taxnotes federal

Volume 178, Number 13 ■ March 27, 2023

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Reprinted from *Tax Notes Federal*, March 27, 2023, p. 2107

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VIEWPOINT
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Is the IRS Still Mining for Foot Faults in Easement Cases?

by Hale E. Sheppard

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In this article, Sheppard reviews the Tax Court's recent decision in *Cattail Holdings* and argues that it demonstrates the court's waning patience with the IRS's technical challenges to conservation easements.

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I. Introduction

Those familiar with tax disputes know that the IRS ordinarily prioritizes the substance of transactions over their form. In scrutinizing the actions of taxpayers, the IRS frequently urges the court to apply the substance-over-form doctrine to disallow tax benefits. When it comes to wrangling with conservation easement donations, some might argue that the IRS has adopted the contrary approach, focusing on minutiae instead of the bigger picture — land preservation and its worth. This point of view finds support in the many challenges to technical items that the IRS typically raises in easement battles, leaving valuation demoted to a lower-tier issue. A recent Tax Court case, *Cattail Holdings*,[1] shows that judicial patience for these technical challenges might be waning.

II. Overview of Easement Donations

Taxpayers that own undeveloped real property have several choices regarding its use, one of which is voluntarily restricting future uses for the benefit of society as a whole. This is called donating a conservation easement, and it often triggers tax deductions for donors.[2]

Protected property needs to be special. Taxpayers must demonstrate that the property placed under easement has at least one acceptable conservation purpose.[3] This would include preserving land for public recreation or education, safeguarding a relatively natural habitat for plants and animals, maintaining open space for public enjoyment, or using property under a government conservation policy.[4]

Taxpayers memorialize a donation by filing a deed of conservation easement or similar document (deed). In preparing the deed, taxpayers often identify limited activities that they can continue to engage in on the property after the donation without prejudicing the conservation purposes (reserved rights).[5]

An appropriate party must receive the conservation easement to trigger the tax deduction. This means some type of governmental, private, or tax-exempt entity that is committed to protecting the conservation purpose and has sufficient resources to enforce the restrictions in the deed (qualified organization).[6] A land trust often plays this role, for logical reasons.

The IRS will not allow the tax deduction stemming from a conservation easement unless the taxpayer obtains documentation establishing the condition and characteristics of the property

[1] *Cattail Holdings LLC v. Commissioner*, T.C. Memo. 2023-17.

[2] Section 170(f)(3)(B)(iii); reg. section 1.170A-7(a)(5); section 170(h)(1) and (2); reg. section 1.170A-14(a); reg. section 1.170A-14(b)(2).

[3] Section 170(h)(4)(A); reg. section 1.170A-14(d)(1); S. Rep. No. 96-1007, at 10 (1980).

[4] Section 170(h)(4)(A); reg. section 1.170A-14(d)(1).

[5] IRS Publication 5464, "Conservation Easement Audit Techniques Guide," at 94 (Jan. 2021); *see also* reg. section 1.170A-14(b)(2); reg. section 1.170A-14(e)(2) and (3).

[6] Section 170(h)(3); reg. section 1.170A-14(c)(1).

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around the time of the donation (baseline report).[7] Given its purpose, expertise, and policy of only accepting conservation-worthy properties, a land trust frequently prepares the baseline report.

Taxpayers donate the conservation easement to the land trust, along with money so that the land trust has sufficient resources to oversee and enforce the deed forevermore.[8] The land trust must provide the taxpayers with a contemporaneous written acknowledgment (CWA) to confirm receipt of both the conservation easement and the funds.

The value of the conservation easement is the fair market value of the property at the time of donation.[9] FMV ordinarily means the price on which a willing buyer and willing seller would agree if neither party was obligated to participate in the transaction and if both parties had reasonable knowledge of the relevant facts.[10] The best evidence of an easement's FMV would be the sale price of other easements of comparable size and location. The IRS recognizes that it can be difficult, if not impossible, to find these.[11]

Consequently, appraisers often resort to the before-and-after method instead. This means that they need to determine the highest and best use (HBU) of the property and the corresponding FMV twice. First, they calculate the FMV as if the property had been put to its HBU, which generates the "before" value. Second, they calculate the FMV, taking into account the serious restrictions on the use of the property imposed by the conservation easement, which creates the "after" value.[12] The difference between the before and after values, with certain adjustments, produces the value of the donation.

