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CONSERVATION EASEMENTS, VALUATION, AND SUBSTANTIATION

More and more government policies and private practices favor "going green." Paradoxically, conservation easements, which seem axiomatically green, appear to be under fire.

A conservation easement is a voluntary restriction placed on the use of land for a conservation purpose. Valid conservation purposes can include the protection of open space, timberland, farm land, scenic views, wetlands, or other significant natural resource values.

The IRS has made a concerted effort to reduce or disallow charitable deductions for transfers in connection with conservation easements.[1] The IRS has met with some success in its efforts, and that creates uneasiness.[2] Just how much conservation easements may be scrutinized in the future remains open to debate.[3]

For the time being, these environmentally friendly and tax-advantaged devices are still available. Indeed, they hopefully will remain a part of the law for many years. It is clear, however, that the IRS likes to disallow conservation easements, and to scrutinize the various technical rules that taxpayers must carefully navigate.

Moreover, valuation disputes are commonplace.[4] Indeed, this is an area in which valuation methodology and expertise is critical. A recent Tax Court case, *Kiva Dunes Conservation, LLC*,[5] underscores just how important it can be.

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Myriad rules

In general, charitable donations of "partial" interests of property do not qualify for any tax deduction, no matter how charitable the recipient.[6] Easements are obviously partial interests in real property. Thus, without an exception, the donation of an easement would not qualify for a charitable contribution deduction. Fortunately, there is an exception for "qualified conservation contributions."[7] Although there are many requirements, in essence, a donor can obtain the deduction by putting a perpetual conservation easement on the property and donating that easement to a charitable organization, permanently restricting the use and value of the property. In broad strokes, the donor has given part of his or her property to charity.

Nevertheless, this partial interest may not cost the donor much in real dollars. Indeed, it may not even alter the basic use to which the donor intends to put the property. For all these reasons, conservation easements are truly remarkable.

Significantly, conservation easements generally do not need to provide the public with a right of access or use of the land subject to the easement. This is so unless the purpose of the easement is a public benefit that requires public access (i.e., preservation of the land for outdoor recreation or education of the general public). The easement need not even restrict the sale of the property.

Easement refresher.

Although *Kiva Dunes* is all about valuation—with a surprising lack of disagreement about virtually

all of the technical conservation easement rules—not everyone is so lucky. In fact, there are plenty of issues that can foment disagreement. To begin with, the donee must be a "qualified organization," having a commitment to protect the conservation purposes of the donation.

Moreover, the donee organization must have the resources to enforce the restrictions.[8] Qualified organizations include local, state, or federal governmental agencies, and public charities defined in Section 501(c)(3). A public charity's commitment to protect the conservation purposes of the donation can generally be found in its articles of incorporation or by-laws.

There are four broad categories of conservation purposes that can qualify for a deduction. They are:

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 certain open space (including farmland and forest land).
4. The preservation of an historically important land area or a certified historic structure.[9]

If the conservation purpose of the easement is outdoor recreation or education of the general public, the recreation or education must be for the "substantial and regular use" of the general public.[10] Such an easement must therefore provide access to the real property for the general public.

The preservation of an historic land area or structure is another valid conservation purpose. Historic land areas are defined as any that meet the National Register Criteria for Evaluation,[11] any land area within a registered historic district, and any land area adjacent to a property listed in the National Register of Historic Places where the physical or environmental features of the land area contribute to the historic or cultural integrity of the property.[12] A historic structure is defined as any building, structure, or land area listed in the National Register, or any building located in a registered historic district, and certified by the Secretary of the Interior as being of historic significance to the district.[13]

Generally, the easement (as well as the restrictions it imposes) is donated to a charitable organization or government agency. The easement's terms are ordinarily negotiated between the landowner and the charitable conservation organization or government agency. The donor who grants the easement can claim a tax deduction for the value of the easement (typically, the value of the property *before* contribution of the easement, minus the value of the property *after* contribution of the easement).[14]

This before-and-after valuation methodology is terribly important, as shown below. The deduction is subject to annual limitations, but unused deductions can be carried over to future years.[15]

Conservation easements appear to be under fire.

