Conservation Oriented Real Estate 2019 Outlook

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Due to a niche transactional structure and unique set of suitability considerations, the conservation oriented real estate program clearly stands apart from other retail syndicated real estate investments, such as Delaware Statutory Trusts ("**DSTs**"), Real Estate Investment Trusts ("**REITs**"), and funds holding conventional types of real estate. Unlike the aforementioned programs, the conservation oriented real estate program, in concept, buys into a pass-through entity holding real estate that has both conservation value and commercial development potential. If structured properly, the investors, upon receiving information about the property, decide whether to develop it or conserve it. If conserved, and if conservation value and economic development truly co-exist, the investor can potentially reap the benefits of a federal charitable income tax deduction premised upon the value of the development rights sacrificed. **This assumes that property's highest and best use as commercial real estate, its development potential, and associated economics are bona fide and appropriately documented within a qualified appraisal**.

Historical Perspective

In March 2016, our firm wrote a law review article titled *Conservation Easements: The Federal Tax Rules and Special Considerations Applicable to Syndicated Transactions*. The article brought to light the methods and practices in which conservation easement transactions were being used within retail syndicated programs. Our decision in doing so was predicated upon a growing level of interest and/or curiosity among our financial service firm clients concerning structure, economics, and related tax consequences. While being skeptical of those sponsors and legal practitioners that believed their transactional structuring methods were supported by the legislative history of Internal Revenue Code ("**IRC**") Sect. 170(h), we also acknowledged the conceptual legitimacy of the program structure as long as a bona fide business plan and economic substance were in place.

Over the past few years, transactional activity within this segment of real estate has increased steadily, with the segment growing from perhaps two or three sponsors raising about $100 million annually to over a half dozen raising $250-300 million per year. Given the billions in capital raised in DSTs, REITs, and other conventional real estate pass throughs, the conservation oriented real estate program can hardly be thought of as a mainstream retail product. Notwithstanding, its place within the financial service industry has remained steadfast. Outside of the financial service arena, the levels of interest and associated capital raising activities are more significant, with possibly 40-50 syndicators offering close to 200 conservation-related programs. This has occurred despite the issuance of IRS Notice 2017-10, which made a conservation-oriented real estate program a listed transaction in cases where the claimed charitable deduction exceeds 250% of the taxpayer's invested capital.

The DOJ Compliant

In a second effort to curb the general utilization of conservation oriented real estate programs, the Department of Treasury ("**DOT**") has now partnered with its cousin, the Department of Justice ("**DOJ**"), in a frontal assault levied upon, among others, a prominent retail sponsor of such programs. On December 18, 2018, the U.S. Department of Justice filed a Complaint seeking an order to stop Nancy Zak, appraiser Claud Clark, EcoVest Capital, Inc. ("**EcoVest**"), Alan Solon, Robert McCullough, and Ralph Teal (collectively the "**Defendants**") from organizing and selling private placement programs that involve conservation easement transactions. The Complaint's allegations endeavor to call into question: (i) the marketing and promotion of the investment programs sponsored by Ms. Zak and EcoVest; (ii) the business viability of the programs; and (iii) the appraisal methods used by Mr. Clark in valuing program-related real estate. The Complaint's allegations also characterize the program platforms of Ms. Zak and EcoVest as schemes whereby income tax deductions were sold to investors.

The government's "sale of a tax deduction" theme within the Complaint is not that surprising nor are the allegations directed at Ms. Zak (In fact, we rejected Ms. Zak's sponsor firm, Forever Forests, in 2017 and our due diligence process has not uncovered any ownership link between Ms. Zak and EcoVest). In our article written in March 2016, we pointed out the need for economic substance within these programs and for these programs to be careful of (i) the quality of the real estate they purchased, and (ii) the viability of the development options presented to investors. We urged for the adoption of investor rights that are emblematic of what is provided in other forms of conventional real estate programs. We urged for sponsors to be mindful of the level of due diligence support for the development options. We likewise urged sponsors to be mindful of their marketing practices and to be fair and balanced when presenting the land use options in marketing and offering materials.

