Conservation Easements

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CONSERVATION EASEMENT WHITE PAPER

By: David W. Wooldridge and Ronald A. Levitt

WHAT IS A CONSERVATION EASEMENT?

If you do anything involving real estate or tax planning, you have probably heard the term "conservation easement." The concept is a hot topic, and we have had numerous requests from landowners and taxpayers alike for information about conservation easements and how they can be used to accomplish various tax and real estate goals. These requests have prompted us to write this article which covers the basics of conservation easement planning. Points covered include:

- The history, purpose and public benefits of conservation easements.
- The technical requirements that must be satisfied before a land owner will be entitled to a federal tax deduction for the contribution of a conservation easement.
- Valuation of conservation easements, which determines the amount of any deduction.
- Issues related to ownership of easement property through entities taxed as partnerships.

History, Purpose and Public Benefits of Conservation Easements

Congress determined years ago that it was in the country's best interest to preserve land of ecological or historic importance in a manner that protects or preserves conservation values identified by Congress as being important. To accomplish this goal, Congress provided substantial tax benefits for those who voluntarily restrict their property in a manner which preserves these conservation values on their property in perpetuity. These restrictions are commonly known as conservation easements. The income tax benefits provided by Congress for these restrictions are found in section 170(a) and (h) of the Internal Revenue Code. Estate tax benefits are found in sections 2031(c) and 2055(f) of the Code. Many states have also enacted tax benefits for donating landowners, usually in the form of a credit.

A conservation easement (also called a conservation restriction or restrictive covenant) is a legal conveyance between a landowner and a third party whose role is to monitor the easement and enforce it if necessary. This third party must be a governmental entity or, more commonly, a special kind of tax-exempt Section 501(c)(3) organization known as a "land trust." Land trusts are viewed by the conservation community and Congress as the "gate keepers" for conservation easements. Land trusts accept easements on property with appropriate conservation values, and they monitor and enforce the legal restrictions on the property in perpetuity. The landowner will continue to own the land and may use the land for various purposes that do not impair the conservation values of the property. The landowner may also sell the land or pass it on to heirs. However, the conservation easement must give the land trust the right and power to permanently restrict the uses of the land to those uses allowed by the easement.

Conservation easements offer great flexibility and can contain a variety of restrictions and of permissible uses. For example:

- An easement might apply to all or to only a portion of a landowner's property.
- It might allow recreational uses, such as hunting, fishing and water sports.
- It can, but need not (in most cases), allow public access to the eased property.
- Landowners sometimes reserve sites on the easement on which to build homes and other structures.
- On the other hand, conservation easements necessarily place limitations on some uses of the property. For example:
- A conservation easement typically prohibits any intense development of the property for residential or commercial uses.
- Particular conservation values associated with the property must be perpetually protected; for example, significant wildlife or plant habitat, streams and lakes, or in some cases a scenic vista.
- Lenders may be unwilling to loan funds secured by restricted property, and existing mortgages must be subordinated to the conservation easement.
- The Tax Court has recently explained that the conservation easement must permanently encumber the real property upon with it is granted, and cannot ever be "substituted" to different real property.

Potential Tax Benefits for Donation of Conservation Easements

To encourage the preservation (in perpetuity) of land with significant conservation values, Congress has provided substantial tax benefits to landowners donating qualifying conservation easements. The primary incentive to this conservation is an income tax deduction under Section 170(a) and (h) of the Internal Revenue Code. A landowner who donates a "qualified" conservation easement to a qualified governmental entity or land trust, and who satisfies the technical requirements of the regulations issued under section 170, is eligible for a federal income tax deduction equal to the value of the donated easement. However, the value of restrictions placed on real property is a difficult question. The IRS regulations require the taxpayer to first attempt to value the conservation easement by looking at sales of other "comparable" easements. In practice, however, such comparable easements rarely exist, so the value of a conservation easement donation generally is measured by the difference between the fair market value of the property before the easement takes effect and the fair market value after the easement takes effect.

Other potential tax benefits to donors of qualifying conservation easements include an estate tax deduction for donations made at the time of death (section 2055(f)) and an estate tax exclusion for eased property included in a decedent's estate (section 2031(c)).

Technical Requirements for Income Tax Benefits

To qualify for the income tax deduction under Section 170, a conservation easement must meet several requirements:

1. *The easement must be perpetual.*

In order to be eligible for an income tax deduction, the donation must be perpetual. What this means is that the conservation restrictions will be recorded and will forever prohibit the uses of the property described in the easement. The perpetuity requirement manifests itself in various ways, and the scope of this requirement is only partly explained in the regulations. The scope of the perpetuity requirement is a common source of controversy and litigation in the courts.

It is clear that Congress intended that conservation easements perpetually encumber the land on which the easement is granted. For this reason, any outstanding mortgages, liens, encumbrances or other rights of third parties must be subordinated to the rights of the land trust to enforce the conservation easement restrictions. The subordination must be obtained and be effective before the easement is granted. Also, if the eased property were to be condemned, the land trust must receive a proportionate share of the proceeds from condemnation. There are unsettled questions about the impact on perpetuity of such things as amendment or modification of an easement. However, the courts have recently determined it is impermissible for a donor to retain the right to modify the boundary lines of an easement. Whether the nature and extent of the restrictions within the eased property (such as the location of reserved "development areas") can be moved, is subject to ongoing litigation.

2. *The easement must be held by a qualified governmental or non-profit organization.*

A conservation easement must be donated to a qualified governmental entity or to a qualified tax-exempt organization. Tax-exempt donee organizations are generally referred to as "land trusts" and they must be a tax-exempt entity that is qualified to receive tax-deductible contributions. It was the intent of Congress to have land trusts function as the regulators of conservation easements. A land trust will monitor conservation easement property periodically to assure that the property is in compliance with the terms of the conservation easement and that the conservation values of the property are being preserved. If a land owner violates the terms of a conservation easement, the land trust must be willing and able to take appropriate enforcement actions that are available under the law.

3. *The easement must serve a valid "conservation purpose," meaning the property must have a significant ecological, scenic, historic, scientific, recreational, or open space value.*

Congress has specified four types of property that it wishes to be preserved, and these types of property are enumerated in the Internal Revenue Code and are further defined in the Treasury Regulations. The four conservation values that Congress has allowed as a basis for a deduction are:

- preservation of land areas for outdoor recreation by, or education of, the general public;
- protection of a significant, relatively natural habitat of fish, wildlife, or plants, or similar ecosystem;
- preservation of open space, including farmland and forest land, for the scenic

enjoyment of the general public, or preservation of open space pursuant to a clearly defined governmental conservation policy, provided such preservation will yield a significant public benefit; and

- preservation of an historically important land area or certified historic structure.

The conservation easement must secure one, but only one, of these four types of preservation values. If land is suitable for such a purpose, the donor and the land trust must agree on, and implement, a set of restrictions which will preserve the identified characteristics of the property in perpetuity. These restrictions become the core of the conservation easement document, together with specified uses reserved to the landowner. The IRS is currently taking the position that a land owner cannot protect one type of conservation purpose, while allowing a use that would impair a separate conservation purpose. For this reason, all potential conservation purposes should be evaluated in light of the easement restrictions and uses reserved by the donor.

4. *The easement donation must be substantiated and reported in specific ways.*

An appraisal of the value of the donated conservation easement must be obtained within a certain time period and must be performed by a qualified appraiser whose work satisfies standards set out in the Treasury Regulations, as discussed more fully below. The landowner must obtain a written acknowledgement from the land trust prior to the earlier of filing his tax return or the due date (including extensions) thereof, that confirms the donation and that makes certain certifications required by the Regulations. A document called the baseline documentation must be obtained which details the condition of the property and the conservation values associated with it. The fundamental documentation of the conservation easement must be carefully drawn, and the execution and recording of the documents must be done in the proper time and manner. In addition, the donor's tax return must include a form (Form 8283) that is signed by the appraiser and by the land trust and that sets out certain information about the donation and the donated property. The IRS is carefully scrutinizing Forms 8283, and will deny a deduction if it determines a Form 8283 is incomplete.

The Income Tax Deduction

1. *Enhanced incentives for conservation easement donations available to individuals.*

Under current law, individuals may deduct conservation easement donations up to 50% of the individual's contribution base and the unused portion the donation may be carried forward for up to 15 additional tax years. This enhanced incentive applies to deductions for conservation easement donations made directly by an individual taxpayer directly as well as those "passed through" from an entity such as a partnership or S-Corporation (as discussed in the following subsection, separate limitations apply to donations made by C-Corporations). Further, an individual that is a "qualified farmer or rancher" (defined as a taxpayer that earns 50% or more of its annual gross income from the trade or business of farming) may deduct a conservation easement donation of property used in, or made available for use in, the production of agriculture or livestock production ("agricultural property") up to 100% of the qualified farmer or rancher's contribution base provided that the easement includes a restriction that such agricultural property remain available for such production.

These enhanced incentives, signed into law by President George W. Bush as part of the Pension Protection Act of 2006, were enacted to encourage and reward conservation easement donations. Prior to the enactment of these incentives, conservation easement donations by individuals were subject to the general 30% contribution base limitation and the 5 year carryover period. While the enhanced incentives for conservation easement donations were originally scheduled to expire at the end of 2007, these incentives were subsequently (and, as necessary, retroactively) extended by Congress for each year between 2008 and 2014, thereby making this one of the most confusing areas of conservation easement law. Fortunately, the pro-easement incentives were finally (and retroactively for 2015) made permanent when President Barack Obama signed into law the Protecting Americans from Tax Hikes Act of 2015 (the "2015 PATH Act") on December 18, 2015. Accordingly, the 50% contribution base limitation and 15 year carryover period apply to conservation easement donations made in every tax year beginning on or after January 1, 2006. While some of the uncertainty surrounding this topic was eliminated when the enhanced incentives were made permanent in 2015, these limitations remain complex and particular to each taxpayer, so anyone considering a conservation easement donation should consult with a tax advisor prior to making the decision to pursue a conservation easement donation.

2. *Enhanced incentives for conservation easement donations by certain corporations.*

Under current law, C-Corporations may deduct conservation easement donations up to 10% of the C-Corporation's taxable income and the unused portion the donation may be carried forward for up to 5 additional tax years. However, like the incentives for individuals, some pro-easement incentives are available for conservation easement donations made by certain C-Corporations. First, much like the similar incentive for individuals, a non-publicly traded corporation that is a qualified farmer or rancher may deduct a conservation easement donation of agricultural property up to 100% of the corporation's taxable income, and any unused deduction may be carried over for up to 15 subsequent tax years, provided that the easement includes a restriction that such agricultural property remain available for such production. Like the pro-easement incentives for individuals, this provision was originally enacted by the Pension Protection Act of 2006 and was subsequently made permanent by the 2015 PATH Act. Accordingly, this incentive applies to tax years beginning on or after January 1, 2006.

In addition to making the incentive for corporate farmers and ranchers permanent, the 2015 PATH Act also added a new (and permanent) pro-easement incentive for certain Alaskan "Native Corporations" (generally defined as entities, whether for-profit or not, organized under the laws of the State of Alaska for the purpose of holding, managing, investing or distributing funds, land or other property and rights on behalf of Native Alaskans). Under this new incentive, a Native Corporation may deduct a conservation easement donation of property conveyed under the Alaska Native Claims Settlement Act up to 100% of the Native Corporation's taxable income, and any unused deduction may be carried over for up to 15 subsequent tax years. Unlike the other pro-easement incentives discussed above, this new incentive applies only to donations made in tax years beginning on or after January 1, 2016.

Valuing a Conservation Easement

The amount of the charitable deduction available for a donation of property is the fair market value of the property donated. In the case of a conservation easement, however, the donation

involves a landowner placing restrictions on land he will still own after the donation. The land trust receives the right to enforce the restrictions. The value of these rights and restrictions would be difficult to appraise under normal appraisal methods. In some cases, there are actual sales and purchases of conservation easements that can be compared to the donated easement. In these cases, a standard appraisal method can be employed based upon the comparable sales. However, in most cases, such "comparable sales" of easements either do not exist or they are insufficient to perform a valid appraisal.

When there is no substantial record of marketplace sales of comparable easement rights, the Treasury Regulations provide that the fair market value of the conservation easement is deemed to be the difference between the fair market value of the property the easement encumbers immediately before granting the easement (the "Before Value") and the fair market value of the encumbered property after granting the easement (the "After Value"). Under Section 1.170A-14(h)(3)(ii), this "before-and-after" valuation must take into account the "highest and best" use of the property in question, based upon an objective assessment of how immediate or remote the likelihood is that such property, absent the restriction, would in fact be put to that use. The analysis must also take into account realistically the impact of zoning laws, conservation or historic preservation laws, and other issues related to feasibility of the property's potential highest and best use. The following example illustrates a before-and-after valuation scenario.

Mr. Jones owns 100 acres of ecologically important, undeveloped land. It is feasible and reasonably probable that Mr. Jones could develop the land into a residential community, and if so then the fair market value of the land at its highest and best use is $10 million. However, Mr. Jones wants to donate to Land Trust a conservation easement over the land, which will eliminate in perpetuity his right to develop the land. A qualified appraiser determines that the value of the land after the restrictions are in place (thus eliminating any development potential) is only $1 million. Assuming Mr. Jones meets all of the technical requirements applicable to conservation easement donations, Mr. Jones will be entitled to a $9 million deduction.

If the amount claimed or reported as a charitable contribution deduction exceeds $5,000, the deduction must be substantiated by a "qualified appraisal" performed by a "qualified appraiser" under Section 1.170A-13(c) of the Regulations. This is often a complicated and relatively expensive process which requires an appraiser with special skills and experience. As a result of this complexity and of the inherent subjectivity of property appraisal, tax controversies involving conservation easements are often embroiled in valuation concerns and issues. Moreover, the 2006 Pension Protection Act and subsequent guidance have expanded on the requirement of a "qualified appraisal" and "qualified appraiser." The IRS is frequently raising issues about what these terms mean and require in light of the changes.

Other Tax Benefits of Conservation Easements

There are other benefits beyond the federal income tax deduction that are available for conservation easement donations. Two of the more important benefits are discussed below.

- **Reducing Estate Taxes**

A conservation easement can facilitate passing undeveloped land on to the next generation. By removing the land's development potential, the easement typically lowers the property's fair market value, which in turn lowers the potential estate tax. Whether the easement is donated during life or by will, it may make a critical difference to the heirs' ability to keep the land intact. If "eased" property is included in a decedent's estate at the reduced value of the property post-easement, the estate's estate tax liability may be reduced, and the need to sell the eased property to raise funds to pay estate taxes may be eliminated. Accordingly, the absence of development potential may make it more likely that the property will stay in the family, and in its current use, for generations.

Another incentive for conservation easement donations is an estate tax exclusion of up to 40% of the restricted value (the "after value") of land protected by a conservation easement. That exclusion is capped at $500,000 and is further reduced in cases where the easement reduces a property's value by less than 30%.

- **State Tax Benefits**

In 1983, North Carolina became the first state to establish a state income tax program which provides donors of qualified conservation easements with credits that can be used to pay state income tax. In 1999 four state legislatures enacted state tax credit programs (Virginia, Delaware, Colorado, and Connecticut). South Carolina and California followed in 2000. Several other states, including Georgia, have followed since, although there have been subsequent restrictions on the availability and prerequisites to obtaining such state tax benefits.

For landowners with little income subject to state taxation, a tax credit can be of little benefit. In response to this problem, Colorado in 2000 made their state tax credit transferable — that is, the donor/landowner can sell her/his credit to other parties; the buyers can then use the purchased tax credit to pay their Colorado income tax. Virginia followed by enacting transferability in 2002. Other states, including Georgia, have followed since. However, the amount of credit an easement can generate is often capped, and other restrictions limit the scope of the state tax credit programs in various ways.

In the states where the credit for conservation land donations is transferable, free markets for such credits have formed. Brokers assist landowners with excess credits to identify buyers. The brokers often handle payments and paperwork to protect the principals and to ensure that transfers are fully reported to the state tax authorities.

Conservation Easements and Real Estate Partnerships

A conservation easement can be a valuable tool for maximizing real property value. In certain instances, the tax benefits that can be realized from a conservation easement donation will make such a donation attractive as a stand-alone project or in connection with other development objectives. Moreover, the use of partnership structures can allow, under the right circumstances, the maximal use of tax benefits attributable to a conservation easement donation. This has the result of allowing preservation of land that might not otherwise be protected.

Many landowners are not able to take advantage of a deduction for a conservation easement on their property because they lack sufficient income. However, there are high-income taxpayers willing to invest in land owning entities if they can possibly receive the benefit of a conservation easement deduction. This matching of interests allows preservation of the land on terms satisfactory to all and increases the amount of land preserved by fully utilizing the

tax incentives of section 170(h). For example, this may occur if, after the investment is made by the high-income taxpayer, the entity chooses to donate a conservation easement on the property and forego other options available to it. The charitable deduction resulting from the conservation easement would then be allocated to the current owners of the land owning entity, which would include the newly admitted high-income investor. Thus, the tax incentive for conservation easements found in Section 170(h) will achieve its purpose by encouraging the donation of a conservation easement on property and by protecting the conservation values Congress wants to preserve in perpetuity for future generations. These transactions can be complex, but they are designed to allow the tax incentives of Section 170(h) to be used as Congress originally intended. An example of how this works is provided below.

Assume that Mr. Jones (from the example above) owns the property with his son, Casey, in a partnership, and assume that Mr. Jones and Casey each have an annual adjusted gross income of only $50,000. If Mr. Jones and Casey were to donate a conservation easement over their property, they would likely be unable to fully utilize the $9 million deduction attributable to an easement donation because of the deduction limitations discussed above (Mr. Jones and Casey would each be limited to deducting $15,000 of the $9 Million deduction in the year of donation, and roughly the same amount for each carryover year afterward). However, if Mr. Jones and Casey admitted other high-income investors into their partnership by selling them LLC interests, and the partnership subsequently elected to donate an easement over the property, the investors would be able to share in the deduction. Thus, the partnership structure and the admission additional partners, can enable the tax benefits attributable to a conservation easement donation to be fully utilized.

Conclusion

Conservation easements can provide land owners and potential real estate investors with significant tax and non-tax benefits. Congress has repeatedly expressed its desire for the preservation of private property for public benefit by enacting Section 170(h) of the Code and by repeatedly expanding or extending the tax benefits available for conservation easement donations.

Despite Congress's clear intent to promote easement transactions, however, the IRS has been active trying to weed out what they perceive as "bad" easements. Unfortunately, these efforts by IRS to find and to disallow bad easements has resulted in many good easements being examined and often deductions being disallowed due to a technical problem, inaccurate paperwork or simple disagreement over value issues. The courts have often drawn hard lines on certain technical issues, so it is more important than ever to makes sure easement transactions are carefully scrutinized by competent and experienced tax counsel and that all of the many procedural and technical requirements are satisfied.

In more specific terms, a conservation easement (also called a conservation restriction or restrictive covenant) is a legal conveyance between a landowner and a third party whose role is to monitor the easement and enforce it if necessary. This third party must be a governmental entity or, more commonly, a special kind of tax-exempt Section 501(c)(3) organization known as a "land trust." Land trusts are viewed by the conservation community and Congress as the

NAVIGATING THE DEFENSES TO VALUATION PENALTIES IN CHARITABLE DEDUCTION CASES

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By: David M. Wooldridge, Ronald A. Levitt, Gregory P. Rhodes, and Michelle A. Levin

Navigating the Defenses to Valuation Penalties in Charitable Deduction Cases

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The "good faith investigation" requirement imbedded in Section 6664(c)(3)'s reasonable cause provision provides courts with ample leeway to deny or grant relief from the imposition of charitable deduction valuation penalties.

The quest to avoid valuation penalties is often an effort to avoid insult to a tax deficiency injury. Before embarking on a journey through the judicially-created maze of law on establishing "reasonable cause" to avoid valuation penalties in charitable deduction cases, it is important to have a full understanding of the types of penalties that might apply in valuation cases and whether a "reasonable cause" defense is even available. This requires an understanding of the relevant statutory framework set out in Sections 6662 and 6664.

SUBSTANTIAL AND GROSS VALUATION PENALTIES—HOW THEY WORK

There are two penalties specific to charitable contribution valuations: (1) a "substantial" valuation misstatement penalty, and (2) a "gross" valuation misstatement penalty. The substantial valuation misstatement penalty applies if "the value of property (or the adjusted basis of any property) claimed on any return is 150% or more of the amount determined to be the correct amount of such valuation or adjusted basis....'[1] In such instances, Section 6662(a) imposes a penalty of "20 percent of the portion of the underpayment to which [Section 6662(a)] applies."[2]

The "gross" valuation penalty mirrors the "substantial" valuation penalty, except the 150% threshold is replaced with a 200% threshold.[3] The penalty is ratcheted up from 20% of the portion of the underpayment attributable to the misstatement to 40%. Moreover, as discussed in more detail in this article, there is currently no reasonable cause exception available for a gross valuation misstatement.[4]

A couple of examples illustrate the math.

Examples: Taxpayer donates real estate to charity and values the real estate at $1,500,000, resulting in a tax savings of $300,000. The IRS challenges the valuation, claiming the real estate is worth only $100,000, and asserts valuation penalties under Section 6662.

If the value of the real estate is ultimately determined to be $1,000,000 or less (thus the claimed value is 150% of the value ultimately determined), the substantial valuation misstatement penalty will apply (barring a reasonable cause defense). Because the redetermination of value in this case results in a tax deficiency of $100,000, the 20% penalty would be applied to the $100,000 deficiency, resulting in a $20,000 penalty.

If the value of the real estate is ultimately determined to be $750,000 or less (thus the claimed value is 200% of the value ultimately determined), the gross valuation misstatement penalty will apply. Because the redetermination of value results in a tax deficiency of $150,000, the 40% penalty would apply against the deficiency, resulting in a $60,000 penalty.

As demonstrated by these examples, valuation penalties can be substantial. The larger the understatement, the larger the deficiency will be, and the larger the applicable penalty. Moreover, once an overstatement in value reaches the "gross" valuation level, the penalty percentage increases and the "reasonable cause" exception is no longer available.

OVERVIEW OF THE STRUCTURE AND HISTORY OF THE CHARITABLE DEDUCTION PROPERTY VALUATION PENALTY EXCEPTIONS

Under the assumption that tax penalties are, at least in part, punitive in nature, Congress provided relief from penalties when a taxpayer had "reasonable cause" for his or her reporting position. These rules are currently found in Section 6664(c).

The Current Structure of Section 6664(c)

Section 6664(c)(1) provides the general rule that valuation penalties are not imposed with respect to any portion of an underpayment if it is shown there was (1) "reasonable cause" for such portion of the underpayment and (2) the taxpayer acted in "good faith" with respect to the tax position. This is the general "reasonable cause" exception applicable to most Section 6662 accuracy-related penalties.

Section 6664(c)(3), however, modifies the reasonable cause exception for "charitable deduction property." Charitable deduction property is defined as "any property contributed by the taxpayer in a contribution for which a deduction was claimed under section 170."[5] In this case, the reasonable cause exception is not available unless the taxpayer can establish (1) the claimed value of the property was based on a "qualified appraisal" made by a "qualified appraiser," and (2) the taxpayer made a good faith investigation of the value of the contributed property. Furthermore, Section 6664(c)(3) entirely removes the reasonable cause exception for *gross* valuation misstatements of charitable deduction property, thereby making the gross valuation misstatement penalty a strict liability penalty.

The "giveth and taketh" framework of Section 6664(c) makes it unnecessarily difficult to interpret. The end result however is relatively simple. First, there is no reasonable cause exception to a "gross" valuation misstatement penalty involving charitable contribution property. Second, in order to qualify for the reasonable cause exception to the "substantial" valuation penalty with respect to charitable contribution property, the taxpayer must establish (1) the taxpayer had reasonable cause (as that term has been interpreted under prior law), (2) the taxpayer acted in good faith, (3) the value of the charitable deduction property was based on a "qualified appraisal" made by a "qualified appraiser," and (4) the taxpayer made a good faith investigation of the value of the contributed property.

> The "giveth and taketh" framework of Section 6664(c) makes it unnecessarily difficult to interpret.

These four elements inevitably overlap, and the courts interpreting Section 6664(c) have intertwined the elements in their analyses. This makes dissecting the elements difficult. Moreover, the reasonable cause analysis involves parsing through the definitions within each of the four elements, and each definition can be complex. For instance, the terms "qualified appraisal" and "qualified appraiser" are the subject of extensive regulations (Regs. 1.170A-13(c)(3) and (5)) and have been the focus of several cases before the Tax Court.

The History of Charitable Deduction Property Valuation Penalties and Why It Still Matters

The valuation misstatement penalties discussed above have undergone a series of significant and relevant changes. The most significant of these changes are a result of the 2006 Pension Protection Act (PPA), which substantially altered the relevant provisions by (1) changing the percentage-of-value thresholds defining gross and substantial valuation misstatements and (2) making significant changes to the application of the "reasonable cause" exception.

With respect to the percentage-of-value thresholds, the PPA lowered the substantial valuation misstatement threshold from 200% to 150% of final value and the gross valuation misstatement threshold from 400% to 200%. Probably more significant, the PPA eliminated the "reasonable cause" exception for gross valuation misstatements.

Additionally, the PPA redefined the term "qualified appraisal." Most notably, the PPA changed the definition to specifically require, among other things, that an appraisal must be conducted in accordance with "generally accepted appraisal standards." Moreover, a qualified appraisal must be performed by a "qualified appraiser." Prior to the PPA, in order to be a "qualified appraiser," an individual simply had to hold himself or herself out to the public as an appraiser, or had performed appraisals on a regular basis and, because of his or her training and experience, was qualified to appraise the type of property being valued.[6] After the PPA, a qualified appraiser must have earned an appraisal designation from a recognized professional appraiser organization or must meet minimum education and experience requirements set forth in regulations. In addition, the appraiser must now demonstrate verifiable education and experience in valuing the type of property subject to the appraisal.[7]

The PPA changes were significant, but it is the authors' experience that the pre-PPA statute remains relevant. Charitable valuation cases, like many tax cases, often take years to work through resolution, and it is not uncommon for cases currently in court or under audit to involve tax years prior to 2006. Accordingly, the law in effect prior to the PPA changes is often applicable.

In *Chandler*, 142 TC No. 16 (2014), the Tax Court recently expanded on the applicability of the pre-PPA law by determining that carryover deductions attributable to a contribution made prior to the effect of the PPA changes will be governed by the law in effect during the year in which the carryover deduction is taken, at least in regards to the changes that made the gross valuation misstatement penalty a strict liability penalty. An understanding of the basic facts of *Chandler* helps illustrate its effect.

Chandler involved two facade easements (also known as "preservation" or "conservation" easements) granted on two single-family residences in Boston. The first issue before the court was the value of the preservation easements. The court found the value of the preservation easements to be zero. The court next turned to the application of penalties. Importantly for purposes of this article, the carryovers (taken in 2005 and 2006) generated by the donations (made in 2004) resulted in multiple years being at issue in the case. This, in turn, raised questions about how (and when) the PPA changes to the penalty provisions applied to tax returns filed after the effective date of the statute (7/25/06),[8] but which contained carryover deductions attributable to a donation made prior to the PPA changes. At issue were the PPA changes that made the gross valuation penalty a "strict liability" penalty by eliminating the "reasonable cause and good faith" exception to the penalty. The issue was critical because the court determined that the taxpayers had made a good faith attempt to determine the values of the donated easements, allowing the taxpayers to avoid the 40% penalty under the law in place prior to the PPA changes.

The applicability of the reasonable cause exception to the 2004 and 2005 tax years at issue in the case was straightforward because the deductions were claimed *and* reported prior to the effective date of the 2006 changes. The 2006 year, however, reported a deduction attributable to a donation made prior to the PPA changes, but the tax return claiming the carryover deduction was filed after the PPA changes (in 2007). The IRS argued that the strict liability changes should apply due to the filing date of the return. The taxpayers argued that the reasonable cause exception under the prior law should apply because the easements were granted and the deductions were originally taken prior to the PPA changes. The court found for the IRS, determining that the filing of the 2006 return amounted to a "reaffirmation" of the value originally claimed by the taxpayers.

Based on the holding in *Chandler*, the IRS now has support for the position that any return filed after 8/17/06[9] is subject to the PPA changes to the penalty provisions, regardless of when a charitable contribution claimed on such return was made. This would specifically include denying "reasonable cause" relief to any taxpayer claiming a carryover of a charitable deduction attributable to a property that was determined to be grossly overstated in value.

It is worth noting that *Chandler* did not resolve the issue of whether the PPA changes that reduced the substantial valuation misstatement percentage from 200% to 150% and the gross valuation misstatement percentage from 400% to 200% apply to carryover deductions taken after the effective date of the PPA change but attributable to a donation claimed on

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NOTES

1 Section 6662(e)(1)(A). The "correct amount could be determined by a court decision or by agreement with the IRS. If by agreement, a waiver of the penalty might be part of the negotiation.

2 Section 6662(a).

3 Section 6662(h)(A)(i).

4 Section 6664(c)(3).

5 See Section 6664(c)(4)(A)

6 Regs. 1.6664-4(h)(2), 1.170A-13(c)(5).

7 Section 6664(c)(3)(B), added by the Pension Protection Act of 2006 (2006 PPA), PL. 109-280, § 1219(c)(2), 8/17/06. Sections 170(f)(11)(E)(ii), (iii), added by 2006 PPA § 1219(c)(1), in each case, effective with respect to returns filed after 8/17/06 (7/25/06 in the case of a conservation easement relating to the exterior of a building described in Section 170(h)(4)(C)(ii)). Regs. 1.6664-4(h)(2), 1.170A-13(c)(5). Prop. Reg. 1.170A-17(b). Notice 2006-96, 2006-46 IRB 902 provides additional transitional guidance on these definitions.

8 See note 7 *supra*.

9 7/25/06 for preservation easement donations.

10 See footnote 23 in the case ("In *Chandler v. Commissioner* we held that provisions of the PPA that removed the reasonable cause defense for gross valuation misstatements under sec. 6662(h) applied to a carryover that the taxpayer claimed on a return filed after the PPAs effective date even though the carryover related to a deduction that arose on a return that the taxpayer filed before that date. However, *Chandler* did not decide whether the pre- or post- PPA rules apply with respect to the determination of whether a substantial or gross valuation misstatement penalty applies in the case of a post-PPA carryover that arose from a deduction claimed on a return before PPAs effective date.") (internal citations omitted).

a return prior to the date. In *Schmidt*, TCM 2014-159,[10] and again in *Zarlengo*, TCM 2014-161,[11] the Tax Court clarified that the percentage threshold issue was not resolved in *Chandler*, and that the case was limited to the application of the PPA changes to the availability of the reasonable cause exception. Accordingly, the impact of the PPA changes to the gross and substantial valuation misstatement percentage thresholds for carryover deductions taken after 8/17/06 but attributable to a donation claimed on a return prior to 8/17/06 remains unresolved.

ESTABLISHING REASONABLE CAUSE IF AND WHEN IT IS AVAILABLE

Considering the relatively-clear status of the general rules pertaining to valuation misstatement penalties, one would expect some uniformity in the charitable deduction valuation penalty cases. Although the factual-nature of the "reasonable cause" analysis would lead one to expect some variation in the results when reasonable cause is raised as a defense, one would expect the cases to be reconcilable. After all, uniformity would promote certainty and produce a guide on which taxpayers could base their behavior. The punitive goal of the penalties is not served if application of the penalties is uncertain. Uniformity, or even a reconcilable basis for the results in cases, however, has not occurred.

In order to understand the application of the valuation penalties, an understanding of the recent cases and facts relevant thereto is necessary. Following is a review of what the authors believe to be the most important charitable deduction property valuation penalty cases issued in the last year.

The *Whitehouse* Cases

One of the most important and anticipated opinions involving valuation penalties is *Whitehouse Hotel Ltd. Partnership*, 755 F.3d 236, 113 AFTR2d 2014-2489 (CA-5, 2014) (*Whitehouse IV*), which was issued by the Fifth Circuit on 6/11/14. This case marks the conclusion of a series of back and forth decisions by the Fifth Circuit and the Tax Court over valuation principles and the role of valuation penalties.[12] *Whitehouse* involved a partnership (Whitehouse) that was formed in 1995 for the purpose of acquiring and renovating a historic New Orleans building known as the Maison Blanche Building (the Maison Blanche) for an ultimate purchase price of just over $10 million.

The partnership intended to renovate the Maison Blanche to establish a mixed-use hotel/retail space operated under the Ritz-Carlton brand. In February 1997, negotiations between the partnership and Ritz-Carlton culminated in agreements, pursuant to which the partnership agreed to renovate the Maison Blanche and the adjacent (but not yet acquired) Kress Building. Ritz-Carlton agreed to operate a hotel in the newly renovated buildings. In October 1997, the partnership acquired additional properties in New Orleans, including the Kress Building.

Subsequently, the partnership conveyed certain of its rights in the Maison Blanche to a charitable organization committed to protecting historic buildings. The conveyance was made by an "Act of Donation of Perpetual Real Rights" (the Preservation Easement). The day after it executed and recorded the Preservation Easement, the partnership finalized its plans for converting the Maison Blanche and the Kress Building into a single, indivisible condominium unit (Unit RC).[13] Effectively, this condominium regime legally combined the Maison Blanche and Kress Building into a single unit of property.[14]

The Partnership claimed a charitable deduction of $7.445 million on its 1997 Form 1065, based on a qualified appraisal (the Cohen Appraisal) prepared by M. Richard Cohen, a qualified appraiser.[15] The deduction was taken on the Partnership's 1997 Form 1065, which included the requisite Form 8283.

In 2003, the IRS issued a Notice of Final Partnership Administrative Adjustment (FPAA), disallowing all but $1.15 million of the $7.445 million charitable deduction claimed by Whitehouse. The IRS also asserted a gross valuation misstatement penalty of 40% of the portion of underpayment of tax that year. The partnership filed a petition for redetermination with the Tax Court.

> Uniformity, or even a reconcilable basis for the results in cases, however, has not occurred.

Whitehouse I. The initial Tax Court proceeding, *Whitehouse Hotel Ltd. Partnership*, 131 TC 112 (2008) (*Whitehouse-I*), was a classic "battle of valuation experts," in which Whitehouse challenged the qualifications of the IRS's expert and his methodology and valuation, and the IRS challenged the partnership's expert's methodology and the property that he considered in his appraisal (i.e., the Maison Blanche and Kress Building). The partnership further argued against imposition of the accuracy-related penalty, by asserting the correctness of its valuation and, alternatively, the Section 6664(c)(1) reasonable cause exception.

The Tax Court discarded much of the valuation testimony presented by Whitehouse's expert and concluded that the value of the Preservation Easement was $1,792,501, as compared to the $7.445 million claimed by Whitehouse (i.e. 415% greater than the "correct" value). As a result, the Tax Court determined, absent a valid reasonable cause defense, a 40% gross valuation misstatement penalty would apply under Section 6662(h).

In order to avail itself of the reasonable cause exception to the penalty application, the partnership had to establish that it obtained a "qualified appraisal" and that it made a "good faith" investigation of the value of the Preservation Easement. The IRS conceded that the partnership obtained a "qualified appraisal," thus the reasonable cause exception hinged on the court determining that the partnership made a good-faith investigation of the value of the contributed property. The deductions were claimed in the tax year prior to the PPA.

Because Whitehouse was a partnership, Whitehouse had to argue that someone with authority to act on its behalf made a good faith investigation of the value of the donated preservation easement.[16] Although the law on who has the authority to make such an investigation for a partnership is sparse and inconclusive at best,[17] Whitehouse principally relied on the testimony of an employee of its tax matters partner[18] and manager to establish its good-faith investigation. The employee testified that the partnership investigated the value of the Preservation Easement and the "qualified appraisal" valuing the Preservation Easement. However, the Tax Court determined that the employee had no direct knowledge of any efforts made by the partnership to investigate the value of the Preservation Easement because the employee's employer did not become the partnership's manager (or tax matters partner) until well after the conveyance of the Preservation Easement.

Whitehouse then argued that it relied on another appraisal, which it had obtained for reasons unrelated to the charitable contribution. However, the Tax Court rejected the relevance of the second appraisal, noting that it addressed only the before-easement value of the property, as opposed to the value of the Preservation Easement itself. Furthermore, the Tax Court noted that Whitehouse failed to present any evidence relating to professional tax advice that it received from its accountants or legal counsel in filing its 1997 Form 1065. Having found that Whitehouse failed to establish reasonable cause, the Tax Court sustained application of the Section 6662(a) accuracy related penalty on the basis of a gross valuation misstatement (i.e., 40% of the underpayment attributable to such misstatement). The partnership appealed the holding to the Fifth Circuit.

Whitehouse II. In the first appeal, *Whitehouse Hotel Ltd. Partnership*, 615 F.3d 321, 106 AFTR2d 2010-5759 (CA-5, 2010) (*Whitehouse II*), the Fifth Circuit vacated the Tax Court's valuation holding and remanded the case for a redetermination of the value of the Preservation Easement, making Whitehouse's appeal of the gross undervaluation penalty moot. Nevertheless, the Fifth Circuit addressed the penalty issue in dicta[19] by discussing the applicable standards and law relevant to Section 6662, as well as the partnership's burden of proof with respect to the Section 6664(c)(1) reasonable cause exception (including what evidence the Tax Court should consider). In so doing, the Fifth Circuit implied that the Tax Court inappropriately applied the law to the facts before it by (1) disregarding the employee's testimony as lacking credibility because his employer was not the manager of the partnership at the time of the Preservation Easement donation, and (2) finding that the partnership did not provide adequate evidence demonstrating that it sought review from tax advisors.[20] In summary, the Fifth Circuit noted that the Treasury regulations provide that a taxpayer demonstrates reasonable cause by showing that he or she exercised ordinary business care and prudence.[21] Furthermore, the Fifth Circuit pointed out that when an accountant or attorney advises a taxpayer on a matter of tax law, it is reasonable for the taxpayer to rely on that advice.[22] With these criteria and observations in mind, the Fifth Circuit

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11 See discussion *infra* about Zarlengo ("In *Chandler* we had no need to consider whether the pre-PPA thresholds or the post-PPA thresholds applied to the taxpayers 2006 return...").

12 See Wooldridge, Levitt, and Rhodes, "Conservation Easement Confusion in the Tax Court and Fifth Circuit," 41 Real Estate Taxation 129 (2nd Quarter 2014).

13 Through the renovation plans, the Maison Blanche and Kress Buildings would also be a single *functional unit* in addition to being a single *legal unit* under the condominium regime. For instance, the *porte-cochere* and the air conditioning supply units required for operating the Maison Blanche would be contained in the Kress Building. This led the Fifth Circuit, as discussed later, to determine that, as a practical matter, the buildings would remain functional only while under common control and, thus, any future owner of the Kress Building would also be the owner of the Maison Blanche (vice-versa). See Whitehouse II at 339.

14 The facts contained in this paragraph are derived from Whitehouse I and Whitehouse II. In Whitehouse I, the Tax Court declined to find that, on 12/30/97, the Partnership established a condominium regime by which the Maison Blanche and Kress Building were established as a single condominium unit. The Tax Court would not make this finding based in part on the fact that the Partnership recorded the condominium declaration the day after the Conveyance (which contained the Easement). As a result, the Tax Court determined that this finding would have little, if any relevance, to the Valuation Date issues (i.e., valuation of the Easement). Whitehouse I at n. 9. The Fifth Circuit, however, concluded that the legal combination of the properties should have been considered by the Tax Court when valuing the Easement. See Whitehouse II at 338-39. That being said, the Tax Court again failed to mention the condominium regime declaration on remand, in Whitehouse III.

15 Due to a serious illness, Mr. Cohen was unable to participate in the trial. Whitehouse II at 325. As a result, the Partnership retained Richard Roddewig to prepare a valuation report for the Easement and to provide expert testimony at trial. Whitehouse I at 119.

16 Certain partnership audits are governed by special rules enacted in the Tax Equity and Fiscal Responsibility Tax Act of 1982 (TEFRA). The TEFRA rules treat certain items as "partnership items," which are determined during the partnership-level proceedings. Penalties, including valuation penalties, are subject to such a partnership-level determination. Accordingly, the reasonable cause defenses available to a valuation misstatement penalty can and should be raised during the partnership-level proceeding. However, if an individual partner also has a partner-level defense specific to himself or herself, the partner cannot raise that during the partnership-level proceeding, but must do so through a refund forum. See e.g. Fears, 129 TC 8 (2007).

17 See e.g. Murfam Farms, LLC ex rel. Murphy, 106 AFTR2d 2010-5893 (Fed. Cl. Ct., 2010) (Indicating CFO of partnership and individual partner's knowledge can be imputed to the partnership).

18 The TEFRA procedures create a tax matters partner (TMP) who serves as the representative of the partnership in the TEFRA proceeding. The TMP, who can be designated through various procedures, has special rights to conduct the partnership audit and a broad range of authority and responsibilities concerning the audit.

19 In a concurring opinion, Circuit Judge Emilio M. Garza refused to take part in certain aspects of the Whitehouse II opinion that he felt addressed moot issues not properly before the court. To this end, Judge Garza noted that such portions of the opinion (including the court's discussion of the penalty issue) constituted impermissible advisory opinion.

20 To this end, the Fifth Circuit went so far as to specifically note that the Partnership offered evidence that it relied on its accountants' and attorneys' opinions of the Cohen Appraisal. As such, the Fifth Circuit mentioned that a "possible" issue on remand would be whether the Partnership needed to prove more to show reasonable cause.

21 Citing Reg. 301.6651-1(c)(1).

22 Citing Boyle, 469 U.S. 241, 55 AFTR2d 85-1535 (1985).

directed the Tax Court to reconsider the penalty, should it be relevant on remand.

Whitehouse III. Although the Tax Court's opinion in *Whitehouse Hotel Ltd. Partnership*, 139 TC 304 (2012) (*Whitehouse III*), on remand is worth discussion for many reasons relevant to valuation principles, for purposes of this article, it is only important to note that the Tax Court essentially readopted its prior valuation determination, with a negligible adjustment. Indeed, the Tax Court seemed to pay mere lip-service to the Fifth Circuit's instructions; arriving at the same result, while at the same time avoiding another remand.

In order to understand the application of the valuation penalties, an understanding of the recent cases and facts relevant thereto is necessary.

Turning to the valuation penalty, the Tax Court found it unbelievable that the partnership could reasonably believe, "without further investigation," that the building it purchased in 1995 for $8.98 million would be valued by its appraiser just two years later for $96 million. Given the vast differences in these valuations in such a short period, the Tax Court found the lack of further investigation counter-indicative of a "good-faith" investigation of the Preservation Easement's value. Additionally, just as in *Whitehouse I*, the Tax Court found that the second appraisal obtained by the partnership could not be relied on to establish a good-faith investigation of the value of the Preservation Easement because that appraisal valued only the Masion Blanche itself (not its reduction in value on account of the Preservation Easement).

The Tax Court further found that the partnership failed to provide evidence on the content of any professional advice or opinions with respect to the charitable contribution claimed on its 1997 Form 1065.

Whitehouse IV. On appeal for the second time, the partnership argued that the Tax Court's remand opinion exhibited evidence of "judicial insubordination that infects the entire Remand Opinion." The Fifth Circuit seemed to acknowledge (as would anyone who reads the Tax Court opinion) that the Tax Court applied its mandates in an "unenthusiastic" manner, but held that such "begrudging compliance" was sufficient. Accordingly, the Fifth Circuit upheld the Tax Court's valuation determination.

The Fifth Circuit next addressed the valuation misstatement penalty. Because the Fifth Circuit did not overturn the Tax Court's valuation determination, the taxpayer's avoidance of the gross valuation penalty hinged on its ability to establish "reasonable cause" (under pre-PPA rules). The Fifth Circuit noted that this required basing the claimed deduction on a qualified appraisal and, in addition, making a good faith investigation of the Preservation Easement's value. The "qualified appraisal" requirement had been stipulated, leaving the "good faith investigation" the essence of the determination.

The Tax Court seemed to accept that the partnership relied on advice from attorneys and accountants when it filed its return containing the deduction of the Preservation Easement, but noted that the partnership did not require the professionals to investigate the value of the easement, which is required under Section 6664(c)(3)(B). The issue before the Fifth Circuit was whether the steps taken by the partnership, including following the advice of accountants and tax professionals, even if they did not specifically investigate the value set forth in the "qualified appraisal," was sufficient to show a good faith investigation of the value of the contributed property.