Conserving golf

The Tax Court is overwhelmingly favored for federal tax disputes. The simple reason is that taxpayers can file a petition and dispute an IRS deficiency notice without paying any portion of the taxes first. To sue in U.S. District Court or the Claims Court, the tax must first be paid.

The Tax Court's most recent foray into conservation easements came in *Kiva Dunes.* Kiva Dunes was a partnership operating a golf course in Alabama. Its tax matters partner was one E. A. Drummond. In 1992, he purchased real estate in Alabama from the Resolution Trust Corporation for slightly over $1 million. In 1993, Drummond formed D&E Investments LLC, an Alabama limited liability company. In early 1994, Drummond conveyed his interest in the real estate to D&E. During 1994, D&E started developing a resort community consisting of a gated residential subdivision called Kiva Dunes. The development included a golf course, swimming pools, tennis courts, and beach access. The Kiva Dunes Golf Course opened to the public in 1995 and residential lots began selling thereafter.

In 2002, Drummond formed Kiva Dunes LLC, an Alabama limited liability company. The next day, D&E executed a warranty deed

1 See Notice 2004-41, 2004-1 CB 31; Ann. 2005-80, 2005-2 CB 967.
2 See Turner, 126 TC 299 (2006).
3 See Glass, 471 F.3d 698, 98 AFTR2d 2006-8309 (CA-6, 2006).
4 See e.g., Whitehouse Hotel Ltd. Partnership et al., 131 TC No. 10 (2008).
5 TCM 2009-145.
6 Section 170(f)(3)(A).
7 Section 170(f)(3)(B)(iii).
8 Reg. 1.170A-14(c)(1).
9 Reg. 1.170A-14(c)(2).
10 Reg. 1.170A-14(d)(2)(i).
11 36 C.F.R. section 60.4 (2004).
12 Regs. 1.170A-14(d)(5)(ii)(A), (C).
13 Sections 170(h)(4)(B), (C).
14 Section 170(a)(1).
15 See Section 170(b)(1).

conveying the Kiva Dunes Golf Course to Kiva Dunes LLC. A few days after that, Kiva Dunes placed a perpetual conservation easement on the golf course, donating the easement to the North American Land Trust (NALT), a charity.

On its partnership tax return for 2002, Kiva Dunes claimed a charitable contribution deduction of $30,588,235 for the easement. This valuation was supported by an appraisal prepared for Kiva Dunes by Claud Clark. The IRS determined that Kiva Dunes was not entitled to the deduction and the matter went to Tax Court. There, Clark emerged as the star of this case, a kind of Michael Jackson of the appraisal world.

Valuation methodology and expertise are critical.

True value

By the time of the trial, the IRS had conceded that the easement qualified as a qualified conservation contribution. Thus, many of the nitty-gritty rules of the statute discussed above simply were not at issue. It was clear that a deduction was appropriate. The critical question was just how big it should be.

The amount of a charitable contribution is generally the fair market value of the contributed property at the time of the contribution.[16] Axiomatically, fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having a reasonable knowledge of relevant facts.[17] Notably, the Tax Court takes into account not only the current use of the property, but also its highest and best use.[18]

A property's highest and best use is the highest and most profitable use for which it is adaptable and needed, or likely to be needed, in the reasonably near future.[19] Can one readily refer to comparable sales of easements? Usually the answer is no. In the atypical case where there is a substantial record of sales of easements, the fair market value of a donated easement will be based on the sales prices of those comparable easements.[20]

In the case of Kiva Dunes, though, there was no established market for similar conservation easements. In fact, there was no record of sales of *any* such easements. In such a case, the regulations provide specific guidance about how one should determine the easement's fair market value:

> 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.[21]

There is considerable history of this before-and-after valuation methodology for conservation easements. Besides, both the IRS and the taxpayer in *Kiva Dunes* agreed that this was the appropriate valuation method. Significantly, though, one must take into account not only the property encumbered by the easement, but other afflicted parcels as well.

