taxnotes federal

Volume 181, Number 10 ■ December 4, 2023

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Reprinted from *Tax Notes Federal*, December 4, 2023, p. 1741

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In this article, Sheppard examines *Mill Road 36 Henry*, a recent Tax Court decision involving a conservation easement in which the taxpayer was able to salvage only a small portion of its original deduction, and he argues that some of the court's findings will be advantageous to taxpayers in other easement cases.

I. Introduction

All too often taxpayers lack the time or patience to read an entire court decision. This is understandable, but it leads to problems. Among other things, when taxpayers focus only on headlines or the ultimate holding, they tend to overlook important rulings that might be helpful to themselves and others. This is precisely what occurred with a recent conservation easement case, *Mill Road 36 Henry*.[1] Admittedly, it is challenging to dig into the details of a lengthy Tax Court opinion in which the taxpayer only salvaged about $400,000 of a $9 million tax deduction and then got hit with the highest valuation-related penalty. However, those who persevered discovered that the case contains six silver linings in the form of rulings favorable to all taxpayers involved in conservation easement disputes. This article explores the main rules concerning conservation easement donations, key facts in *Mill Road 36 Henry*, the valuation rulings beneficial to the IRS, and the obscure rulings advantageous to taxpayers.

II. Overview of Easement Donations

Taxpayers that own undeveloped real property have several choices. They might hold the property for investment purposes and sell it when it appreciates sufficiently, they may determine how to maximize profitability from the property and act immediately, or they might donate a conservation easement on the property to a charitable organization. The third option not only achieves environmental protection but also might trigger another benefit — a tax deduction for the donors.[2]

Taxpayers cannot donate an easement on any old property and claim a tax deduction; they must demonstrate that the property is worth protecting. A donation has an acceptable conservation purpose if it meets at least one of the following requirements: (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, plants, or a similar ecosystem; (3) it preserves open space for the scenic enjoyment of the general public and will yield a significant public benefit; (4) it preserves open space under a federal, state, or local governmental conservation policy and will yield a significant public benefit; or (5) it preserves historically important land or certified historic structures.[3]

Taxpayers memorialize the donation to charity by filing a public deed of conservation easement. In preparing the deed, taxpayers often coordinate

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

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

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

with a land trust to identify limited activities that can continue on the property after the donation, without interfering with the deed and without prejudicing the conservation purposes.[4] These activities are called reserved rights. The IRS recognizes that reserved rights are common in deeds.[5]

The IRS will not allow the tax deduction stemming from a conservation easement unless the taxpayer obtains "documentation sufficient to establish the condition of the property at the time of the gift."[6] This is called the baseline report. It features several things, including, but not limited to, a survey map showing property boundaries and nearby protected areas, photographs taken at various locations throughout the property, and a map drawn to scale showing all existing man-made improvements or incursions, vegetation, animals, and distinct natural features.[7]

The value of the conservation easement is the fair market value of the property at the time of the donation.[8] The term "fair market value" ordinarily means the price on which a willing buyer and willing seller would agree, with neither party being obligated to participate in the transaction, and with both parties having reasonable knowledge of the relevant facts.[9] The best evidence of FMV would be the sale price of other easements that are comparable in size, location, and so on. However, the IRS recognizes that it is difficult, if not impossible, to find comparable sales.[10] Thus, appraisers often must use the "before and after" method instead. This means that an appraiser must determine the highest and best use (HBU) of the property and the corresponding FMV twice. First, the appraiser calculates the FMV as if the property were put to its HBU, which generates the "before" value. Second, the appraiser identifies the FMV, taking into account the restrictions on the property imposed by the easement, which creates the "after" value.[11] The difference between the before and after values, with certain other adjustments, produces the FMV of the easement.

