# TAX COURT ANALYSIS OF LAND CONSERVATION EASEMENT VALUES —DEVELOPMENTS SINCE *KIVA DUNES*

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**The IRS is likely to challenge the value of a conservation easement, primarily because of the inherently subjective nature of the determination of value.**

On 6/22/09, the Tax Court issued its opinion in *Kiva Dunes Conservation, LLC,* TCM 2009-145, which addressed an issue that has been hotly debated among the conservation easement community—whether or not a conservation easement can be granted on golf course property. In its decision, the court also addressed several other important issues, including valuation methods applicable to conservation easements.[1] The decision is a valuable guide for taxpayers seeking to make conservation easement contributions. The Tax Court also decided *Hughes,* TCM 2009-94, which solely concerned valuation of the subject conservation easement, at about the same time it decided *Kiva Dunes.* In recent developments, the Tax Court decided *Trout Ranch, LLC* TCM 2010-283, on 12/27/10. The central theme of that case was again valuation methods and deriving a fair market value of the easement. *Kiva Dunes, Hughes,* and *Trout Ranch* all exemplify the Tax Court's current approach to valuing conservation easements.

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## *Kiva Dunes*

*Kiva Dunes* involved a taxpayer's gift of a conservation easement over certain property (which included a golf course) to an eligible land trust. The taxpayer in the case was a limited liability company (LLC) taxed as a partnership for federal income tax purposes. On 12/31/02, the taxpayer donated the conservation easement to the North American Land Trust (NALT) by a grant (the easement declarations). The conservation easement was granted on 140.9 acres (the property), which was located on the Ft. Morgan Peninsula in Baldwin County, Alabama.

The Ft. Morgan Peninsula is 22 miles long and ranges between 1.2 and 3.1 miles wide. The property lies between, but does not abut, the Gulf of Mexico on the south, and Mobile Bay and Bon Secour Bay on the north. The tract's widest dimension from east to west is approximately 3,600 feet, and its widest dimension from north to south is approximately 2,300 feet.

The conservation easement is located between two nearby segments of the Bon Secour National Wildlife Refuge (approximately 0.85 miles west/northwest of the easement, and approximately 1.55 miles east of the easement). The property includes the Kiva Dunes Golf

Course. As discussed below, however, it has many unique attributes that made it well suited for a conservation easement.

The easement declarations restrict development of the property, the practical effect of which was to limit the use of the property to a golf course, a park, or a low-density agricultural enterprise. Specifically, the easement declarations limit the use of the property to protect relatively natural habitats for fish, wildlife, and plants, and to preserve open space for scenic enjoyment of the general public and for the advancement of governmental conservation policies. The easement declarations also preserve land areas for outdoor recreational use by the general public.

The LLC claimed two charitable contribution deductions on its partnership return for the tax year. One was a deduction for a $35,000 cash contribution to NALT.[2] The other was for the qualified conservation contribution of a conservation easement on the property to NALT in the amount of $30,588,235.

**Summary of trial.** The case was tried before Judge Thomas B. Wells. The week-long trial brought forth evidence including 103 exhibits, testimony of 18 witnesses, and numerous charts, photographs and videography.

At trial, the taxpayer first had the burden of proving that the conservation easement met one or more of the conservation purposes necessary for a deduction of a qualified conservation contribution. Specifically, the taxpayer had to establish that the easement accomplished one of the following purposes: preservation of land areas for outdoor recreation by, or for the education of, the general public; protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; or preservation of open space, either for the scenic enjoyment of the general public or pursuant to a clearly delineated federal, state, or local governmental conservation policy.[3]

Next, the taxpayer had the burden of establishing the value of the conservation easement. Specifically, the taxpayer attempted to substantiate that the value of the property before imposition of the conservation easement (the "before value") was $31,938,985, and that the value of the property after imposition of the easement (the "after value") was $1,050,750.

The court issued an opinion highly favorable to the taxpayer and to the use of conservation easements generally. Specifically, the court found that the taxpayer was entitled to a charitable deduction of $28,656,004, which was 94% of the deduction the taxpayer claimed on its income tax return. The valuation methods and variables taken into account by the taxpayer's appraiser and the IRS appraiser were critical to the court's determination of value.

**Key issue—valuation.** After the IRS conceded that a conservation purpose existed, the primary issue remaining was the fair market value of the easement. The experts agreed that the value was equal to the difference between the fair market value of the property before and after the easement was granted, reduced by the increase in the enhancement in value of other nearby property owned by the taxpayer or a related party as a result of granting the easement.

The "before value" of the property was based on its potential highest and best use as a residential development. To derive the before value, both experts used a discounted-cash-flow analysis of estimated revenues and costs associated with development and sale of lots in hypothetical subdivisions—the so-called "subdivision method."[4] The two appraisers' assumptions differed significantly, however, regarding the number of lots available for sale, average sale price of the lots, and rate at which the lots would sell.

The taxpayer's expert determination that 370 lots could be developed for sale (as opposed to the 300 lots projected by the Service's expert) was in accordance with the testimony of the county zoning director. Ultimately, the court ruled that the Service's expert misinterpreted the local zoning regulations when he concluded that only 300 lots could be built. The court accepted the feasibility of 370 lots.

The court also accepted the taxpayer's expert's average lot price of $170,000. The Service's expert's estimate of $85,000 per lot was based essentially on the value of two of the least desirable interior lots of an adjoining subdivision; they had

[1] The issue of sufficient "conservation purpose" was also extensively tried in *Kiva Dunes*. However, after two days of trial time and initial briefing, the IRS conceded that the conservation purpose existed.

[2] The IRS did not contest the cash contribution. In recent façade easement cases and some open space easement examinations, however, the IRS has challenged cash contributions as constituting improper quid pro quo for the acceptance of the easement by the land trust. See Scheidelman, TCM 2010-151; Kaufman, 134 TC No. 9 (2010).

