FEE SIMPLE CHARITABLE DONATIONS INSTEAD OF CONSERVATION EASEMENTS

Introduction

The IRS has been attacking for several years what it has labeled syndicated conservation easement transactions (“SCETs”). Among the many weapons employed by the IRS are identifying SCETs as “listed transactions” in Notice 2017-10, 2017-4 IRB 544, launching a “compliance campaign” consisting of dozens of specialized Revenue Agents, featuring SCETs on the IRS’s “dirty dozen” list, and engaging in a widespread practice of claiming that tax deductions related to SCETs should be $0 and imposing severe penalties.

Assaults on SCETs are now common knowledge, but what many fail to realize is that the IRS does not limit itself. Indeed, the IRS has also been challenging fee-simple donations of property to charities for years, applying many of the same techniques used more recently against SCETs. This article examines a relatively obscure case from yesteryear, Terrene Investments, whose importance likely will increase as tax disputes involving SCETs and fee-simple property donations increase. This case demonstrates that the IRS has a history of taking extreme positions, many of which ultimately cannot be supported before the Tax Court.

Common challenges by the IRS

The IRS has been advancing a series of arguments to challenge charitable donations by partnerships, and the list continues to expand.

Description of SCETs. In December 2016, the IRS announced in Notice 2017-10 that it intended to challenge SCETs on grounds that they supposedly constitute “tax-avoidance transactions” that involve overvaluations of donations. The effect of Notice 2017-10 was that SCETs became what are known as “listed transactions.” Accordingly, participants, material advisors, and others involved with SCETs that occurred during or after 2010 are subject to additional reporting, due diligence, and record-keeping requirements. For instance, participants in SCETs must file Forms 8886 (Reportable Transaction Disclosure Statement) with the IRS each year, while material advisors are obligated to file Forms 8918 (Material Advisor Disclosure Statement).

Notice 2017-10 broadly defines an SCET as follows:

- An investor receives promotional materials [oral or written] that offer prospective investors...
in a pass-through entity [such as a partnership] the possibility of a charitable contribution deduction;⁴

• Such deduction equals or exceeds an amount that is two and one-half times the amount of the investor’s investment;

• The investor purchases an interest, directly or indirectly (through one or more tiers of pass-through entities), in the pass-through entity that holds real property;

• The pass-through entity that holds the real property contributes a conservation easement encumbering the property to a tax-exempt entity; and

• Then allocates, directly or through one or more tiers of pass-through entities, a charitable contribution deduction to the investor.

Following that contribution, the investor reports on his or her federal income tax return a charitable contribution deduction with respect to the conservation easement.⁵

Notice 2017-10 also identifies “tacking” of the holding period of the relevant property as one of the hallmarks of an SCET. It describes this concept in the following manner: “Investors who hold their direct or indirect interests in the pass-through entity for one year or less may rely on the pass-through entity’s holding period in the underlying real property to treat the donated conservation easement as long-term capital gain property under [Section] 170(e)(1).”⁶

Finally, Notice 2017-10 indicates that the inflated values of the easement donation are attributable to “unreasonable conclusions about the development potential of the real property.”⁷

Technical arguments raised by the IRS. The IRS has published an audit technique guide (“ATG”) concerning conservation easement donations, which Revenue Agents and other IRS personnel often follow when conducting examinations.⁸ The ATG contains a “Conservation Easement Issue Identification Worksheet.” It identifies a large number of technical challenges (i.e., those not related to valuation) that the IRS might raise as a reason for completely disallowing an easement-related tax deduction:

• The donation of the easement lacked charitable intent, because there was some form of quid pro quo between the donor and the easement-recipient;

• The donation of the easement was conditional upon receipt by the donor of the full tax deduction claimed on its Form 1065 (U.S. Return of Partnership Income);

• The easement-recipient failed to give a proper “contemporaneous written acknowledgement” letter;

• The appraisal was not attached to the partnership’s Form 1065;

• The appraisal was not prepared in accordance with the Uniform Standards of Professional Appraisal Practice (“USPAP”);

• The appraisal fee was based on a percentage of the easement value;

