taxnotes federal

Volume 175, Number 7 ■ May 16, 2022

Valuation, Highest and Best Use, And Easements: New IRS Attacks

by Hale E. Sheppard

Reprinted from *Tax Notes Federal*, May 16, 2022, p. 1061

For more *Tax Notes* content, please visit www.taxnotes.com.

Valuation, Highest and Best Use, And Easements: New IRS Attacks

by Hale E. Sheppard

Hale E. Sheppard is a shareholder in the tax controversy section of Chamberlain, Hrdlicka, White, Williams & Aughtry in Atlanta.

In this report, Sheppard suggests that the IRS, in its aggressive challenges of conservation easements, is overlooking long-standing authorities that support valuation of real property based on its highest and best use.

Copyright 2022 Hale E. Sheppard.
All rights reserved.

Table of Contents

I. **Introduction** 1061
II. **Overview of Easement Donations** 1061
III. **Focus on Technical Issues** 1063
IV. **A Few Comments About HBU** 1064
V. **IRS Attacks Valuation, Sort Of** 1065
A. Appraisal Status in Income Tax Disputes 1065
B. Appraisal Status Elsewhere. 1066
VI. **Sources Buttressing HBU**. 1066
A. Observations by Congress 1066
B. Tax Regulations 1067
C. Additional IRS Guidance 1068
D. Appraisal Standards Organizations 1068
E. Audit Techniques Guide 1069
F. IRS Administrative Rulings. 1069
G. HBU in the Estate Tax Context 1070
H. More HBU in the Estate Tax Context 1071
I. Even Opponents Acknowledge HBU. 1072
VII. **Conclusion** 1073

I. Introduction

There is a significant disconnect when it comes to conservation easement disputes. The IRS has argued for several decades that the biggest problem, bar none, is that taxpayers are overvaluing easements and then claiming excessive tax deductions. For example, when it published Notice 2017-10, 2017-4 IRB 544, to label the formation of partnerships, pooling of funds, acquisition of real property, and donation of easements as listed transactions, the IRS alleged that taxpayers were obtaining "greatly inflated" appraisals thanks to "unreasonable conclusions about the development potential of the real property." Despite its indignation about the supposed scourge of inaccurate valuations, the evidence might lead one to conclude that the IRS has done everything in its power to avoid addressing the valuation issue. Indeed, using a recent motion filed with the Tax Court as a backdrop, this report underscores that even when the IRS appears poised to attack *the substance* of valuation, it turns out that the IRS is merely challenging *the procedure* yet again.

This report summarizes the rules affecting conservation easement donations; identifies the technical arguments on which the IRS has depended heavily in recent years; describes the IRS's newest attacks focused on appraisals that supposedly miss the mark; analyzes multiple sources supporting valuation of real property based on its highest and best use (HBU); and suggests that the IRS has failed to adequately explain why it, taxpayers, or the courts should ignore long-standing authorities.

II. Overview of Easement Donations

Taxpayers who own undeveloped real property have several choices. They might (1)

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

hold the property for investment purposes, hoping it appreciates significantly in value; (2) determine how to maximize profitability from the property and do that regardless of negative effects on the local environment, community, or economy; or (3) voluntarily restrict future uses of the property, such that it is protected forever for the benefit of society. The third option, known as donating a conservation easement, not only achieves environmental protection but also might trigger tax deductions for donors.[1]

Taxpayers cannot place an easement on just any property and claim a tax deduction; they must demonstrate that the property has at least one acceptable conservation purpose.[2] Common conservation purposes include preserving land for public recreation or education, safeguarding a relatively natural habitat for plants and animals, maintaining open space for scenic enjoyment by the public, and using property in accordance with a government conservation policy.[3]

Taxpayers memorialize the donation by filing a deed of conservation easement or similar document. In preparing the deed, taxpayers often coordinate with a land trust to identify limited activities that can continue on the property after the donation without compromising the conservation purposes.[4]

The IRS will not allow a tax deduction stemming from a conservation easement unless the taxpayer obtains, shortly before making the donation, documentation establishing the condition and characteristics of the property (the baseline report).[5]

Taxpayers generally can claim a deduction the year in which the charitable donation occurs.[6] If the donation consists of something other than money, the amount of the deduction normally is the fair market value of the relevant property at the time of the donation.[7] For these purposes, FMV ordinarily means the price on which a willing buyer and willing seller would agree, with neither party being obligated to participate in the transaction, and with both parties having reasonable knowledge of the facts.[8]

In theory, the best evidence of the FMV of an easement would be the sale price of other easements that are comparable in size, location, etc. The IRS recognizes, however, that it is difficult, if not impossible, to find comparable easement sales.[9] Consequently, appraisers normally must use the before-and-after method instead. The IRS has acknowledged this reality for at least half a century, as demonstrated by a 1973 revenue ruling stating:

> More often than not open space easements in perpetuity are granted by deed of gift so there is usually no substantial record of market place sales to use as a meaningful or valid comparison. As a consequence, the valuation of any open space easement in perpetuity is generally made on the basis of the "before and after" approach. Thus, the difference between the [FMV] of the total property before the granting of the easement and the [FMV] of the property after the grant is the [FMV] of the easement given up.[10]

Using the before-and-after method means that the taxpayer, relying on an independent appraiser, must determine the HBU of the property and the corresponding FMV twice. First, the appraiser calculates the FMV as if the property had been put to its HBU, which generates the "before" value. Second, the appraiser identifies the FMV, taking into account the serious restrictions on the property imposed by the conservation easement, which creates the "after" value. The difference between the values of the

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

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

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

[4] IRS, "Conservation Easement Audit Techniques Guide," at 23 (rev. Nov. 4, 2016) (2016 ATG); *see also* reg. section 1.170A-14(b)(2), (e)(2), and (e)(3).