[3] The IRS conceded that the taxpayer met the conservation purpose requirement after two days of trial time, the testimony of five biologists, and initial briefing.

[4] The original IRS engineer's valuation report that was relied upon in issuing the statutory notice of deficiency also used the subdivision method.

no gulf or lake view and were far removed from the amenities. The taxpayer's expert assumed a sales "absorption rate" (see below) of 37 lots per year, which was also accepted over the estimate of 20 lots per year by the Service's expert.

The parties agreed, for purposes of determining the value of the property after it was encumbered by the easement, that the property's highest and best use was its continued operation as a golf course. The Service's expert used an income approach to determine this value, while the taxpayer's expert determined the after value by analyzing sales of comparable but unimproved properties that were purchased for recreational uses. The court rejected the income approach valuation used by the Service's expert because he failed to take into account significant expenses of operating a golf course—such as salaries and wages, employee benefits, repairs and maintenance, taxes, licenses, and replacement reserves—in calculating the net income from the course.

The court accepted the "after value" determined by the taxpayer's expert through the comparable sales method. This aspect of the court's decision was significant because the IRS had argued that the taxpayer's comparables, which had different characteristics and uses from those of the subject property as encumbered by the easement (i.e., as a golf course), were improperly used. The court, however, accepted the use of the comparables, with the exception of an upward adjustment made to the value of the comparables reflecting the expense that would have been necessary to convert the unimproved land into comparable golf course property. The taxpayer argued that adding the cost of such improvements was inappropriate unless supported by sufficient net income from the golf course.[5]

**Valuation—The battle of the experts.** If a taxpayer can establish that it has made a "qualified contribution" to a "qualified donee" for a permissible "conservation purpose," and that all of the technicalities regarding the contribution are satisfied, the last and final issue is the value of the easement. The value of a conservation easement is a key issue the IRS is likely to challenge, primarily because of the inherently subjective nature of the determination of value. No matter how well taxpayers document their contribution, the issue of value will always be in play for the IRS.

As one might expect, and as was the case in the *Kiva Dunes*, the valuation of a conservation easement will evolve into a "battle of the appraisers." In such a situation, it is important that the taxpayer's appraiser support the appraisal conclusions with knowledgeable and persuasive analysis, as well as detailed fact-finding.

*Kiva Dunes* demonstrates that a taxpayer's selection of a qualified and experienced appraiser will likely be critical to withstanding an IRS challenge to the value of the conservation easement. It is helpful to hire an appraiser with experience in valuing charitable contributions because such appraisers are more likely to have knowledge about the various appraisal and appraiser requirements. Moreover, *Kiva Dunes* provides a good illustration that although an appraiser's technical education and licenses are quite important, it is equally important, if not more so, that the appraiser have extensive knowledge of the actual geographic area and real estate market being appraised. Indeed, in *Kiva Dunes* the Tax Court seemed as impressed with the taxpayer's expert's knowledge of the local area as with his technical certifications.

**Fair market value.** The amount of a charitable contribution is determined by the fair market value of the contributed property at the time it is contributed.[6] When there is a substantial record of sales of easements comparable to a donated easement, those comparables are used to determine the fair market value of the easement.[7] When no such comparables exist, as in *Kiva Dunes*, the fair market value of a conservation easement is determined with the "before and after" methodology prescribed in the regulations.[8] Specifically, Reg. 1.170A-14(h)(3)(i) provides as follows:

[5] No one would pay for golf course property or build course improvements if the course would not make money. Golf course property has steadily declined in profit potential over recent years. Dozens of courses closed as a result of urban sprawl, when the land became more valuable for development. See Wexler, "The Missing Links: America's Greatest Lost Golf Courses and Holes" (Wiley, 2000).

[6] Additionally, Section 170(e)(1) requires a donor to reduce the amount of his or her charitable deduction in appreciated property by the amount of gain that would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (i.e., the amount of the donor's deduction will be limited to his or her basis in the contributed property). Section 170(e)(1) applies to conservation easements if the property on which the easement is granted is "dealer property" in the hands of the contributor or has not been owned by the taxpayer for the applicable holding period (currently one year). Accordingly, it is important that a taxpayer verify the date of the original acquisition of the property, and that the acquisition was properly recorded.

[7] See Reg. 1.170A-14(h)(3)(i).

[8] Although the Tax Court prefers a "comparable sales" method of appraisal and the use of comparables when they are available, comparables are often unavailable for the easements because the market, if any, for such easements is usually thin. See Kayser, "Conservation Easements: The Blues of Before-and-After Valuation," 2 Valuation Strat. 14 (Sep/Oct 1998).

> 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 fair market value of a perpetual conservation restriction is equal to the difference between the fair market value of the property it encumbers before the granting of the restriction and the fair market value of the encumbered property after the granting of the restriction.

When applying the before and after methodology, all property contiguous to the encumbered property that is owned by the taxpayer or the taxpayer's family must be taken into account in the valuation.[9] This has the effect of reducing the value of the deduction to the extent that the value of any contiguous property is enhanced by the easement. Additionally, any economic benefit that accrues to the donor or related party as a result of the contribution must be taken into account.[10] These rules could conceivably have a substantial effect on the deduction when the donor or a related party has retained a significant amount of property surrounding a golf course easement if such property appreciates in value as a result of the easement.

