

CONSERVATION EASEMENTS: THE FEDERAL TAX RULES AND SPECIAL CONSIDERATIONS APPLICABLE TO SYNDICATED TRANSACTIONS

BRADFORD UPDIKE, JD, LL.M. AND BRYAN MICK, JD, MBA

Conservation easements are a fairly recent approach to land conservation. As government acquisitions and regulatory restrictions on land use have become prohibitively invasive, costly, and ineffective, governments, such as the United States, have looked to conservation easements as a potentially effective and less expensive conservation method than government ownership and regulation. The "use of conservation easements began to gain steam by the 1980s, and by the 1990s, exploded on the scene."¹ Today, several million acres of conservation-sensitive land have been protected with such easements.² Coincidentally, the income tax benefits associated with these easements have included several billion dollars in federal income tax deductions.³

While the vast majority of conservation easement transactions involve private landowners, a cottage sub-industry evolved within the financial services market over the past decade that involves companies that syndicate real estate investment opportunities to retail investors that utilize conservation as a possible program investment purpose.⁴ These securities offerings are premised on a real estate investment transaction that involves the acquisition by an investor group of an interest in environmental sensitive real estate that is also developable or marketable as commercial real estate. This transaction is further supported with, in many cases, significant federal income tax deductions that apply to conservation easements and that may be allocated to the investor partners if a conservation purpose is ultimately adopted by the partners.

1. Dana J. Gattuso, *Conservation Easements: The Good, Bad, and the Ugly*, NATIONAL POLICY ANALYSIS (May 2008), <http://www.nationalcenter.org/NPA569.html>.

2. See NATIONAL CONSERVATION EASEMENT DATABASE, <http://conservationeasement.us> (last visited Sept. 24, 2015) (reporting 23,349,840 acres of land held in 114,216 easements across the U.S.).

3. See Kate Deal, *Incentivizing Conservation: Restructuring the Tax Preferred Easement Acceptance Process to Maximize Overall Conservation Value*, 101 GEO. L. J. 1587, 1589 (2013) (reporting more than \$11 billion of easement tax deductions from 2003-2009 and \$1-2 billion of deductions claimed annually by taxpayers in such years).

4. See generally *Bosque Canyon Ranch, L.P. v. C.I.R.*, T.C.M. (RIA) 2015-130 (T.C. 2015) (involving two syndicated partnerships whose interests were sold to investors from 2004-2007).

This Article is presented in an effort to provide readers with an overview of the basic federal tax rules that apply to conservation easements, and to alert readers of special tax considerations that apply in cases where a conservation easement is contemplated within the context of syndicated partnerships or limited liability companies (sometimes referred to as “programs” or “investment programs”). While we believe conservation easements established as a component of a real estate and investment program can conceptually work for investors if structured with due care, the phrase *caveat emptor* is especially meaningful in regard to these investment programs given that certain of these programs have fallen short of meaningful economic substance or have presented issues relating to valuation or conservation purpose. The consequences of having too many transactions that fall within such parameters include (i) a potential audit nightmare for the investors that placed their capital in the programs, and more importantly (ii) the de-legitimization of a well-intended code provision aimed at protecting valuable natural resources through well-intended income tax benefits.

While we have written this Article to provide some foundational federal income tax-related information for individuals who may want to use conservation easements for income tax planning reasons, we would alert your attention, in particular, to our discussion of the following: the partnership “anti-abuse” regulations of the Internal Revenue Code (“Code”); supporting case law doctrines that discuss economic substance; and how these tax law authorities can affect the suitability and viability of investment programs where a conservation easement is contemplated as a part of the program’s purposes.⁵ As a note to those that are evaluating these transactions on behalf of securities firms, Regulatory Notice 10-22 promulgated by Financial Industry Regulatory Authority, Inc. (“FINRA”) requires its member broker-dealers to conduct reasonable investigations that relate to the viability of an issuer’s business and assets in general.⁶ This requirement is a part of the reasonable-basis due diligence that must be conducted by a financial service firm to determine whether an investment product is suitable for any investor.⁷ Given that the viability of substantially all private placements would, in the eyes of investors, hinge upon the

