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In this article, Sheppard analyzes conservation easement donations and a recent case that he argues is good for taxpayers because the Tax Court and Eleventh Circuit supported a common valuation method that the IRS regularly opposes.

I. Introduction

For more than four decades, the IRS has consistently declared, before Congress and elsewhere, that the fundamental problem with some conservation easement donations is inflated valuations. The IRS has not focused on appraisal issues, though. Instead, in an effort to dispense with cases swiftly and skirt the thorny issue of worth, the IRS first unleashed an assault on what seems like every conceivable "technical" issue, every possible flaw in the long list of documents that taxpayers must submit to the IRS to claim a charitable deduction. Later, when obligated to address valuation, the IRS tried to deny the existence of concepts used by appraisers and accepted by courts for well over a century. The IRS had some initial success with this strategy, but things have started to change in favor of taxpayers.

After an overview of conservation easement donations, this article chronicles the diverse sources supporting the appraisal of property based on its highest and best use (HBU) and analyzes a recent case, *Glade Creek Partners*,[1] in which both the Tax Court and the relevant court of appeals indicate that the value of a conservation easement donation is determined by identifying the HBU of the property, using the before-and-after method, and applying a discounted cash flow analysis.[2]

II. Overview of Easement Donations

Taxpayers owning undeveloped real property have several choices. They might (1) hold the property for investment purposes, hoping it appreciates significantly over time; (2) determine how to maximize profitability from the property and do that right away, regardless of negative effects on the local environment, community, or economy; or (3) voluntarily restrict some future uses of the property so that it is protected forever for the benefit of everyone and everything. The third option, known as donating a "conservation easement," not only achieves environmental protection but could also trigger tax deductions for donors.[3]

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."[4] Common conservation purposes include preserving land for public recreation or education, safeguarding a relatively natural habitat for plants and animals,

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[1] *Glade Creek Partners LLC v. Commissioner*, T.C. Memo. 2020-148, *vacated by* No. 21-11251 (11th Cir. 2022).

[2] This article supplements an earlier one by the same author. *See* Hale E. Sheppard, "Valuation, Highest and Best Use, and Easements: New IRS Attacks," *Tax Notes Federal*, May 16, 2022, p. 1061.

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

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

maintaining open space for scenic public enjoyment, and using property in accordance with a government conservation policy.[5]

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 activities that can continue on the property even after the donation, without prejudicing the conservation purposes.[6]

The IRS will not allow the 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 (baseline report).[7]

Taxpayers generally can claim a deduction for a charitable contribution in the year in which it occurs.[8] If the contribution 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.[9] 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.[10]

In theory, the best evidence of the FMV of an easement would be the sale prices of other easements that are comparable in size, location, timing, and so forth. The IRS recognizes, though, that it is difficult, if not impossible, to find them.[11] Thus, appraisers normally *must* use the before-and-after method instead. The IRS has acknowledged this reality for at least half a century, as shown by a revenue ruling from 1973 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.[12] [Emphasis added.]

Using the before-and-after method means that taxpayers, relying on independent appraisers, must determine the HBU of the property and the corresponding FMV twice. First, appraisers calculate the FMV as if the property had been put to its HBU, which generates the "before" value. Second, appraisers identify 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 before and after values of the property, with specific adjustments, produces the amount of the donation.[13]

Claiming the tax deduction from an easement donation is surprisingly complicated. It involves a significant amount of actions and documents. A taxpayer ordinarily must obtain a qualified appraisal from a qualified appraiser; demonstrate that the land trust is a qualified organization; obtain an adequate 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 do much more.[14]

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

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

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

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

[9] *Id.*; reg. section 1.170A-1(c)(1).

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

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

[12] Rev. Rul. 73-339, 1973-2 C.B. 68 (1973).

[13] IRS, *supra* note 11, at 43.

[14] *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); section 170(f)(11); reg. section 1.170A-13; Notice 2006-96, 2006-2 C.B. 902; T.D. 9836.