Claiming the tax deduction from an easement donation is surprisingly complicated; it involves several actions and documents. Among other things, taxpayers must obtain a qualified appraisal; demonstrate that the land trust is a qualified organization; obtain an adequate baseline report; prepare and file the deed; complete Form 8283, "Noncash Charitable Contributions"; receive CWAs verifying the donations; and file a timely tax return with all the necessary enclosures and disclosures.[13]

III. Initial IRS Focus on Technical Issues

The IRS announced in Notice 2017-10, 2017-4 IRB 544, that it intended to challenge what it called "syndicated conservation easement transactions" because they supposedly constituted tax avoidance transactions characterized by serious overvaluations.[14] From the outset, the IRS has consistently said that the main problem with easement donations is inflated valuations. However, for many years, the IRS's primary focus has been the technical flaws in conservation easements — that is, issues unrelated to valuation. These technical flaws ordinarily consisted of alleged shortcomings in the qualified appraisal, deed, baseline report, Form 8283, CWA, or other documents related to the donations.[15] Technical issues that the IRS commonly pursues include:

- the donation of the easement lacked charitable intent because there was some form of quid pro quo between the donor and the land trust;
- the donation of the easement was conditioned upon receipt by the donor of the full tax deduction claimed on its Form 1065, "U.S. Return of Partnership Income";
- the land trust failed to issue the donor a proper CWA;
- the appraisal was not attached to the donor's Form 1065;
- the appraisal was not qualified because it was not prepared in accordance with the applicable standards;
- the appraisal fee was based on a percentage of the easement's value;

[7] Reg. section 1.170A-14(g)(5)(i).

[8] Reg. section 1.170A-14(c)(1); reg. section 1.170A-14(g)(5)(ii).

[9] Section 170(a)(1); reg. section 1.170A-1(c)(1).

[10] Reg. section 1.170A-1(c)(2).

[11] IRS, *supra* note 5, at 61.

[12] *Id.* at 61-62.

[13] *See id.* at 39-46; IRS Publication 1771, "Charitable Contributions — Substantiation and Disclosure Requirements" (Mar. 2016); IRS Publication 526, "Charitable Contributions" (2022); section 170(f)(8) and (11); reg. section 1.170A-13; Notice 2006-96, 2006-2 C.B. 902; T.D. 9836.

[14] Notice 2017-10, preamble and section 1.

[15] *See, e.g.*, Hale E. Sheppard, "20 Recent Enforcement Actions in Conservation Easement Disputes: Awareness and Preparation Are Key," 134(3) *J. Tax'n* 15 (2021).

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- the appraisal was not timely, in that it was not sufficiently proximate to the date of the donation or the filing of Form 1065;
- the Form 8283 was missing, incomplete, or inaccurate;
- the donor's tax basis in the property, as listed on the Form 8283, was improperly calculated;
- not all appraisers who participated in the analysis signed the Form 8283;
- the baseline report was insufficient in describing the condition of the property;
- the conservation easement was not "protected in perpetuity";
- mortgages or other encumbrances on the property were not satisfied or subordinated to the easement before the donation;
- the deed contained an improper clause regarding how the proceeds from the sale of the property upon extinguishment of the easement would be allocated among the donor and land trust;
- the deed featured an amendment clause that might allow the parties to modify the donation after taking the tax deduction in a way that harms the conservation purposes;
- the deed had a merger clause, as a result of which the fee simple title and the easement might end up in the hands of the same party, thereby undermining the ability to protect the property forever;
- the deed was not filed in a timely manner with the proper court or other authority;
- the land trust was not a qualified organization; and
- the property lacked acceptable conservation purposes for any number of reasons, including that the habitat was not protected in a relatively natural state, there were insufficient threatened or endangered species on the property, the habitat or ecosystem to be protected was not "significant," the public lacked access to the property, the conservation would not yield a significant public benefit, the conservation purposes did not comport with a clearly delineated government policy, the donor had reserved rights that interfered with or destroyed the conservation purposes, and so on.[16]

The IRS encouraged creativity, explaining that the preceding checklist should not serve as a limitation. Rather, the IRS said the checklist was "*not* an all-inclusive list of potential issues for donations of conservation easements" (emphasis added) and urged its personnel to review the code, tax regulations, IRS administrative rulings, and case law to identify other potential challenges.[17]

IV. What's Old Is New Again

The Tax Court ruled in favor of the IRS on technical issues in several early cases, but things began to change over time.[18] For example, in *Hewitt*, the Eleventh Circuit held that the IRS broke the law when it came to addressing the proper division of sales proceeds when an easement is extinguished.[19] It determined that the IRS violated the Administrative Procedure Act in construing the relevant regulation. Then various other courts held that the IRS had breached the APA again when it issued Notice 2017-10 demonizing conservation easements.[20] Finally, several courts have accepted the easement valuation methods advanced by taxpayers. One example is *Glade Creek Partners*, in which both the Tax Court and the Eleventh Circuit held that an easement donation may be valued by identifying the HBU of the property by using the before-and-after method and applying a discounted cash flow analysis.[21]

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[16] IRS, *supra* note 5, at 110-114.