5. Treas. Reg. § 1.701-2 (amended 1995); *see also* Historic Boardwalk Hall, LLC v. C.I.R., 694 F.3d 425, 455-59 (3d Cir. 2012) (applying an economic substance inquiry, the court believed that the taxpayer’s investment was more characteristic of a debt investment as opposed to a partnership equity investment).

6. FINRA Regulatory Notice 10-22, *Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings* (Apr. 2010), available at <https://www.finra.org/industry/notices/10-22>.

7. *Id.*

presence of a reasonable opportunity for the investment in question to achieve an economic benefit that exceeds the amount of the invested capital (which, in the context of an easement-related offering, may possibly hinge upon the ability for the investor to claim significant charitable tax deductions), we would urge certain readers to cautiously review Section VI of this Article in particular, which addresses the implications of the economic substance and anti-abuse provisions of partnership income tax law.⁸

I. WHAT IS A CONSERVATION EASEMENT?

An easement refers to a legal interest that one person has in the land of another, with the land subject to the rights of the interest holder referred to as the servient tenement, and with the easement itself being the dominant tenement.⁹ As applied to the preservation of lands, a conservation easement, which is a legal tool for conserving private land, is a written legal agreement between a landowner and a land trust or government agency that permanently limits uses of certain selected land in an effort to protect the land's conservation values.¹⁰ As is the case with other real estate instruments that convey ownership rights, conservation easements will (i) be drafted to legally identify the real estate whose use is so restricted, (ii) follow the acknowledgement requirements of the state where the property is located, and (iii) be filed within the real estate records of the county where the real estate is located to provide sufficient notice of the property use restrictions to the public.¹¹ Although these legal agreements significantly restrict the permitted uses of the subject property, these agreements can allow landowners to continue to own and use their land and to also sell or pass such land to heirs.¹² If properly drafted, these agreements can, in many cases, also provide the property owners with limited development rights within very carefully defined boundaries.¹³

The United States Congress determined years ago that it was in the country's best interest to preserve land of ecological or historic im-

8. See *infra* notes 132-216 and accompanying text.

9. *Easement*, BLACK'S LAW DICTIONARY (10th ed. 2014).

10. Deal, *supra* note 3.

11. See Treas. Reg. § 1.170A-14(g)(1) (as amended in 2009) (stating "[i]n the case of any donation under this section, any interest in the property retained by the donor must be subject to legally enforceable restrictions that will prevent uses of the retained interest inconsistent with the conservation purposes of the donation."). *Id.*

12. See Treas. Reg. § 1.170A-14(f) (providing examples of some retained land uses that do not violate the conservation purposes of an easement).

13. See, e.g., *Butler v. C.I.R.*, 103 T.C.M. (CCH) 1359 (T.C. 2012) (involving a case where the taxpayer retained the right to conduct agricultural and recreational activities and to also construct buildings on 12 lots of the property subject to the easement).

portance in a manner that protects conservation values identified by Congress as being important. To accomplish this, the Code provides significant federal income tax benefits to those who voluntarily restrict their property in a manner that preserves significant conservation values on their property in perpetuity. The federal income tax benefits provided by the Code for these restrictions are found in sections 170(a) and (h). The federal estate tax rules that apply to such easements are also found in sections 2031(c) and 2055(f) (as explained in Section VIII of this Article).¹⁴

