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Courts to IRS: Ease Up on Conservation Easement Valuations

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The popularity of donating conservation easements has exploded in recent years. According to statistics reported by the Land Trust Alliance, between 2000 and 2005, the amount of land protected by local and state land trusts using easements doubled, totaling 6.2 million acres. In response to this growing popularity, the IRS has begun scrutinizing charitable contribution deductions for conservation easements, including challenging the valuation given by some donors. Increasingly, the IRS has taken the position that conservation easements have little or no value.

Generally, conservation easements are legal agreements in which the owner of real property agrees to voluntarily restrict his use or development of the land to a conservation purpose. The income tax deduction for those easements was made a permanent feature of the Internal Revenue Code in 1980 as a result of Congress's recognition that ''the preservation of our country's natural resources and cultural heritage is important, and . . . that conservation easements now play an important role in preservation efforts.''[1]

This article, after reviewing the general requirements for the income tax deduction and applicable limitations, reviews court decisions addressing the valuation of conservation easements and concludes that courts largely reject the IRS's zero or negligible valuation position and find significant value in conservation easements.

A. Qualified Conservation Contributions

1. Qualified conservation contribution defined. Taxpayers may claim federal income tax deductions for qualified conservation contributions. Section 170(h) defines qualified conservation contributions as contributions (1) of a qualified real property interest; (2) to a qualified organization; and (3) exclusively for conservation purposes. Included in the definition of qualified real property interest is a conservation easement that restricts, in perpetuity, the use of the property to conservation purposes. The term ''conservation purpose'' includes (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 open space, including farmland and forest land; and (4) the preservation of a historically important land area or certified historic structure. The qualified organizations that can receive those donations include governmental units and publicly supported charitable organizations.

Some estate tax benefits not addressed in this article are also available for qualified conservation contributions.[2]

2. Deduction limits and extended carryforward of excess deductions. An individual taxpayer who makes a qualified conservation contribution may deduct the FMV of a qualified conservation contribution up to the excess of 50 percent of the donor's ''contribution base'' (generally, contribution base refers to a taxpayer's adjusted gross income) over the amount of all other allowable charitable contributions.[3] A qualified farmer or rancher may deduct up to the excess of 100 percent of his contribution base over the amount of all other charitable contributions.[4] Any unused portion of a qualified conservation contribution may be carried forward a maximum of 15 years.[5] When calculating a taxpayer's deduction, if the taxpayer makes contributions in addition to qualified conservation contributions in a given year, other contributions are used first against existing deduction limits. Only after the other contributions are used up are qualified conservation contributions taken into account.

The tax incentive provisions described above expire on December 31, 2009. On expiration, the deduction limits for a qualified conservation contribution will be the same as those generally applicable to charitable contributions. For example, the FMV of a contribution of long-term capital gain property generally may be deductible by an individual only to the extent of 30 percent of the donor's contribution base, and any excess may be carried forward for 5, rather than 15, years.[6] There is support in Congress for extending the increased tax incentives beyond 2009. On April 1, 2009, Rep. Mike Thompson, D-Calif., and House Ways and Means Committee member Eric Cantor, R-Va., accompanied by 93

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[1] S. Rep. No. 96-1007, 96th Cong., 2d Sess. 1980.

[2] Sections 2031(c) and 2055(f).

[3] Section 170(b)(1)(E)(i) and (b)(1)(G).

[4] Section 170(b)(1)(E)(iv)(I).

[5] Section 170(b)(1)(E)(ii).

[6] Section 170(b)(1)(C)(i) and (d)(1).

original cosponsors, including 13 additional members of the Ways and Means Committee, introduced the Conservation Easement Incentive Act (H.R. 1831). That act will make permanent the tax incentive provisions described above. A bill with identical effect, the Rural Heritage Conservation Act of 2009 (S. 812), was introduced in the Senate by Finance Committee Chair Max Baucus, D-Mont., and ranking minority member Chuck Grassley, R-Iowa, on April 2, 2009.