**Fair market value in *Kiva Dunes*.** In *Kiva Dunes*, the experts' opinions of the before value, after value, and enhancement involved critical, subjective judgments and assumptions. The taxpayer presented evidence at trial and on brief that its expert was the most experienced and respected appraiser in the region surrounding the property, and that his judgments and assumptions reflected this experience. As evidenced by its opinion, the court generally agreed with the taxpayer's expert. Specifically, the court stated that the expert "performs more appraisal work in Baldwin County than any other appraiser, and he has a great depth of knowledge of the comparable properties used in valuing the easement and of the surrounding local real estate market."[11] In contrast the court stated the Service's expert had "no particular expertise in Baldwin County, and he [had] been to the Baldwin County, Alabama, area only twice in connection with his appraisal of the easement."

*Before value.* Both appraisers agreed that the development of a residential subdivision would have been the highest and best use of the property at the time of the contribution. In its opinion, the court focused on the differences in three key assumptions made by the experts[12] that led to the drastic difference in their before value conclusions—$31,938,985 versus $10,018,000.

1. *Number of lots for sale.* The taxpayer's expert determined that 370 lots could be developed in the hypothetical Kiva Dunes subdivision. The Service's expert determined that only 300 lots could be developed, based in part on his misinterpretation of a county zoning regulation. The planning and zoning director of the zoning board testified and confirmed the taxpayer's interpretation of the regulation.
2. *Average sale price of the lots.* The taxpayer's appraiser determined that the initial sales price of lots in his hypothetical subdivision would average $170,000, while the Service's expert determined that the lot price would have been only $85,000. The court agreed with the taxpayer's expert and noted that the Service's expert arrived at the $85,000 value by "averaging the 2001 sales prices of just two interior lots sold at the [adjacent] Kiva Dunes subdivision." The court's acceptance of the taxpayer's conclusions highlights the importance of a sound conceptual plan (often called a "yield plan") supporting a subdivision analysis. The court noted that the conceptual plan used by the taxpayer's expert proposed enlargement of several lakes, and creation of several pool and recreation areas on the property—all of which significantly increased the lot value. The taxpayer also overcame IRS arguments that the yield plan would not pass muster with the wetland and other regulatory requirements.
3. *Absorption rate.* The parties in Kiva Dunes differed on the time it would take to sell out the hypothetical subdivision—i.e., the period over which cash flow was projected to be received (the "absorption rate"). The court relied on the taxpayer's expert's local experience and specific examples of actual nearby subdivisions. The court adopted the taxpayer's absorption rate of 37 lots per year for ten years, noting: "Considering that the proposed plan would have had more than three times as many lots available

[9] Reg. 1.170A-14(h)(3)(i). This can also lead to computational uncertainties, especially when gifts are made from the same tract over several years. Consideration of contiguous property, although required in the regulations, often has no real purpose or effect on the value. In most cases, it results in adding and subtracting the same value for the contiguous property. In such cases, failure to account for contiguous property might be considered "substantial compliance" with the rules.

[10] *Id.*

[11] One commentator referred to Mr. Clark as the "Michael Jackson" of the case because of his "star" power in persuading the court. Wood, "Conservation Easements, Valuation, and Substantiation," 37 Jnl. Real Estate Tax'n 132 (Second Quarter 2010).

[12] The Court concluded that the other variables used by the appraisers had an immaterial effect on the final value amount. This had been suggested in the taxpayer's briefs.

for purchase as [a nearby subdivision], we conclude that a sales forecast of 37 lots per year is reasonable."

Ultimately, the court adopted the taxpayer's before value of $31,938,985. One lesson from the court's value analysis is that value is based on the highest and best use of the property on the date of the donation, and that the highest and best use is not necessarily the current use. Although the property was being used as a golf course, the Kiva Dunes course, like many golf courses around the country, was making little or no profit and its continued operation was not assured. Golf courses are frequently redeveloped for commercial or residential use, when their value as a golf course becomes less than the value for other uses.

*After value.* The experts agreed that the highest and best use of the property after being burdened by the easement was its continued operation as a golf course. Little else could be done on the property to generate income. The taxpayer's expert used comparable properties to reach an after value, and the Service's expert used an income capitalization approach, an approach that was ultimately determined by the court to be flawed. The court rejected the income approach because the Service's expert had omitted essential categories of expenses that "when subtracted from [the Service's expert's computation of] 2002 net income, result in a negative number." These omitted expenses included: (1) salaries and wages, (2) employee benefits, (3) repairs and maintenance, and (4) taxes and licenses.[13]

The court ultimately relied on the taxpayer's comparables approach. Even though the comparable properties used by the taxpayer's expert were not developed as golf courses at the time, the court determined that they were potentially suitable for such a use. The taxpayer's expert adjusted the sales prices of his comparables to reflect differences in market conditions, location value, access and visibility, size, availability of utilities, topographical and wetland characteristics, and financing terms. The court made its only significant adjustment to the taxpayer's expert's value by adjusting the after value upwards to reflect the cost associated with converting the comparable properties into golf course properties akin to the Kiva Dunes property. Ultimately, the court concluded that the after value of the Kiva Dunes golf course was $2,982,981 ($1,070,980 comparable value plus $1,912,001 for the cost of the golf course improvements).[14]

The court also accepted the taxpayer's expert's conclusion that the conservation easement had enhanced nearby property owned by the taxpayer by $300,000. In the end, the court concluded that the fair market value of the conservation easement was $28,656,004. This holding constituted an unusually high percentage of claimed value (approximately 94%). It is noteworthy that the IRS had asserted a gross overvaluation penalty of 40%, which the court found to be inapplicable because the taxpayer's value was substantially correct.

The taxpayer's success in *Kiva Dunes* demonstrates that, especially in the context of conservation easements, a thorough and knowledgeable appraisal expert can make all of the difference. It is important that the appraiser, in addition to being well-qualified and knowledgeable, spend the time necessary to investigate, examine, and understand the property being valued and particularly its highest and best uses before and after the easement. When using a hypothetical subdivision analysis, an appraiser should pay particular attention to every detail of his or her proposed hypothetical subdivision, including whether or not the zoning and other restrictions (wetlands and endangered species regulation, engineering feasibility, setback lines, etc.) to which the encumbered property is subject would prevent (or increase the costs of) developing the hypothetical subdivision.