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

[6] Section 170(a)(1).

[7] Section 170(a)(1) and reg. section 1.170A-1(c)(1).

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

[9] IRS, "Conservation Easement Audit Techniques Guide," at 43 (rev. Jan. 24, 2018) (2018 ATG).

[10] Rev. Rul. 73-339, 1973-2 C.B. 68.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

property, with some adjustments, produces the amount of the donation.[11]

Claiming the tax deduction from an easement donation is surprisingly complicated. It involves a significant amount of actions and documents. The taxpayer typically must obtain a qualified appraisal from a qualified appraiser; demonstrate that the land trust is a qualified organization; obtain a baseline report; complete a Form 8283, "Noncash Charitable Contributions"; file a timely Form 1065, "U.S. Return of Partnership Income," with all necessary enclosures and disclosures; receive a written acknowledgment of the donation from the land trust; and more.[12]

III. Focus on Technical Issues

As mentioned in the introduction, the IRS has consistently stated that the main problem with easement donations is inflated valuations. However, the primary focus in tax disputes thus far has been on so-called technical flaws — that is, issues unrelated to valuation. These ordinarily consist of alleged shortcomings with the deed, baseline report, qualified appraisal, Form 8283, or other documents affiliated with charitable donations.[13] To the dismay of many in the land conservation and legal communities, the Tax Court has ruled in the IRS's favor on technical issues in several cases over the past few years.[14]

Below is a partial list of the technical challenges pursued by the IRS[15]:

- the donation of the easement lacked charitable intent because there was some form of quid pro quo between the donor and the easement recipient;
- the donation of the easement was conditioned on the donor's receipt of the full tax deduction claimed on its Form 1065;
- the easement recipient failed to issue the donor a proper contemporaneous written acknowledgment letter;
- the appraisal was not attached to the donor's Form 1065;
- the appraisal was not a qualified appraisal because it was not prepared in accordance with the applicable standards;
- the appraisal fee was based on a percentage of the easement value;
- the appraisal was not timely, in that it was insufficiently proximate to the making of the donation or the filing of the Form 1065;
- the Form 8283 was missing, incomplete, or inaccurate;
- the donor's tax basis in the property, as listed on Form 8283, was improperly calculated;
- not all appraisers who participated in the analysis signed 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 contains an improper clause regarding how the proceeds from sale of the property upon extinguishment of the easement would be allocated among the donor and easement recipient;
- the deed contains an amendment clause, which might allow the parties to modify the donation, after taking the tax deduction, in a way that harms the conservation purposes;
- the deed contains 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 location;
- the easement recipient was not a qualified organization; and
- the property lacks acceptable conservation purposes for any number of reasons,

---

[11] 2018 ATG, *supra* note 9, at 43.

[12] *See id.* at 24-31; IRS Publication 1771, "Charitable Contributions — Substantiation and Disclosure Requirements" (Mar. 2016); IRS Publication 526, "Charitable Contributions" (2016); section 170(f)(8) and (11); reg. section 1.170A-13; Notice 2006-96, 2006-2 C.B. 902; and T.D. 9836.

[13] For more information about the categories of arguments raised by the IRS, see Hale E. Sheppard, "20 Recent Enforcement Actions in Conservation Easement Disputes: Awareness and Preparation Are Key," 134 *J. Tax'n* 15 (Mar. 2021).

[14] *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); *Riverpointe at Ogeechee LLC v. Commissioner*, No. 4011-18 (T.C. order Dec. 10, 2019); *River's Edge Landing LLC v. Commissioner*, No. 1111-18 (T.C. order Dec. 10, 2019); and *TOT Property Holdings LLC v. Commissioner*, No. 5600-17 (T.C. order Dec. 13, 2019).

[15] 2016 ATG, *supra* note 4.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

> including that the habitat is not protected in a relatively natural state, there are insufficient threatened or endangered species on the property, the habitat or ecosystem to be protected is not significant, the public lacks physical or visual access to the property, the conservation will not yield a significant public benefit, the conservation purposes do not comport with a clearly delineated government policy, or the donor has reserved rights that interfere with or destroy the conservation purposes.[16]

The IRS encourages creativity, explaining to its personnel that the preceding list should not serve as a limitation. In fact, the IRS states that it "is not an all-inclusive list of potential issues for donations of conservation easements," and it urges personnel to review the code, tax regulations, IRS administrative rulings, and case law to identify other potential challenges.[17]

IV. A Few Comments About HBU

Courts have recognized for many decades the use of HBU in valuing real property interests. For instance, the Supreme Court held way back in 1878 that a property's HBU is the most profitable use for which it is adaptable and needed, or likely to be needed, in the reasonably near future.[18] The Supreme Court added the following color to the issue:

> In determining the value of land appropriated for public purposes [for example, by condemnation], the same considerations are to be regarded as in a sale of property between private parties. The inquiry in such cases must be what the property is worth, viewed not merely with reference to the uses to which it is at the time applied, but with reference to the uses to which it is plainly adapted — that is to say what is it worth from its availability for valuable uses. Property is not to be deemed worthless because the [current] owner allows it to go to waste, or to be regarded as valueless because [the current owner] is unable to put it to any use. Others may be able to use it, and make it subserve the necessities or conveniences of life. Its capability of being made thus available gives it a market value which can be readily estimated. So many varied are the circumstances to be taken into account in determining the value of property condemned for public purposes that it is perhaps impossible to formulate a rule to govern its appraisement in all cases. Exceptional circumstances will modify the most carefully guarded rule; but as a general thing, we should say that the compensation to the owner is to be estimated by reference to the uses for which the property is suitable having regard to the existing business or wants of the community or such as may be reasonably expected in the immediate future.[19]

Courts have also defined HBU as the reasonably probable use of property that is physically possible, legally permissible, financially feasible, and maximally productive.[20] Valuation in the conservation easement context does not depend on whether the current owner has actually put the property to its HBU yet.[21] The HBU can be any realistic potential use of the property.[22] Many courts have emphasized the necessity, not the option, of evaluating the HBU of property.[23] Importantly, respected appraisal organizations underscore that HBU is viewed from the perspective of the potential buyer, not the seller. They explain it as follows:

> The [HBU] may be for the continuation of an asset's existing use or for some alternative use. This is determined by the use that a market participant would have

[16] *Id.* at 78-81.

[17] *Id.*

[18] *Boom Co. v. Patterson*, 98 U.S. 403 (1878); *see also Olson v. United States*, 292 U.S. 246 (1934).

[19] *Boom*, 98 U.S. at 407-408.

[20] *Esgar Corp. v. Commissioner*, 744 F.3d 648, 659 n.10 (10th Cir. 2014).

[21] *Id.* at 657.

[22] *Symington v. Commissioner*, 87 T.C. 892, 896 (1986).

[23] *Palmer Ranch Holdings Ltd. v. Commissioner*, T.C. Memo. 2014-79 (explaining that "in deciding the property's [FMV] before the [conservation easement], we must take into account not only the property's then-current use, but also its [HBU]").

For more Tax Notes® Federal content, please visit www.taxnotes.com.

in mind for the asset *when formulating the price that it would be willing to bid*.[24] [Emphasis added.]

V. IRS Attacks Valuation, Sort Of

After years of prioritizing its attacks on purely technical matters, it looked like the IRS was evolving, shifting its attention to what it has repeatedly characterized as the main problem: valuation. However, further analysis reveals that recent IRS enforcement activity is just more of the same.

A. Appraisal Status in Income Tax Disputes

The IRS has started arguing in civil income tax disputes that the Tax Court should resolve cases in its favor — without a trial and without determining the value of the easement — because taxpayers supposedly failed to meet all the eligibility requirements on the front end. More specifically, the IRS contends that taxpayers should get a goose egg, nothing, nada, zippo, zilch, zero, solely because the appraiser they hired to value the conservation easement, before filing the Form 1065 and claiming the tax deduction, allegedly did not produce a qualified appraisal. The IRS, in effect, is trying to convert a valuation issue into a technical issue, taking the position that the HBUs identified by some appraisers yielded defective appraisals.

An illustration of this phenomenon is *Green Valley Investors*.[25] The IRS's argument in that case, which is not entirely clear from the filings with the Tax Court, might be paraphrased as follows:

- A taxpayer must acquire and provide the IRS with a qualified appraisal as a condition to claiming an easement-related deduction.
- To meet this standard, the taxpayer, normally relying on an appraiser, must determine the FMV of the property on the date of the donation.
- Appraisers ordinarily identify FMV by applying the willing-seller, willing-buyer formula.
- However, because of a lack of comparable sales of conservation easements, appraisers frequently must calculate FMV using the before-and-after method.
- That method obligates appraisers to identify the FMV of the property both before and after the placement of the easement on the property.
- To determine the before value, appraisers must address "unimproved land with development potential" instead of "fully developed property."
- Imagining that a property has been put to its HBU for purposes of calculating the before value constitutes an improper assumption or hypothetical condition by an appraiser.
- Appraisers must make an "objective assessment" of the likelihood of achieving the HBU.
- Concluding that unimproved property could be used as a residential subdivision, an owner-operated mine, etc. is not "objective" from the IRS's perspective.
- If appraisers identify HBUs that are not objective, value the wrong property interest, or rely on unsuitable assumptions or hypothetical conditions, their appraisals are not qualified appraisals.
- Taxpayers who attach to their tax returns documents that are not qualified appraisals deserve a charitable deduction of $0 because of this technical violation, regardless of the true value of easement as determined by independent appraisers serving as testifying experts at trial, by appraisers hired by the IRS, or by any other means.
- The land in *Green Valley Investors* largely had been used for agricultural purposes before donation of the easement, which represented its current use. The appraisers concluded that the HBU of the property was mining. The appraisers in *Green Valley Investors* supposedly did not calculate the before value of the property applying its current use, but rather on the basis that an operating mine existed at the time. This "as if developed" valuation derives from factual assumptions that are "indisputably false," ignore that "a willing-buyer would never purchase an unimproved parcel of land for

---

[24] Appraisal Institute, *The Dictionary of Real Estate Appraisal* 109 (2015). In this context, a market participant means one who invests equity in real property or real property use. *Id.* at 140.