• The appraisal was not timely, in that it was not sufficiently proximate to the making of the donation or the filing of the Form 1065;

• The appraisal was not a “qualified appraisal;”

• The appraiser was not a “qualified appraiser;”

• The Form 8283 (Noncash Charitable Contributions) was missing, incomplete, or inaccurate;

• The donor’s cost or adjusted basis in the donated property, as listed on Form 8283, was improperly calculated;

• Not all appraisers who participated in the analysis signed Form 8283;

• The Baseline Report was insufficient in describing the condition of the property;

• The conservation easement was not protected in perpetuity;

• Any mortgages or other encumbrances on the property were not satisfied or subordinated to the easement before the donation;

• The Deed of Conservation Easement contains an improper clause regarding how the proceeds from sale of the property upon extinguishment of the easement would be allocated among the donor and easement-recipient;

• The Deed of Conservation Easement contains an amendment clause, which, in theory, might allow the parties to modify the donation, after taking the tax deduction, in such a way to undermine the conservation purposes;

• The Deed of Conservation Easement contains a merger clause, as a result of which the fee simple title and the easement might end up in the hands of the same party, thereby undermining the ability to protect the property forever;

• The Deed of Conservation Easement was not timely filed with the proper court or other location;

The IRS announced in Notice 2017-10 that it intended to challenge syndicated conservation easement transactions (SCETs) on grounds that they supposedly constitute “tax-avoidance transactions” that involve overvaluations of donations.
• The easement-recipient was not a “qualified organization;”
• The easement-recipient was not an “eligible donee;” and
• The property lacks acceptable “conservation purposes” for any number of reasons, including the habitat is not protected in a relatively natural state, there are insufficient threatened or endangered species on the property, the habitats or ecosystems to be protected are not “significant,” the public lacks physical or visual access to the property, the conservation will not yield a significant public benefit, the property lacks historical significance, the conservation purpose does not comport with a clearly-delineated government policy, the easement allows uses that are inconsistent with the conservation purposes, the donor has certain “reserved rights” that interfere with or destroy the conservation purposes, etc.\(^9\)

As if this were not enough, the “Conservation Easement Issue Identification Worksheet” in the ATG expressly indicates that these are not all the possibilities. Indeed, it states that “[t]his worksheet is not an all-inclusive list of potential issues for donations of conservation easements [and] users should review IRC Section 170, DEFRA section 155, the corresponding Treasury Regulations, Notice 2006-96, and case law.”

### Fee simple donations as an alternative

Taxpayers donate property in fee simple to charitable organizations for a broad range of legitimate reasons, one of which is the desire not to fall into the SCET category. If a transaction is not considered a SCET, the duty to place the IRS on notice by participants filing Forms 8886 and material advisors filing Forms 8918 would disappear. Perhaps more importantly, many of the technical arguments listed above would no longer apply, such that the IRS’s ability to challenge a donation would be diminished.

This sounds good, at least in theory. However, the reality is that many parties fully disclose fee simple charitable donations to the IRS anyway for several reasons. First, the standards in Notice 2017-10, as well as the duties to file Forms 8886 and Forms 8918, apply not only to SCETs, but also to all transactions that are “substantially similar” to SCETs. This term broadly encompasses any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on a similar tax strategy.\(^10\) The regulations underscore the following about the concept: (1) The term “substantially similar” must be broadly construed in favor of making disclosures to the IRS; (2) Receipt of a tax/legal opinion regarding the tax consequences of a transaction is not relevant to the issue of whether such transaction is the same as or substantially similar to another transaction; and (3) A transaction may be substantially similar to a listed transaction, even though it involves different entities and/or applies different provisions of the Internal Revenue Code.\(^11\) The IRS has issued regulations, multiple Private Letter Rulings, Field Service Advisories, General Counsel Memos, and Chief Counsel Advisories liberally interpreting the notion of “substantially similar.”\(^12\)

Second, penalties for non-compliance by participants can be significant. If participants fail to file timely, complete Forms 8886, and material advisors can assert a penalty equal to 75% of the tax savings resulting from their participation.\(^13\) In the case of a listed transaction, like an SCET, the maximum penalty for individual taxpayers is $100,000, while

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\(^{1}\) Terrene Investments, Ltd., TCM 2007-218.