The Fifth Circuit ultimately vacated the Tax Court's penalty determination, finding that the partnership established reasonable cause. Although not entirely clear, the Fifth Circuit seemed to conclude that the partnership's reliance on the advice of accountants and tax professionals who were familiar with the donation established a good faith investigation of the value of the Preservation Easement.[23] The determination is somewhat surprising because no evidence was presented establishing that the accountants and tax advisors investigated or opined on the *value* of the preservation easement. However, the Fifth Circuit also noted that the partnership "analyzed" the "qualified appraisal" and commissioned another appraisal (although this was not done in connection with the donation of the Preservation Easement.)

Kaufman

The *Whitehouse* opinions are helpful in understanding what evidence a taxpayer might present to establish that an investigation was made of the value of contributed property. Another recent case, *Kaufman*, TCM 2014-52, sheds light onto the "good faith" requirement relevant to the investigation of value.

Kaufman involved the donation of a preservation easement by individual taxpayers. The central issue in the first *Kaufman* case (*Kaufman I*)[24] was whether the taxpayers properly subordinated the outstanding mortgage on their eased property, as required in applicable statutory and regulatory provisions relating to conservation easements.[25] Based on its interpretation of Section 170(g)(6), the Tax Court granted summary judgment to the IRS on the technical issue, but held that a genuine issue of material fact existed as to other issues.[26] In a second opinion after trial on the remaining issues (*Kaufman II*)[27] the Tax Court reaffirmed its ruling on the technical issue. The taxpayers appealed.

The First Circuit reversed the Tax Court on the technical issue, and remanded the case.[28] Interestingly for purposes of this article, however, the First Circuit addressed, in dicta, issues concerning the value of the easement (issues not technically before the court). The court went to great lengths to describe how certain evidence indicated the facade easement had been overvalued (e.g., a letter obtained by the taxpayer that, in essence, assured the taxpayer that he was not giving the charitable organization anything of value), and it explained how penalties (civil and criminal) might be appropriate in such situations. The First Circuit's statement about penalties, quoted below, is illustrative of the importance of the "good faith" element of the reasonable cause exception to valuation penalties.

> To reject overly aggressive IRS interpretations of existing regulations is hardly to disarm the IRS. Without stifling Congress' aim to encourage legitimate easements, one can imagine IRS regulations that require appraisers to be functionally independent of donee organizations, curtail dubious deductions in historic districts where local regulations already protect against alterations, and require more specific market-sale based information to support any deduction. Forward looking regulations also serve to give fair warning to taxpayers.
>
> If taxpayers still do not get the message, the penalties regime is formidable, *see, e.g.*, 26 U.S.C. § 6662(h)(l) (40 percent penalty for gross valuation misstatements); and, for willful abusers, there are criminal penalties, *e.g.*, 26 U.S.C. § 7201 (prison term up to five years). The Justice Department has already secured a permanent injunction against the trust to prohibit some of the practices alluded to in this case. [citation omitted] The IRS is properly zealous to protect the revenues and over the long run it has been given tools to do so.

Accordingly, although the First Circuit denied the Service a swift victory based on technical arguments, the court was not hesitant to express its opinion about potential valuation abuses, and the role of penalties to curtail such abuses.

On remand, the Tax Court picked up the First Circuit's lead and determined that a 40% gross valuation misstatement penalty was applicable.[29] At issue was whether the taxpayers could establish that they qualified for the reasonable cause exception.

The court first addressed whether the taxpayers obtained a "qualified appraisal" by a "qualified appraiser." The IRS argued that the appraisal was not qualified because it was not performed by a "qualified appraiser," as that term is defined in Reg. 1.170A-13(c)(5).[30] Specifically, the IRS argued that the appraiser falsely overstated the value of the Preservation Easement and that a reasonable taxpayer would have realized such. However, the Tax Court rejected this argument, finding that, although the taxpayers may have "had reason to question his valuation," there was insufficient evidence to establish that the appraiser acted "falsely" with respect to the appraisal of the Preservation Easement. Moreover, the court found that although there were many errors and potential methodology issues with the appraisal report, the regulatory "procedural requirements" were met such that the appraisal was "qualified." As stated by the Tax Court, "[w]hether the valuation was overstated, grossly or otherwise, is a factual question different from whether the formal procedural requirements were met, either strictly or under the 'substantial compliance' doctrine, which may forgive minor discrepancies."

After determining that the taxpayers obtained a qualified appraisal, the Tax Court turned to the issue of whether the taxpayers made a good faith investigation that confirmed the value claimed in the appraisal. The Tax Court set an arguably high-bar by stating that the taxpayers had the burden of demonstrating "how they honestly came to believe that, beyond being simply the amount determined in the … appraisal, the value of the facade easement was [as claimed by the report]." In doing so, the court readopted its approach to placing the initial burden of proving a valuation misstatement penalty on the IRS (a burden that is met when the IRS establishes the percentage threshold is met), but placing the burden of proving "reasonable cause" on the taxpayer.

While the *Whitehouse* cases are helpful in understanding what evidence a taxpayer might present to establish that an investigation was made of the value of contributed property, another recent case, *Kaufman*, sheds light onto the "good faith" requirement relevant to the investigation of value.

In an attempt to meet their burden, the taxpayers testified that they "believed" in their own minds that the preservation easement created restrictions that decreased the value of their property, although they failed to quantify the value they believed they were giving up. The taxpayers also testified that their concerns about what they were giving up prompted

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23 The Fifth Circuit's indication that reliance on tax professionals can establish a good faith investigation is further supported by its statement that "[a]s we were in our 2010 opinion, we are skeptical of the tax court's conclusion that following the advice of accountants and tax professionals was insufficient to meet the requirements of the good faith defense…"

24 Kaufman, 134 TC 182 (2010).

25 See Section 170(h)(5)(A); Reg. 1.170A-14(b)(2); Reg. 1.170A-14(g)(1) and (2).

26 The other issues consisted of the deductibility of the cash payment made by the taxpayer to the donee and the application of penalties.

27 *Kaufman*, 136 TC 294 (2011).

28 See Kaufman v. Shulman, 687 F.3d 21, 110 AFTR2d 2012-5278 (CA-1, 2012).

29 *Kaufman*, TCM 2014-52.

30 See Section 170(f)(11) and Reg. 1.170A-13(c)(3)(i)(B) clarifying that a qualified appraisal must be prepared by a qualified appraiser.

them to write a letter to the donee expressing their worries about the large value of the gift; however, the court noted that the donee responded that the preservation easement would not significantly affect the value of their building, i.e., that the easement did not have much economic value. Finally, the taxpayers testified that they provided a copy of the appraisal to their long-time accountant, who reviewed it and determined that it was consistent in form with other appraisals he had seen; however, the court noted that the accountant testified that he did not offer any opinion as to whether the value in the appraisal was reasonable.

The Tax Court ultimately determined that the taxpayers could not establish that they made a good faith investigation of the value of the preservation easement and imposed a gross valuation misstatement penalty.

Pollard

Pollard, TCM 2013-38 is a 2013 opinion in which the Tax Court addressed the application of the gross valuation misstatement penalty and the other accuracy-related penalties. The case involved another conservation easement donation that the IRS determined to be grossly overvalued. Although the deduction was denied on grounds unrelated to valuation,[31] the IRS sought to impose accuracy-related penalties under Section 6662 for the years in issue. Moreover, in an Amendment to Answer, as an alternative to the 20% Section 6662(a) penalty for a substantial valuation misstatement, the IRS asserted that the taxpayer was liable for the 40% penalty for a gross valuation misstatement for all years involved.

In a somewhat inverted analysis, after the Tax Court determined that the conservation easement failed because it did not constitute a charitable contribution, it analyzed whether there was a gross valuation misstatement in the years in issue. Because this argument was raised in the Amendment to Answer, the Tax Court noted that the IRS bore the burden of proof and that the gross valuation misstatement penalty was inapplicable if the taxpayer could establish the claimed value of the donated property was based on a "qualified appraisal" made by a "qualified appraiser," and he made a good faith investigation of the value of the contributed property.

The taxpayer was able to establish that he obtained an appraisal of the donated preservation easement and alleged that he relied on the appraisal and made a good faith investigation of the value of the easement. In support, the taxpayer testified that he reviewed the local county website to determine the value of comparable properties and spoke with an expert in land use on the potential value of the property subject to the easement. The IRS, however, contended that the appraisal at issue was not a "qualified" appraisal because it contained several technical errors, including, most notably, that it did not adequately identify the highest and best use of the conservation easement property.

Similar to its opinion in *Kaufman*, the Tax Court declared that the "qualified appraisal" requirement does not concern the "reliability" of the appraisal, but "whether the report identified a method of valuation or the basis for the valuation." Like the First Circuit in *Kaufman*, the Tax Court expressed that it was "especially concerned" with the IRS's attempt to turn the "qualified appraisal" requirement from a procedural requirement into a substantive analysis of the conclusions reached therein.

The Tax Court ultimately concluded that the taxpayer obtained a qualified appraisal. Additionally, based on the testimony of the taxpayer that he "investigated" the appraisal by reviewing the county website and confirming the appraisal assumptions with a land use expert, the court concluded that the taxpayer made a good faith investigation of the value of the contributed property as set forth in the appraisal. Accordingly, the court determined that the taxpayer qualified for the reasonable cause exception to any otherwise applicable valuation misstatement penalties.

While determining that the taxpayer had met the reasonable cause exception to either of the valuation misstatement penalties, the taxpayer was not left off of the penalty hook. To the contrary, the Tax Court then noted that the taxpayer had substantial understatements of income tax in the years at issue because the taxpayer's deduction failed to meet the requirements of Section 170. This showing by the IRS satisfied its burden of production, shifting the burden of proving reasonable cause to the taxpayer.

The Tax Court noted that an accuracy-related penalty does not apply to any portion of an underpayment of tax if there was reasonable cause for such portion and that the taxpayer acted in good faith, made on a case-by-case, facts-and-circumstances analysis. Unlike the valuation penalties, a showing of a qualified appraisal, a qualified appraiser, and a good faith investigation of value are not required to satisfy the general reasonable cause standard. The Tax Court noted that the most important factor in a normal reasonable cause analysis is the extent of the taxpayer's efforts to determine his or her proper tax liability and, in a circular sentence, found that "(r)eliance on professional advice may constitute reasonable cause and good faith, but it must be established that this reliance was reasonable." Specifically, the Tax Court indicated that the taxpayer must satisfy a three-prong test to establish reasonable reliance on professional advice: (1) the advisor was a competent advisor who had sufficient experience to justify the taxpayer's reliance; (2) the taxpayer provided necessary and accurate information to the advisor; and (3) the taxpayer relied in good faith on the advisor's judgment.[32]

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[31] The Tax Court, in holding for IRS, found that the external features of the conservation easement transaction was part of a quid pro quo exchange in which the taxpayer received a substantial benefit in the form of a grant of a subdivision exemption request. Accordingly, the Tax Court sustained the IRS's determination that the taxpayer's grant of a conservation easement did not constitute a charitable contribution.

[32] Citing Neonatology Assoc., P.A., 115 TC 43 (2000), *aff'd* 299 F. 3d. 221, 90 AFTR2d 2002-5442 (CA-3, 2002) and Dunlap, TCM 2012-126.

The court was quick to find that the taxpayer had failed to qualify for this Section 6664(c)(1) reasonable cause exception because he could not satisfy his burden of establishing that he acted with reasonable cause or good faith. Specifically, the Tax Court found that the evidence made clear that a quid pro quo transaction had taken place, and that none of the individuals upon which the taxpayer relied in the transaction were tax professionals, other than the taxpayer's CPA. The CPA's testimony, however, was insufficient because there was no evidence that the CPA was aware of the quid pro quo nature of the conservation easement.

While the taxpayer in *Pollard* avoided the valuation misstatement penalties, the taxpayer was unable to skirt the accuracy-related penalty, illustrating how the different reasonable cause exceptions apply and how the burden of proof can have a significant impact on a court's analysis.

Zarlengo

Zarlengo, TCM 2014-161 is a 2014 case in which the Tax Court again addressed the reasonable cause exception. The case involved a facade easement that the taxpayers donated to the National Architectural Trust (NAT), a qualified charitable donee. Although the taxpayers, a divorced couple, intended to donate the easement to NAT in 2004 and obtained all of the paperwork (including an appraisal) in that year, the easement deed was not recorded until 2005.

The husband deducted the full amount of his half of the charitable deduction in 2004, the year the taxpayers donated the property to NAT. The wife deducted only a portion of the charitable contribution in 2004, carrying the remainder over into the 2005 through 2007 tax years. The IRS claimed the "contribution date" of the facade easement was not until January, 2005, when the easement deed

was recorded. The IRS also argued that the taxpayers failed to properly substantiate the value of the donation.

The Tax Court ultimately denied the deductions claimed by both taxpayers in 2004 on grounds specific to New York state law and the perpetuity requirements relevant to qualified conservation easement contributions.[33] The Tax Court, nevertheless, concluded that the wife was entitled to a deduction in 2005, after the easement deed had been recorded. However, the court found that the easement was worth $157,500 (as opposed to the $660,000 value claimed by the taxpayer).

Due to the determined overvaluation (and IRS assertion of penalties), the Tax Court had to address whether the taxpayers were liable for overvaluation misstatement penalties and to which years the penalties applied. The IRS had stipulated that the appraiser the taxpayers relied on was a "qualified appraiser." Additionally, the Tax Court determined that, although the appraisal did not meet all the technical requirements of the Treasury regulations,[34] it "substantially" complied with the requirements, and that substantial compliance was sufficient to make the appraisal "qualified."

The court next turned to the issue of whether the taxpayers made a good faith investigation of the value of the contributed property. Before referencing the "good faith investigation" element of the reasonable cause analysis, the Tax Court discussed how the taxpayers had consulted with their "longtime accountant" about the legitimacy of the preservation easement donation. The court discussed how the accountant reviewed the appraisal report and conservation easement deed and that "nothing in the documents gave [the accountant] cause for concern as to the accuracy of the appraised value of the conservation easement." The court then determined that the taxpayers satisfied the reasonable cause exception, stating that the taxpayers "made a good faith investigation into the value of the conservation easement by obtaining the [qualified appraisal] and the [accountant's] advice." This determination was made despite the absence of any evidence or testimony indicating that the accountant actually investigated or opined on the value of the contributed property. Accordingly, no penalty was applicable for the 2005 tax year.

Following *Chandler*, the Tax Court reiterated that the changes to the overvaluation misstatement penalties enacted as part of PPA apply to tax returns filed after 7/25/06, including the wife's 2006 and 2007 returns. Accordingly, since the IRS had met its burden of production as to the gross valuation misstatement penalties with respect to the wife, no reasonable cause and good faith defense for 2006 or 2007 could be raised because "the PPA makes the gross valuation penalty a strict liability penalty with respect to charitable deduction property."

Seventeen Seventy Sherman Street, LLC

In *Seventeen Seventy Sherman Street, LLC*, TCM 2014-124, the Tax Court held that an understanding between the taxpayer and a development company, that the taxpayer would grant conservation easements on its property if the development company assisted the taxpayer in obtaining variances, constituted a quid pro quo, resulting in a complete loss of the related deduction.

As the case related to penalties, once again the burden of proof affected the Tax Court's decision. While the FPAA mailed to the taxpayer challenged the deductibility of the subject conservation easements, the IRS asserted in an amendment to its answer that even if the easements were deductible, the fair market value of the easements was only $400,000 (compared to $7,150,000 claimed by the taxpayer). The amended answer further asserted that an accuracy-related penalty applied to the underpayment in the form of a gross valuation misstatement, or, alternatively, (1) because of negligence or disregard of rules or regulations under Section 6662(b)(1), (2) a substantial understatement of income tax under Section 6662(b)(2), or (3) a substantial valuation misstatement under Section 6662(b)(3).

Because the assertion of penalties was raised in an amended answer, the Tax Court assigned the burden of proof on the "new matter" under Rule 142(a) to the IRS. As to the proposed gross valuation misstatement, the Tax Court did not accept the IRS's expert's opinion that the subject easements had no value, which testimony was refuted at trial by representatives from both the City of Denver and Historic Denver, the recipient of the easement. While concluding that one of the easements at issue had value, the Tax Court found that the IRS failed to meet its burden of establishing that the value of the subject conservation easements exceeded 400% of the correct value of the easements, meaning that the gross valuation misstatement penalty could not apply.

With respect to the other (non-valuation) accuracy-related penalties asserted in the amended answer, the Tax Court found that, because the deductions were disallowed, the IRS had met its burden of establishing that the taxpayer acted negligently or with disregard to Section 170 and the regulations thereunder.

To prove that taxpayer had acted with reasonable cause and good faith through reliance on professional advice, the evidence offered at trial included testimony from the taxpayer's tax advisor that he had advised the taxpayer that the taxpayer had to reduce the value of the claimed deduction by the consideration received in the quid pro quo exchange. Of course, the taxpayer failed to follow that advice. Accordingly, the Tax Court found that the taxpayer's disregard of the advisor's advice was not reasonable and in good faith.

HOW TO BE "REASONABLE"

Reconciling the above cases in a meaningful and instructive manner is a difficult task at best. All of the cases facially follow the rule that in order to avoid valuation misstatement penalties for "reasonable cause" in charitable deduction property cases, assuming it is available, a taxpayer must establish the following:

- The taxpayer had reasonable cause (as that term has been interpreted under prior law).
- The taxpayer acted in good faith.
- The taxpayer obtained a "qualified appraisal" by a "qualified appraiser."
- The taxpayer made a good faith investigation of the value of the donated property.

While some courts have addressed each of the four above-referenced elements separately, due to the overlapping nature of the provisions, most courts have in practice reduced the test in charitable deduction property cases to the last two elements.

The IRS has attempted on several occasions to contest the "qualified appraiser" and "qualified appraisal" components of the first element. However, *Kaufman* and *Pollard* are illustrative of the courts' unwillingness to find appraisers and appraisals unqualified. The general attitude of the courts has been that, when a taxpayer has attempted to commission a valid appraisal, minor deficiencies in the appraisal or disagreements over the appraisal's conclusions will not cause the appraisal to be unqualified.[35]

Accordingly, a taxpayer's ability to avail himself or herself of the reasonable cause defense under Section 6664(c)(2) generally comes down to whether the taxpayer can establish that he or she made a good faith investigation of the value of the contributed property. This leads to the question: How can someone establish that he or she made a good faith investigation of property?

In *Whitehouse*, the Tax Court determined that a taxpayer fell short of this standard even though it had a second appraisal done, relied on various advisors, and had a partnership representative testify that the partnership believed the reported value was accurate. The issue that seemed to bother the Tax Court and drive its determinations was the fact that Whitehouse had purchased the relevant property shortly before the contribution date for a fraction of the value the partnership was claiming on its return. In these authors' view, the Tax Court's decision in *Whitehouse* was driven by this fact more than the steps taken (or not taken by Whitehouse) to establish it made a good faith investigation, which makes it hard to learn too much from the case. However, the Fifth Circuit looked past this issue, finding that the reasonable cause exception was met. In so finding, the court seemed to be persuaded by (1) the existence of multiple appraisals and (2) the role of independent tax return preparation advice, even though the advice was not directly related to value.

The existence of an independent tax advisor also seemed to play a critical role in the good faith investigation analysis set forth in *Zarlengo*, in which the court determined that obtaining an accountant's advice constituted a good faith investigation of the value of the property, even though the accountant did not testify or opine as to the value of the property. This result, however, is hard to reconcile with *Kaufman*, wherein the Tax Court indicated that reliance on an accountant is not sufficient if the accountant does not express an opinion as to the value contained in the appraisal.

Given that the above cases cannot be easily reconciled, a belt-and-suspenders approach to avoiding valuation penalties, when available, is best. First, a taxpayer should always obtain a qualified appraisal of property, and take steps to have his or her tax advisor review the appraisal to determine that it satisfies the relevant statutory and regulatory requirements. Second, the taxpayer will ideally obtain a second appraisal, which will verify and support that the original appraisal determines a reasonable value. This step should, according to *Whitehouse*, help establish a good faith investigation of the value set forth in the qualified appraisal. Finally, the taxpayer should take steps to document additional investigations into the value of the property, such as independently investigating the value of comparable properties (such as what the taxpayer did in *Pollard*). These independent investigations should be documented. If the taxpayer is a partnership, someone clearly authorized on behalf of the partnership should take these steps at the time of the contribution, and any independent partner wishing to raise a partner-level reasonable cause defense (in the event the partnership-level defense fails) should take similar actions.

Perhaps the most important lesson to learn from the above cases is that the "good faith investigation" requirement imbedded in the reasonable cause provision relevant to charitable deduction property gives the courts a wide degree of latitude to justify denying or granting reasonable cause relief. When the courts determine that the taxpayer tried to honestly arrive at the right result, they have tended to grant relief, regardless of the technical steps taken or not taken by the taxpayer. On the other hand, when the courts have indicated or implied that the taxpayer may not have been genuine as to his or her intentions to report the value of charitable contribution property accurately, they have tended not to grant relief, regardless of the procedural hoops jumped through or documentation obtained by the taxpayer.

NOTES

33 The IRS argued that the taxpayers were not entitled to deductions because the facade easement was neither (1) a "qualified real property interest" as defined in Section 170(h)(2)(C) (i.e., "a restriction (granted in perpetuity) on the use which may be made of the real property") nor (2) donated exclusively for conservation purposes as required under Section 170(h)(5) (i.e., the conservation purpose of the easement was not "protected in perpetuity"). After noting the rule that, "[i]n a Federal tax controversy, State law controls the determination of a taxpayer's interest in property while the tax consequences are determined under Federal law," the court concluded that New York law governed when the taxpayers' donation of the facade easement was regarded as complete, but federal tax law determined the tax consequences. Because New York law provides that conservation easements in the state are not effective unless they are recorded, the facade easement was not effective (and thus not deductible) until 1/26/05—the date on which it was recorded.

34 The appraisal was untimely and contained other alleged minor violations of the Treasury regulations, all of which the court determined were non-substantive violations.

35 Because a "qualified appraisal" is prerequisite for obtaining a deduction for a non-cash donation of more than $5,000, the "qualified appraisal" issue is relevant to and has been addressed in many cases in which reasonable cause and penalties were not at issue. In such cases, the IRS has systematically attacked, with very little success, the issue of whether an appraisal was qualified. For a discussion of these hyper-technical arguments and their treatment by the courts, see Wooldridge, Levitt, and Rhodes, "Circuit Courts Speak on Conservation Easements, But is the IRS Listening?" 24 Taxation of Exempts 35 (January/February 2013).

CONSERVATION EASEMENT CONFUSION IN THE TAX COURT AND FIFTH CIRCUIT

Taxation of Exempts, September/October 2013

By: David M. Wooldridge, Ronald A. Levitt, Gregory P. Rhodes, and Nathan Vinson

CONSERVATION EASEMENT CONFUSION IN THE TAX COURT AND FIFTH CIRCUIT

DAVID M. WOOLDRIDGE, RONALD A. LEVITT, AND GREGORY P. RHODES

The *Whitehouse* trilogy of decisions illustrates differences in approach and interpretation that have that have made planning conservation easements difficult.

The Tax Court (Judge James Halpern presiding) recently issued a third opinion in the ongoing conservation easement litigation between Whitehouse Hotel Ltd. Partnership ("Whitehouse") and the IRS.[1] The *Whitehouse* trilogy of opinions provides unique insight into important valuation issues pertinent to conservation easements. The third and most recent opinion largely involves the valuation of a façade preservation easement and the application of penalties under Section 6662. The three cases discussed herein (and there may be more, given who the taxpayer is and how much is at issue), illustrates significant differences in approach relating to conservation easement cases being played out in the Tax Court and in several of the Courts of Appeals. This inconsistency in approach makes planning difficult for taxpayers and practitioners.[2]

Factual overview

Whitehouse was formed in 1995 for the purpose of acquiring and renovating an historic New Orleans building known as the Maison Blanche Building (the "Maison Blanche").[3] The Maison Blanche is located within the Vieux Carré National Historic District and the Canal Street Historic District. It is categorized as a building of major architectural importance; the U.S. National Park Service has determined that it is a certified historical structure.

Whitehouse intended to renovate the Maison Blanche to create a mixed-use hotel/retail building operated under the Ritz-Carlton brand. In February 1997, Whitehouse and Ritz-Carlton reached agreements, pursuant to which Whitehouse agreed to renovate the Maison Blanche and the adjacent—but as-yet-unacquired—Kress Building, while Ritz-Carlton agreed to operate a hotel in the newly renovated buildings. In October 1997, Whitehouse acquired additional properties in New Orleans, including the Kress Building.[4]

The easement (façade preservation). On 12/29/97 (the "valuation date"), Whitehouse conveyed a preservation easement in the Maison Blanche to the Preservation Alliance of New Orleans, Inc., d/b/a Preservation Resource Center of New Orleans (PRC).[5]

The easement provided that the owner intended to convert the Maison Blanche into a hotel. It restricted changes to the exterior surfaces of the Maison Blanche ("the façade"), and required the owner maintain the façade in a

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good and sound state of repair. Without permission, the owner was to do nothing to the façade that would alter its appearance, and PRC had the right to require the owner to maintain the façade. The easement did not directly mention the neighboring Kress Building, but did grant to PRC the right to approve the development plans ("the plans") for the Maison Blanche and contiguous buildings (including the Kress Building). The plans pre-dated Whitehouse's acquisition of the Kress Building but contained references to the Kress Building (labeled as "Future Donation" or "To Be Acquired at a Later Date").[6] According to the Fifth Circuit, it was critical that the plans *did not* include construction in the air space above the Kress Building.[7]

On the day after it executed and recorded the easement, Whitehouse finalized and recorded its plans for converting the Maison Blanche and the Kress Building into a single, indivisible condominium unit.[8] Effectively, this condominium regime legally combined the Maison Blanche and Kress Building into a single unit of property.[9]

The deduction and notice. Whitehouse claimed a charitable contribution deduction of $7.445 million on its 1997 Form 1065, based on an easement appraisal ("the Cohen Appraisal") prepared by M. Richard Cohen, a qualified appraiser.[10] The deduction was reported on the requisite Form 8283.

In 2003, the IRS issued a Notice of Final Partnership Administrative Adjustment (FPAA) in which it disallowed all but $1.15 million of the $7.445 million charitable deduction claimed by Whitehouse. The IRS also imposed an accuracy-related penalty under Section 6662. Whitehouse filed a petition for redetermination with the Tax Court.

Whitehouse-I

The initial Tax Court proceeding, *Whitehouse-I*,[11] was a classic "battle of valuation experts." Whitehouse challenged the qualifications of the Service's expert as well as his methodology and valuation, and the IRS challenged Whitehouse's expert's methodology and particularly the property that he considered in his easement (i.e., the Maison Blanche *and* the Kress Building).[12] Whitehouse further challenged the imposition of the accuracy-related penalty by asserting the correctness of its valuation and, alternatively, the Section 6664(c)(1) reasonable-cause exception.

The Tax Court disregarded much of the valuation testimony presented by Whitehouse's expert and concluded that the value of the easement was $1,792,301, as compared to the $7.445 million claimed by Whitehouse. As a result, the Tax Court applied a 40% gross valuation misstatement penalty under Section 6662(h). A discussion of the

[1] Whitehouse Hotel Ltd. Partnership, 131 TC 112 (2008) ("Whitehouse-I"), *vacated and remanded*, 615 F.3d 321, 106 AFTR2d 2010-5759 (CA-5, 2010) ("Whitehouse-II"), 139 TC No. 13 (2012) ("Whitehouse-III").

[2] See "Circuit Court Speaks on Conservation Easements, But is the IRS Listening?" 24 Exempts 4, page 35 (Jan/Feb, 2013).

[3] Whitehouse paid $6 million for the property in December 1995 and just over an additional $4 million in September 1996 for release of certain commitments and early termination of the current tenant's lease. The Tax Court "deemed" Whitehouse to have paid $10 million for the Maison Blanche in December 1995. Whitehouse-I at 149.

[4] Of the $3.4 million purchase price for these additional properties, the Tax Court accepted an allocation of $1 million to the Kress Building and assumed that this would have been the cost of the building had Whitehouse purchased it in 1995 (when it purchased the Maison Blanche). See Whitehouse-I at 149.

[5] The IRS did not dispute that PRC was a "qualified organization" for purposes of Section 170(h).

[6] See Whitehouse-III, at 24 (the Tax Court, however, determined that PRC's consent would not be required for modification of the plans as respects to the Kress Building because the plans involved only renovating the Maison Blanche).

[7] Whitehouse-II at 325.

[8] Through the renovation plans, the Maison Blanche and Kress Buildings would also be a single *functional* unit in addition to being a single *legal* unit under the condominium regime. For instance, the *porte-cochere* (portico, in essence) and the air conditioning supply units required for operating the Maison Blanche would be contained in the Kress Building. This led the Fifth Circuit, as discussed later, to determine that as a practical matter the buildings would remain functional only while under common control and, thus, any future owner of the Kress Building would also be the owner of the Maison Blanche (and vice-versa). See Whitehouse-II at 339.

[9] The facts contained in this paragraph are derived from Whitehouse-I and Whitehouse-II. In Whitehouse-I, the Tax Court declined to find that, on 12/30/97, Whitehouse established a condominium regime by which the Maison Blanche and Kress Building were established as a single condominium unit. Part of the reason why the Tax Court would not make this finding is that Whitehouse recorded the condominium declaration the day after the conveyance (which contained the casement). As a result, the Tax Court determined that such a finding would have little, if any, relevance to the valuation date issues (i.e., valuation of the easement). Whitehouse-I at fn. 9. The Fifth Circuit, however, concluded that the legal combination of the properties should have been considered by the Tax Court when valuing the easement. See Whitehouse-II at 338-39. That being said, the Tax Court again failed to mention the condominium regime declaration on remand, in Whitehouse-III.

[10] Due to a serious illness, Mr. Cohen was unable to participate in the trial. Whitehouse-II at 325. As a result, Whitehouse retained Richard J. Roddewig to prepare a valuation report for the easement and to provide expert testimony at trial. Whitehouse-I at 119.

[11] See note 1, *supra*.

[12] See note 10, *supra*.

valuation testimony presented during trial and the Tax Court's treatment of that testimony is instructive.

Whitehouse's expert and valuation. At trial, Whitehouse offered the expert testimony of Richard J. Roddewig with respect to the value of the easement. Mr. Roddewig applied the "before and after" approach to determine the value of the easement. Under this approach, the fair market value of the subject property is determined both before and after encumbrance by the easement. The difference between these values is deemed to be the value of the easement itself and, thus, the amount of the deduction.[13] After considering valuation under three different methods (discussed below), Roddewig opined that the easement reduced the value of the Maison Blanche *and associated properties* (i.e., the Maison Blanche, the Kress Building and each of their underlying parcels) by $10 million.[14]

In determining the "highest/best use" of the property before the easement, Roddewig looked to both the Maison Blanche (to which the easement applied) as well as the contiguous Kress Building. He determined that the highest/best use of the combined property was a mixed-use development including a Ritz-Carlton Hotel (a luxury hotel) with 512 rooms (60 of which could be built on top of the Kress Building), an additional all-suites hotel with about 268 rooms, and retail space on the first two floors and mezzanine of the Maison Blanche Building. After the conveyance of the easement, Roddewig determined that additional floors could no longer be constructed on top of the Kress Building because those floors would block the view of the façade of the Maison Blanche (thereby violating the easement terms).

The Service's expert and valuation. The Service's expert valuation witness was Richard Dunbar Argote, who opined that the conveyance of the easement to PRC did not reduce the value of the Maison Blanche. Argote did not consider the Kress Building in his valuation. The IRS, however, did not ask that the Tax Court find that the value of the easement was any less than determined in the examination: $1.15 million.[15]

The Tax Court noted Argote's more than 25 years of experience in appraising real estate in Louisiana, including between 50 and 70 buildings between 1990 and 2000 in and around New Orleans that were converted into or to be used as hotels. Notably, 85% of those buildings were located within the Central Business District or the Vieux Carre. The court also noted

[13] See Reg. 1.170A-14(h)(3) (use of the before and after valuation approach for purposes of deductions for donations of perpetual conservation easements).

[14] As noted, Whitehouse used the Cohen Appraisal for purposes of claiming the $7.445 million charitable deduction on its 1997 Form 1065. The Cohen Appraisal valued the easement by appraising the before- and after-easement valuation of only the Maison Blanche Building. Whitehouse-I at 118. At trial, however, Roddewig looked to the diminution in value caused by the easement on the Maison Blanche *and associated properties*. *Id.* In so doing, Roddewig determined that the value of the easement was $10 million.

[15] Whitehouse-I at 129.

[16] Critically, for purposes of appeal on the valuation issue, the IRS asked Argote to value only the Maison Blanche and to ignore the contiguous Kress Building. In fact, the Fifth Circuit noted that Argote was not even aware that the Treasury regulations called for valuation of the contribution based on its impact on contiguous property owned by the taxpayer/donor that was not subject to the restrictions. See Whitehouse-II at 327, 337-38.

[17] Whitehouse-I at 123 (citing Thayer, TCM 1977-370).

[18] Whitehouse-I at 123. It is worth noting that IRS Notice 2006-96, 2006-2 CB 902, and Prop. Regs. 1.170A-16 and -17, may alter the analysis with respect to a taxpayer's appraiser for purposes of the "qualified appraiser" and "qualified easement" substantiation requirements for qualified conservation contributions. The Notice and proposed regulations say that experience with conservation easement easements is relevant. As to Argote's valuation, however, the Tax Court noted that the "qualified easement" requirement only applied to taxpayers (not the IRS). See Whitehouse-I at 125.

[19] The USPAP is maintained by The Appraisal Foundation via a congressional grant of authority.

[20] Whitehouse-I at 124 (noting that reliability is a prerequisite to expert testimony under Rule 702 of the Federal Rules of Evidence).

[21] Whitehouse-I at at 128.

[22] Roddewig's "before" valuation under the comparable sales analysis identified five comparable properties, while Argote identified nine. After determining that four of these properties were similar to each expert's analysis, the Tax Court used the four properties in its own before-easement comparable sales valuation of Maison Blanche. The Tax Court applied its own adjusted price per square foot value to the average square footage for Maison Blanche presented by the experts. See Whitehouse-I at 161-62.

[23] The Tax Court found that the reproduction method and the income method were not adequate for purposes of valuing the façade preservation easement at issue, at least with respect to the testimony presented by Roddewig. Whitehouse-I at 152, 156.

[24] Section 6662(a) mandates a 20% accuracy-related penalty for any portion of an underpayment of tax attributable to a substantial valuation misstatement. See Sections 6662(b)(3), (e)(1)(A). The penalty is increased to 40% for a "gross" valuation misstatement under Section 6662(h). For the period in issue, a gross valuation misstatement occurred if the valuation claimed was 400% or more of the ultimately determined correct value. See Section 6662(h)(2)(A)(i).

[25] Section 6664(c)(2) sets out the requirements for the "reasonable cause" exception to the Section 6662 accuracy penalty. The Tax Court noted that this determination is made at the partnership level and that partnership bears the burden of proof. See Whitehouse-I at 173 (citing Reg. 301.6221-1T(d) (partnership-level determination) and Santa Monica Pictures, LLC, TCM 2005-104 (burden of proof)).

[26] The Revac Appraisal was conducted for purposes unrelated to donation of the easement.

that Argote appraised the Maison Blanche itself on three prior occasions.

In valuing the easement, Argote also applied the "before and after" approach. He determined, however, that the highest and best use of the Maison Blanche was as a mixed-use, *non*-luxury hotel and retail space, both before and after the easement.[16] In his opinions the easement had no impact on the highest and best use or on the value of the Maison Blanche.

The Tax Court's analysis. The Tax Court noted Argote's extensive and relevant real estate easement experience and the fact that he was a qualified expert. Argote lacked experience in valuing façade preservation easements, but the court noted that the "before and after" approach involved traditional real estate valuation principles, with the only difference being the use of two valuations instead of one (i.e., a valuation before and a valuation after an encumbrance).[17] Since the easement at issue was an encumbrance on real property, the court found that it made little difference whether Argote had extensive experience with respect to this particular type of restriction. Accordingly, the court found that valuation of the easement was within Argote's qualifications.[18]

The Tax Court next addressed whether the methods employed by Argote failed to comply with certain provisions of the regulations or otherwise conform to the Uniform Standards of Professional Appraisal Practice (USPAP).[19] The court determined that the Federal Rules of Evidence governed the admissibility and reliability of expert testimony,[20] and that failure to comply with USPAP or the regulations only affected the weight accorded to the testimony (i.e., its credibility or reliability).[21] Determining that Argote's testimony was admissible, the Tax Court largely accepted his before-easement comparable sales analysis. The Tax Court disregarded Roddewig's before-easement comparable sales analysis based, in part, on the grounds that it over-utilized nonlocal sales.

Ultimately, the Tax Court derived the before-easement value of the Maison Blanche (on an adjusted price per squate foot basis) by selecting four properties mentioned by both Argote and Roddewig in their before-easement valuation under the comparable sales method.[22] After applying adjustments to each of these four properties' valuation (on a price per square footage basis), the Tax Court averaged the square footage of the Maison Blanche Building (as presented by Argote and Roddewig) to arrive at a before-easement value of $12,092,301 for Maison Blanche.

The Tax Court next turned to the after-easement value of Maison Blanche. It rejected Roddewig's after-easement analysis, in part because it was derived, not under the comparable sales method, but only through the modified income and reproduction cost methods, which the court found unpersuasive.[23] The Tax Court essentially adopted Argote's after-easement comparable sales valuation of $10.3 million for Maison Blanche.

The Tax Court determined that the value of the easement was $1,792,301 by subtracting the after-easement value ($10,300,000) from the before-easement value. Whitehouse's claimed valuation (of $7.445 million) was about 415% greater than the value determined by the court.

The valuation misstatement penalty. As a result of its determination that Whitehouse overstated the value of the easement by more than 415%,[24] the Tax Court found that a 40% accuracy-related penalty under Section 6662(h) would be applicable unless Whitehouse could establish "reasonable cause" under Section 6664(c)(1). Since the IRS conceded that Whitehouse obtained a "qualified easement" (the Cohen Appraisal) from a "qualified appraiser" (Mr. Cohen) for purposes of claiming the deduction, the reasonable-cause exception hinged on the Tax Court's determining that Whitehouse made a good-faith investigation of the value of the contributed property.[25]

Whitehouse relied principally on the testimony of an employee of its tax matters partner and manager, QHR Holdings-New Orleans Ltd. (QHR), to establish its good faith investigation of the value of the easement. Unfortunately, the Tax Court determined that the employee, Robert Drawbridge, had no direct knowledge of any efforts made by Whitehouse to investigate the value of the easement because QHR did not become Whitehouse's manager until 9/15/00—well after the conveyance of the easement. The Tax Court also rejected Whitehouse's assertion that it relied as well on another appraisal ("the Revac Appraisal").[26] In rejecting the relevance of the Revac Appraisal, the Tax Court focused on the fact that it addressed only the before-easement value of the property, and not the value of the easement itself, concluding that a taxpayer must investigate the value of the contributed property (i.e., the easement) in order to qualify for the reasonable-cause exception.[27] Furthermore, the Tax Court noted Whitehouse failed to present any evidence relating to professional tax advice that it received from its accountants or legal counsel in filing its 1997 Form 1065. Having found that Whitehouse failed to establish the availability of the reasonable-cause exception, the Tax Court sustained application of the Section 6662(a) accuracy related penalty on the basis of a gross valuation misstatement (i.e., 40% of the underpayment attributable to such misstatement).

Whitehouse-II

In its appeal to the Fifth Circuit, Whitehouse reasserted its arguments that Argote was not qualified to provide expert testimony, that he failed to conform to USPAP, and that this rendered his report inadmissible. Whitehouse also appealed the Tax Court's valuation of the easement and its imposition of the accuracy-related penalty on the basis of a gross valuation misstatement. The Fifth Circuit found that the primary issue on appeal was whether the Tax Court properly considered the easement's effect on Whitehouse's opportunity to build on top of a building that it owned (the Kress Building), contiguous to the building to which the easement applied (the Maison Blanche). Ultimately, the Fifth Circuit vacated the Tax Court's rulings regarding valuation and remanded the case for further proceedings.

Whitehouse-I was a classic 'battle of valuation experts.'

Before moving to its opinion, the Fifth Circuit highlighted certain facts that shed light on its concerns on appeal. It noted that the experts disagreed on two threshold issues: (1) which property should be valued and (2) the nature of the property's "highest and best use" (a key factor in determining fair market value).[28]

The Fifth Circuit highlighted Roddewig's determination that the relevant property consisted of the Maison Blanche (including annexes) as well as the contiguous Kress Building, but not the Kress parking garage. In so doing, Roddewig determined that the before-easement highest and best use of the properties was as a mixed-use luxury hotel and retail space, with an additional 60 rooms constructed on top of the Kress Building.[29] Conversely, Argote valued *only* the Maison Blanche Building, as specifically directed by the IRS.[30] The Fifth Circuit determined that the failure to consider the impact of the easement on the value of the contiguous and commonly owned Kress Building violated the regulations concerning the valuation of conservation easements.[31]

The Fifth Circuit further observed that Roddewig's report addressed three "recognized" methods to reach the before-donation valuation, although he did not employ the "comparable sales" method for determining the after-donation valuation. On the other hand, the Fifth Circuit called attention to the fact that Argote employed only the comparable sales method and, in so doing, found no difference in the before-easement value and after-easement value of Maison Blanche (thus, in the court's characterization, "extraordinarily" assigning a value of zero to the easement).[32]

Initial matters—Partnership challenges to the Service's expert. Initially, Whitehouse argued that the Tax Court erred in admitting the report of the Service's expert because Argote lacked experience with this particular type of easement (of a façade), and because his report, by failing to conform to USPAP, lacked reliability. In examining—and rejecting—Whitehouse's challenges to the admissibility of Argote's report, the Fifth Circuit observed that the trial court's role as a "gatekeeper" for expert testimony is

[27] Whitehouse-I at 175 (noting that Whitehouse's investigation must have been into the value of the "servitude" as opposed to the Maison Blanche).

[28] Whitehouse-II at 326 (citing Stanley Works & Subsidiaries, 87 TC 389 (1986)).

[29] Roddewig based his after-donation valuation, in part, on his understanding that the easement precluded the possibility of building the additional 60 rooms on top of the Kress Building. Whitehouse-II at 327.

[30] The Fifth Circuit made note that the IRS did not ask Argote to opine on any potential reduction to the value of the contiguous Kress Building as a result of the easement. Whitehouse-II at 326.

[31] See Whitehouse-II at 326 (citing Reg. 1.170A-14(h)(3)(i)). The Fifth Circuit continued by noting that Argote had not even read Reg. 1.170A-14 when he opined that the easement had no effect on Whitehouse's rights to construct additional rooms on top of the Kress Building. It found this particularly troublesome in light of the requirement set forth in Reg. 1.170A-14(h)(3) that in valuing the easement, consideration must also be given to its impact on the fair market value of any applicable contiguous property. *Id.* at 327.

[32] *Id.* at 327. In its amicus brief, the National Trust for Historic Preservation in the United States (National Trust) stated that valuation of preservation easements is a fundamentally important issue to National Trust because, if such easements are determined to have little or no value, the tax incentives Congress has established to encourage preservation would be severely weakened. Thus, National Trust challenged Argote's appraisal and noted that the Tax Court's decision, if allowed to stand, would obscure the proper method for easement appraisals. *Id.* at 328.

diminished in bench trials (as occur in Tax Court) because there is no risk of exposing a jury to unreliable evidence.[33] The Fifth Circuit therefore reviewed the Tax Court's admissibility determination as respects to Argote's report, as well its assessment of his qualifications and reliability, under the "abuse of discretion" standard.[34] Noting Argote's qualifications as an appraiser of real estate (particularly for property located in New Orleans), the Fifth Circuit rejected Whitehouse's assertion that Argote lacked experience with historic preservation façade easements. It found that the Tax Court had not made a manifestly erroneous abuse of discretion by determining that Argote was qualified to provide expert testimony.