III. Historical Sources Supporting HBU Valuation

As indicated earlier, HBU plays a critical role in valuation of real property interests, a reality against which the IRS often tries to rebel in the context of conservation easement disputes. The long list of sources below shows, however, that the notion of HBU has been widely supported for many decades.

A. Early Supreme Court Decision

Courts have recognized the use of HBU in valuing real property interests for many decades. For example, the Supreme Court held about a century and a half ago, in 1878, that a property's HBU is the most profitable use for which it is adaptable and needed, now or in the reasonably near future.[15] The Supreme Court added the following color:

> In determining the value of land appropriated for public purposes [*e.g.*, 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. . . . 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.[16]

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

[16] *Boom Co. v. Patterson*, 98 U.S. at 407-408.

B. 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:

> 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. . . . 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.[17]

C. 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 to enhance readability, contains the following guidance:

> 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.

[17] U.S. Senate Committee on Finance, Tax Treatment Extension Act of 1980. S. Rep. No. 96-1007, at 14-15 (June 12, 1980).

> 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.[18] [Emphasis added.]

The regulations provide additional guidance for when the appraiser uses the before-and-after method:

> 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].[19] [Emphasis added.]

The regulations contain a dozen examples, one of which specifically mentions residential home development as the appropriate HBU for a parcel.[20]

In summary, the general rule in the regulations is that a taxpayer donating a conservation easement should get a tax deduction equal to its FMV. When there is a "substantial record" of sales of comparable easements, the taxpayer should use the comparable-sales 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, taking into account the probability of the property being developed to its HBU.

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

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

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

D. Additional IRS Guidance

Congress changed the law in 2006, creating, among other things, a new meaning of the term "qualified appraisal."[21] The updated definition is an appraisal that is prepared by a qualified appraiser and meets the "generally accepted appraisal standards."[22]

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, which somewhat clarified the meaning of qualified appraisal. Notice 2006-96 explained that the IRS would deem an appraisal as having met "generally accepted appraisal standards" if, for example, the appraisal is consistent with the substance and principles of the Uniform Standards of Professional Appraisal Practice (USPAP).[23]

The IRS asked the public to comment on Notice 2006-96, and the agency described that input when it released proposed regulations in 2008.[24] Interestingly, the preamble to the proposed regulations explains that (1) an appraisal *must* address a property's HBU to meet USPAP standards, (2) Notice 2006-96 and the proposed regulations indicate that an appraisal must satisfy USPAP or similar standards to be considered a qualified appraisal, and (3) the obligation to analyze a property's HBU is so evident that it is unnecessary for the IRS to explicitly state it:

> *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*

[21] Pension Protection Act of 2006 (P.L. 109-280), section 1219.

[22] Section 170(f)(11)(E)(i); 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).

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

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

does not include a development of [HBU] when required by USPAP is not consistent with the substance and principles of USPAP.[25] [Emphasis added.]

The final regulations 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.[26] Those three approaches, or variations thereof, constitute the widely accepted ways of valuing real property.[27]

E. Appraisal Standards Organizations

As explained above, USPAP provides that, when it is necessary for formulating a market value opinion, an appraiser must do several things. He must, for instance, develop an opinion on the HBU of the property and analyze the relevant legal, physical, and economic factors to support that HBU.[28] USPAP further identifies three permissible approaches for valuation: the sales-comparison approach, income approach, and cost approach.[29] Also, 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.[30] USPAP also permits appraisers to rely on extraordinary assumptions or hypothetical conditions, as long as they state them clearly and conspicuously.[31]

Other respected organizations follow similar standards. For example, the International Valuation Standards Council (IVSC), which creates rules on a global basis, identifies HBU as an acceptable premise of value.[32] 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.[33] 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.[34] The IVSC also advises that the income approach "should be applied and afforded significant weight" when the income-producing ability of property is the critical element affecting value or when reasonable projections of the timing and amount of future income from the property are available and few, if any, comparable sales exist.[35]

The Uniform Appraisal Standards for Federal Land Acquisitions (yellow book) contains analogous parameters.[36] It explains that the appraiser's determination of 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.[37] 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.[38] Finally, the yellow book agrees that appraisers may use extraordinary assumptions and hypothetical conditions under some circumstances.[39]

F. Audit Technique Guide

The audit technique 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."[40]

[25] REG-140029-07, 73 F.R. 45911, preamble (Aug. 7, 2008).