Parsing the allegations of the DOJ Compliant, and while we are in no way predicting the outcome of the litigation, the allegations against Ms. Zak appear troubling in view of the website materials cited within allegations 117-122. The DOJ's cited website excerpts suggest, in our opinion, and if true, that Ms. Zak's marketing, which was in no manner connected to EcoVest, was substantially focused upon the presentation of income tax benefits and selling of deductions as opposed to a balanced presentation of multiple land use options.

Note that in response to the DOJ's Compliant, EcoVest has issued a "**Press Release**" in which the DOJ's allegations are essentially characterized as meritless and as an attempt to litigate via press release sensationalism. An excerpt from the Press Release is provided below:

> "*Our business undertakes the most rigorous of processes to ensure that our investment programs and the appraisals of the value of conservation easements are valid. These appraisals are made by highly qualified appraisers which are then corroborated by secondary reviews from independent sources. We commission multiple third parties to perform independent due diligence and verify the validity of the independent, third-party appraisals and related work product.*
>
> *We rely upon major law firms to provide legal opinions on each of these programs before making any programs available for investment. Only after this rigorous*

review process do we move forward with making real estate offerings to investors—by engaging a FINRA-registered managing broker-dealer to distribute these offerings that give investors a choice to develop the real estate, hold it for appreciation, or to donate an easement on the real estate to a land trust for the benefit of the public in perpetuity. We have always been fully compliant with disclosure and reporting requirements of the IRS, the SEC and FINRA.

Our lawyers are prepared to vigorously defend this case. In the words of Benjamin Razi, a partner at Covington & Burling, who is representing EcoVest, "this is an over-reaching government lawsuit that should never have been filed. It is based on gross misrepresentations about the conduct of EcoVest and its principals. While the government has unfortunately chosen to try to litigate the case by press release, we look forward to presenting the real facts in Court."

Again, and while we cannot predict the ultimate outcome of this case, many of the DOJ's allegations directed at EcoVest appear incomplete and/or inaccurate. Based upon our due diligence findings, a few examples of the Complaint's questionable claims are, in our opinion, as follows:

- With respect to EcoVest, the deductions were subject to investor voting procedures whereby the investors could choose to develop or to conserve the program real estate. While the Complaint goes to great efforts to emphasize EcoVest's alleged tax benefit related statements through references to Mr. Clark's appraisals, the investor's voting right, which is a condition precedent to the realization of any deduction, is not mentioned within portions of the Complaint that discuss program structure.

- The Complaint states that Claud Clark, Appraiser, used "*predetermined*" highest and best use ("**HBU**") classifications and improperly used discounted cash flow methods of valuation. The Compliant however does not mention the zoning classifications of the properties supporting residential development, nor does it reference the marketing feasibility studies commissioned by EcoVest with respect to the properties. The Complaint also fails to mention engineering opinions, development plans, debt feasibility studies, and other data routinely commissioned by EcoVest and used by the appraisers, including Mr. Clark, to help support the asserted HBU stated in the appraisals. As the appropriateness of applied appraisal methods is an inherently subjective matter, the Tax Court is perhaps a more appropriate forum to ligate the appropriateness of appraisal methods and results of the same.

- A number of places in the Complaint hold Ms. Zak out as a former equity holder of EcoVest. Interestingly, Ms. Zak described her relationship with EcoVest as a consultant and selling representative as opposed to a part owner during our firm's due diligence in late 2015 (and no ownership intent was disclosed to us by Ms. Zak). While the government seeks to portray the Zak/EcoVest relationship as something dangerous in its nature, the reality of it seems very far from what is portrayed in the Complaint.