Responding to Whitehouse's argument that Argote's report should be rejected as unreliable (and, therefore, inadmissible) because it failed to comply with USPAP, the Fifth Circuit noted that Whitehouse was arguing, in essence, that compliance with USPAP was a prerequisite for admissibility, as opposed to credibility. The Fifth Circuit upheld the Tax Court's determination that any differences between Argote's methods and USPAP spoke to the *credibility* of the report, not to its *admissibility*.[35]

Proper valuation methods. Whitehouse also appealed the Tax Court's disregard of Roddewig's income and replacement-cost valuation methods in favor of reliance solely on the comparable-sales method. The Fifth Circuit began by noting that valuation is a mixed question of law and fact (with the factual premises subject to review on a clearly-erroneous standard, and the legal conclusions subject to de novo review). At the same time, however, the court observed that the Tax Court's determination of the proper *method* to use for determining fair market value is a conclusion of *law*, subject to *de novo* review.[36] Noting the dearth of evidence of sales of easements comparable to the easement donated by Whitehouse, the Fifth Circuit observed that in such situations there are three commonly recognized valuation methods: (1) comparable sales, (2) income, and (3) replacement cost.[37] Unfortunately, since the Fifth Circuit remanded the case for redetermination by the Tax Court, it did not rule on whether the Tax Court erred by rejecting the other methods in favor of the comparable-sales method alone. However, the Fifth Circuit directed the Tax Court to reconsider all three methods on remand, including which of them may be applicable in determining the value of the easement.[38]

Valuation—Highest and best use. The Fifth Circuit then turned its attention to Whitehouse's contention that the highest and best use of the Maison Blanche and Kress Building (combined) was as a *luxury* hotel (like the Ritz-Carlton), instead of a non-luxury hotel, and, that the easement prohibited constructing space for 60 additional hotel rooms on top of the Kress Building.[39] The Fifth Circuit observed that, in ascertaining a property's "highest and best use" for purposes of valuation, the applicable "use" is the "*reasonable* and *probable* use that supports the *highest present value*."[40] To this end, it noted that the key inquiry concerns the information a hypothetical willing buyer would consider in deciding how much to pay for the property.[41] Thus, if a reasonable buyer would consider a potential use in deciding whether to purchase the property, that potential use should also be considered in valuing the property.[42]

The Fifth Circuit found the primary issue to be the easement's effect on Whitehouse's opportunity to build on top of a building contiguous to that burdened by the easement.

The Fifth Circuit found that the Tax Court did not explicitly determine the "highest and best use" of the property but simply rejected Roddewig's opinion of highest and best use. Consequently, the Fifth Circuit directed the Tax Court, on remand, to determine the highest and best use of the property for purposes of valuation.

Valuation—Impact on contiguous property. Next, the Fifth Circuit addressed Whitehouse's contention that the Tax Court erred in failing to consider the impact of the easement on the Kress Building (in combination with the Maison Blanche). It noted that while the Tax Court considered whether the easement itself *burdened* the Kress Building, it failed to consider the impact of the easement (as well as the planned condominium declaration) on the *value* of the Kress Building.[43] Since the easement's impact on any property rights in the contiguous Kress Building would constitute a question of law, the Fifth Circuit observed that this issue is subject to *de novo* review; and furthermore, that Louisiana state law would apply in ascertaining such property rights.[44] In looking to both Louisiana state law and practical considerations related to a hypothetical sale of the subject property, the Fifth Circuit found that the Maison Blanche and the Kress Building constituted a single, indivisible unit of property both functionally (as a result of the renovation plans) and legally (as a result of recordation of the condominium declaration).[45] Furthermore, since any potential buyer would have been aware of this functional and legal unity as of the easement date, a hypothetical buyer would have considered such facts in deciding whether to buy the property (i.e., whether to buy either *both* buildings or neither) and in arriving at a price.[46] Accordingly, the Fifth Circuit disagreed with the Tax Court's determination that the Kress Building was irrelevant for purposes of valuing the easement.[47]

In light of the imminent legal and functional combination of the buildings on the date of the easement, the Fifth Circuit instructed the Tax Court to consider the easement's impact on the highest and best use of the combined Maison Blanche and the Kress Building (both before and after the recording of the easement).

The penalty. Having vacated the Tax Court's holdings in *Whitehouse-I* and remanded the case for revaluation of the easement, Whitehouse's appeal of the gross undervaluation penalty became moot. The Fifth Circuit nevertheless addressed it in dicta,[48] discussing the applicable standards of the Section 6662 accuracy-related penalty and Whitehouse's burden of proof with respect to the Section 6664(c)(1) reasonable-cause exception (including what evidence the Tax Court should consider). In so doing, the Fifth Circuit implied that the Tax Court inappropriately applied the law to the facts before it by (1) disregarding the testimony of Robert Drawbridge, an employee of Whitehouse's manager (QHR), as lacking credibility because QHR was not the manager of Whitehouse at the time of the easement, and (2) finding that Whitehouse did not provide adequate evidence that it sought review from tax advisors.[49]

In summary, the Fifth Circuit noted that the regulations provide that a taxpayer demonstrates reasonable cause by showing that he or she exercised ordinary business care and prudence.[50] Furthermore, it pointed out that when an accountant or attorney advises a taxpayer on a matter of tax law, it is reasonable for the taxpayer to rely on that advice.[51] With these criteria and observations in mind, the Fifth Circuit directed the Tax Court to reconsider the penalty, should it even be an issue on remand.[52]

Whitehouse-III

On remand, in *Whitehouse-III*, the Tax Court revised its analysis and opinion to comply with the directions and framework established by the Fifth Circuit in *Whitehouse-II*. Specifically, the Tax Court addressed: (1) whether the before and after values of the encumbered property are best determined under the comparable-sales method, rather than the cost or income methods; (2) an ex-

[33] Whitehouse-II at 330 (citing Gibbs v. Gibbs, 210 F.3d 491 (CA-5, 2000)).

[34] See *id.* (referring to various cases for the proposition that the trial judge has wide latitude and broad discretion in making such determinations and his or her decision will not be disturbed absent a manifestly erroneous abuse of discretion).

[35] Whitehouse-II at 332.

[36] *Id.* at 333 (citing In re Sternbridge, 394 F.3d 383 (CA-5, 2004) (valuation is a mixed question of law and fact) and Cook, 349 F.3d 850, 88 AFTR2d 2001-6485 (CA-5, 2002) (selection of the proper valuation *method* is a conclusion of law)).

[37] Whitehouse-II at 333 (citing Reg. 1.170A-14(h)(3)(i), Hilborn, 85 TC 677 (1985), and USPAP Standards Rule 1-4).

[38] Whitehouse-II at 334-35.

[39] The Fifth Circuit found that Argote, for the IRS, opined that the highest and best use of the Maison Blanche was as a "non-luxury" hotel with retail space. Additionally, Argote ignored the contiguous Kress Building when he valued the easement and, as a result, did not consider the economic impact of the easement possibly restricting Whitehouse from building additional hotel rooms on top of the Kress Building.

[40] Whitehouse-II at 335 (citing Frazee, 98 TC 554 (1992) (emphasis added)).

[41] Whitehouse-II at 335 (citing U.S. v. 320.0 Acres of Land, 605 F.2d 762 (CA-5,1979)).

[42] Whitehouse-II at 335.

[43] As noted, Whitehouse owned both the Maison Blanche and Kress Building when it donated the easement. Furthermore, at the time of granting the easement, Whitehouse planned to make a condominium declaration that would effectively combine the Maison Blanche and Kress Buildings, functionally and legally. This declaration was recorded the day after the easement was conveyed. The Fifth Circuit thus observed (and directed the Tax Court accordingly) that the value of the easement should be determined with reference to the before-easement and after-easement valuations of both the Maison Blanche and the Kress Building (i.e., a determination of the easement's impact on the value of the buildings combined). The Fifth Circuit's directions to the Tax Court on this issue stem from its observation that, in practical terms, the Maison Blanche and Kress Building were not likely to be separately owned due to the renovation plans and condominium declaration. Though Whitehouse recorded the condominium declaration after it recorded the easement, the Fifth Circuit observed that any potential buyer would have been aware of it and, thus, would have considered whether to purchase either property (as well as what price to pay) with the condominium declaration in mind. Thus, the Fifth Circuit concluded that these facts must be considered, not only in determining the highest and best use of the buildings, but also for purposes of valuing the easement. Whitehouse-II at 338-40.

[44] Whitehouse-II at 337 (citing Succession of McCord, 461 F.3d 614, 98 AFTR2d 2006-6147 (CA-5, 2006)).

[45] See Whitehouse-II at 337. It does not appear that the Tax Court, in Whitehouse-III, afforded much consideration, if any, to these "*clear*" threshold matters set forth by the Fifth Circuit.

[46] See notes 43 and 45, *supra*.

[47] See Whitehouse-II at 337 (citing Reg. 1.170A-14(h)(3)(i), noting that the regulation directs that valuation of the easement must be determined by the difference in the fair market value of the *entire contiguous parcel* of property before and after the granting of the easement).

planation of its conclusion that the easement did not deprive Whitehouse of the ability to add stories above the Kress Building;[48] and (3) the accuracy-related penalty and reasonable-cause exception thereto. The Tax Court, however, seemed to lack enthusiasm for this review.[54]

The proper valuation method. Just as in *Whitehouse-I*, the Tax Court soundly rejected the use of any method other than comparable-sales in determining its before-easement and after-easement valuations of the subject property. Moreover, the Tax Court again disregarded nearly all assumptions, judgments, and opinions offered by Whitehouse's expert (Roddewig) as unreliable or inappropriate.[55] The Tax Court's "revised analysis" of the valuation method essentially mirrored *Whitehouse-I*, with the exception that Tax Court slightly modified its valuation of the easement by including the square footage of the Kress Building in its valuation analysis.[56] Furthermore, just as in *Whitehouse-I*, the Tax Court determined that Roddewig's reliance on non-local sales and a "national marketplace" for luxury hotels was improper and unsupportable. As a result, the Tax Court used its own before-easement comparable-sales analysis but accepted the comparable-sales analysis of the service's expert's for the after-easement valuation. Effectively, the Tax Court arrived at the same conclusions as in *Whitehouse-I* but by a different route.

Comparable sales: 'Highest and best' or 'second-best.' As noted, the Fifth Circuit directed the Tax Court to make a clearer ruling on the highest and best use of the relevant property (i.e., the combined Maison Blanche and Kress buildings).[57] Specifically, in valuing the impact of the easement on these combined properties, the Fifth Circuit directed the Tax Court to consider the impact of the easement as well as the pending condominium regime and renovation plans.[58] Similarly, the Fifth Circuit directed the Tax Court to consider the factual question of the easement's impact on the property's fair market value, such as any effect stemming from Whitehouse's inability to add 60 hotel rooms on top of the Kress Building.[59]

The Fifth Circuit observed that the Tax Court's determination of the proper *method* for ascertaining fair market value is a conclusion of *law*, subject to *de novo* review.

On remand, however, the Tax Court concluded that the "highest and best use" presented by each expert did not matter because the "highest and best use" of the property (e.g., luxury vs non-luxury hotel), would have no impact on the value of the easement itself.[60] In arriving at this conclusion, the Tax Court discussed an alternative approach utilized by the Seventh Circuit's 1996 opinion in *Van Zelst*,[61] in which that court opined that the valuation of the property should be determined with reference to the "second-best use" of the property.[62]

Under this "second-best use" analysis, the Tax Court found an additional reason to reject Roddewig's use of non-local, luxury hotel comparables. The Tax Court noted that, even if it agreed with Roddewig's opinion that the highest and best use of the property was as a luxury hotel, the fair market value of the subject property would not be any greater than that determined by its "second-best use" (i.e., as a non-luxury hotel).[63]

The Tax Court further observed that because on the date of the easement the Maison Blanche Building was a "shell" that had "*potential* for hotel development (luxury or not)," it did not matter whether, for purposes of its comparable-sales analysis, it considered properties that ultimately became luxury or non-luxury hotels.[64] According to the Tax Court, the relevant "comparable" was a "shell" building that could *possibly* be developed into a hotel, whether or not it ultimately was developed into a luxury or non-luxury hotel.[65] Since the Tax Court found that Whitehouse failed to show any difference between the Maison Blanche "shell" and any other "shell" building that could potentially become a hotel, it concluded that

[48] Whitehouse-II at 341-43. In a concurring opinion, Circuit Judge Emilio Garza refused to take part in certain aspects of the Whitehouse-II opinion that he felt addressed moot issues not properly before the court. He noted that such portions of the opinion (including the court's discussion of the penalty issue) constituted impermissible advisory opinion. *Id.* at 343 (Garza, J., concurring).

[49] To this end, the Fifth Circuit went so far as to specifically note that Whitehouse offered evidence that it relied on its accountants' and attorneys' opinions of the Cohen Appraisal. As such, the Fifth Circuit mentioned that a "possible" issue on remand would be whether Whitehouse needed to prove more to show reasonable cause. Whitehouse-II at 342.

[50] Whitehouse-II at 342 (citing Reg. 301.6651-1(c)(1)).

[51] Whitehouse-II at 342 (citing Boyle, 469 U.S. 241, 55 AFTR2d 85-1535 (1985)).

[52] Whitehouse-II at 343.

[53] The Tax Court made additional findings on the bases that (1) the servitude did deprive Whitehouse of the ability to build above the Kress Building and (2) the pending combination of the Maison Blanche and Kress buildings made unlikely separate ownership of the two buildings. Whitehouse-III at page 7.

[54] It appears that the Tax Court ignored certain determinations and directions from the Fifth Circuit's opinion in Whitehouse-II. For example, rather than explicitly determining the highest and best use, the Tax Court determined: "We do not need to choose between the two experts' opinions of highest and best use, since ... it would make no difference." Whitehouse III at page 19. In rejecting the highest and best use analysis dictated by Reg. 1.170A-14(h)(3)(ii) and the Fifth Circuit's instructions, the Tax Court applied a "second-best use" standard. See note 60, *infra* (Tax Court rejects the "highest and best use" approach for the "second-best use"). Additionally, the Tax Court noted that it saw "some daylight" in a newly discovered approach under which it could address the Kress Building in valuing the easement. Whitehouse-III at page 21. "Because the distinction we have drawn ... was not considered by the Court of Appeals, we see some daylight to again examine the [easement] to see whether it imposes an obligation on the partnership not to block views of the Maison Blanche Building" (i.e., not to build additional rooms on top of the adjacent Kress Building).

[55] See, e.g., Whitehouse-III at page 7 (rejecting, as unreliable, Roddewig's testimony regarding the reproduction-cost approach); *id.* at page 13 (noting Roddewig's unreliable or inadequate explanations with respect to certain inputs under the income approach); *id.* at pages 18-19 (noting "inappropriate" dissimilarities in comparables found by Roddewig and testimony by Roddewig that "defies common sense" in rejecting aspects of his use of the comparable-sales approach).

[56] As noted, the Tax Court effectively disregarded the Fifth Circuit's conclusion that the easement itself precluded Whitehouse from building on top of the Kress Building. See note 54, *supra*. However, having been directed by the Fifth Circuit to take into account the contiguous Kress Building in valuing the easement, the Tax Court multiplied the square footage of the Kress Building as it stood (16,210) by the court's before-easement and after-easement price value per square foot for the Maison Blanche Building (this multiple was determined in Whitehouse-I). By adding the square footage of the Kress Building to the valuation formula, the Tax Court increased the value of the easement by a mere $65,415 (about 3.6%) to $1,857,716. As a result, Whitehouse's claimed valuation of $7.445 million remained well within the 400% gross overvaluation misstatement range for purposes of imposing the 40% accuracy-related penalty. Whitehouse-III at pages 26-27.

[57] See notes 43 and 45, *supra*.

[58] See note 43, *supra* (consideration of the impact of not only the easement but also the legal and functional combination of the buildings as a result of the condominium declaration and renovation plans, respectively).

[59] See, e.g., Whitehouse-II at 338 ("[D]etermining the easement's effect on the fair market value of the Kress building ... is crucial for determining the fair market value of the easement."); *id.* at page 340 ("The effect of the easement's impact on the property's fair market value, such as prohibiting building 60 additional rooms on top of the Kress building, is a question of fact for the tax court to decide on remand.").

[60] See Whitehouse-III at page 19 ("We do not need to choose between the two experts' opinions of highest and best use, since ... it would make no difference.") *id.* at pages 17-19 (the Tax Court found that it did not matter if the highest and best use was determined to be a luxury or non-luxury hotel, and instead concluded that the property's value should be determined by looking to its "second-best use," as discussed in Van Zelst, 100 F.3d 1259, 78 AFTR2d 96-7106 (CA-7, 1996)). In Van Zelst, the Seventh Circuit cited McAfee and McMillan, "Auctions and Bidding," 25 J. Econ. Lit. 699 (1987), on the subject of auction bidding, as the source of its own "second-best use" valuation analysis. See also note 61, *infra* (additional reference to the "second-best use" analysis derived from the Van Zelst case and the McAfee and McMillan article).

[61] Note 60, *supra*.

[62] See Whitehouse-III at page 17 (the Tax Court determined that it should disregard the "highest and best use" analysis directed by the Fifth Circuit in Whitehouse-II in favor of a "second-best use" analysis used by the Seventh Circuit in Van Zelst, *supra* note 60 (citing McAfee and McMillan, *supra* note 60)).

[63] Whitehouse-III at page 18.

valuation would be determined, once again, under the comparable-sales method it had used in *Whitehouse-I*.[66]

The easement's impact on the value of the property. Just as in *Whitehouse-I*, the Tax Court concluded that the easement did not affect Whitehouse's right to build additional hotel rooms on top of the Kress Building.[67] Applying Louisiana law, the Tax Court determined that "a servitude of view" was "a predial servitude" (i.e., one created by title or judicial act)[68] and that it could not be created by implication.[69] Under this alternative analysis (not addressed in *Whitehouse-I* or *Whitehouse-II*), the Tax Court concluded that any prohibition from building on top of the Kress Building was personal to Whitehouse and would not bind subsequent owners of the Maison Blanche.[70] Based on this analysis of state law, the Tax Court determined that the value of the easement would not be affected by Whitehouse's inability to build on top of the Kress Building, if such a restriction in fact existed.[71]

Despite the Tax Court's conclusions as to state law, it reluctantly complied with the Fifth Circuit's instructions to include the Kress Building in its final valuation analysis. The change in analysis, however, was only superficial because the Tax Court never accepted the possibility that development of the Kress Building was prohibited.[72]

The accuracy-related penalty and reasonable-cause exception. Having determined the value of the easement, the Tax Court turned to the accuracy-related penalty. Even after adding the square footage of the Kress Building in its formula for determining the before-easement and after-easement valuation of the subject property, the Tax Court increased the value of the easement by a mere 3.6%, to $1.857 million, compared to $7.445 million claimed by Whitehouse.[73] As a result, the Section 6662(a) penalty would remain 40% under Section 6662(h), on the basis of a gross valuation misstatement, unless Whitehouse could show that the Section 6664(c) reasonable cause exception applied.[74] The Tax Court (just as it had in *Whitehouse-I*) found that Whitehouse failed to show that it made a good-faith investigation of the value of the easement, and so did not qualify for the Section 6664(c)(1) exception).[75]

Following the principles set forth by the Fifth Circuit in *Whitehouse-II*, the Tax Court revisited the testimony of Drawbridge, the employee of Whitehouse's manager (QHR). Having noted that the Cohen Appraisal (on which Whitehouse based its easement valuation) valued only the Maison Blanche, the Tax Court

[66] *Id.*

[67] *Id.*

[68] *Id.* The Tax Court did not discuss the easement's impact on the ability to add rooms on top of the Kress Building in this portion of its opinion, as it would later reject the notion that this prohibition stemmed from the easement itself, concluding that any such restriction that arose under Louisiana law was personal to Whitehouse and would not accrue a future owner of the Kress Building alone (necessarily, this required the Tax Court to discount the Fifth Circuit's determination that, practically speaking, the Maison Blanche Building and Kress Building constituted a single unit as of the date of the easement, even if not legally combined until the condominium declaration was recorded the next day).

[69] Whitehouse-III at page 25 ("We do not find in the operative terms of the [easement] any prohibition restricting Whitehouse from building atop the Kress Building.").

[70] Whitehouse-III at page 25.

[71] *Id.* ("To accept that servitude of view (a predial servitude) is established by implication, however, is prohibited.") (citing Palomeque v Prudhomme, 664 So.2d 88 (La. 1995)).

[72] See Whitehouse-III at pages 25-26 ("[W]e have no assurance that a successor owner of the Maison Blanche Building (whether united with the Kress Building or not) would [agree not to block the view of the side of the Maison Blanche Building]. ... No one coming across the conveyance in the conveyance records ... could determine from its terms that they were prohibited (if they owned the Maison Blanche Building) from building atop the Kress Building...").

[73] See Whitehouse-III at page 21 ("[U]nless the obligation is, or constitutes part of, a perpetual conservation restriction, that reduction in value cannot be counted as part of [sic] qualified conservation contribution.") (citing Reg. 1.170A-14(h)(3)). Interestingly, the Fifth Circuit cited the same regulation provision for the proposition that the effect of the easement on the fair market value of all contiguous property owned by Whitehouse must be determined in valuing the easement (without limitation for the easement actually burdening the contiguous property). See Whitehouse-II at 338.

[72] See Whitehouse-III at page 26 ("Notwithstanding our conclusion about the terms of the conveyance, we shall, consistent with the instruction of the Court of Appeals, reconsider the value of the servitude on the assumptions that, while it does not burden the Kress Building, it restricts Whitehouse from building atop it and that separate ownership of the Maison Blanche and Kress Buildings is unlikely (thus, in effect, making that restriction perpetual."). Additionally, the Tax Court applied a price per square foot that it established under its comparable-sales method in Whitehouse-I by analyzing only the Maison Blanche Building and comparables without consideration of the additional hotel rooms on top of the Kress Building. Thus, the Tax Court (in following the Fifth Circuit's instructions) presumably should have calculated the before-easement value by also considering the additional rooms but calculating the after-easement value without the additional rooms.

[73] See note 56, *supra*.

[74] Section 6664(c) provides for a reasonable cause exception to the Section 6662 penalty if the taxpayer can show that he or she acted in good faith in assessing the proper tax liability. See Section 6664(c)(1). With respect to gross valuation misstatements, Section 6662(c)(2) further requires the taxpayer show that (1) the claimed value of the property was based on a qualified appraisal, and (2) the taxpayer made a good-faith investigation of the value of the contributed property. Since the IRS did not dispute whether Whitehouse obtained a qualified appraisal, the dispute over reasonable cause and good faith in Whitehouse-III principally involved the Section 6664(c)(2)(B) requirement that Whitehouse show that it made a good-faith investigation of the value of the contributed property (i.e., the easement).

[75] See Whitehouse-III at page 34.

found it unbelievable that Whitehouse could reasonably believe, without further investigation, that the building it purchased in 1995 for $8.98 million (i.e., just the Maison Blanche) would be valued by its appraiser just two years later for $96 million, or that an easement on that building would be found to devalue the property by $7.445 million.[78] Given the vast differences in these valuations in such a short period, the Tax Court found that the lack of further investigation was counter-indicative of a "good-faith" investigation of the easement's value. Additionally, the Tax Court rejected Drawbridge's testimony regarding the Revac Appraisal. Just as in *Whitehouse-I*, the Tax Court found that the Revac Appraisal could not be relied upon for showing a good-faith investigation of the value of the easement because that appraisal valued only the Maison Blanche itself (not its reduction in value on account of the easement).

Beyond the Cohen and Revac Appraisals, the Tax Court found that Drawbridge did not provide additional testimony regarding any material actions taken by Whitehouse or its legal/accounting advisors with respect to the value of the easement.[77] The court found that Whitehouse failed to provide evidence on the content of any professional advice or opinions with respect to the charitable contribution claimed on its 1997 Form 1065. It further found that Whitehouse failed to provide it with any authority that its auditor had a duty to evaluate the reasonableness of the stated value of the charitable contribution. Thus, though it was possible that Whitehouse's legal and tax advisors provided it with an opinion or advice that constituted part of an investigation of the value of the easement, Whitehouse failed to present any such evidence that such advice met its burden in establishing the reasonable-cause exception.[78]

It is difficult to square the Tax Court's treatment of reasonable cause in *Whitehouse-III* with the Tax Court's treatment of the analogous issue in *Crimi*, TCM 2013-51. The *Crimi* court dealt with the reasonable cause exception relating to qualified appraisals in Reg. 1.170A-13(c)(3). Finding no law under this particular provision, the court indicated "it is instructive to look at our other cases interpreting 'reasonable cause.'" The other cases examined related to the penalty provisions in Section 6664, the same area addressed in *Whitehouse-III*. Seemingly without evidence of the specific activities of the taxpayer's long-term tax advisor, the *Crimi* court appears to have found that the full reliance on such professionals, when they are deemed competent and fully informed, was sufficient to satisfy the reliance requirement. As the court related, "Mr. Crimi put it at trial, 'I rely on them heavily to tell me what to do.'"[79]

Conclusion.

The pattern of the *Whitehouse* trilogy has similarities to the opinions in *Scheidelman*, TCM 2010-151, *vacated and remanded* 682 F3d 189, 109 AFTR2d 2012-2536 (CA-2, 2012), TCM 2013-018.[80] The initial decision of the Tax Court was adverse to the taxpayer and made on technical grounds. It was reversed by an appellate court critical of the Tax Court's restrictive interpretations. On remand to the Tax Court, however, the taxpayer lost, though on grounds based more on factual determinations. The detailed and technical analysis of the Tax Court contrasted with the more practical approach by the appellate court. The Tax Court appeared to be undeterred in its approach. The analytical thought process of the Tax Court judge was highlighted by the give-and-take of the appeal process. A battle of wills is on display. Unfortunately, this battle of wills does little to inform on how the law is this area will develop, and makes planning conservation easements difficult for taxpayers and practitioners. ■

[76] As noted by the Tax Court, unlike the taxpayer's expert at trial, Cohen valued only the Maison Blanche in his appraisal report. Whitehouse-III at page 29.

[77] Whitehouse-III at page 31 (the Tax Court noted that the lack of evidence regarding any investigation of the substantial appreciation in value under the Cohen Appraisal indicated a failure by anyone to even consider the valuation issue and, thus, no good faith investigation was made).

[78] See Whitehouse-III at page 34 (the Tax Court rejected any argument that, by hiring experienced firms in connection with filing its tax return, Whitehouse had met the requirements for the exception to the penalty).

[79] Whitehouse-III at page 34.

[80] See Woodridge et al, "Circuit Courts Speak on Conservation Easements, but is the IRS Listening?" 24 Exempts 4 at page 35 (Jan/Feb 2013).

CIRCUIT COURTS SPEAK ON CONSERVATION EASEMENTS, BUT IS THE IRS LISTENING?

Taxation of Exempts, *January/February 2013*

By: David M. Wooldridge, Ronald A. Levitt, Gregory P. Rhodes and Nathan Vinson

CIRCUIT COURTS SPEAK ON CONSERVATION EASEMENTS, BUT IS THE IRS LISTENING?

DAVID M. WOOLDRIDGE, RONALD A. LEVITT, GREGORY P. RHODES, AND NATHAN VINSON

Kaufman v. Shulman, 687 F.3d 21, 110 AFTR2d 2012-5278 (CA-1, 2012), and *Scheidelman*, 682 F.3d 189, 109 AFTR2d 2012-2536 (CA-2, 2012), are the two most recent cases brought before the federal courts of appeals involving key conservation easement issues. In each case, the courts rendered taxpayer victories on threshold technical issues. The *Kaufman* and *Scheidelman* decisions are welcome developments in conservation easement jurisprudence. In each, the appellate court found that the IRS and the Tax Court went too far in their narrow interpretation of conservation easement compliance and substantiation rules. Unfortunately, the Service's reaction to, and Tax Court's subsequent narrow interpretation of, these decisions has done much to cool taxpayer enthusiasm.

Describing a prior taxpayer victory in the D.C. Circuit,[1] the authors noted that, notwithstanding the court's affirmation that substantial compliance applies in conservation easement cases, the Service had continued to pursue the most technical of challenges. As the following discussion describes, the authors are seeing a similar IRS reaction to the *Kaufman* and *Scheidelman* decisions.

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Kaufman—Taxpayer wins the battle but the war rages on

The highly anticipated First Circuit opinion in *Kaufman* originated in the Tax Court.[2] The court held that a façade easement granted by taxpayers on a historic row house was not protected in perpetuity, and thus was not a qualified conservation contribution. The holding was based on language contained in a subordination agreement between the mortgagee of the property and the preservation trust.

***Kaufman* in the Tax Court.** The central issue in *Kaufman* originally was whether the taxpayers properly subordinated the outstanding mortgage on their eased property, as required in applicable statutory and regulatory provisions.[3] In accordance with Reg. 1.170A-14(g)(2), the taxpayers obtained a subordination agreement from the mortgagee that seemed to satisfy the subordination regulation. However, a particular clause in the subordination agreement lead the Tax Court to determine the subordination was not sufficient, creating a potentially far-reaching problem for the conservation easement community.

The subordination agreement at issue in *Kaufman* contained the following language:

> The Mortgagee/Lender and its assignees shall have a prior claim to all insurance proceeds as a result of any casualty, hazard or accident occurring to or about the Property and

The Service's reaction to, and Tax Court's subsequent narrow interpretation of, two decisions has done much to cool taxpayer enthusiasm.

> all proceeds of condemnation, and shall be entitled to same in preference to Grantee until the Mortgage is paid off and discharged, notwithstanding that the Mortgage is subordinate in priority to the [Preservation Restriction] Agreement.[4]

Pursuant to the subordination agreement, the mortgagee subordinated its rights under the mortgage to those of the easement holder but for the quoted reservation. The taxpayers (as would many in the conservation easement community) believed that they had satisfied Reg. 1.170A-14(g)(2), which simply states that "no deduction will be permitted under this section for an interest in property which is subject to a mortgage unless the mortgagee subordinates its rights in the property to the right of the qualified organization to enforce the conservation purposes of the gift in perpetuity."

The IRS, however, argued that the lender improperly reserved priority over any condemnation or insurance proceeds. According to the IRS, this violated another provision in the regulations that addresses allocation of proceeds upon the extinguishment of the easement. In particular, Reg. 1.170A-14(g)(6)(ii) provides, in part:

> [F]or a deduction to be allowed under this section, at the time of the gift the donor must agree that the donation of the perpetual conservation restriction gives rise to a property right, immediately vested in the donee organization, with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction at the time of the gift, bears to the value of the property as a whole at that time. See § 1.170A-14(h)(3)(iii) relating to the allocation of basis. For purposes of this paragraph (g)(6)(ii), that proportionate value of the donee's property rights shall remain constant. Accordingly, when a change in conditions give [sic] rise to the extinguishment of a perpetual conservation restriction under paragraph (g)(6)(i) of this section, the donee organization, on a subsequent sale, exchange, or involuntary conversion of the subject property, must be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction, unless state law provides that the donor is entitled to the full proceeds from the conversion without regard to the terms of the prior perpetual conservation restriction.

Because the "proceeds clause" in the *Kaufman* subordination agreement gave the bank first priority over condemnation and insurance proceeds, Judge James Halpern held that the clause violated Reg 1.170A-14(g)(6)(ii). He reasoned that the division of proceeds regulation mandated that the preservation trust be guaranteed a proportionate share of future proceeds and that the mortgagee cannot have an absolute preference over the proceeds.

On appeal, the taxpayer argued that the Tax Court had commingled two independent regulations to create a requirement for easements over mortgaged property that had never before existed. The new requirement was that the mortgage, in addition to being subordinated to the easement, would have to provide for a proportionate sharing of proceeds from any condemnation or other extinguishment of the easement between the mortgage holder and the preservation trust. Moreover, although the Tax Court's Summary Judgment Order was not clear, it seemed to indicate that a donee organization must be "entitled" to such proceeds, in the sense of having an "absolute right" to its proportionate share of such proceeds over all third parties. As explained by the First Circuit, such a rule, when taken to its logical conclusion, would have a draconian effect on easement contributions.

Based on its interpretation of Reg 1.170A-14(g)(6), the Tax Court granted summary judgment to the IRS on the division of proceeds issue, but held that a genuine issue of material fact existed as to other issues.[5] In a second opinion, after trial on the remaining issues, the Tax Court reaffirmed its ruling on the division of proceeds issue.[6] The taxpayers appealed.

***Kaufman* on appeal.** The First Circuit analyzed the extinguishment, subordination, and division of proceeds provisions of Reg. 1.170A-14(g). It concluded that the Tax Court relied entirely on Reg. 1.170A-14(g)(6), the division of proceeds provision, to deny the taxpayers' deduction. Acknowledging that paragraph (g)(6) was not explained when first promulgated, the court reasoned that it "appears designed in case of extinguishment both (1) to prevent taxpayers from reaping a windfall if the property is destroyed or condemned and they get the proceeds from insurance or condemnation and (2) to assure that the donee organization can use its proportionate share of the proceeds to advance the cause of historic preservation elsewhere."[7]

The Tax Court's decision was summarized by the First Circuit as follows:

> [A]lthough the Kaufmans in the Preservation Restriction Agreement ... granted the Trust an entitlement to a proportionate share of post-extinguishment proceeds, thus seemingly complying with the regulation, the lender agreement executed by Washington Mutual undercut this commitment—and so defeated the deduction—by stipulating that "[t]he Mortgagee/Lender and its assignees shall have a prior claim to all insurance proceeds ... and all proceeds of condemnation, and shall be entitled to same in preference to Grantee until the Mortgage is paid off and discharged."[8]

The First Circuit then rejected the Service's position as adopted by the Tax Court, in large part on policy grounds. First, the court observed that the taxpayers had no control over what the mortgagee would and would not agree to. Taking this rationale a step further, the court noted that subordination of certain other liens, such as municipal tax liens, are completely out of the taxpayers' control. The court reasoned:

> Certainly the IRS has good reason to assure that the Kaufmans could not recapture the value of what they gave up by granting the easement in order to get the deduction; but the Kaufmans had no power to make the mortgage-holding bank give up its own protection against fire or condemnation and, more striking, no power to defeat tax liens that the city might use to reach the same insurance proceeds—tax liens being superior to most prior claims.[9]

The court went on to scrutinize the Service's interpretation of the word "entitled" found in Reg. 1.170A-14(g)(6), providing that the word does not mean "gets the first bite" as against the rest of the world. Instead, a "grant that is absolute against the owner-donor is also an entitlement."[10] In the final counterargument to the Service's position, the court reasoned that, "given the ubiquity of superiority for all tax liens, the IRS's reading of its regulation would appear to doom practically all donations of easements, which is surely contrary to the purpose of Congress."[11] Accordingly, the court determined that Reg. 1.170A-14(g)(6) does not require the donee organization to be guaranteed first priority to its share of insurance and condemnation proceeds.

The First Circuit then turned to an unrelated, technical argument made by the Service pertaining to the perpetuity requirement of Section 170(h)(5)(A). Specifically, the Service argued that because the agreement between the taxpayers and the trust contained the provision that "nothing herein contained shall be construed to limit the [trust's] right to give its consent (e.g., to changes in the Façade) or to abandon some or all of its rights hereunder," the trust had a "blank check" to consent to any type of change, even changes that were inconsistent with the easement.[12] Therefore, the Service argued, Reg. 1.170A-14(g)(1), requiring enforceable restrictions that will prevent uses of the retained interest (i.e. the interest not granted to the trust) inconsistent with the conservation purposes of the donation, was violated.

The court cited the D.C. Circuit's rejection of the same argument in *Simmons,* 646 F.3d 6, 10, 107 AFTR2d 2011-2632 (CA-D.C., 2011), *aff'g* TCM 2009-208. The First Circuit agreed with the D.C. Circuit that such a clause has no significant effect on the perpetuity of the easement. A change might be necessary to allow a charitable organization to accommodate changed conditions, but the agreement ensured that any changes would be consistent with the conservation purposes of the easement.

The IRS also argued that the regulation was a "reasonable interpretation" of Section 170(h)(5), and should be given deference. The court rejected this argument, concluding, "Yet the question here is not whether paragraph (g)(1) is reasonable, but whether the Service's *interpretation* of that regulation is reasonable."[13] The court concluded that it was not.[14]

The First Circuit next turned to the Service's arguments concerning substantiation, recordkeeping, and reporting requirements. The bulk of these arguments turned on the completion of the appraisal summary, IRS Form 8283, which taxpayers must complete in connection with a donation. The Service identified elements of the Form 8283 that were in fact incomplete, such as the manner and date of acquisition of the donated property and the cost or other basis of the property contributed. The taxpayers argued, however, and the court agreed, that they did not "acquire" the façade easement and had no "cost or other basis" to report.[15] The court noted that technically the taxpayers should have written "None" or "N/A" in the space provided, but just as it was decided in *Scheidelman*,[16] these "defects" were not nearly egregious enough to doom the appraisal summary.

After finding in favor of the taxpayers on the "proceeds" issues, the issue concerning the

On appeal, the taxpayer argued that the Tax Court had commingle two independent regulations to create a requirement that had never before existed.

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1 Wooldridge et al., "Simmons—Substantial Compliance Revisited, 126 Tax Notes 474 (1/25/10).

2 Kaufman ("Kaufman I") 134 TC 182 (2010).

3 Section 170(h)(5)(A); Regs. 1.170A-14(b)(2), (g)(1), (g)(2).

4 Kaufman ("Kaufman II"). 136 TC 294 (2011), 299.

5 The other issues consisted of the deductibility of the cash payment made by the taxpayer to the donee and the application of penalties.

6 Kaufman II, *supra* note 4.

7 Kaufman v. Shulman, 687 F.3d 21, 26, 110 AFTR2d 2012-5278 (CA-1, 2012).

8 *Id.*, citing Kaufman II, *supra* note 4 at 299, 313; Kaufman I, supra note 2 at 187.

9 Kaufman v. Shulman, *supra* note 1 at 26.

10 *Id.* (citation omitted).

11 Kaufman v. Shulman, *supra* note 1 at 26.

12 Kaufman v. Shulman, *supra* note 1 at 27.

13 Kaufman v. Shulman, *supra* note 1 at 28. (emphasis in original).

14 The court noted that the Service's reading of the regulation would inappropriately deprive the donee organization of flexibility to deal with remote contingencies. If the Service was concerned about the donee organization properly exercising its rights, it has the ability under Reg. 1.501(c)(3)-1 to regulate the organizations.

15 Kaufman v. Shulman, *supra* note 1 at 29. The court reasoned that the easement was created upon donation, and was therefore not acquired.

16 Scheidelman is explored in more detail below.

trust's rights to "abandon" or amend the easement, and the "record keeping and reporting" requirements, the First Circuit went a step further, providing guidance to the Tax Court, the Kaufmans, and taxpayers generally. Specifically, the court addressed issues concerning the value of the easement (issues not technically before it). The court went to great lengths to describe how certain evidence indicated the façade easement had been overvalued. Moreover, the court described how penalties (civil and criminal) might be appropriate in certain situations.

Perhaps the First Circuit's view of the case, of conservation easements generally, and of the way the Service has zealously challenged technical issues is best summarized in the last paragraphs of the court's opinion, in which it states:

In *Kaufman* and *Scheidelman*, the appellate courts found that the IRS and the Tax Court went too far in their narrow interpretations

> To reject overly aggressive IRS interpretations of existing regulations is hardly to disarm the IRS. Without stifling Congress' aim to encourage legitimate easements, one can imagine IRS regulations that require appraisers to be functionally independent of donee organizations, curtail dubious deductions in historic districts where local regulations already protect against alterations, and require more specific market-sale based information to support any deduction. Forward looking regulations also serve to give fair warning to taxpayers.
>
> If taxpayers still do not get the message, the penalties regime is formidable, *see, e.g.*, 26 U.S.C. § 6662(h)(I) (40 percent penalty for gross valuation misstatements); and, for willful abusers, there are criminal penalties, *e.g.*, 26 U.S.C. § 7201 (prison term up to five years). The Justice Department has already secured a permanent injunction against the trust to prohibit some of the practices alluded to in this case.[17] The IRS is properly zealous to protect the revenues and over the long run it has been given tools to do so.

Accordingly, although the First Circuit denied the Service a swift victory based on technical arguments, the court was not hesitant to express its opinion regarding potential abuses in the easement arena and the potential overvaluation of the façade easement at issue before the court.

***Kaufman*—The fallout.** Under the "Golsen Rule,"[18] the Tax Court follows decisions of the court of appeals to which a case is appealable. Conversely, the Tax Court will not necessarily follow decisions of a circuit court of appeals—e.g., the First Circuit—when an appeal will be to another circuit—e.g., the Second Circuit. However, the IRS can and sometimes does acquiesce to certain appellate court decisions, stating that it will apply a particular circuit court ruling in all circuits.

Considering the Service's aggressive positions in previous easement cases, there is much pessimism in the easement community that the IRS will acquiesce in the First Circuit's opinion in *Kaufman*. In fact, the IRS recently declined the opportunity to do so in *Mount*, Docket No. 17390-09, a New York case that is appealable to the Second Circuit. In that case, the IRS filed a response conceding that the taxpayer satisfied Reg. 1.170A-14(g)(6), but it based its concession on a narrower basis than *Kaufman*, relying instead on an interpretation of New York state law.[19]

Based on the Service's narrow concession in *Mount*, as well as its failure to acquiesce in recent taxpayer-friendly rulings in the circuit courts, one can anticipate continued controversy in this area. Indeed, the IRS has informally stated that it would not apply the *Kaufman* decision in other circuits. Moreover, as is demonstrated in *Scheidelman* (discussed below), the Tax Court has shown little inclination to alter its positions any more than required under the Golsen Rule.

[17] The court here noted, as its footnote 9, "See Stipulated Order of Permanent Injunction, McClain, No. 11-1087 (DC D.C., 7/15/11), which *inter alia* prevents a trust from claiming that the IRS has recognized a 'safe harbor' for easement valuation in the 10%-15% range and from '[p]articipating in the appraisal process for a conservation easement in any regard, including but not limited to recommending ... any appraiser ... or list of appraisers' beyond furnishing a list of all appraisers who have been certified to appraise conservation easements by a profession organization."

[18] The Golsen Rule was articulated in Golsen, 54 TC 742 (1970).

[19] Representatives of the Service have recently stated publicly that Service does not agree with the Kaufman and Scheidelman decisions and will not acquiesce to them.

[20] Drazner's percentage diminution determination was consistent with an article entitled "Façade Easement Contributions" that was prepared by Mark Primoli of the IRS, which was included as part of the Service's 1994 Market Segment Specialization Program Audit Technique Guide on the Rehabilitation Tax Credit. The article was published at one point on the National Park Service Web site, and was commonly referred to and often relied on by façade easement appraisers.

[21] The IRS also asserted that the appraisal did not describe the property contributed, did not include the terms of the easement deed, and did not include a statement that it was prepared for income tax purposes.

[22] The Tax Court did not ever reach a conclusion on this issue, presumably because it determined that failure to obtain a qualified appraisal was sufficient to disallow the taxpayer's deduction.

[23] In prior cases, the courts had acknowledged that, in certain instances, "substantial compliance" with the contribution rules was sufficient to entitle the donor to a deduction. See, e.g., Simmons, TCM 2009-208. See also Wooldridge et al., *supra* note 1.

[24] Scheidelman, TCM 2010-151 (citation and internal quotations omitted).

[25] *Id.*

[26] *Id.*

Scheidelman—How much is enough?

Scheidelman is one of the more significant recent taxpayer victories in the easement area. Although its primary holding is based on the specific facts in the case, the decision provides an interesting perspective on how the conservation easement rules may be applied by the courts and on how they should be applied by the Service.

