tax notes federal

Volume 177, Number 8 ■ November 21, 2022

New Cases Bolster Special Valuation Methods for Conservation Easements

by Hale E. Sheppard

Reprinted from *Tax Notes Federal*, November 21, 2022, p. 1107

New Cases Bolster Special Valuation Methods for Conservation Easements

by Hale E. Sheppard

Hale E. Sheppard (hale.sheppard@chamberlainlaw.com) is a shareholder in the tax controversy section at Chamberlain Hrdlicka in Atlanta.

In this article, Sheppard analyzes conservation easement donation rules, property valuation principles, and two recent cases that demonstrate the courts' approval of valuation theories advanced by taxpayers rather than the IRS.

Copyright 2022 Hale E. Sheppard.
All rights reserved.

I. Introduction

Determining the value of property can be hard, but agreeing on the appropriate valuation method should be easy. It is not, though, particularly when it comes to conservation easement donations. The IRS has proclaimed for decades, before Congress and elsewhere, that inflated appraisals represent the main problem with conservation easements and the corresponding tax deductions under section 170(h). However, IRS attacks over the past several years have centered on just about everything *but* valuation. As taxpayers engage in more pre-donation due diligence, track the evolving judicial and administrative authorities, and continually modify easement-related documentation to address all technical challenges raised by the IRS, valuation is now coming to the forefront in many cases. Finally.

Celebrating at this point would be premature. The problem now is that the IRS and taxpayers clash over how, exactly, to calculate the value of conservation easement donations. The IRS frequently looks to the current use of the relevant property, supposedly comparable sales, property tax records, or amounts paid for partial ownership interests in partnerships that hold property. Taxpayers, by contrast, commonly take the position that (1) there are special valuation rules in the conservation easement context; (2) the starting point is identifying the highest and best use (HBU) of the property; (3) the next step is determining the value of the property both before and after the donation; and (4) the income approach is the proper valuation method.

This article analyzes conservation easement donation rules, property valuation principles, and multiple sources supporting the use of HBU, the before-and-after method, and the income approach. It then explores two recent cases, *Glade Creek*[1] and *Champions Retreat*,[2] which demonstrate that the Tax Court and Eleventh Circuit approve of valuation theories advanced by taxpayers.[3]

II. Overview of Conservation Easements

Taxpayers who own undeveloped real property have several choices. They might (1) hold the property for investment purposes, waiting for it to appreciate; (2) determine how to maximize profitability from the property and do that right away; or (3) voluntarily and permanently restrict future uses of the property for the benefit of society. The third option, known as donating a conservation easement, achieves

[1] *Glade Creek Partners LLC v. Commissioner*, T.C. Memo. 2020-148, *vacated by* No. 21-11251 (11th Cir. 2022) (unpublished).

[2] *Champions Retreat Golf Founders LLC v. Commissioner*, T.C. Memo. 2022-106, *remanded by* 959 F.3d 1033 (11th Cir. 2020), *vacating* T.C. Memo. 2018-146.

[3] This article supplements earlier ones by the same author. *See* Hale E. Sheppard, "Recent Rulings Confirm Conservation Easement Valuation Method," *Tax Notes Federal*, Sept. 26, 2022, p. 2027; and Sheppard, "Valuation, Highest and Best Use, and Easements: New IRS Attacks," *Tax Notes Federal*, May 16, 2022, p. 1061.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

environmental goals and triggers tax deductions for donors.[4]

Taxpayers cannot place an easement on just any property and claim a tax deduction; they must demonstrate that the property has at least one acceptable conservation purpose.[5] Common conservation purposes include preserving land for public recreation or education, safeguarding a relatively natural habitat for plants and animals, maintaining open space for scenic public enjoyment, and using property in accordance with government conservation policy.[6]

Taxpayers memorialize the donation by filing a deed of conservation easement or similar document. In preparing that deed, taxpayers often coordinate with a land trust to identify limited activities that can continue on the property, even after the donation, without prejudicing the conservation purposes.[7]

The IRS will not allow the tax deduction stemming from a conservation easement unless the taxpayer obtains, shortly before making the donation, documentation establishing the condition and characteristics of the property (the baseline report).[8]

Taxpayers generally can claim a deduction for a charitable contribution the year in which the donation is made.[9] If the contribution consists of something other than money, the amount of the deduction normally is the fair market value of the property at the time of the donation.[10] Special valuation rules apply to conservation easement donations, as explained below.

