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Tax Court Determines Value of Donated Conservation Easement

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June 25, 2009
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Overview

In general, a deduction is not available for charitable contributions of partial interests in property and an easement, by definition, is a partial interest in property. But, an exception exists for an easement that is a "qualified conservation contribution."[1] A "qualified conservation contribution" is defined in as the contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes.[2]

The amount of the deduction is tied to the value of a charitable contribution - its fair market value as of the date of the donation. On that point, the regulations define fair market value as: "the price at which property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."[3] For real property, the "highest and best use" of the property is considered to be fair market value. When an easement is involved, a common valuation approach (if comparable sale aren't available) is the "before and after" method – the value of the donated easement is the value of the property before the easement less the value of the property after the easement. Experts play a key role in determining easement values for tax purposes, with the courts often choosing the expert they feel has the best analysis. However, the courts sometimes reject the experts and go with their own valuation methodology.

The Tax Court, in an interesting recent opinion,[4] dealt with the valuation of a perpetual conservation easement on a golf course that was donated by a Limited Liability Company (LLC) and deducted as a charitable contribution on its tax return.

Facts of the Case

Under the facts of the case, the taxpayer purchased 251 acres in Alabama on the Gulf of Mexico for $1,050,000 in the early 1990s. About 18 months later, the taxpayer conveyed his interest in the property to an LLC that he had created a few weeks earlier. (D&E Investments, LLC). The LLC then developed the property into a gated, residential subdivision (a resort) known as Kiva Dunes and a 141-acre golf course. The golf course was then conveyed to another LLC that the taxpayer had formed - Kiva Dunes LLC. In 2002, this LLC placed a perpetual conservation easement on the golf course and donated the easement to the North American Land Trust – a qualified land trust. The property subject to the easement could be used either as a golf course, park or some type of agricultural enterprise. The LLC (which was taxed as a partnership) took a $30,588,235 charitable contribution deduction for the easement on its 2002 Form 1065. The IRS audited and, while conceding that the taxpayer was entitled to a charitable contribution, disallowed a large chunk of the deduction by valuing the easement at $10,018,000. IRS also assessed an accuracy-related penalty.

Battle of the Experts

Two issues faced the Tax Court – (1) the proper value of the donated easement; and (2) whether the taxpayer was subject to an accuracy-related penalty. As mentioned above, the key to valuation is to determine the fair market value of the property at the time the charitable contribution is made. That's the willing-buyer/willing-seller test. The Tax Court said arriving at the proper value involved not only examining the current use of the property, but also determining its highest and best use. On that point, the experts for the IRS and the taxpayer's expert agreed that the highest and best use of the easement would have been as a residential subdivision. But, here there wasn't a great deal of data for comparable easement sales. So, the Tax Court used the fall-back test of the regulations – the before and after approach.[5] In assessing the value of the donated property *before* the easement restriction was placed on the property, the Tax Court focused on three key variables on which the experts assumptions varied – (1) the number of lots available for sale on the easement area in the hypothetical residential subdivision; (2) the average sale price of the lots and; (3) the rate at which the lots would sell. Due to the differences in assumptions behind these three points, the experts' "before donation" valuation differed dramatically. The taxpayer's expert valued the property before the easement restriction was placed on the property at $31,938,985 and the expert for the IRS came up with a before easement restriction value of $10,018,000.

The Tax Court first noted that another golf course in the area had been sold for $17,800,000 for development as a residential community. But, that course was 15 miles from the Kiva Dunes golf course and was six miles inland. The Kiva Dunes course, the Tax Court noted, was on "one of the most beautiful stretches of coastline in the United States." As such a willing buyer would pay a premium for the property. Accordingly, the "before" valuation of the IRS expert was way too low. Then, when the Tax Court examined the experts' assumptions they noted that the IRS expert incorrectly interpreted a local zoning regulation to conclude that only 300 lots could be developed. The taxpayer's expert determined that 370 lots could be developed, and the IRS expert later conceded that point – further adding to the value of the property before the easement restriction was imposed. On the second assumption (average selling price of each lot), the taxpayer's expert did a market analysis that came up with an average $170,000 per lot based on quality of the lots, market demand and comparable sales.[6] The IRS expert, on the other hand didn't rely on comparable lot characteristics when determining value, and the Tax Court determined his assumptions were not realistic in arriving at an average lot value of $85,000. On the third assumption (absorption rate), the taxpayer's expert assumed the 370 lots would all be sold in 10 years based on absorption data from other nearby developments. The IRS expert projected a 15-year absorption rate for 300 lots. The Tax Court believed the assumptions for the taxpayer's expert were reasonable and that his testimony was credible. Based on a discounted cash-flow analysis, the taxpayer's expert came up with a valuation before the easement restriction was placed on the property of $31,938,985.[7]