As noted, in calculating the FMV of a property, appraisers and courts must take into account not only the current use of the property but also its HBU.[12] A property's HBU is the most profitable use for which it is adaptable and needed in the reasonably near future.[13] The term HBU has also been defined as the use of property that is physically possible, legally permissible, financially feasible, and maximally productive.[14] Importantly, valuation in the easement context does not depend on whether the owner has actually put the property to its HBU in the past; the HBU can be any realistic potential use of the property.[15]

Properly claiming a tax deduction derived from an easement donation is surprisingly complicated. It involves a significant number of actions and documents. For instance, the taxpayer must secure a qualified appraisal from a qualified appraiser, demonstrate that the land trust is a qualified organization, obtain a baseline report, receive a contemporaneous written acknowledgment from the land trust, and file a timely tax return enclosing the qualified appraisal, Form 8283, "Noncash Charitable Contribution," and Form 8886, "Reportable Transaction Disclosure Statement."[16]

III. Key Facts in *Mill Road 36 Henry*

The Tax Court opinion in *Mill Road 36 Henry* is long by any measure — 72 pages — and many of those pages are dense with discussions of tax provisions, regulations, and other authorities. Because of its length, many taxpayers and their advisers likely did not get through it all, or only superficially if they did. This article attempts to

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

[5] IRS, "Conservation Easement Audit Techniques Guide," at 23 (rev. Nov. 4, 2016); *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); reg. section 1.170A-1(c)(1).

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

[10] IRS, *supra* note 5, at 41.

[11] *Id.* at 41.

[12] *Stanley Works & Subsidiaries v. Commissioner*, 87 T.C. 389, 400 (1986); reg. section 1.170A-14(h)(3)(i) and (ii).

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

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

[15] *Id.* at 657; *Symington v. Commissioner*, 87 T.C. 892, 896 (1986).

[16] *See* IRS, *supra* note 5, at 24-30; 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; T.D. 9836.

remedy this situation by focusing only on the key facts and by using simplified terms to identify the main characters.

The original landowner in *Mill Road 36 Henry* contributed 40 acres of undeveloped real property (the property) to a partnership (property company). It had a carryover basis in the property of about $428,000. The property was located on the south side of Atlanta, in an area experiencing heavy commercial and residential development. The only asset of the property company was the property itself, which was held for the purpose of selling to a developer. With this goal in mind, "Smith," the initial managing member, obtained topography, soil, rock, and wetland surveys. He also secured a concept plan from an independent consulting firm, which contemplated the development of an assisted living facility on the property. The concept plan envisioned a total of 677 units. Reaching this figure would require the construction of four-story buildings with as many units as possible packed in each. Neither Smith nor the head of the consulting firm had special training in, or experience with, assisted living facilities; they were unaware of unique requirements regarding approvals, licenses, construction, or operation.

The property company, through Smith, filed an application in July 2016 to develop an assisted living facility. The county's planning and zoning staff then issued a conditional use evaluation report. It recommended approval by the Zoning Advisory Board, subject to a few conditions set forth in the Unified Land Development Code. Approving the construction of an assisted living facility or leaving an application pending could negatively affect the county's overall development plan. Specifically, it could disrupt the approval of other potential assisted living facilities because the county would reach a limit. The county's planning and zoning staff therefore asked Smith to withdraw his application after getting conditional approval if he believed that actual development would not occur. Smith, and thus the property company, obliged. They withdrew the application.

At the same time that Smith was working with the property company, he was the owner or agent of at least 10 other partnerships. The only asset of each partnership was a separate tract of land in the same county. The pattern was the same: Smith obtained a concept plan for an assisted living facility, filed an application with the county's planning and zoning division, received conditional approval, and then withdrew the application. All 10 partnerships ultimately donated conservation easements, and their values were all based on the notion that their HBUs were construction of assisted living facilities.

"Jones" formed "investment company" in 2016. It issued a private placement memorandum, aggregated capital from many individual partners, used $1 million of the funds to purchase a 97 percent ownership interest in the property company in September 2016, and then voted three months later to donate a conservation easement on 33 of the 40 acres of the property.

Shortly before the donation happened, the land trust issued a baseline report describing the worthiness of the property. It explained that the conservation easement would protect various habitats (including a creek flood plain, wetlands, and an oak-hickory forest), preserve the forest view along a main road, and contribute to state and country policies by safeguarding waterways, air quality, and green space in the Atlanta metropolitan area. Consistent with these notions, the deed identified several conservation values, including the protection of various relatively natural habitats, the preservation of open space in accordance with governmental policies, and the creation of scenic enjoyment.