Claiming the tax deduction for an easement donation is surprisingly complicated. It involves many actions and documents. A taxpayer ordinarily must obtain a qualified appraisal; demonstrate that the land trust is a qualified organization; obtain an adequate baseline report; complete a Form 8283, "Noncash Charitable Contributions"; file a Form 1065, "U.S. Return of Partnership Income," with all necessary enclosures and disclosures; receive a written acknowledgment of the donation from the land trust; and much, much more.[11]

III. Valuation Principles

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.[12] In theory, the best evidence of the FMV of an easement would be the sale prices of other easements that are comparable in size, location, timing, etc.[13] The IRS recognizes that it is difficult, if not impossible, to find them.[14] Consequently, appraisers normally must use the before-and-after method instead. The IRS has acknowledged this reality for at least half a century, conceding in a long-standing revenue ruling that "more often than not open space easements in perpetuity are granted by deed of gift so there is usually no substantial record of market place sales to use as a meaningful or valid comparison."[15]

Using the before-and-after method means that taxpayers, relying on independent appraisers and other experts, must determine the HBU of the property and then determine corresponding FMV twice. First, appraisers calculate the FMV as if the property had been put to its HBU, which generates the "before" value. Second, appraisers identify the FMV taking into account the serious restrictions that the conservation easement imposes on the property, which creates the "after" value. The difference between the before and after values of the property, with some adjustments, produces the amount of the donation.[16]

---

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

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

[6] Section 170(h)(4)(A); reg. section 1.170A-14(d)(1).

[7] IRS, "Conservation Easement Audit Techniques Guide," at 23 (rev. Nov. 4, 2016); *see also* reg. section 1.170A-14(b)(2), (e)(2), and (e)(3).

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

[9] Section 170(a)(1).

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

[11] *See* IRS, "Conservation Easement Audit Techniques Guide," at 24-31 (rev. Jan. 24, 2018) (2018 ATG); IRS Publication 1771, "Charitable Contributions — Substantiation and Disclosure Requirements" (Mar. 2016); IRS Publication 526, "Charitable Contributions" (2016); section 170(f)(8) and (11); reg. section 1.170A-13; Notice 2006-96, 2006-2 C.B. 902; and T.D. 9836.

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

[13] Reg. section 1.170A-14(h)(3)(i).

[14] 2018 ATG, *supra* note 11, at 43.

[15] Rev. Rul. 73-339, 1973-2 C.B. 68.

[16] 2018 ATG, *supra* note 11, at 43.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

IV. Long-Standing Valuation Methods

HBU plays a critical role in the valuation of real property. It is a reality against which the IRS often rebels in conservation easement disputes. Yet the long list of sources below shows that the notion of HBU has been widely supported for a long time.

A. Early Supreme Court Decision

For many decades, courts have recognized the use of HBU in valuing real property interests. For instance, the Supreme Court held in 1878 that a property's HBU is the most profitable use for which it is adaptable and needed, now or in the reasonably near future.[17] The Supreme Court added the following color:

> In determining the value of land appropriated for public purposes [for example, by condemnation], the same considerations are to be regarded as in a sale of property between private parties. The inquiry in such cases must be what the property is worth, viewed not merely with reference to the uses to which it is at the time applied, but with reference to the uses to which it is plainly adapted — that is to say what is it worth from its availability for valuable uses. Property is not to be deemed worthless because the [current] owner allows it to go to waste, or to be regarded as valueless because [the current owner] is unable to put it to any use. . . . Exceptional circumstances will modify the most carefully guarded rule; but as a general thing, we should say that the compensation to the owner is to be estimated by reference to the uses for which the property is suitable having regard to the existing business or wants of the community or such as may be reasonably expected in the immediate future.[18]

[17] *Boom Co. v. Patterson*, 98 U.S. 403 (1878); *see also Olson v. United States*, 292 U.S. 246 (1934).

[18] *Boom Co.*, 98 U.S. at 407-408.

B. Observations by Congress

Congress expanded and made permanent rules allowing income tax deductions for conservation easements in 1980. In doing so, it sanctioned the before-and-after method, combined with respect for a property's HBU:

> In general, a deduction is allowed for a charitable contribution in the amount of the [FMV] of the contributed property, defined as the price at which the property would change hands between a willing buyer and a willing seller. . . . However, because markets generally are not well established for easements or similar restrictions, the willing buyer-seller test may be difficult to apply. . . . As a consequence, conservation easements are typically (but not necessarily) valued indirectly as the difference between the [FMV] of the property involved before and after the grant of the easement. Where this test is used, however, the committee believes it should not be applied mechanically. For example, where before and after valuation is used, the [FMV] of the property before contribution of the easement should take into account not only the current use of the property but also an objective assessment of how immediate or remote the likelihood is that the property, absent the [easement], would be developed.[19]

C. Tax Regulations

The regulations feature special rules for calculating a deduction stemming from the donation of a conservation easement. They contain the following guidance:

> If no substantial record of market-place sales is available to use as a meaningful or valid comparison, as a general rule (but not necessarily in all cases) the [FMV] of a perpetual conservation restriction is equal to the difference between the [FMV] of the property it encumbers before the granting of the restriction and the [FMV] of the

[19] S. Rep. No. 96-1007, at 14-15 (June 12, 1980).