***Scheidelman* in the Tax Court.** *Scheidelman*, TCM. 2010-151, involved a taxpayer who donated a façade conservation easement to the National Architectural Trust (NAT) in 2004. In connection with the donation, the taxpayer received an appraisal from Michael Drazner. Drazner determined the value of the façade easement by applying what he considered to be the "before and after" approach, in which the fair market value of the building is determined before and after it is encumbered by the façade easement, the difference being the value of the preservation easement. Importantly, when determining the "after value" of the building, he applied a percentage discount (11.3%) to the "before value," determining that the building had decreased by that amount as a result of the easement. Explaining why an 11.3% diminution was appropriate, Drazner noted that the "conclusion is based on consideration of range of value that the IRS has historically found to be acceptable as well as historical precedents."[20]

In the Tax Court, the Service asserted that the taxpayer failed to obtain a "qualified appraisal" of the donated façade easement, thereby violating Section 170(f)(11). Specifically, the IRS argued that the taxpayer's appraisal insufficiently explained the method and basis of valuation, and thereby failed to comply with Reg. 1.170A-13(c)(3)(ii).[21] Regs. 1.170A-13(c)(3)(ii)(J) and (K) require the appraiser to provide the "method of valuation to determine fair market value" and the "specific basis for the valuation, such as specific comparable sales transactions or statistical sampling," respectively. The Service argued, in the alternative, that the taxpayer failed to fully complete the Form 8283 (Appraisal Summary), by omitting the property acquisition information on the form.[22]

The taxpayer proposed three arguments as to why she satisfied the "qualified appraisal" requirement. First, she argued that her appraisal clearly specified the "method of valuation" it used—the "before and after" method. She pointed out that the before and after method of appraising easements had been repeatedly accepted by the courts, and that percentage reductions, in particular, had been accepted as a qualified methodology. Second, she argued in the alternative that, even if Dazner's appraisal was not qualified, her failure to obtain a "qualified appraisal" was due to reasonable cause, citing Section 170(f)(11)(A)(ii)(II). Finally, she argued that she was entitled to a deduction because she "substantially complied" with the appraisal regulations.[23]

The Tax Court agreed with the Service that the appraisal lacked a method of valuation because "the application of a percentage to the fair market value before conveyance of the façade easement, without explanation, cannot constitute a method of valuation."[24] Accordingly, the Tax Court determined that the taxpayer failed to obtain a "qualified appraisal," as required under Section 170(f)(11). With respect to the taxpayer's argument that she had reasonable cause for failing to provide a qualified appraisal, the Tax Court summarily dismissed the argument by stating "Petitioners have not persuaded us that reasonable cause existed and excuses the failure to comply with the requirements for obtaining a qualified appraisal."[25]

The Tax Court next turned to the question of whether the taxpayer "substantially complied" with the qualified appraisal requirement. The court noted that the "critical question was whether the requirements at issue relate 'to the substance or essence of the statute,'" in which case substantial compliance was not applicable, as opposed to "procedural or directory" requirements. Ultimately, the court determined that the lack of a recognized methodology or specific basis for the calculated after-donation value was "too significant for [the court] to ignore under the guise of substantial compliance."[26]

In connection with granting the façade easement, the taxpayer also made a payment to NAT in the amount of $9,275. Although the taxpayer did not initially deduct the amount as a contribution on her 2004 tax return, the deductibility of this payment was tried by consent of the parties in the Tax Court. The Service alleged that the payment was not a "contribution or a gift" under Section 170, but was rather a "quid pro quo" because NAT accepted the easement and assisted the taxpayer in claiming a tax deduction in return for the payment, which

was calculated as a percentage of the valuation of the easement. The Tax Court determined that the taxpayer was not entitled to a deduction of the cash donation because the taxpayer "failed to provide evidence necessary for [the court] to determine that in return for the payment of cash [the taxpayer] received nothing of substantial value...."[27]

***Scheidelman* on appeal.** The Second Circuit reversed the Tax Court's determination that the taxpayer failed to substantiate the value of the donated preservation easement with a "qualified appraisal." The Second Circuit determined that the appraisal was sufficient for purposes of the Code, holding that "the regulation requires only that the appraiser identify the valuation method 'used'; it does not require that the method adopted be reliable. By providing the information required by the regulation, [the appraiser] enabled the IRS to evaluate his methodology."[28] In fact, the court noted, the appraiser expressly selected the before and after method.[29] In so holding, the court observed, "[The appraiser] did in fact explain at some length how he arrived at his numbers."[30]

The Second Circuit further noted that, despite the Tax Court's finding otherwise, the appraisal approach used by Drazner was "nearly identical" to the approach approved by the Tax Court in *Simmons*. The Second Circuit noted that although the *Simmons* appraisal took into account some additional statistical information, such data only renders an appraisal more persuasive. It does not distinguish a qualified appraisal from one that is unqualified.

The court next turned to the Service's argument that the taxpayer's deduction should be denied because the appraisal summary, Form 8283, required to be filed with the taxpayer's return, was incomplete. The basis of the Service's argument was identical to what it later asserted in *Kaufman*—that the date and manner of acquisition of the donation and the cost or other basis of the property were not provided. The Second Circuit held that any deficiencies with the form were attributable to reasonable cause and that the form "substantially complied" with the regulations.[31]

Finally, the Second Circuit reversed the Tax Court's determination that the cash donation made by the taxpayer was not deductible. The Court of Appeals concluded that the donee's agreement to accept the gift of the easement was not a transfer of anything of value to the taxpayer, and thus did not constitute a quid pro quo for the gift of the cash.[32] The quid pro quo argument has lingered for a long time in the Service's arsenal, but the argument has generally not gained traction in court. The argument has been rejected several times.[33]

***Scheidelman*—The fallout.** The Second Circuit's decision in *Scheidelman* was a welcome victory to taxpayers concerning completion of the Form 8283, the deductibility of cash donations, and most importantly the "qualified appraisal issue." However, taxpayers should not expect the IRS to change course as a result of the decision. The Service has shown little willingness to broadly apply taxpayer-friendly decisions in the conservation easement area, and it has already demonstrated that this stance will not change in light of the *Scheidelman* opinion.

In *Rothman*, TCM 2012-218, the Tax Court entered a Supplemental Memorandum and Opinion addressing the application of the Second Circuit's decision in *Scheidelman*. *Rothman* involved a situation in which the Tax Court had previously determined that the taxpayer's appraisal was not a qualified appraisal, based substantially on the Tax Court's decision in *Scheidelman*.[34] After the Second Circuit issued its *Scheidelman* decision, the taxpayer in *Rothman* moved the Tax Court to reconsider and vacate its prior decision. The Tax Court acknowledged that the Second Circuit's decision in *Scheidelman* was binding on the court under the Golsen Rule, and vacated the portion of its opinion that related to specific failures addressed in *Scheidelman*. However, the Tax Court affirmed its conclusion that the appraisal was not a qualified appraisal. The court held that the appraisal failed to meet other requirements under Reg. 1.170A-13(c)(3) that were not at issue in *Scheidelman*. In so holding, the Tax Court interpreted the Second Circuit's decision in *Scheidelman* very narrowly.

Recently, in *Gorra*, Docket No. 15366-10, a façade easement case currently before the Tax Court, the taxpayer submitted a Motion for Partial Summary Judgment on the issue of whether the appraisal he submitted was a "qualified appraisal." The taxpayer argued that his appraisal was very similar to the appraisal at issue in *Scheidelman*, and should be determined to be a qualified appraisal. The motion had not been decided at the time of this writing. However, the arguments made by the Service in its response to the motion for partial summary judgment shed light on how it is reacting to the *Scheidelman* decision. In its response, the Service asserted that *Scheidelman* was not applicable because (1) the particular facts of the appraisal at issue were different than those in *Scheidelman* and (2) a different statutory scheme was applicable in *Gorra*.

With respect to the first issue, the Service stated as follows:

> The Second Circuit in *Scheidelman* states that a qualified appraisal must include enough information to "enable ... the IRS to evaluate [the appraiser's] methodology." The [appraisal at issue] does not state the method of valuation actually used to determine the value of [the] easement and does not adequately explain how it arrived at that value. Therefore, [the appraisal] fails to meet the requirement of Treas. Reg. Sec. 1.170A-13(c)(3)(ii)(I) and (K) and is not a qualified appraisal.

The Service's distinction between the facts at issue in *Gorra* and those addressed in *Scheidelman* is arguably stretched, as the appraisers in both cases stated that they applied the before and after approach when valuing the property and described similar reasons.

With respect to the second item, the Service argued that the Pension Protection Act (PPA) of 2006, which in this instance applies to returns filed after 8/17/06, amended Section 170(f)(11)(E) by expanding the requirements for a "qualified appraisal." Specifically, the Service argued that the law now required that an appraisal must follow "generally accepted appraisal standards." While it is true that the version of Section 170(f)(11)(E) that was analyzed by the Second Circuit in *Scheidelman* did not contain the "generally accepted appraisal standards" language added by the PPA, it is difficult to understand how this distinction would alter the Second Circuit's analysis.[35]

Finally, it is worth noting that the petitioner in *Gorra* resided in New York, and an appeal of the case would be to the Second Circuit, the same court that decided *Scheidelman*. For this reason, the Service could not argue that *Scheidelman* was not binding precedent on the Tax Court under the Golson Rule. However, in all cases not appealable to the Second Circuit, the Service is almost certain to argue that *Scheidelman* is not applicable.

Conclusion

It is difficult to predict how the law pertaining to conservation easements will evolve over the upcoming years. Considering the number of cases now before the courts and the number of cases still in the administrative process, it is safe to assume additional guidance will be forthcoming. What appears clear is that taxpayers have substantial obstacles to overcome with respect to "foot fault" or "qualification issues." There are a host of requirements pertaining to qualifying and substantiating a conservation easement. The Service appears to be scouring easement donations to determine if any of these requirements were not met. In some instances the Service has been very creative in its interpretation of the requirements, fashioning requirements donors never anticipated.

Taxpayer results on the technical issues have been mixed in the Tax Court. In some instances the Tax Court is willing to excuse minor technical deficiencies under the "substantial compliance" doctrine and other related concepts.[36] For example, the Tax Court has recently stated that the "contemporaneous written acknowledgment" requirement under Section 170(f)(8) can be satisfied by language in the conservation easement deed.[37] Additionally, in some instances, the Tax Court has refused to adopt creative or strained arguments by the Service regarding the interpretation of the regulations pertaining to conservation easements.[38] As the *Scheidelman* and *Kaufman* decisions demonstrate, however, the Tax Court has issued some very unfavorable decisions to taxpayers on technical issues.

From the few decisions that have been issued by the circuit courts of appeals, it appears that these courts are finding it difficult to deny charitable deductions based on overly technical and arguably incorrect interpretations of

[27] *Id.*

[28] Scheidelman, 682 F.3d 189, 197, 109 AFTR2d 2012-2536 (CA-2, 2012).

[29] *Id.* at 196.

[30] *Id.*

[31] *Id.* at 200.

[32] *Id.* at 682 F.3d 200-201.

[33] See, e.g., Dunlap, TCM 2012-126 (2012) (rejecting the Service's quid pro quo argument); See, e.g., Kaufman II, supra note 4 at 300. Representatives of the Service have recently publicly stated the Service will no longer challenge the deductibility of "stewardship" payments.

[34] See Rothman, TCM 2012-163.

[35] Representatives of the Service have recently stated publicly that they believe the cases applying pre-PPA amendment law are generally not applicable to cases in which post-PPA law is applicable.

[36] See, e.g., Simmons, 646 F.3d 6, 10, 107 AFTR2d 2011-2632 (CA-D.C., 2011), *aff'g* TCM 2009-208; and Averyt, TCM 2012-198.

[37] See, e.g., R.P. Golf, LLC et al., TCM 2012-282 and Averyt, TCM 2012-198. But see Schrimsher TCM 2011-71.

[38] See, e.g., Butler, TCM 2012-72 (Tax Court refuses to accept Service's overly aggressive application of conservation purpose and "inconsistent use" requirements).

the Code and regulations. First, the D.C. Circuit affirmed, and arguably broadened, the application of substantial compliance to conservation easement contributions. Next, the First Circuit reversed the Tax Court and rejected the Service's interpretation of the regulations applicable to subordination agreements and the "proceeds" clause, as well as the Service's application of the regulations pertaining to Form 8283. Finally, the Second Circuit reversed the Tax Court and rejected the Service's interpretation of the "qualified appraisal" requirement.

Although the recent decisions by the courts of appeals are welcome developments for taxpayers, taxpayers should not be overly optimistic. It is unlikely the IRS will be willing to apply the decisions in any instance not mandated under the Golsen Rule. Moreover, the Service, with some support in the Tax Court, has read the decisions very narrowly, limiting their application, and perhaps requiring additional appeals. Finally, the circuit court decisions, particularly the *Kaufman* decision, indicate that, notwithstanding overly technical readings and application of the substantiation rules, valuation remains a significant issue of fact. The statements made by the Second Circuit in *Scheidelman* indicate that value should be closely scrutinized by the Tax Court, and that penalties should be carefully considered in instances in which value has been overstated. ■

PROVING THE VALUE OF A CHARITABLE DONATION MAY BE THE LEAST OF YOUR PROBLEMS

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By: David M. Wooldridge, Ronald A. Levitt, Gregory P. Rhodes, and Nathan Vinson

Proving the Value of a Charitable Donation May Be the Least of Your Problems

By David M. Wooldridge, Ronald A. Levitt, Gregory P. Rhodes, and Nathan Vinson

The Service is becoming more and more creative in its attacks on charitable contribution deductions claimed for various types of easements, and the Tax Court has upheld the technical requirements and refused to entertain taxpayer arguments that there was substantial compliance. The new focus is on appraisers and appraisals.

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Imagine you have advised a client on deduction of a sizeable charitable donation of property. A reputable appraiser has prepared a thick appraisal, and he seems to have his facts straight. You have made sure the technical requirements of the Regulations have been satisfied, and appropriate parties have completed Form 8283 ("Noncash Charitable Contributions"). You probably feel comfortable advising your client that his risk is essentially an IRS challenge of the value, something typically resolved in negotiations if audited. Well, think again. Like a black cat in the shadows on Halloween night, other issues are lurking. Proving the value of the property donation may be the least of your problems.

Several issues have recently sprung up, mostly in the conservation easement arena, that directly affect appraisals in *all* valuation cases. IRS is currently attacking appraisals as not being "qualified" (even while conceding the appraiser himself *is* qualified). It is liberally proposing taxpayer and appraiser penalties in large amounts. The Service is even trying to exclude apparently sound appraisals from being used in evidence in Tax Court trials under the principles of *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993), which excluded opinions based on an insufficient foundation.

Even practitioners with tax controversy practices have never experienced the intensity and variety of scrutiny that is becoming standard practice within the IRS. Having tried and defended deductions for qualified conservation contributions, the authors have witnessed first hand these attacks on qualified appraisers and their work, and the impact of these attacks on taxpayers.[1] Taxpayers are having mixed success meeting the challenges. Also, these issues are not limited to conservation easement donations; they lap over into all valuation-based cases. What follows is an overview of the importance of having a "qualified appraisal," the attack on seemingly good appraisals by the IRS in audits and in court, and the imposition and consequences of very substantial taxpayer and appraiser penalties.

THE ATTACK ON THE QUALIFIED APPRAISAL AND EXPERT REPORTS

For a charitable contribution of property with a claimed value of more than $5,000, a taxpayer must obtain a "qualified appraisal" of the property prepared by a "qualified appraiser."[2] Practically speaking, a qualified appraisal should be obtained for every substantial noncash charitable contribution, considering that the value of such a donation is often, or might be found to be, in excess of $5,000. Although much of the recent IRS focus involves contributions of conservation easements, a qualified appraisal must be obtained for *any* contribution of property with a claimed value

of more than $5,000. The scope of this article is therefore relevant to appraisals of all types of donated property.

IRS is currently attacking appraisals as not being 'qualified' (even while conceding the appraiser himself *is* qualified).

Definition of 'Qualified Appraisal'

Section 170(f)(11)(E) defines both "qualified appraisal" and "qualified appraiser." A qualified appraisal is an appraisal prepared by a qualified appraiser and prepared in accordance with generally accepted appraisal standards[3] and with Regulations prescribed by the Secretary. The Treasury Regulations extensively expand on the definition of a qualified appraisal. The definition consists of several technical requirements that must be met as a prerequisite before the determined value of the contributed property is even considered.

A qualified appraisal report must relate to an appraisal performed no earlier than 60 days before the contribution of the property, and no later than the due date of the taxpayer's return (including extensions), and be prepared, signed, and dated by the qualified appraiser.[4] The Regulations also require certain information to be in the qualified appraisal, including:

- A description of the property in sufficient detail that a person not familiar with the property can ascertain the type of property being contributed.
- The physical condition of the property.
- The date or expected date of contribution.
- Any agreements entered into between the donor and donee (or reserved rights of the donor or third party) with respect to the property.[5]

Further information is required that is specifically aimed at the qualifications of the appraiser and the appraiser's methodology and approach to valuation. This information includes:

- The qualifications of the qualified appraiser[6] (including background, general experience, experience evaluating the particular type of property, education, and membership in professional associations).
- A statement that the appraisal was prepared for income tax purposes.
- The date the property was appraised.
- The FMV of the property.
- The method of valuation.
- The specific basis for the valuation.[7]

Effect of Not Having a Qualified Appraisal

If the taxpayer does not obtain a qualified appraisal, generally no deduction for the charitable contribution of property is allowed.[8] IRS is frequently alleging that the thick, impressive-looking appraisal obtained by the taxpayer and performed by a qualified appraiser was not a qualified appraisal. If a taxpayer cannot resolve her case with the IRS Appeals Office and ultimately takes it to the Tax Court, the Service may file a motion before trial, or argue during trial or in subsequent briefing, that the original appraisal report was not a qualified appraisal. If the judge agrees, the taxpayer has no qualified appraisal, no case, and therefore no deduction.

Based on recent cases, and motions filed in pending cases, it appears that judges are reluctant to rule on the issue of qualified appraisal before trial; the issue is too highly factual not to allow the parties to present evidence. Such judicial cautiousness, however, will only get the taxpayer into trial. If the judge is unconvinced after evidence has been presented that the *original* appraisal was "qualified," the taxpayer gets no deduction.

This is true *even if* the taxpayer has another appraiser prepared to testify whose appraisal is based on sound methodology and assumptions and avoids whatever deficiency was found in the original appraisal. If it is determined that the taxpayer lacked a qualified appraisal, the taxpayer never gets to the issue of value, which is what taxpayers and practitioners traditionally have expected cases to come down to.[9]

ATTACK OF APPRAISALS BY THE IRS AND IN TAX COURT

Two recent Tax Court cases exemplify the Service's current attack on appraisals and the Tax Court's approach to analyzing the quality and sound foundation of appraisals.

Recently, IRS has been keen on what it deems "sloppy" appraisals. These attacks have focused not on the technical aspects of the Regulations but rather on the appraiser's basic methodology and assumptions—criteria selection usually governed by generally accepted appraisal standards under USPAP. Although the Regulations require that the qualified appraisal describe the methodology and specific basis of valuation used by the qualified appraiser,[10] and require that USPAP principles be applied,[11] the Regulations do not provide exact guidelines to be used to perform the methodology or the specific basis of valuation.[12] The appraiser is still given the freedom of exercising the art of appraising property.

The *Scheidelman* Case

In *Scheidelman,* TCM 2010-151, the taxpayer was denied a deduction for the charitable contribution of a façade easement, because she lacked a *qualified* appraisal.

The taxpayer owned property in a registered historic district of New York City. After educating herself regarding the city's various conservation and preservation organizations, the taxpayer decided to donate a façade easement to the National Architectural Trust (NAT). The taxpayer was advised that an appraisal would be necessary for the contribution to qualify for a charitable deduction under the Code.

The taxpayer hired an appraiser having considerable experience in valuing façade easements. The appraiser prepared an appraisal that was the basis for the taxpayer's claimed charitable contribution deduction. In denying the deduction, the IRS alleged that several requirements of the Regulations defining a qualified appraisal had not been satisfied, including that the appraisal did not describe the property contributed, did not include the terms of the deed of easement, did not include a statement that it was prepared for income tax purposes, and did not provide the method and specific basis for valuing the easement.

Before beginning the analysis of its decision, the Tax Court observed, "Because we conclude that the [original appraisal] report is not a qualified appraisal, we do not discuss [conflicting expert testimony] or reach a conclusion as to the value of the easement." Although the IRS alleged several deficiencies in the taxpayer's appraisal, the court focused only on the appraiser's methodology and basis of valuation. Both of these components are required under the qualified appraisal Regulations.[13] The court explained that the pertinent Regulation "provides that the qualified appraisal is to include the method of valuation used to determine fair market value, such as the income approach, the market-data approach, and the replacement-cost-less-depreciation approach. These methods are suggested, but not mandatory."

The *Scheidelman* appraisal purportedly used the before-and-after method, which is the most widely used method for valuing conservation easements.[14] The court did not criticize the appraiser's approach to "before" value (i.e., the value before placing the façade easement).

Under the Regulations, several technical requirements must be met as a prerequisite before the determined value of the contributed property is even considered.

The appraiser's approach to determining "after" value, however—the value of the property after the façade easement was placed, and ultimately the value of the easement—was lacking a recognized methodology and specific basis of valuation. To determine the value of the easement, the appraisal cited the appraiser's experience in appraising façade easements for income tax purposes. Specifically, the appraisal determined that the façade easement had an approximate value of "11-11.5% of the total value of the property. That figure is based on the appraiser's experience as to what the Internal Revenue Service has found acceptable (on prior appraisals)." Based on the cited value range, the appraiser concluded that the façade easement had an FMV of 11.33% of the total unencumbered FMV of the property.

The Tax Court criticized such an approach because it "applied mechanically a percentage with no demonstrated support as to its derivation, other than acceptance of similar percentages in prior [Tax Court cases]." Furthermore, the court determined that the appraiser failed to provide a specific basis for valuing the property because it was not explained "how the specific attributes of the subject property led to the value determined in the [appraisal]."

Applying a percentage reduction to the unencumbered FMV of the property was thought by many to be a recognized valuation methodology when valuing façade easements. Even IRS seemed to adopt the approach.[15] The opinion indicated that had the appraisal expanded on certain reasoning contained in the appraisal, the court might have given more consideration to the appraisal. Although the appraisal explained that estimating the value of the subject property was akin to condemnation appraisal practice that includes attempts to define what rights have been lost and the value of such rights to establish damages, the Tax Court determined that the appraiser failed to conduct an analysis of such methodology.

The taxpayer argued that she had substantially complied with the substantiation requirements for quali-

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[1] See, e.g., Wooldridge, Levitt, and Rhodes, "*Kiva Dunes*—Making and Substantiating the Value of Conservation Easements," 111 JTAX 300 (November 2009).

[2] Section 170(f)(11)(C).

[3] Generally accepted appraisal standards are currently embodied in the Uniform Standards of Professional Appraisal Practice (USPAP).

[4] Regs. 1.170A-13(c)(3)(i) and (iv)(B). Recent examinations have challenged appraisals made 62 days prior, and even have resisted reports made within 60 days when identical to a prior report not made within 60 days.

[5] Reg. 1.170A-13(c)(3)(ii). The Regulations contain additional required information, but an exhaustive analysis of this information is beyond the scope this article.

[6] Reg. 1.170A-13(c)(5) defines "qualified appraiser" and will be revisited during the discussion regarding appraiser penalties.

[7] The distinction between the "method of valuation" and the "specific basis" for valuation will be discussed later in this article in connection with a recent Tax Court case.

[8] See Scheidelman, TCM 2010-151.

[9] See Levitt, Wooldridge, Rhodes, and Vinson, "Tax Court Analysis of Land Conservation Easement Values—Developments Since *Kiva Dunes,*" 22 Tax'n of Exempts No. 6 (May/June 2011), page 31.

[10] Regs. 1.170A-13(c)(3)(ii)(J) and (K).

[11] Although the Regulations do not refer to USPAP directly, Notice 2006-96, 2006-2 CB 902, incorporates USPAP into the definition of generally accepted appraisal standards.

[12] *Id.;* the Regulations do provide specific examples of methodologies and specific bases of valuation. See Scheidelman, *supra* note 8.

[13] See note 10, *supra.*

[14] Using the before-and-after method, the appraiser derives a value for the property before it is encumbered by the easement, and then finds a value for the property after it is encumbered by the easement. The difference between the two values represents the value of the easement. See Reg. 1.170A-14(h)(3)(i).

[15] The IRS had published a Market Segment Specialization Program Guide and a Topical Tax Brief which indicated a range that IRS believed a façade easement could be expected to reduce the value of property. These documents were posted on the IRS website, but have since been removed. See CCA 200738013 (addressed to IRS counsel involved in Scheidelman on 9/21/07, long after the appraisal was done).

fied conservation contributions, and that she should nevertheless be entitled to the claimed deduction (or at least some of the claimed deduction). The court concluded that it would not apply the substantial compliance doctrine, stating it had never applied the doctrine in the absence of a qualified appraisal.

The Tax Court declined to address the Service's alternative argument that the contribution failed to meet the Section 170(h) requirements because it was neither exclusively for conservation purposes nor protected in perpetuity. Thus, the lack of a qualified appraisal at the outset precluded the taxpayer from advocating the value of the easement and rendered moot the other issues raised by the IRS.

The *Boltar* Case

In *Boltar, L.L.C.,* 136 TC No. 14, a taxpayer lost its deduction when the Tax Court excluded the taxpayer's appraisal report from evidence at trial, as contrasted with determining the taxpayer's appraisal was not a "qualified appraisal."

The taxpayer claimed a charitable deduction for the donation of a land conservation easement. To establish the value of the easement (and thus the amount of the deduction) the taxpayer obtained a professional appraisal, which determined the value of the conservation easement by purportedly applying the before-and-after method.

The appraisers determined that the highest and best use of the property before being encumbered by the conservation easement was residential development (a condominium development), which would be worth $3,340,000 (i.e., the "before" value). They concluded that a conservation easement which would preclude the assumed development would be valued at $3,270,000. As an alternative, the appraisal considered the value of the property as "raw land," and concluded the property after the easement would be worth $68,700. As the Tax Court noted, however, the appraisal never determined the highest and best use of the property after the easement (i.e., the "after" value).

The taxpayer used the appraisal (without any revisions) as its expert report, and the IRS moved before trial to exclude the taxpayer's report as unreliable and irrelevant under Federal Rules of Evidence (FRE) 702 and *Daubert*. The Tax Court held that the standards of reliability and relevance apply in Tax Court trials, and because the taxpayer's appraisers failed to properly apply the before-and-after valuation method, the expert report was excluded from evidence under the principles of *Daubert*. Without any direct, affirmative evidence as to value, the court adopted the IRS expert's valuation in full and upheld the value determination in the statutory notice of deficiency.

The appraisers' development of the before-and-after method of valuation was determined to be deficient in several respects. For instance, with respect to the "before" value, the hypothetical development used by the taxpayer's appraisers to determine that value (i.e., the value of the property if developed) could not fit on the eight acres of easement property (the hypothetical development was plotted on ten acres).

The appraisers also failed to take into consideration the proper zoning laws affecting the easement property. The appraisers assumed that the property was within the city limits and zoned PUD (planned unit development). With respect to the purported "after" value, the appraisers failed to determine the highest and best use of the property after being encumbered by the easement.

The Tax Court pointed out that the taxpayer's appraisers acknowledged these deficiencies but still persisted in defending their "peculiar methodology" instead of making adjustments to the appraisal. In several parts of the opinion, the court suggested that had the taxpayer's appraisers made adjustments and corrections based on the alleged and admitted deficiencies, the court might have considered the appraisal in determining value.[16]

In *Scheidelman* the Tax Court determined that the appraisal was not a *qualified* appraisal but in *Boltar* the court found the appraisal unreliable and excluded it.

Accordingly, the court therefore found that the appraisers "failed to determine the value of the Eased Area before and after the grant of the easement." The court found that the IRS in its reply brief aptly summarized the deficiencies of the taxpayer's expert report as the failure "to properly apply the before and after methodology, to value all of petitioner's contiguous landholdings, to take into consideration zoning restraints and density limitations and to take into consideration the preexisting conservation easements. As a result, the [taxpayer's experts] saw nothing wrong with a hypothetical development project that could not fit on the land they purportedly valued, was not economically feasible to construct and would not be legally permissible to be built in the foreseeable future."

In addition, the taxpayer's appraisers' approach to "after" value was determined to be unfounded and unsupported. The appraisers failed to determine a highest and best use of the property after the grant of the conservation easement.

Based on these deficiencies, the court then considered the application of *Daubert* to bench trials, and to Tax Court cases in particular. The court first determined that FRE 702, governing the use of expert testimony, was applicable to Tax Court cases. Therefore, the Supreme Court's directives in *Daubert* were equally applicable. The court then observed:

"We have long recognized that receipt of unreliable evidence is an im-

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[16] Under Tax Court practice, an expert's report is identified and offered into evidence by counsel as the expert's direct testimony. Opposing counsel has an opportunity to examine the witness about the sufficiency of the report, before the report can be admitted into evidence.

position on the opposing party and on the trial process.... We have also frequently stated that an expert loses usefulness to the Court and loses credibility when giving testimony tainted by overzealous advocacy.... Expert opinions that disregard relevant facts affecting valuation or exaggerate value to incredible levels are rejected...." (Citations omitted.)

Whereas in *Scheidelman* the Tax Court determined that the appraisal was not a *qualified* appraisal under the Section 170 substantiation rules, in *Boltar* the court found the appraisal unreliable and excluded it from being used as an expert report under *Daubert* principles. This distinction leads to the conclusion that while an appraisal might be a qualified appraisal under the Regulations, the taxpayer still must survive a *Daubert* challenge should the case proceed to Tax Court.[17] Otherwise, the taxpayer is only slightly better off than not having a qualified appraisal. The taxpayer is left without any affirmative evidence of value (although some evidence might still be gleaned from opposing experts or other witnesses).

Rarely is there an issue with the appraiser being a qualified appraiser. As the Tax Court in *Boltar* commented, "[i]n most cases, as in this one, there is no dispute about the qualifications of the appraisers. The problem is created by their willingness to use their resumes and their skills to advocate the position of the party who employs them without regard to objective and relevant facts, contrary to their professional obligations."

The Impact of *Daubert*

Daubert entailed a suit against a pharmaceutical company for birth defects allegedly caused by the mother's ingestion of a particular drug marketed by the company. On motion for summary judgment by the defendant Merrell, the trial court considered the expert opinions of Merrell's expert and eight experts offered by the plaintiffs.

The trial court granted Merrell's motion, and in affirming the trial court the Ninth Circuit cited *Frye v. U.S.*, 293 F. 1013 (D.C. Ct. App., 1923), as embodying the correct standard to apply to scientific evidence. This standard excludes expert testimony unless the expert's scientific technique in deriving conclusions is "generally accepted" as reliable in the relevant scientific community.

In reversing, the Supreme Court held in *Daubert* that FRE 702, as opposed to *Frye,* was controlling on the issue of relevant and reliable expert testimony. In its opinion, the Court clarified the standard for determining admissibility of novel scientific evidence and noted that *Frye* predated the Federal Rules. FRE 702 provides the limits of expert testimony, as follows:

Judges are reluctant to rule before trial on the highly factual issue of qualified appraisal, but this will only get the taxpayer into trial.

"If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, [an expert] may testify thereto in the form of an opinion or otherwise, if (1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case."

The Court analyzed the particular phrases of Rule 702 to determine the limits prescribed by the conditions of the Rule. For instance, the Rule requires that testimony *assist* the trier of fact, which goes primarily to relevance. The Court also described how the Rule establishes the trial court's role as a *gatekeeper* with regard to relevant and irrelevant expert testimony. Another important limit established by the Rule concerns reliability. Elaborating on the application of the Rule, the Supreme Court's landmark opinion established what has come to be known as the *Daubert* factors.

Furthermore, the Supreme Court in *Kumho Tire Company, Ltd. v. Carmichael,* 526 U.S. 137 (1999), clarified that the principles of *Daubert* apply to expert opinion testimony in addition to scrutinizing experts' scientific techniques. Specifically, *Kumho Tire* held that *Daubert* applies to *all* expert testimony, regardless of whether the expert is a scientist.

Application to appraisals. As exemplified in the Tax Court's decision in *Boltar, Daubert* challenges are becoming more relevant to attacks on the work of financial experts in court. The attacks are not only made with respect to appraisers of property; empirical studies show that from 2000-2010, the number of *Daubert* challenges to financial experts increased from 253 in 2000 to 879 in 2010. In 2000, 121 of these challenges succeeded in having the expert witness evidence excluded at trial; in 2010 that number climbed to 431.[18]

The *Daubert* factors are not as workable in the context of examining the admissibility of appraisals and appraiser testimony. In *Boltar,* the Tax Court used the "gatekeeper" directive to analyze the reliability of the taxpayer's expert report. Tax Court Rule 143(g) requires an expert to submit a report before the expert is entitled to testify at trial. Therefore, if the report is excluded as unreliable, the expert cannot testify directly as to its contents.

The Tax Court in *Boltar* appeared to focus on variations of two *Daubert* factors: (1) the theory or technique used and (2) its acceptability in the relevant [appraisal] community. In

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[17] An interesting aspect of Boltar is that the IRS moved, pursuant to a preliminary motion, to exclude the expert report from evidence, as opposed to alleging the appraisal failed to constitute a qualified appraisal under the Regulations. Whether this was a tactical decision by the IRS or a failure to spot the "qualified appraisal" issue is unknown.

[18] PricewaterhouseCoopers, "Daubert Challenges to Financial Experts: An 11-year study of trends and outcomes," February 2011, available at www.pwc.com/us/en/forensic-services/publications/daubert-study-2010.jhtml.

excluding the report, the court criticized the "peculiar" valuation methodology used and the erroneous assumptions made by the appraiser. The court also inquired as to general principles of reliability under FRE 702 without trying to force its inquiry into any particular *Daubert* factor. In fact, the Tax Court never explicitly referred to any single *Daubert* factor; it instead simply determined that the *Daubert* principles apply to expert testimony in Tax Court.

The consequences of having a poor quality appraisal are apparent in both *Scheidelman* and *Boltar.* The taxpayer faces the prospects of the appraisal being deemed not a qualified appraisal; alternatively, if the appraisal is used as an expert report, the taxpayer faces the prospects of the appraisal (the expert report) being excluded at trial. As seen in both cases, either result kills or badly damages the taxpayer's charitable deduction. While not having a qualified appraisal defeats the deduction entirely, having expert testimony and evidence as to value excluded at trial may result in the taxpayer receiving little or no percentage of the claimed deduction.

Planning

There are lessons to learn from the Tax Court's recent *Scheidelman* and *Boltar* cases. When advising clients on non-cash contributions and other value issues, the practitioner must be sure that the appraiser has all the facts, uses sound methodology (e.g., proper application of the before-and-after method), and makes reasonable assumptions in employing the methodology (e.g., takes into account zoning restrictions and property size limitations). Careful vetting of an appraisal is advised and a desk review by a second appraiser is sometimes appropriate.

When cases come to the practitioner after the fact, the front-end safeguards are no longer available to the practitioner. Nevertheless, the practitioner can create an anticipatory defense by securing a reputable appraiser to prepare a quality appraisal before trial. A vigorous defense of the original appraisal should be made and clear errors corrected. When the taxpayer lacks a qualified appraisal or a viable expert report at trial, the taxpayer faces valuation and understatement penalties.[19]

APPRAISER PENALTIES

As if worrying about keeping the client happy weren't enough: appraisers have always had to do a quality job to keep the doors open, but now they must watch their backs for penalties, suspension, and disbarment. Valuing the property may be the least of the appraiser's problems.

In one case, the appraiser did not explain 'how the specific attributes of the subject property led to the value determined in the [appraisal].'

As noted above, a "qualified appraiser" must prepare the taxpayer's "qualified appraisal." Section 170(f)(11)(E)(ii)(I) provides that a qualified appraiser is an individual who has received an "appraisal designation from a recognized professional appraiser organization" (i.e., a licensed appraiser) and regularly performs appraisals for compensation. Section 170(f)(11)(E)(ii)(III) authorizes the Secretary to prescribe other requirements (in Regulations or other guidance) that an appraiser must meet to be deemed a "qualified appraiser."

Notice 2006-96, 2006-2 CB 902, and Reg. 1.170A-13(c)(5) expound on the requirements of a qualified appraiser. The qualified appraiser, among other things, must include, in an appraisal summary, a declaration that the appraiser understands that an intentionally false or fraudulent overstatement of value may subject the appraiser to civil penalties under Section 6701.

Reg. 1.170A-13(c)(3)(ii) requires several pieces of information to be included in the qualified appraisal, including the method of valuation used to determine FMV and the specific basis for the valuation, such as specific comparable sales transactions or statistical sampling (including a justification for using sampling and an explanation of the sampling procedure employed).

In addition, the Regulations require that the qualified appraisal be made no earlier than 60 days before the contribution and no later than the due date of the tax return.[20] The qualified appraiser must sign and date the appraisal, and the appraiser must not have received a prohibited appraisal fee, which is a fee based on a percentage of the appraised value of the property.[21]

Technically, the absence of any of the requirements can cause the appraisal to not be a qualified appraisal. The requirements specifically relating to value, however, are the ones that lead to the imposition of appraiser penalties.

Section 6695A Penalties

Section 6695A is directly applicable to appraisers. This penalty was added by section 1219 of the Pension Protection Act of 2006 (PPA), and applies to all appraisals prepared for returns or submissions filed after 8/17/06. It imposes a penalty against an appraiser if:

"(1) a person prepares an appraisal of the value of property and such person knows, or reasonably should have known, that the appraisal would be used in connection with a return or a claim for refund, and

"(2) the claimed value of the property on a return or claim for refund which is based on such appraisal results in a substantial valuation misstatement ... (within the meaning of section 6662(e)), ... or a gross valuation misstatement (within the meaning of section 6662(h)), with respect to such property."

The penalty amount is the lesser of (1) the greater of 10% of the amount of the underpayment or $1,000, or (2) 125% of the gross income received by the appraiser in exchange for preparing the appraisal.[22] A "substantial valuation misstatement" generally occurs if the claimed value of property is 150% or more of the amount determined to be the correct value. A "gross valuation misstatement" occurs when the claimed value of the property is 200% or more of the correct amount of such value. If the Section 6695A penalty is assessed, the appraiser faces a lengthy administrative procedure before the penalty will be abated.

The Section 6695A penalty will not apply if the appraiser establishes that the value set forth in the appraisal "was more likely than not the proper value."[23] There is some doubt as to the workability of this relief provision. If the determined value is so far removed from the appraised value that the penalty has been asserted, how could the appraised value be "more likely than not" the proper value?[24]

The court stated it had never applied the substantial compliance doctrine in the absence of a qualified appraisal.

Section 6701 Penalties

Section 6701 imposes a penalty of $1,000 on any person "(1) who aids or assists in, procures, or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim, or other document, (2) who knows (or has reason to believe) that such portion will be used in connection with any material matter arising under the internal revenue laws, and (3) who knows that such portion (if so used) would result in an understatement of the liability for tax of another person."

In the context of appraisers, the first two requirements are typically satisfied. The appraisal is a "document" prepared by the appraiser, and because the appraiser must fill out the appraisal summary on the Form 8283 filed by the donor, the appraiser knows that the client will use the appraisal in connection with the valuation of a charitable gift, which is a material matter. Therefore, the element to be proved is in the third requirement, which is that the appraiser knows that such portion (if so used) would result in an understatement of the tax liability of another person.

The appraiser has many avenues to challenge the Section 6701 penalty, and CCA 200512016 elaborates on these avenues. Like the Section 6695A penalty, the appraiser has post-assessment Appeals rights. Unlike the Section 6695A penalty, however, Appeals rights are post-payment rights.

To successfully challenge the assessed Section 6701 penalty, the appraiser must show that there was a reasonable basis for the valuation. This is a more workable standard than the relief provision of Section 6695A(c). *Internal Revenue Manual* 20.1.6.13.1(3) (09-17-2010) explains as follows:

"A tax advisor would not be subject to this penalty for suggesting to a client an aggressive but supportable filing position even though that position was later rejected by the courts and even though the client was subjected to the substantial understatement penalty. However, if the advisor suggested a position which he or she knew could not be supported on any reasonable basis under the law, the penalty would apply."

Consequences of the Appraiser Penalties

Appraisers are subject to oversight by the IRS Office of Professional Responsibility (OPR), which administers and enforces the Regulations governing practice before the IRS.

Practice Notes

If a practitioner determines an appraisal is deficient in material respects, the practitioner should not use the appraisal as an expert witness report at trial. Although the practitioner cannot retroactively cure a "qualified appraisal" problem, she can prevent a *Daubert* challenge by obtaining a new or substantially revised report.

These governing Regulations are found in title 31 of the Code of Federal Regulations, part 10, and are published as Circular 230.[25]

Circular 230 authorizes OPR to disqualify appraisers who provide supporting valuations for internal revenue matters. As explained in CCA 200512016, "[i]n 1985, the Service amended Circular 230 to conform to legislative changes requiring the disqualification of an appraiser who is assessed a penalty under section 6701 of the Internal Revenue Code for aiding and abetting the understatement of a tax liability."

Section 10.60(b) of Circular 230 provides that "the Director of the Office of Professional Responsibility may reprimand ... [or] institute a proceeding for disqualification of the appraiser" if the Director is advised or becomes aware that a Section 6701 penalty has been assessed against the appraiser. Whether or not such a proceeding is instituted, the Director may confer with the appraiser concerning allegations of misconduct.[26] The Director may institute proceedings to suspend the appraiser for a certain period.[27] Whether disqualification or suspension is sought, an administrative law

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19 Sections 6662(d), (e), and (h).

20 Regs. 1.170A-13(c)(3)(i) and (c)(3)(iv)(B).

21 Reg. 1.170A-13(c)(6)(i).

22 Section 6695A(b).

23 Section 6695A(c). Unlike a Section 6701 penalty, the Section 6695A penalty does not require that the appraiser have knowledge of any resulting understatement of tax.

24 This task becomes even more difficult if a taxpayer were to settle a case at the administrative level, accepting a value that would indicate a valuation misstatement. Such a decision might become evidence against an appraiser even if the taxpayer settled on grounds unrelated to valuation, e.g., technical issues or the desire to avoid litigation costs.

25 See generally Lipton, "New Circular 230 Guidance Is Broad—and May Prove to Be Controversial," page 61, this issue.

26 Circular 230, section 10.61.

27 *Id.*, section 10.62.

judge presides over the proceeding,[28] and (yielding a small sigh of relief for the appraiser) the Director must prove any fact that is necessary for a finding of disqualification against an appraiser by clear and convincing evidence in the record.[29]

If the ALJ decides in favor of the Director and thus suspends or disqualifies the appraiser, the Director also will give notice to the proper authorities of the state in which the suspended or disqualified person was licensed to practice.[30] Thus, the appraiser faces potential suspension by the appropriate state board of appraisers. The appraiser may petition the OPR for reinstatement after the expiration of five years following disqualification, and such reinstatement is at the discretion of the Director of OPR.[31]

Given the Circular 230 procedures and rules governing appraiser suspension and disqualification, the imposition or assessment of a penalty against an appraiser does not, by itself, affect the appraiser's ability to prepare an appraisal for use in connection with the filing of a tax return. The Director of OPR must file a complaint and pursue formal administrative proceedings against the appraiser before disqualification occurs.

If an appraiser is disqualified, the appraiser is barred from presenting evidence or testimony in any administrative proceeding before Treasury or the IRS, unless and until authorized to do so by the Director, regardless of whether the evidence or testimony would pertain to an appraisal made prior to or after the effective date of disqualification. Furthermore, any appraisal made by a disqualified appraiser after the effective date of disqualification will not have any probative effect in any administrative proceeding before Treasury or the IRS. An appraisal otherwise barred from consideration pursuant to these provisions may be used solely for the purpose of determining the taxpayer's reliance in good faith on such appraisal.

Because the disqualified appraiser cannot present evidence or testimony in any administrative proceeding before the IRS, *regardless of whether the appraisal was performed before or after the effective date of the disqualification*, reliance on the appraisal by a taxpayer to establish value is effectively barred at that level.

No Tax Court Rule explicitly bars an appraiser from testifying at trial as an expert as a consequence of being suspended or disbarred from appearing before the IRS. It can be safely assumed, however, that a suspension or disqualification would heavily affect the appraiser's usefulness as an expert.

CONCLUSION

So where are we heading? The IRS appears to improvise new ways to attack qualified conservation contributions in rapid succession. First, conservation purpose and other technical requirements of the Regulations were the focus of the attack. Next, the Service particularly focused on the claimed value of the conservation easement.[32] In addition to continuing to allege these failings, as well as contending in general that appraisals are not qualified appraisals, the IRS has fine-tuned its attack by focusing on the requirements of an appraiser conducting an appropriate valuation methodology. Taking it to the next level, the IRS is employing this attack to get appraisals and appraiser testimony excluded at trial under *Daubert*.

As empirical evidence shows, and with the recent IRS victory in *Boltar*, it appears that the use of *Daubert* to exclude appraiser testimony in Tax Court will become more commonplace in valuation cases generally. Nevertheless, we must keep in mind that a *Daubert* challenge works both ways. It can be used to disqualify IRS experts, too.

Practitioners have only recently seen the use of the "new" Section 6695A appraiser penalties. Defending against these penalties may prove to be extremely difficult, given the circular "relief" standard embodied in the statute. As with other valuation issues, defenses against these penalties will develop over time. ■

NOTES

28 *Id.*, section 10.72.
29 *Id.*, section 10.76.
30 *Id.*
31 *Id.*, section 10.81.
32 See Levitt et al., *supra* note 9.

