Bosque Canyon Ranch v. Comm’r—Partnerships Denied Deductions for Conservation Easements Allowing Movable Homesites and Taxed on Disguised Sales of Homesites

In Bosque Canyon Ranch v. Comm'r, T.C. Memo. 2015-130, the Tax Court denied $15.9 million of deductions claimed by partnerships for the donation of conservation easements on two grounds: (i) the easements permitted 47 unencumbered 5-acre homesites to move around the easement-protected properties with the holder’s approval and (ii) the partnerships failed to provide the donee with adequate and timely baseline documentation. The court also sustained the IRS’s imposition of gross valuation misstatement penalties with regard to the conservation easement deductions. The court further held that partnerships’ transfers of the 5-acre homesites to limited partners in exchange for purported “capital contributions” were, in fact, taxable disguised sales.

Background

In 2003, Bosque Canyon Ranch, L.P. (BCR I), purchased a 3,744-acre ranch (the Ranch) for just over $4.97 million. In 2005, BCR I contributed approximately 1,866 acres of the Ranch to BC Ranch II, L.P. (BCR II).

BCR I sold 24 limited partnership interests with regard to its 1,877-acre share of the Ranch for $350,000 per unit, or a total of $8.4 million. Each limited partner was entitled to a 5-acre “Homesite parcel,” the right to build a house on the parcel, and the right to use the Ranch for various recreational activities, such as swimming, hiking, biking, horseback riding, and hunting. In 2005, BCR I granted a conservation easement to the North American Land Trust (NALT) with regard to 1,750 of the 1,877 acres and claimed a charitable deduction of $8.4 million.

BCR II sold 23 limited partnership interests with regard to its 1,866-acre share of the Ranch for $385,00 to $550,000 per unit, or a total of over $9.957 million. As with BCR I, each limited partner was entitled to a 5-acre Homesite parcel, the right to build a house on the parcel, and the right to use the Ranch for various recreational activities. In 2007, BCR II granted a conservation easement to NALT with regard to 1,732 of its 1,866 acres and claimed a deduction of $7.5 million.

The terms of the two easements are substantially the same. Both provide that portions of the subject land include habitat of the golden-cheeked warbler (pictured above), an endangered species endemic to and nesting only in Texas. Both prohibit residential, commercial, institutional, industrial, and agricultural uses, but permit BCR I and II to raise livestock; hunt; fish; trap; cut down trees; and construct buildings, recreational facilities, skeet shooting stations, deer hunting stands, wildlife viewing towers, fences, ponds, roads, trails, and wells. The easements also permit the Homesite parcel owners and NALT to mutually agree to modify the boundaries of the Homesite parcels, provided that:

- in NALT's "reasonable judgment," the modification will not result in any material adverse effect on the conservation purposes of the easements,
- the size of the Homesite parcels will not be increased,
- the exterior boundaries of the property subject to the easements will not be modified, and
- the overall amount of property subject to the easements will not be decreased.

Following the various transfers noted above, the 47 limited partners of BCR I and II owned approximately 235 acres (the Homesite parcels), which were not encumbered by the easements; 99.2% of the remaining land (3,482 of the remaining 3,509 acres) was subject to the conservation easements; and the Homesite parcels could, subject to the conditions noted above, be moved around the Ranch.

Denial of § 170(h) Deductions

The Tax Court denied the deductions claimed with regard to the easement donations on two grounds. First, the boundary modifications to the Homesite parcels could cause property that was protected by the easements at the time of their donation to subsequently lose that protection. Accordingly, citing the 4th Circuit's opinion in Belk v. Commissioner, the Tax Court held that the easements were not "restrictions (granted in perpetuity) on the use which may be made of the real property" as required under IRC § 170(h)(2)(C). For a similar holding, see Balsam Mountain v. Commissioner (also involving NALT as donee).