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

> encumbered property after the granting of the restriction.[20]

The regulations provide additional guidance for situations in which the appraiser uses the before-and-after method:

> If before and after valuation is used, the [FMV] of the property before contribution of the conservation restriction must take into account not only the current use of the property but also an objective assessment of how immediate or remote the likelihood is that the property, absent the [easement], would in fact be developed, as well as any effect from zoning, conservation, or historic preservation laws that already restrict the property's potential [HBU].[21]

The regulations contain a dozen examples, one of which specifically mentions residential home development as the appropriate HBU for a parcel.[22]

D. Additional Regulations and IRS Guidance

Congress changed the law in 2006, creating a new meaning of the term "qualified appraisal."[23] The updated definition is an appraisal that is prepared by a qualified appraiser and meets the "generally accepted appraisal standards."[24]

The IRS decided to issue transitional guidance in late 2006 while it was busy drafting new regulations to address the legislative changes. That guidance came in the form of Notice 2006-96, 2006-2 C.B. 902. It explained that the IRS would deem an appraisal as having met generally accepted appraisal standards if, for instance, the appraisal is consistent with the substance and principles of the Uniform Standards of Professional Appraisal Practice (USPAP).[25]

The IRS asked the public to comment on Notice 2006-96, and it did. The IRS described that input when it released proposed regulations.[26] Interestingly, the preamble to the proposed regulations explains that (1) an appraisal *must* address a property's HBU to meet USPAP standards, (2) Notice 2006-96 and the proposed regulations indicate that an appraisal must satisfy USPAP or similar standards to be considered qualified, and (3) the obligation to analyze a property's HBU is so evident that it is unnecessary for the IRS to explicitly state it:

> Some commenters requested a specific reference to [HBU] in the proposed regulations. This suggestion was not incorporated in the proposed regulations because USPAP [already] requires an appraiser to "develop an opinion of the [HBU] of the real estate" when it is "necessary for credible assignment results in developing a market value opinion." An appraisal that does not include a development of [HBU] when required by USPAP is not consistent with the substance and principles of USPAP.[27]

The final regulations demand that all qualified appraisals determine the FMV of the donated property and state the valuation method used, such as the sales comparison approach, the income approach, or the cost approach.[28] These three approaches, or variations thereof, constitute the widely accepted ways of valuing real property.[29]

E. Appraisal Standards Organizations

As explained earlier, USPAP provides that when it is necessary for formulating a market value opinion, an appraiser must do several things, including develop an opinion on the HBU of the property and analyze the relevant legal, physical, and economic factors to support that

[20] Reg. section 1.170A-14(h)(3)(i).

[21] Reg. section 1.170A-14(h)(3)(ii).

[22] Reg. section 1.170A-14(h)(4), Example 7.

[23] Pension Protection Act of 2006, P.L. 109-280, section 1219.

[24] Section 170(f)(11)(E)(i); Joint Committee on Taxation, "Technical Explanation of H.R. 4, the Pension Protection Act of 2006, as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006," JCX-38-06, at 312 (Aug. 3, 2006).

[25] Notice 2006-96, section 3.02(2).

[26] Preamble to REG-140029-07, 73 F.R. 45908 (Aug. 7, 2008).

[27] *Id.*, 73 F.R. at 45911.

[28] Reg. section 1.170A-17(a)(3)(i)(D) and (a)(3)(viii).

[29] Appraisal Institute, *The Dictionary of Real Estate Appraisal*, at 10 (2015).

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

HBU.[30] USPAP further identifies three permissible approaches for valuation: the sales comparison approach, the income approach, and the cost approach.[31] Further, USPAP instructs appraisers to reconcile the applicability and relevance of the various approaches to arrive at a value and then explain in their reports the reasons for excluding any of the three approaches.[32] USPAP also permits appraisers to rely on extraordinary assumptions and hypothetical conditions, as long as they state them clearly and conspicuously.[33]

Other respected organizations follow similar standards. For instance, the International Valuation Standards Council (IVSC), which creates rules on a global basis, identifies HBU as an acceptable premise of value.[34] It explains that when it comes to interests in real property, an appraiser "must consider" HBU because that concept is critical when evaluating an asset that is capable of changing uses or possessing development potential.[35] The IVSC confirms that appraisers, after identifying the HBU of the property, can use the sales comparison approach, income approach, and/or cost approach to calculate value, depending on the facts and circumstances.[36] It also advises that the income approach "should be applied and afforded significant weight" when the property's income-producing ability is the critical element affecting value or when reasonable projections of the timing and amount of future income for the property are available and few, if any, comparable sales exist.[37]