\(^{2}\) Notice 2017-10, Preamble and section 1.

\(^{3}\) Section 6707A(c)(2); Reg. 1.6011-4(b)(2).

\(^{4}\) For purposes of Notice 2017-10, promotional materials include “written materials, including tax analyses or opinions, relating to each reportable transaction that are material to an understanding of the purported tax treatment or tax structure of the transaction that have been shown or provided to any person who acquired or may acquire an interest in the transactions, or to their representatives, tax advisors, or agents, by the material advisor or any related party or agent of the material advisor.” Reg. 301.6122-2(b)(3)(iii)(B).

\(^{5}\) Notice 2017-10, section 2.

\(^{6}\) Notice 2017-10, section 1.

\(^{7}\) Notice 2017-10, section 1.

\(^{8}\) IRS, Conservation Easement Audit Techniques Guide (Rev. 11/4/16).

\(^{9}\) IRS, Conservation Easement Audit Techniques Guide. (Rev. 11/4/16), pp. 78-81.

\(^{10}\) Reg. 301.6011-4(c)(4).

\(^{11}\) Reg. 301.6011-4(c)(4).

\(^{12}\) See, e.g., Reg. 301.6011-4(c)(4), Ltr. Rul. 2010170776 (substantial similarity to Notice 95-34), Field Service Advice 2002/80104 (substantial similarity to Notice 2001-16), Chief Counsel Advice 2007/2044 (substantial similarity to Notice 2005-13), and Chief Counsel Advice 2009/29005 (substantial similarity to Notice 2004-8).

\(^{13}\) Section 6707A(a), (b), Reg. 301.6707A-1(a).
Taxpayers donate property in fee simple to charitable organizations for a broad range of legitimate reasons, one of which is the desire not to fall into the SCET category.

does not file a Form 8918 is equal to the greater of (1) $200,000, or (2) 50% of the gross income derived by the material advisor with respect to the aid, assistance, or advice that is provided before the date the return is filed. To be clear, the failure to file Form 8918 triggers at least a penalty of $200,000 per violation, per year. The penalty increases where the IRS assesses Form 8918 penalties, participates generally cannot fight them as they would other penalties, by filing a Protest Letter and addressing matters with the Appeals Office and/or by filing a Petition with the Tax Court. Rather, they must dispute the penalties through the collection process or by fully paying the penalties, filing a Claim for Refund, and, if the IRS ignores or rejects the Claim for Refund, by filing a refund suit in federal court.

Third, penalties against material advisors are extreme, too. In the case of a listed transaction, like an SCET, the penalty for a material advisor who does not file a Form 8886 is equal to the greater of (1) $200,000, or (2) 75% of the gross income derived by the advisor with respect to the aid, assistance, or advice that is provided before the date the return is filed. To be clear, the failure to file Form 8886 triggers at least a penalty of $200,000 per violation, per year. The penalty increases where the IRS assesses Form 8886 penalties, participates generally cannot fight them as they would other penalties, by filing a Protest Letter and addressing matters with the Appeals Office and/or by filing a Petition with the Tax Court. Rather, they must dispute the penalties through the collection process or by fully paying the penalties, filing a Claim for Refund, and, if the IRS ignores or rejects the Claim for Refund, by filing a refund suit in federal court.

Fourth, in addition to financial penalties, if a “participant” fails to enclose a Form 8886 with a tax return, the assessment period with respect to the tax return shall remain open until one year after, the earlier of, when the participant eventually files Form 8886, or when the material advisor provides the IRS with the required list of data about the SCET in response to the written request from the IRS.

Finally, the IRS gives participants and material advisors the opportunity to file “protective disclosures,” thereby avoiding the negative consequences described above, without having to admit, acknowledge, or concede that they are involved with an SCET.

Determining the value of a charitable donation

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

In deciding the FMV of property, appraisers and courts must take into account not only the current use of the property, but also its highest and best use (“HBU”). A property’s HBU is the most profitable use for which it is adaptable and needed, or likely to be needed in the reasonably near future. The term HBU has also been defined as the reasonably probable use of property that is physically possible, legally permissible, financially feasible, and maximally productive. Importantly, valuation does not depend on whether the owner has actually put the property to its HBU. The HBU can be any realistic, objective potential use of the property.