The Tax Court also found that BCR I and II did not satisfy the Treasury Regulation's "baseline documentation" requirement, which provides, in part, that:

for a deduction to be allowable … the donor must make available to the donee, prior to the time the donation is made, documentation sufficient to establish the condition of the property at the time of the gift. Such documentation is designed to protect the conservation interests associated with the property, which although protected in perpetuity by the easement, could be adversely affected by the exercise of the reserved rights.... The documentation...must be accompanied by a statement signed by the donor and a representative of the donee clearly referencing the documentation and in substance saying 'This natural resources inventory is an accurate representation of [the protected property] at the time of the transfer.' Treas. Reg. § 1.170A-14(g)(5)(i).

The court explained that the baseline documentation requirement "ensures that the conservation interests are not 'adversely affected by the exercise of the reserved rights' and that 'the donor will be able to deduct only what the donee organization actually receives.'"

The court found that the baseline documentation NALT prepared with regard to the easements was “unreliable, incomplete, and insufficient to establish the condition of the relevant property on the date the respective easements were granted.” The documentation was also untimely, parts having been prepared well before and parts having been prepared well after the date of the donations. In addition, in “rambling, incoherent testimony,” the president of NALT “failed to clarify these glaring inconsistencies.” The required donor acknowledgments in the baselines, which provide that the baseline was fully reviewed by the donor and accurately describes the condition of the property at the time of donation, also were not executed by the donor prior to the donation (this was apparent with regard to the 2007 easement and seemed to be the case with regard to the 2005 easement). Unsurprisingly given the extent of the deficiencies, the court found meritless and rejected the taxpayers’ argument that they had substantially complied with the baseline documentation requirement.

Disguised Sales

The Tax Court held that both partnerships (BCR I and II) had, in effect, sold the Homesite parcels and appurtenant rights to the limited partners in taxable transactions. The court found that the distributions of the Homesite parcels to the limited partners were made in exchange for the limited partners’ payments and were not subject to the entrepreneurial risks of the partnerships’ operations. Accordingly, BCR I and II were required to recognize and include in their gross income any gains relating to the disguised sales. IRC § 707—the disguised sale provision—prevents use of the partnership provisions to render nontaxable what would in substance have been a taxable exchange if it had not been "run through" the partnership. For similar holdings involving the disguised sale of state income tax credits generated by conservation easement donations, see Route 231, LLC v. Commissioner and SWF Real Estate, LLC, v. Commissioner.

Gross Valuation Misstatement Penalties

Each of BCR I and II was also found liable for a gross valuation misstatement penalty with regard to the charitable deduction it claimed for its easement donation. The court determined that zero was the correct value relating to the easements because BCR I and II were not entitled to deductions for the donations. Accordingly, each had made a gross valuation misstatement on the return on which it claimed the deduction. The fact that the deductions were disallowed for failure of the easements to qualify under IRC § 170(h) rather than on overvaluation grounds did not matter. The Tax Court explained that, in Woods v. United States, 134 S. Ct., 557 (2013), the U.S. Supreme Court "reject[ed] the distinction between legal and factual valuation misstatements.

Moreover, neither BCR I nor BCR II was eligible for the reasonable cause exception to the gross valuation misstatement penalty. For returns filed after August 17, 2006, as BCR II's was, the gross valuation misstatement penalty is a strict liability penalty (i.e., there is no reasonable cause defense). Also, even though BCR I was entitled to raise the reasonable cause defense (because it filed its return before the August 17, 2006, date), it did not qualify for the defense. Although the court found that the appraisal BCR I used to substantiate its deduction was a qualified appraisal and BRC I's reliance on the appraisal constituted a good faith investigation of the 2005 easement's value, that was not good enough. Because the baseline documentation for the easement was insufficient, unreliable, and incomplete, BCR I's submission of the baseline to NALT "did not constitute a reasonable attempt to comply with section 170 and the related regulations." BCR I failed to effectively supervise or review NALT's "slipshod preparation" of the baseline and "failed to make any plausible contentions sufficient to establish reasonable cause." Accordingly, BCR I was also liable for the gross valuation misstatement penalty.

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