As ninety-five percent of all endangered species of plants and wildlife are reported as living on privately-owned lands, the public policy that encourages private land owners to grant conservation easements to land trusts organized as federal tax exempt organizations and governmental agencies is well established.¹⁵ Historically, these easements have protected millions of acres of wildlife habitat and open space.¹⁶ The National Conservation Easement Database reports that 114,216 conservation easements cover 23.349 million acres of land in the U.S. (July 2015 data). According to the Land Trust Alliance, a nationwide association of land trusts in the 48 contiguous U.S. states, there are twice as many acres subject to conservation easements on private lands as compared with lands situated within National Parks.¹⁷ The vastness of land covered by such protective easements has also translated to several billion dollars in income tax savings to donors.¹⁸

II. CONSERVATION EASEMENT'S PURPOSES AND DRAFTING REQUIREMENTS

Conservation easements are restrictions placed on real property to protect its natural resource values or those of ecologically related properties. Easements are either voluntarily sold or donated by the landowner and constitute legally binding agreements that limit certain types of uses or development on the subject property in perpetuity.¹⁹ A central attribute of these easements is that their re-

14. See *infra* notes 247-258 and accompanying text.

15. A.M. Merenlender, et. al., *Land Trusts and Conservation Easements: Who is Conserving What for Whom?* 18 CONSERVATION BIOLOGY, Feb. 2004, at 66.

16. NATIONAL CONSERVATION EASEMENT DATABASE, <http://conservationeasement.us> (last visited Sept. 24, 2015).

17. Damon Arthur, *Conservation Easements and Land Trusts Growing Trend in North State*, REDDING, Sept. 27, 2012, <http://www.redding.com/news/conservation-easements-and-land-trusts-growing>.

18. Deal, *supra* note 3.

19. *Final Report Conservation Easement Working Group*, THE NATURE CONSERVANCY (April 29, 2004), <http://www.nature.org/about-us/private-lands-conservation/conservation-easements/easements-working-group-report.pdf>.

strictions and terms can sometimes be designed to fit the needs of the underlying fee owner and the easement holder so long as they retain a public purpose or intent.²⁰

Permitted Purposes. To be deductible, donated conservation easements must be legally binding and permanent restrictions on the use, modification, and development of conservation valued property such as parks, wetlands, farmland, forest land, scenic areas, historic land, or historic structures. Section 170(h) of the Code states that a qualified conservation contribution is “a contribution (i) of a qualified real property interest” (i.e., a restriction granted in perpetuity on the use which may be made of the real property), “(ii) to a qualified organization, (iii) exclusively for conservation purposes.”²¹ Qualified organizations that accept conservation easements (i.e., charitable organizations that are organized for conservation purposes and governmental units) must have a commitment to protect the conservation purposes of the donation and must have sufficient resources to enforce compliance with the terms of the easement agreement.²² Section 170(h)(4)(A) specifies the four deductible types of conservation easements:

- Preservation of land areas for outdoor recreation by, or the education of, the general public;
- Protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem;
- Preservation of open space (including farmland and forest land); or
- Preservation of a historically important land area or a certified historic structure.²³

The *preservation of land for outdoor recreational or educational use* requires that the general public be granted substantial and regular physical access to the preserved land.²⁴ Examples of such purpose are provided within the Treasury Regulations and include the preservation of (i) a water area for the use of the public for boating or fishing, or (ii) a nature or hiking trail for the use of the public.²⁵ Property that is not made available to the public for access and use must satisfy one of the other requirements.

20. Treas. Reg. § 1.170A-14(f).

21. I.R.C. § 170(h) (2014).

22. Treas. Reg. § 1.170A-14(c).

23. I.R.C. § 170(h)(4) (2006). A more specific explanation of the qualification criteria relating to all four conservation purposes is provided within section 1.170A-14(d) of the Treasury Regulations. Treas. Reg. § 1.170A-14(d).