TAX COURT ANALYSIS OF LAND CONSERVATION EASEMENT VALUES - DEVELOPMENTS SINCE KIVA DUNES

Taxation of Exempts, May/June 2011

By: Ronald A. Levitt, David M. Wooldridge, Gregory P. Rhondes and Nathan Vinson

TAX COURT ANALYSIS OF LAND CONSERVATION EASEMENT VALUES —DEVELOPMENTS SINCE *KIVA DUNES*

RONALD A. LEVITT, DAVID M. WOOLDRIDGE, GREGORY P. RHODES, AND NATHAN VINSON

On 6/22/09, the Tax Court issued its opinion in *Kiva Dunes Conservation, LLC,* TCM 2009-145, which addressed an issue that has been hotly debated among the conservation easement community—whether or not a conservation easement can be granted on golf course property. In its decision, the court also addressed several other important issues, including valuation methods applicable to conservation easements.[1] The decision is a valuable guide for taxpayers seeking to make conservation easement contributions. The Tax Court also decided *Hughes*, TCM 2009-94, which solely concerned valuation of the subject conservation easement, at about the same time it decided *Kiva Dunes*. In recent developments, the Tax Court decided *Trout Ranch, LLC* TCM 2010-283, on 12/27/10. The central theme of that case was again valuation methods and deriving a fair market value of the easement. *Kiva Dunes*, *Hughes*, and *Trout Ranch* all exemplify the Tax Court's current approach to valuing conservation easements.

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Kiva Dunes

Kiva Dunes involved a taxpayer's gift of a conservation easement over certain property (which included a golf course) to an eligible land trust. The taxpayer in the case was a limited liability company (LLC) taxed as a partnership for federal income tax purposes. On 12/31/02, the taxpayer donated the conservation easement to the North American Land Trust (NALT) by a grant (the easement declarations). The conservation easement was granted on 140.9 acres (the property), which was located on the Ft. Morgan Peninsula in Baldwin County, Alabama.

The Ft. Morgan Peninsula is 22 miles long and ranges between 1.2 and 3.1 miles wide. The property lies between, but does not abut, the Gulf of Mexico on the south, and Mobile Bay and Bon Secour Bay on the north. The tract's widest dimension from east to west is approximately 3,600 feet, and its widest dimension from north to south is approximately 2,300 feet.

The conservation easement is located between two nearby segments of the Bon Secour National Wildlife Refuge (approximately 0.85 miles west/northwest of the easement, and approximately 1.55 miles east of the easement). The property includes the Kiva Dunes Golf

The IRS is likely to challenge the value of a conservation easement, primarily because of the inherently subjective nature of the determination of value.

Course. As discussed below, however, it has many unique attributes that made it well suited for a conservation easement.

The easement declarations restrict development of the property, the practical effect of which was to limit the use of the property to a golf course, a park, or a low-density agricultural enterprise. Specifically, the easement declarations limit the use of the property to protect relatively natural habitats for fish, wildlife, and plants, and to preserve open space for scenic enjoyment of the general public and for the advancement of governmental conservation policies. The easement declarations also preserve land areas for outdoor recreational use by the general public.

The LLC claimed two charitable contribution deductions on its partnership return for the tax year. One was a deduction for a $35,000 cash contribution to NALT.[2] The other was for the qualified conservation contribution of a conservation easement on the property to NALT in the amount of $30,588,235.

Summary of trial. The case was tried before Judge Thomas B. Wells. The week-long trial brought forth evidence including 103 exhibits, testimony of 18 witnesses, and numerous charts, photographs and videography.

At trial, the taxpayer first had the burden of proving that the conservation easement met one or more of the conservation purposes necessary for a deduction of a qualified conservation contribution. Specifically, the taxpayer had to establish that the easement accomplished one of the following purposes: preservation of land areas for outdoor recreation by, or for the education of, the general public; protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; or preservation of open space, either for the scenic enjoyment of the general public or pursuant to a clearly delineated federal, state, or local governmental conservation policy.[3]

Next, the taxpayer had the burden of establishing the value of the conservation easement. Specifically, the taxpayer attempted to substantiate that the value of the property before imposition of the conservation easement (the "before value") was $31,938,985, and that the value of the property after imposition of the easement (the "after value") was $1,050,750.

The court issued an opinion highly favorable to the taxpayer and to the use of conservation easements generally. Specifically, the court found that the taxpayer was entitled to a charitable deduction of $28,656,004, which was 94% of the deduction the taxpayer claimed on its income tax return. The valuation methods and variables taken into account by the taxpayer's appraiser and the IRS appraiser were critical to the court's determination of value.

Key issue—valuation. After the IRS conceded that a conservation purpose existed, the primary issue remaining was the fair market value of the easement. The experts agreed that the value was equal to the difference between the fair market value of the property before and after the easement was granted, reduced by the increase in the enhancement in value of other nearby property owned by the taxpayer or a related party as a result of granting the easement.

The "before value" of the property was based on its potential highest and best use as a residential development. To derive the before value, both experts used a discounted-cash-flow analysis of estimated revenues and costs associated with development and sale of lots in hypothetical subdivisions—the so-called "subdivision method."[4] The two appraisers' assumptions differed significantly, however, regarding the number of lots available for sale, average sale price of the lots, and rate at which the lots would sell.

The taxpayer's expert determination that 370 lots could be developed for sale (as opposed to the 300 lots projected by the Service's expert) was in accordance with the testimony of the county zoning director. Ultimately, the court ruled that the Service's expert misinterpreted the local zoning regulations when he concluded that only 300 lots could be built. The court accepted the feasibility of 370 lots.

The court also accepted the taxpayer's expert's average lot price of $170,000. The Service's expert's estimate of $85,000 per lot was based essentially on the value of two of the least desirable interior lots of an adjoining subdivision; they had

[1] The issue of sufficient "conservation purpose" was also extensively tried in *Kiva Dunes*. However, after two days of trial time and initial briefing, the IRS conceded that the conservation purpose existed.

[2] The IRS did not contest the cash contribution. In recent façade easement cases and some open space easement examinations, however, the IRS has challenged cash contributions as constituting improper quid pro quo for the acceptance of the easement by the land trust. See Scheidelman, TCM 2010-151; Kaufman, 134 TC No. 9 (2010).

[3] The IRS conceded that the taxpayer met the conservation purpose requirement after two days of trial time, the testimony of five biologists, and initial briefing.

[4] The original IRS engineer's valuation report that was relied upon in issuing the statutory notice of deficiency also used the subdivision method.

no gulf or lake view and were far removed from the amenities. The taxpayer's expert assumed a sales "absorption rate" (see below) of 37 lots per year, which was also accepted over the estimate of 20 lots per year by the Service's expert.

The parties agreed, for purposes of determining the value of the property after it was encumbered by the easement, that the property's highest and best use was its continued operation as a golf course. The Service's expert used an income approach to determine this value, while the taxpayer's expert determined the after value by analyzing sales of comparable but unimproved properties that were purchased for recreational uses. The court rejected the income approach valuation used by the Service's expert because he failed to take into account significant expenses of operating a golf course—such as salaries and wages, employee benefits, repairs and maintenance, taxes, licenses, and replacement reserves—in calculating the net income from the course.

The court accepted the "after value" determined by the taxpayer's expert through the comparable sales method. This aspect of the court's decision was significant because the IRS had argued that the taxpayer's comparables, which had different characteristics and uses from those of the subject property as encumbered by the easement (i.e., as a golf course), were improperly used. The court, however, accepted the use of the comparables, with the exception of an upward adjustment made to the value of the comparables reflecting the expense that would have been necessary to convert the unimproved land into comparable golf course property. The taxpayer argued that adding the cost of such improvements was inappropriate unless supported by sufficient net income from the golf course.[5]

Valuation—The battle of the experts. If a taxpayer can establish that it has made a "qualified contribution" to a "qualified donee" for a permissible "conservation purpose," and that all of the technicalities regarding the contribution are satisfied, the last and final issue is the value of the easement. The value of a conservation easement is a key issue the IRS is likely to challenge, primarily because of the inherently subjective nature of the determination of value. No matter how well taxpayers document their contribution, the issue of value will always be in play for the IRS.

As one might expect, and as was the case in the *Kiva Dunes,* the valuation of a conservation easement will evolve into a "battle of the appraisers." In such a situation, it is important that the taxpayer's appraiser support the appraisal conclusions with knowledgeable and persuasive analysis, as well as detailed fact-finding.

Kiva Dunes demonstrates that a taxpayer's selection of a qualified and experienced appraiser will likely be critical to withstanding an IRS challenge to the value of the conservation easement. It is helpful to hire an appraiser with experience in valuing charitable contributions because such appraisers are more likely to have knowledge about the various appraisal and appraiser requirements. Moreover, *Kiva Dunes* provides a good illustration that although an appraiser's technical education and licenses are quite important, it is equally important, if not more so, that the appraiser have extensive knowledge of the actual geographic area and real estate market being appraised. Indeed, in *Kiva Dunes* the Tax Court seemed as impressed with the taxpayer's expert's knowledge of the local area as with his technical certifications.

Fair market value. The amount of a charitable contribution is determined by the fair market value of the contributed property at the time it is contributed.[6] When there is a substantial record of sales of easements comparable to a donated easement, those comparables are used to determine the fair market value of the easement.[7] When no such comparables exist, as in *Kiva Dunes*, the fair market value of a conservation easement is determined with the "before and after" methodology prescribed in the regulations.[8] Specifically, Reg. 1.170A-14(h)(3)(i) provides as follows:

[5] No one would pay for golf course property or build course improvements if the course would not make money. Golf course property has steadily declined in profit potential over recent years. Dozens of courses closed as a result of urban sprawl, when the land became more valuable for development. See Wexler, "The Missing Links: America's Greatest Lost Golf Courses and Holes" (Wiley, 2000).

[6] Additionally, Section 170(e)(1) requires a donor to reduce the amount of his or her charitable deduction in appreciated property by the amount of gain that would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (i.e., the amount of the donor's deduction will be limited to his or her basis in the contributed property). Section 170(e)(1) applies to conservation easements if the property on which the easement is granted is "dealer property" in the hands of the contributor or has not been owned by the taxpayer for the applicable holding period (currently one year). Accordingly, it is important that a taxpayer verify the date of the original acquisition of the property, and that the acquisition was properly recorded.

[7] See Reg. 1.170A-14(h)(3)(i).

[8] Although the Tax Court prefers a "comparable sales" method of appraisal and the use of comparables when they are available, comparables are often unavailable for the easements because the market, if any, for such easements is usually thin. See Kayser, "Conservation Easements: The Blues of Before-and-After Valuation," 2 Valuation Strat. 14 (Sep/Oct 1998).

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 fair market value of a perpetual conservation restriction is equal to the difference between the fair market value of the property it encumbers before the granting of the restriction and the fair market value of the encumbered property after the granting of the restriction.

When applying the before and after methodology, all property contiguous to the encumbered property that is owned by the taxpayer or the taxpayer's family must be taken into account in the valuation.[9] This has the effect of reducing the value of the deduction to the extent that the value of any contiguous property is enhanced by the easement. Additionally, any economic benefit that accrues to the donor or related party as a result of the contribution must be taken into account.[10] These rules could conceivably have a substantial effect on the deduction when the donor or a related party has retained a significant amount of property surrounding a golf course easement if such property appreciates in value as a result of the easement.

Fair market value in *Kiva Dunes*. In *Kiva Dunes*, the experts' opinions of the before value, after value, and enhancement involved critical, subjective judgments and assumptions. The taxpayer presented evidence at trial and on brief that its expert was the most experienced and respected appraiser in the region surrounding the property, and that his judgments and assumptions reflected this experience. As evidenced by its opinion, the court generally agreed with the taxpayer's expert. Specifically, the court stated that the expert "performs more appraisal work in Baldwin County than any other appraiser, and he has a great depth of knowledge of the comparable properties used in valuing the easement and of the surrounding local real estate market."[11] In contrast the court stated the Service's expert had "no particular expertise in Baldwin County, and he [had] been to the Baldwin County, Alabama, area only twice in connection with his appraisal of the easement."

Before value. Both appraisers agreed that the development of a residential subdivision would have been the highest and best use of the property at the time of the contribution. In its opinion, the court focused on the differences in three key assumptions made by the experts[12] that led to the drastic difference in their before value conclusions—$31,938,985 versus $10,018,000.

1. *Number of lots for sale.* The taxpayer's expert determined that 370 lots could be developed in the hypothetical Kiva Dunes subdivision. The Service's expert determined that only 300 lots could be developed, based in part on his misinterpretation of a county zoning regulation. The planning and zoning director of the zoning board testified and confirmed the taxpayer's interpretation of the regulation.
2. *Average sale price of the lots.* The taxpayer's appraiser determined that the initial sales price of lots in his hypothetical subdivision would average $170,000, while the Service's expert determined that the lot price would have been only $85,000. The court agreed with the taxpayer's expert and noted that the Service's expert arrived at the $85,000 value by "averaging the 2001 sales prices of just two interior lots sold at the [adjacent] Kiva Dunes subdivision." The court's acceptance of the taxpayer's conclusions highlights the importance of a sound conceptual plan (often called a "yield plan") supporting a subdivision analysis. The court noted that the conceptual plan used by the taxpayer's expert proposed enlargement of several lakes, and creation of several pool and recreation areas on the property—all of which significantly increased the lot value. The taxpayer also overcame IRS arguments that the yield plan would not pass muster with the wetland and other regulatory requirements.
3. *Absorption rate.* The parties in Kiva Dunes differed on the time it would take to sell out the hypothetical subdivision—i.e., the period over which cash flow was projected to be received (the "absorption rate"). The court relied on the taxpayer's expert's local experience and specific examples of actual nearby subdivisions. The court adopted the taxpayer's absorption rate of 37 lots per year for ten years, noting: "Considering that the proposed plan would have had more than three times as many lots available for purchase as [a nearby subdivision], we conclude that a sales forecast of 37 lots per year is reasonable."

Ultimately, the court adopted the taxpayer's before value of $31,938,985. One lesson from the court's value analysis is that value is based on the highest and best use of the property on the date of the donation, and that the highest and best use is not necessarily the current use. Although the property was being used as a golf course, the Kiva Dunes course, like many golf courses around the country, was making little or no profit and its continued operation was not assured. Golf courses are frequently redeveloped for commercial or residential use, when their value as a golf course becomes less than the value for other uses.

After value. The experts agreed that the highest and best use of the property after being burdened by the easement was its continued operation as a golf course. Little else could be done on the property to generate income. The taxpayer's expert used comparable properties to reach an after value, and the Service's expert used an income capitalization approach, an approach that was ultimately determined by the court to be flawed. The court rejected the income approach because the Service's expert had omitted essential categories of expenses that "when subtracted from [the Service's expert's computation of] 2002 net income, result in a negative number." These omitted expenses included: (1) salaries and wages, (2) employee benefits, (3) repairs and maintenance, and (4) taxes and licenses.[13]

The court ultimately relied on the taxpayer's comparables approach. Even though the comparable properties used by the taxpayer's expert were not developed as golf courses at the time, the court determined that they were potentially suitable for such a use. The taxpayer's expert adjusted the sales prices of his comparables to reflect differences in market conditions, location value, access and visibility, size, availability of utilities, topographical and wetland characteristics, and financing terms. The court made its only significant adjustment to the taxpayer's expert's value by adjusting the after value upwards to reflect the cost associated with converting the comparable properties into golf course properties akin to the Kiva Dunes property. Ultimately, the court concluded that the after value of the Kiva Dunes golf course was $2,982,981 ($1,070,980 comparable value plus $1,912,001 for the cost of the golf course improvements).[14]

The court also accepted the taxpayer's expert's conclusion that the conservation easement had enhanced nearby property owned by the taxpayer by $300,000. In the end, the court concluded that the fair market value of the conservation easement was $28,656,004. This holding constituted an unusually high percentage of claimed value (approximately 94%). It is noteworthy that the IRS had asserted a gross overvaluation penalty of 40%, which the court found to be inapplicable because the taxpayer's value was substantially correct.

The taxpayer's success in *Kiva Dunes* demonstrates that, especially in the context of conservation easements, a thorough and knowledgeable appraisal expert can make all of the difference. It is important that the appraiser, in addition to being well-qualified and knowledgeable, spend the time necessary to investigate, examine, and understand the property being valued and particularly its highest and best uses before and after the easement. When using a hypothetical subdivision analysis, an appraiser should pay particular attention to every detail of his or her proposed hypothetical subdivision, including whether or not the zoning and other restrictions (wetlands and endangered species regulation, engineering feasibility, setback lines, etc.) to which the encumbered property is subject would prevent (or increase the costs of) developing the hypothetical subdivision.

The subdivision method—blessed by the Tax Court

There are only a few sanctioned valuation methodologies. As provided above, the regulations direct the taxpayer to use nearby comparable easement sales to derive a fair market value of the subject easement if possible. In the absence of such sales, which is very common, the taxpayer is directed to subtract the value of the property encumbered by the easement from the value of the property before encumbrance by the easement.

[9] Reg. 1.170A-14(h)(3)(i). This can also lead to computational uncertainties, especially when gifts are made from the same tract over several years. Consideration of contiguous property, although required in the regulations, often has no real purpose or effect on the value. In most cases, it results in adding and subtracting the same value for the contiguous property. In such cases, failure to account for contiguous property might be considered "substantial compliance" with the rules.

[10] *Id*.

[11] One commentator referred to Mr. Clark as the "Michael Jackson" of the case because of his "star" power in persuading the court. Wood, "Conservation Easements, Valuation, and Substantiation," 37 Jnl. Real Estate Tax'n 132 (Second Quarter 2010).

[12] The Court concluded that the other variables used by the appraisers had an immaterial effect on the final value amount. This had been suggested in the taxpayer's briefs.

[13] It appears that the IRS expert, like the IRS engineer before him, used the tax return schedule of "other" expenses, which did not include the expenses on specific expense lines on the first page of the return. He disregarded a schedule provided to him before trial detailing the income and expenses of the golf course operations. Although the reason for the error was debated in court, the error evidently harmed the expert's credibility in the case. Oddly, the IRS engineer admitted at trial that he was aware that the schedule omitted key categories of expense, such as compensation.

[14] See note 5, *supra*.

This approach is dubbed the "before and after" method.[15]

The most common approach to the before and after valuation methodology is the "sales comparison approach."[16] Under this approach, the appraiser compiles comparable sales of properties that were in fact developed in a manner that directly relates to the subject property's highest and best use. Using this data, the appraiser derives a before value for the subject property. As the Tax Court rationalized, "This approach is based on the principle that the prudent purchaser would pay no more for a property than the cost of acquiring an existing property with the same utility."[17] The appraiser then compiles sales data of properties that are restricted as to use similar to the subject property to derive an after value. The difference between the before value and after value equals the value of the conservation easement.

Though the sales comparison approach is the most common methodology and often the preferred one, another variation of the before and after valuation approach known as the "subdivision approach" is frequently and appropriately used. The subdivision approach has taken on a variety of labels, including the "discounted cash flow analysis,"[18] the "income approach,"[19] and the "development technique."[20] Regardless of what the parties or a court call it, the subdivision approach entails treating the subject property "as if it were subdivided, developed, and sold. Expected proceeds from sales of the subdivided lots are reduced by development costs and discounted over the period during which the lots are expected to sell."[21]

Though specifically referred to in the regulations, and accepted and explained by the Tax Court as appropriate, the IRS continuously attacks the methodology as being inappropriate, usually asserting that it is too prone to error.[22] The attack generally takes the form of an IRS expert testifying that the subdivision approach is not a reliable method for valuing the subject property.

Interestingly enough, the IRS itself used the subdivision approach to value the property in *Kiva Dunes* and to challenge the petitioner's valuation using the same approach. As discussed above, the Tax Court in *Kiva Dunes* ultimately rejected the Service's expert's value while mostly accepting the petitioner's value. Importantly, the Tax Court did not criticize or reject the use of the subdivision method. Instead, it engaged in a detailed analysis of each expert's assumptions and estimates associated with development of the hypothetical subdivision. The Tax Court's detailed analysis portrays the willingness of the court to delve into the major issues of valuation without simply accepting one side or the other or merely "splitting the difference."

The Tax Court's detailed analysis in *Kiva Dunes* seems to have started a trend in how the court approaches the issue of valuation in land conservation easement cases. Valuation, as opposed to hyper-technical issues,[23] has become center stage in conservation easement cases. This trend continued in the Tax Court's recent opinions in *Hughes* and *Trout Ranch*. Both cases involved donations of land conservation easements in Gunnison County, Colorado and the sole issue for the Tax Court was valuation. Even more so in *Trout Ranch* than in *Hughes*, the Tax Court engaged in a methodical and logical analysis of each major issue considered by the experts concerning valuation. Such analysis was similar to the Tax Court's approach in *Kiva Dunes*. Furthermore, all expert appraisers in *Trout Ranch* employed the subdivision method explicitly blessed by the Tax Court.

Hughes

Nick Hughes purchased two large parcels of property in Gunnison County, Colorado known as Bull Mountain and Sylvester on 10/6/99 and 9/18/00, respectively. Hughes paid $1,535,000 for the Bull Mountain parcel and $671,350 for the Sylvester parcel. Both parcels lie southwest of the intersection of two public roads servicing the area. The 1,950-acre Bull Mountain parcel consisted of "rolling, brush-covered hills with two permanent streams," and abutted a national forest to the west with views of the Ragged Mountains to the north and east. To reach state highways, Hughes had to utilize two access easements acquired by previous owners. The 463.35-acre Sylvester parcel was "an irregular, long, brush-covered ridge" that also had views of the Ragged Mountains to the north and east. The parcel did not have direct access to state highways, and its access easements to such highways mostly overlapped those of Bull Mountain. Both properties had historically been used for cattle ranching and recreational purposes.

On 12/28/00, Hughes granted a conservation easement to both parcels to the Valley Land Conservancy.[24] As a result, Hughes was prohibited in perpetuity from "subdividing the parcels, constructing buildings or other structures except for a single-family residential dwelling on each parcel, and using the parcels for any commercial, residential, or industrial uses not specifically permitted."

Hughes engaged Pamela Sant of Appraisal Associates of Colorado, Inc. to appraise the property for purposes of taking a charitable contribution deduction on his 2000 federal income tax return. She determined that the combined value of the two parcels was $4,100,000 before and $1,000,000 after Hughes granted the easement. Therefore, Hughes took a $3,100,000 charitable deduction on his 2000 individual tax return. On 2/7/06, the Commissioner determined a deficiency disallowing $1,107,625 of the charitable contribution deduction and asserting a $437,153 income tax deficiency. The parties stipulated that the contribution was a qualified conservation contribution and that Hughes was entitled to a charitable contribution deduction. The sole issue before Judge Wherry's Tax Court was valuation.

The *Hughes* court's approach to valuation. Citing the lack of comparable easement sales, the court explained that the "so-called before-and-after approach" is often used to derive the fair market value of conservation easements. With this foundation, the court discussed and analyzed the taxpayer's expert's appraisal[25] and the IRS expert's appraisal, including the qualifications of each appraiser.

Both experts employed the comparable sales approach, which is the most commonly used before and after valuation approach when comparable properties exist. In valuing the Bull Mountain parcel, the taxpayer's expert also employed the subdivision method. However, the court explained that because the expert "stated that he had 'a greater degree of confidence in the direct comparison technique,'"[26] he relied primarily on the comparable sales approach. Furthermore, the court gave no consideration to the expert's subdivision approach because it ultimately found that the highest and best use of Bull Mountain before the grant of the easement was as agricultural and recreational property.

The court concluded that there were "three major issues that divide[d] the experts" with respect to valuing the Bull Mountain parcel.[27] First, relating to the highest and best use of the property before the grant of the easement, the experts did not agree as to the demand for residential property. Second, they did not agree that Bull Mountain's access was improved as a result of Hughes purchasing the Sylvester parcel. Third, relating to before value, the experts did not agree that Hughes purchased Bull Mountain at a discount. Each of these issues is analyzed below along with the court's ultimate disposition of the case.

Bull Mountain (before value). Most of the court's analysis concerned the three major issues described above.

Demand for residential property and highest and best use. The taxpayer's expert concluded that the highest and best use of the Bull Mountain parcel was as a residential subdivision containing 39 parcels of 35 acres or more. Citing local realtors to conclude that demand for residential property in the area was high, he projected that all of the lots could be sold within five years. As the court pointed out, however, the taxpayer's expert acknowledged that there had not been any significant amount of development in the part of Gunnison County that included Bull Mountain. Agreeing with the IRS expert, the court found that there was little or no demand for residential property in the area at the time the conservation easement was granted. Therefore, the court found that the highest and best use of Bull Mountain before the grant of the easement was continued agricultural and recreational use.

Improvement of access to Bull Mountain upon purchase of Sylvester. The taxpayer's expert concluded that as a result of Hughes purchasing the Sylvester parcel, access to Bull Mountain was im-

[15] See Reg. 1.170A-14(h)(3)(i), (ii).
[16] Hughes, TCM 2009-94.
[17] Schwab, TCM 1994-232, 10.
[18] See Kiva Dunes Conservation, TCM 2009-145 at 4.
[19] See Reg. 1.170A-13(c)(3)(ii)(J); Trout Ranch, LLC, TCM 2010-283, at 8; see Schwab, *supra* note 17.
[20] See Estate of McCormick, TCM 1995-371.
[21] Hughes, *supra* note 16 at 7 n.15.
[22] See Schwab, *supra* note 17; see generally Whitehouse Hotel Ltd. Partnership, 131 TC 112 (2008).
[23] See generally Lord, TCM 2010-196 (disallowance of deduction for qualified conservation contribution upheld because of missing "significant" information—e.g., date of appraisal, appraised fair market value of the property, and easement contribution date—which prevented appraisal from being a "qualified appraisal"); see, e.g., Whitehouse Hotel Ltd. Partnership, *supra* note 22 (IRS expert's alleged nonconformance with Uniform Standards of Professional Appraisal Practice (USPAP) did not preclude finding of reliability).

[24] The court did not discuss in depth whether the Valley Land Conservancy was a qualified organization. In footnote 1 of the opinion, however, the court explained that a qualified conservation contribution must be made to a qualified organization. Because the parties agreed that Hughes made a qualified conservation contribution, it follows that Valley Land Conservancy was a qualified donee.
[25] The taxpayer used a different appraiser to prepare expert appraisals for trial purposes.
[26] Hughes, *supra* note 16 at 7 n.15.
[27] *Id*. at 9.

proved, and Bull Mountain more than doubled in value. The expert assumed that the access easements over both parcels could somehow be combined to provide superior access to both parcels. The court was quick to correct the taxpayer's expert, who was not an attorney, explaining that both easements were appurtenant and could only be used to benefit their respective dominant estates despite the fact that Hughes now owned both parcels and access easements. Therefore, the taxpayer's expert's large upward adjustment to value was found to be unwarranted.

The court further concluded that the taxpayer's expert was wrong in valuing both parcels together as one contiguous parcel. The expert apparently believed that combining the access easements over both parcels rendered the parcels contiguous. However, the parties stipulated that the parcels were separate and distinct, and even the conservation easement documents referred to Bull Mountain and Sylvester as "two legally distinct and separately deeded properties."[28]

Evidence of a discounted sales price. The taxpayer's expert suggested that the sales price of Bull Mountain was at a discount due to the financial distress of its seller. The expert relied on the prolonged listing of the property at a higher price before Hughes purchased the property.

The court found no evidence of a discounted sales price for Bull Mountain. The expert admitted that he never spoke with the seller's managing partner regarding financial distress of the seller. The seller's managing partner also testified that the seller was not under any financial distress and had actually rejected three prior offers for parts of Bull Mountain. The seller's real estate agent testified that although the seller's motivation for selling Bull Mountain may have increased after the managing partner moved out of the area, he had no reason to believe that Hughes paid anything but fair market value for the property.

Conclusion as to before value of Bull Mountain. Having rejected most of the taxpayer's expert's assumptions, the court found that the fair market value of Bull Mountain before Hughes granted the conservation easement was $1,710,000. This figure was derived from the actual purchase price of Bull Mountain plus an 11% upward adjustment for appreciation from the time Hughes purchased the property to the time Hughes granted the conservation easement. The court found "that an 11-percent positive adjustment [was] generous but reasonable."[29]

Sylvester (before value). The court did not go into great detail concerning the value of the Sylvester parcel other than finding that the property did not appreciate in value from the time Hughes bought it to the time Hughes granted the conservation easement. The court again found the highest and best use of the Sylvester property before the grant of the easement to be continued agricultural and recreational use. Given that the property did not appreciate in value and its highest and best use did not differ from its historic use, the court concluded that the fair market value of the Sylvester property was the price that Hughes paid for it, or $671,350.

Value of easements. The court determined that the highest and best use of both properties did not change after the conservation easement was granted. The highest and best uses of the properties were as agricultural and recreational use both before and after the easements were granted. The taxpayer's expert concluded that as a result of the easement, the combined diminution in value of Bull Mountain and Sylvester was 70%. On the other hand, the IRS expert concluded that the diminution in value was between zero and 10%.

The court rejected both expert opinions, citing serious flaws in their valuations. The taxpayer's expert had concluded an improper highest and best use of the property before the conservation easement was granted. Therefore, his conclusion as to the value of the easement was disproportionately large. The IRS expert concluded that the grant of the easement had little or no effect on the value of the properties. The court rejected the notion that a prospective purchaser of property would ignore open-space easement restrictions in determining price. In an important finding, the court found that the easement could not reasonably have *no* value.

Though rejecting both experts' opinions as to the value of the conservation easements, the court did not determine a fair market value of its own. Instead, it determined that the correct diminution in value lay somewhere between the expert's opinions of 10% and 70%. However, "because of [the Court's] conclusions with respect to the fair market values of the Bull Mountain and Sylvester parcels, no diminution in that range will lead to a larger deduction than [the Commissioner] has already allowed."[30] Therefore, the entire tax deficiency was upheld.

[28] *Id.* at 11.
[29] *Id.* at 12.

The *Hughes* court's rejection of the 'matrix' approach. Other than the court's methodical dissection of each expert's appraisal, its rejection of the government's "matrix" approach to deriving an after value of property subject to a conservation easement is a key determination to take away from *Hughes*.

The matrix is essentially a compilation of easement-encumbered properties in the state of Colorado that took five IRS employees over one year to assemble. It has been described as "largely a body of factual information with assumptions, analysis, and conclusions reached by the [IRS] concerning the effect of a conservation easement on value."[31] The matrix was used by the IRS to determine the value of an easement-encumbered property by comparing other encumbered properties with similar characteristics as the subject property. It is therefore akin to a statistical approach to determining an after value of easement-encumbered property.

In *Hughes*, the IRS expert actually included the matrix in his report that "incorporated information from 35 easement-encumbered properties and illustrated generally that the amount of diminution caused by an easement changes a property's highest and best use."[32] In other words, the IRS expert asserted that the after value of the subject property was directly determinable by referencing other properties that did not experience a change in highest and best use.

The court rejected the use of the matrix to determine an after value of the two properties. It concluded that because the matrix "included general information that did not have a specific connection to the Bull Mountain and Sylvester parcels, we afforded it little weight in our analysis."[33] The court therefore confirmed that valuation of property in conservation easement cases is to be performed on a case-by-case basis using specific factual data related to the subject property instead of a generalized "one size fits all" approach or generalized statistical data. This detailed and specific approach to valuation taken by the Tax Court is evidenced by the court's decision in *Trout Ranch*.

Trout Ranch

Trout Ranch, LLC (the "partnership") was formed in October 2002 as a Colorado limited liability company and elected to be taxed as a partnership for federal tax purposes. As a result of purchasing property and entering into land trades with neighboring property owners, the partnership owned 457 acres of land in Gunnison County, Colorado. The property abuts several thousand acres to the east managed by the U.S. Bureau of Land Management. Rural residential tracts between two and ten acres occupy the west and north boundaries of the property, and large residential tracts of 35 acres or more are to the south of the property. The partnership planned to develop a residential subdivision called Gunnison Riverbanks Ranch on 453 acres of the property.[34] Gunnison Riverbanks Ranch was planned to include a minimum of 20 lots and exclusive amenities, including a clubhouse, a guest house, fishing, a riding arena and stable, ponds, a boathouse, duck blinds, and an archery range. The court referred to the ranch as a "shared ranch" as opposed to residential subdivisions without such amenities.[35]

Gunnison County has no zoning, and the county Land Use Resolution governs land development and subdivision. At the time the partnership planned to develop Gunnison Riverbanks Ranch, there were two pertinent development regulations: the Large Parcel Incentive Program (LPIP) and the Major Impact Project Process. These two regulations essentially allow a developer to subdivide land into more lots, based on the percentage of land the developer preserves for open space or other conservation purposes. In April 2003, the partnership filed a Land Use Change Permit Application under LPIP proposing to preserve 85% of Gunnison Riverbanks Ranch. Pursuant to the proposal, the partnership could create 21 residential lots and a lot for a clubhouse. The land use commission visited the property in May 2003 and held a public hearing concerning the proposed land use change in July 2003.

In December 2003, the partnership donated a conservation easement to the Crested Butte Land Trust encumbering 384 acres of Gunnison Riverbanks Ranch. The partnership then entered into a Land Conservation Covenant with Gunnison County encumbering an additional

[30] *Id.* at 16.
[31] See RCL Properties, Inc., 102 AFTR2d 2008-7302 (DC Col.) (quoting plaintiff's reply to government's response to motion to compel).
[32] Hughes, *supra* note 16 at 14.
[33] *Id.* at 15 n.30.
[34] The partnership granted an easement to the Colorado Department of Transportation (CDOT) covering one acre of the property. Subsequently, the CDOT granted the partnership a State Highway Access Permit over four acres of the property. Therefore, out of the 457 acres owned by the partnership, 453 acres were planned for residential development.
[35] Trout Ranch, LLC, *supra* note 19 at 2.

four acres. In total, the conservation easement and the Land Conservation Covenant covered just over 85% of Gunnison Riverbanks Ranch. The partnership reserved the right to subdivide the remaining unencumbered 66 acres into 22 lots, including 21 residential lots and a lot for a clubhouse. The residential lots consisted of three acres each and included land that the conservation easement encumbered. The conservation easement allowed the construction of three open horse shelters, three duck blinds, two corrals, three ponds with docks, a tent platform, and a skeet trap wobble deck. In February 2004, the partnership submitted its final plan for development of Gunnison Riverbanks Ranch, and the land use commission approved the plan in April 2004.

The partnership claimed a charitable contribution deduction of $2,179,849 for the contribution of the conservation easement on its 2003 return. In 2008, the IRS issued a notice to the partnership disallowing $1,694,849 of the claimed deduction, only allowing $485,000. Before trial, the Tax Court allowed the IRS to amend its answer to disallow the entire $2,179,849 claimed deduction.

The parties stipulated to several facts, and the IRS conceded that the donation of the conservation easement was a qualified conservation contribution. The only issue before the Tax Court, therefore, was the value of the conservation easement, which the court ultimately concluded was $560,000.

The *Trout Ranch* court's approach to valuation. Judge James S. Halpern presided over the case and wrote the opinion for the Tax Court. In discussing and analyzing the experts' appraisals, Judge Halpern refrained from merely accepting one expert's opinion, averaging the experts' derived values of the easement, or agreeing with the IRS that there was no value. Instead, Judge Halpern methodically and logically analyzed each major issue considered by all the experts and affecting the value of the easement.

The ultimate value of the easement was derived from three appraisals submitted for the court's consideration. The IRS presented two appraisals prepared by two of its experts ("IRS Expert 1" and "IRS Expert 2," respectively) and the taxpayer presented one appraisal prepared by its expert. After addressing the backgrounds and qualifications of the experts, the court analyzed the issues presented in the appraisals in the same order as they were presented by the experts. Below is a summary of some of the major issues affecting valuation and the court's resulting conclusions.

The proper valuation methodology. All three experts used the subdivision approach.[36] The court agreed that this approach was a proper valuation method and "in accordance with the regulations" but did not find any of the experts completely convincing. The court instead chose to conduct its own discounted cash flow analysis to derive the proper value of the easement. In so concluding, the court discussed the common components and structure of the experts' discounted cash flow analyses.

Highest and best use (after value). IRS Expert 1 and Trout Ranch's expert found that the highest and best use of the property after the imposition of the easement was as a shared ranch identical to Gunnison Riverbanks Ranch. IRS Expert 2 differed slightly in opinion and found the highest and best use to be a 22-lot residential subdivision. The IRS experts' after values were both double that of Trout Ranch's expert.

The court discussed each expert's choice of assumptions in constructing their respective discounted cash flow analyses and deriving a present value of the proposed development. If provided by the expert, the court explained each expert's reasoning for choosing each variable. If no explanation was provided, the court inquired as to why. It was evident that explaining assignments of value to various components was crucial to persuading the court. Agreeing with Trout Ranch's expert and IRS Expert 1 as to the highest and best use of the property, the court explained that because IRS Expert 2 "failed to explain exactly why he placed such a low value on the clubhouse, we find that a 21-lot shared ranch was the highest and best use after imposition of the conservation easement."[37]

Comparable properties and data analysis. Because the court agreed that the property's highest and best use was a 21-lot shared ranch, it adopted 21 lots as the optimal number of lots to be developed. Therefore, comparable properties should be shared ranches or very similar to a shared ranch. The court analyzed a group of five ranches proposed as comparable properties by the experts in varying degrees. Gunnison Riverbanks Ranch, the actual development on the subject property, was one of these comparables. The court rejected comparison to three of the five ranches, reasoning that two of the ranches "are complete unknowns" and the other was "completely different" from Gunnison Riverbanks Ranch in lot size, location, and amenities.

The court settled on two ranches as appropriate sources of sales data, including Gunnison Riverbanks Ranch itself. It is interesting that the court found sales at Gunnison Riverbanks Ranch as appropriate data for comparison because Gunnison Riverbanks Ranch was developed on the subject property. The property is to be valued at the time the conservation easement is granted, and subsequent events are not usually deemed appropriate for consideration. Trout Ranch opposed the use of post-valuation data, but the court explained: "The rule that has developed, and which we accept, is that subsequent events are not considered in fixing fair market value, except to the extent that they were reasonably foreseeable at the date of valuation."[38] In keeping with the rule, the court accepted as comparables certain sales at Gunnison Riverbanks Ranch made within one year of the contribution date.

Lot prices assumed by each expert varied widely as well as the sources used to estimate lot prices. The experts used a mix of sales data from surrounding developments to estimate lot prices for the hypothetical subdivision. As indicated above, the court narrowed the comparable sales to those at two shared ranches.

Trout Ranch's expert assumed that the lots in the hypothetical subdivision would sell for considerably less than the estimates of the IRS experts. He abandoned his position in his rebuttal reports, however, stating that the IRS experts' data was more reasonable. The court assumed that Trout Ranch's expert changed his opinion because he assigned the same selling price to the lots in his before value analysis. Trout Ranch's expert also agreed with all other assumptions concerning lot prices made by the IRS experts. The court rejected Trout Ranch's expert's lot price, not only because the expert abandoned his prior position and conceded the other experts' assumptions, but also because the court found his assumption that lot prices would remain the same regardless of the number of lots in a hypothetical subdivision as "implausible."

Both IRS Experts used high-priced lot sales from properties found by the court not to be comparable to Gunnison Riverbanks Ranch. The court did not find much support for the experts' choice of sales data, just as it did not find Trout Ranch's assumptions reasonable. Therefore, analyzing the data for itself, the court derived its own appropriate sales price for the lots. These lot prices were closer to the Service's lot prices, which were much higher than those of Trout Ranch's expert. Even though it could be a coincidence and the court appeared to heavily analyze the data, the lot price decided upon was an average of the three experts' price per lot.

After establishing a lot price, an appropriate "absorption rate" must be established before future income can be discounted to present value. The "absorption rate" is the rate at which the lots in the hypothetical subdivision are estimated to sell over a number of years.[39] For example, more lots may sell in the early years of the development as compared to later years, or vice versa, depending on the area's residential lot inventory and demand.

Again, the experts "broadly disagreed" on the appropriate absorption rate. Trout Ranch's expert and IRS Expert 1 forecasted a more rapid absorption rate, while IRS Expert 2 adopted a "sluggish" rate. Although agreeing with the analysis of Trout Ranch's expert, the court found his absorption rate "slightly aggressive" as suggested by IRS Expert 2. However, Trout Ranch's expert and IRS Expert 1 both justified a rapid absorption rate, so the court adopted the rate used by IRS Expert 1. Here again, thorough justification for choosing an absorption rate was critical. The court completely disregarded the rate forecast by IRS Expert 2 because he "failed to justify his sluggish absorption rate."

After taking into account several project management expenses, selling expenses, and other expenses, the court needed to assign an appropriate discount rate to the net sales proceeds of the lots. Using this rate, the hypothetical future sales proceeds are discounted to present value to reach an after value for the property. Finding some support for the discount rate used by both Trout Ranch's expert and IRS Expert 2, the court adopted that discount rate. The court found "their evidence and their reasons convincing," while IRS Expert 1 "failed to offer much support" for his discount rate.

After embarking on the thorough analysis above, the court found that the after value of the property as encumbered by the conserva-

[36] Trout Ranch's expert submitted a sales comparison analysis in a supplemental report. The court found the approach to be of no help because "none of the other four conservation easements is comparable to the Trout Ranch CE." Trout Ranch, LLC, *supra* note 19 at 5.

[37] Trout Ranch, LLC, *supra* note 19 at 10.

[38] Trout Ranch, LLC, *supra* note 19 at 12 (citations omitted).

[39] See Kiva Dunes Conservation, *supra* note 18 at 10; Hughes, *supra* note 16 at 6.

tion easement was $3.89 million. This figure is far from a simple average of the experts' after values of approximately $4.5 million and exemplifies the Tax Court's willingness to analyze and scrutinize conservation easement valuations objectively and independently

Before value. The court's analysis of the before value of the property was very similar to its after value analysis. The number of lots that could possibly be developed (the "yield") was the only major difference (40 lots before as compared to 21 lots after). Trout Ranch's expert and IRS Expert 2 both assumed that a 40-lot subdivision was the highest and best use of the property before being encumbered by the easement. The court agreed with the experts, but adopted the subdivision "configuration" assumed by IRS Expert 2. It found Trout Ranch's expert's configuration unreasonable with respect to lot sizes and in light of Gunnison County land use regulations. To divide the land into 40 lots, as proposed by Trout Ranch's expert, a developer would have had to apply under special rules, which only required the developer to preserve 50% of the land. Given access to 50% of the land, the court found the decision of Trout Ranch's expert to concentrate all the lots on the river (with resulting higher values) to be unreasonable. Trout Ranch's expert "failed to explain why a developer would have restricted itself to between 15 to 20 percent of the land when as much as 50 percent of the land was available."[40]

While briefer than its after value analysis, the court's before value analysis was no less thorough. The ultimate before value found was $4.45 million, which was slightly more than the average of Trout Ranch's expert's before value and the before value reached by IRS Expert 2. Note that the court did not discuss the before value derived by IRS Expert 1 because such value was less than his after value, making the conservation easement value negative. IRS Expert 1 also did not employ the subdivision method to derive a before value. These considerations apparently did not impress the court.

Subtracting the after value of the property from the before value of the property, the court concluded that the conservation easement was worth $560,000. While this figure is much closer to the Service's first determination of value, it is the court's analysis of the data that is important.

Conclusion

Beyond the Tax Court's obvious blessing of the subdivision approach, *Trout Ranch* exemplifies the Tax Court's current approach to analyzing land conservation easement valuation. Like *Kiva Dunes*, *Trout Ranch* provides valuable guidance for potential donors, tax advisors, appraisers, or recipients of such easements.

Trout Ranch and *Hughes*, together with *Kiva Dunes*, point to the future of valuation in land conservation easement cases—a fair, analytical, and objective approach to valuation. Older cases involved IRS challenges based on the technical requirements of the regulations. Even though valuation was a large part of the *Kiva Dunes* opinion, the IRS initially challenged technical regulatory requirements (and conceded conservation purpose after trial). In both *Trout Ranch* and *Hughes*, which were decided close in time to *Kiva Dunes*, the IRS stipulated that the contribution was a qualified conservation contribution before trial. These cases show that the serious controversy may be over valuation of the conservation easements and not hyper-technical requirements of the regulations. Referring back to *Kiva Dunes*, however, it is very important that these technical requirements are followed. Otherwise, the fight *can* be over a hyper-technical requirement that should have been resolved through careful implementation of the easement at the front end.[41]

[40] Trout Ranch, LLC , *supra* note 19 at 17.

[41] A detailed discussion of such technical requirements can be found in Wooldridge, Levitt and Rhodes, "Kiva Dunes—Making and Substantiating the Value of Conservation Easements,: 111 J. Tax'n 300 (Nov. 2009); Wooldridge, Levitt and Rhodes, "Simmons—Substantial Compliance Revisited, Tax Notes, 1/25/10, p. 474.

SIMMONS - SUBSTANTIAL COMPLIANCE REVISITED

Tax Notes, January 25, 2010

By: David M. Wooldridge, Ronald A. Levitt, and Gregory P. Rhodes

Simmons — Substantial Compliance Revisited

By David Wooldridge, Ronald Levitt, and Gregory P. Rhodes

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This article analyzes, in light of the Tax Court's recent holding in *Simmons v. Commissioner*, the state of the substantial compliance doctrine (the doctrine that the regulations are directory and not mandatory) as it applies to specific issues relating to conservation easement contributions.