[25] Memorandum in Support of Partial Summary Judgment, *Green Valley Investors LLC v. Commissioner*, No. 17379-19 (T.C. Apr. 5, 2022).

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

the price of an already-developed parcel," and violate the qualified appraisal regulations.[26]

The preceding bullet points are not statements of applicable law; rather, they simply summarize notions that the IRS is advancing now in *Green Valley Investors* and likely will advance later in other cases.

One might consider the IRS's position flawed for several reasons. A couple stand out. It appears that the IRS is trying to obligate taxpayers to value property based on its current use, as opposed to its HBU, despite the long list of contrary authorities examined later in this report. Moreover, it seems that the IRS is confused about how appraisers apply the income approach — particularly the development analysis using a property's HBU — in calculating the before value. Below is a short summary of how this common approach works:

> The appraiser first determines the total gross proceeds that would be realizable for lot sales if the property were developed to its fullest extent. The gross proceeds figure is then discounted for the various factors that a prospective purchaser-developer would consider, such as the risk and delay associated with obtaining any necessary approvals or zoning changes, the time it would take to sell all of the lots, the various costs associated with developing the property such as marketing, engineering, and infrastructure costs, and the profit a purchaser-developer would demand given the overall risk and difficulty of pursuing the development project. That discounted figure is then presented as the [FMV] of the property.[27]

B. Appraisal Status Elsewhere

The IRS and the Department of Justice are trying to demonize consideration of a property's HBU in other contexts, too. First, in *Zak*, the Justice Department is attempting to enjoin particular people from easement activities.[28] It maintains in that case that the appraisers relied on, and others knowingly condoned, "predetermined" and "unsupportable" HBU conclusions.[29] Second, the Justice Department recently filed a criminal indictment against multiple people, accusing them of using unfeasible HBUs in preparing appraisals.[30] Commentators have described the Justice Department's actions as launching a "sideswipe attack on HBU" and trying to "criminalize HBU."[31]

VI. Sources Buttressing HBU

It is fine for taxpayers and the IRS to disagree on the facts, the law, or the application of the facts to the law; that is the essence of a tax dispute. It is also acceptable for both parties to take innovative positions, as long as they have a reasonable basis and are acting in good faith. However, some might question the validity of recent IRS attacks on HBU in light of the sources discussed below, as well as others not revealed in this report, that taxpayers surely will invoke in future conservation easement litigation.

A. Observations by Congress

Congress expanded and made permanent rules allowing income tax deductions for conservation easements in 1980. In doing so, it sanctioned the before-and-after method, combined with respect for a property's HBU. The legislative history explains:

> In general, a deduction is allowed for a charitable contribution in the amount of the [FMV] of the contributed property, defined as the price at which the property would change hands between a willing buyer and a willing seller. Thus, the amount of the deduction for the

---

[26] *Id.* at 12-16.

[27] Nancy A. McLaughlin, "Increasing the Tax Incentives for Conservation Easement Donations — A Responsible Approach," 31 *Ecology L.Q.* 1, 83-84 (2004).

[28] *See* Complaint, *United States v. Zak*, No. 1:18-cv-05774 (N.D. Ga. Dec. 10, 2019).

[29] United States' Brief in Support of Motion for Partial Summary Judgment at 16-26, *Zak*, No. 1:18-cv-05774 (N.D. Ga. Feb. 15, 2022).

[30] First Superseding Criminal Indictment, *United States v. Fisher*, No. 1:21-cr-00231 (N.D. Ga. Feb. 24, 2022).

[31] Nathan J. Richman, "Government Seen as Escalating Attack in Latest Easement Indictment," *Tax Notes Federal*, Apr. 18, 2022, p. 505.

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

> contribution of a conservation easement or other restriction is the [FMV] of the interest conveyed to the recipient. However, because markets generally are not well established for easements or similar restrictions, the willing buyer-seller test may be difficult to apply. . . . *As a consequence, conservation easements are typically (but not necessarily) valued indirectly as the difference between the [FMV] of the property involved before and after the grant of the easement. Where this test is used, however, the committee believes it should not be applied mechanically*. For example, where before and after valuation is used, the [FMV] of the property before contribution of the easement *should take into account not only the current use of the property but also an objective assessment of how immediate or remote the likelihood is that the property, absent the [easement], would be developed*.[32] [Emphasis added.]

B. Tax Regulations

The regulations feature special rules for calculating a deduction stemming from the donation of a conservation easement. The relevant portion of the regulations, broken down into numbered sentences to enhance readability, contains the following guidance[33]:

1. "The value of the contribution under Section 170 in the case of a charitable contribution of a perpetual conservation restriction is the [FMV] of the perpetual conservation restriction at the time of the contribution."
2. "If there is a substantial record of sales of easements comparable to the donated easement . . . the [FMV] of the donated easement is based on the sales prices of such comparable easements."
3. "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 [FMV] of a perpetual conservation restriction is equal to the difference between the [FMV] of the property it encumbers *before* the granting of the restriction and the [FMV] of the encumbered property *after* the granting of the restriction." (Emphasis added.)

