(2); Reg. 301.6707A-1(a).

50 Section 6707A(b)(3); Reg. 301.6707A-1(a).

51 Section 6707A(d)(1).

52 Section 6662A(a).

53 Section 6662A(c).

54 Section 6501(c)(10).

55 Reg. 301.6501(c)-1(g)(7).

56 Section 6662; Section 6662A.

57 *Conservation Easement Audit Techniques Guide*, *supra* note 12, at page 77.

58 Section 6664(c)(1); Section 6664(d)(1); Reg. 1.6664-4.

59 Section 6664(c)(3); Reg. 1.6664-4.

60 Section 6664(c)(3); Reg. 1.6664-4.

61 Reg. 1.6664-4(c)(1).

62 *Boyle*, 469 U.S. 241, 251 (1985).

For its part, the Tax Court has held that reasonable cause exists where three elements are present:

1. The advisor was a competent professional who had sufficient expertise to justify reliance.
2. The taxpayer provided necessary and accurate information to the advisor in a timely manner.
3. The taxpayer actually relied in good faith on the advisor's advice.[63]

The Tax Court has entertained the reasonable-reliance-on-a-qualified-informed-disinterested-tax-professional defense on several occasions in the context of conservation easements. Examples follow.

In *Palmer Ranch*, the Tax Court found that the taxpayer's reliance on professionals was sufficient to meet the reasonable cause exception. It stated the following in this regard:

> Palmer Ranch retained a tax attorney to advise it on how to donate the easement in compliance with the Internal Revenue Code. The attorney further retained ... a licensed appraiser, and ... a land planning and engineering firm. We have identified flaws in the appraisal, but they were not due to information contained in the omitted ordinance. We think these actions represent a good-faith attempt to determine the easement's value. Accordingly, Palmer Ranch may raise a reasonable cause defense for the tax underpayment.[64]

In *Butler*,[65] the Tax Court made adjustments to the value of the conservation easements, but nonetheless found that the taxpayer was not liable for penalties. The Tax Court stated the following regarding reliance:

> Petitioners presented evidence that throughout the process of donating the conservation easements and preparing their tax returns, they relied upon ... their longtime attorney and accountant, respectively. They also engaged Conservation Advisors, who helped them select the appraisers…. Both of those appraisers were qualified and had experience appraising conservation easements. From the appraisal reports they prepared, it is evident that they both had access to sufficient information to value the conservation easements. We conclude that petitioners had reasonable cause and acted in good faith with respect to their underpayment in each year. Accordingly, we hold that petitioners are not liable for the accuracy-related penalties.

Similarly, in *Esgar Corp.*,[66] the Tax Court discussed the taxpayer's reliance on appraisers and qualified tax professionals:

> Petitioners argue they made a good faith investigation by relying on their adviser and his accounting firm, by obtaining a core sampling report of the underlying valuable gravel reserves, and by obtaining a qualified appraisal from a qualified appraiser (a fact that [the IRS] does not dispute). They assert that they first requested assistance more than a year before the easements were donated, that [their adviser and his accounting firm] did extensive research and analysis, and that an outside law firm had been hired to ensure that any donation met the requirements of substantiation and administration…. On the basis of the evidence in this case, we conclude that petitioners met all three prongs of [the relevant] test. [Their adviser and accountant] was a competent professional whom petitioners had worked with for over 25 years, petitioners provided him with all relevant information, and petitioners relied on [his] advice in good faith. Petitioners have established they met the reasonable cause exception to the accuracy-related penalty.