[26] Reg. section 1.170A-17(a)(3)(i)(D); reg. section 1.170A-17(a)(3)(viii).

[27] Appraisal Institute, *The Dictionary of Real Estate Appraisal*, at 10 (2015).

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

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

[30] *Id.* at Standard 1-6, Standard 2-2(a)(x).

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

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

[33] *Id.* at 83.

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

[35] *Id.* at 36.

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

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

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

[39] *Id.* at 13.

[40] IRS, *supra* note 11, at 46 (emphasis added).

G. IRS Administrative Rulings

Several IRS rulings discuss the significance of HBU in valuing real property as well as the notable flexibility in 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 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.[41]

H. HBU in the Estate Tax Context

Estate tax cases have embraced 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 specific 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.[42] In other words, if the relevant criteria are met, some property can be valued at something other than its HBU for estate tax purposes.

Why did Congress enact this "special use valuation" in the context of estate taxes? The legislative history, featured below, explains that Congress didn't want to force estates to sell properties solely to cover large estate tax bill that would result from valuing properties according to their HBUs.[43] Below is a clear picture of what Congress was thinking in allowing estates, but not donors of conservation easements, to use something other than HBU valuation:

> 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*.[44]
>
> 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]*.[45]
>
> The committee believes that, when land is actually used for farming, woodlands, or

[41] ILM 201319010 (May 10, 2013).

[42] 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").

[43] *Lucas v. United States*, 97 F.3d 1401 (11th Cir. 1996), 78 AFTR 2d 96-6911, 96-6913.

[44] S. Rep. No. 94-938, Part II (July 20, 1976) (emphasis added); *see also* JCT and Congressional Research Service, "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); *see also* H.R. Rep. No. 95-1515, at 609-610 (Sept. 13, 1976); *see also* JCT, "Summary of the Tax Reform Act of 1976," JCS-31-76, at 85-86 (Oct. 1, 1976).

[45] S. Rep. No. 94-938, *supra* note 44 (emphasis added).

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*.[46]

In summary, the preceding 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 valuation method used, (3) the current use of property and the HBU of property are often two separate things, (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 a high 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, so that they must value property according to its HBU instead of its current use.[47] Yes, that is correct, in those cases the IRS advances the very same position as donors in conservation easement cases.

Congress warned of the likelihood of significant valuation disparities. Time has validated this prediction. Courts have resolved many cases over the years that showcase drastic differences in value depending on reference to current use, HBU, or special use under section 2032A.[48]

I. Even Opponents Acknowledge HBU

Critics of "syndicated" conservation easements, as well as the valuation techniques used with such easements, are numerous. 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.[49] They acknowledge, in particular, that (1) it is often necessary to use the before-and-after method to value conservation easement donations; (2) the first step in the method is to identify the HBU of the property; (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.[50]

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

[46] *Id.* (emphasis added).

[47] *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 v. United States*, 97 F.3d 1401 (11th Cir. 1996) (agreeing with the IRS that, if the election by the estate 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).

[48] *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 election by the executor 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 for estate tax purposes from $225,248 to $94,210); *LeFever v. Commissioner*, 103 T.C. 525 (1994) (addressing property with HBU value was $712,000 and special use value under section 2032A was just $126,921); *Estate of Cowser v. Commissioner*, 80 T.C. 783 (1983) (farm property with an HBU value of $300,000 and a special use value of $62,500); *Martin v. Commissioner*, 84 T.C. 620 (1985) (calculating that the estate taxes using HBU valuation were $95,088 while those taxes using special use valuation dropped to $11,473); and *Van Alen v. Commissioner*, T.C. Memo. 2013-235 (starting with an HBU value of $1.96 million for the property and ending with a special use value of $98,735).