[17] *Id.* at 110.

[18] *See, e.g*, *Dasher's Bay at Effingham LLC v. Commissioner*, No. 4078-18 (T.C. order Dec. 10, 2019); *Ogeechee River Preserve LLC v. Commissioner*, No. 2771-18 (T.C. order Dec. 10, 2019); *River's Edge Landing LLC v. Commissioner*, No. 1111-18 (T.C. order Dec. 10, 2019); *TOT Property Holdings LLC v. Commissioner*, No. 5600-17 (T.C. order Dec. 13, 2019).

[19] *Hewitt v. Commissioner*, 21 F.4th 1336 (11th Cir. 2021).

[20] *GBX Associates LLC v. United States*, No. 1:22-cv-00401 (N.D. Ohio 2022); *see also* government's answer in *GBX Associates*, No. 1:22-cv-00401 (May 20, 2022); *Green Valley Investors LLC v. Commissioner*, 159 T.C. No. 5 (2022); *Green Rock LLC v. IRS*, No. 2:21-cv-01320 (N.D. Ala. 2023); Kristen A. Parillo, "Another Court Invalidates IRS Easement Listing Notice," *Tax Notes Federal*, Feb. 13, 2023, p. 1057.

[21] *Glade Creek Partners LLC v. Commissioner*, T.C. Memo. 2020-148; *Glade Creek Partners LLC v. Commissioner*, No. 21-11251 (11th Cir. 2022); *see also Champions Retreat Golf Founders LLC v. Commissioner*, T.C. Memo. 2018-146; *Champions Retreat Golf Founders LLC v. Commissioner*, 959 F.3d 1033 (11th Cir. 2020); *Champions Retreat Golf Founders LLC v. Commissioner*, T.C. Memo. 2022-106.

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V. Judicial Fatigue With Technical Arguments?

It could be argued, based on several recent cases, that the Tax Court has grown weary of the IRS's efforts to win conservation easement cases based solely on foot faults — that is, minor technical issues that are unrelated to the principal matter of valuation. The Tax Court's recent decision in *Cattail Holdings* strengthens this theory.[22]

A. Relevant Facts

Cattail Holdings covered two interesting issues, only one of which is examined here.[23] Cattail Holdings LLC (partnership) owned approximately 200 acres in Virginia on which it donated a conservation easement to a land trust in 2017. The deed contained the following provisions of interest:

- Paragraph 3 generally prohibited any activity on the property that would be inconsistent with the easement, the conservation purposes, or the conservation values.
- Paragraph 3(h), which is key to this case, specifically disallowed post-donation mining activities, including "the exploration for, or development and extraction of, minerals and hydrocarbons by any surface or subsurface mining method, by drilling, or by any other method, or transportation of the same via new pipelines or similar facilities, that would impair or interfere with the conservation purposes and conservation values of the property in any material respect" in the discretion of the land trust.
- Paragraph 4 listed various reserved rights of the partnership, such as its ability to engage in forestry activities and farming operations, its use of the property for certain recreational purposes (for example, hiking, camping, hunting, fishing, and horseback riding), and its construction of barns, sheds, and facilities for the generation of renewable electrical power. However, as the Tax Court noted, it reserved "no mining rights of any kind" for the partnership.[24]
- Paragraph 4(a) expressly prevented the partnership from exercising any of its reserved rights in a manner that would adversely affect the conservation purposes or conservation values.
- Paragraph 5 required the partnership to seek prior consent from the land trust before conducting activities that might negatively affect the conservation purposes or conservation values. Silence by the land trust would be deemed a reasonable withholding of its consent.

B. Inevitable Impasse

The partnership filed its Form 1065 for 2017, claiming a charitable tax deduction of about $41 million. The IRS began an audit and ultimately concluded — as it does in virtually every conservation easement case — that (1) the partnership should get a deduction of $0 because it supposedly failed to meet all the substantiation requirements of section 170; (2) even if the partnership satisfied its obligations, it had not proved that the donation was worth more than $3.5 million; and (3) in all events, the partnership should be hit with the largest possible penalty, equal to 40 percent of the tax liability, for submitting a "gross valuation misstatement." The partnership disputed the IRS allegations by filing a petition with the Tax Court.