The property company hired "original appraiser" to determine the value of the conservation easement. His original appraisal said, incorrectly, that the property had been approved for construction of 677 assisted living units. In reality, only conditional approval had been obtained, and the application had then been withdrawn. The original appraiser concluded that the HBU of the property before donating an easement would have been the development of an assisted living facility. He apparently believed that this was legally possible based on the conditional use evaluation report. Next, the original appraiser used the sales-comparison approach, employing a price-per-unit theory instead of a price-per-acre one. He concluded that each unit was worth $13,500, a figure he then multiplied by 677 units. This product, minus the

cost of connecting public sewers to the property, yielded a before-easement value of $8,992,500. The original appraisal determined that the HBU after donating the easement would be agricultural activity, low-impact outdoor recreation and education, or limited hunting. Using a price-per-acre measurement this time around, the original appraiser calculated the after-donation value at about $56,000, which he slightly reduced to account for enhancement of an adjacent property. In the end, the original appraiser concluded that the FMV of the easement was $8,935,000.

The property company filed a timely tax return for 2016 showing the easement transaction with the original appraisal, Form 8283, and Form 8886 attached.

The IRS audited, of course. It eventually issued its final notice asserting, as it invariably does, that the property company should get a tax deduction of $0 and pay a penalty equal to 40 percent of the resulting tax liability because of a "gross valuation misstatement." The property company challenged the IRS by submitting a timely petition in the Tax Court. Litigation ensued, and the Tax Court issued its opinion in late October.

IV. Holdings Favoring the IRS

Because of the public's short attention span and the media's tendency to produce only sound bites, many believe that *Mill Road 36 Henry* was a complete victory for the IRS. That is not true. This article examines the Tax Court's rulings and which parties they favor.

A. Valuation Generally

As noted, a property's HBU is the most profitable use for which it is adaptable and needed in the reasonably near future.[17] It is also the use of property that is physically possible, legally permissible, financially feasible, and maximally productive.[18] The appraisal offered by the IRS at trial (government expert appraisal), the appraisal of the expert presented by the property company at trial (private expert appraisal), and the Tax Court centered their attention on the concept of legal permissibility.

The Tax Court first pointed out that the property company only received conditional approval to build an assisted living facility, after which it withdrew its application. Thus, any assumption that construction was legally permissible "was unwarranted on the facts" as they existed when the original appraisal was prepared and the conservation easement was donated.[19] The Tax Court then explained that the conditional approval by the county specifically contemplated additional state-level approval by the Georgia Division of Healthcare Facilities. The property company neither sought nor obtained this second nod. The Tax Court concluded that the lack of necessary approvals "gravely undermined" the HBU assumption that the property could be developed into an assisted living facility.

Even if the property company had managed to secure the requisite approval both at the county and state levels, the Tax Court determined that the value of the easement would still be low. Why? It noted that the supposedly comparable sales used in the private expert appraisal did not occur in the relevant county, so they were discarded. The Tax Court then cited the regulation providing that it must objectively consider the likelihood of development on the property absent the easement and explained that the property company failed to show "that the particular qualities of the [property] made it uniquely suitable for an assisted living facility," Smith himself found 10 other properties on which a facility could have been built, and nobody argued that the county's population could support the development of 11 facilities.[20]

The Tax Court next turned to transactions dealing with the property itself, namely, the purchase of the property by the original owners (for about $10,700 per acre) and the purchase of a 97 percent interest in the property company by the investment company (for about $28,500 per acre). The Tax Court explained that these figures, particularly the latter, were better indicators of

[17] *Olson*, 292 U.S. at 255.

[18] *Esgar Corp.*, 744 F.3d 648, 659 n.10.

[19] *Mill Road 36 Henry LLC*, T.C. Memo. 2023-129, at 49.

[20] *Id.* at 51.

value than the $203,000 per acre suggested in the private expert appraisal.[21]

Based on the preceding, the Tax Court decided to rely on the value stated in the government expert appraisal, which was $900,000.

B. The One-Two Punch

The Tax Court was not finished, though. Readers need some background to understand how things progressed from there.