The Uniform Appraisal Standards for Federal Land Acquisitions (the yellow book) contains analogous guidelines.[38] It explains that the determination of HBU "is one of the most important elements of the entire appraisal process" and depends on several things, including what is physically possible, legally permissible, financially feasible, and maximally profitable.[39] The yellow book also recognizes that appraisers use the sales comparison approach, income approach, or cost approach (or subsets of those approaches) in calculating value.[40] Finally, the yellow book agrees that appraisers may use extraordinary assumptions and hypothetical conditions under some circumstances.[41]

F. Audit Technique Guide

The audit technique guide for conservation easements, published by the IRS for use by its own personnel, states that the determination of a property's HBU "is vital to the valuation of any real estate, including conservation easements," and that "all professional appraisal organizations recognize that the HBU of the property is a key element to proper valuation."[42]

G. IRS Administrative Rulings

Several IRS rulings discuss the significance of HBU in valuing real property, as well as notable flexibility surrounding the concept. The following is a good example:

> The [FMV] of property is determined on the basis of a hypothetical willing buyer and a hypothetical willing seller . . . and reflects its [HBU] as of the date of its valuation. The [FMV] of property is not affected by whether an owner has actually put the property to its [HBU]. The reasonable and objective possibilities for the [HBU] of property control its value. A potential [HBU] for the property can be considered even though the potential use is prohibited on the valuation date by some restriction in a deed, statute or zoning regulation. In such case, the proper approach is to value the property at its [HBU] even though its [HBU] is prohibited as of the date of the valuation

[30] Appraisal Foundation, Uniform Standards of Professional Appraisal Practice, Standard 1-3(b) (2020-2021).

[31] *Id.* at Standard 1-4.

[32] *Id.* at Standard 1-6 and Standard 2-2(a)(x).

[33] *Id.* at Standard 1-2(f) and (g), and Standard 2-2(a)(xiii).

[34] IVSC, International Valuation Standards, at 24 (2017).

[35] *Id.* at 83.

[36] *Id.* at 29 and 83-85.

[37] *Id.* at 36.

[38] Interagency Land Acquisition Conference, Uniform Appraisal Standards for Federal Land Acquisitions (2016).

[39] *Id.* at 22-23, 63-64, 70, and 101-117.

[40] *Id.* at 25-36, 63-70, and 118-145.

[41] *Id.* at 13.

[42] 2018 ATG, *supra* note 11, at 46.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

> by the applicable restriction and then to proceed to reduce or discount such value by a reasonable estimate of the cost of removing the restriction and for the time needed to accomplish such removal. However, the projected [HBU] must have a strong possibility of achievement. It should not be remote, speculative or conjectural.[43]

H. Even Opponents Acknowledge HBU

Critics of so-called syndicated conservation easements, as well as the valuation techniques used with those easements, abound. However, even those detractors acknowledge the consistent support of section 170(h) by Congress; the content of the valuation regulations issued by the IRS; and the appraisal methods accepted by valuation organizations, government agencies, and courts.[44] They acknowledge, in particular, that (1) using the before-and-after method to value conservation easement donations is often necessary; (2) the first step in that method is to identify the HBU of the property; (3) once the HBU is known, an appraiser generally uses the sales comparison approach, income approach, or cost approach to determine value; and (4) given the unique nature of conservation easements, only the income approach is feasible in many situations.[45] Opponents of syndicated easements also concede that one variant of the income approach — the subdivision-development analysis — effectively requires appraisers to start with the value of property in a developed state and then work backward to identify its value.[46]

V. Cases Endorsing Taxpayer Valuation Methods

Two recent cases underscore the acceptance, by the Tax Court and at least one court of appeals, of the method commonly used by taxpayers to value conservation easement donations.

A. First Case

The parties in *Glade Creek* have faced off in two rounds already,[47] with a third on the way.

1. Round one: Tax Court.

a. Key facts.

In 2006 International Land Co. (ILC) purchased about 2,000 acres in Tennessee for approximately $9 million through a seller-financed arrangement. In other words, ILC put down some cash and agreed to pay the remainder to the original owner of the property over time, with interest. ILC intended to create and sell lots in three phases (tracts I-III) to out-of-state buyers who wanted to build vacation homes.

The property was undeveloped when ILC bought it. Therefore, ILC spent about $6 million extra to complete various infrastructure projects and obtain necessary permits and approvals. In 2007, ILC recorded the lots on Tract I, marketed them, and made some sales. ILC ran out of money in 2009, though, so marketing ceased and sales plummeted. ILC faced a depressed real estate market, slow sales, substantial debt, and considerable uncertainty. Some of its members wanted out.