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

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

section 170(h).[51] 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*.[52]

In addition to acknowledging the appropriateness of using the before-and-after method and integrating a property's HBU, opponents 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 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.[53] [Emphasis added.]

IV. Courts Uphold HBU and Discounted Cash Flow

A recent conservation easement dispute, *Glade Creek Partners*, has received little attention thus far. However, for the reasons examined below, this case, particularly the recent opinion by the Eleventh Circuit Court of Appeals, is critical when it comes to obligating the IRS to accept the notions of HBU and the discounted cash-flow analysis. The parties have faced off in two rounds already, with a third on the way.

A. Round 1 — Tax Court

1. Key facts.

In 2006 International Land Company (ILC) purchased about 2,000 acres in Tennessee for approximately $9 million through a seller-financed arrangement. In other words, ILC put down some cash and agreed to pay the remainder to the original owner of the property over time, with interest. ILC intended to create and sell lots in three phases to out-of-state buyers who wanted to build vacation homes. The phases were called Tract I, Tract II, and Tract III.

The property was undeveloped when ILC bought it, so ILC spent about $6 million in additional funds to complete various infrastructure projects and obtain the necessary permits and approvals. In 2007 ILC recorded the lots on Tract I, marketed them, and made some sales. ILC ran out of money in 2009, so marketing ceased and sales plummeted. It faced a depressed real estate market, slow sales, substantial debt, and considerable uncertainty. Some of its members wanted out.

Their departure occurred when Hawks Bluff Investment Group Inc. acquired the remaining unsold lots in Tract I, as well as all of Tract II and Tract III, in exchange for assuming ILC's liabilities. The debts largely consisted of the unpaid amount of the purchase price still owed to the original owner, along with the costs of building infrastructure. One of the three shareholders of Hawks Bluff was James Vincent, a

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

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

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

local real estate investor with government contacts who had provided services for the initial ILC project.

Because of troubles servicing the ongoing debt, one of the shareholders in Hawks Bluff departed. The remaining two shareholders obtained his shares in exchange for assuming his one-third of the debt. In 2011 Hawks Bluff entered into a mortgage modification agreement, which resulted in a decrease of the total amount owed to the original landowner. Even after the reduction, Hawks Bluff was still on the hook for about $3.3 million. Vincent was concerned that the other remaining shareholder would be unwilling or unable to continue paying his portion of the debt, particularly since Vincent had personally guaranteed some of the loans.

In his quest to find a financial solution, Vincent entertained various options, including selling the property to a developer, timbering, and donating a conservation easement. Vincent ultimately dismissed the first two possibilities because they would not protect the environment, they were inconsistent with the vision marketed to early purchasers of lots, and they would negatively affect development of the remaining lots, in which he still had a financial interest through Hawks Bluff. Vincent decided to pursue a conservation easement on Tract II and Tract III.

Vincent approached an experienced individual (the organizer), who understood that "the goal was to raise enough money to repay the Hawks Bluff debt and [he] designed the easement transaction with that goal in mind."[54]

The organizer formed two entities in connection with the proposed transaction, Glade Creek Partners LLC (PropCo) and Sequatchie Holdings LLC (InvesCo). According to the Tax Court, the organizer set the price of interests in InvesCo solely to gather enough money to cover the debts of Hawks Bluff and "did not consider" the property's FMV.[55] The organizer hired many professionals to complete the pre-donation actions, among them a brokerage firm, securities lawyer, tax lawyer, and two appraisers.

The basic idea was that (1) Hawks Bluff would contribute the property to PropCo in exchange for 98 percent of the interests in PropCo, (2) InvesCo would use a portion of the proceeds from its private offering to buy nearly all the interests in PropCo from Hawks Bluff, (3) Hawks Bluff would use the funds from InvesCo to satisfy its debts, and (4) if the partners in PropCo voted to donate a conservation easement instead of immediately developing the property or holding it for appreciation, nearly all the charitable deductions would be allocated to InvesCo, which, in turn, would pass them along to its individual partners.