The IRS filed a pretrial motion for partial summary judgment. It asked the Tax Court, among other things, to dispense with the case right away because the deed supposedly permitted surface mining on the property, meaning that the conservation purposes were not "protected in perpetuity."

C. Analysis by the Tax Court

The Tax Court began by summarizing the relevant code provisions. It noted that for an easement donation to trigger a tax deduction, it must be a "qualified conservation contribution." To meet this definition, the conservation purpose must be "protected in perpetuity," and this does

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[22] *Cattail Holdings*, T.C. Memo. 2023-17.

[23] The issue addressed by the Tax Court but irrelevant to this article was whether the IRS complied with the requirements of section 6751(b) by obtaining supervisory approval before proposing penalties. *See Cattail Holdings*, T.C. Memo. 2023-17, at 7-11.

[24] *Id.* at 4.

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not occur if a party "retains a qualified mineral interest" and "if at any time there may be extraction or removal of minerals [from the property under easement] by any surface mining method."[25]

The IRS argued that paragraph 3(h) of the deed, set forth above, somehow gave the partnership a "contingent right to engage in surface mining," subject to approval by the land trust. Building on this notion, the IRS suggested that paragraph 3(h) authorized surface mining unless, at the discretion of the land trust, the mining "would impair or interfere with the conservation purposes and conservation values of the property in any material respect."

The Tax Court did not mince words in rejecting the IRS's assertion, calling it "unconvincing" for several reasons. First, the court underscored that the tax provision cited by the IRS only applies in situations in which a "retention of a qualified mineral interest" exists. It then emphasized that the IRS failed to point to any portion of the deed that allowed the partnership to exploit any "qualified mineral interest." Indeed, the reserved rights enumerated in the deed did not contemplate any type of mining-related activity. The court concluded that it "did not see how a prohibition against mining can be interpreted to endow [the partnership] with a reserved right to engage in mining."[26] The court then added some dicta, explaining that the IRS did not allege that any party other than the partnership retained some type of mineral interest. Even if the IRS had made that challenge, the court explained, the partnership would still be entitled to the tax deduction if the probability of surface mining on the property were "so remote as to be negligible."[27]

Second, the court said the IRS made a mistake in interpreting paragraph 3(h) of the deed to permit mining at the discretion of the land trust. The court essentially criticized the IRS's understanding of statutory construction, particularly the scope of the caveat. After breaking down the text of paragraph 3(h), the court concluded that "far from permitting development or extraction of minerals, this grant of discretionary authority gives [the land trust] maximum power to prevent any transportation of existing minerals that it views as problematic."[28]

Third, the court characterized the IRS's suggestion that the deed permits surface mining on the property with approval from the land trust as "fanciful." It explained that the applicable law is clear in that mining would be completely at odds with the conservation purposes, and that paragraph 3 of the deed explicitly prohibits "any activity or use of the property inconsistent with the purpose of the easement." The court then pointed out that the IRS's suggestion that the partnership enjoyed a "contingent right to engage in surface mining" was necessarily based on the idea that the land trust "might be faithless to its charitable mission by permitting [the partnership] to engage in activity explicitly barred by" section 170. The court strongly declined to accept this accusation because it was launched by the IRS as part of the pretrial motion without any supporting evidence.[29]

VI. Conclusion

What's the problem with conservation easements? Well, when it comes to the IRS, the answer seems to depend on the audience. In situations in which the IRS (1) urges Congress to change legislation, (2) issues administrative guidance, (3) makes presentations at conferences, or (4) places transactions on its "Dirty Dozen" list, it normally decries "inflated appraisals." However, when the IRS attacks easements during audits and litigation, it invariably starts with purported technical problems, relegating valuation to a secondary or tertiary argument. This disconnect has caused significant turmoil in recent years. A large number of easement cases with mining HBUs are now awaiting trial, preserving hope that the IRS and Tax Court will focus on the key issue: valuation. The recent decision in *Cattail Holdings* offers some optimism in this regard. ■

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[25] Section 170(f)(3)(B)(iii), (h)(1)(C), and (h)(5)(B)(i).

[26] *Cattail Holdings*, T.C. Memo. 2023-17, at 6.

[27] *Id.* at 6 n.4 (citing reg. section 1.170A-14(g)(4)(ii)(A)).

[28] *Id.* at 6-7.

[29] *Id.* at 7.

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