1. Character counts.

The value of a conservation easement is its FMV at the time of donation.[22] That figure must be reduced, however, by the amount of gain that would not have been characterized as long-term capital gain if the taxpayer had actually sold the property for its FMV.[23] In other words, if the sale of the property would have generated either ordinary income or short-term capital gain, then the charitable deduction must be reduced by that amount. The effect is that the charitable deduction is limited to the donor's adjusted basis in the donated property.

On a related note, if a partner contributes property to a partnership that is considered inventory in the partner's hands and the partnership then sells or otherwise disposes of the property within five years, the resulting gain or loss is treated as ordinary, not capital.[24] Congress enacted this inventory rule to prevent partners from converting ordinary income property into capital gain property by simply contributing it to a partnership that has a different purpose for owning it.[25]

2. Applying the inventory limitation.

The IRS raised the inventory argument in *Mill Road 36 Henry*. Referencing a case recently addressing this issue, the Tax Court explained that the character of a particular property depends on whether (1) the taxpayer was engaged in a trade or business, (2) the taxpayer held the property primarily for sale in that business, and (3) the sale anticipated by the taxpayer was ordinary in its business. In answering these three questions, courts normally consider the following factors: the purpose for acquiring the property, the duration of ownership, the extent and type of efforts to sell the property, the continuity and substantiality of sales, the use of advertising and other methods to increase sales, the degree of supervision or control exercised over any representative selling the property, the use of a business office to sell the property, and the time and effort the taxpayer historically devoted to sales.[26]

The Tax Court explained that the original owner, comprised of two entities, was engaged in the business of buying and selling real estate, both before and after contributing the property to the property company. The Tax Court also noted that the original owner acquired the parent tract enveloping the property "in furtherance of the real estate business" and later contributed the property "in furtherance of the real estate business." The fact that the original owner later sold 97 percent of its interest in the property company to the investment company does not alter the fact that the property was contributed by partners "who were real estate professionals within five years of donating the conservation easement."[27]

The Tax Court concluded that the easement was not worth $8,935,000 (as per the original appraisal), $6,695,000 (as per the private expert appraisal), or even $900,000 (as per the government expert appraisal). The correct value, reasoned the Tax Court, was $416,563 because the original owner held the property as inventory, contributed the property to the property company when it had a basis of $416,563 in the relevant 33 acres, and the property company donated an easement on the property within five years.

[21] *Id.* at 52-53.

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

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

[24] Section 724(b).

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

[26] *Mill Road 36 Henry LLC*, T.C. Memo. 2023-129, at 55-56 (citing *Glade Creek Partners LLC v. Commissioner*, T.C. Memo. 2020-148; *Glade Creek Partners LLC v. Commissioner*, No. 21-11251 (11th Cir. 2022); *Glade Creek Partners LLC v. Commissioner*, T.C. Memo. 2023-82).

[27] *Mill Road 36 Henry LLC*, T.C. Memo. 2023-129, at 56.

V. Holdings Favoring the Property Company

Valuation did not go the property company's way, but it had better luck in several other areas. The following principal issues were discussed by the Tax Court and might benefit all taxpayers donating easements, not just the property company.

A. Donative Intent and Congressional Incentives

The IRS argued that the property company lacked the necessary donative intent because "it was primarily motivated to monetize the federal income tax deductions for its investors" and "it was subjectively motivated not by disinterested generosity but by tax avoidance." In support of this position, the IRS pointed to a private placement memorandum and emails in which prospective partners were promised tax deductions more than four times the amount of their capital contributions.

The Tax Court swiftly rejected this argument, underscoring that the partners were presented with three options, they voted to donate a conservation easement, and that is exactly what occurred. It then clarified, consistent with several other courts recently, that the existence of tax benefits is not problematic in the charitable donation context:

> That federal income tax benefits are a consideration in determining whether to make a contribution does not undermine the validity of the contribution. It may be that the ideal donor does not let his left hand know what his right hand is doing . . . but Section 170 does not insist on that ideal. Rather, a donor motivated by guilt, or by the hope of being admired, or by the desire for a tax benefit, may still deduct his contribution. Congress long ago decided to incentivize charitable contributions by allowing a deduction for those contributions, and it would be perverse indeed to deny a deduction to a donor simply because he had responded to the incentive. The Government may not "take away with the executive hand what it gives with the legislative."[28]

B. Partnership Status

The IRS maintained that the property company was not a true partnership for federal tax purposes because of timing issues. Apparently, the contribution of the property to the property company occurred before its articles of organization had been filed with the Georgia Secretary of State. That oversight, the IRS argued, constitutes a lack of intent to form a "true partnership."