B. Placing a Value on Conservation

The value of a qualified conservation contribution under section 170 is equal to the FMV of the contributed property at the time of the contribution. As provided in reg. section 1.170A-14(h)(3)(i), the FMV of contributed property should be calculated using a sales comparable method if there is a substantial record of sales of comparable easements. However, conservation easements are typically unique in nature, and, as explained by the Tax Court in *S.K. Johnson III*,[7] ''a conservation easement . . . is normally granted by deed of gift; consequently, there is rarely an established market from which to derive fair market value.''[8] When ''no substantial record of marketplace sales is available to use as a meaningful or valid comparison,'' the regulations provide that a ''before and after'' approach generally should be applied to calculate the FMV of the contributed property.[9] Under the before-and-after approach, the FMV of contributed property is equal to the difference between the FMV of the property it encumbers before the granting of the restriction and the FMV of the encumbered property after the granting of the restriction. Reg. section 1.170A-14(h)(3)(ii) notes that in applying the before-and-after approach, the FMV of the property before the contribution of a conservation restriction ''must take into account not only the current use of the property but also an objective assessment of how immediate or remote the likelihood is that the property, absent the restriction, would in fact be developed, as well as any effect from zoning, conservation, or historic preservation laws that already restrict the property's potential highest and best use.''

Calculating FMV under the before-and-after method is a fact-intensive analysis, and courts may take a hands-on approach. As the Tax Court described in *Akers*,[10] ''valuation is not an exact science and cannot be determined with mathematical precision. It is a subjective determination which requires the exercise of our best judgment considering all the facts and circumstances of record.''[11] Describing the court's role concerning valuation, the Court of Federal Claims in *McLennan* explained that the court is ''not restricted to choose one valuation over the other, but may extract relevant findings from each in drawing . . . conclusions.''[12]

The table at the end of this article summarizes valuation determinations across a sample of 26 cases. It highlights the range of values assigned to the contributed properties as well as the courts' practice of assigning a unique (and significant) value to the contributed properties. The courts have often arrived at a valuation independently and have avoided merely splitting the difference between the parties.

C. Courts Largely Reject IRS Zero Valuation

In a news release (IR-2004-86 (June 30, 2004), *Doc 2004-13500*, *2004 TNT 127-7*), the IRS announced its intent to subject the valuation of conservation contributions to greater scrutiny, stating that it was aware that ''some taxpayers are claiming inappropriate charitable contribution deductions for easement transfers that do not qualify as qualified conservation contributions, or are claiming deductions for amounts that exceed the fair market value of the donated easement.'' The IRS has reacted to those perceived abuses by challenging taxpayer valuations of conservation contributions, frequently arguing that the contributed easement has no value. Reg. section 1.170A-14(h)(3)(ii) raises the theoretical possibility of a zero value, stating that ''there may be instances where the grant of a conservation restriction may have no material effect on the value of the property or may in fact serve to enhance, rather than reduce, the value of the property.'' As a practical matter, however, the courts have generally rejected a zero valuation argument, often expressing doubt that a perpetual restriction may ever have a value of zero.

Although taxpayers often have had their initial valuations reduced on challenge by the IRS, the table of cases at the end of this article shows that the courts consistently find significant value in qualified conservation contributions. In the 26 valuation cases included in the table, court judgments range from $31,000 to $28,656,004. In nine of those cases, the IRS asserted that the contributed property had a zero value. The court rejected the IRS's zero valuation in each of those cases, assigning values ranging from $65,860 to $1,992,375.

In *Akers*, for example, the Tax Court rejected the IRS's argument that the value of the land would not be affected by the granting of the easement. *Akers* involved the granting of an easement over 1,342.66 acres located in Tennessee. The easement was granted for scenic enjoyment of the public as well as conservation and protection of the natural environmental systems on the property. The easement also limited the number of family dwelling units to one per 200 acres. Rejecting the valuation determined by the IRS expert, the Tax Court said, ''We cannot accept Mr. Johnson's opinion that the restrictions put on the land by the easement would in no way reduce its value. Mr. Johnson reached this conclusion by confusing

[7] *Johnston v. Commissioner*, T.C. Memo. 1997-475, *Doc 97-28976*, *97 TNT 203-8*.
[8] *Id.* at 3,167.
[9] Reg. section 1.170A-14(h)(3)(i).
[10] *Akers v. Commissioner*, T.C. Memo. 1984-490 (citing *Messing v. Commissioner*, 48 T.C. 502, 512 (1967)).
[11] *Id.* at p. 84-1971.

[12] *McLennan v. United States*, 23 Cl. Ct. 99 (1991) (citing *Chester W. Fannon Jr.*, T.C. Memo. 1986-572 at 86-2668, *modified in unpublished opinion*, 842 F.2d 1290 (4th Cir. 1988)).

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the post-easement value of the land to Mr. Akers with the fair market value of the land to a willing buyer and seller. . . . The restrictions clearly affect any potential use of the land.''[13] The Sixth Circuit affirmed.