## The subdivision method—blessed by the Tax Court

There are only a few sanctioned valuation methodologies. As provided above, the regulations direct the taxpayer to use nearby comparable easement sales to derive a fair market value of the subject easement if possible. In the absence of such sales, which is very common, the taxpayer is directed to subtract the value of the property encumbered by the easement from the value of the property before encumbrance by the easement.

[13] It appears that the IRS expert, like the IRS engineer before him, used the tax return schedule of "other" expenses, which did not include the expenses on specific expense lines on the first page of the return. He disregarded a schedule provided to him before trial detailing the income and expenses of the golf course operations. Although the reason for the error was debated in court, the error evidently harmed the expert's credibility in the case. Oddly, the IRS engineer admitted at trial that he was aware that the schedule omitted key categories of expense, such as compensation.

[14] See note 5, *supra*.

This approach is dubbed the "before and after" method.[15]

The most common approach to the before and after valuation methodology is the "sales comparison approach."[16] Under this approach, the appraiser compiles comparable sales of properties that were in fact developed in a manner that directly relates to the subject property's highest and best use. Using this data, the appraiser derives a before value for the subject property. As the Tax Court rationalized, "This approach is based on the principle that the prudent purchaser would pay no more for a property than the cost of acquiring an existing property with the same utility."[17] The appraiser then compiles sales data of properties that are restricted as to use similar to the subject property to derive an after value. The difference between the before value and after value equals the value of the conservation easement.

Though the sales comparison approach is the most common methodology and often the preferred one, another variation of the before and after valuation approach known as the "subdivision approach" is frequently and appropriately used. The subdivision approach has taken on a variety of labels, including the "discounted cash flow analysis,"[18] the "income approach,"[19] and the "development technique."[20] Regardless of what the parties or a court call it, the subdivision approach entails treating the subject property "as if it were subdivided, developed, and sold. Expected proceeds from sales of the subdivided lots are reduced by development costs and discounted over the period during which the lots are expected to sell."[21]

Though specifically referred to in the regulations, and accepted and explained by the Tax Court as appropriate, the IRS continuously attacks the methodology as being inappropriate, usually asserting that it is too prone to error.[22] The attack generally takes the form of an IRS expert testifying that the subdivision approach is not a reliable method for valuing the subject property.

Interestingly enough, the IRS itself used the subdivision approach to value the property in *Kiva Dunes* and to challenge the petitioner's valuation using the same approach. As discussed above, the Tax Court in *Kiva Dunes* ultimately rejected the Service's expert's value while mostly accepting the petitioner's value. Importantly, the Tax Court did not criticize or reject the use of the subdivision method. Instead, it engaged in a detailed analysis of each expert's assumptions and estimates associated with development of the hypothetical subdivision. The Tax Court's detailed analysis portrays the willingness of the court to delve into the major issues of valuation without simply accepting one side or the other or merely "splitting the difference."

The Tax Court's detailed analysis in *Kiva Dunes* seems to have started a trend in how the court approaches the issue of valuation in land conservation easement cases. Valuation, as opposed to hyper-technical issues,[23] has become center stage in conservation easement cases. This trend continued in the Tax Court's recent opinions in *Hughes* and *Trout Ranch*. Both cases involved donations of land conservation easements in Gunnison County, Colorado and the sole issue for the Tax Court was valuation. Even more so in *Trout Ranch* than in *Hughes*, the Tax Court engaged in a methodical and logical analysis of each major issue considered by the experts concerning valuation. Such analysis was similar to the Tax Court's approach in *Kiva Dunes*. Furthermore, all expert appraisers in *Trout Ranch* employed the subdivision method explicitly blessed by the Tax Court.

## *Hughes*

Nick Hughes purchased two large parcels of property in Gunnison County, Colorado known as Bull Mountain and Sylvester on 10/6/99 and 9/18/00, respectively. Hughes paid $1,535,000 for the Bull Mountain parcel and $671,350 for the Sylvester parcel. Both parcels lie southwest of the intersection of two public roads servicing the area. The 1,950-acre Bull Mountain parcel consisted of "rolling, brush-covered hills with two permanent streams," and abutted a national forest to the west with views of the Ragged Mountains to the north and east. To reach state highways, Hughes had to

[15] See Reg. 1.170A-14(h)(3)(i), (ii).

[16] Hughes, TCM 2009-94.

[17] Schwab, TCM 1994-232, 10.

[18] See Kiva Dunes Conservation, TCM 2009-145 at 4.

[19] See Reg. 1.170A-13(c)(3)(ii)(J); Trout Ranch, LLC, TCM 2010-283, at 8; see Schwab, *supra* note 17.

[20] See Estate of McCormick, TCM 1995-371.

[21] Hughes, *supra* note 16 at 7 n.15.

[22] See Schwab, *supra* note 17; see generally Whitehouse Hotel Ltd. Partnership, 131 TC 112 (2008).

[23] See generally Lord, TCM 2010-196 (disallowance of deduction for qualified conservation contribution upheld because of missing "significant" information—e.g., date of appraisal, appraised fair market value of the property, and easement contribution date—which prevented appraisal from being a "qualified appraisal"); see, e.g., Whitehouse Hotel Ltd. Partnership, *supra* note 22 (IRS expert's alleged nonconformance with Uniform Standards of Professional Appraisal Practice (USPAP) did not preclude finding of reliability).

utilize two access easements acquired by previous owners. The 463.35-acre Sylvester parcel was "an irregular, long, brush-covered ridge" that also had views of the Ragged Mountains to the north and east. The parcel did not have direct access to state highways, and its access easements to such highways mostly overlapped those of Bull Mountain. Both properties had historically been used for cattle ranching and recreational purposes.