The Tax Court disagreed. It explained that the timing "irregularity" was not fatal to the property company's right to donate a conservation easement or to claim the corresponding tax deduction. The Tax Court explained that both Georgia law and federal law define the concept of partnership broadly, with the latter expressly including syndicates, groups, pools, joint ventures, or other unincorporated organizations through which any business, financial operation, or venture is carried on. The Tax Court underscored that the Supreme Court has shared this expansive interpretation of partnership for more than seven decades.

Regarding the property company, the Tax Court pointed out that its operating agreement was executed in December 2015, its members were real estate professionals who had a history of working and investing together, and its articles of organization were properly filed before the end of 2015. Thus, the Tax Court held that the property company "met the standard to be considered a valid partnership both under Georgia law and for federal income tax purposes" when it received the property in August 2015.

C. Conservation Purposes

The IRS raised three principal attacks on the conservation purposes announced by the property company. The Tax Court rebuffed all of them.

[28] *Id.* (internal citation omitted).

1. The 'relatively natural habitat' standard is high.

The IRS first questioned whether the conservation easement protected a "relatively natural habit." Alluding to section 170, the underlying regulations, and legislative history, the IRS argued that a tax deduction is not warranted unless the habitats and ecosystems being safeguarded are "significant" and "high quality." The IRS then turned to the report by its expert witness, which said that the property did not offer a habitat for rare, endangered, or threatened species of animals and plants.

The Tax Court did not challenge the conclusions reached by the IRS's expert, as it was unnecessary to do so. It explained that "Congress did not determine to incentivize only the preservation of 'natural' or 'high-quality' areas, but rather to allow a charitable contribution deduction for the donation of an easement that has, as its conservation purpose, the protection of a *relatively natural* habitat of fish, wildlife, or plants, or similar ecosystems."[29] (Emphasis in original.) The Tax Court also indicated that the IRS misinterpreted the relevant regulation, putting excessive emphasis on the word "significant" while conveniently omitting the phrase "but not limited to." In short, the Tax Court concluded that the plain text of the regulation says that relatively natural habitats are not limited to those with rare, endangered, or threatened species, as the IRS contended.

The Tax Court proceeded to criticize the IRS's insistence on a "high quality" habitat, as it surpasses what the relevant regulation demands. The Tax Court explained that the property offered four habitats: oak-hickory-pine forest, bottomland hardwood forest, beaver ponds, and streams. It acknowledged that the property company's expert only observed five of the 57 bird species of priority concern in the region. It indicated, however, that this ratio was not problematic because applicable law does not require that species be rare or threatened and does not set a threshold number that must be present. The Tax Court concluded that the easement on the property had an acceptable conservation purpose because it "protects plant communities and ecosystems natural to Henry County, which will continue to exist in a relatively natural state as the surrounding area is developed."[30]

2. All trees look the same.

The Tax Court next turned to whether the easement on the property adequately preserved open space for scenic enjoyment and yielded a significant public benefit. It did. The property company underscored that the protected land creates a scenic view for more than 7,000 vehicles that transit the bordering street each day.

The IRS tried to minimize this idea, saying that the view (mainly of pine trees) is the same on both sides of the street and throughout much of the county. The Tax Court was unimpressed by the IRS's stance, explaining that it ignored the reality that the property is located in an area of heavy commercial and residential development. The Tax Court, with an eye to the future, said:

> As the general public commutes along Mill Road in the years ahead, it will benefit from a stretch of open space pine forest more than from another stretch of the continuing development (whether strip malls or residential subdivisions). The easement deed ensures that this forested view will exist in perpetuity along Mill Road, and the significance of the public benefit will only increase as Henry County becomes more developed and Mill Road becomes more heavily traveled. We therefore hold that the [property] easement meets the "open space" conservation purpose.[31]

3. Size matters.

The IRS claimed that size matters, regardless of whether taxpayers attempt to qualify under the "relatively natural habitat" standard or the "open space" standard. The IRS argued that "the [property] is too small to have a conservation purpose."[32] The Tax Court held that the IRS was off the mark here, too.