After all, it is not uncommon for *other* property to be affected by the grant of an easement. Accordingly, the regulations provide that any enhancement in the value of a donor's *other* property resulting from the easement contribution, or of property owned by certain related persons, will reduce the value of the contribution deduction.[22]

So far, a reading of this much of the *Kiva Dunes* case might suggest that everyone agreed on everything, not something that is typical in a tax case. Significantly, both the IRS and the taxpayer agreed that this was a qualified conservation contribution. Given the complexity of the qualified conservation easement rules, in many cases the taxpayer and the IRS fight tooth and nail over such matters. Moreover, both the IRS and the taxpayer in *Kiva Dunes* agreed that the before-and-after valuation method was the appropriate one.

But this was *still* not a recipe for a settlement. In fact, there was an outsized disagreement over valuation. Valuation, said the Tax Court with the gift of understatement, "is not a precise science."[23] As the Tax Court noted, the fair market value of property on a given date is a question of fact to be resolved on the basis of the entire record.[24] The government and the taxpayer

[16] See Reg. 1.170A-1(a).
[17] See Reg. 1.170A-1(c)(2).
[18] See Reg. 1.170A-14(h)(3)(i). See also Stanley Works and Subsidiaries, 87 TC 389 (1986).
[19] See Olson, 292 US 246 (1934).
[20] See Reg. 1.170A-14(h)(3)(i).
[21] *Id.*
[22] *Id.*
[23] The Tax Court has been uttering this pabulum since at least Crane & Co., TCM 1976-371.
[24] See Kaplan, 43 TC 663 (1965).
[25] See Federal Rules of Evidence 702.
[26] See National Grocery Co., 304 US 282, 20 AFTR 1269 (1938).
[27] See Silverman, 538 F.2d 927, 38 AFTR2d 76-6258 (CA-2, 1976).

each had an expert. The expert testimony (as is so frequently the case in valuation disputes) turned out to be pivotal.

Expert battle

The courts can hear expert testimony and admit it if it is helpful in assisting the trier of fact in understanding the evidence or in determining a fact in issue.[25] Notably, the court is not bound by the opinion of any expert witness. It may accept or reject expert testimony in the exercise of its sound judgment.[26] In fact, despite expert testimony, the court may reach a decision as to the value of property based on its own examination of the evidence in the record.[27] The credentials, credibility, and methodology of expert witnesses often is critical.

Kiva Dunes' expert, Claud Clark, was a professional real estate appraiser with decades of experience. Most of that experience was in Baldwin County, where Kiva Dunes is located. In addition to living and owning property in the area, the Tax Court pointed out that Clark performs more appraisals in Baldwin County than any other appraiser.

The government's appraiser and expert was Philip Paulk. He was no Michael Jackson—nor for that matter was he even a Claud Clark. Paulk was primarily familiar with other vicinities. He had spent much of his appraisal career in Atlanta. He had only recently moved to Birmingham, Alabama, and that was 250 miles from Kiva Dunes.

The court noted that Paulk had no particular experience with Baldwin County real estate. In fact, he had only been to Baldwin County twice, both times in connection with his appraisal of the Kiva Dunes easement. This may sound like nitpicking, but the Tax Court's review of this sort of detail was thorough.

Both experts determined before-and-after values for the golf course, and considered the issue of enhancement of other property owned by Kiva Dunes or by related parties. Both sets of conclusions as to fair market value were reached by calculating an estimate of the "after value" and of any enhancement to other pertinent properties. Then, both subtracted this total from the "before value."

Given this process, one might assume the two appraisers came out in the same valuation ballpark (or got onto the same green), but that was not so. Based on different assumptions, Clark's value for the easement was $31,938,985, while Paulk's was $10,018,000. Faced with such disparate appraisals, the Tax Court had to painstakingly go through each one, and each set of assumptions supporting it.

Lot number and price

One of the factual questions was how many lots could be developed from the parcel in question. Clark determined that 370 lots could be developed. The planning and zoning director of the Baldwin County Zoning Board agreed.

Paulk, on the other hand, said zoning regulations would limit the development to 300 lots. The Tax Court found that Paulk's conclusion was based on an erroneous interpretation of the local zoning regulation. In fact, the Tax Court even noted that Paulk had admitted that Clark's 370-lot subdivision was viable, thus making Clark's appraisal more credible.