The partners voted for the conservation easement option, after which PropCo donated an easement to a land trust and claimed a charitable deduction of just over $17.5 million on its Form 1065 for 2012. This amount was determined by a qualified appraiser, who "used a before and after valuation method, which valued the easement property unencumbered by the easement and used a hypothetical development similar to ILC's project (before value) and valued the property restricted by the easement (after value)."[56]

The IRS audited. It concluded, as it invariably does in cases involving so-called syndicated conservation easement transactions, that PropCo should get a charitable deduction of $0 and should pay the highest possible penalty, equal to 40 percent of the tax underpayment. PropCo disagreed with the IRS and filed a petition with the Tax Court to begin litigation.

2. First issue.

The Tax Court sided with the IRS on the first issue, holding that PropCo was entitled to a charitable deduction of $0 because the conservation easement was not "protected in perpetuity."

Here is what led to that conclusion. Taxpayers must donate conservation easements in perpetuity, but nothing really lasts forever. Mindful of this, the regulations explain that a post-donation change in conditions surrounding the relevant property can make it impossible or impractical to continue using it for conservation purposes at some future point.[57] This occurs, for

[54] *Glade Creek Partners*, T.C. Memo. 2020-148, at 9.

[55] *Id.*

[56] *Id.* at 11.

[57] Reg. section 1.170A-14(g)(6)(i).

instance, when the government approaches a taxpayer, like PropCo, years after it donates a conservation easement, and offers to purchase part of the protected land for purposes of installing a power line or constructing a road. If the taxpayer refuses, the government forces the sale through a process called condemnation. The government effectively takes the property but must pay for it. The question thus becomes, who gets the sales proceeds — the taxpayer, which still owns the property, the land trust, which holds the conservation easement on the property, or both in accordance with some formula? The regulations mandate use of a formula, which is far from clear.[58]

For purposes of this article, it is enough to understand that the regulations state that a conservation easement is a "property right," held by the land trust, that is worth at least the "proportionate value that the [conservation easement] at the time of the gift bears to the value of the property as a whole at that time."[59]

The deed filed by PropCo in *Glade Creek Partners* expressly stated that any increase in value of the property *after* the donation resulting from post-donation improvements, made and paid by PropCo, should be subtracted from the total value of the property before calculating the proportionate share of sales proceeds owed to the land trust.[60] The Tax Court determined that the formula violated the applicable regulations, triggering a deduction of $0 for PropCo.

3. Second issue.

The second issue ostensibly addresses penalties, but further reflection reveals that it is really about valuation. Readers might be asking themselves at this point why the Tax Court addressed valuation at all, when it had already decided that PropCo deserved a charitable deduction of $0. The answer is that the Tax Court was obligated to ascertain the value, despite its initial decision, to decide whether PropCo should be penalized.

a. Penalties asserted.

The IRS's primary penalty argument was that there was a "gross valuation misstatement," which would have occurred if the value of the conservation easement claimed by PropCo on its Form 1065 was 200 percent or more of the correct amount, as ultimately determined by the Tax Court. This makes more sense when one inserts some figures. PropCo claimed a deduction of about $17.5 million on its Form 1065. Therefore, if the Tax Court were to conclude that the conservation easement was really worth $8.75 million or less, a gross valuation misstatement would exist, and PropCo would suffer a hefty penalty equaling 40 percent of the tax underpayment.

The IRS further argued that if the case did not involve a "gross valuation misstatement," surely PropCo should suffer penalties for submitting a substantial valuation misstatement. This would apply when the value declared by PropCo on its Form 1065 was between 150 and 200 percent of the correct amount, as calculated by the Tax Court.

The opinion issued by the Tax Court in *Glade Creek Partners* exceeds 60 pages. Much of it is devoted to valuation methods, flaws, and disparities. It is unnecessary to do a deep dive, as they say, to make the relevant points in this article. Key aspects are as follows.

b. IRS expert.