Their departure occurred when Hawks Bluff Investment Group Inc. (Hawks Bluff) acquired the remaining unsold lots in Tract I, as well as all of Tract II and Tract III, in exchange for assuming ILC's liabilities. The debts largely consisted of the unpaid amount of the purchase price still owed to the original owner, along with the costs of building the infrastructure. One of the three shareholders of Hawks Bluff was James Vincent, a local real estate investor with government contacts, who had provided services in connection with the initial ILC project.

To reduce the debts taken on by Hawks Bluff, Vincent entertained various options, including selling the property to a developer, timbering, or donating a conservation easement. He dismissed the first two possibilities because they would not protect the environment, were inconsistent with the vision of the early purchasers of the lots, and would negatively affect development of the remaining lots, in which he still had a financial

[43] ILM 201319010.

[44] Nancy M. McLaughlin, "Conservation Easements and the Valuation Conundrum," 19 *Fla. Tax Rev.* 225 (2016).

[45] *Id.* at 231-247; C. Timothy Lindstrom, "Income Tax Aspects of Conservation Easements," 5 *Wyo. L. Rev.* 1, 38-40 (2005).

[46] McLaughlin, "Increasing the Tax Incentives for Conservation Easement Donations — A Responsible Approach," 31 *Ecology L. Q.* 1, 83-84 (2004); Lindstrom, "A Guide to the Tax Aspects of Conservation Easement Contributions," 7 *Wyo. L. Rev.* 441, 500 (2007).

[47] *Glade Creek*, T.C. Memo. 2020-148, *vacated by* No. 21-11251.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

interest through Hawks Bluff. Vincent decided to pursue a conservation easement.

Vincent approached an experienced individual (organizer), who formed Glade Creek Partners LLC (PropCo) and Sequatchie Holdings LLC (InvesCo). The basic idea was that (1) Hawks Bluff would contribute the property to PropCo in exchange for a 98 percent ownership interest in PropCo; (2) InvesCo would then disperse a large portion of its capital to buy nearly all of Hawks Bluff's interest in PropCo; (3) Hawks Bluff would use the funds from InvesCo to satisfy its preexisting debts; and (4) if the partners in PropCo voted to donate a conservation easement, almost all the charitable deductions would be allocated to InvesCo, which, in turn, would pass them along to its individual partners.

The PropCo partners voted for the conservation easement option, after which PropCo donated an easement to a land trust and claimed a charitable deduction of just over $17.5 million in 2012. The IRS audited. It concluded, as it invariably does in cases involving so-called syndicated conservation easement transactions, that PropCo should get a charitable deduction of $0 and pay the highest possible penalty. PropCo disagreed with the IRS, filing a petition with the Tax Court to get litigation underway.

b. Technical issue.

The Tax Court sided with the IRS on the first issue, technical in nature, holding that PropCo was entitled to a charitable deduction of $0 because the conservation easement was not protected in perpetuity.

Here is what led to that conclusion: Taxpayers must donate conservation easements in perpetuity, but nothing lasts forever. Mindful of this, the regulations explain that a post-donation change in conditions can make it impossible or impractical to continue conserving the property at some future point.[48] This occurs, for instance, when the government approaches a taxpayer, like PropCo, years after it donates a conservation easement, and offers to purchase part of the protected land to install a power line or construct a road. If the taxpayer refuses, the government forces the sale through condemnation. The government effectively "takes" the property from the taxpayer but must pay for it. The question thus becomes, who gets the sales proceeds? The taxpayer, which still owns the property? The land trust, which holds the conservation easement on the property? Or both under some formula? The regulations mandate use of a formula, which is far from clear.[49]

The deed filed by PropCo in *Glade Creek* specified that any increase in value of the property *after* the donation resulting from improvements, made and paid by PropCo, should be subtracted from the total value of the property before calculating the proportionate share of sales proceeds going to the land trust. The Tax Court believed that the formula violated the applicable regulations, triggering a deduction of $0 for PropCo.

c. Valuation issue.

The Tax Court was obligated to ascertain the value of the conservation easement solely to determine whether PropCo should be penalized.

At trial, the IRS presented an appraisal by a local real estate appraiser with some 40 years of experience. He used a comparable sales method; found that the HBU of the property was rural residential, agricultural, and recreational; and calculated the before value at approximately $1.5 million.

PropCo introduced two experts at trial — namely, a land use professional (planning expert) and an appraiser (taxpayer appraiser). The planning expert prepared a study of economic trends, housing demand, the target market, regional attractions, and amenities. He concluded that the HBU of the property, before donation of a conservation easement, would be residential development. He envisioned a resort-style community featuring outdoor activities, which would appeal both to multigenerational families and to those seeking vacation homes. The planning expert identified five types of lots on the property and calculated an average price for each

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

[49] *Id.* and reg. section 1.170A-14(g)(6)(ii); *see, e.g.*, *Belk v. Commissioner*, 774 F.3d 221 (4th Cir. 2014), *aff'g* 140 T.C. 1 (2013); *PBBM-Rose Hill Ltd. v. Commissioner*, 900 F.3d 193 (5th Cir. 2018); *Carroll v. Commissioner*, 146 T.C. 196 (2016); *Coal Property Holdings LLC v. Commissioner*, 153 T.C. 126 (2019); and *Oakbrook Land Holdings LLC v. Commissioner*, 154 T.C. 180 (2020).