[29] *Id.* at 32.

[30] *Id.* at 34.

[31] *Id.* at 36.

[32] *Id.* at 37.

The Tax Court began by clarifying that the easement area was 33 of the total 40 acres of the property, an amount that is "hardly negligible" when it comes to an urban setting. It then favorably compared the size of the property to that of the Boston Common, one of the oldest and best-known city parks in the country. The Tax Court ended the comparison by saying that "an undeveloped area, even on this modest scale, and especially when surrounded by development in an urban or suburban setting, can be a noteworthy and beneficial feature."[33] It also pointed out that the IRS continued to invent standards that do not exist in the law. It said, in particular, that the IRS's "insistence of a requisite size for a conservation easement, like [its] arguments about high-quality habitats, lacks any basis in the statutory text."[34] The Tax Court acknowledged that the portion of the property providing scenic public views was merely a quarter mile but emphasized that this constituted the entire northern boundary. The court concluded its liberal interpretation of the conservation purpose criteria as follows:

> Even a quarter-mile respite from development alters the character of the neighborhood. If sprawl moving south from Atlanta is otherwise unchecked, the perpetual presence of the pine forest on at least this portion of Mill Road may for many be a welcome relief from the strip malls, shopping centers, and residential subdivisions. The [property] easement substantially benefits the public by preserving a scenic view of this quarter-mile forest.[35]

D. Perpetual Protection

Relevant law demands that to claim the tax deduction affiliated with a conservation easement the conservation purposes must be "protected in perpetuity."[36] Things are not as extreme as they might at first glance appear, though. Various Tax Court cases, citing applicable regulations, have held that donors can specify certain "reserved rights" in the deed so long as they do not permit use of the property that is inconsistent with the easement.[37]

The IRS argued that the reserved rights to engage in limited forestry and agriculture, and to build certain structures and trails, would destroy the conservation purposes in the deed. The Tax Court dispensed with the IRS's position quickly. It noted, among other things, that all construction had to occur outside the special natural areas, the deed explicitly stated that reserved rights cannot be exercised to the extent that they are inconsistent with conservation purposes, and the land trust was tasked with monitoring and preventing any improper use of the property. The Tax Court thus concluded that "the reserved rights do not interfere with the protection of the conservation purposes in perpetuity."[38]

E. Adequate Initial Valuation

To say that claiming tax deductions derived from easement donations is complicated would be an understatement. Taxpayers must take many actions, including, but certainly not limited to, obtaining a qualified appraisal from a qualified appraiser and enclosing a completed Form 8283 with the relevant tax return. Following its standard playbook in syndicated conservation easement cases, the IRS alleged that the property company failed to meet all the requirements. Specifically, it maintained that the original appraiser was not a qualified appraiser because the property company "had knowledge of facts" that would cause a reasonable person to expect that the original appraiser had falsely overstated the value.

The Tax Court began by noting that an appraiser does not become disqualified under the regulations merely because he incompetently or carelessly overstated the value, the donor knew he overstated it, or the donor knew facts about the relevant property that caused the overstatement. Instead, the regulations call for disqualification only when the donor knows facts that cause it, or should cause it, to expect the appraiser to

[33] *Id.* at 38.

[34] *Id.* at 38.

[35] *Id.* at 38.

[36] Section 170(h)(5)(A).

[37] *See, e.g.*, *Belk v. Commissioner*, 140 T.C. 1 (2013); reg. section 1.170A-14(d)-(g).