On the post-donation valuation of the property (the value of the property after the easement restriction has been placed on the value), the experts again used different valuation methods. The taxpayer's expert used comparable sales (market approach) to determine value, but the IRS's expert used the capitalization of income approach which focused on the projected earnings of the golf course. Unfortunately (for the IRS), their expert didn't have much experience in Alabama and made some serious errors in the application of his valuation methodology, not the least of which was that he capitalized the wrong income stream. The IRS expert divided a capitalization rate of 12 percent into what he thought was the golf course's net income. But, when he calculated net income, he didn't account for all of the golf course's expenses for 2002 or reserves in lieu of depreciation. Those numbers, had they been accounted for, would have shown a negative net income in 2002.[8] The IRS expert testified that he had the 2002 tax return before he did his appraisal. Consequently, the Tax Court placed no weight on his testimony on post-restriction value testimony. Alternatively, the taxpayer's expert presented five comparable sales of similar pieces of property in Alabama. He then made adjustments to each comparable sale based on seven variables, including market conditions, location, and size.[9] So, it was easy for the Tax Court to find the taxpayer's expert valuation to be more persuasive, but the Tax Court did increase the post-easement value of the property for improvements that had been made to the golf course. After accounting for those adjustments and an additional value enhancement on the taxpayer's property that was not subject to the easement, the Tax Court concluded the post-easement value of the property equaled $3,282,981. Subtracting that amount from the property's pre-restriction value resulted in a charitable deduction for the donated easement valued at $28,656,004.

Valuation Penalty

Legislation in recent years has increased the penalties for valuation misstatements. I.R.C. §§6662(a) and (b) impose a 20 percent penalty on the portion of any underpayment that result from a substantial valuation misstatement. A substantial misstatement occurs if the value of any property claimed on the return is 200 percent or more of the amount determined to be the correct amount.[10] Because the court corrected the taxpayer's claimed deduction (based on the valuation) by just under six percent ($30,588,235 was claimed, but $28,858,004 was allowed) the taxpayer was not subject to a penalty.

Conclusion

Clearly, the IRS erred in utilizing an expert with little experience compared to the taxpayer's expert. Given the amount at stake, that move is a hard one to understand. The taxpayer had a lot to lose, and hired a well-qualified expert with specific knowledge and experience in the real estate market where the property to be appraised was located. History has shown that valuation cases often turn on how well the expert performs in conducting the valuation. That certainly was evident in this case.

> **Note:** For additional commentary on the case and an interesting insight as to the propriety of tax policy with respect to conservation easements, see the following article by G. Christopher Wright at http://taxlaw.typepad.com/tax_law/2009/06/valuing-conservation-easements-playing-golf.html

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[1] I.R.C. §§170(c), (f)(3)(B)(iii), (h).
[2] I.R.C. §170(h).
[3] Treas. Reg. §1.170A-1(c).
[4] Kiva Dunes Conservation LLC, *et al.* v. Comr., T.C. Memo. 2009-145
[5] Treas. Reg. §1.170A-14(h)(3)(i).
[6] The taxpayer's expert considered how many lots would front adjacent lakes, have access to resort amenities, and have views of Mobile Bay. The expert also considered the local market for houses and noted a population surge during the relevant valuation period which, when coupled with a decreasing supply of available homes, would increase demand for the lots.
[7] The taxpayer's expert assumed a 5 percent lot appreciation rate, a 20 percent rate for the developer's profit, 6 percent sales commission, 3 percent for closing costs and overhead, and a 9.5 percent discount rate.
[8] While the court noted, and the experts agreed, that depreciation is not to be used in a valuation appraisal, some type of reserve was to be used to account for the economic cost of maintaining and/or replacing golf course equipment. However, the Tax Court noted that it didn't have to address the issue because the golf course's other expenses more than offset the golf course's income.
[9] The Tax Court also noted that the IRS expert had only recently moved to Alabama from Georgia to a location 250 miles from the subject property and had only visited the property twice during the appraisal process. On the other hand, the taxpayer's expert had many years of experience in the locality of the golf course and performed more appraisal work in the area than any other appraiser.
[10] I.R.C. §6662(e)(1)(A). The penalty is increased to 40 percent in the case of a gross valuation misstatement. I.R.C. §6662(h). That occurs if the value is 400 percent or more of the value determined to be the correct amount. I.R.C. §6662(h)(2)(A)(i).