The regulations provide additional guidance in situations in which the appraiser uses the before-and-after method, described in sentence 3, above. They state the following:

> If before and after valuation is used, the [FMV] of the property before contribution of the conservation restriction must take into account not only the current use of the property but also an objective assessment of how immediate or remote the likelihood is that the property, absent the [easement], would in fact be developed, as well as any effect from zoning, conservation, or historic preservation laws that already restrict the property's potential [HBU].[34]

The regulations contain a dozen examples, one of which specifically mentions residential home development as the appropriate HBU for a parcel.[35]

In summary, the general rule found in the applicable regulations is that a taxpayer donating a conservation easement should get a tax deduction equal to the FMV of that easement. In situations in which there is a "substantial record" of sales of comparable easements, the taxpayer should use the sales comparison method to determine the FMV. However, when a "substantial record" of comparable sales does not exist, the taxpayer normally should use the before-and-after method. In calculating the before value, the taxpayer must consider the HBU of the property, making an objective assessment about the likelihood of the property being developed to its HBU.

---

[32] S. Rep. No. 96-1007, at 14-15.

[33] Reg. section 1.170A-14(h)(3)(i).

[34] Reg. section 1.170A-14(h)(3)(ii).

[35] Reg. section 1.170A-14(h)(4), Example 7.

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

C. Additional IRS Guidance

Congress changed the law in 2006, creating, among other things, a new meaning of the term "qualified appraisal."[36] The updated definition means an appraisal that (1) is done by a qualified appraiser, and (2) meets the "generally accepted appraisal standards," as well as applicable regulations or other IRS guidance.[37]

The IRS decided to issue "transitional guidance" in late 2006 while it was busy crafting new regulations to address the changes. That guidance came in the form of Notice 2006-96, 2006-2 C.B. 902, which somewhat clarified the meaning of qualified appraisal. It explained that the IRS would deem an appraisal as having met "generally accepted appraisal standards" if, for instance, the appraisal was consistent with the substance and principles of the Uniform Standards of Professional Appraisal Practice (USPAP).[38]

The IRS asked the public to comment on Notice 2006-96, and it did. The IRS described that input when it released proposed regulations in 2008.[39] Interestingly, the preamble to the proposed regulations explains that an appraisal *must* address a property's HBU in order to meet USPAP standards; Notice 2006-96 and the proposed regulations indicate that an appraisal must satisfy USPAP or similar standards to be considered a qualified appraisal; and the obligation for an appraiser to do an analysis of a property's HBU is so evident that it is unnecessary for the IRS to explicitly state this in the regulations. The preamble puts it the following way:

> Some commenters requested a specific reference to [HBU] in the proposed regulations. This suggestion was *not* incorporated in the proposed regulations because USPAP Standards Rule 1-3(b) [already] requires an appraiser to "develop an opinion of the [HBU] of the real estate" when it is "necessary for credible assignment results in developing a market value opinion." *An appraisal that does not include a development of [HBU] when required by USPAP is not consistent with the substance and principles of USPAP.*[40] [Emphasis added.]

The final regulations, issued more than a decade later, contain a nearly identical definition of qualified appraisal, citing "generally accepted appraisal standards" and the "substance and principles" of USPAP.[41] The final regulations clarify that some degree of leniency is appropriate, with the IRS rejecting the suggestion that a qualified appraisal must be completed "in accordance with USPAP" instead of just "in accordance with the substance and principles of USPAP." The preamble to the final regulations explains that the IRS believes that "it is beneficial to provide some flexibility by requiring conformity with appraisal standards that are consistent with the substance and principles of USPAP rather than requiring that all appraisals be prepared strictly in accordance with USPAP."[42]

The final regulations also demand that all qualified appraisals determine the FMV of the donated property and state the valuation method used, such as the sales comparison approach, income approach, or cost approach.[43] These three approaches, or variations thereof, constitute the widely accepted ways to value real property, depending on the nature of the property, the purpose of the assignment, and the scope of work.[44]

D. Appraisal Standards Organizations

As noted above, the final regulations on qualified appraisals state that it is acceptable to adhere to USPAP or similar standards. A quick review of various standards is warranted.

USPAP provides that when it is necessary for formulating a market value opinion, an appraiser

[36] Pension Protection Act of 2006, section 1219.

[37] Section 170(f)(11)(E)(i); and Joint Committee on Taxation, "Technical Explanation of H.R. 4, 'The Pension Protection Act of 2006,' as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006," JCX-38-06, at 312 (Aug. 3, 2006).

[38] Notice 2006-96, section 3.02(2).

[39] REG-140029-07, 73 F.R. 45908 (Aug. 7, 2008).

[40] *Id.* at 45911.

[41] Reg. section 1.170A-17(a)(2).

[42] Preamble to T.D. 9836, 83 F.R. 36471 (July 30, 2018).

[43] Reg. section 1.170A-17(a)(3)(i)(D) and (3)(viii).

[44] Appraisal Institute, *supra* note 24, at 10.