The Tax Court expressed similar skepticism of the IRS's valuation in *Symington*,[14] in which the taxpayer donated a perpetual open space easement, prohibiting subdivision and restricting the construction of new buildings. The IRS expert in *Symington* concluded that the conveyance of the open-space easement had no adverse effect on the FMV of the affected property. The Tax Court disagreed with the IRS expert, saying:

> We are hard pressed to imagine a prospective purchaser of a 60-plus acre parcel of land who would not have considered the restrictions of such an open-space easement in determining his offering price. The fact that a purchaser of Friendship Farm would have been precluded from even giving away part of his land if he ever so desired, for example, to his children, or, along the same lines, precluded from ever building an additional home on his property, would certainly have affected the purchase price he would have been willing to pay.[15]

The Tax Court followed the same approach in *David L. Fannon*.[16] In that case, the IRS expert argued that a taxpayer's donation of a perpetual open-space easement had no value, on the basis that agricultural use was the highest and best use of the property both before and after the easement, and that the easement did not interfere with that use. Rejecting the notion that these facts would necessarily result in a zero value for the easement, the Tax Court said, ''On its face, this appears to us to be shortsighted. Even if the highest and best use of the land before the easement was for agricultural use, or as a country gentleman's estate, the imposition of the easement was bound to reduce the value somewhat, unless we acknowledge that such use of the land will never change.''[17] The Tax Court ultimately held that the easement resulted in a 37 percent reduction in the value of the property, or $65,860.

The Tax Court also criticized the IRS's zero value argument in *Schwab*.[18] The taxpayer in *Schwab* granted, in perpetuity, an agricultural, open-space conservation easement on a 1,558-acre parcel located in California. The easement prohibited the construction of permanent structures, subdivision, and timber harvesting. The taxpayer's expert determined that the easement had a value of $900,000. The IRS expert argued that the easement had no value because ''the highest and best use of a fee simple interest in the land remained the same after donation of the easement.''[19] Rejecting the zero valuation as untenable, the Tax Court held that the easement had a value of $544,000. The Tax Court found it ''hard to imagine a prospective purchaser of a 1,558-acre parcel of land who would not have considered the restrictions of the open-space easement in determining the price.''[20]

In a recent case, *Hughes*,[21] the Tax Court set forth its most detailed analysis yet of the zero value argument. In *Hughes* the taxpayer granted to a qualified organization an easement prohibiting subdividing the affected 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. The IRS sent the taxpayer a notice of deficiency, disallowing $1,107,635 of the taxpayer's claimed $3.1 million deduction. At trial, however, the IRS expert's report asserted values well below the amount allowed in the notice of deficiency, concluding that the FMV of the conservation easement was between zero and $238,135. The IRS expert's report included a chart that attempted to illustrate that the reduction in value ''for those properties that did not experience a change in highest and best use . . . is quite small and was often found to be 0%.''[22] Despite that report, the IRS did not assert an increased deficiency.

The Tax Court disapproved of the use of the IRS expert's matrix because it included information not connected with the parcels under examination. The court also strongly disagreed with the IRS expert's testimony that the easement had no real value:

> With respect to [IRS expert] Mr. Packard, we disagree with his conclusion that the conservation easement may have had no, or only a nominal, impact on the fair market values of the Bull Mountain and Sylvester parcels. See *Schwab*, T.C. Memo. 1994-232. (''We find it hard to imagine a prospective purchaser of a 1,558-acre parcel of land who would not have considered the restrictions of the open space easement in determining the price.'')[23]

The Tax Court further noted that the IRS expert failed to consider two important factors. The first factor was the value of certain transferable Colorado state income tax credits. Because the grant of the conservation easement precluded any future purchaser of the property from obtaining the benefit of those credits, the FMV of the property would necessarily have been reduced as a result of the easement.

The second factor noted by the Tax Court was the IRS expert's failure to take into account the potential for changes in circumstances that could cause the easement to have a significant value, even if it did not currently restrict the highest and best use of the property. The Tax Court explained:

> Second, Mr. Packard has seemingly neglected the possibility that circumstances may change in the

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[13]*Akers,* T.C. Memo. 1984-490 at 84-1970.
[14]*Symington v. Commissioner*, 87 T.C. 892 (1986).
[15]*Id.* at 898.
[16]*David L. Fannon v. Commissioner*, T.C. Memo. 1989-136.
[17]*Id.* at 89-642.
[18]*Schwab v. Commissioner*, T.C. Memo. 1994-232, *Doc 94-5077*, *94 TNT 102-12*.
[19]*Id.* at 94-1297.
[20]*Id.*
[21]*Hughes v. Commissioner*, T.C. Memo. 2009-94, *Doc 2009-10285*, *2009 TNT 86-12*.
[22]*Id.* at 712.
[23]*Id.* at 712-713.