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

using figures from several benchmark residential communities already in existence. He put his ideas on paper, supplying a "concept plan" for a hypothetical development. He acknowledged that development would require aggressive marketing, a significant upfront investment to build amenities, and additional costs to construct a model home and several speculative homes ready for immediate purchase. The planning expert estimated that it would take seven years to sell out the lots.

The taxpayer appraiser reviewed and largely accepted the data from the planning expert. He agreed with the hypothetical development described in the concept plan, average lot prices, need for upfront expenditures, and absorption rate. The taxpayer appraiser then incorporated additional development costs, including a 15 percent profit for the hypothetical developer who might buy the property. He also applied a discount rate of 11.25 percent to account for the time value of money. In short, to calculate the before value, the taxpayer appraiser "performed a discounted cash-flow analysis from the sale of lots in [the planning expert's] hypothetical development."[50] After reducing the before value by the after value and making some adjustments, he concluded that the easement was worth about $16.2 million.

The Tax Court began by providing foundational information about valuation in conservation easements. It ultimately reached the following conclusion about the HBU of the property in *Glade Creek*:

> Residential development was physically and financially feasible on the easement date. In light of the improved real estate market [in 2012] and the significant infrastructure work and approvals previously granted, a hypothetical buyer would have reasonably purchased the property for the development of a vacation or residential community. Accordingly, we hold that residential development is the unencumbered property's [HBU].[51]

Based on the planning expert, the taxpayer appraiser, an IRS concession, and some machinations of its own, the Tax Court found that the FMV of the conservation easement donated by PropCo was about $8.88 million.

2. Round two: Court of appeals.

Unhappy about the Tax Court's ruling that it was entitled to a charitable deduction of $0 and that penalties apply (because of the difference between the value claimed by PropCo of $17.5 million and the value determined by the Tax Court of $8.88 million), PropCo sought relief from the Eleventh Circuit.[52]

a. Technical issue.

Time was on PropCo's side. Things significantly changed after the Tax Court initially held that the deed filed by PropCo failed to comport with the relevant regulation: The Eleventh Circuit in *Hewitt*[53] held that the IRS's interpretation of that regulation was arbitrary, capricious, and in violation of the Administrative Procedure Act. The court of appeals therefore reasoned in *Glade Creek* that the Tax Court could not give PropCo a deduction of $0 based on supposed noncompliance with an invalid regulation. The Eleventh Circuit returned the case to the Tax Court for reconsideration, this time ignoring the IRS's argument about a faulty deed.

b. Valuation issue.

The Eleventh Circuit situated things by summarizing the earlier decision by the Tax Court. The court of appeals explained that the planning expert determined that the HBU of the property was residential development, and the taxpayer appraiser applied a discounted cash flow analysis to that HBU to arrive at the before value. The Eleventh Circuit noted that the Tax Court accepted the HBU suggested by the planning expert and largely agreed with the valuation approach used by the taxpayer appraiser. Finally, the court of appeals indicated that in determining the value, the Tax Court used the before-and-after valuation method, accepted

[50] *Glade Creek Partners*, T.C. Memo. 2020-148, at 19.

[51] *Id.* at 34 (internal citations omitted).

[52] *See* Kristen A. Parillo, "Appeals Court Vacates Denial of Easement Deduction," *Tax Notes Federal*, Aug. 29, 2022, p. 1505.

[53] *Hewitt v. Commissioner*, 21 F.4th 1336 (11th Cir. 2021).

For more *Tax Notes®* *Federal* content, please visit www.taxnotes.com.

© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

the HBU of residential development, and applied its own discounted cash flow rate.

With that history out of the way, the court of appeals offered an overview of how to value conservation easements, the improbability or impossibility of using the comparable sales approach, the need to use the before-and-after method, and the foundational character of HBU. Then, the Eleventh Circuit addressed PropCo's complaint that the Tax Court erred in reaching a value of $8.88 million (which triggered the penalty) because it allegedly invented its own valuation method, without any urging from the parties. The court of appeals downplayed PropCo's grievance. In doing so, it emphasized that the taxpayer appraiser and the Tax Court "both used the before-and-after method, which is the standard method for determining the value of an easement like the one here." It also underscored that both the taxpayer appraiser and the Tax Court used a discounted cash flow analysis to calculate the before value of the property.