Congress has, over the decades, unambiguously expressed its desire to promote the preservation of valuable land areas and historic structures by creating tax incentives for conservation easements. The framework for conservation incentives was enacted by Congress in the Tax Treatment Extension Act of 1980,[1] which created section 170(h). In the act, Congress recognized what it stated was the important role that conservation easements play in the preservation of the country's natural resources and cultural heritage.[2]

In accordance with Congress's instructions, Treasury has issued a broad set of regulations to implement section 170(h). The regulations cover everything from establishing the criteria for determining a "conservation purpose" to the documentation a taxpayer must provide to deduct the value of a conservation easement. Also, the regulations provide guidance on establishing the value of a conservation easement, the types of organizations that are qualified to accept conservation easements, and the characteristics and time period requirements that apply to conservation easement appraisals, as well as a myriad of other technicalities concerning conservation easement contributions.

The regulations provide detailed rules about the type of documentation a donor must receive when contributing a conservation easement[3]; those rules vary depending on the value of a contribution. In general, however, the regulations focus on four major requirements found in the code: (1) the type of "contemporaneous acknowledgement" a donor must receive from the donee of the easement,[4] (2) the type of "qualified appraisal" the donor of the easement must obtain,[5] (3) rules as to who constitutes a "qualified appraiser" of the property,[6] and (4) rules concerning the method of valuing a conservation easement.[7]

The regulations were expressly intended by Congress to provide a basis for which taxpayers could be "secure in their knowledge that a conservation easement will qualify for a deduction."[8] However, because of the IRS's application of the regulations, they have become an often insurmountable obstacle to qualifying for a charitable contribution.

Apparently recognizing that the complexity of the conservation easement regulations frustrates Congress's intention to promote the preservation of the country's natural resources, the courts have in many instances ruled that "substantial compliance" with the regulations will satisfy the requirements for a conservation easement deduction. However, the IRS has consistently maintained that taxpayers are required to strictly comply with the regulations, justifying that position on a dubious interpretation of a couple cases.

This article provides a survey of the decisions pertinent to the substantial compliance doctrine, and how they have shaped the application of the doctrine for conservation easement contributions. The article then turns to the Tax Court's recent decision in *Simmons v. Commissioner*,[9] and analyzes its potential effect on the issue.

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[1]Tax Treatment Extension Act of 1980, section 6. Conservation easement deductions were provided for before 1980 under former section 170(f)(3)(B)(iii) and (iv). *See* Tax Reform Act of 1976, providing a deduction for an easement regarding real property granted in perpetuity made "exclusively for conservation purposes."

[2]*Id.*

[3]Although reg. section 1.170A-14(i) addresses the substantiation requirements particular to conservation contributions, many of the regulations apply to other types of charitable contributions.

[4]*See, e.g.*, reg. section 1.170A-13(g).

[5]*See, e.g.*, reg. section 1.170A-13(c)(3). The Pension Protection Act of 2006 amended section 170(f)(11)(E) to modify the terms "qualified appraiser" and "qualified appraisal." These changes are not reflected in the regulations as of this time, but the Service has provided temporary guidance reflecting the changes in Notice 2006-96, 2006-46 IRB 902, *Doc 2006-21534, 2006 TNT 203-3*. To the extent that Notice 2006-96 contradicts reg. section 1.170A-13(c), the notice governs.

[6]*See, e.g.*, reg. section 1.170A-13(c)(5).

[7]*See, e.g.*, reg. section 1.170A-14(h)(3).

[8]Tax Treatment Extension Act of 1980.

[9]*Simmons v. Commissioner*, T.C. Memo. 2009-208, *Doc 2009-20571, 2009 TNT 177-17*. In *Consolidated Investors Group v. Commissioner*, T.C. Memo. 2009-290, *Doc 2009-27621, 2009 TNT 240-18*, a recently decided case involving a contribution by a taxpayer of a nonconservation easement charitable contribution, the Tax Court cited *Simmons* in support of the substantial compliance doctrine articulated therein as it applies to the charitable contribution regulations. *See infra* note 38.

A. Applicable Law

The code appears in some respects to require that, to obtain a deduction for a charitable contribution of property, a taxpayer must strictly comply with the regulations. The code states:

> There shall be allowed as a deduction any charitable contribution . . . payment of which is made within the taxable year. A charitable contribution shall be allowable as a deduction *only if verified under regulations* prescribed by the Secretary.[10]

In 2004 Congress codified the substantiation requirements, and in section 170(f)(11)(A)(ii)(II) it codified an exception to strict compliance with the substantiation requirements in instances when a taxpayer has "reasonable cause" for noncompliance.[11] The 2004 provisions, including the reasonable cause exception, are applicable to contributions made after June 3, 2004. As the statute is written, the reasonable cause exception applies only to the qualified appraisal and qualified appraiser requirements, and does not facially apply to the other contribution requirements (that is, the contemporaneous acknowledgement and other related requirements).

Despite the seemingly strict language contained in section 170(a) (both before and after the 2004 changes), the courts have generally not required taxpayers to rigidly comply with the regulations to be entitled to a charitable contribution for a conservation easement. The instances in which the courts have found substantial compliance with the regulations have been widespread and have involved taxpayers' noncompliance with several different regulations. Moreover, the courts have applied the substantial compliance doctrine to conservation easement contributions occurring both before and after June 3, 2004.

1. Substantial compliance permissible. Some of the instances in which the courts have not required taxpayers to comply strictly with the regulations are provided below.

2. *Bond v. Commissioner.* The concept of substantial compliance was first fully articulated in the charitable contribution context in *Bond v. Commissioner*.[12]

In *Bond* the Tax Court had to determine whether the failure of a taxpayer to attach a qualified appraisal to his tax return prevented the taxpayer from receiving a charitable deduction for the contribution. The taxpayer in the case had attached an appraisal summary to his income tax return in the year of the contribution. The applicable regulations, however, required a full appraisal compliant with reg. section 1.170A-13 to be attached to the return.

The IRS argued that the taxpayer's failure to attach a qualified appraisal, as required by the regulations, resulted in a disallowance of the taxpayer's deduction. The Tax Court, however, sided with the taxpayer. It stated that, by attaching the appraisal summary, the taxpayer substantially complied with the regulations, and that a deduction should be allowed for the contribution. The Tax Court explained its position as follows:

> Under the above test we must examine section 170 to determine whether the requirements of the regulations are mandatory or directory with respect to its statutory purpose. At the outset, it is apparent that the essence of section 170 is to allow certain taxpayers a charitable deduction for contributions made to certain organizations. It is equally apparent that the reporting requirements of reg. section 1.170A-13, income tax regulations, are helpful to respondent in the processing and auditing of returns on which charitable deductions are claimed. However, the reporting requirements do not relate to the substance or essence of whether or not a charitable contribution was actually made. We conclude, therefore, that the reporting requirements are *directory and not mandatory*.[13]

3. *Daniel v. Commissioner.* In *Daniel v. Commissioner*,[14] the Tax Court confirmed that substantial compliance with the regulations is all that is required in some instances. The Tax Court found that a taxpayer had failed to retain records related to property the taxpayer had contributed to a charity and did not strictly comply with reg. section 1.170A-13(b)(2) and (3). Nonetheless, the Tax Court determined that the taxpayer was entitled to a charitable deduction for the donation:

> We find that petitioners have substantially complied with the substantiation requirements and have made a good faith attempt to provide respondent with sufficient information. We accept [petitioner]'s estimates of the fair market values of the donated items.[15]

Surprisingly, the Tax Court in *Daniel* did not cite *Bond* as support for its holding that the taxpayer substantially complied with the regulations. Rather, the Court seemed to presume that substantial compliance was a well-established, equitable aspect of Tax Court jurisprudence.

4. *Mudd v. Commissioner.* In *Mudd v. Commissioner*,[16] the Tax Court found that a taxpayer substantially complied with the contemporaneous written acknowledgement requirement of section 170(f)(8), even though the taxpayer did not receive an acknowledgement letter that met the requirements of the code section.

In *Mudd* the only acknowledgement that the taxpayer received from the charitable donee regarding the $3,685.64 of property contributions the taxpayer made

[10]Section 170(a) (emphasis added).

[11]*See* American Jobs Creation Act of 2004, section 883, 118 Stat. 1631, which added section 170(f)(11).

[12]100 T.C. 32 (1993).

[13]*Id.* (Emphasis added.)

[14]T.C. Memo. 1997-328, *Doc 97-21379, 97 TNT 140-7*.

[15]*Id. See also Fair v. Commissioner,* T.C. Memo. 1993-377, *Doc 93-9034, 93 TNT 176-11*. (Tax Court addressing substantial compliance in context of reg. section 1.170A-13(b), and determining that the taxpayer substantially complied with regulations because his only omission in reporting pertained to the basis of the contributed property.) In *Fair*, the Tax Court cited *Bond* as authority for its holding.

[16]T.C. Summ. Op. 2004-1, *Doc 2004-450, 2004 TNT 6-15*. Although a summary opinion is not citable as precedent, the case does indicate the attitude of the Tax Court on the issue.

was a letter that stated the charity had received the described items. Although the letter did not fully comply with section 170(f)(8) and the regulations promulgated thereunder, the Tax Court allowed the deduction.[17]

As demonstrated below, before the Tax Court's decision in *Simmons v. Commissioner*, *Mudd* was something of an anomaly, as the Tax Court has been hesitant to find that a failure to comply with the contemporaneous acknowledgement requirement was excusable under a concept of substantial compliance.

5. Substantial compliance not found (*Bond* distinguished). There have been some cases when the courts adopted a more rigid approach to substantiation, thereby disallowing a deduction for charitable contributions when a taxpayer failed to fully comply with the regulations. The rationale for the stricter application of the regulations is generally that full compliance with the substantiation requirements is necessary to accomplish the congressional intent underlying the specified regulations.

6. Contemporaneous written acknowledgement. The courts have been more hesitant to apply the doctrine of substantial compliance in instances dealing with section 170(f)(8), which requires a contemporaneous written acknowledgement of all contributions of more than $250.[18]

The instances in which the Tax Court has disallowed a deduction because of a taxpayer's failure to comply with the contemporaneous written acknowledgement requirement, however, have generally been situations in which the taxpayer completely neglected to receive or produce any type of acknowledgment from a donee. Because no acknowledgement of any kind was received by the taxpayer, the issue of *substantial* compliance was not directly addressed by the Tax Court in those instances (that is, the Tax Court never overruled, and generally did not address, *Bond*).[19]

Moreover, the Tax Court has stated that the legislative history pertaining to the contemporaneous written acknowledgement requirement makes the requirement uniquely critical. In *Weyts v. Commissioner*,[20] the Tax Court noted that the legislative history behind the provision indicates the provision was enacted to prevent "difficult problems of tax administration [that] arise with respect to fundraising techniques in which an organization that is eligible to receive tax deductible contributions provides goods or services in consideration for payments from donors."[21]

7. Qualified appraisal and appraisal summary. The requirement that a taxpayer obtain a qualified appraisal (or in some instances, an appraisal summary) has also been more strictly applied by some courts. For instance, in *Hewitt v. Commissioner*, 109 T.C. 258 (1997), the Tax Court determined that a taxpayer's failure to attach an appraisal to his tax return prevented the taxpayer from receiving a deduction for the contribution. The Tax Court, however, expressly noted that there were multiple noncompliance problems at issue in the case: The taxpayer did not even obtain a qualified appraisal and no summary appraisal was attached to the taxpayer's return as required by reg. section 1.170A-13.

In addressing the taxpayer's argument that, under the precedent of *Bond*, he substantially complied with the regulations, the Tax Court stated:

> [In *Bond*] we concluded that the *reporting* requirements of section 1.170A-13 . . . were directory, not mandatory, and therefore, that these requirements could be met by substantial, rather than strict, compliance. In effect, we held that the appraisal summary itself constituted the required appraisal. In this connection, we note that the appraisal requirements may not be entirely procedural so as to justify the application of the substantial compliance rules under any and all circumstances. We find nothing in *Bond* . . . which relieves petitioners of the requirement of *obtaining a qualified appraisal*. Such a requirement is statutorily imposed by section [170(a)] and its impact is reflected in the legislative history of that provision.[22]

[17]Section 170(f)(8) requires the acknowledgement to be contemporaneous and to provide: a description of the property donated and a statement whether the donee provided any goods or services in exchange for the property contributed (as well as a description of such goods or services, if provided). Reg. section 1.170A-13(f), which was promulgated by the Service under the authority delegated to it in section 170(f)(8)(E), contains additional requirements.

[18]*See, e.g.*, *Hill v. Commissioner*, T.C. Memo. 2004-156, *Doc 2004-13564, 2004 TNT 127-9* (deduction disallowed because no contemporaneous written acknowledgment); *Stussy v. Commissioner*, 86 T.C. Memo. 2003-232, *Doc 2003-18079, 2003 TNT 150-14* (no deduction because taxpayer lacked a contemporary written acknowledgment); *Weyts v. Commissioner*, T.C. Memo. 2003-68, *Doc 2003-6509, 2003 TNT 49-10* (contribution not substantiated by contemporary written acknowledgment); *Whitehurst v. Commissioner*, T.C. Summ. Op. 2003-7, *Doc 2003-2893, 2003 TNT 21-15* (charitable contributions deduction disallowed because lack of acknowledgement of contribution); *Gomez v. Commissioner*; T.C. Summ. Op. 2008-93, *Doc 2008-16748, 2008 TNT 148-13* (stating written acknowledgement dated as of the date of the Tax Court trial did not satisfy the *contemporaneous* acknowledgement requirement in the regulations). Note, however, that *Whitehurst* and *Gomez* are summary opinions, and are cited merely as examples of prior Tax Court decisions.

[19]Although in *Weyts*, the Tax Court did not address the *Bond* decision, it addressed the taxpayer's argument that the Tax Court's decision in *Cohan*, 11 B.T.A. 743 (1928), should apply. *Cohan* can be read generally as a rule regarding substantial compliance because, in that case, the Tax Court held that a taxpayer could receive a deduction for expenses despite being unable to substantiate the deduction items. However, *Cohan* is not generally thought of as a substantial compliance case, and the Tax Court in *Weyts* did not characterize it as such.

[20]T.C. Memo. 2003-68, *supra* note 18.

[21]*Id.* (quoting H. Rept. 103-111, 1993-3 C.B. 167, 361).

[22]*Hewitt v. Commissioner*, 109 T.C. 258, 263-264, *Doc 97-29748, 97 TNT 210-12* (1997) (citations omitted) (emphasis added). The Tax Court decision was appealed and confirmed by the Court of

(Footnote continued on next page.)

In *Smith v. Commissioner*,[23] the Tax Court found that a taxpayer's failure to attach a qualified appraisal summary to the taxpayer's return, as is required by the regulations, prevented the taxpayer from claiming a charitable deduction for the contribution. The Tax Court noted that the holding in *Bond* provided for substantial compliance in many instances, but that the taxpayer at hand could not avail himself of the benefits of the rule because the taxpayer had failed to substantially comply with the applicable regulation. The Tax Court noted that, like the taxpayer in *Hewitt*, the taxpayer at issue violated multiple substantiation requirements. The court stated:

> Under these circumstances we consider whether petitioners' compliance was substantial or whether they failed to meet the statutorily mandated regulatory requirements.
>
> We hold that petitioners did not provide sufficient information . . . to have substantially complied. . . . Petitioners, in each year under consideration, did not attach to their returns qualified summary appraisal reports as required by the statute and the regulations. In addition, it has not been shown that petitioners' [appraiser] was a qualified appraiser within the meaning of the regulatory requirements. Moreover, certain of the reports that were referenced on the returns were not shown to exist, and none of the purported reports or documentation submitted met the time requirements for their preparation and submission.[24]

B. *Bruzewicz* — Substantial Compliance Criticized

Bruzewicz v. United States[25] is the only instance in which a court has directly questioned the continued viability of *Bond* in the context of the charitable contribution regulations. In *Bruzewicz*, the District Court for the Northern District of Illinois stated that *Bond*, and the doctrine of substantial compliance, had a very limited application in cases arising within the Seventh Circuit.

Before addressing the facts in *Bruzewicz*, the court analyzed the history of the substantial compliance cases, noting that the Seventh Circuit Court of Appeals had "adhered to a tough standard for applying the doctrine of substantial compliance" in cases involving the code and regulations outside the charitable contribution context.[26]

The court recognized that the Tax Court had, based on *Bond*, applied the doctrine of substantial compliance in charitable contribution cases, but stated that the Tax Court rulings had no binding effect on the district court, and that the district court would instead apply the general position of the Seventh Circuit that the doctrine of substantial compliance should be very narrowly applied, even in the context of charitable contribution situations.

Turning to the facts at issue in the case, the court found that even though the taxpayer received a letter from the land trust that vaguely acknowledged the receipt of contributions made by the taxpayer, the taxpayer in the case had failed to comply with the contemporaneous written acknowledgement requirement of section 170(f)(8).[27]

The court stated that allowing the letter to satisfy the contemporaneous acknowledgement requirement would be to "flout the express language of section 170(f)(8)(A) and (B)."[28] It went on to state that the code section at issue was neither "unclear" nor "confusing" and that the taxpayer neither substantially nor strictly complied with the code.[29]

After noting that the taxpayer's deduction would be disallowed for the reasons stated above, the district court proceeded to address other deficiencies pertaining to the contribution. First, the court noted that the appraisal used by the taxpayer failed to set out the qualifications of the appraiser as required by reg. section 1.170-13(c)(3)(ii)(F). The court stated that the regulation was neither "unimportant" nor "confusing," and determined that the taxpayer's failure to comply with this provision was also fatal to the taxpayer's claim for a deduction.[30]

Next, the court addressed the taxpayer's failure to provide a description of the parts of the taxpayer's property which were subject to the facade easement at issue in the case. The court noted that the taxpayer's failure to provide such a description was in violation of reg. section 1.170A-13(c)(3)(ii)(A). Nonetheless, the court stated that this one failure alone would not have caused the court to disallow the taxpayer's deduction:

> These substantiation requirements are important, indeed essential, to the review of charitable contribution deductions and the reliability of corresponding appraisal. Neither is the requirement in any way confusing. There is really no excuse for the [taxpayer]'s failure to comply strictly with its terms.

Appeals for the Fourth Circuit. In its opinion, the court of appeals also distinguished the facts at hand with the facts of *Bond* by stating:

> In *Bond*, the taxpayers made a good faith effort to comply with the appraisal requirement. In the case at bar, the [taxpayers] utterly ignored the appraisal requirement. Furthermore, unlike the taxpayers in *Bond*, the [taxpayers before us] failed to supply all the information required by the regulations. In sum, the taxpayers failed to substantially comply with the regulations.

Hewitt v. Commissioner, 166 F.3d 332, 333 (4th Cir. 1998), *Doc 98-34000*, *98 TNT 227-3*.

[23]T.C. Memo. 2007-368, *Doc 2007-27573*, *2007 TNT 243-12*.

[24]*Id.*

[25]604 F. Supp.2d. 1197 (N.D. Ill. 2009), *Doc 2009-6839*, *2009 TNT 58-85*.

[26]*Id.* In support of its position that the Seventh Circuit did not accept the doctrine of substantial compliance, the district court cited *Prussner v. United States*, 896 F.2d 218 (7th Cir. 1990) and *Tamulis v. Commissioner*, 509 F.3d 343 (7th Cir. 2007), *Doc 2007-26343*, *2007 TNT 231-10*. Neither of those cases, however, applied to reg. section 1.170A-13.

[27]*Id.* at 1204.

[28]*Id.*

[29]*Id.* at 1205.

[30]*Id.* at 1204.

> That being said, *however*, if that was the only flaw in the [taxpayer]'s claim, this Court would be loath to disqualify the claimed deduction on that basis alone. Here the [actions] would, in this Court's view, *qualify that defect for substantial compliance treatment*.[31]

Thus, the district court seemed to imply that the doctrine of substantial compliance was still applicable in some circumstances, even within the Seventh Circuit.

1. *Simmons v. Commissioner*. In *Simmons v. Commissioner*,[32] the Tax Court clarified that the doctrine of substantial compliance is applicable in the context of conservation easement contributions.

Simmons involved a taxpayer who had made a contribution of a facade easement to a qualified donee, but failed, according to the IRS, to comply with several of the substantiation regulations. The IRS alleged[33] that the taxpayer had failed to obtain a contemporaneous acknowledgement letter from the donee that was in compliance with the regulations, and failed to obtain a qualified appraisal of the property because the appraisal provided by the taxpayer did not contain a statement that it was prepared for income tax purposes.

The Tax Court addressed the noncompliance issue by discussing the history of the substantial compliance doctrine as it had been formulated in *Bond*, *Hewitt*, and *Smith*.[34] The Tax Court noted that in *Bond* it found the regulations to be directory, and not mandatory, and that, taken together, the Tax Court's prior jurisprudence provided a framework whereby the court could consider whether a taxpayer "provided sufficient information to permit respondent to evaluate . . . reported contributions, as intended by Congress."[35]

After unambiguously confirming the application of the substantial compliance doctrine to the contributions of conservation easements, the Tax Court turned to the alleged inadequacies. First, the Tax Court resolved the contemporaneous acknowledgement issue in favor of the taxpayer by finding that the conservation easement deed contained all the information required by section 170(f)(8)(C). Interestingly, the Tax Court did not address whether the donor received a statement from the donee organization stating whether the donee received something in exchange for the contribution, as is required under the code and regulations.[36] Although the facts are not clear, it does not appear that such a statement was provided, and it is unlikely the conservation easement deed would have contained that language.

Next the Tax Court addressed the IRS's allegation that the taxpayer's appraisals were not qualified appraisals because they did not contain a statement that they were prepared for income tax purposes, as required by the regulations.[37] The Tax Court recognized that the appraisal did not contain language stating it was prepared for income tax purposes, but noted that the appraisal document contained information clearly indicating the purpose of the appraisal. The Tax Court determined that language was sufficient to meet the requirements of the regulations.

Based on its finding that the taxpayer had substantially complied with the code and regulations, the Tax Court determined that the taxpayer was entitled to a charitable contribution deduction.

C. The Current Status of the Law

The Tax Court's decision in *Bond* — that some of the reporting requirements found in reg. section 1.170A-13 are directory and not mandatory — is good law in the Tax Court and, most likely, in all other courts.

1. Tax Court. The Tax Court in cases since *Bond* has distinguished its holding in *Bond* from the facts at issue in the subsequent cases to find that the substantial compliance standard was not met. Those subsequent cases have, however, generally involved situations in which the taxpayer completely disregarded several regulations. Moreover, the Tax Court never stated that substantial compliance was inapplicable in the cases, but rather that the taxpayers had failed to meet enough of the mandates of the regulations to substantially comply with the regulations. Also, most of the instances in which the court found that substantial compliance was not met involved situations in which a taxpayer completely failed to timely obtain a qualified appraisal or appraisal summary, or to obtain sufficient written acknowledgement of its donation.

Moreover, in *Simmons*, the Tax Court unambiguously confirmed that the regulations governing conservation easement contributions are directory and not mandatory. That *Simmons* involved a taxpayer's noncompliance with several regulations provides a strong indication that the

[31]*Id.* (emphasis added).

[32]T.C. Memo. 2009-208, *supra* note 9.

[33]The IRS also alleged that the taxpayer failed to meet other requirements, which resulted in an unqualified appraisal. The Tax Court, however, made findings of fact in favor of the taxpayer on these issues.

[34]The Tax Court also noted that section 170(f)(11) provided a reasonable cause exception for "failure to comply with the substantiation requirements for noncash charitable contributions," but noted that the provision did not apply to the case because the contribution was made before June 3, 2004. *See Simmons*, *supra* note 9, at n.3. Interestingly, the Tax Court did not indicate that the reasonable cause exception would have been limited to the qualified appraiser and qualified appraisal requirements (the provisions it is found under in the code), but rather implied that the provision applies to the substantiation requirements in general (including the contemporaneous acknowledgement requirement that was at issue in the case, which is found in section 170(f)(8)).

[35]T.C. Memo. 2009-208, *supra* note 9.

[36]*See* section 170(f)(8)(B)(ii). This requirement is more explicit in reg. section 1.170A-13(f)(2)(ii), which requires a statement as to whether the donee organization provides any consideration for any of the property transferred to it.

[37]*See* reg. section 1.170A-13(c)(3)(ii)(G). The IRS also alleged other deficiencies with the appraisals, but the Tax Court summarily dismissed these allegations by finding facts contrary to those asserted by the IRS.

doctrine of substantial compliance might have a broader application than had been indicated by other decisions of the Tax Court.[38]

2. The Seventh Circuit. While several courts have distinguished the facts of the cases before them from the facts in *Bond* to hold that a taxpayer did not substantially comply with the regulations, *Bruzewicz* is the only decision in which a court has expressly declined to follow the Tax Court's decision in *Bond*. The *Bruzewicz* decision, however, is not binding on the Tax Court.

The Seventh Circuit decisions cited in the district court's opinion in *Bruzewicz* are binding on the Tax Court for which an appeal would lie in the Seventh Circuit.[39] However, the Tax Court would have to determine if the district court correctly interpreted and applied the Seventh Circuit cases to the facts at hand (that is, whether the court of appeals' decisions regarding substantial compliance were applicable to the charitable contribution requirements).[40]

Moreover, despite the district court's seeming rebuke of the decision in *Bond*, it indicated in *Bruzewicz* that there were at least three instances in which the doctrine of substantial compliance might apply in the context of the charitable contribution regulations. First, the district court implied that in instances in which a regulation was deemed to be unimportant, the doctrine of substantial compliance might apply. Second, the court implied that in instances in which a regulation was unclear or confusingly stated, the doctrine of substantial compliance might apply.

Finally, despite its rhetoric, the district court seemed to imply that the doctrine of substantial compliance might be appropriate in instances in which a taxpayer complies with almost all of the applicable regulations. As noted above, after stating that the taxpayer in the case had violated the regulations by failing to sufficiently describe the portions of the eased property, the district court in *Bruzewicz* acknowledged that it would have been loath to disqualify the claim based on that single flaw and that the taxpayer's actions would have qualified that defect for substantial compliance treatment.[41]

Thus, despite the district court's apparent disapproval of the doctrine of substantial compliance, it seemed to confirm that the doctrine is appropriately applied in some situations. To some extent, the district court reiterated what the Tax Court has found in many prior cases pertaining to the application of the substantial compliance doctrine: In situations when a regulation is unimportant, confusing, or unclear — or in situations in which a taxpayer has complied with most of the requirements of a regulation — a taxpayer should not be denied a deduction for a charitable contribution.

Finally, *Bruzewicz* was decided before the Tax Court's recent decision in *Simmons*, and at a time when the state of the substantial compliance doctrine was arguably ambiguous. Although the Tax Court's decision in *Simmons* is not binding on the district court (and clearly not on the court of appeals), it is conceivable that the Tax Court's unambiguous confirmation of the doctrine of substantial compliance in *Simmons* would be influential on those courts.

D. Conclusion

Although the Tax Court has distinguished its holding in *Bond* from several cases that have come before the court, the doctrine of substantial compliance is still clearly applicable in charitable contribution situations. Moreover, despite the district court's opinion in *Bruzewicz*, the doctrine of substantial compliance appears to continue to be applicable to some extent even within the Seventh Circuit.

It remains to be seen whether the IRS will, as a result of *Simmons*, finally reform its position and acknowledge that strict compliance is not required in the context of conservation easements. It has been the author's experience that, at least at examination, the IRS continues to assert that strict compliance is required, alleging that any minor deviation from the conservation easement contribution regulations results in a total disallowance of a deduction.

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[38]*Simmons* has been cited for its substantial compliance holding in a charitable contribution case outside the context of conservation easement contributions. In *Consolidated Investors Group*, *supra* note 9, the Tax Court cited *Simmons* in support of its holding that a taxpayer that failed to comply strictly with the charitable contribution substantiation regulations under reg. section 1.170A-13(c) was nonetheless entitled to a charitable contribution for a bargain sale of real property to the Ohio Turnpike Commission, a state agency. Although the charitable contribution did not involve a conservation easement contribution, the substantiation regulations discussed in the opinion (regarding which the taxpayer failed to strictly comply) are also applicable to conservation easement contributions. In *Consolidated Investors Group*, the Tax Court cited *Simmons* (and the substantial compliance cases before it) to hold that the taxpayer was entitled to a charitable contribution despite its failure to comply with the following requirements in the regulations: (1) the obligation to obtain a timely appraisal (the appraisal was performed more than 60 days before the contribution), (2) the requirement that a taxpayer provide the date that a contribution is made, and (3) the requirement that a taxpayer obtain a statement from the appraiser that the appraisal was prepared for income tax purposes.

[39]*See Golsen v. Commissioner*, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971).

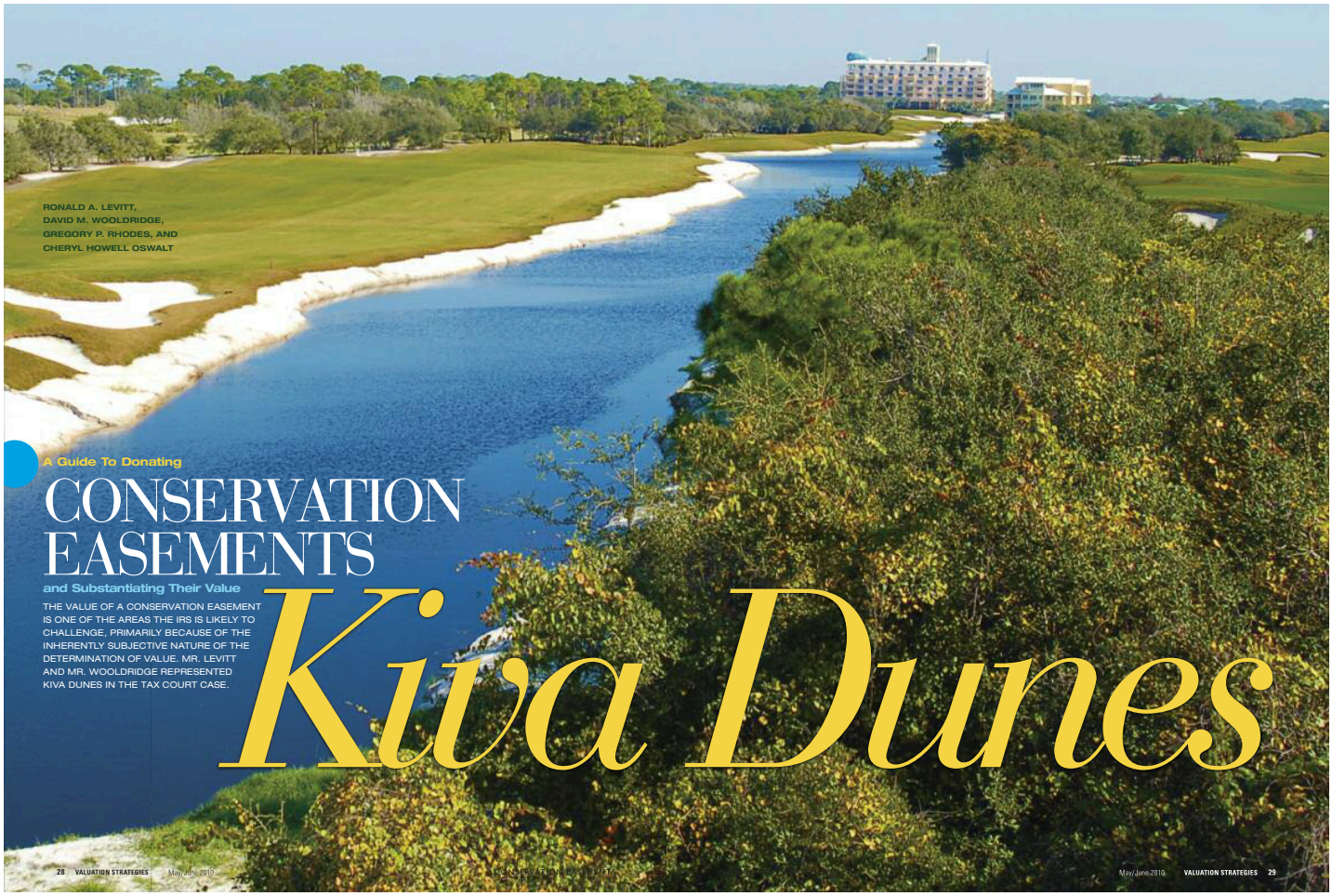
[40]The district court cited *Tamulis*, *supra* note 26, and *Prussner*, *supra* note 26, for the proposition that the Seventh Circuit disapproved of the doctrine of substantial compliance. *Tamulis* addressed whether a trustee's intentional disregard of the requirement that a trust must be reformed to comply with the charitable remainder trust rules could be disregarded. The court in *Tamulis* determined that, because the trustee at issue failed to comply with a "clear," "unambiguous," and "important" rule of which the trustee was aware, substantial compliance was inapplicable. *Tamulis v. Commissioner*, 509 F.3d 343 at 346. *Prussner* involved a situation in which an executor made "no effort" to comply with the requirement that he file a recapture agreement with his estate tax return, as is required by section 2032A(d)(3). *Prussner v. United States*, 896 F.2d 218 at 224-225. The Seventh Circuit Court of Appeals did not state in either of these cases that the doctrine of substantial compliance was inapplicable in the Seventh Circuit. Moreover, neither of the cases addressed the charitable contribution regulations.

[41]604 F. Supp.2d. 1197, *supra* note 25.

A GUIDE TO DONATING CONSERVATION EASEMENTS AND SUBSTANTIATING THEIR VALUE

Valuation Strategies, May/June 2010

By: Ronald A. Levitt, David M. Wooldridge, Gregory P. Rhodes, and Cheryl Howell Oswalt



RONALD A. LEVITT,
DAVID M. WOOLDRIDGE,
GREGORY P. RHODES, AND
CHERYL HOWELL OSWALT

A Guide To Donating

CONSERVATION EASEMENTS

and Substantiating Their Value

THE VALUE OF A CONSERVATION EASEMENT IS ONE OF THE AREAS THE IRS IS LIKELY TO CHALLENGE, PRIMARILY BECAUSE OF THE INHERENTLY SUBJECTIVE NATURE OF THE DETERMINATION OF VALUE. MR. LEVITT AND MR. WOOLDRIDGE REPRESENTED KIVA DUNES IN THE TAX COURT CASE.

Kiva Dunes

On 6/22/09,

the Tax Court issued its opinion in *Kiva Dunes Conservation, LLC*,[1] which addressed an issue that has been hotly debated among the conservation easement community—whether or not a conservation easement can be granted on golf course property. In its decision, the court also addressed several other important issues, including valuation methods applicable to conservation easements. The decision is a valuable guide for taxpayers seeking to make conservation easement contributions. In-depth understanding of the case and the issues addressed by the court is useful for anyone involved with conservation easements, whether such involvement is in one's capacity as a potential donor, tax advisor, appraiser, or recipient of such an easement.

Facts

Kiva Dunes involved a taxpayer's gift of a conservation easement over certain property (which included a golf course) to an eligible donee. The taxpayer in the case was a limited liability company (LLC) taxed as a partnership for federal income tax purposes. On 12/31/02, the taxpayer donated a conservation easement to the North American Land Trust (NALT) by a grant (the easement declarations). The conservation easement was granted on 140.9 acres owned by the taxpayer (the property), which was located on the Ft. Morgan Peninsula in Baldwin County, Alabama.

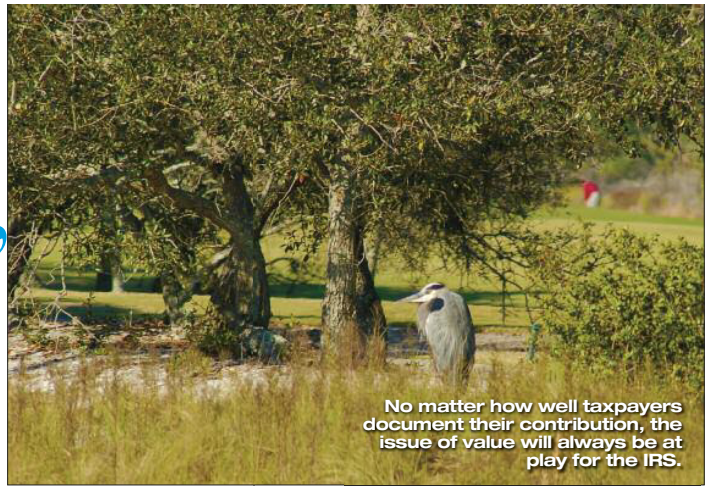
RONALD A. LEVITT, DAVID M. WOOLDRIDGE, GREGORY P. RHODES, AND CHERYL HOWELL OSWALT are attorneys at Sirote and Permutt, PC in Birmingham, Alabama. Their practice inlcudes planning and defending conservation easements. Mr. Levitt and Mr. Wooldridge represented Kiva Dunes in the Tax Court case.

The Ft. Morgan Peninsula is 22 miles long and ranges between 1.2 and 3.1 miles wide. The property lies between, but does not abut, the Gulf of Mexico on the south, and Mobile Bay and Bon Secour Bay on the north. The tract's widest dimension from east to west is approximately 3600 feet, and its widest dimension from north to south is approximately 2300 feet.

The conservation easement is located between two segments of the Bon Secour National Wildlife Refuge (Refuge). One Refuge segment lies approximately 0.85 miles west/northwest of the easement, and the other Refuge segment lies approximately 1.55 miles east of the easement. The property includes the Kiva Dunes Golf Course. However, as discussed later in the article, it has many unique attributes that made it well suited for a conservation easement.

The easement declarations restrict development of the property, the practical effect of which was to limit the use of the property to a golf course, a park, or a low-density agricultural enterprise. Specifically, the easement declarations limit the use of the property to protect relatively natural habitats for fish, wildlife, and plants, and to preserve open space for scenic enjoyment of the general public and for the advancement of governmental conservation policies. The easement declarations also preserve land areas for outdoor recreational use by the general public.[2]

The LLC claimed two charitable contribution deductions on its partnership return for the tax year. One was a deduction for a $35,000 cash contribution to NALT.[3] The other was for the qualified conservation contribution of a conservation easement on the property to NALT in the amount of $30,588,235.



No matter how well taxpayers document their contribution, the issue of value will always be at play for the IRS.

Key Issues

The case was tried before Judge Thomas B. Wells. The week-long trial brought forth evidence including 103 exhibits, testimony of 18 witnesses, and numerous charts, photographs and videography.

At trial, the taxpayer first had the burden of proving that the conservation easement met one or more of the conservation purposes necessary for a deduction of a qualified conservation contribution. Specifically, the taxpayer had to establish that the easement accomplished one of the following purposes: preservation of land areas for outdoor recreation by, or for the education of, the general public;[4] protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem;[5] or preservation of open space either for the scenic enjoyment of the general public or pursuant to a clearly delineated federal, state, or local governmental conservation policy.[6]

Next, the taxpayer had the burden of establishing the value of the conservation easement. Specifically, the taxpayer attempted to substantiate that the value of the property before imposition of the conservation easement (the "before value") was equal to $31,938,985, and that the value of the property after imposition of the easement (the "after value") was equal to $1,050,750.[7]

The court issued an opinion favorable to the taxpayer and to the use of conservation easements generally. Specifically, the court found that the taxpayer was entitled to a charitable deduction of $28,656,004, which was 94% of the deduction the taxpayer claimed on its income tax return. In coming to its decision, the court addressed several different issues, each of which is described next.

Conservation Purpose. The IRS initially challenged whether the purpose of the easement constituted a permissible "conservation purpose." This "threshold issue" was strongly contested by the IRS throughout the trial. The IRS was skeptical as to whether an easement restricting golf course property could be for a permissible conservation purpose.

After a week-long trial, much of which was devoted to testimony on the conservation purpose issue, the IRS relented by conceding the issue in its brief to the court. Why, one might ask, would the IRS concede the conservation purpose issue in this case? As is discussed later in this article, the property's unique qualities that made it particularly well suited for a conservation easement.

Value. After the IRS conceded the conservation purpose, the primary issue left was the fair market value of the easement. The experts agreed that the value was equal to the difference between the fair market value of the property before and after the easement was granted, reduced by the increase in the value of other nearby property owned by the taxpayer or a related party as a result of granting the easement.

The "before value" of the property was based on its potential highest and best use as a residential development. To derive the before value, both experts used a discounted-cash-flow analysis of estimated revenues and costs associated with development and sale of lots in hypothetical subdivisions—the so-called "subdivision method." However, the two appraisers' assumptions regarding the number of lots available for sale, average sale price of the lots, and rate at which the lots would sell, differed significantly.

The taxpayer's expert determination that 370 lots could be developed for sale (as opposed to the 300 lots projected by the IRS's expert) was in accordance with the testimony of the county zoning director. Ultimately, the court ruled that the IRS's expert misinterpreted the local zoning regulations in concluding that only 300 lots could be built.

The court also accepted the taxpayer's expert's average lot price of $170,000. The IRS's expert's estimate of $85,000 per lot was based essentially on the value of two of the least desirable interior lots in the hypothetical subdivision; they had no gulf or lake view and were far removed from the amenities. The taxpayer's expert's assumed sales absorption rate of 37 lots per year was also accepted over the estimate of 20 lots per year by the IRS's expert.

The parties agreed, for purposes of determining the value of the property after it was encumbered by the easement, that the property's highest and best use was its continued operation as a golf course. The IRS's expert used an income approach to determine this value, while the taxpayer's expert determined the after value by analyzing sales of comparable but unimproved properties that were purchased for recreational uses. The court rejected the income approach valuation used by the IRS's expert because he failed to take into account significant expenses, such as salaries and wages, employee benefits, repairs and maintenance, taxes, licenses, and depreciation reserves in calculating the net income from the course.

The after value determined by the taxpayer's expert through the comparable sales method was accepted by the court. This aspect of the court's decision was significant because the IRS had argued that the taxpayer's comparables, which had different characteristics and uses from those of the subject property as encumbered by the easement (i.e., as a golf course), were inadmissible. The court, however, accepted the use of the comparables, with the exception that an upward adjustment must be made to the value of the comparables to reflect the expense that would have been neces-

sary to convert the unimproved land into comparable golf course property.

Penalties. The IRS claimed that the taxpayer was subject to a valuation penalty. The court, however, determined the penalty was inapplicable in light of the court's determined that that the taxpayer's charitable contribution valuation did not exceed 200% of the determined value of the easement.

Lessons from the Case

Kiva Dunes contains a wealth of information for individuals or entities that are considering making a contribution of a conservation easement, and to tax professionals advising these individuals in the contribution process, or in defending an IRS attack on such easements.

Technical Requirements. Many issues involving the deduction for the conservation easement were never challenged by the IRS in this case, however,because they were handled correctly at the front end. Correctly confronting and resolving these issues is, however, crucial to receiving a contribution for a conservation easement.

Qualified Donee. The first thing a taxpayer must do to receive a deduction for contribution of a conservation easement is to make the donation to an "eligible donee." The regulations require that in order to be an eligible donee, an organization must meet the following requirements:

1. Be a governmental agency or a qualified public charitable organization.[8]
2. Have a "commitment to protect the conservation purposes of the donation."[9]
3. "Have the resources to enforce the restrictions."[10]

There are many qualified donees available to accept conservation easements, although they may vary in their interests and requirements. In *Kiva Dunes*, the donee was the NALT, a public charity. Additionally, it is an "accredited" organization. The accreditation is a distinction received from the Land Trust Alliance, a nationally known land conservation organization. When a contribution is being made to a non-accredited organization, taxpayers and practitioners should pay special attention to documenting the proposed donee's commitment to protecting the conservation purpose of the donation, as well as documenting and establishing that the organization has the resources to enforce the conservation easement restrictions.

Baseline Documentation. Another issue of critical importance to conservation easement contributions is whether the donor of the conservation easement has created or received proper "baseline documentation" detailing the contributed easement. Baseline documentation is a report that documents the condition of the easement property at the time an easement is completed and provides a baseline for future monitoring of the property and determining whether there are any violations of the easement. The regulations require this report when the landowner reserves the ability to exercise a right that might interfere with the conservation value of the property.[11] Under the Code and the regulations, it is technically the landowner's responsibility to create this report,[12] although it is typically required by a land trust for all easements, and it is normal for the land trust to prepare the report.