Content of FPAs in charitable donation disputes

The standard approach by the IRS in recent years, both in SCET and fee-simple cases, is to fully disallow the charitable deduction claimed by the partnership based on one or more of the technical arguments under Section 170, described above. Then, as a backup plan, the IRS disallows or minimizes the deduction for supposed valuation problems. Below is the language from a notice of Final Partnership Administrative Adjustment (“FPAA”) in a pending Tax Court case, which is representative of the stance that the IRS is taking in essentially all cases:

The partnership claimed a non-cash charitable contribution deduction of [entire amount claimed] for the taxable year ending December 31, 2015 a donation of property to [charitable organization]. It is determined that the claimed deduction is not allowed. It has not been established that the claimed deduction meets all of the requirements of Internal Revenue Code Section 170.

Alternatively, if it is determined that the requirements of Internal Revenue Code Section 170 have been satisfied for the claimed non-cash charitable con-
tribution, it has not been established that the value of the contributed property interest exceeded [the extremely low valuation determined by an IRS appraiser during the audit].

In addition to disallowing the charitable deduction based on a combination of supposed technical and valuation issues, the IRS ordinarily proposes in the FPAA several alternative penalties, ranging in severity. These include, but are certainly not limited to, (1) negligence or disregard of rules and regulations, (2) substantial understatement of income tax, (3) substantial valuation misstatement, or (4) gross valuation misstatement.

**Terrene—facts, issues, and interesting aspects**

**Key points from the case.** The facts and issues in *Terrene Investments* are dense, but here is the essence. The Wilkerson family bought a large tract of land near Houston, Texas in 1994 at a tax foreclosure auction for $50,000. Given the circumstances under which they snagged the land, it is logical to assume that the Wilkersons got a bargain; persons who cannot afford to pay their taxes generally are not in strong negotiating positions.

The land was located beneath the floodplain of the San Jacinto River, such that it was filled with sand and gravel deposits. As the Tax Court noted, “[t]hese deposits are valuable when found near a big city like Houston with a strong local construction industry.”

The Wilkerson family bought the land primarily because it had white pine trees, which they knew were valuable. Shortly after buying the property in 1994, they cut down all the trees and sold them for $45,000, nearly recouping the total amount they transferred the entire property to Terrene Investments, Ltd. (“Partnership”), which the Wilkerson family controlled through four family trusts. Soon thereafter, in 1997, the Wilkersons noticed that there were active sand and gravel mining operations on nearby land. Therefore, they retained geotechnical experts, who took core samples on the land and analyzed the content at the laboratory. These experts determined that the property contained about four million tons of marketable sand and gravel.

The Partnership divided the property into three parcels: (1) one parcel, consisting of 24 acres, which did not have mining potential; (2) a second parcel consisting of 19 acres; and (3) the third parcel, comprised of 31 acres, which was the focus of *Terrene Investments*.

The Partnership got an independent appraisal of the 19-acre parcel, which turned out to be worth $2.5 million, even after all its trees had been removed. In 1997, the Partnership donated the parcel in fee simple to a charitable foundation and claimed the deduction on its 1997 Form 1065. The IRS never challenged this deduction.

Buoyed by the success of its first donation of the 19-acre parcel, the Partnership then had the 31-acre parcel evaluated by an independent appraiser. He concluded that it was worth $2.7 million. In 1998, the Partnership donated the parcel in fee simple to the same charitable foundation and claimed the corresponding deduction on its 1998 Form 1065. The Partnership was less fortunate the second time around, with the IRS starting an audit of its 1998 Form 1065. The IRS initially contended in its FPAA that the property was only worth $150,000. The IRS later increased the allowable deduction to $301,000 based on a report from its expert witness at trial. The Partnership challenged
the FPAA by filing a timely Petition with the Tax Court, and litigation ensued.