There also was significant variation in the projected selling prices. Clark concluded that the initial selling price for the lots would average $170,000 each. He reached this conclusion by considering assorted variables, including lot quality, market demand, and comparable sales. Notably, his conceptual plan for the subdivision included the enlargement of several lakes, as well as the creation of pool and recreational areas. The idea was that approximately 70% of the proposed lots would front lakes. This was important, because Clark and Paulk both testified that lake frontage would dramatically (and positively) impact lot value. The taxpayer also offered testimony about the amenities available at Kiva Dunes.

Clark employed statistical data regarding the market for lots for single family homes in Baldwin County. His appraisal reflected a dizzying array of population and valuation figures, as well as data about the local housing supply. Finally, he considered comparable sales that were as close as possible in proximity and price to Kiva Dunes. He then discounted these figures, which was appropriate because the quality and size of the comparables were inferior to those of the proposed lots.

Paulk's analysis paled beside Clark's detailed examination. Rather than the $170,000 that Clark's appraisal set for hypothetical lot prices, Paulk determined that the average lot would sell for $85,000. To get to this figure, he used only two interior lots as comparables. The Tax Court was quite critical. It said Paulk had essentially assumed that two of the *least* desirable lots would be comparable to the hypothetical sales.

The real gravitas of a good appraisal will turn on the skills and credibility of the individuals involved.

To the Tax Court, this looked like cherry-picking, and selecting only the rotten cherries. These two lots would not front any lake. They would have no views, and would be far removed from the amenities of the subdivision. The Tax Court therefore concluded that Paulk's assumptions were not realistic. Moreover, the Tax Court called out Paulk's testimony as inconsistent with his appraisal in several respects. Paulk's report stressed that most of the lots in the proposed development would have water views. He denied this in his testimony. Again, the Tax Court showed displeasure.

Absorption rate

The absorption rate at which lots could be sold was another critical area of disagreement between the experts. Clark assumed that a 370-lot subdivision would sell out in ten years, averaging 37 lots sold per year. To arrive at this rate, he compared absorption data from local developers. He included Kiva Dunes as well as Martinique, a neighboring development. Paulk, on the other hand, assumed the sales would take 15 years, averaging 20 lots per year. He apparently relied exclusively on the absorption data from Martinique.

The Tax Court agreed that Martinique was clearly relevant, but found Clark's evidence more compelling. Clark clearly tried to discern and describe differences between Kiva Dunes and Martinique. He even reflected comments from a former sales agent at Martinique (to which Clark's appraisal had referred). The Martinique sales report had indicated that sales of lots at Martinique would have been more rapid had they been sold as vacant lots.

The Tax Court noted that it had found Clark's assumptions as to available lots for sale, initial lot price, and annual rate of lot sales reasonable. Consequently, the court said it did not need to address the remaining assumptions made by the respective experts. Indeed, the court said that using Clark's assumptions and Paulk's cash flow computation made the respective appraisals come out fairly close together.

The Tax Court concluded that Clark's testimony was credible. It found his assumptions reasonable and amply supported by the evidence. As a result, the court assigned a "before value" to the Kiva Dunes Golf Course of $31,938,985, a figure that was close to Clark's appraised "before value."

Fair market value

Fair market value is an illusory concept. In one way or another, it has occupied the courts for hundreds of years. Usually the disputes are not so much about how one should define it as they are about exactly what something in particular is worth. Here, both experts agreed that immediately after the charitable contribution, the highest and best use of the Kiva Dunes Golf Course was its continued operation as a golf course.

The experts, however, used very different methodologies in determining that "after value." Paulk used an income approach, dividing a capitalization rate into a number that he represented was the 2002 net income of the golf course. He determined the "after value" to be $8,808,000.

In contrast, Clark concluded that the economic health of the Kiva Dunes Golf Course during 2002 was too poor to support an income capitalization approach. He therefore relied on sales of comparable properties. He analyzed and adjusted those figures to reach an "after value" of $1,050,750. There was, therefore, a whopping difference of nearly $7 million between Paulk's and Clark's "after" values!