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future. For example, although there was little demand for residential property at the time petitioner granted the easement, residential development may be a realistic possibility in the future. In that event, the conservation easement would nevertheless prevent petitioner or his successors in interest from taking advantage of potentially lucrative development opportunities. Mr. Packard should have at least considered this possibility in his report and, if appropriate, reflected it in the diminution in value of the Bull Mountain and Sylvester parcels' fair market values.[24]

In a footnote, the Tax Court rejected the argument that those factors would, as a practical matter, have no significant effect on the value of the affected property. The Tax Court cautioned, however, that the possibility of future development would need to be discounted to present value:

Mr. Packard tried to explain that these two factors are of minimal importance ''in the real world,'' but we are not persuaded. To the extent future demand for residential development could have been anticipated, any increase in fair market value due to such demand would have had to have been discounted under time value of money principles. There is no evidence that there will be significant demand for residential development in the area surrounding the Bull Mountain and Sylvester parcels in the near to intermediate future. Accordingly, in light of the necessary discount for the time value of money, the possibility of future residential development does not affect our conclusion as to the value of the conservation easement.[25]

The Tax Court concluded that the taxpayer was not entitled to claim more than the $1,992,375 amount that was allowed in the notice of deficiency. Accordingly, the Tax Court was not required to determine the exact value of the easement under examination. Nevertheless, the *Hughes* decision is an important indication of the courts' continued recognition that conservation easements generally have significant value.

We are aware of only two cases in which a court has acknowledged that a conservation easement may have zero value. In each of those cases, however, the courts ultimately found the easement to have significant value. In *Losch*[26] the taxpayer donated a scenic, open space, architectural façade, and partial interior easement in property located in a historic district of the District of Columbia. The IRS initially disallowed the deduction in full, asserting a value of zero in its notice of deficiency. At trial, the IRS conceded a value of $70,000. The Tax Court found that the taxpayer was not entitled to claim any diminution in value attributable to the donation of development rights, holding that the taxpayer failed to prove that further development of the property would have been economically feasible. Nevertheless, the Tax Court ultimately held that the property was reduced in value by $130,000. In *Strasburg*[27] the donated easement related to property located in an area that had high demand for property with rural development or recreational use, but with severe restrictions on supply. The IRS asserted that a comparable easement had zero value. Noting that ''it is probable that a portion of the buying public will not pay less for petitioner's property even if it is encumbered by the . . . easement,'' the Tax Court took the zero value comparable into account in its averaging of five comparable diminution percentages to determine the deduction value of the easement.[28] Ultimately, the Tax Court concluded that the easement had a value of $1,129,680.

The courts' rejection of the IRS's zero value argument appears to be grounded on the recognition that a conservation easement is a permanent restriction on the use of property. Thus, even if the permissible use of the property does not currently appear to have been restricted by the grant of the easement, a future buyer of the property would necessarily take into account the possibility that circumstances could change to make the easement a more significant restriction. The possibility of increased future use, however remote, is restricted after the grant of an easement. As the Tax Court indicated in *Hughes*, this possibility must be taken into account in determining the value of the easement; consequently, it is difficult to conclude that the easement does not reduce the FMV of the property.

It is unclear if the IRS will continue to assert zero valuation in light of the courts' general rejection of this argument. It may be significant that in the recent cases of *Hughes* and *Whitehouse Hotel*,[29] the IRS did not ask the Tax Court to find that the value of the easement at issue was less than the amount allowed in the notice of deficiency, even though the IRS expert opined at trial that the value was nominal or zero.

D. Conclusion

Conservation easements have been subjected to increased scrutiny in recent years. The IRS has aggressively challenged the claimed value of conservation easements, frequently asserting that the value of the donated easement is zero. As discussed above, the courts generally have rejected this argument, recognizing that taxpayers who permanently restrict the permissible use of their property have given up significant value. As the recent *Hughes* decision indicates, valuation of a conservation easement must take into account the possibility of changed circumstances that may allow increased development of the affected property. Thus, a court may find that an easement has significant value even if it does not restrict the current highest and best use of the property.