Because the IRS never challenged the charitable deduction in 1997 related to the 19-acre parcel, the Partnership ended up paying $50,000 for a total of 74 acres, cutting and selling the timber for $45,000, dividing the land into three parts, retaining 24 acres of unrestricted land, claiming total charitable deductions of $5.2 million, and, after engaging in a Tax Court battle, benefiting from tax deductions of $3.81 million.

Keeping key figures straight can be hard, so they are set forth in Exhibit 1.

**Interesting aspects of the case.** Nearly all Tax Court cases are parables; they teach valuable lessons to those who take the time to pay close attention. Below are some of the interesting aspects of *Terrene Investments*, which have applicability to the tax disputes with the IRS today involving SCETs and fee simple donations.

*The IRS conceded penalties.* The IRS asserted in its FPAA substantial valuation misstatement penalties and substantial understatement of income tax penalties. The IRS later conceded these penalties, before trial, in a Stipulation of Settled Issues. This is noteworthy because the IRS rarely relinquishes penalties now, largely because they are solely the product of mathematical calculations.

Some penalties can be avoided if the taxpayer can demonstrate that there was “reasonable cause” for the violation. Others will not be asserted if the value was based on a qualified appraisal by a qualified appraiser and the taxpayer made a good faith investigation of the value of the property. However, under current law, certain penalties, like the one for making a gross valuation misstatement, cannot be overcome by evidence of “reasonable cause.” It is mathematical in nature; that is, if the value of the deduction originally claimed by the taxpayer on the Form 1065 exceeds the value ultimately determined by the Tax Court by a certain percentage, then the penalty applies, period.

*No technical issues.* As explained above, taxpayers give property in fee simple to charitable organizations, instead of donating a conservation easement, for various reasons. One is that a fee simple donation is not an “E,” such that it cannot, by definition, be an SCET. Consequently, it avoids
many of the “technical” challenges by the IRS, described earlier in this article, that apply only in the conservation context. That is precisely what occurred in Terrene Investments. The FPAA only questioned the valuation of the donation by the Partnership in 1998.

No dispute over key issues. The Partnership and the IRS found harmony on two issues, which are generally at the heart of a dispute concerning a charitable donation. First, the parties agreed that the HBU for the relevant property was sand and gravel mining. In the current environment, the IRS is notorious for claiming that property would be best utilized for agriculture, limited public recreation, etc. Second, the parties agreed that the property could be valued using the so-called “royalty method,” instead of the “business enterprise” or “ongoing business concern” method. The IRS often takes the position that the only appropriate manner for valuing property with minerals is the “royalty method.” This argument by the IRS, which is vigorously opposed by taxpayers, is based largely on certain standards set forth in the Uniform Appraisal Standards for Federal Land Acquisition (“UASFLA”). The debate centers on the fact that (1) the UASFLA is the only major set of appraisal standards that advances the royalty-method-is-the-only-proper method position, (2) the UASFLA is a governmental publication designed to be used solely in the context of valuing land that is forcibly taken from a private party by the government through condemnation or eminent domain, which uses a concept of “just compensation,” derived from the U.S. Constitution, which is not the same as the notions of FMV and HBU used in the charitable donation environment, and (3) a significant amount of case law, reputable articles, and industry professionals support the use of the “business enterprise” or “ongoing business concern” method in the appropriate circumstances.

It appears that the parties in Terrene Investments did not scrap over the valuation method because there was uniformity in that particular market near Houston, which is certainly not the case in other locations. The Tax Court described it as follows: “Property owners in this market [near Houston] rarely mine their own deposits, instead leasing their land to sand-and-gravel operators for a royalty.”