Appraisal aficionados will doubtless want to read the full Tax Court opinion. It goes on for pages about the capitalization versus comparable sales methods. The opinion also contains enormous factual detail about the Kiva Dunes Golf Course, the sales prices of lots on comparable properties, why certain properties are or are not comparable, and so on. After a discussion spanning many pages, the Tax Court confronted the differences between the respective valuations concerning something as fundamental as highest and best use.

Most of the opinion extols Clark's virtues and thoroughness, although the court does recognize that Clark did not consider the highest and best use of his comparables "in the traditional sense." Rather than properties used for any purpose whatever, Clark selected properties for permitted recreational use. The IRS argued that this was a fatal flaw but the Tax Court thought it made sense, commenting that Clark had considered the market forces in Baldwin County to be an accurate barometer of the highest and best use of a comparable property.

In fact, the Tax Court said it was satisfied that Clark's selection of comparables was reasonable under the circumstances. The court even concluded that his adjustments to the prices of the comparables were based on sound

judgment and on a detailed knowledge of all the properties mentioned in his report.

The court spent some time thereafter analyzing improvements to the property. Improvements had to be reflected in the comparables, because Clark's comparables consisted of unimproved land. In contrast, Kiva Dunes Golf Course was already an award-winning golf course. The court thus approved an upward adjustment to the prices of the comparables for the cost of turning those unimproved tracts into a comparable golf course property. The court approved of those adjustments, and then approved of reducing them to take depreciation into account.

After adjusting Clark's "after value" to account for the improvements, the Tax Court concluded that the "after value" for the Kiva Dunes Golf Course was $2,982,981. This figure was made up of $1,070,980 for comparable value plus a $1,912,001 depreciation adjustment. Finally, Clark's report determined that the conservation easement enhanced *other* property owned by D&E (an entity related to the donor) in the amount of $300,000.

The IRS agreed, and the Tax Court therefore adjusted its final value accordingly. After a lengthy opinion, the Tax Court concluded that the fair market value of the conservation easement was $28,656,004.

Forest for the trees

It is difficult to read the *Kiva Dunes* case without reflecting on appraisals in general and on this appraisal in particular. The Tax Court has not infrequently bristled at becoming the arbitrator of disputes that are solely about factual matters in appraisals.[28] For all their asserted precision, after all, appraisals involve a number of judgment calls and a number of determinations that can only be described as subjective, at least in part. *Kiva Dunes* illustrates this point in spades.

When it comes right down to it though, the real gravitas of a good appraisal will turn on the skills and credibility of the individuals involved, and the extent to which they have done a thorough and reasoned job. Not only must the appraiser be qualified and believable, but he or she must manifest a familiarity with local terms, conditions, and properties. Real estate is an inherently local phenomenon.

This does not mean one cannot use an expert from one part of the country in another. It does mean that the appraiser selected must do his or her homework. From all that appears, Clark knew this well. Clearly, Paulk did not.

Conclusion

Valuation issues are key to virtually any charitable contribution. That means appraisals and expert testimony. Government lawyers have occasionally been known to complain that private taxpayers can afford to pay more for appraisals than can the government. That tilts the playing field, they complain, giving taxpayers an advantage. *Kiva Dunes* provides a great roadmap for the care and feeding of a stellar expert.

The mere fact that taxpayers can hire a dream team of appraisers does not mean they will choose wisely or that they will always win. Still, for the taxpayer armed with a good appraisal and, if needs be, a credible expert, charitable conservation easements are an enormously good deal.

[28] See Buffalo Tool & Die Mfg. Co., 74 TC 441, 452 (1980): "We are convinced that the valuation issue is capable of resolution by the parties themselves through an agreement which will reflect a compromise Solomon-like adjustment, thereby saving the expenditure of time, effort, and money by the parties and the Court—a process not likely to produce a better result.... If the parties insist on our valuing any or all of the assets, we will. We do not intend to avoid our responsibilities but instead seek to administer to them more efficiently—a factor which has become increasingly important in light of the constantly expanding workload of the Court."