[38] *Mill Road 36 Henry LLC*, T.C. Memo. 2023-129, at 40.

overstate the value and to do so "falsely."[39] The Tax Court also explained that the law already contains specific remedies for overstated valuations, namely penalties for substantial or gross valuation misstatements. It then clarified that the regulations challenging whether a report is a qualified appraisal are "manifestly focused on something beyond that: a taxpayer-donor's knowledge of an appraiser's deception."[40]

The IRS suggested to the Tax Court that Jones, as the current managing member of the property company, and Smith, as the former managing member and the person who hired the original appraiser, knew facts that would cause the original appraisal to be considered unqualified. The Tax Court met these suggestions with a blunt question: So what? The Tax Court acknowledged that Jones and Smith knew that the property did not get final zoning approval to build an assisted living facility, that it was not possible to fit the 677 units contemplated by the concept plan, and the per-acre value in the original appraisal far exceeded the price at which they were selling surrounding properties. The Tax Court concluded that those facts alone "do not show any falseness or deception" by the original appraiser.[41] It further noted that the original appraiser executed Form 8283 in which the property company's low basis in the property was "frankly juxtaposed" with the high easement value claimed. According to the Tax Court, "the opportunity for deception in such a circumstance would be complicated."[42]

F. No Fraud

The IRS has followed the same procedure in essentially all syndicated conservation easement cases for years: It claims that donors are entitled to tax deductions of $0 and then asserts high penalties for "gross valuation misstatements." The IRS has upped the ante recently, alleging that donors should be assessed with even stronger penalties, those for civil fraud. This is precisely what occurred in *Mill Road 36 Henry*. Interestingly, the IRS did not allege fraud in its examination report or notice of final partnership administrative adjustment. It also did not allege fraud in its answer filed with the Tax Court in response to the petition filed by the property company. Likewise, the IRS did not receive and review materials as part of the pretrial discovery process and then ask the Tax Court for permission to file an amended answer alleging fraud before litigation began. The IRS, instead, waited until after the Tax Court litigation had ended and then filed a "motion to conform the pleadings to the evidence."[43] The Tax Court declined this belated request by the IRS for reasons explained below.

The IRS argued that the fraud penalty was appropriate because the property company, through Smith and Jones, supposedly "intended to evade a tax known or believed to be owing through an intent to mislead."[44] In rejecting this position, the Tax Court first turned to disclosures made by the property company to the IRS regarding the easement donation. It explained that charitable tax deductions face a "robust regime" of reporting and substantiation obligations. These include attaching a qualified appraisal, Form 8283, and Form 8886 to the relevant tax return. The Tax Court noted that the property company did precisely that, clearly showing the IRS the large disparity between the "very low basis" in the property and the "very high claimed value" of the easement on the property:

> We do not see conduct meant . . . to "conceal" or "mislead." This is not an instance in which a taxpayer buried an improper deduction deep in his return, nor even a case where the taxpayer relegated his disclosure of an improper deduction on a self-composed attached statement, which no one at the IRS might ever understand or even see. Rather, the conservation easement transaction was fully disclosed, in exactly the manner designed by the Treasury itself to reveal charitable contribution deductions based on overstated value. And in this instance,

[39] *Id.* at 42 (citing reg. section 1.170A-13(c)(5)(ii)).

[40] *Id.* at 43.

[41] *Id.* at 43.

[42] *Id.* at 43 n.28.

[43] *Id.* at 43 (confirming that "after the trial, the [IRS] filed an Amended Answer alleging that the Section 6663 fraud penalty is applicable").

[44] *Id.* at 58.

> the substantiation and reporting requirements of Section 170(f)(11) appear to have functioned exactly as intended by Congress. . . . We think that [the property company's] compliant reporting was starkly at odds with an intention to conceal.[45]

Down but not entirely out, the IRS next argued that fraud existed, despite full compliance by the property company with all disclosure duties. Courts generally consider various "badges of fraud" in making their determinations, but none of the normal items were present in this case. The IRS, therefore, was forced to invent five supposed fraud badges unique to the property company. These case-specific assertions follow.