IRS caught talking out of both sides of its mouth. In determining the value of the fee simple donation of mineral-rich property by the Partnership to the charitable organization, the Tax Court adopted the income capitalization approach, using a discounted cash flow (“DCF”) analysis. The Tax Court indicated that it would need to consider a long list of factors to get to the correct figure, among them the total amount of minerals on the property, size of the setbacks, slope of the pit walls, amount of natural waste from the mining process, rate of

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EXHIBIT 1
Sources of Valuation in Terrene Investments case

<table>
<thead>
<tr>
<th>Source of Valuation for 1997 Donation</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pro-rated portion of purchase price for property</td>
<td>$12,888</td>
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<tr>
<td>1997 Form 1065, appraisal, and Form 8283</td>
<td>$2,500,000</td>
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<tr>
<td>Source of Valuation for 1998 Donation</td>
<td>Amount</td>
</tr>
<tr>
<td>Pro-rated portion of purchase price for property</td>
<td>$20,946</td>
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<tr>
<td>1998 Form 1065, appraisal, and Form 8283</td>
<td>$2,700,000</td>
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<td>FPAA issued by IRS</td>
<td>$150,000</td>
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<td>Expert witness of IRS at Tax Court</td>
<td>$301,000</td>
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<td>Expert witness of Partnership at Tax Court</td>
<td>$1,810,000</td>
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<tr>
<td>Decision by Tax Court</td>
<td>$1,310,000</td>
</tr>
</tbody>
</table>

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34 Terrene Investments, Ltd., Answering Brief for Respondent, p. 3.
35 Section 6664(c)(1); Section 6664(d)(1), Reg. 1.6664-4.
36 Section 6664(c)(3); Reg. 1.6664-4.
37 Section 6664(c)(3); Reg. 1.6664-4.
39 See, e.g., Mountanos, TCM 2013-138 (taxpayer claimed the HBU was as a vineyard, while the IRS argued it was recreation); Eiger, TCM 2012-35 (taxpayer claimed the HBU was mining, while the IRS argued it was agriculture).
41 Terrene Investments, Ltd., TCM 2007-218, p. 4.
extraction of the minerals, the royalty rate, the discount rate, and the residual value of the property after mining.\(^{42}\)

One of the key factors in the calculation was the discount rate, which is linked to the potential risks during the mining period. The expert for the IRS, who applied the “royalty method” in practically all regards, attempted to change course and use the “business enterprise” or “ongoing business concern” method to set the discount rate. The Tax Court rejected this inconsistency by the IRS, explaining that the “royalty method” would have much less risk, leading to a lower discount rate, and triggering a higher tax deduction for the Partnership.\(^{43}\)

Conclusion
Putting aside the complexities inherent in any dispute involving large charitable donations, mineral property, and valuation experts, Terrene Investments teaches some straightforward, important lessons.

- Generally, money is made on the purchase of real estate, not its later sale or charitable donation. This means that finding the proverbial diamond in the rough, seeing the property’s potential, and negotiating a low purchase price are what dictate future profit. Selling is merely the completion of a wise buying decision. In Terrene Investments, the Wilkerson family spotted a bargain and bought the entire tract for just $50,000 during a tax foreclosure auction.
- There is nothing inherently wrong with subdividing a property before making a charitable donation. In Terrene Investments, the Partnership divided the property into three separate parcels, later donating two of them, successfully claiming values that far exceeded the purchase price.
- One key component to value is the HBU, and the seller is often unaware of it. In Terrene Investments, the Wilkerson family initially thought the HBU of the property was timber harvesting. The family later came to understand that it was really sand and gravel mining, with which the IRS agreed. The fact that the seller was willing to part with the entire property for merely $50,000 indicates that the seller, the tax authorities, and/or the auctioneer were oblivious of the HBU.
- The fact that a taxpayer acquires a piece of land for a low value and soon thereafter donates it for a large value is not necessarily problematic. In Terrene Investments, (1) one parcel of the property was purchased for $12,828 in 1994 and donated for $2.5 million in 1997, which the IRS never challenged, and (2) another parcel was purchased for $20,946 in 1994 and donated for $2.7 million in 1998, which the Tax Court reduced to $1.31 million. After harvesting the timber and donating two parcels, the Partnership essentially paid $5,000, received a tax deduction of $3.81 million, and retained 24 acres of land.

More than a decade has passed since Terrene Investments was decided by the Tax Court, but it still has relevance today, as many of the techniques used by the IRS, and many of the key issues raised in SCET and fee-simple charitable donation cases, remain the same. Eyes will be on Terrene Investments and its progeny as Tax Court battles arise over an increasing number of donations of property with a mining HBU.\(^{43}\)