Taxpayers should be encouraged that the courts have respected donations of conservation easements as having

[24]*Id.* at 713.
[25]*Id.* at note 31.
[26]*Losch v. Commissioner*, T.C. Memo. 1988-230.
[27]*Strasburg v. Commissioner*, T.C. Memo. 2000-94, *Doc 2000-8550*, *2000 TNT 55-15*.
[28]*Id.* at 513.
[29]*Whitehouse Hotel Ltd. Pship., et al. v. Commissioner*, 131 T.C. No. 10 (2008), *Doc 2008-23156*, *2008 TNT 212-12*.

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significant value. Of course, the valuation of any easement depends on the facts and circumstances of each case. Taxpayers and their advisers should maximize their chances of success by ensuring that the appraisals substantiating the easement value are reasonable and well supported and by complying with all other requirements for the charitable deduction.

Table of Cases
(Cases Arranged in Alphabetical Order)

Case		Taxpayer Proposed Value	IRS Proposed Value	Court Judgment
William B. Akers v. Commissioner, T.C. Memo. 1984-490 (1984), *aff'd*, 799 F.2d 243 (6th Cir. 1986), *cert. denied*, 479 U.S. 1086 (1987)		$789,000	IRS expert #1: $0 IRS expert #2: $114,000	$114,000
Charles H. Browning Jr. v. Commissioner, 109 T.C. 303 (1997)		540,500	367,000	518,000
Alvin H. Clemens v. Commissioner, T.C. Memo. 1992-436 (1992)		910,000	175,000 or 0	703,000
Dorsey v. Commissioner, T.C. Memo. 1990-242 (1990)		245,000	46,000	153,305
Chester W. Fannon Jr. v. Commissioner, T.C. Memo. 1986-572 (1986), *modified in unpublished opinion*, 842 F.2d 1290 (4th Cir. 1988)		236,752	0	121,781
David L. Fannon v. Commissioner, T.C. Memo. 1989-136 (1989)		249,211	0	65,860
Orville W. Forte v. Commissioner, T.C. Memo. 1991-36 (1991)		209,150	77,500	173,000
Jeffrey E. Griffin v. Commissioner, T.C. Memo. 1989-130, *aff'd*, 911 F.2d 1124 (5th Cir. 1990)		195,000	35,000	70,000
Norton A. Higgins v. Commissioner, T.C. Memo. 1990-103 (1990)		110,000	50,150	103,000
Hilborn v. Commissioner, 85 T.C. 677 (1985)		94,000	24,500	55,278
Nick R. Hughes v. Commissioner, T.C. Memo. 2009-94 (2009)		3,100,000	Between 0 and 238,135	1,992,375
S.K. Johnston III, et ux. et al. v. Commissioner, T.C. Memo. 1997-475 (1997)		1,131,348	203,500	1,131,348
Robert E. Losch v. Commissioner, T.C. Memo. 1988-230 (1988)		215,000	70,000	130,000
McLennan v. United States, 68 AFTR 2d 91-5572, 24 Cl. Ct. 102 (1991), *aff'd* 994 F.2d 839 (1993)		329,859	70,000	223,260
Frank Nicoladis v. Commissioner, T.C. Memo. 1988-163 (1988)		350,000	86,000	168,700
Richmond v. United States, 699 F. Supp. 578 (E.D. La. 1988)		150,000	59,000	59,000
John D. Schapiro v. Commissioner, T.C. Memo. 1991-128 (1991):	Easement #1	375,000	281,000	375,000
	Easement #2	220,031	107,000	220,031
Charles R. Schwab v. Commissioner, T.C. Memo. 1994-232 (1994)		900,000	0	544,000
Stanley Works v. Commissioner, 87 T.C. 389 (1986)		12,000,000	1,100,000	4,970,000
Henry T. Stotler, et al., T.C. Memo. 1987-275 (1987)		1,065,000	427,000	1,065,000
Katherine Strasburg v. Commissioner, T.C. Memo. 2000-94 (2000):	Orig. Easement	1,304,000	275,000	839,000
	Amend. To Easement	290,000	0	290,000
Symington v. Commissioner, 87 T.C. 892 (1986)		150,000	0	92,370
Robert H. Thayer v. Commissioner, T.C. Memo. 1977-370 (1977)		147,688	60,000	113,000
Todd v. United States, 617 F. Supp. 253 (W.D. Pa. 1985)		353,000	31,000	31,000
Whitehouse Hotel Ltd Partnership, et al. v. Commissioner, 131 T.C. No. 10 (Oct. 30, 2008)		7,445,000	0	1,792,301

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