At trial, the IRS presented an appraisal by, and testimony from, a local real estate appraiser with some 40 years of experience (government expert appraiser). He used a comparable-sales method, determined that the HBU of the property was rural residential, agricultural, and recreational, and calculated the before value at about $1.5 million. The Tax Court was unimpressed with the government expert appraiser, to put it lightly. It harshly criticized many aspects of his appraisal and characterized it as "unreliable," "not helpful," "of little relevance," and in some ways "clearly wrong" — and even went so far as to strike portions of the appraisal at trial.

Importantly, the Tax Court admonished the purported comparable sales selected by the government expert appraiser, emphasizing that

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[58] Reg. section 1.170A-14(g)(6)(i) and (ii); *see, e.g., Belk v. Commissioner*, 774 F.3d 221 (4th Cir. 2014), *aff'g* 140 T.C. 1 (2013); *PBBM-Rose Hill Ltd. v. Commissioner*, 900 F.3d 193 (5th Cir. 2018); *Carroll v. Commissioner*, 146 T.C. 196 (2016); *Coal Property Holdings LLC v. Commissioner*, 153 T.C. 126 (2019); and *Oakbrook Land Holdings LLC v. Commissioner*, 154 T.C. 180 (May 12, 2020).

[59] Reg. section 1.170A-14(g)(6)(ii).

[60] *Glade Creek Partners*, T.C. Memo. 2020-148, at 14-15.

they were dissimilar in many ways and that even if they were comparable, he "was not evaluating [them] for their development potential."

c. PropCo experts.

PropCo presented two experts at trial: a land-use professional (planning expert) and an appraiser (taxpayer expert appraiser). The planning expert prepared a market study of economic trends, housing demand, target market, regional attractions, and amenities. He concluded that the HBU of the property, before donation of a conservation easement, would be residential development. He envisioned a resort-style community featuring outdoor activities, which would appeal both to multi-generational families and to those seeking vacation homes.

The planning expert identified five types of lots on the property and calculated an average price for each using figures from seven "benchmark" residential communities already in existence. He put his ideas on paper, supplying "a Concept Plan for a hypothetical development similar to ILC's [original] project with slight alterations." He acknowledged that development would necessitate aggressive marketing, a significant upfront investment to build community amenities, and additional costs to construct a model home and several speculative homes ready for immediate purchase. The planning expert estimated that, even with all the effort and investment, it would take seven years to sell out the lots, and the number of annual sales (the absorption rate) during this period would follow a bell curve, with sales trailing off toward the end.

The taxpayer expert appraiser reviewed and largely incorporated the data from the planning expert. He agreed with the hypothetical development described in the concept plan, average lot prices, need to make upfront expenditures, and absorption rate. The taxpayer expert appraiser then incorporated additional development costs, including a 15 percent profit for the hypothetical developer that might buy the property. He also applied a so-called discount rate of 11.25 percent to account for the time value of money.

In short, to calculate the before value, the taxpayer expert appraiser "performed a discounted cash-flow analysis from the sale of lots in [the planning expert's] hypothetical development." After reducing the before value to consider the effect of the after value and enhancement to neighboring property, he estimated that the conservation easement was worth about $16.2 million. This was slightly lower than the $17.5 million originally claimed by PropCo on its Form 1065 for 2012.

d. Tax Court analysis.

The Tax Court began by providing foundational information about valuation in the context of conservation easements. It ultimately arrived at the following conclusion about the HBU of the property at issue in *Glade Creek Partners*:

> Residential development was physically and financially feasible on the easement date. In light of the improved real estate market [in 2012] and the significant infrastructure work and approvals previously granted, a hypothetical buyer would have reasonably purchased the property for the development of a vacation or residential community. Accordingly, we hold that residential development is the unencumbered property's [HBU].[61]

While the Tax Court accepted the HBU advanced by PropCo, a huge victory by itself, it indicated that the taxpayer expert appraiser overvalued the property for a few reasons. Specifically, the Tax Court believed that the planning expert, and by extension the taxpayer expert appraiser, had overestimated the average prices of the lots in the hypothetical development because several of the benchmark properties that they considered in fixing prices were superior in various ways. The Tax Court further explained that the taxpayer expert appraiser did not adequately account for the large degree of uncertainty and risk affiliated with any hypothetical residential development when he created his discounted cash flow analysis.