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

must do several things, including developing an opinion on the HBU of the property and analyzing the relevant legal, physical, and economic factors to support that HBU conclusion.[45] USPAP further identifies three permissible approaches for valuation: the sales comparison approach, the income approach, and the cost approach.[46] USPAP instructs appraisers to reconcile the applicability and relevance of the various approaches to arrive at a value and then explain in the report the reasons for excluding any of the three approaches.[47] USPAP also permits appraisers to rely on extraordinary assumptions or hypothetical conditions, as long as they are stated clearly and conspicuously in the appraisal report.[48]

Other respected organizations follow standards similar to those issued by the USPAP. For instance, the International Valuation Standards Council (IVSC), which creates rules on a global basis, identifies HBU as an acceptable premise of value.[49] When it comes to interests in real property, the IVSC explains that an appraiser must consider HBU because this concept is critical when evaluating an asset capable of changing uses or possessing development potential.[50] The IVSC confirms that appraisers, after identifying the HBU of the property, can use the sales comparison approach, income approach, or cost approach to calculate value, depending on the facts and circumstances.[51] The IVSC also advises that the income approach "should be applied and afforded significant weight" in situations in which (1) the income-producing ability of property is the critical element affecting value; or (2) reasonable projections of the timing and amount of future income for the property are available and few, if any, comparable sales exist.[52]

The Uniform Appraisal Standards for Federal Land Acquisitions (yellow book) contains similar guidelines.[53] It explains that the appraiser's determination of a property's HBU "is one of the most important elements of the entire appraisal process" and depends on several things, including what is physically possible, legally permissible, financially feasible, and maximally profitable.[54] The yellow book also recognizes that appraisers use the sales comparison approach, income approach, or cost approach (or subsets of these approaches) in calculating value.[55] Finally, the yellow book agrees that appraisers may use extraordinary assumptions and hypothetical conditions under specific circumstances.[56]

E. Audit Techniques Guide

The audit techniques guide for conservation easements, published by the IRS for use by its own personnel, states that the determination of a property's HBU "is *vital* to the valuation of any real estate, including conservation easements" and that "all professional appraisal organizations recognize that the HBU of the property is a *key element* to proper valuation."[57] (Emphasis added.)

F. IRS Administrative Rulings

Several IRS rulings discuss the significance of HBU in valuing real property, as well as notable flexibility surrounding the concept. The following is a good example:

> The [FMV] of property is determined on the basis of a hypothetical willing buyer and a hypothetical willing seller . . . and reflects its [HBU] as of the date of its valuation. The [FMV] of property is not affected by whether an owner has actually put the property to its [HBU]. The reasonable and objective possibilities for the [HBU] of property control its value. A potential [HBU] for the property can be considered even though the potential use is prohibited on the valuation date by some restriction in a deed, statute or

---

[45] Appraisal Foundation, Uniform Standards of Professional Appraisal Practice, Standard 1-3(b) (2020-2021).

[46] *Id*. at Standard 1-4.

[47] *Id*. at standards 1-6 and 2-2(a)(x).

[48] *Id*. at standards 1-2(f), 1-2(g), and 2-2(a)(xiii).

[49] IVSC, International Valuation Standards, at 24 (2017).

[50] *Id*. at 83.

[51] *Id*. at 29, 83-85.

[52] *Id*. at 36.

[53] Interagency Land Acquisition Conference, Uniform Appraisal Standards for Federal Land Acquisitions (2016).

[54] *Id*. at 22-23, 63-64, 70, and 101-117.

[55] *Id*. at 25-36, 63-70, and 118-145.

[56] *Id*. at 13.

[57] 2018 ATG, *supra* note 9, at 46.

© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

> zoning regulation. In such case, the proper approach is to value the property at its [HBU] even though its [HBU] is prohibited as of the date of the valuation by the applicable restriction and then to proceed to reduce or discount such value by a reasonable estimate of the cost of removing the restriction and for the time needed to accomplish such removal. However, the projected [HBU] must have a strong possibility of achievement. It should not be remote, speculative or conjectural.[58]

G. HBU in the Estate Tax Context

Estate tax cases have addressed the HBU concept and taken things a step further, acknowledging the large difference in valuation when applying the HBU of property as opposed to its current use.

Section 2032A generally provides that, for purposes of estate taxes, the value of some farming and other property "shall be its value for the use for which it qualifies," as long as the decedent was a U.S. citizen or resident at the time of death, the executor of the estate makes the proper election, and the executor obtains a written agreement from all interested parties.[59] In other words, if the relevant criteria are met, specified property can be valued at something other than its HBU for estate tax purposes.

Why did Congress enact this "special use valuation" principle in the context of estate taxes? The legislative history explains that Congress did not want to force estates to sell properties solely to cover large estate tax bills that would be caused by valuing properties according to their HBUs.[60] The excerpts below offer a clear picture of what Congress was thinking in allowing estates, but not donors of conservation easements, to avoid valuation grounded in HBU:

> Under present law, the value of property included in the gross estate of the decedent is the [FMV] of the property interest at the date of the decedent's death. . . . *One of the most important factors in determining the [FMV] of the land is the [HBU] to which the property can be put*.
>
> In some cases, the use of land for farming, woodlands, scenic or historical purposes may be its [HBU]. *However, in other cases, land which is used for such purposes might be worth significantly more if it were sold and converted to other uses, such as residential or commercial purposes*. Thus, where the land is used for farming, woodlands, or scenic or historical purposes, *the value of the land based on actual use may be substantially less than the value if it were to be converted to its [HBU] . . . .*
>
> The committee believes that, when land is actually used for farming, woodlands, or scenic or historical purposes (both before and after the decedent's death), *it is inappropriate to value the land on the basis of its potential [HBU]. Valuation on the basis of [HBU], rather than actual use, may result in the imposition of substantially higher estate taxes*."[61] [Emphasis added.]
>
> Where the [FMV] of real property is the subject of dispute, there are several valuation techniques which the courts tend to accept. These methods include the income-capitalization technique, the reproduction-cost-minus-depreciation technique, and the comparative sales technique. Courts will generally use of these methods, or a combination of these methods, in determining [FMV]. *However, in all cases, it is presumed that the land would change hands between a willing buyer and a willing seller based on the [HBU] to which the land could be put, rather than the actual use of the land at the time it is transferred. . . .*

---

[58] ILM 201319010.