On 12/28/00, Hughes granted a conservation easement to both parcels to the Valley Land Conservancy.[24] As a result, Hughes was prohibited in perpetuity from "subdividing the 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."

Hughes engaged Pamela Sant of Appraisal Associates of Colorado, Inc. to appraise the property for purposes of taking a charitable contribution deduction on his 2000 federal income tax return. She determined that the combined value of the two parcels was $4,100,000 before and $1,000,000 after Hughes granted the easement. Therefore, Hughes took a $3,100,000 charitable deduction on his 2000 individual tax return. On 2/7/06, the Commissioner determined a deficiency disallowing $1,107,625 of the charitable contribution deduction and asserting a $437,153 income tax deficiency. The parties stipulated that the contribution was a qualified conservation contribution and that Hughes was entitled to a charitable contribution deduction. The sole issue before Judge Wherry's Tax Court was valuation.

**The *Hughes* court's approach to valuation.** Citing the lack of comparable easement sales, the court explained that the "so-called before-and-after approach" is often used to derive the fair market value of conservation easements. With this foundation, the court discussed and analyzed the taxpayer's expert's appraisal[25] and the IRS expert's appraisal, including the qualifications of each appraiser.

Both experts employed the comparable sales approach, which is the most commonly used before and after valuation approach when comparable properties exist. In valuing the Bull Mountain parcel, the taxpayer's expert also employed the subdivision method. However, the court explained that because the expert "stated that he had 'a greater degree of confidence in the direct comparison technique,'"[26] he relied primarily on the comparable sales approach. Furthermore, the court gave no consideration to the expert's subdivision approach because it ultimately found that the highest and best use of Bull Mountain before the grant of the easement was as agricultural and recreational property.

The court concluded that there were "three major issues that divide[d] the experts" with respect to valuing the Bull Mountain parcel.[27] First, relating to the highest and best use of the property before the grant of the easement, the experts did not agree as to the demand for residential property. Second, they did not agree that Bull Mountain's access was improved as a result of Hughes purchasing the Sylvester parcel. Third, relating to before value, the experts did not agree that Hughes purchased Bull Mountain at a discount. Each of these issues is analyzed below along with the court's ultimate disposition of the case.

**Bull Mountain (before value).** Most of the court's analysis concerned the three major issues described above.

*Demand for residential property and highest and best use.* The taxpayer's expert concluded that the highest and best use of the Bull Mountain parcel was as a residential subdivision containing 39 parcels of 35 acres or more. Citing local realtors to conclude that demand for residential property in the area was high, he projected that all of the lots could be sold within five years. As the court pointed out, however, the taxpayer's expert acknowledged that there had not been any significant amount of development in the part of Gunnison County that included Bull Mountain. Agreeing with the IRS expert, the court found that there was little or no demand for residential property in the area at the time the conservation easement was granted. Therefore, the court found that the highest and best use of Bull Mountain before the grant of the easement was continued agricultural and recreational use.

*Improvement of access to Bull Mountain upon purchase of Sylvester.* The taxpayer's expert concluded that as a result of Hughes purchasing the Sylvester parcel, access to Bull Mountain was im-

[24] The court did not discuss in depth whether the Valley Land Conservancy was a qualified organization. In footnote 1 of the opinion, however, the court explained that a qualified conservation contribution must be made to a qualified organization. Because the parties agreed that Hughes made a qualified conservation contribution, it follows that Valley Land Conservancy was a qualified donee.

[25] The taxpayer used a different appraiser to prepare expert appraisals for trial purposes.

[26] Hughes, *supra* note 16 at 7 n.15.

[27] *Id.* at 9.

proved, and Bull Mountain more than doubled in value. The expert assumed that the access easements over both parcels could somehow be combined to provide superior access to both parcels. The court was quick to correct the taxpayer's expert, who was not an attorney, explaining that both easements were appurtenant and could only be used to benefit their respective dominant estates despite the fact that Hughes now owned both parcels and access easements. Therefore, the taxpayer's expert's large upward adjustment to value was found to be unwarranted.

The court further concluded that the taxpayer's expert was wrong in valuing both parcels together as one contiguous parcel. The expert apparently believed that combining the access easements over both parcels rendered the parcels contiguous. However, the parties stipulated that the parcels were separate and distinct, and even the conservation easement documents referred to Bull Mountain and Sylvester as "two legally distinct and separately deeded properties."[28]

*Evidence of a discounted sales price.* The taxpayer's expert suggested that the sales price of Bull Mountain was at a discount due to the financial distress of its seller. The expert relied on the prolonged listing of the property at a higher price before Hughes purchased the property.

The court found no evidence of a discounted sales price for Bull Mountain. The expert admitted that he never spoke with the seller's managing partner regarding financial distress of the seller. The seller's managing partner also testified that the seller was not under any financial distress and had actually rejected three prior offers for parts of Bull Mountain. The seller's real estate agent testified that although the seller's motivation for selling Bull Mountain may have increased after the managing partner moved out of the area, he had no reason to believe that Hughes paid anything but fair market value for the property.

*Conclusion as to before value of Bull Mountain.* Having rejected most of the taxpayer's expert's assumptions, the court found that the fair market value of Bull Mountain before Hughes granted the conservation easement was $1,710,000. This figure was derived from the actual purchase price of Bull Mountain plus an 11% upward adjustment for appreciation from the time Hughes purchased the property to the time Hughes granted the conservation easement. The court found "that an 11-percent positive adjustment [was] generous but reasonable."[29]

**Sylvester (before value).** The court did not go into great detail concerning the value of the Sylvester parcel other than finding that the property did not appreciate in value from the time Hughes bought it to the time Hughes granted the conservation easement. The court again found the highest and best use of the Sylvester property before the grant of the easement to be continued agricultural and recreational use. Given that the property did not appreciate in value and its highest and best use did not differ from its historic use, the court concluded that the fair market value of the Sylvester property was the price that Hughes paid for it, or $671,350.