Baseline documentation must contain all of the following items:

1. The appropriate survey maps from the United States Geological Survey, showing the property line and other contiguous or nearby protected areas.[13]
2. A map of the area, drawn to scale, showing all existing man-made improvements or incursions and natural species on the property.[14]
3. A contemporaneous aerial photograph of the property.[15]
4. On-site photographs taken at appropriate locations on the property.[16]
5. The condition of any protected property.[17]
6. A statement signed by the donor and a representative of the donee making reference to the baseline documentation and stating that the documentation is accurate.[18]

Taxpayers should identify an experienced and reputable donee when making a donation of a conservation easement in which the taxpayer desires to retain some rights. This is especially important when the taxpayer is attempting to make a donation of a conservation easement over golf course property, because generally the rights sought to be retained in order to run and operate a golf course will be fairly extensive.

Although baseline documentation need satisfy only the minimum requirements just discussed, the documentation can, if done properly, provide a great opportunity to document the state of the property as it exists at the time of the contribution. Specifically, pictures, videography, and other tangible evidence of the property as it existed at the time of the contribution can paint a convincing picture of the conservation preservation attributes of the property. This evidence can play a vital role if the conservation purpose of the contribution is eventually challenged by the IRS.

Qualified Appraisal. There are two key issues relating to conservation easement appraisals: (1) whether the appraisal meets the technical requirements of a "qualified appraisal" under the Code and the regulations;[19] and (2) whether the appraisal substantiates the value of the conservation easement claimed by the donor. Careful pre-contribution planning can help a taxpayer avoid challenges by the IRS as to the first issue. However, the IRS frequently challenges valuations, and will often, whether merited or not, be capable of presenting a serious challenge to the valuation derived by a taxpayer's expert.

Technical requirements regarding appraisals. The regulations have detailed requirements. Specifically, they require that, in the context of a contribution of greater than $5,000, a taxpayer must do all of the following:

1. Obtain a qualified appraisal for such property contributed.
2. Attach a fully completed appraisal summary to the tax return on which the deduction for the contribution is first claimed (or reported) by the donor.
3. Maintain records containing certain required information.[20]

A qualified appraisal is defined in Reg. 1.170A-13(c)(3), which provides a host of requirements for a "qualified appraisal." The appraisal report must:

1. Relate to an appraisal made not earlier than 60 days before the date of contribution of the appraised property.[21]
2. Be prepared, signed, and dated by a qualified appraiser.[22]
3. Include all information that is required to be included in a qualified appraisal (as discussed in the regulations).[23]
4. Not involve a prohibited appraisal fee.[24]

Moreover, for appraisals performed after 8/17/06, Reg. 1.170A-(f)(11)(E)(i)(I) requires that an appraisal must comply with generally accepted appraisal standards and any regulations or other guidance prescribed by the Service.[25]

Appraisals must be performed in accordance with the Uniform Standard of Professional Appraisal Practice (USPAP). Notwithstanding the fact that USPAP standards are generally followed by most experienced appraisers, the Service has tended to argue with increasing frequency that the standards have not been followed. The problem with countering such allegations is that USPAP provides general standards and principles which, by their very nature, are somewhat ambiguous. To counter such an assertion, appraisals should refer to the USPAP standards, and adhere to them as closely as practicable.

The Kiva Dunes easement was contributed long before 8/17/06. Nonetheless, the Service initially argued that the appraisal should have been performed in accordance with USPAP, and that the appraisal failed to meet this standard. The Service ultimately abandoned this argument. However, it is not uncommon for the Service to argue (at least within IRS Examination and Appeals) that appraisals relating to contributions made prior to 8/17/06 must be performed in accordance with USPAP.

1 TCM 2009-145.

2 Among the key restrictions of the easement declarations are the following: (1) the property cannot be used for residential or commercial purposes; (2) few structures can be built; (3) the owner must apply the best environmental practices then prevailing in the golf industry; (4) no ground removal is allowed other than golf course irrigation practices; (5) no cutting, removal or destruction of trees is allowed; (6) no signs or billboards are allowed; (6) no filling in or removal of soil or mining is allowed; (7) dumping is prohibited; (9) no material change in topography is permitted; (10) manipulation of natural water courses is prohibited; (11) soil erosion is to be minimized; (12) no introduction of non-native plants is permitted; and (13) the property is not to be used to meet zoning requirements on property outside of the property.

3 Before trial, the IRS stipulated that the $35,000 cash contribution to NALT was properly deducted.

4 Section 170(h)(4)(A)(i).

5 Section 170(h)(4)(A)(ii).

6 Section 170(h)(4)(A)(iii).

7 Additionally, the taxpayer had the burden of establishing that the enhancement in the value of other property owned by the taxpayer or related parties as a result of the conservation easement was not more than the $300,000 amount determined by the taxpayer.

8 Reg. 1.170A-14(c)(1)(i-iv).

9 Reg. 1.170A-14(c)(1).

10 *Id.*

11 Reg. 1.170A-14(g)(5)(i). There may be instances in which the donor does not reserve any rights which might impair the conservation value of the property, although this very rarely happens. The regulations, however, anticipate the possibility of such a situation.

12 *Id.*

13 Reg. 1.170A-14(g)(5)(ii)(A).

14 Reg. 1.170A-14(g)(5)(ii)(B).

15 Reg. 1.170A-14(g)(5)(ii)(C).

16 Reg. 1.170A-14(g)(5)(ii)(D).

17 *Id.*

18 *Id.*

19 The technical requirements in the regulations create a complex web of traps for the uninformed. The IRS has frequently argued that failure by a taxpayer to meet any one of the requirements will result in a total disallowance of a charitable contribution deduction. Courts, however, have provided taxpayers leeway in many instances by requiring only "substantial compliance" with the regulations. See, e.g., Simmons, TCM 2009-208.

20 Reg. 1.170A-13(c)(2)(i). The information required is listed in Reg. 1.170A-13(b)(2)(ii) and consists of the following: (1) the name and address of the donee organization to which the contribution was made; (2) the date and location of the contribution; (3) a description of the property in detail reasonable under the circumstances (including the value of the property); (4) the fair market value of the property at the time the contribution was made, the method used in determining the fair market value, and, if the valuation was determined by appraisal, a copy of the signed report of the appraiser; and (5) the terms of any agreement or understanding entered into by or on behalf of the taxpayer that relates to the use, sale, or other disposition of the property contributed.

21 Reg. 1.170A-13(c)(3)(i)(A).

22 Reg. 1.170A-13(c)(3)(i)(B). See discussion below.

23 Reg. 1.170A-13(c)(3)(i)(C). Reg. 1.170-A-13(c)(3)(ii) requires a host of information that must be provided.

Substantiation of value. Kiva Dunes illustrates that no matter how informative or detailed an appraisal is, it will always be subject to some challenge by the Service. Even when an appraisal is performed in accordance with all of the applicable regulations, is performed in accordance with USPAP principles, and is thorough and complete, the Service will often challenge its conclusions by presenting the government's own valuation expert with a contrary opinion.

In many instances, as was the case in the *Kiva Dunes*, the valuation of the conservation easement will evolve into a "battle of the appraisers." In such a situation, it is important that the taxpayer's appraiser support the appraisal conclusions with knowledgeable and persuasive analysis, as well as detailed fact-finding, described later in the article.

Qualified Appraiser. The regulations provide a complex framework of provisions governing who is a "qualified appraiser" for purposes of the Code. Due to the patchwork nature of legislation in this area, the appraiser requirements differ depending on the year of the appraisal and the type of property being appraised.

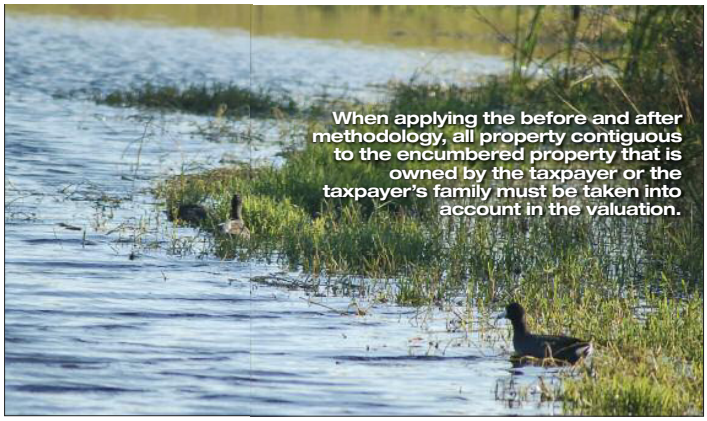
Presently, a qualified appraiser is defined in Section 170(f)(11)(E)(ii)[26] as an individual who meets all of the following requirements:

1. The appraiser has earned an appraisal designation from a recognized professional appraiser organization[27] or has otherwise satisfied minimum education and experience requirements set forth in regulations prescribed by the IRS.[28]
2. The appraiser regularly performs appraisals for which he or she receives compensation.
3. The appraiser satisfies such other requirements as may be prescribed by the Secretary in regulations or other guidance.[29]

Moreover, under Section 170(f)(11)(E)(iii), an individual cannot be treated as a qualified appraiser unless the following criteria are met:

1. The individual demonstrates verifiable education and experience in valuing the type of property subject to the appraisal.[30]
2. The individual has not been prohibited from practicing before the IRS under 31 U.S.C. section 330(c) at any time during the three-year period ending on the date of the appraisal.

Although in *Kiva Dunes* the IRS conceded that the taxpayer's appraiser was a "qualified appraiser," the Service is generally quick to dispute this issue in audits of conservation easements. Moreover, as a result of the enactment of the Pension Protection Act (PPA), the definitions and standards for a "qualified appraiser" have become much more complex. Accordingly, it is important for taxpayers to have a comprehensive understanding of the qualifications their appraiser must have, as well as the process the appraiser must engage in.



It is generally advisable for taxpayers to hire an appraiser who has substantial experience in valuing conservation easements. Such appraisers are more likely to have knowledge of the applicable appraisal requirements. Moreover, *Kiva Dunes* illustrates (as is discussed later) that although an appraiser's technical education and licenses are important, it is at least equally important that the appraiser has extensive knowledge of the specific geographic area and market of the property being appraised. Indeed, in *Kiva Dunes*, the Tax Court gave great weight to specific knowledge about the local area.

Subordination Agreement. A recurring issue in IRS examinations of easement deductions involves the subordination of any existing mortgages that encumber conservation easement property to the rights of the donee to enforce the conservation easement. Without such a subordination agreement, the conservation easement will not be deductible.[31]

Reg. 1.170A-14(g)(2) provides, in pertinent part, as following:

> [N]o deduction will be permitted under this section for an interest in property which is subject to a mortgage unless the mortgagee subordinates its rights in the property *to the right of the qualified organization* to enforce the conservation purposes of the gift in perpetuity. . . .[32]

Although the IRS has sometimes contended that subordination agreements must be entered into prior to the date on which the easement is contributed, the regulations do not appear to require this expressly. It would, however, be advisable to avoid this potential issue by assuring that any subordination agreement is entered into before the contribution occurs, and in all events before the tax return for the applicable year is submitted.

The Service has also contended in some audits that a subordination agreement must be recorded in order to satisfy the regulations. However, Reg. 1.170A-14(g)(2) requires only that "the mortgagee subordinates its rights in the property *to the right of the qualified organization* to enforce the conservation purposes of the gift in perpetuity."[33] Thus, it does not expressly require that the mortgagee subordinate its rights to third parties or that the subordination be recorded. Accordingly, it is possible that when state law provides that an unrecorded mortgage will be effective as to the parties to the agreement, Reg. 1.170A-14(g)(2) will be satisfied by the existence of a subordination agreement, regardless of whether it is recorded or enforceable against third parties.

Conservation Purpose. One of the most important issues in the *Kiva Dunes* case was whether there was a qualified "conservation purpose" for the conservation easement. This issue was mentioned only in passing by the court in its opinion because the issue was conceded by the IRS after the trial of the case and partial briefing. Initially, however, the issue was critical in the *Kiva Dunes* case, as it is in many conservation easement controversies.

Section 170(h)(4)(A) and Reg. 1.170A-14(d)(1) identify four different categories of permissible conservation easement purposes, only one of which must be satisfied:

1. Preservation of land areas for outdoor recreation by, or the education of, the general public.
2. Protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem.
3. Preservation of certain open space (including farmland and forest land).
4. Preservation of a historically important land area or a certified historic structure.

In *Kiva Dunes*, the taxpayers had alleged that the conservation easement served the first three conservation purposes. The issue is important because the IRS and many experts had claimed that a conservation easement restricting property to use as a golf course could not meet any of the conservation purposes. Nonetheless, after an extensive trial in which the LLC brought forth convincing conservation purpose evidence, the Service conceded that an easement over golf course property in this instance satisfied the conservation easement purposes required in the Code and regulations.[34]

The three "conservation purposes" the taxpayer argued the easement satisfied are described next.[35]

Relatively Natural Habitat. Reg. 1.170A-14(d)(3)(ii) provides a nonexclusive list of habitats and natural areas that will satisfy the protection of a "relatively natural habitat":

1. Habitats for rare, endangered, or threatened species of animals, fish, or plants.
2. Natural areas, such as undeveloped islands, that represent high-quality examples of terrestrial or aquatic communities.
3. Natural areas included in, or contributing to, the ecological viability of a local, state, or national park, preserve, wildlife refuge, wilderness area, or similar conservation area.

In *Kiva Dunes*, the taxpayer asserted that the easement protected virtually all of the above types of habitats and natural areas. The taxpayer demonstrated through the use of pictures, video, and

[24] Reg. 1.170A-13(c)(3)(i)(D). Reg. 1.170A-13(c)(6) lists the requirements pertaining to appraisal fees.

[25] The term "generally accepted appraisal standards" refers to the substance and principles of the Uniform Standards of Professional Appraisal Practice.

[26] Section 170(f)(11)(E)(ii) was enacted by the 2006 Pension Protection Act, effective for appraisals prepared with respect to returns or submissions filed after 8/17/06.

[27] Notice 2006-96, 2006-2 CB 902, section 3.03(1) provides that an appraisal designation from a recognized appraisal organization is sufficient to satisfy this requirement if it relates to valuing the type of property for which the appraisal is performed.

[28] For returns filed on or before 10/19/06, the education and experience requirements are satisfied if the appraiser is a "qualified appraiser" within the meaning of Reg. 1.170A-13(c)(5). For returns filed after 10/19/06, the minimum education and experience requirements depend on the type of property to which an appraisal relates. For real property appraisals, the appraiser must be licensed or certified for the type of property being appraised in the state in which the real property is located. See Notice 2006-96, section 3.03(b)(ii).

[29] While Prop. Reg. 1.170A-17 was issued on 8/7/08, until such time as the regulation is finalized, Notice 2006-96 will continue to apply.

[30] The appraiser is required to make a designation in the appraisal that because of the appraiser's background, experience, education, and membership in professional associations, the appraiser is qualified to make appraisals of the type of property being valued. See Notice 2006-96, section 3.03(2).

[31] Reg. 1.170A-14(g)(2).

[32] Emphasis added.

[33] *Id.*

[34] It is possible that the IRS had planned to use Kiva Dunes as a "test case" to demonstrate that granting an easement on golf course property cannot support a permissible conservation purpose. The IRS's concession reflects that the IRS was concerned that the court would determine the issue in the taxpayer's favor. By conceding the issue, the IRS effectively prevented the court from addressing the issue head-on, although the concession in will undoubtedly be cited by taxpayers for the proposition that conservation easements can permissibly be granted over golf course property.

[35] The only conservation purpose not argued by the taxpayer was that the easement preserved a historically important land area or a certified historic structure. This conservation purpose is generally not applicable in golf course easement situations. It is most commonly used in situations involving "façade easements." See, e.g., Dorsey, TCM 1990-242 (conservation easement deduction for a façade easement restricting development of facade of historic commercial building); but see Herman, TCM 2009-205 (conservation easement restricting development of air rights above historic apartment building was not exclusively for conservation purposes where easement allegedly failed to prevent alteration or demolition of the building). It is anticipated that Herman will be appealed as it addresses an arguably novel concept regarding the deductibility of "development rights." Additionally, Herman is facially contradictory to Dorsey, although the Tax Court attempted to distinguish the case in its opinion.

[36] As will often be the case when an easement encumbers a geographically large area, it was virtually impossible for the taxpayer to prove that the entire portion of the property that was encumbered by the easement provided a "relatively natural habitat of fish, wildlife, or plants, or similar ecosystem" as described in the regulations. The taxpayer, however, was able to rely on prior case law indicating that the entire eased area does not need to provide conservation benefits, as long as significant portion of such easement satisfies the requirement. See, e.g., Glass, 124 TC 258 (2005), *aff'd* 471 F.3d 698, 98 AFTR2d 2006-8309 (CA-6, 2006).

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other trial exhibits, the various types of habitats present on the property.

The property and conservation easement are located on a narrow part of the Ft. Morgan Peninsula, which shares many characteristics with barrier islands, and is in some cases classified as a "barrier resource" for federal regulatory purposes. The taxpayer was able to demonstrate that the area consisted of unique habitat that helped provide for a diverse array of habitats for wildlife. The taxpayer's ability to describe, in specific detail, the types and quality of habitat and wildlife located on the property was essential to establishing the easement provided for the "protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem."

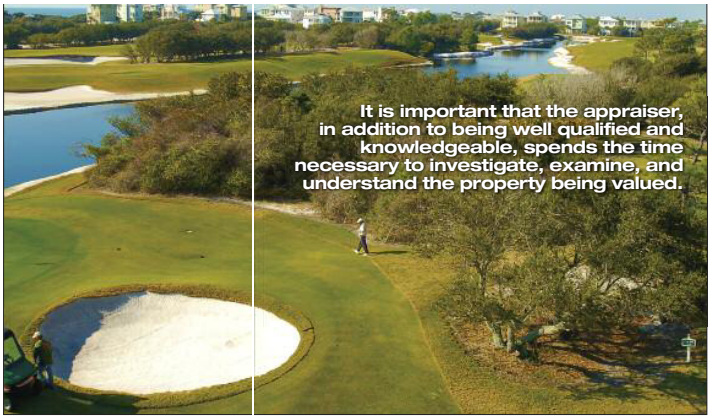
Habitat. The conservation easement contained seasonal freshwater wetlands, permanent lakes and ponds, wooded hammocks, and coastal dunes, each of which provided natural or relatively natural habitat. The taxpayer was able to demonstrate that the dispersed pattern of the habitat areas did not negate its conservation values.

The taxpayer's experts testified that a particular habitat need not support all phases of species' lives to be termed a "habitat." For instance, wildlife may "nest" in one area and "feed" in another. Many species of birds and animals are migratory, and may only pass through the habitat. However, such "stop-over" habitat is often of critical importance. "Habitat" includes areas used occasionally by species or areas used in unpredictable patterns that vary over time.

The taxpayer's expert established that 61.15 acres of the 140.9 acre easement (43.4%) could be described as a "primary habitat" for wildlife, and that 49 of these acres (34.8% of the total easement) could be classified as "fully natural." The LLC also established that the remaining 12.15 acres of the "primary habitat" area was a "relatively natural" habitat for fish, wildlife and plants.[36]

In addition, the taxpayer demonstrated that the habitat areas within the conservation easement directly contributed to the conservation efforts of the nearby federal wildlife refuge. The taxpayer also argued that the areas of the property comprising the primary elements of the Kiva Dunes Golf Course (i.e., fairways, greens, rough, and tees) provide habitat and conservation benefits, such as areas for feeding, migration, and protection from storms. Under the regulations, such property can be deemed to serve a conservation purpose.[37]

Wildlife. The regulations and Tax Court opinions suggest that the habitats protecting "rare, endangered, or threatened species of animals, fish, or plants" qualify more easily within the habitat conservation purpose.[38] Thus, taxpayers should highlight such wildlife when it is located in the preserved habitats.



In *Kiva Dunes*, the taxpayer demonstrated the conservation values of various species of wildlife located on the property, including neotropical migratory birds migrating annually between North America and South America.[39] Parts of the property also served as transitional habitat of the endangered Alabama beach mouse. When the primary habitat of the mouse is affected by storms, the availability of areas of the conservation easement for refuge becomes particularly important. Such uses of the property demonstrate the breadth of the term "habitats," including uses beyond mere permanent presence of the species.

Open Space. The taxpayer also argued that the conservation easement preserved "open space," meeting the requirements of the Code. Section 170(h)(4)(A)(iii) provides an alternate sufficient conservation purpose for:

> the preservation of open space (including farmland and forest land) where such preservation is—
>
> (I) for the scenic enjoyment of the general public,[40] or
>
> (II) pursuant to a clearly delineated Federal, State, or local governmental conservation policy,[41]
>
> and will yield a significant public benefit.

The term "open space" is somewhat ambiguous, and neither the Code nor the regulations provide much clarity to the definition. Moreover, there can be significant difficulties in demonstrating the "scenic enjoyment" of an "open space" to the IRS or Tax Court. In *Kiva Dunes*, the taxpayer presented visual evidence at trial in the form of photographs and video of the conservation easement's open space vistas.

Interestingly, in *Kiva Dunes*, the majority of the visual evidence presented by the taxpayer (other than what is in the baseline documentation) was prepared specifically for the trial. However, it may be prudent for grantors of conservation easements to go above and beyond the usual baseline documentation photos and record the most favorable images possible of their open space vistas *at the time the easement is granted*. Although professional videography is certainly not a requirement for baseline documentation, it is great preparation for defending a conservation easement if the easement is challenged at a later time.

Education or Outdoor Recreation of the General Public. Finally, the taxpayer argued that the conservation easement provided outdoor recreation for the general public, and, therefore, satisfied the conservation purpose provided for in Section 170(h)(4)(A)(i). That section states that "the preservation of land areas for outdoor recreation by, or the education of, the general public" constitutes a permissible conservation purpose. Reg. 1.170A-14(d)(2)(i) elaborates on this definition, as follows:

> The donation of a qualified real property interest to preserve land areas for the outdoor recreation of the general public or for the education of the general public will meet the conservation purposes test of this section. Thus, conservation purposes would include, for example, the preservation of a water area for the use of the public for boating or fishing, or a nature or hiking trail for the use of the public.

When dealing with a golf course easement, taxpayers who want to use the encumbered property as a *private* golf course will need to establish a public benefit other than those described in Section 170(h)(4)(A)(i).[42]

Although the Code requires that conservation easements meet only one of four conservation purposes, it is important for taxpayers to present evidence that as many of these purposes are met as is possible. It is important for taxpayers to allege that more than one of the four conservation purposes is met so that the taxpayer will have an alternate theory if the court finds against them on one of their conservation purpose for some reason. In effect, this is a "two bites at the apple" situation. In *Kiva Dunes*, the taxpayer presented evidence that the easement met three out of the four conservation purposes.

Valuation—The Battle of the Experts. If a taxpayer can establish that it has made a "qualified contribution" to a "qualified donee" for a permissible "conservation purpose" and that all of the technicalities regarding the contribution are satisfied, the last and final issue is the value of the easement. The value of a conservation easement is one of the areas the IRS is likely to challenge, primarily because of the inherently subjective nature of the determination of value. No matter how well taxpayers document their contribution, the issue of value will always be in play for the IRS.

Kiva Dunes demonstrates that a taxpayer's selection of a qualified and experienced appraiser will likely be critical to the taxpayer's ability to withstand an IRS challenge of the value of the conservation easement. It is helpful to hire an appraiser with experience in valuing charitable contributions because such appraisers are more likely to have knowledge about the various appraisal and appraiser requirements. Moreover, *Kiva Dunes* provides a good illustration that although an appraiser's technical education and licenses are quite important, it is equally, if not more, important that

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[37] Reg. 1.170A-14(d)(3)(i) provides that to satisfy the conservation easement purpose requirement, an easement need only protect a "relatively" natural habitat. Accordingly, it permits easements over property that has been partially altered by human development.

[38] Reg. 1.170A-14(d)(3)(ii) explains that "rare, endangered, or threatened species" are specific examples of the type of animal habitats that can be protected. Finding a rare, endangered or threatened species would be ideal, but the absence of such a species is not necessarily detrimental. See also Glass, note 36 *supra*.

[39] The Ft. Morgan Peninsula is a critical stop-over habitat for these birds when they fly over the Gulf of Mexico. The passage often takes 18 to 24 hours. Prior to their crossing, the birds feed and prepare physically. They often collapse and rest following the passage. The higher dune ridges of the easement area provide regions of tree, shrub and grass vegetation of particular importance to these birds.

[40] See also Reg. 1.170A-14(d)(4)(i)(B)(ii) ("A contribution made for the preservation of open space may be for the scenic enjoyment of the general public . . . if development of the property would impair the scenic character of the local rural or urban landscape or would interfere with a scenic panorama that can be enjoyed from a park, nature preserve, road, waterbody, trail, or historic structure or land area, and such area or transportation way is open to, or utilized by, the public. . . .")

[41] See also Reg. 1.170A-14(d)(4)(i)(A)(iii) ("The requirement that the preservation of open space be pursuant to a clearly delineated Federal, state, or local governmental policy is intended to protect the types of property identified by representatives of the general public as worthy of preservation or conservation. A general declaration of conservation goals by a single official or legislative body is not sufficient. However, a governmental conservation policy need not be a certification program that identifies particular lots or small parcels of individually owned property. . . .")

[42] *See* Reg. 1.170A-14(d)(2)(ii), which states, "The preservation of land areas for recreation or education will not meet the test of this section unless the recreation or education is for the substantial and regular use of the general public."

[43] Additionally, Section 170(e)(1) requires a donor to reduce the amount of his or her charitable deduction in appreciated property by the amount of gain that would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (i.e., the amount of the donor's deduction will be limited to his or her basis in the contributed property). Section 170(e)(1) applies to conservation easements if the property on which the easement is granted is "dealer property" in the hands of the contributor or has not been owned by the taxpayer for the applicable holding period (currently one year). Accordingly, it is important that a taxpayer verify the date of the original acquisition of the property, and that the acquisition was properly recorded.

[44] See Reg. 1.170A-14(h)(3)(i).

[45] Although the Tax Court prefers the use of comparables when they are available, comparables are often unavailable for the easements themselves because the market, if any, for such easements is usually thin. See Kayser, "Conservation Easements: The Blues of Before-and-After Valuation," 2 Val. Strat. 14 (September/October 1998).

[46] Reg. 1.170A-14(h)(3)(i). This can also lead to computational uncertainties, especially when gifts are made from the same tract over several years.

[47] *Id.*

[48] The court concluded that the other variables used by the appraisers had an immaterial effect on the final value amount.

[49] It appears that the IRS expert, like the IRS engineer before him, used the tax return schedule of "other" expenses, which did not include the expenses on specific lines of the return. He disregarded a schedule provided to him detailing the income and expenses of the golf course operations. Although the reason for the error was debated in court, the error evidently harmed the expert's credibility in the case.

the appraiser have extensive knowledge of the actual geographic area being appraised. Indeed, in *Kiva Dunes* the Tax Court seemed as impressed with the taxpayer's expert's knowledge of the local area as with his technical certifications.

Fair Market Value. The amount of a charitable contribution is determined by the fair market value of the contributed property at the time it is contributed.[43] When there is a substantial record of sales of easements comparable to a donated easement, those comparables are used to determine the fair market value of the easement.[44] When no such comparables exist, as in *Kiva Dunes*, the fair market value of a conservation easement is determined with the "before and after" methodology prescribed in the regulations.[45] Specifically, Reg. 1.170A-14(h)(3)(i) provides as follows:

> If no substantial record of marketplace sales is available to use as a meaningful or valid comparision, as a general rule (but not necessarily in all cases) the fair market value of a perpetual conservation restriction is equal to the difference between the fair market value of the property it encumbers before the granting of the restriction and the fair market value of the encumbered property after the granting of the restriction.

When applying the before and after methodology, all property contiguous to the encumbered property that is owned by the taxpayer or the taxpayer's family must be taken into account in the valuation.[46] This has the effect of reducing the value of the deduction to the extent that the value of any contiguous property is enhanced by the easement. Additionally, any economic benefit that accrues to the donor or related party as a result of the contribution must be taken into account.[47] These rules could conceivably have a drastic effect on the deduction when the donor or a related party has retained a significant amount of property surrounding a golf course easement if such property appreciates in value as a result of the easement.

Fair Market Value in *Kiva Dunes*. In *Kiva Dunes*, the experts' opinions of the before value, after value, and enhancement involved critical, subjective judgments and assumptions. The taxpayer presented evidence at trial and on brief, that its expert was the most experienced and respected appraiser in the region surrounding the property, and that his judgments and assumptions reflected this experience. As evidenced by its opinion, the court generally agreed with the taxpayer's expert. Specifically, the court stated that the expert "performs more appraisal work in Baldwin County than any other appraiser, and he has a great depth of knowledge of the comparable properties used in valuing the easement and of the surrounding local real estate market." In contrast the court stated the IRS's expert "ha[d] no particular expertise in Baldwin County, and he ha[d] been to the Baldwin County, Alabama, area only twice in connection with his appraisal of the easement."

Before value. Both appraisers agreed that the development of a residential subdivision would have been the highest and best use of the property at the time of the contribution. In its opinion, the court focused on the differences in three assumptions made by the experts[48] that led to the drastic difference in their before value conclusions—$31,938,985 versus $10,018,000.

1. *Number of lots for sale.* The taxpayer's expert determined that 370 lots could be developed in the hypothetical Kiva Dunes subdivision. The IRS's expert determined that only 300 lots could be developed, based in part on his misinterpretation of a county zoning regulation. The planning and zoning director of the zoning board testified, essentially confirming the taxpayer's interpretation of the regulation.
2. *Average sale price of the lots.* The taxpayer's appraiser determined that the initial sales price of lots in his hypothetical subdivision would average $170,000, while the IRS's expert determined that the lot price would have been only $85,000. The court agreed with the taxpayer's expert and noted that the IRS's expert arrived at the $85,000 value by "averaging the 2001 sales prices of just two interior lots sold at the Kiva Dunes subdivision." The court's acceptance of the taxpayer's conclusions highlights the importance of a sound conceptual plan supporting a subdivision analysis. The court noted that the conceptual plan used by the taxpayer's expert proposed enlargement of several lakes, and creation of several pool and recreation areas on the property—all of which significantly increased the lot value.
3. *Absorption rate.* The parties in Kiva Dunes differed on the time it would take to sell out the hypothetical subdivision, i.e., the period over which cash flow was projected to be received (the absorption rate). The court relied on the taxpayer's expert's local experience and specific examples of actual nearby subdivisions. The court adopted the taxpayer's absorption rate of 37 lots per year for ten years, noting: "Considering that the proposed plan would have had more than three times as many lots available for purchase as [a nearby subdivision], we conclude that a sales forecast of 37 lots per year is reasonable."

Ultimately, the court adopted the taxpayer's before value of $31,938,985. One lesson from the court's value analysis is that value is based on the highest and best use of the property on the date of the donation, and that the highest and best use is not necessarily the current use. Although the property was being used as a golf course, the Kiva Dunes course, like many golf courses around the country, was making little or no profit and its continued operation was not assured.

After value. The experts agreed that, the highest and best use of the property after being burdened by the easement was its continued operation as a golf course. The taxpayer's expert used comparable properties to reach an after value, and the IRS's expert used an income capitalization approach, an approach that was ultimately rejected by the court. The court rejected the income approach because the IRS's expert had omitted essential categories of expenses that "when subtracted from [the IRS's expert]'s computed 2002 net income, result in a negative number." These omitted expenses included: (1) salaries and wages, (2) employee benefits, (3) repairs and maintenance, and (4) taxes and licenses.[49]

The court ultimately relied on the taxpayer's comparables approach. Even though the comparable properties used by the taxpayer's expert were not developed as golf courses at the time, the court determined that they were potentially suitable for such a use. The taxpayer's expert adjusted the sales prices of his comparables to reflect differences in market conditions, location value, access and visibility, size, availability of utilities, topographical and wetland characteristics, and financing terms. The court made its only significant adjustment to the taxpayer's expert's value by adjusting the after value upwards to reflect the cost associated with converting the comparable properties into golf course properties akin to the Kiva Dunes property. Ultimately, the court concluded that the after value of the Kiva Dunes golf course was $2,982,981 ($1,070,980 comparable value plus $1,912,001 for the cost of the golf course improvements).

The court also accepted the taxpayer's expert's conclusion that the conservation easement had enhanced nearby property owned by the taxpayer by $300,000. In the end, the court concluded that the fair market value of the conservation easement was $28,656,004. This holding constituted an unusually high percentage of claimed value (approximately 94%). It is noteworthy that the IRS had asserted a gross overvaluation penalty of 40%, although the court denied it.

The taxpayer's success in *Kiva Dunes* demonstrates that especially in the context of conservation easements, a thorough and knowledgeable appraisal expert can make all of the difference. It is important that the appraiser, in addition to being well qualified and knowledgeable, spend the time necessary to investigate, examine, and understand the property being valued. When using a hypothetical subdivision analysis, an appraiser should pay particular attention to every detail of his or her proposed hypothetical subdivision, including whether or not the zoning and other restrictions to which the encumbered property is subject would prevent (or increase the costs) of developing the hypothetical subdivision.

Conclusion

Although *Kiva Dunes* is probably most noteworthy for demonstrating that a conservation easement can legitimately be granted on property operated as a golf course, the case is instructive on many issues. The case emphasizes the need to select an appraiser with many years of experience, preferably in the local area, and the need for the appraiser to choose valuation methods and comparable properties suitable to the analysis thoghtfully and carefully. The taxpayer in *Kiva Dunes* also benefited greatly from detailed planning of the proposed subdivision used in the before value analysis, and careful attention to feasibility and costs of the proposed plan.

There are many pitfalls and nuances in planning and defending conservation easements, but with the help of good advisors and a capable land trust, a landowner can successfully negotiate the treacherous path through the applicable rules. By applying expertise at the front end in the areas of planning, drafting, and defending conservation easements, the taxpayer puts himself or herself in the best possible position for success, even if the taxpayer's deduction is challenged. ●

KIVA DUNES - MAKING AND SUBSTANTIATING THE VALUE OF CONSERVATION EASEMENTS

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KIVA DUNES—MAKING AND SUBSTANTIATING THE VALUE OF CONSERVATION EASEMENTS

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The Tax Court not only upheld a deduction for a conservation easement on a golf course but also substantially adopted the taxpayer's valuation of the property, both before and after the grant. The case is instructive on the steps taxpayers should take to increase the likelihood of having a claimed deduction for such an easement upheld, and also on how the Tax Court will view valuation appraisals.

The Tax Court's opinion in *Kiva Dunes Conservation, LLC*, TCM 2009-145, addressed a question that has been hotly debated in the conservation easement community—whether a conservation easement can be granted on golf course property. The decision also dealt with several other important issues, including valuation methods applicable to conservation easements. *Kiva Dunes* is a valuable guide for taxpayers seeking to make conservation easement contributions. An in-depth understanding of the case and the issues examined by the court will be useful for anyone involved with conservation easements, whether such involvement is in one's capacity as a potential donor, tax advisor, appraiser, or recipient of a conservation easement.

THE CASE

Kiva Dunes involved a taxpayer's gift of a conservation easement over certain property—which included a golf course—to an eligible donee.

The taxpayer was an LLC taxed as a partnership for federal income tax purposes. On 12/31/02, the taxpayer donated a conservation easement to the North American Land Trust (NALT) by a grant (the "easement declarations"). The conservation easement was granted on 140.9 acres owned by the taxpayer (the "property"), which was located on Alabama's Fort Morgan Peninsula.

The Fort Morgan Peninsula is 22 miles long and ranges between 1.2 and 3.1 miles wide. The property was between, but did not abut, the Gulf of Mexico on the south, and Mobile Bay and Bon Secour Bay on the north. The tract's widest dimension from east to west was approximately 3,600 feet, and its widest dimension from north to south was approximately 2,300 feet.

The conservation easement was located between two segments of the Bon Secour National Wildlife Refuge. One Refuge segment was approximately 0.85 miles west/northwest of the easement, and the other Refuge segment was approximately 1.55 miles east of the easement. The property included the Kiva Dunes Golf Course. As discussed below, however, it had many unique attributes that made it well suited for a conservation easement.

The easement declarations restricted the development of the property, the practical effect of which was to limit the use of the property to a golf course, a park, or a low-density agricultural enterprise. Specifically, the easement declarations limited the use of the property to protect relatively natural habitats for fish, wildlife, and plants, and to preserve open space for scenic enjoyment of the general public and for the advancement of governmental conservation policies. The easement declarations also pre-

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served land areas for outdoor recreation use by the general public.[1]

The LLC claimed two charitable contribution deductions on its partnership return. One was a deduction for a $35,000 cash contribution to NALT.[2] The other was for the qualified conservation contribution of a conservation easement on the property to NALT in the amount of $30,588,235.

Key issues

The week-long trial brought forth evidence that included 103 exhibits, testimony of 18 witnesses, and numerous charts, photographs, and videography.

At trial, the taxpayer had the burden of first proving that the conservation easement met one or more of the conservation purposes necessary for a deduction of a qualified conservation contribution. Specifically, the taxpayer had to establish that the easement accomplished one of the following purposes specified in Section 170(h)(4)(A):

- Preservation of land areas for outdoor recreation by, or for the education of, the general public.
- Protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem.
- Preservation of open space either for the scenic enjoyment of the general public or pursuant to a clearly delineated federal, state, or local governmental conservation policy.

Next, the taxpayer had the burden of establishing the value of the conservation easement. Specifically, the taxpayer attempted to substantiate that the value of the property before imposition of the conservation easement (the "before value") was equal to $31,938,985, and that the value of the property after the imposition of the conservation easement (the "after value") was $1,050,750.[3]

The Tax Court opinion was favorable to the taxpayer and to the use of conservation easements generally. Specifically, the court found the taxpayer was entitled to a charitable deduction of $28,656,004, which was 94% of the deduction the taxpayer claimed on its income tax return. In coming to its decision, the Tax Court addressed several different issues.

Conservation purpose. The Service initially challenged whether the easement constituted a permissible "conservation purpose." This "threshold issue" was strongly contested by the IRS throughout the trial. The IRS was skeptical as to whether an easement restricting golf course property could constitute a permissible conservation purpose.

Much of the trial was devoted to testimony on the conservation purpose issue, after which the IRS conceded the issue in its brief to the Tax Court. Why, one might ask, would the IRS concede the conservation purpose issue in this case? Later in this article we will address the property's unique qualities that made it particularly well-suited for a conservation easement.

Valuation. After the IRS conceded the conservation purpose, the primary issue left was the value of the easement. The experts agreed that the FMV of the easement was equal to the difference between the FMV of the property before and after the easement was granted, reduced by the increase in the value of other nearby property, owned by the taxpayer or a related party, as a result of granting the easement.

The "before value" of the property was based on its potential highest and best use as a residential development. In order to derive the before value, both experts used a discounted cash-flow analysis of estimated revenues and costs associated with the development and sale of lots in their hypothetical subdivisions (the "subdivision method"). The two appraisers' assumptions regarding the number of lots available for sale, average sale price of the lots, and rate at which the lots would sell differed significantly.

The practical effect of the easement declarations was to limit the use of the property to a golf course, a park, or a low-density agricultural enterprise.

The taxpayer's expert's determination that 370 lots could be developed for sale (as opposed to the 300 lots projected by the Service's expert) accorded with the testimony of the county zoning director. Ultimately, the court ruled that the Service's expert misinterpreted the local zoning regulations in concluding that only 300 lots could be built.

The Tax Court also accepted the taxpayer's expert's average lot price of $170,000. The Service's expert's estimate of $85,000 per lot was based essentially on the value of two of the least desirable interior lots in the hypothetical subdivision that had no gulf or lake view and were far removed from the amenities. The taxpayer's expert's assumed sales absorption rate of 37 lots per year was also accepted over the estimate of 20 lots per year by the Service's expert.

The parties agreed, for purposes of determining the value of the property after it was encumbered by the easement, that the property's highest and best use was its continued operation as a golf course. The Service's expert used an income approach to determine such value, while the taxpayer's expert determined the after value by analyzing sales of comparable but unimproved properties that were purchased for recreational uses. The court rejected the income approach valuation used by the Service's expert because he failed to take into account significant expenses, such as salaries and wages, employee benefits, repairs and maintenance, taxes, licenses, and depreciation reserves, in calculating the net income from the course.

USPAP standards are generally adhered to by most experienced appraisers, but IRS has argued with increasing frequency that the standards have not been followed.

The after value determined by the taxpayer's expert through the comparable sales method was accepted by the court. This aspect of the Tax Court's decision was significant because the IRS had argued that the taxpayer's comparables, which had different characteristics and uses than the subject property as encumbered by the easement (e.g., as a golf course), were inadmissible. The Tax Court, however, accepted the use of the comparables, with the exception that an upward adjustment be made to the value of the comparables to reflect the expense necessary to convert the unimproved land into comparable golf course property.

Penalties. The IRS claimed that the taxpayer was subject to a valuation penalty. The Tax Court found the penalty was inapplicable, however, in light of the court's determination that the taxpayer's charitable contribution valuation did not exceed 200% of the determined value of the easement.

LESSONS FROM THE CASE

Kiva Dunes contains a wealth of information for individuals or entities that are considering making a contribution of a conservation easement, and for tax professionals advising these individuals in the contribution process, or in defending an attack on such easements by the IRS.

Technical Requirements

Many issues involved with the *Kiva Dunes* conservation easement were never challenged by the IRS because they were handled properly at the front end. Correctly confronting and resolving these issues is crucial to receiving a contribution for a conservation easement.

Qualified donee. The first thing that a taxpayer must do in order to obtain a deduction for the contribution of a conservation easement is to make the donation to an "eligible donee." Reg. 1.170A-14(c)(1) requires that in order to be eligible a donee must meet the following requirements:

1. The organization must be a governmental agency or a qualified public charitable organization.

2. The organization must have a "commitment to protect the conservation purposes of the donation."

3. The organization must "have the resources to enforce the restrictions."

There are many qualified donees available to accept conservation easements, although they may vary in their interests and requirements. In *Kiva Dunes*, the donee was the North American Land Trust. NALT is both a public charity and an "accredited" organization. The accreditation is a distinction received from the Land Trust Alliance, a nationally known land conservation organization.[4]

Where a contribution is made to a non-accredited organization, taxpayers and practitioners should pay special attention to documenting the proposed donee's commitment to protecting the conservation purpose of the donation. In addition, documenting and establishing that the organization has the resources to enforce the conservation easement restrictions will be essential.

Baseline documentation. Another issue of critical importance to conservation easement contributions is whether the donor of the easement has created or received proper "baseline documentation" detailing the contribution.

Baseline documentation is a report that documents the condition of the easement property at the time an easement is completed and provides a baseline for future monitoring of the property and determining whether there are any violations of the easement. Reg. 1.170A-14(g)(5)(i) requires this baseline property report when the landowner reserves the ability to exercise a right that might interfere with the conservation value of the property. Under the Code and Regulations, it is technically the landowner's responsibility to create this report, although it is typically required by a land trust for all easements, and it is normal for the land trust to prepare the report.

Due to patchwork legislation, the appraiser requirements differ depending on the year of the appraisal and the type of property being appraised.

Baseline documentation must consist of all of the following items:

1. The appropriate survey maps from the U.S. Geological Survey, showing the property line and other contiguous or nearby protected areas.[5]

2. A map of the area drawn to scale showing all existing man-made improvements or incursions and natural species on the property.[6]

3. A contemporaneous aerial photograph of the property.[7]

NOTES

[1] Among the key restrictions of the easement declarations were the following: (1) the property could not be used for residential or commercial purposes; (2) few structures could be built; (3) the owner had to apply the best environmental practices then prevailing in the golf industry; (4) no ground removal was allowed other than golf course irrigation practices; (5) no cutting, removal, or destruction of trees was allowed; (6) no signs or billboards were allowed; (8) no filling in or removal of soil or mining was allowed; (9) dumping was prohibited; (9) no material change in topography was permitted; (10) manipulation of natural water courses was prohibited; (11) soil erosion was to be minimized; (12) no introduction of non-native plants was permitted; and (13) the property was not to be used to meet zoning requirements on outside property.

[2] Before trial, the IRS stipulated that the deduction of the $35,000 cash contribution to North American Land Trust was proper.

[3] Additionally, the taxpayer had the burden of establishing that the enhancement in the value of other property owned by the taxpayer or related parties as a result of the conservation easement was not more than the $300,000 amount determined by the taxpayer.

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[4] See www.landtrustalliance.org.

[5] Reg. 1.170A-14(g)(5)(ii)(A).

[6] Reg. 1.170A-14(g)(5)(ii)(B).

[7] Reg. 1.170A-14(g)(5)(ii)(C).