B. Second Case

The latest case is *Champions Retreat*.[54]

1. Background and main events.

Champions Retreat Golf Founders LLC (the partnership) acquired about 463 acres in 2002 to build a golf course. The partnership raised money by selling 66 residential lots in a development called Founders Village. Each lot came with a lifetime membership at the golf club, which featured three nine-hole courses, a pro shop, a restaurant, a locker room, a cart storage facility, a driving range, and a parking lot.

The partnership was not profitable initially. Accordingly, after learning about a Tax Court decision upholding a charitable tax deduction for the placement of a conservation easement on an operating golf course, the accountant for the partnership proposed doing the same thing.[55] The idea was to attract more investment so that the partnership could reduce its construction-related debts.

Enter Kiokee Creek Preservation Partners LLC whose partners invested total capital of $2.7 million. These funds were then contributed to the partnership in exchange for a 15 percent ownership, along with a special allocation of any charitable tax deduction.

The partnership donated an easement on about 349 acres in 2010. The easement covered 25 out of the 27 total holes on the three golf courses and the driving range.

The deed identified three conservation purposes: (1) protection of a relatively natural habitat of fish, wildlife, or plants, or a similar ecosystem; (2) preservation of open space for the scenic enjoyment of the general public, while yielding a significant public benefit; and (3) preservation of open space in accordance with a federal, state, or local governmental conservation policy, also while yielding a significant public benefit.

2. Let the dispute commence.

The partnership claimed a charitable deduction of about $10.4 million in 2010, nearly 99 percent of which was allocated to Kiokee Creek, even though it held only a 15 percent interest. An audit ensued. The IRS eventually issued a notice of final partnership administrative adjustment allowing a charitable deduction of $0. The partnership challenged this utter rejection by filing a petition with the Tax Court.

3. Tax Court opinion.

The Tax Court's analysis focused on just one issue: whether the easement donation had an acceptable conservation purpose. As explained earlier, the partnership claimed that the easement protected a relatively natural habitat, preserved open space for scenic enjoyment by the public, and safeguarded open space in accordance with a governmental policy. The Tax Court held in favor of the IRS, ruling that the alleged conservation purposes were insufficient.[56]

The Tax Court dispensed with the entire case by deciding merely one issue: conservation purpose. Moreover, the IRS never proposed penalties against the partnership in the FPAA.

[54] *Champions Retreat*, T.C. Memo. 2022-106, *remanded by* 959 F.3d 1033, *vacating* T.C. Memo. 2018-146.

[55] *Kiva Dunes LLC v. Commissioner*, T.C. Memo. 2009-145.

[56] *Champions Retreat*, T.C. Memo. 2018-146, at 24-28.

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

The Tax Court, therefore, failed to address many interesting issues, including valuation.

4. Decision by court of appeals.

The partnership challenged the Tax Court's decision, raising the matter to the Eleventh Circuit.[57] The court of appeals disagreed with earlier critiques about conservation purpose. In short, it overruled the Tax Court and sent the case back, instructing the Tax Court to determine the value of the conservation easement this time.[58] The Eleventh Circuit gave the following admonition:

> The bottom line is this: The record establishes that [the partnership] is entitled to a deduction in the proper amount. Because it upheld the [IRS's] disallowance of the deduction, the Tax Court did not address the proper amount, and we express no opinion on it. That will be an issue for the Tax Court on remand.[59]

5. Back to Tax Court.

The second opinion from the Tax Court was thorough, consisting of 43 pages and delving into detail on various points.[60] Analyzing the entire opinion is unnecessary for purposes of this article. It centers on the key matter: the Tax Court's approval of the valuation method used by the appraisers retained by the partnership.

The Tax Court began by summarizing the valuation principles applicable to conservation easement donations, citing the pertinent tax provisions, regulations, and cases. It noted that (1) the charitable tax deduction amount equals the FMV of the property at the time of the donation; (2) the FMV generally is the price at which the property would change hands between a hypothetical willing buyer and seller, each possessing the same information; (3) comparable sales are the preferred indicator of FMV; and (4) when adequate comparable sales are lacking, the tax deduction is calculated under the before-and-after method. On remand, the Tax Court confirmed that the partnership and the IRS agreed that the before-and-after method applied in *Champions Retreat*.

The Tax Court next stated that to calculate the FMV of the property, one must first identify its HBU. Again referencing the relevant tax provisions, regulations, and cases, the Tax Court explained that the HBU is the most profitable use for which property is adaptable and currently needed or likely to be needed in the reasonably near future. It also acknowledged that the HBU can be any realistic, objective, potential use. The Tax Court agreed with the appraisers that a residential subdivision linked to an 18-hole golf course constituted the proper pre-donation HBU.