**Value of easements.** The court determined that the highest and best use of both properties did not change after the conservation easement was granted. The highest and best uses of the properties were as agricultural and recreational use both before and after the easements were granted. The taxpayer's expert concluded that as a result of the easement, the combined diminution in value of Bull Mountain and Sylvester was 70%. On the other hand, the IRS expert concluded that the diminution in value was between zero and 10%.

The court rejected both expert opinions, citing serious flaws in their valuations. The taxpayer's expert had concluded an improper highest and best use of the property before the conservation easement was granted. Therefore, his conclusion as to the value of the easement was disproportionately large. The IRS expert concluded that the grant of the easement had little or no effect on the value of the properties. The court rejected the notion that a prospective purchaser of property would ignore open-space easement restrictions in determining price. In an important finding, the court found that the easement could not reasonably have *no* value.

Though rejecting both experts' opinions as to the value of the conservation easements, the court did not determine a fair market value of its own. Instead, it determined that the correct diminution in value lay somewhere between the expert's opinions of 10% and 70%. However, "because of [the Court's] conclusions with respect to the fair market values of the Bull Mountain and Sylvester parcels, no diminution in that range will lead to a larger deduction than [the Commissioner] has already allowed."[30] Therefore, the entire tax deficiency was upheld.

[28] *Id.* at 11.
[29] *Id.* at 12.

**The *Hughes* court's rejection of the 'matrix' approach.** Other than the court's methodical dissection of each expert's appraisal, its rejection of the government's "matrix" approach to deriving an after value of property subject to a conservation easement is a key determination to take away from *Hughes.*

The matrix is essentially a compilation of easement-encumbered properties in the state of Colorado that took five IRS employees over one year to assemble. It has been described as "largely a body of factual information with assumptions, analysis, and conclusions reached by the [IRS] concerning the effect of a conservation easement on value."[31] The matrix was used by the IRS to determine the value of an easement-encumbered property by comparing other encumbered properties with similar characteristics as the subject property. It is therefore akin to a statistical approach to determining an after value of easement-encumbered property.

In *Hughes*, the IRS expert actually included the matrix in his report that "incorporated information from 35 easement-encumbered properties and illustrated generally that the amount of diminution caused by an easement changes a property's highest and best use."[32] In other words, the IRS expert asserted that the after value of the subject property was directly determinable by referencing other properties that did not experience a change in highest and best use.

The court rejected the use of the matrix to determine an after value of the two properties. It concluded that because the matrix "included general information that did not have a specific connection to the Bull Mountain and Sylvester parcels, we afforded it little weight in our analysis."[33] The court therefore confirmed that valuation of property in conservation easement cases is to be performed on a case-by-case basis using specific factual data related to the subject property instead of a generalized "one size fits all" approach or generalized statistical data. This detailed and specific approach to valuation taken by the Tax Court is evidenced by the court's decision in *Trout Ranch.*

## *Trout Ranch*

Trout Ranch, LLC (the "partnership") was formed in October 2002 as a Colorado limited liability company and elected to be taxed as a partnership for federal tax purposes. As a result of purchasing property and entering into land trades with neighboring property owners, the partnership owned 457 acres of land in Gunnison County, Colorado. The property abuts several thousand acres to the east managed by the U.S. Bureau of Land Management. Rural residential tracts between two and ten acres occupy the west and north boundaries of the property, and large residential tracts of 35 acres or more are to the south of the property. The partnership planned to develop a residential subdivision called Gunnison Riverbanks Ranch on 453 acres of the property.[34] Gunnison Riverbanks Ranch was planned to include a minimum of 20 lots and exclusive amenities, including a clubhouse, a guest house, fishing, a riding arena and stable, ponds, a boathouse, duck blinds, and an archery range. The court referred to the ranch as a "shared ranch" as opposed to residential subdivisions without such amenities.[35]

Gunnison County has no zoning, and the county Land Use Resolution governs land development and subdivision. At the time the partnership planned to develop Gunnison Riverbanks Ranch, there were two pertinent development regulations: the Large Parcel Incentive Program (LPIP) and the Major Impact Project Process. These two regulations essentially allow a developer to subdivide land into more lots, based on the percentage of land the developer preserves for open space or other conservation purposes. In April 2003, the partnership filed a Land Use Change Permit Application under LPIP proposing to preserve 85% of Gunnison Riverbanks Ranch. Pursuant to the proposal, the partnership could create 21 residential lots and a lot for a clubhouse. The land use commission visited the property in May 2003 and held a public hearing concerning the proposed land use change in July 2003.

In December 2003, the partnership donated a conservation easement to the Crested Butte Land Trust encumbering 384 acres of Gunnison Riverbanks Ranch. The partnership then entered into a Land Conservation Covenant with Gunnison County encumbering an additional

[30] *Id.* at 16.

[31] See RCL Properties, Inc., 102 AFTR2d 2008-7302 (DC Col.) (quoting plaintiff's reply to government's response to motion to compel).

[32] Hughes, *supra* note 16 at 14.

[33] *Id.* at 15 n.30.

[34] The partnership granted an easement to the Colorado Department of Transportation (CDOT) covering one acre of the property. Subsequently, the CDOT granted the partnership a State Highway Access Permit over four acres of the property. Therefore, out of the 457 acres owned by the partnership, 453 acres were planned for residential development.