- The Complaint goes to great effort to explain how the Defendants used a partnership tax structure, and the Complaint alleges that it was fraudulent for the Defendants to hold the programs out as partnerships due to (i) the alleged selling of tax deductions, and (ii) lack

of business purpose and economic substance within the programs. These allegations however ignore many other critical facts:

(i) The programs were validly formed as pass through entities per state law;
(ii) Each investor was required to make a non-refundable capital investment at subscription, and a loss of the investment due to either development risk or tax audit risk was disclosed in the offering materials;
(iii) No guarantees of a return of investment capital were made in the offering materials;
(iv) Property use was dictated by a majority investor vote, which was binding upon all partners;
(v) Capital was allocated from offering proceeds to fund initial development activities or secondary investments; and
(vi) Marketing feasibility studies, engineering opinions, development yield plans, and other supporting data were routinely commissioned by EcoVest to help support the development options.

- The Compliant patronizes the IRS as a weary and exhausted agency that must allocate scarce resources to litigating its tax challenges. As is the case with any federal agency, however, the IRS should be expected, on its own efforts, to allocate its resources responsibly to promote the public's interests.

- The Complaint takes issue with the fact that that 29 EcoVest sponsored programs were offered after Notice 2017-10 was issued. Notwithstanding the disclosure obligations imposed upon the investors and advisors engaged in such offerings, such transactions are not unlawful to engage in.

Where to Go from Here

Based upon an informal inquiry, a number of sponsor companies have expressed their intentions to offer conservation real estate programs in 2019. The predominate development option of the companies responding to our inquiry involves natural resource surface mining, with one of the sponsors also having offered development options involving residential related developments. Sentiments among companies marketing such programs have been mixed.

As we stated from the beginning, the economic viability of the real estate acquired within the programs and the development options presented is of paramount importance. Of equal importance is the manner in which the property use options are presented for consideration. To the credit of some sponsors whose programs we reviewed in 2018, the quality of the properties and development options continue to show improvement. Certain developments within these programs would include the following:

- Procurements of financing commitments from banks;
- Natural resource assets being located adjacent to properties being surfaced mined;
- Sponsors establishing mining operating companies;
- More capital expenditure allocations to the mining plan and/or secondary investments; and
- Marketing materials presenting a more balanced presentation of all property use options.

Despite these developments, there are lingering issues that may challenge the conservation real estate program concept in the future. These circumstances involve the following:

- Minimal business purpose observed from programs offered outside of the broker-dealer channel due to sketchy development plans and/or limited investor rights and which may increase negative scrutiny from the government and the media (e.g., put/call options, unreasonable reversions/flips incorporated into distribution provisions, and lack of investor voting rights on matters of a fundamental nature such as manager removal);
- The Land Trust Alliance and possibly federal government actors working in concert to preserve the use of the conservation easement tax strategy as a tool for ultra-wealthy individuals while throwing all conservation-oriented real estate programs "under the bus" regardless of their character and substance; and
- The lack of programs available whose income tax deductions fall materially below the listing notice threshold.

Conceptually and legally, it is not unlawful to structure an investment in a partnership that holds property that has both conservation value and economic development potential and whereby its investors may use conservation to achieve economic and altruistic objectives. Unlike low income housing, solar energy, and oil and gas, wherein investments within economically challenged assets are encouraged by statute through tax credits, there is no direct legislative support for the notion that Congress wants to support land preservation through tax incentivized <u>investments</u>. As such, but while acknowledging the general good that conservation easements provide the public in their ability to preserve tens of millions of acres from harmful commercial exploitation, we must find solutions consistent with the government's notion of legitimacy if conservation and program investing are to co-exist.

In summary, and to reiterate what we said in March 2016, we believe that there is a genuine opportunity for real estate programs that utilize conservation and legitimate development activities within the confines of a single fund. Such programs can serve legitimate business and investment purposes, while preserving conservation sensitive acreage for the public good. While some efforts are already being made to accomplish this through acreage carve outs and/or allocating small portions of a fund's capital to secondary investments, we would encourage more capital invested in legitimate commercial related assets/projects within these programs. Additionally, and while we believe it is conceptually appropriate to permit investor groups to either develop or preserve properties situated within their programs, we need to hold the development options in these programs to a standard of one that can legitimately be adopted by reasonable accredited investors from a due diligence perspective. These initiatives we believe could have the effect of bringing more conservation-oriented programs to market that fall outside the confines of IRS Notice 2017-10.