[59] Section 2032A(a)(1); Bradley Holtorf, "An Analysis of the Actual Use Valuation Procedure of Section 2032A," 56 *Neb. L. Rev*. 860 (1977) (explaining that the general rule would require farm and some other property to be valued at its HBU "even though the valuation cannot be justified because of the lack of profitability of the farm or small business").

[60] *Lucas v. United States*, 97 F.3d 1401 (11th Cir. 1996).

[61] S. Rep. No. 94-938, pt. 2, at 14-15 (July 20, 1976). *See also* JCT, "Summary of Statements Submitted to the Finance Committee on Tax Revision and Extension of Tax Reductions," JCS-21-76, at 46-47 (Apr. 30, 1976); H.R. Rep. No. 95-1515, at 609-610 (Sept. 13, 1976); and JCT, "Summary of the Tax Reform Act of 1976," JCS-33-76, at 85-86 (Oct. 4, 1976).

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

> The Congress believed that when land is actually used for farming purposes or in other closely-held businesses (both before and after the decedent's death), it is inappropriate to value the land on the basis of its potential [HBU], especially since it is desirable to encourage the continued use of the property for farming and other small business purposes. *Valuation on the basis of [HBU], rather than actual use, may result in the imposition of substantially higher estate taxes*. In some cases, the greater estate tax burden makes continuation of farming, or the closely-held business activities, not feasible because the income potential from these [current] activities is insufficient to service extended payments or loans obtained to pay the [estate] tax. Thus, the heirs may be forced *to sell the land for development purposes*.[62] [Emphasis added.]

In summary, the legislative history indicates that (1) taxpayers must use FMV for estate tax purposes; (2) a critical factor in determining the FMV of real property is its HBU, regardless of the specific valuation method used; (3) the current use of property and the HBU of property are often two separate things, particularly when it comes to farmlands, woodlands, and scenic lands; (4) the HBU value of property can be significantly greater than its current-use value; and (5) if estates were obligated to value properties held by decedents at their HBU, the result might be values so high, and corresponding estate taxes so high, that the estates would be forced to sell the properties just to pay the taxes.

From a financial perspective, the IRS wants an elevated valuation of property to maximize its take. Cases abound in which the IRS, seeking the largest possible amount of estate taxes, has stringently argued that section 2032A does not apply to some taxpayers, such that they must value property according to its HBU instead of its current use.[63] Yes, that is correct — in those cases the IRS is advancing the same position as donors in conservation easement cases.

Congress warned of the likelihood of significant valuation disparities. Time has validated that prediction. Courts have resolved many cases over the years that showcase drastic differences in valuation depending on reference to current use, HBU, or special use under section 2032A.[64]

H. More HBU in the Estate Tax Context

Generally, in determining the value of the gross estate of a decedent, all items of property are calculated using their FMV.[65] Although not expressly stated in the IRC or tax regulations, other sources establish that when valuing real property for estate tax purposes, one must first determine its HBU.[66] As explained earlier, Congress recognized several decades ago that forcing estates to value land of a decedent using its HBU would trigger large estate tax bills and unwanted sales of land for the sole purpose of covering those bills. Therefore, Congress enacted not only section 2032A in 1976, but also section 2031(c) in 1997.

Section 2031(c) allows an executor to elect to exclude from a decedent's gross estate up to 40 percent of the value of specified land restricted by a conservation easement.[67] The land favored by

[62] JCS-33-76, *supra* note 61, at 537.

[63] *See, e.g.*, *Estate of Hankins v. Commissioner*, T.C. Memo. 1981-326 (agreeing with the IRS that absent a special use valuation election under section 2032A, the HBU "of the property is the method to be employed, not merely the actual use of the property to be valued"); and *Lucas*, 97 F.3d 1401 (agreeing with the IRS that if the estate's election for special use valuation under section 2032A did not substantially comply with the regulations, the land should be valued at its HBU for estate tax purposes).

[64] *See, e.g.*, *Estate of Gibbs v. United States*, 161 F.3d 242 (3d Cir. 1998) (holding that the HBU of the relevant property was development, its HBU value was $988,000, its special use value as a farm was $349,770, and the executor's election under section 2032A to apply the special use value resulted in an estate tax savings of $218,328); *Williamson v. Commissioner*, 974 F.2d 1525 (9th Cir. 1992) (explaining that using the special use value under section 2032A instead of the HBU decreased the value of the property from $225,248 to $94,210 for estate tax purposes); *LeFever v. Commissioner*, 103 T.C. 525 (1994) (addressing property whose HBU value was $712,000 and whose special use value under section 2032A was just $126,921); *Estate of Cowser v. Commissioner*, 80 T.C. 783 (1983) (involving farm property with an HBU value of $300,000 and a special use value of $62,500).

[65] Section 2031(a) and reg. section 20.2031-1(b).

[66] Brenda J. Brown, "Land Preservation Provides Estate Tax Benefits: Section 2031(c)," 17 *UCLA J. Envtl. L. & Pol'y* 117, 120 (1998-1999).

[67] Section 2031(c).