4. On-site photographs taken at appropriate locations on the property.[8]

5. The condition of any protected property.[9]

6. A statement signed by the donor and a representative of the donee clearly referencing the documentation and stating that the baseline documentation is accurate.[10]

Taxpayers should identify an experienced and reputable donee when making a donation of a conservation easement in which the taxpayer desires to retain some rights. This is especially important when the taxpayer is attempting to make a donation of a conservation easement over golf course property, because generally the rights sought to be retained in order to run and operate a golf course will be fairly extensive.

Although baseline documentation need only satisfy the minimum requirements discussed above, if done properly the documentation can provide a great opportunity to record the state of the property as it exists at the time of the contribution. Specifically, pictures, videography, and other tangible evidence of the property as it existed at the time of the contribution can paint a convincing picture of the conservation preservation attributes of the property. This evidence can play a vital role if the conservation purpose of the contribution is eventually challenged by the IRS.

Qualified appraisal. There are two key issues relating to conservation easement appraisals:

1. Whether the appraisal meets the technical requirements of a "qualified appraisal" under the Code and Regulations.[11]

2. Whether the appraisal substantiates the value of the conservation easement claimed by the donor.

Careful precontribution planning can help a taxpayer avoid challenges by the IRS as to the first issue. The Service frequently challenges valuations, however, and—whether merited or not—often will be capable of presenting a serious challenge to the valuation derived by a taxpayer's expert.

It would be advisable to ensure that any subordination agreement is entered into before the contribution occurs, and in all events before the return is filed.

Technical requirements regarding appraisals. Reg. 1.170A-13(c)(2)(i) contains specific requirements that must be met before an appraisal will be deemed a "qualified appraisal." Specifically, in the context of a contribution of greater than $5,000, a taxpayer must do all of the following:

1. Obtain a qualified appraisal for such property contributed.

2. Attach a fully completed appraisal summary to the tax return on which the deduction for the contribution is first claimed (or reported) by the donor.

3. Maintain records containing certain required information.[12]

A "qualified appraisal" is defined in Reg. 1.170A-13(c)(3), which provides a host of requirements. The appraisal report must:

- Relate to an appraisal made not earlier than 60 days before the date of contribution of the appraised property.[13]
- Be prepared, signed, and dated by a qualified appraiser.[14]
- Include all information that is required to be included in a qualified appraisal (as discussed in the Regulations).[15]
- Not involve a prohibited appraisal fee.[16]

Moreover, for appraisals performed after 8/17/06 for contributions made after that date, Section 170(f)(11)(E)(i)(I) requires that an appraisal must comply with generally accepted appraisal standards and any Regulations or other guidance prescribed by the Service. "Generally accepted appraisal standards" refers to the substance and principles of the Uniform Standards of Professional Appraisal Practice (USPAP).

Notwithstanding the fact that USPAP standards are generally adhered to by most experienced appraisers, the IRS has tended to argue with increasing frequency that the standards have not been followed. The problem with countering such allegations is that USPAP provides general standards and principles which, by their very nature, are somewhat ambiguous. To counter such an assertion, appraisals should reference and adhere to the USPAP standards as closely as practicable.

The *Kiva Dunes* easement was contributed long before 8/17/06.

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8 Reg. 1.170A-14(g)(5)(i)(D).

9 *Id.*

10 *Id.*

11 The technical requirements in the Regulations create a complex web of potential traps. The IRS has frequently argued that the failure by a taxpayer to meet any one of the requirements will result in a total disallowance of a charitable contribution deduction. The courts, however, have provided taxpayers leeway in many instances by requiring only "substantial compliance" with the Regulations. See, e.g., Simmons, TCM 2009-208.

12 The information required, listed in Reg. 1.170A-13(b)(2)(ii), consists of the following: (1) the name and address of the donee organization to which the contribution was made; (2) the date and location of the contribution; (3) a description of the property in detail reasonable under the circumstances (including the value of the property); (4) the FMV of the property at the time the contribution was made; the method used in determining FMV; and, if the valuation was determined by appraisal, a copy of the signed report of the appraiser; and (5) the terms of any agreement or understanding entered into by or on behalf of the taxpayer that relates to the use, sale, or other disposition of the property contributed. Finally, if the property contributed consists of ordinary income property (for example, if it was not held for a year or more prior to the donation of the easement), or if less than the entire interest in the property is contributed in the same year, the Regulations require additional information regarding the contribution.

13 Reg. 1.170A-13(c)(3)(iii).

14 Reg. 1.170A-13(c)(3)(iii). See the discussion in the text, below.

15 Reg. 1.170A-13(c)(3)(i)(C). Reg. 1.170A-13(c)(3)(iv) sets forth a host of information that must be provided.

16 Reg. 1.170A-13(c)(3)(iv)(D). Reg. 1.170A-13(c)(6) lists the requirements pertaining to appraisal fees.

Nonetheless, the Service initially argued that the appraisal should have been performed in accordance with USPAP, and that the appraisal failed to meet this standard. The IRS ultimately abandoned this argument. Nevertheless, it is not uncommon for the Service to misapprehend this rule and attempt to argue, at least within IRS Examination and Appeals, that appraisals relating to contributions made prior to 8/17/06 must be performed in accordance with USPAP.

Substantiation of value. Kiva Dunes illustrates that no matter how informative or detailed an appraisal is, it will always be subject to some challenge by the Service. When an appraisal is performed in accordance with all of the applicable Regulations, is performed in accordance with USPAP principles, and is thorough and complete, the IRS often will nonetheless challenge the conclusions in the appraisal by presenting its own valuation expert with a contrary opinion.

In many instances, as in *Kiva Dunes*, the value of the conservation easement will evolve into a "battle of the appraisers." In such a situation, it is important that the taxpayer's appraiser be able to support the appraisal conclusions with knowledgeable and persuasive analysis, as well as detailed fact finding. (A description of this process is described later in this article.)

Qualified appraiser. The Regulations provide a complex framework of provisions governing who will constitute a "qualified appraiser" for purposes of the Code. Due to the patchwork nature of congressional legislation in this area, the appraiser requirements differ depending on the year of the appraisal and the type of property being appraised.

Currently, Section 170(f)(11)(E)(ii) defines a qualified appraiser[17] as an individual who meets all of the following requirements:

- The appraiser has earned an appraisal designation from a recognized professional appraiser organization[18] or has otherwise satisfied minimum education and experience requirements set forth in Regulations.[19]
- The appraiser regularly performs appraisals for which compensation is received.
- The appraiser satisfies such other requirements as may be prescribed by in Regulations or other guidance.[20]

Moreover, under Section 170(f)(11)(E)(iii),[21] an individual cannot be treated as a qualified appraiser unless the following criteria are met:

- The individual demonstrates verifiable education and experience in valuing the type of property subject to the appraisal.[22]
- The individual has not been prohibited from practicing before the IRS under 31 U.S.C. section 330(c) at any time during the three-year period ending on the date of the appraisal.

Although in *Kiva Dunes* the IRS conceded that the taxpayer's appraiser was a "qualified appraiser," the Service is generally quick to dispute this issue in audits of conservation easements. Moreover, as a result of the enactment of the PPA, the definitions and standards for a "qualified appraiser" have become much more complex. Accordingly, it is important for taxpayers to have a comprehensive understanding of the qualifications their appraiser must meet, as well as the process the appraiser must engage in.

The Regulations identify four different categories of permissible conservation easement purposes, only one of which must be satisfied.

It is generally advisable for taxpayers to hire an appraiser that has substantial experience in valuing conservation easements. Such appraisers are more likely to have knowledge of the applicable appraisal requirements. Moreover, *Kiva Dunes* illustrates (as is discussed below) that, although an appraiser's technical education and licenses are very important, it is at least equally important that the appraiser has an extensive knowledge of the specific geographic area and market of the property being appraised. Indeed, in *Kiva Dunes*, the Tax Court gave great weight to specific knowledge about the local area.

Subordination agreement. A recurring issue in IRS examinations of easement deductions involves existing mortgages that encumber conservation easement property. Unless such mortgages are subordinated to the rights of the donee to enforce the conservation easement, the conservation easement will not be deductible. Reg. 1.170A14(g)(2) provides that "no deduction will be permitted under this section for an interest in property which is subject to a mortgage unless the mortgagee

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17 Section 170(f)(11)(E)(ii) was enacted by the Pension Protection Act of 2006 (PPA), P.L. 109-280, 8/17/06, effective for appraisals prepared with respect to returns or submissions filed after that date.

18 Notice 2006-96, 2006-46 IRB 902, provides in section 3.03(1) that an appraisal designation from a recognized appraisal organization is sufficient to satisfy this requirement if it relates to valuing the type of property for which the appraisal is performed.

19 For returns filed before 10/20/06, the education and experience requirements are satisfied if the appraiser is a "qualified appraiser" within the meaning of Reg. 1.170A-13(c)(5). For returns filed after 10/19/06, the minimum education and experience requirements depend on the type of property to which an appraisal relates. For real property appraisals, the appraiser must be licensed or certified for the type of property being appraised in the state in which the real property is located. See Notice 2006-96, *supra* note 18, section 3.03(b)(ii).

20 No additional Regulations have been issued at this point. Until such Regulations are issued, Notice 2006-96, *supra* note 18, governs.

21 Section 170(f)(11)(E)(iii) is also in effect for appraisals prepared with respect to returns or submissions filed after 8/17/06.

22 The appraiser is required to make a designation in the appraisal that, because of the appraiser's background, experience, education, and membership in professional associations, the appraiser is qualified to make appraisals of the type of property being valued. See Notice 2006-96, *supra* note 18, section 3.03(2).

Other Conservation Easement Cases

In addition to *Kiva Dunes*, practitioners contemplating the benefits of a conservation easement might consider the following decisions.

- *Turner*, 126 TC 299 (2006) (providing a thorough discussion of the "open space requirement" and finding that such requirement is not satisfied where a conveyance of an easement does not limit the size of the homes developable on the eased property).
- *Glass*, 124 TC 258 (2005), *aff'd* 471 F.3d 698, 98 AFTR2d 2006-8309 (CA-6, 2006) (seminal case on conservation easement purpose, particularly the purpose of protecting a relatively natural habitat).
- *Bond*, 100 TC 32 (1993) (finding substantial compliance with the "qualified appraisal" Regulations is sufficient to receive a charitable contribution deduction).
- *Symington*, 87 TC 892 (1986) (explaining that the "before and after method" of valuing conservation easements is generally appropriate because of the scarcity of sales of conservation easements that can be used as comparables).
- *Thomason*, 2 TC 441 (1943) (distinguishing between private and "public benefit").
- *Hughes*, TCM 2009-94 (recent case denying the Service's ever more pervasive "zero value" argument that conservation easements have no value).
- *Simmons*, TCM 2009-208 (applying the substantial compliance doctrine in the context of the qualified appraisal and contemporaneous written acknowledgment requirements with respect to the donation of a facade easement).
- *Herman*, TCM 2009-205 (conservation easement restricting development of air rights above historic apartment building was not exclusively for conservation purposes where easement allegedly failed to provide for maintenance of the property or prevent alteration or demolition of the building).
- *Daniel*, TCM 1997-328 (applying the substantial compliance doctrine in context of the requirements of Regs. 1.170A-13(b)(2) and (3)).
- *Satullo*, TCM 1993-614 (discussing the mortgage subordination requirement of Reg. 1.170A-14(g)(2), and indicating an unsubordinated mortgage might not result in a disallowed deduction in limited instances in which the mortgage is unlikely to be enforced).
- *Schapiro*, TCM 1991-128 (Tax Court determined, based on the subdivision analysis, that the value of the conservation easement was greater than taxpayer had claimed on its return).
- *Brizzewicz*, 604 F. Supp. 2d. 1197, 103 AFTR2d 2009-1428 (DC Ill., 2009) (stating substantial compliance doctrine might not apply in the Seventh Circuit).

subordinates its rights in the property *to the right of the qualified organization* to enforce the conservation purposes of the gift in perpetuity."

Although the IRS has sometimes contended that subordination agreements must be entered into prior to the date on which the easement is contributed, the Regulations do not appear to expressly require this. It would, however, be advisable to avoid this potential issue by assuring that any subordination agreement is entered into before the contribution occurs, and in all events before the tax return for the applicable year is submitted.

The Service also has contended in some audits that a subordination agreement must be recorded in order to satisfy the Regulations. As quoted above, however, Reg. 1.170A-14(g)(2) requires only that the mortgagee subordinates its rights to the right of the donee to enforce the conservation purposes of the gift. Thus, the Regulations do not expressly require that the mortgagee subordinate its rights to third parties or that the subordination must be recorded. Accordingly, it is possible that when state law provides that an unrecorded mortgage will be effective as to the parties to the agreement, the Regulations will be satisfied by the existence of a subordination agreement, regardless of whether it is recorded or enforceable against third parties.

Conservation Purpose

One of the most important issues in *Kiva Dunes* was whether there was a qualified "conservation purpose" for the conservation easement. This issue was only mentioned in passing by the court in its opinion because the issue was conceded by the IRS after the trial of the case and partial briefing. The issue, however, was critical to the case, as it is in many conservation easement controversies.

Section 170(h)(4)(A) and Reg. 1.170A-14(d)(1) identify four different categories of permissible conservation easement purposes, only one of which must be satisfied:

1. The preservation of land areas for outdoor recreation by, or the education of, the general public.

2. The protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem.

3. The preservation of certain open space (including farmland and forest land).

4. The preservation of a historically important land area or a certified historic structure.

In *Kiva Dunes*, the taxpayer had alleged that the conservation easement served the first three conservation purposes. The issue is important because the IRS and many experts had been of the opinion that a conservation easement restricting property to use as a golf course could not meet any of the conservation purposes. Nonetheless, after an extensive trial in which the LLC brought forth convincing conservation purpose evidence, the Service conceded that an easement over golf course property in this instance satisfied the conservation easement purposes required in the Code and Regulations.[23]

The three "conservation purposes" that the taxpayer argued the easement satisfied are described below.[24]

Relatively natural habitat. Reg. 1.170A-14(d)(3)(ii) provides a nonexclusive list of habitats and natural areas that will satisfy the protection of a "relatively natural habitat":

- Habitats for rare, endangered, or threatened species of animals, fish, or plants.
- Natural areas, such as undeveloped islands, that represent high quality examples of terrestrial or aquatic communities.
- Natural areas included in, or contributing to, the ecological viability of a local, state, or national park, preserve, wildlife refuge, wilderness area, or similar conservation area.

In *Kiva Dunes*, the taxpayer asserted that the easement protected virtually all of the above types of habitats and natural areas. The taxpayer demonstrated—through the use of pictures, video, and other trial exhibits—the various types of habitats present on the property.

The property and conservation easement were located on a narrow part of the Fort Morgan Peninsula in Baldwin County, Alabama, which shares many characteristics with barrier islands, and is in some instances classified as a "barrier resource" for federal regulatory purposes. The taxpayer was able to demonstrate that the area consisted of unique habitat that helped provide a diverse array of habitats for wildlife.

The taxpayer's ability to describe, in specific detail, the types and quality of habitat and wildlife located on the property was essential to establishing that the easement provided for the "protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem."

Habitat. The conservation easement contained seasonal freshwater wetlands, permanent lakes and ponds, wooded hammocks, and coastal dunes, each of which provided natural and/or relatively natural habitat. The taxpayer was able to demonstrate that the dispersed pattern of the habitat areas did not negate its conservation values.

The taxpayer's ability to describe, in specific detail, the types and quality of habitat and wildlife located on the property was essential.

The taxpayer's experts testified that a particular habitat need not support all phases of species' lives to be termed a "habitat." For instance, wildlife may "nest" in one area and "feed" in another. Many species of birds and animals are migratory, and may only pass through the habitat. Such "stop-over" habitat is often of critical importance, however. "Habitat" includes areas used occasionally by species or areas used in unpredictable patterns that vary over time.

The taxpayer's expert established that 61.15 acres of the 140.9 acre easement (43.4%) could be described as a "primary habitat" for wildlife, and that 49 of these acres (34.8% of the total easement) could be classified as "fully natural." The LLC also established that the remaining 12.15 acres of the "primary habitat" area was a "relatively natural" habitat for fish, wildlife, and plants.[25]

In addition, the taxpayer demonstrated that the habitat areas within the conservation easement directly contributed to the conservation efforts of the nearby federal wildlife refuge. The taxpayer also argued that the areas of the property that comprised the primary golfing elements of the Kiva Dunes Golf Course (e.g., fairways, greens, rough, and tees) provided habitat and conservation benefits, such as areas for feeding, migration, and protection from storms. Under the Regulations, such

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[23] It is possible that the IRS had planned to use Kiva Dunes as a test case to demonstrate that granting an easement on golf course property cannot support a permissible conservation purpose. The Service's concessions reflect that the IRS was concerned that the court would determine the issue in the taxpayer's favor. By conceding the issue, the IRS effectively prevented the court from addressing the issue head-on, although the Service's concession in Kiva Dunes will undoubtedly be cited by taxpayers for the proposition that conservation easements can permissibly be granted over golf course property.

[24] The only conservation purpose not argued by the taxpayer was that the easement preserved a historically important land area or a certified historic structure. This conservation purpose is generally not applicable in golf course easement situations. It is most commonly used in situations involving facade easements. See, e.g., Dorsey, TCM 1950-242 (conservation easement deduction for a facade easement restricting development of facade of historic commercial building), but see Herman, TCM 2009-205 (conservation easement restricting development of air rights above historic apartment building was not exclusively for conservation purposes where easement allegedly failed to prevent alteration or demolition of the building). It is anticipated that Herman will be appealed as it addresses an arguably novel concept regarding the deductibility of "development rights." Additionally, Herman is facially contradictory to Dorsey, although the Tax Court attempted to distinguish the case in its opinion.

[25] As often will be the case when an easement encumbers a geographically large area, it was virtually impossible for the taxpayer to prove that the entire portion of the property that was encumbered by the easement provided a "relatively natural habitat of fish, wildlife, or plants, or similar ecosystem" as described in the Regulations. The taxpayer, however, was able to rely on prior case law indicating that the entire eased area did not need to provide conservation benefits, as long as a significant portion of such easement satisfies the requirement. See, e.g., Glass, 124 TC 258 (2005), *aff'd* 471 F.3d 698, 98 AFTR2d 2006-8309 (CA-6, 2006).

[26] The Regulations provide that an easement need protect only a "relatively" natural habitat. Accordingly, the Regulations permit easements over property that has been partially altered by human development to satisfy the conservation easement purpose requirement. See Reg. 1.170A-14(d)(2)(i).

property can be deemed to serve a conservation purpose.[26]

Wildlife. The Regulations and prior Tax Court opinions suggest that the habitats protecting "rare, endangered, or threatened species of animals, fish, or plants" qualify more easily within the habitat conservation purpose.[27] Thus, taxpayers should highlight such wildlife when it is located in the preserved habitats.

In *Kiva Dunes*, the taxpayer demonstrated the conservation values of various species of wildlife located on the property, including neotropical migratory birds migrating annually between North America and South America.[28] Parts of the property also served as transitional habitat of the endangered Alabama beach mouse. When the primary habitat of the mouse is affected by storms, the availability of areas of the conservation easement for refuge becomes particularly important. Such uses of the property demonstrate the breadth of the term "habitats," including uses beyond mere permanent presence of the species.

Taxpayers should highlight rare, endangered, or threatened species when such wildlife is located in the preserved habitats.

Open space. The taxpayer also argued that the conservation easement preserved an "open space," meeting the requirements of the Code. Section 170(h)(4)(A)(iii) provides an alternate sufficient conservation purpose for "the preservation of open space (including farmland and forest land) where such preservation is ... for the scenic enjoyment of the general public;"[29] or "pursuant to a clearly delineated Federal, State, or local governmental conservation policy;"[30] and "will yield a significant public benefit."

Practice Notes

- Where a contribution is made to a non-accredited organization, taxpayers and practitioners should pay special attention to documenting the proposed donee's commitment to protecting the conservation purpose of the donation.
- Documenting and establishing that the organization has the resources to enforce the conservation easement restrictions will be essential.
- Taxpayers should identify an experienced and reputable donee when making a donation of a conservation easement in which the taxpayer desires to retain some rights.
- It may be prudent for grantors of conservation easements to go above and beyond the usual baseline documentation photos and record the most favorable images possible of their open space vistas *at the time the easement is granted.*

"Open space" is a somewhat ambiguous term, and neither the Code nor the Regulations provide much clarity to the definition. Moreover, there can be significant difficulties to demonstrating the "scenic enjoyment" of an "open space" to the IRS or Tax Court. In *Kiva Dunes*, the taxpayer presented visual evidence at trial in the form of photographs and video of the conservation easement's open space vistas.

In *Kiva Dunes*, the majority of the visual evidence presented by the taxpayer (other than what was in the baseline documentation) was prepared specifically for the trial. Nevertheless, it may be prudent for grantors of conservation easements to go above and beyond the usual baseline documentation photos and record the most favorable images possible of their open space vistas *at the time the easement is granted.* Although professional videography is certainly not a requirement for baseline documentation, it is great preparation for defending a conservation easement if the easement is challenged at a later time.

Education or outdoor recreation of the general public. Finally, the taxpayer argued that the conservation easement provided outdoor recreation for the general public, and, therefore, satisfied the conservation purpose provided for in Section 170(h)(4)(A)(i).

That section states that "the preservation of land areas for outdoor recreation by, or the education of, the general public" constitutes a permissible conservation purpose. Reg. 1.170A-14(d)(2)(i) elaborates on this definition, as follows:

"The donation of a qualified real property interest to preserve land areas for the outdoor recreation of

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[27] Reg. 1.170A-14(d)(3)(i); Class, supra note 25.

[28] The Fort Morgan Peninsula is a critical stopover habitat for these birds when they fly over the Gulf of Mexico. The passage often takes 18 to 24 hours. Prior to their crossing, the birds feed and prepare physically. They often collapse and rest following the passage. The higher dune ridges of the easement provide regions of tree, shrub, and grass vegetation of particular importance to these birds.

[29] See also Reg. 1.170A-14(d)(4)(iii)(A) ("A contribution made for the preservation of open space may be for the scenic enjoyment of the general public ... if development of the property would impair the scenic character of the local rural or urban landscape or would interfere with a scenic panorama that can be enjoyed from a park, nature preserve, road, waterway, trail, or historic structure or land area, and such area or transportation way is open to, or utilized by, the public...").

[30] See also Reg. 1.170A-14(d)(4)(iii)(A) ("The requirement that the preservation of open space be pursuant to a clearly delineated Federal, state, or local governmental policy is intended to protect the types of property identified by representatives of the general public as worthy of preservation or conservation. A general declaration of conservation goals by a single official or legislative body is not sufficient. However, a government at all conservation policy need not be a certification program that identifies particular lots or small parcels of individually owned property...").

the general public or for the education of the general public will meet the conservation purposes test of this section. Thus, conservation purposes would include, for example, the preservation of a water area for the use of the public for boating or fishing, or a nature or hiking trail for the use of the public."

The value of a conservation easement is one of the areas IRS is likely to challenge, primarily because of the inherently subjective nature of the determination of value.

When dealing with a golf course easement, taxpayers who want to use the encumbered property as a *private* golf course will need to establish a public benefit other than those described in Section 170(h)(4)(A)(i).[31]

Although the Code requires only that conservation easements meet one of four conservation purposes, it is important for taxpayers to present evidence that as many of these purposes are met as is possible. In *Kiva Dunes*, the taxpayer presented evidence that the easement met three out of four conservation purposes.

Valuation—Battle of the Experts

If a taxpayer can establish that it has made a "qualified contribution" to a "qualified donee" for a permissible "conservation purpose" and that all of the technicalities regarding the contribution are satisfied, the last and final issue is the value of the easement.

The value of a conservation easement is one of the areas the IRS is likely to challenge, primarily because of the inherently subjective nature of the determination of value. No matter how well a taxpayer documents the contribution, the issue of value will always be in play for the Service.

Kiva Dunes demonstrates that a taxpayer's selection of a qualified and experienced appraiser will likely be critical to the taxpayer's ability to withstand an IRS challenge of the value of the conservation easement. It is helpful to hire an appraiser with experience in valuing charitable contributions because such appraisers are more likely to have knowledge about the various appraisal and appraiser requirements. Moreover, *Kiva Dunes* provides a good illustration that, although an appraiser's technical education and licenses are very important, it is equally if not more important that the appraiser has extensive knowledge of the actual geographic area being appraised. Indeed, in *Kiva Dunes* the Tax Court seemed as impressed with the taxpayer's expert's knowledge of the local area as his technical certifications.

FMV. The amount of a charitable contribution is determined by the FMV of the contributed property at the time it is contributed.[32] Where there is a substantial record of sales of easements comparable to a donated easement, those comparables are used to determine the FMV of the easement.[33] Where no such comparables exist, as in *Kiva Dunes*, the FMV of a conservation easement is determined with the "before and after" methodology prescribed in the Regulations.[34] Specifically, Reg. 1.170A-14(h)(3)(i) provides as follows:

"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 fair market value of a perpetual conservation restriction is equal to the difference between the fair market value of the property it encumbers before the granting of the restriction and the fair market value of the encumbered property after the granting of the restriction."

The court's acceptance of the taxpayer's expert's conclusions highlights the importance of a sound conceptual plan supporting a subdivision analysis.

When applying the before and after methodology, the Regulation provides that all property contiguous to the encumbered property that is owned by the taxpayer or the taxpayer's family must be taken into account in the valuation.[35] This has the effect of reducing the value of the deduction to the extent that the value of any contiguous property is enhanced by the easement. Additionally, any economic benefit that accrues to the donor or a related party as a result of the contribution must be taken into account. These rules could conceivably have a drastic effect on the deduction where the donor or a related party has retained a significant amount of property surrounding a golf course easement, if such property appreciates in value as a result of the easement.

FMV in *Kiva Dunes*. In *Kiva Dunes*, the experts' opinions of the before value, after value, and enhancement involved critical, subjective judgments and assumptions. The key elements of the valuation issue in *Kiva Dunes* are described below.

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[31] See Reg. 1.170A-14(d)(2)(iii), which states that the "preservation of land areas for recreational or education will not meet the test of this section unless the recreation or education is for the substantial and regular use of the general public."

[32] Additionally, Section 170(e)(1) requires a donor to reduce the amount of his charitable deduction in appreciated property by the amount of gain that would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its FMV (e.g., the donor's deduction will be limited to his basis in the contributed property). Section 170(e)(1) applies to conservation easements of the property on which the easement is granted (a "donee property" in the hands of the contributor or has not been owned by the taxpayer for the applicable holding period (currently one year). Accordingly, it is important that taxpayers verify the date of their original acquisition of the property, and that the acquisition was properly recorded.

[33] Id. See also Reg. 1.170A-14(h)(3)(i).

[34] Although the Tax Court prefers the use of comparables when they are available, often in the context of conservation easements there will not be "comparable properties" because properties encumbered by conservation easements are not frequently exchanged.

[35] This also can lead to computational complexities, especially when gifts are made from the same tract over several years.

The taxpayer presented evidence, at trial and in brief, that its expert was the most experienced and respected appraiser in the region surrounding the property, and that his judgments and assumptions reflected this experience. As evidenced by its opinion, the Tax Court generally agreed with the taxpayer's expert. Specifically, the court stated that the expert "perform[ed] more appraisal work in Baldwin County than any other appraiser, and [had] a great depth of knowledge of the comparable properties used in valuing the easement and of the surrounding local real estate market."

In contrast, the court stated the Service's expert "ha[d] no particular expertise in Baldwin County, and he ha[d] been to the Baldwin County, Alabama, area only twice in connection with his appraisal of the easement."

Both appraisers determined the before and after values of the conservation easement, to arrive at the FMV of the easement.

Before value. Both appraisers agreed that the development of a residential subdivision would have been the highest and best use of the property at the time of the contribution. In its opinion, the Tax Court focused on the differences in three assumptions made by the experts[36] that led to the drastic difference in their before value conclusions—$31,938,985 and $10,018,000. The assumptions focused on by the court were:

1. The number of lots available for sale.
2. The average sale price of the lots.
3. The rate at which the lots would sell.

Number of lots for sale. The taxpayer's expert determined that 370 lots could be developed in the hypothetical Kiva Dunes subdivision. The Service's expert determined that only 300 lots could be developed, based in part on his misinterpretation of a county zoning regulation. The planning and zoning director of the zoning board testified about such regulation. His testimony essentially confirmed the taxpayer's interpretation of the regulation.

Value is based on the highest and best use of the property on the date of donation, and the highest and best use is not necessarily the current use.

Average sale price of the lots. The taxpayer's appraiser determined that the initial sales price of lots in his hypothetical subdivision would average $170,000, while the Service's expert determined that the lot price

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36 The court concluded the other variables used by the appraisers had an immaterial effect on the final value.

would have been only $85,000. The court agreed with the taxpayer's expert and noted that the Service's expert arrived at the $85,000 value by "averaging the 2001 sales prices of just two interior lots sold at the Kiva Dunes subdivision."

The court's acceptance of the taxpayer's expert's conclusions highlights the importance of a sound conceptual plan supporting a subdivision analysis. The court noted that the conceptual plan used by the taxpayer's expert proposed the enlargement of several lakes, and the creation of several pool and recreation areas on the property—all of which significantly increased the lot value.

Absorption rate. The parties in *Kiva Dunes* differed on how long it would take to sell out the hypothetical subdivision, i.e. the period over which cash flow was projected to be received (the "absorption rate"). The court relied on the taxpayer's expert's local experience and specific examples of actual nearby subdivisions. The Tax Court adopted the taxpayer's absorption rate of 37 lots per year for ten years, and stated: "Considering that the proposed plan would have had more than three times as many lots available for purchase as [a nearby subdivision], we conclude that a sales forecast of 37 lots per year is reasonable."

Ultimately, the court adopted the taxpayer's before value of $31,938,985.

After value. One lesson from the Tax Court's value analysis is that value is based on the highest and best use of the property on the date of the donation, and the highest and best use is not necessarily the current use. Although the property was being used as a golf course, the Kiva Dunes course, like many golf courses around the country, was making little or no profit and its continued operation was not assured.

In determining the value of the property, the experts agreed that the highest and best use of the property after being burdened by the easement was its continued operation as a golf course. The taxpayer's expert used comparable properties to reach an after value, and the Service's expert used an income capitalization approach, which was ultimately rejected by the court. The Tax Court rejected the income approach because the Service's expert had omitted essential categories of expenses that "when subtracted from [the Service's expert's] computed 2002 net income, result[ed] in a negative number." These omitted expenses included (1) salaries and wages, (2) employee benefits, (3) repairs and maintenance, and (4) taxes and licenses.[37]

The Tax Court ultimately relied on the taxpayer's comparables approach. Even though the comparable properties used by the taxpayer's expert were not developed as golf courses at the time, the court determined them to be potentially suitable for such a use. The taxpayer's expert adjusted the sales prices of his comparables to reflect differences in market conditions, location value, access and visibility, size, availability of utilities, topographical and wetland characteristics, and financing terms. The court made its only significant adjustment to the taxpayer's expert's values by adjusting the after value upwards to reflect the cost associated with converting the comparable properties into golf course properties akin to the Kiva Dunes property. Ultimately, the Tax Court concluded that the after value for the Kiva Dunes Golf Course was $2,982,981 ($1,070,980 comparable value plus $1,912,001 for the cost of the golf course improvements).

The Tax Court also accepted the taxpayer's expert's conclusion that the conservation easement had enhanced nearby property owned by the taxpayer by $300,000. Finally, the court concluded that the FMV of the conservation easement was $28,656,004. This holding constituted an unusually high percentage of claimed value (approximately 94%). The IRS had asserted a gross overvaluation penalty of 40%, although the court denied it.

The taxpayer's success in *Kiva Dunes* demonstrates that, especially in the context of conservation easements, a thorough and knowledgeable appraisal expert can make all of the difference. It is important that the appraiser, in addition to being well qualified and knowledgeable, spends the time necessary to investigate, examine, and understand the property being valued. Additionally, the hypothetical subdivision used in many of these appraisals requires careful attention to every detail, including potential development analysis.

CONCLUSION

Although *Kiva Dunes* is probably most noteworthy for demonstrating that a conservation easement can be legitimately granted on property operated as a golf course, the case is instructive on many issues. The case emphasizes the need to carefully select an appraiser with many years of experience, preferably in the local area, and the need for the appraiser to thoughtfully and carefully choose valuation methods and comparable properties suitable to the analysis. The taxpayer in *Kiva Dunes* also benefited greatly from detailed planning of the proposed subdivision used in the before value analysis, and careful attention to feasibility and costs of the proposed plan.

There are many pitfalls and nuances in planning and defending conservation easements, but with the help of good advisors and a capable land trust, a landowner can successfully negotiate the treacherous path through the conservation easement rules. By applying expertise at the front-end in the areas of planning, drafting, and defending conservation easements, the taxpayer is in the best possible position for success, even if the taxpayer's conservation easement deduction is challenged. ■

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37 It appears that the IRS expert, like the IRS engineer before him, used the tax return schedule of "other" expenses, which schedule did not include the expenses on specific lines of the return. He disregarded a schedule provided to him detailing the income and expenses of the golf course operations. Although the reason for the error was debated in court, the error evidently harmed the expert's credibility.

FIRM OVERVIEW

FIRM OVERVIEW

From the firm's founding in 1946, the people of Sirote & Permutt have approached the practice of law with a focus on uncompromising values: Integrity and trust. Selflessness, courage, and loyalty. Above all, excellence, passion, leadership, and commitment.

What sets Sirote apart is not just the experienced counsel we have provided throughout nearly 70 years of serving the community with distinction. It is also our unwavering belief in always being there for our clients, never satisfied until their goals are fully met, never sacrificing principles along the way.

The history of Sirote & Permutt began after World War II when Morris Sirote and Edward Friend, Jr. joined forces with James Permutt to establish a law office in Birmingham, AL. Karl Friedman soon joined the group, and together these men built one of the Southeast's largest and most respected law firms across a range of practice areas.

Sirote has seen 88 of our attorneys recognized by The Best Lawyers in America, Chambers USA and Super Lawyers, among other accolades the firm has received. Eleven of our lawyers are current or former adjunct professors of law in Real Estate, Corporate/Securities, Tax, Estate Planning and Litigation.

Our professionals place a high priority on serving not only clients but also the communities in which we live and work. To that end, we established Sirote Supports, the firm's charitable initiative that honors programs dedicated to health, education and the arts. The firm is also proud to be a consistent supporter and fundraising leader for the United Way of Central Alabama.

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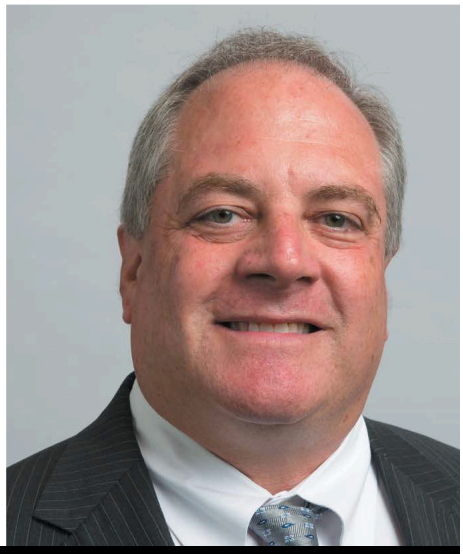

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- "Navigating the Defenses to Valuation Penalties in Charitable Deduction Cases." Journal of Taxation, December 2014.
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Organizations

- American College of Tax Counsel, Fellow; Board of Regents
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- Alabama State Bar, Tax Section, Chair
- American Bar Association, Tax Section, S-Corporation Committee, Chair
- Leadership Birmingham, Class of 1996

- "Reasonable Compensation and the Built-In Gains Tax." NYU Sixty-Eighth Institute on Federal Taxation, Ch. 15 (2010).
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- AV-Preeminent, Martindale-Hubbell® Peer Review Rating™
- Best of US, Tax Law, 2006
- Corporate Counsel Magazine Best Lawyers in America, Tax Law, 2003
- Birmingham Magazine, Top Attorney in Tax Law

Thought Leadership

- Taught for 28 years on Tax Practice and Procedure at the University of Alabama School of Accounting (Master of Tax Accounting) and School of Law (LL.M. in Taxation)

Speeches & Publications

- Speaker, "Standards and Ethics of Tax Practice," Federal Tax Clinic, November 2015
- Speaker, "Circular 230 and Return Preparer Penalties," American Institute on Federal Taxation, June 2011
- Speaker, "Tax Litigation," ABA Institute on Civil Tax Controversy, December 2011
- Speaker, "Amendment, Modification & Termination of Conservation Easements," Land Trust Alliance Rally 2013
- Speaker, "Defending Valuation Disputes," ASCPA, September 2014
- Speaker, "Tax Penalties," Alabama Association of Accountants and Tax Preparers, September 2013
- Co-author, "Navigating the Defenses to Valuation Penalties in Charitable Deduction Cases," Journal of Taxation, December 2014
- Co-author, "Conservation Easement Confusion in the Tax Court and Fifth Circuit," Taxation of Exempts, July 2013, Real Estate Taxation, June 2014
- Co-author, "Circuit Courts Speak on Conservation Easements, but Is the IRS Listening?", Taxation of Exempts, January/February 2013
- Author, "Proving the Value of a Charitable Donation May Be the Least of Your Problems", Journal of Taxation, August 2011
- Co-author, "Simmons-Substantial Compliance Revisited", Tax Notes, January 2010
- Co-author, "Tax Court Analysis of Land Conservation Easement Values—Developments Since Kiva Dunes", Taxation of Exempts, May/June 2011
- Co-author, "A Guide to Donating Conservation Easements Substantiating Their Value", Valuation Strategies, May/June 2010 Edition
- Co-author, "Kiva Dunes—Making and Substantiating the Value of Conservation Easements", Journal of Taxation, November 2009

Outside the Office

- Homewood City Schools Foundation
  Founder and Past President

- Active in fundraising efforts for the United Way and United Cerebral Palsy
- FOCUS on Recovery
  Board Member and Officer (2011-2015)
- Alabama Lawyer Assistant Foundation
  Board Member and Officer (2001-present)

Organizations

- Alabama State Bar Association
  - Tax Section, Chairman, 1987
  - Lawyer Assistance Program, Chair 2004-07
  - Award of Merit, 2009
  - WM Scruggs Service Award, 2013
- American Bar Assocation
  - Tax Section Court Procedure Committee
  - IRS Southeast Region, Former ABA Liaison
- American College of Tax Counsel, Fellow
- Member of Bars of Federal Courts, US Tax Court, US Claims Court and Court of Appeals for the Federal Circuit
- Served as Law Clerk to Judge Irene F. Scott of The United States Tax Court, 1976-78

Sirote

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Practice Areas

Corporate
Litigation
Tax

Greg is an integral member of the Tax Controversy and Tax Planning practices. His areas of focus include income tax litigation, estate and gift taxes, state and local taxes, and business transactions. He has represented partnerships, corporations and individuals in multi-million dollar tax controversies in Tax Court trials in New York, North Carolina, Atlanta, Alabama, and other venues. His work has earned him the recognition as an Alabama Super Lawyers Rising Star in 2011 and 2013-2015. Greg also works in the area of international taxation and has helped set up companies in foreign jurisdictions and has helped several individuals successfully complete the IRS Offshore Voluntary Disclosure program. Greg was Professor of Law at Birmingham School of Law where he taught Federal Income Taxation.

Education

New York University
School of Law
LLM, 2008

University of Mississippi
School of Law
JD, 2005
Magna Cum Laude

Millsaps College
BA, 2001
Cum Laude

Emphasis

- Charitable Planning & Contributions
- Corporate Tax
- Criminal Tax
- Estate Planning & Administration
- High Net Worth Individuals
- Tax Controversy
- Tax Litigation

Industries

- Closely Held Businesses
- Individuals, Families, Estates & Trusts
- Industrials & Natural Resources
- Real Estate

Recognition

- Alabama Super Lawyers, Rising Stars, 2011, 2013-15

Thought Leadership

- Professor of Law at Birmingham School of Law where he taught Federal Income Taxation.

Speeches & Publications

- Author, "Navigating the Defenses to Valuation Penalties in Charitable Deduction Cases," Journal of Taxation, December 2014
- Author, "Conservation Easement Confusion in the Tax Court and Fifth Circuit," Real Estate Taxation, 2014
- Author, Circuit Courts Speak on Conservation Easements, But is the IRS Listening?", Taxation of Exempts, January/February 2013
- Author, Sirote's Conservation Easement Blog
- Author, Sirote's Tax Planning Blog
- Author, Sirote's Tax Controversy Blog
- Author, "Navigating the Defenses to Valuation Penalties in Charitable Deduction Cases," Journal of Taxation, December 2014
- Author, "The "Open and Obvious" Danger Argument", Alabama Law Weekly Update, January 8, 2013
- Co-author, "What is Conservation Easement?," The Counselor, Fall 2013
- Author, "Summary of Selected Provisions of the Emergency Economic Stabilization", The Counselor, Winter 2009
- Author, "Voluntary Disclosure-Now Is The Time To Fulfill That Obligation You Might Not Have Known You Had", The Counselor, Fall 2009
- Speaker, "Tax Issues for Every Practitioner", Cumberland School of Law, September 2012
- Author, "Coming Clean on Worker Classifications- How Good a Deal is the IRS Offering Under the New Voluntary Classification Settlement Program", The Counselor, Summer 2012
- Speaker, "IRS Form 1099 Reporting: What You Need to Know," Lorman Education Services Seminar, May 2012
- Speaker, "Tax Aspects of Real Estate Transactions", National Business Institute, December 8, 2011
- Speaker, Land Trust Alliance, Conservation Easement Planning Conference, 2011
- Author, "A Guide to Donating Conservation Easements Substantiating Their Value," Valuation Strategies, May/June 2010 Edition
- Author, "Simmons—Substantial Compliance Revisited", Tax Notes, Jan 2010
- Co-Author, "Kiva Dunes—Making and Substantiating the Value of Conservation Easements", Journal of Taxation, Nov 2009
- Author, "Proving the Value of a Charitable Donation May Be the Least of Your Problems", Journal of Taxation, August 2011
- Author, Tax Court Analysis of Land Conservation Easement Values—

Organizations

- Birmingham Tax Forum; American Bar Association, Tax Procedure Committee; American Bar Association, Civil and Criminal Penalties Committee
- Admitted to practice law:
  - Alabama
  - Mississippi
  - Federal Tax Court
  - US Court of Federal Claims
  - US Court of Appeals for the Fifth Circuit

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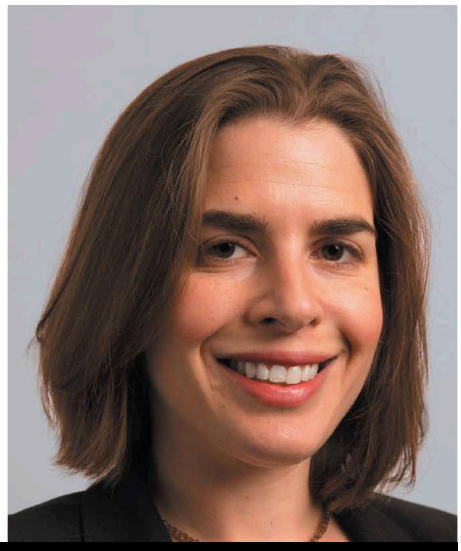

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Of Counsel

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Practice Areas

Alternative Dispute Resolution
Litigation
Tax

Michelle brings extensive tax controversy experience to our firm, where she serves clients from our Tax Controversy and Trust & Estate Litigation Groups. She helps clients navigate a wide range of complex federal tax issues, including IRS audits, administrative appeals and court proceedings in the U.S. Tax Court, U.S. Court of Federal Claims and federal district court. Michelle has unique insight as she previously worked as a trial attorney in the Tax Division in the Department of Justice, representing the United States in tax matters in federal district court.

Education

University of Texas School of Law
JD, 2005
Texas International Law Journal, Staff Editor
James A. Elkins Memorial Scholarship

Washington University, Olin School of Business
BSBA, 2002
Magna Cum Laude
William S. Krebs Accounting Award

Emphasis

- Conservation Easements
- Criminal Law
- Tax Controversy & Litigation
- Trust & Estate Litigation

Industries

- Individuals, Families, Estates & Trusts
- Industrials & Natural Resources
- Real Estate

Speeches & Publications

- Author, Sirote Tax Controversy Blog
- Co-author, "Navigating the Defenses to Valuation Penalties in Charitable Deduction Cases," Journal of Taxation, December 2014
- Author, "Avoiding IRS Penalties: Who Can You Rely On?," The Counselor, September 2013

Organizations

- Admitted to U.S. Tax Court and U.S. Court of Federal Claims
- State Bar of Alabama
- State Bar of Georgia
- District of Columbia Bar