The Tax Court also explained that, although the taxpayer expert appraiser conducted sufficient due diligence to support his projected

[61] *Id.* at 34 (internal citations omitted).

development costs, he neglected to adjust for inflation over the seven-year absorption period. The Tax Court next criticized the taxpayer expert appraiser for omitting from his financial analysis the costs of building the model home and speculative homes. Finally, the Tax Court disapproved of the distinct manner in which the taxpayer expert appraiser applied the 15 percent profit margin for the hypothetical developer and the 11.25 percent discount rate.

The Tax Court held that based on the planning expert, the taxpayer expert appraiser, a concession by the IRS, and machinations of its own, the FMV of the conservation easement donated by PropCo was about $8.88 million. Because the deduction of $17.5 million claimed by PropCo on its Form 1065 for 2012 did *not* exceed the amount determined by the Tax Court by 200 percent or more, the "gross valuation misstatement" penalty did not apply. It was close, though, with the threshold being $8.75 million.

PropCo did not escape completely, however. The Tax Court held that the "substantial valuation misstatement" penalty applied for two reasons. First, the difference between the value claimed by PropCo on its Form 1065 and the correct value set by the Tax Court was between 150 percent and 200 percent. Second, PropCo, based on the actions or inactions of the organizer, lacked reasonable cause, failed to reasonably rely on the original appraisers, and did not conduct its own good-faith investigation into the value of the conservation easement.[62]

B. Round 2 — Eleventh Circuit

Unhappy about the Tax Court's decision that it was entitled to a charitable deduction of $0 and penalties applied, PropCo sought relief from the court of appeals.[63] Only the pertinent aspects of round two are evaluated below.

1. First issue.

Time was on PropCo's side. Things drastically changed after the Tax Court held that the deed filed by PropCo failed to protect the conservation easement in perpetuity, as required, because it did not comport with the regulation addressing how to divide sales proceeds in situations involving post-donation extinguishment actions. Specifically, the court of appeals held in another case, *Hewitt*,[64] that the IRS's interpretation of the regulation was arbitrary, capricious, and in violation of the Administrative Procedure Act.

Because it had later "invalidated the regulation on which the Tax Court relied in disallowing [PropCo's] charitable deduction," the court of appeals vacated that portion of the Tax Court's earlier judgment.[65] In other words, it held that the Tax Court cannot give PropCo a deduction of $0 based on supposed noncompliance with an invalid regulation. It thus returned *Glade Creek Partners* to the Tax Court with instructions to reconsider the case without giving credence to the IRS's argument about the deed. The court of appeals warned, though, that this would not be the proverbial slam-dunk for PropCo. It underscored that the IRS had raised "several other arguments" for giving PropCo a deduction of $0, all of which the Tax Court would need to analyze in round three of the dispute.

2. Second issue.

PropCo did not fare as well on the second issue. The court of appeals refused to alter the earlier decision by the Tax Court about the applicability of the substantial valuation misstatement penalty. A superficial review of the decision might lead one to conclude that it constitutes a negative outcome for partnerships that donate conservation easements, in general, and for PropCo in particular. Additional scrutiny shows that this is not the case. Indeed, a better interpretation of the recent opinion by the court of appeals is that it is an enormously positive development for all those donating easements. Why? Well, because it expressly supports, at the federal appellate level, the valuation method commonly used by taxpayers and consistently challenged by the IRS.

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[62] *Glade Creek Partners*, T.C. Memo. 2020-148, at 55-59.

[63] *Glade Creek Partners*, No. 21-11251; *see also* Kristen A. Parillo, "Appeals Court Vacates Denial of Easement Deduction," *Tax Notes Federal*, Aug. 29, 2022, p. 1505.