First, the IRS underscored that Smith and Jones followed the same pattern in at least 10 other syndicated easement transactions during the same year. The IRS suggested that the repeated methodology shows that the inflated valuation by the property company was fraudulent, not accidental. The Tax Court discarded this accusation altogether, explaining that it "did not view the multiplicity of deals per se as a badge of fraud."[46]

Second, the IRS argued that "deliberate overvaluation" constitutes evidence of fraud. The Tax Court identified a few flaws with this line of reasoning. For instance, the case cited by the IRS to support its position was inapplicable because it involved a scenario involving an overvaluation and a lack of disclosure by the taxpayer. The Tax Court also explained that there is a specific penalty for serious overvaluations called the gross valuation misstatement penalty equal to 40 percent of the tax liability. The Tax Court concluded that because the property company's overvaluation was fully disclosed and triggered a gross valuation misstatement penalty, "we do not think that the overvaluation itself also warrants the 75 percent fraud penalty."[47]

Third, the IRS urged the Tax Court to place serious significance on the property company's reliance on a valuation (that is, the original appraisal) that contained "false statements and fraudulent analysis." The Tax Court clarified that the two main problems with the original appraisal were that it incorrectly assumed that final approval, instead of conditional approval, existed for constructing the assisted living facility and that it was acceptable to value the property on a per-unit, instead of a per-acre, basis. These errors were negligent, the Tax Court conceded, but they did not rise to the level of fraud. Among other things, the Tax Court noted that Smith's business involved locating property, obtaining a concept plan that "seemed to be in the realm of reason," selling the property to a developer that would address any problems involving zoning and permitting, and then moving on to the next project. It further said that neither Smith nor Jones purported to know much about assisted living facilities. The Tax Court ended this discussion as follows:

> Though the per-unit method in the [original appraisal] yielded a value woefully at odds with the principle of substitution, its arithmetic was correct, a licensed appraiser had validated it and it was . . . attached to return. This yielded gross error, but we cannot say it was fraud.[48]

Fourth, the IRS claimed that certain testimony during the trial lacked credibility, and this sufficed to demonstrate fraud. The Tax Court seemed to have little patience for this idea. It pointed out that most of the material facts were either stipulated before the trial or largely undisputed, that only two instances identified by the IRS involved testimony by Smith or Jones, and these limited items were "not especially significant to the issue of fraud," "not critical to the case," or "settled by reference to documents" admitted into evidence at trial.[49]

Fifth, the IRS maintained that the donation lacked "bona fide business transactions." The Tax Court said that this was nothing new; the IRS was simply recharacterizing its earlier argument, already rejected, that the property company was

[45] *Id.* at 59.
[46] *Id.* at 60.
[47] *Id.* at 61.
[48] *Id.* at 62.
[49] *Id.* at 63.

not a true partnership for federal tax purposes. The Tax Court repeated that "by definition, a charitable contribution lacks a profit motive, but that does not invalidate the contribution nor deprive the donor of his deduction, nor does it suggest fraud."[50]

Sixth, the IRS suggested that the decision by Smith and Jones to request that the trials for the 11 conservation easement donations following the "pattern" be held in five different cities showed fraudulent intent. The IRS deemed this an effort to "obfuscate and conceal" the "contemporaneous [syndicated conservation easement] enterprise" involving subdivided land. The Tax Court did not find this site-selection practice particularly troubling, largely because, from its perspective, that practice had no chance of succeeding in the first place. The Tax Court observed the following in this regard: "Since both the [IRS] and the Court have means for coordinating the handling of related cases, even in different geographical areas, we do not see how this practice was orientated toward obfuscation."[51]

VI. Conclusion

The rulings by the Tax Court in *Mill Road 36 Henry* about valuation are disconcerting, particularly the criticisms of the proposed HBU of the property and the limiting effect of the inventory issue. All is not doom and gloom, though. The case, for those who invest the time necessary to read it fully and closely, contains many uplifting aspects for taxpayers. It clarifies that the desire to obtain tax benefits does not undermine charitable donation status, the concept of partnership is broad, conservation purposes should be liberally interpreted, reserved rights in a deed do not necessarily eliminate perpetual protection, characterizing an appraiser as unqualified is an uphill battle, and civil fraud is extremely difficult for the IRS to prove, especially when a taxpayer has fully disclosed the easement donation on all tax and information returns. Taxpayers still engaged in easement battles with the IRS should be aware of, and apply, these positive rulings. ■

[50] *Id.* at 64.

[51] *Id.* at 63 n.38.