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

this exclusion must (1) be located in the United States, (2) owned by the decedent or a member of the family for at least three years before the death, and (3) been subject to a conservation easement by the decedent, a member of the family, the executor of the estate, or the trustee of a trust that holds the land.[68]

Why would Congress allow an estate to significantly decrease the estate taxes on conserved land, even after the decedent previously benefited from a reduction in income taxes upon donating the conservation easement?[69] The legislative history couches it in terms of safeguarding land from development and protecting family-owned land. That congressional reasoning is based on the foundation that land, when considered through the lens of HBU, can produce a substantial value. Reports regarding section 2031(a) state the following:

> The Congress believed that a reduction in estate taxes for land subject to a qualified conservation easement *would ease existing pressures to develop or sell off open spaces in order to raise funds to pay estate taxes*, and would thereby help to preserve environmentally significant land.[70] [Emphasis added.]

I. Even Opponents Acknowledge HBU

There are many critics of so-called syndicated conservation easements in general, and of the valuation techniques used with those easements in particular. However, even those detractors acknowledge the consistent support of section 170(h) by Congress, the content of the valuation regulations issued by the IRS, and the appraisal methods accepted by valuation organizations, government agencies, and courts.[71]

They recognize, for instance, that (1) it is often necessary to use the before-and-after method to value conservation easement donations; (2) the first step in that method is to identify the HBU of the property, both before and after the donation; (3) once the HBU is known, an appraiser generally uses the sales comparison approach, income approach, or cost approach to determine value; and (4) given the unique nature of conservation easements, only the income approach is feasible in many situations.[72]

Opponents of syndicated easements also concede that one variant of the income approach, the subdivision-development analysis, effectively requires appraisers to start with the value of property in a developed state and then work backward to identify the value for purposes of section 170(h).[73] They have described the development analysis in the following manner:

> Appraisers will occasionally use what is known as the "development method" or "build-out" method to determine the [HBU] value of property before the easement is in place. . . . *Essentially, the method determines what the value of the property would be if it were fully developed into residential lots, rather than its actual state*.[74] [Emphasis added.]

Opponents of syndicated conservation easement donations also recognize the need to consider hypotheticals in determining value. Lest there be any doubt, a recent tax guide published by the largest overarching land protection organization explained the following:

> An appraiser must explicitly state any assumptions or hypothetical conditions that support a finding of [HBU] in an appraisal. For example, in using the before-and-after method of easement valuation, if a conservation easement is in place at the time of the appraisal of the easement, *the appraiser must assume a hypothetical condition* (that is, the property as though unrestricted by the easement) to determine the value of the property before the easement. Another example would be

[68] Section 2031(c)(8)(A).

[69] *See* LTR 200143011.

[70] S. Rep. No. 105-33, at 46 (June 20, 1997); and JCT, "General Explanation of Tax Legislation Enacted in 1997," JCS-23-97, at 79 (Dec. 17, 1997).

[71] McLaughlin, "Conservation Easements and the Valuation Conundrum," 19 *Fla. Tax Rev*. 225 (2016).

[72] *Id*. at 231-247; C. Timothy Lindstrom, "Income Tax Aspects of Conservation Easements," 5 *Wyo. L. Rev*. 1, 38-40 (2005).

[73] McLaughlin, *supra* note 27, at 83-84.

[74] Lindstrom, "A Guide to the Tax Aspects of Conservation Easement Contributions," 7 *Wyo. L. Rev*. 441, 500 (2007).

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

> an assumption that the property containing a wetland would receive a wetland permit for development. Assumptions and hypothetical conditions weaken an appraisal. However, if properly justified, they can be and often are included. *In a before-and-after easement appraisal, a hypothetical condition is inescapable* because the property cannot be both restricted and unrestricted by the easement at the time of the appraisal.[75] [Emphasis added.]

VII. Conclusion

The IRS continues to beat the valuation drum in its attempts to rally public and congressional support for eliminating what it calls syndicated conservation easement donations. Contrary to its war cry, though, the IRS has focused most of its efforts on alleged technical flaws, trying to exploit relatively minor defects with deeds, baseline reports, qualified appraisals, Forms 8283, or other documents linked to the charitable donations. Notably, even in cases like *Green Valley Investors*, in which the IRS appears on the surface to be battling valuation, a closer look reveals that the IRS essentially is using the same old playbook: It is challenging qualified appraisal status not to determine valuation, but rather to avoid determining it.

This report is not intended as a comprehensive treatment of the complicated tax, legal, and valuation issues associated with conservation easement donations. Indeed, entire books, training manuals, and other major publications are devoted exclusively to those topics. This report has a more modest goal. It is meant to highlight that in its zeal to stigmatize the before-and-after method, consideration of HBU, and the income approach to valuation, the IRS has overlooked long-standing acceptance of these concepts in the tax regulations, audit techniques guide, administrative rulings, standards of respected appraisal organizations, income tax cases, estate tax cases, legislative history, scholarly articles, and elsewhere. One hopes that the courts do not overlook these critical sources, too. ■

[75] Lindstrom, *A Tax Guide to Conservation Easements* 214 (2016).

taxnotes®

Federal | State | International

Want to be renowned in the tax community?
Write for Tax Notes.

If you do, you will:

- Receive exposure in the world's leading tax publication
- Join a network of the best and brightest minds in tax

taxnotes.com/acquisitions

Your byline here.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.