Finally, in *Schmidt*,[67] the Tax Court considered the appraisals presented by the parties and determined that the FMV of the conservation easement had been overstated. In spite of this, the Tax Court observed the following in declining to sanction the taxpayer:

> In claiming a charitable contribution deduction for the conservation easement at issue, petitioners relied on Mr. Park's 2003 appraisal. Mr. Park had the requisite credentials and experience to justify petitioners' reliance on the 2003 appraisal, and [the IRS] concedes that it was a qualified appraisal. Although we have sustained in part [the IRS's] deficiency determination, we have done so because we did not find Mr. Park's report to be complete and convincing in certain respects. However, we do not think that the problems that we found with Mr. Park's report, and by extension with the 2003 appraisal, call into question the reasonableness of petitioners' reliance on the 2003 appraisal…. Because the record establishes—without regard to the burden of proof—that petitioners had reasonable cause for the underpayment and acted in good faith, we hold that petitioners are not liable for a penalty for a substantial understatement of Federal income tax….

Given the IRS's position in *Pine Mountain* that the 2005 Easement, the 2006 Easement, and the 2007 Easement were all worth $0, and given that this position was based on both "technical" violations of the requirements under Section 170 and supposed deficiencies with the appraisals, and given that certain penalties in the easement arena cannot be precluded by a showing of "reasonable cause" by the taxpayer, it is interesting that the IRS did not include its normal litany of penalties in the three FPAAs.

No Novel Theories Raised by IRS

The IRS has been threatening for years to raise various "novel" theories for attacking conservation easements. These are "novel" in the sense that they generally do not originate in Section 170 or its regulations, but rather in theories developed by the courts.

The IRS announced in Notice 2017-10 that it intended to challenge SCETs on grounds that they supposedly constitute "tax-avoidance transactions" and they involve overvaluations. The IRS further stated in Notice 2017-10 that it might also attack SCETs based on the partnership anti-abuse rules, the economic substance doctrine, or other unspecified rules and doctrines.

More recently, in the Complaint seeking an injunction against certain

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[63] *Neonatology Associates., P.A.*, 115 TC 43, 99.

[64] *Palmer Ranch Holdings Ltd.*, TCM 2014-79.

[65] TCM 2012-72.

[66] TCM 2012-35.

[67] TCM 2014-159.

[68] *United States v. Nancy Zak, Claud Clark, EcoVest Capital Inc., Alan N. Solon, Robert M. McCullough, and Ralph R. Teal*, supra note 41.

[69] TCM 2018-146.

[70] The IRS conceded all these issues after the trial but before the Tax Court rendered its decision.

individuals and entities in the easement space, the DOJ alleged, among other things, that the partnerships involved in SCETs are not true partnerships for federal tax purposes, they exist solely as a conduit to "sell" tax deductions, they are "shams," and they "lack economic substance."[68] The IRS has adhered to this pattern in recent Tax Court cases, such as *Champions Retreat Golf Founders*.[69] There, the IRS initially raised a number of novel theories in its effort to fully disallow the easement deduction, including the relevant parties engaged in a "disguised sale," the allocation of the charitable contribution deduction lacked "substantial economic effect," and the taxpayer improperly decreased the capital accounts of partners receiving allocations of the deduction and improperly allocated interest income and ordinary business losses to partners.[70]

Interestingly, the IRS did *not* advance any novel legal, tax, or technical theories in *Pine Mountain*, sticking with straightforward challenges, namely, that the three easements allegedly did not involve a QRPI, they inadequately protected the conservation purposes, they failed to protect the Pine Mountain Property in perpetuity because of the amendment clause, and they were grounded on inflated appraisals. This might be a reflection of evolution; the FPAAs in *Pine Mountain* were issued in 2013, years before the IRS and DOJ announced their new lines of attack.

Conclusion

As this article demonstrates, *Pine Mountain*, which appears to be a victory for the IRS at first glance, might be better construed as progress for taxpayers in several respects. Regardless of one's vantage point, *Pine Mountain* contributes to the ongoing discussion regarding conservation easements, charitable deductions, and the ensuing disputes. Unless and until the courts or the IRS provide comprehensive clarity regarding the interpretation of applicable rules and standards, a "safe harbor" procedure to follow, an agreement regarding how to satisfy certain ultra-technical requirements, etc., the debate is primed to continue for many years. ●