[35] Trout Ranch, LLC, *supra* note 19 at 2.

four acres. In total, the conservation easement and the Land Conservation Covenant covered just over 85% of Gunnison Riverbanks Ranch. The partnership reserved the right to subdivide the remaining unencumbered 66 acres into 22 lots, including 21 residential lots and a lot for a clubhouse. The residential lots consisted of three acres each and included land that the conservation easement encumbered. The conservation easement allowed the construction of three open horse shelters, three duck blinds, two corrals, three ponds with docks, a tent platform, and a skeet trap wobble deck. In February 2004, the partnership submitted its final plan for development of Gunnison Riverbanks Ranch, and the land use commission approved the plan in April 2004.

The partnership claimed a charitable contribution deduction of $2,179,849 for the contribution of the conservation easement on its 2003 return. In 2008, the IRS issued a notice to the partnership disallowing $1,694,849 of the claimed deduction, only allowing $485,000. Before trial, the Tax Court allowed the IRS to amend its answer to disallow the entire $2,179,849 claimed deduction.

The parties stipulated to several facts, and the IRS conceded that the donation of the conservation easement was a qualified conservation contribution. The only issue before the Tax Court, therefore, was the value of the conservation easement, which the court ultimately concluded was $560,000.

**The *Trout Ranch* court's approach to valuation.** Judge James S. Halpern presided over the case and wrote the opinion for the Tax Court. In discussing and analyzing the experts' appraisals, Judge Halpern refrained from merely accepting one expert's opinion, averaging the experts' derived values of the easement, or agreeing with the IRS that there was no value. Instead, Judge Halpern methodically and logically analyzed each major issue considered by all the experts and affecting the value of the easement.

The ultimate value of the easement was derived from three appraisals submitted for the court's consideration. The IRS presented two appraisals prepared by two of its experts ("IRS Expert 1" and "IRS Expert 2," respectively) and the taxpayer presented one appraisal prepared by its expert. After addressing the backgrounds and qualifications of the experts, the court analyzed the issues presented in the appraisals in the same order as they were presented by the experts. Below is a summary of some of the major issues affecting valuation and the court's resulting conclusions.

**The proper valuation methodology.** All three experts used the subdivision approach.[36] The court agreed that this approach was a proper valuation method and "in accordance with the regulations" but did not find any of the experts completely convincing. The court instead chose to conduct its own discounted cash flow analysis to derive the proper value of the easement. In so concluding, the court discussed the common components and structure of the experts' discounted cash flow analyses.

**Highest and best use (after value).** IRS Expert 1 and Trout Ranch's expert found that the highest and best use of the property after the imposition of the easement was as a shared ranch identical to Gunnison Riverbanks Ranch. IRS Expert 2 differed slightly in opinion and found the highest and best use to be a 22-lot residential subdivision. The IRS experts' after values were both double that of Trout Ranch's expert.

The court discussed each expert's choice of assumptions in constructing their respective discounted cash flow analyses and deriving a present value of the proposed development. If provided by the expert, the court explained each expert's reasoning for choosing each variable. If no explanation was provided, the court inquired as to why. It was evident that explaining assignments of value to various components was crucial to persuading the court. Agreeing with Trout Ranch's expert and IRS Expert 1 as to the highest and best use of the property, the court explained that because IRS Expert 2 "failed to explain exactly why he placed such a low value on the clubhouse, we find that a 21-lot shared ranch was the highest and best use after imposition of the conservation easement."[37]

**Comparable properties and data analysis.** Because the court agreed that the property's highest and best use was a 21-lot shared ranch, it adopted 21 lots as the optimal number of lots to be developed. Therefore, comparable properties should be shared ranches or very similar to a shared ranch. The court analyzed a group of five ranches proposed as comparable properties by the experts in varying degrees. Gunnison Riverbanks Ranch, the actual development on the subject property, was

[36] Trout Ranch's expert submitted a sales comparison analysis in a supplemental report. The court found the approach to be of no help because "none of the other four conservation easements is comparable to the Trout Ranch CE." Trout Ranch, LLC, *supra* note 19 at 5.

[37] Trout Ranch, LLC, *supra* note 19 at 10.

one of these comparables. The court rejected comparison to three of the five ranches, reasoning that two of the ranches "are complete unknowns" and the other was "completely different" from Gunnison Riverbanks Ranch in lot size, location, and amenities.

The court settled on two ranches as appropriate sources of sales data, including Gunnison Riverbanks Ranch itself. It is interesting that the court found sales at Gunnison Riverbanks Ranch as appropriate data for comparison because Gunnison Riverbanks Ranch was developed on the subject property. The property is to be valued at the time the conservation easement is granted, and subsequent events are not usually deemed appropriate for consideration. Trout Ranch opposed the use of post-valuation data, but the court explained: "The rule that has developed, and which we accept, is that subsequent events are not considered in fixing fair market value, except to the extent that they were reasonably foreseeable at the date of valuation."[38] In keeping with the rule, the court accepted as comparables certain sales at Gunnison Riverbanks Ranch made within one year of the contribution date.

Lot prices assumed by each expert varied widely as well as the sources used to estimate lot prices. The experts used a mix of sales data from surrounding developments to estimate lot prices for the hypothetical subdivision. As indicated above, the court narrowed the comparable sales to those at two shared ranches.

Trout Ranch's expert assumed that the lots in the hypothetical subdivision would sell for considerably less than the estimates of the IRS experts. He abandoned his position in his rebuttal reports, however, stating that the IRS experts' data was more reasonable. The court assumed that Trout Ranch's expert changed his opinion because he assigned the same selling price to the lots in his before value analysis. Trout Ranch's expert also agreed with all other assumptions concerning lot prices made by the IRS experts. The court rejected Trout Ranch's expert's lot price, not only because the expert abandoned his prior position and conceded the other experts' assumptions, but also because the court found his assumption that lot prices would remain the same regardless of the number of lots in a hypothetical subdivision as "implausible."