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

[65] *Glade Creek Partners*, No. 21-11251, at 6.

a. Summary of earlier Tax Court decision.

The court of appeals explained that the planning expert determined that the HBU was residential development and created a "hypothetical housing development" to illustrate it, and that the taxpayer expert appraiser applied a discounted cash-flow analysis to the planning expert's development to determine the before value of the property. It further noted that the Tax Court accepted the HBU identified by the planning expert and "largely agreed" with the valuation approach used by the taxpayer expert appraiser. The court of appeals summarized the steps taken by the latter, and fundamentally accepted by the Tax Court, as follows:

> As part of his analysis, [the taxpayer expert appraiser] projected the gross revenues from [the planning expert's] hypothetical housing development. He also projected expenses for the development's sales period, and he increased those expense amounts by 15 percent to account for the developer's profit. He then subtracted the increased projected expenses from the projected gross revenue, producing a projected net revenue. Finally, he discounted the projected net revenue by 11.25 percent to convert the future dollars to present day values.[66]

The biggest point of discord between the taxpayer expert appraiser and the Tax Court was the proper treatment of the profit for the theoretical developer and its effect on the discount rate. The taxpayer planning expert apparently used an industry practice for condominium developments instead of one for subdivisions with single-family homes. Finally, the court of appeals indicated that in determining the correct value and thus concluding that PropCo should suffer penalties, the Tax Court used the before-and-after valuation method, accepted the HBU of residential development, and applied its own discounted cash-flow rate.

b. Analysis by court of appeals.

Similar to the Tax Court before it, the court of appeals began with an overview of how to value conservation easements, the improbability or impossibility of using the comparable-sales approach, the need to use the before-and-after method, and the foundational character of the HBU of property. Then it explained that PropCo complained that the Tax Court erred in reaching the valuation of $8.88 million (which triggered the substantial valuation misstatement penalty) because it "*sua sponte* devised its own appraisal method." For all non-lawyers, as well as those lawyers who have long since forgotten the Latin phrases they were forced to learn in law school, this means that PropCo considered it improper for the Tax Court, without any urging from the parties, to invent and apply its own valuation method.

The court of appeals disagreed. In doing so, it emphasized that the taxpayer expert appraiser and the Tax Court "both used the before-and-after method, which is the standard method for determining the value of an easement like the one here." It also underscored that both used a discounted cash-flow analysis to calculate the before value of the property, which relies on a discount rate to reduce future dollars to present values. It then clarified that what PropCo characterized as a "legal" challenge to the valuation figured by the Tax Court was really a "factual" challenge to its computations.

PropCo cited a recent case involving works of art and the effect of fractional ownership interests on valuation, in which a different court of appeals, the Fifth Circuit, held that it was inappropriate for the Tax Court to adopt its own discount amount "without any supporting evidence."[67] The court of appeals explained that *Glade Creek Partners* was distinct because the Tax Court's decision found support from the entire trial record, including the report from the taxpayer expert appraiser, and the Tax Court applied the before-and-after method, which represents the standard method used for conservation easements.

[66] *Id.* at 9.

[67] *Id.* at 15 (referencing *Estate of Elkins v. Commissioner*, 767 F.3d 443 (5th Cir. 2014)).

V. Conclusion

The safe bet is that the IRS will proclaim victory in *Glade Creek Partners* and emphasize that the partnership will get a charitable deduction of no more than $8.88 million (when it originally claimed $17.5 million), must pay a substantial valuation misstatement penalty, and might ultimately confront a deduction of $0 if the Tax Court, on remand, accepts any of the alternative "technical" arguments raised by the IRS.

However, *Glade Creek Partners* is more accurately characterized as a significant triumph for all taxpayers making charitable contributions of real estate. That is because, in direct contradiction to the valuation theories invariably advanced by the IRS, both the Tax Court and the court of appeals held that the value of a conservation easement donation is calculated by identifying the HBU of the property, using the before-and-after method, and applying a discounted cash-flow analysis. ■