The next step for the Tax Court was to determine the FMV before the donation of the easement in 2010, using the HBU of a neighborhood with golf course amenities. Consistent with various authorities, the Tax Court recognized that there are three accepted ways of valuing real property: the sales comparison approach, the income approach, and the cost approach.[61] The Tax Court further noted that the subdivision-development method is a subset of the income approach, which "values undeveloped land by treating the property as if it were subdivided, developed, and sold."[62] The Tax Court also took the time to identify the six primary steps in the subdivision-development method:

> First, the subdivided property's [HBU] is determined. Second, the comparable sales method is used to identify comparable finished (developed) lots and derive a per-lot value. Third, anticipated gross proceeds from the sale of the developed lots are calculated by multiplying the per-lot value by the total number of estimated finished lots. Fourth, expected net proceeds are calculated by reducing the expected gross proceeds by direct and indirect costs and entrepreneurial profit.

[57] *Champions Retreat*, 959 F.3d 1033.

[58] Order, *Champions Retreat*, 959 F.3d 1033 (11th Cir. Jan. 19, 2021) (No. 4858-15).

[59] *Champions Retreat*, 959 F.3d at 1041. One judge, dissenting in part, observed: "No matter how many animals live on the Champions easement, the reality remains the same: With the chemicals, imported grasses, large fans, artificial drainage, and water pumping, it is not at all clear that the easement amounts to a relatively natural habitat. I do not mean to say that a golf course could never qualify; it's simply not clear that this one does." *Id.* at 1042.

[60] *Champions Retreat*, T.C. Memo. 2022-106.

[61] Reg. section 1.170A-17(a)(3)(i)(D) and (a)(3)(viii).

[62] *Champions Retreat*, T.C. Memo. 2022-106, at 22.

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

> Fifth, net sale proceeds are discounted to present value at a market-derived rate of the development and absorption period. Sixth, appropriate discounts for lack of marketability, partition, and market absorption are applied where appropriate. The resulting figure equals the indicated value of the undeveloped subdivision.[63]

The Tax Court, getting more specific, clarified that the appraisers performed a discounted cash flow analysis of the subdivision portion of the property in *Champions Retreat* to identify the pre-donation (that is, "before") FMV. The Tax Court described the process as follows:

> This involved estimating the retail price at which lots would sell (using the comparable sales method for this step), projecting the probable absorption rate (*i.e.*, the number of lots that would sell every year), estimating sales and holding expenses, and calculating a discounted present value of the resulting net income stream.[64]

In emphasizing the appropriateness of the income method in general, and the subdivision-development method in particular, the Tax Court cited several prior cases. One of them describes the subdivision-development method as follows:

> The [subdivision-development method] determines the value of undeveloped land by treating the land as if it were subdivided, developed, and sold. From the proceeds of the sale, development costs are then subtracted. Finally, the expected net proceeds are discounted over the estimated period required for market absorption of the developed lots in order to determine the amount a developer would pay for the undeveloped property.[65]

The Tax Court in *Champions Retreat* ultimately held that the easement was worth about $7.8 million, instead of the $10.4 million originally claimed by the partnership. In other words, the partnership was entitled to 75 percent of the charitable tax deduction that it initially sought.

6. Caution with the criticisms.

Some people, particularly the IRS, might try to diminish the significance of *Champions Retreat* or distract from its main holdings by highlighting some biting remarks by the Tax Court on valuation matters. That strategy has a major flaw, though. The Tax Court had plenty of comments to go around, directing criticisms at essentially *all* involved, including the IRS and its expert witness.[66]

VI. Conclusion

The fact that several conservation easement disputes are now reaching the pivotal issue of valuation is a positive development. The two recent cases that endorse procedures involving the HBU of property, before-and-after valuations, and the income method are encouraging, too, at least from the perspective of taxpayers. All eyes will be on the Tax Court and courts of appeal as they encounter opportunities to augment the valuation discourse in the near future. ■

[63] *Id.*

[64] *Id.* at 23-24.

[65] *Glick v. Commissioner*, T.C. Memo. 1997-65; *see also Crimi v. Commissioner*, T.C. Memo. 2013-51 (explaining that the "subdivision development method is a variation of the income approach previously recognized by this Court" and it "values undeveloped land by treating the property as if it were subdivided, developed and sold").

[66] The Tax Court criticized (1) counsel for both parties for not alerting it to a pending district court lawsuit naming one of the appraisers as a defendant, (2) IRS counsel for not offering specific comparable sales or valuation alternatives, (3) both parties for submitting "flawed" expert reports, (4) IRS counsel for hiring an expert appraiser who had never before valued a conservation easement, (5) all experts for not performing specified financial analyses, and (6) IRS counsel for stipulating some valuation-related facts that were contrary to those in their own expert's report. *See Champions Retreat*, T.C. Memo. 2022-106, nn.3, 9, 10, 11, and 18, and at 8 and 19-21.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.