Both IRS Experts used high-priced lot sales from properties found by the court not to be comparable to Gunnison Riverbanks Ranch. The court did not find much support for the experts' choice of sales data, just as it did not find Trout Ranch's assumptions reasonable. Therefore, analyzing the data for itself, the court derived its own appropriate sales price for the lots. These lot prices were closer to the Service's lot prices, which were much higher than those of Trout Ranch's expert. Even though it could be a coincidence and the court appeared to heavily analyze the data, the lot price decided upon was an average of the three experts' price per lot.

After establishing a lot price, an appropriate "absorption rate" must be established before future income can be discounted to present value. The "absorption rate" is the rate at which the lots in the hypothetical subdivision are estimated to sell over a number of years.[39] For example, more lots may sell in the early years of the development as compared to later years, or vice versa, depending on the area's residential lot inventory and demand.

Again, the experts "broadly disagreed" on the appropriate absorption rate. Trout Ranch's expert and IRS Expert 1 forecasted a more rapid absorption rate, while IRS Expert 2 adopted a "sluggish" rate. Although agreeing with the analysis of Trout Ranch's expert, the court found his absorption rate "slightly aggressive" as suggested by IRS Expert 2. However, Trout Ranch's expert and IRS Expert 1 both justified a rapid absorption rate, so the court adopted the rate used by IRS Expert 1. Here again, thorough justification for choosing an absorption rate was critical. The court completely disregarded the rate forecast by IRS Expert 2 because he "failed to justify his sluggish absorption rate."

After taking into account several project management expenses, selling expenses, and other expenses, the court needed to assign an appropriate discount rate to the net sales proceeds of the lots. Using this rate, the hypothetical future sales proceeds are discounted to present value to reach an after value for the property. Finding some support for the discount rate used by both Trout Ranch's expert and IRS Expert 2, the court adopted that discount rate. The court found "their evidence and their reasons convincing," while IRS Expert 1 "failed to offer much support" for his discount rate.

After embarking on the thorough analysis above, the court found that the after value of the property as encumbered by the conserva-

[38] Trout Ranch, LLC, *supra* note 19 at 12 (citations omitted).

[39] See Kiva Dunes Conservation, *supra* note 18 at 10; Hughes, *supra* note 16 at 6.

tion easement was $3.89 million. This figure is far from a simple average of the experts' after values of approximately $4.5 million and exemplifies the Tax Court's willingness to analyze and scrutinize conservation easement valuations objectively and independently

**Before value.** The court's analysis of the before value of the property was very similar to its after value analysis. The number of lots that could possibly be developed (the "yield") was the only major difference (40 lots before as compared to 21 lots after). Trout Ranch's expert and IRS Expert 2 both assumed that a 40-lot subdivision was the highest and best use of the property before being encumbered by the easement. The court agreed with the experts, but adopted the subdivision "configuration" assumed by IRS Expert 2. It found Trout Ranch's expert's configuration unreasonable with respect to lot sizes and in light of Gunnison County land use regulations. To divide the land into 40 lots, as proposed by Trout Ranch's expert, a developer would have had to apply under special rules, which only required the developer to preserve 50% of the land. Given access to 50% of the land, the court found the decision of Trout Ranch's expert to concentrate all the lots on the river (with resulting higher values) to be unreasonable. Trout Ranch's expert "failed to explain why a developer would have restricted itself to between 15 to 20 percent of the land when as much as 50 percent of the land was available."[40]

While briefer than its after value analysis, the court's before value analysis was no less thorough. The ultimate before value found was $4.45 million, which was slightly more than the average of Trout Ranch's expert's before value and the before value reached by IRS Expert 2. Note that the court did not discuss the before value derived by IRS Expert 1 because such value was less than his after value, making the conservation easement value negative. IRS Expert 1 also did not employ the subdivision method to derive a before value. These considerations apparently did not impress the court.

Subtracting the after value of the property from the before value of the property, the court concluded that the conservation easement was worth $560,000. While this figure is much closer to the Service's first determination of value, it is the court's analysis of the data that is important.

## Conclusion

Beyond the Tax Court's obvious blessing of the subdivision approach, *Trout Ranch* exemplifies the Tax Court's current approach to analyzing land conservation easement valuation. Like *Kiva Dunes*, *Trout Ranch* provides valuable guidance for potential donors, tax advisors, appraisers, or recipients of such easements.

*Trout Ranch* and *Hughes*, together with *Kiva Dunes*, point to the future of valuation in land conservation easement cases—a fair, analytical, and objective approach to valuation. Older cases involved IRS challenges based on the technical requirements of the regulations. Even though valuation was a large part of the *Kiva Dunes* opinion, the IRS initially challenged technical regulatory requirements (and conceded conservation purpose after trial). In both *Trout Ranch* and *Hughes*, which were decided close in time to *Kiva Dunes*, the IRS stipulated that the contribution was a qualified conservation contribution before trial. These cases show that the serious controversy may be over valuation of the conservation easements and not hyper-technical requirements of the regulations. Referring back to *Kiva Dunes*, however, it is very important that these technical requirements are followed. Otherwise, the fight *can* be over a hyper-technical requirement that should have been resolved through careful implementation of the easement at the front end.[41] ■

[40] Trout Ranch, LLC , *supra* note 19 at 17.

[41] A detailed discussion of such technical requirements can be found in Wooldridge, Levitt and Rhodes, "Kiva Dunes—Making and Substantiating the Value of Conservation Easements,: 111 J. Tax'n 300 (Nov. 2009); Wooldridge, Levitt and Rhodes, "Simmons—Substantial Compliance Revisited, Tax Notes, 1/25/10, p. 474.