24. Treas. Reg. § 1.170A-14(d)(2)(ii).

25. *Id.*

The *natural habitat or ecosystem* conservation purpose is satisfied if the conservation easement protects a "significant relatively natural habitat in which a fish, wildlife, or plant community, or similar ecosystem, normally lives[.]"²⁶ This conservation purpose may be satisfied and the deduction may be allowed if the subject habitat has been altered to some extent by human activity "if the fish, wildlife, or plants continue to exist there in a relatively natural state."²⁷ An ordinary tract of land where a common fish, animal or plant community, or similar ecosystem normally lives does not satisfy this conservation purpose; the conservation easement must protect a habitat that is *significant*.²⁸ Significant habitats and ecosystems include habitats for "rare, endangered, or threatened species of animals, fish, or plants[.]"²⁹ Alternatively, they can include "natural areas that represent high quality examples of a terrestrial or aquatic community[.]"³⁰ They can also include natural areas that "are included in, or which contribute to, the ecological viability of a local, state, or national park, nature preserve, wildlife refuge, wilderness area, or other similar conservation area."³¹

26. Treas. Reg. § 1.170A-14(d)(3)(i).

27. *Id.* For example, the preservation of a lake formed by a man-made dam or a salt pond formed by a man-made dike would meet the conservation purposes test if the lake or pond was a nature feeding area for a wildlife community that included rare, endangered, or threatened native species. *Id.*

28. Treas. Reg. § 1.170A-14(d)(3)(ii) (emphasis added).

29. *Id.* (emphasis added); see also INTERNATIONAL UNION FOR CONSERVATION OF NATURE, *The IUCN Red List of Threatened Species*, <http://www.iucnredlist.org/about/introduction>. The *IUCN Red List of Threatened Species* ("IUCN Red List") is the best known worldwide conservation status listing and ranking system. Species are classified by the IUCN Red List into nine groups set through criteria such as rate of decline, population size, area of geographic distribution, and degree of population and distribution fragmentation. Also included are species that are extinct. When discussing the IUCN Red List, the official term "threatened" is a grouping of three categories: critically endangered, endangered, and vulnerable. The nine groups are: (i) Extinct (EX, no known species remaining), (ii) Extinct in the Wild (EW, known only to survive in captivity, or as a naturalized population outside its historic range), (iii) Critically Endangered (CR, extremely high risk of extinction in the wild); (iv) Endangered (EN, high risk of extinction in the wild), (v) Vulnerable (VU, high risk of endangerment in the wild), (vi) Near Threatened (NT, likely to become endangered in the near future), (vii) Least Concern (LC, lowest risk that does not qualify for a higher risk category and are widespread and abundant), (viii) Data Deficient (DD, not enough data to make an assessment of its risk of extinction), and (ix) Not Evaluated (NE, has not yet been evaluated against the criteria). For due diligence purposes, it is important to consider these classifications when considering the findings of baseline documentation reports that are commissioned by easement donors to justify the conservation values of the properties subjected to easements.

30. Treas. Reg. § 1.170A-14(d)(3)(ii). A high quality example of a terrestrial community would include an island that is undeveloped or not intensely developed where the coastal ecosystem is relatively intact. *Id.*

31. *Id.*

The donation of a qualified real property interest to protect *open space* must be either created “for the scenic enjoyment of the general public,” or alternatively created “pursuant to a clearly delineated federal, state or local governmental conservation policy[.]”³² As such, the open space purpose provides two possible avenues of regulatory qualification so long as the easement also provides a significant level of benefit to the public.³³

The preservation of open space may be for the scenic enjoyment of the general public if the property’s future development would harm the scenic nature of a rural or urban area.³⁴ An example of such harm would include, by way of example, future development activities undertaken on the subject property that interfere with an unbroken view of a vast natural area viewable to the public from parks, roads, waterways, trails, historic structures, or land areas.³⁵ The variables that are considered when determining the extent of a property’s scenic enjoyment include:

1. The compatibility of the land use with other land in the vicinity [(e.g., the consistency of the visual appearance of the property to other property in the surrounding area)];
2. The degree of contrast and variety provided by the visual scene;
3. The openness of the land (which would be a more significant factor in an urban or densely populated setting or in a heavily wooded area);
4. Relief from urban closeness [(e.g., whether the scenic attributes of the property in the future are threatened by encroaching urban development)];
5. The harmonious variety of shapes and textures;
6. The degree to which the land use maintains the scale and character of the urban landscape to preserve open space, visual enjoyment, and sunlight for the surrounding area;
7. The consistency of the proposed scenic view with a methodical state scenic identification program, such as a state landscape inventory; and
8. The consistency of the proposed scenic view with a regional or local landscape inventory made pursuant to a sufficiently rigorous review process, especially if the donation is endorsed by an appropriate state or local governmental agency.³⁶

32. I.R.C. § 170(h)(4)(A)(iii) (2014) (emphasis added).

33. *Id.*

34. Treas. Reg. § 1.170A-14(d)(4)(ii)(A).

35. *Id.*

36. *Id.*

The scenic enjoyment of a property must be evaluated "by considering all pertinent facts germane to the contribution."³⁷ In considering the eight factors previously stated, "regional variations in topography, geology, biology, and cultural and economic conditions require flexibility in the application of [the analysis], but do not lessen the burden on the taxpayer to demonstrate the scenic characteristics of a donation"³⁸ A conservation easement of open space preserved for the scenic enjoyment of the general public does not require that the public be granted physical access to the property.³⁹ Although "the entire property need not be visible to the public, the public benefit from the donation may be insufficient to qualify if only a small portion of the property is visible to the public."⁴⁰

Where open space is to be protected "pursuant to a clearly delineated Federal, state, or local government policy," a broad declaration by a single official or legislative body that the land should generally be conserved is not sufficient.⁴¹ The donation must "further a specific identified conservation project" or policy.⁴² The "policy need *not* be a certification program that identifies specific lots or parcels" to be conserved, and the government need not fund the conservation program; but the stated policy must involve a significant stated *commitment* by the government to a conservation objective.⁴³ Some examples cited in the Treasury Regulations that would address a *clearly delineated* government policy include (i) preservation of lands in state or local areas identified in statutes or ordinances as being *significant* to an area, (ii) the preservation of farmlands pursuant to a state flood program, or (iii) "the protection of the scenic, ecological, or historical character of land contiguous to, or an integral part of, the surroundings of [established] recreation and conservation sites."⁴⁴

A conservation purpose based on the preservation of open space, whether for scenic enjoyment or pursuant to a governmental conservation policy, "must yield a significant *public benefit*."⁴⁵ With respect to the open space purpose, a determination of whether a conservation easement provides a significant public benefit must be made based on all facts.⁴⁶ On this point, the Treasury Regulations list a number of factors that may be considered:

37. *Id.*

38. *Id.*

39. Treas. Reg. § 1.170A-14(d)(4)(ii)(B).

40. *Id.*

41. Treas. Reg. § 1.170A-14(d)(4)(iii)(A).

42. *Id.*

43. *Id.*

44. *Id.*

45. Treas. Reg. § 1.170A-14(d)(4)(iv)(A) (emphasis added).

46. *Id.*

1. “[U]niqueness of the property to the area;”
2. “[I]ntensity of land development in the” area;
3. “[C]onsistency of the proposed open space use with public” and private conservation programs;
4. Likelihood the property would be developed in the absence of the easement;
5. Opportunity of the public to appreciate the property’s scenic values;
6. Importance of the property to preservation, tourism, or commerce;
7. Likelihood of the donee acquiring substitute property;
8. Cost of “enforcing the terms of the conservation restriction[s];”
9. “[P]opulation density in the area;” and the
10. Consistency of “open space use with a legislatively mandated program identifying particular parcels of land for future protection.”⁴⁷

Again, “[t]he preservation of an ordinary tract of land,” by itself, would not normally provide a significant public benefit, “but the preservation of ordinary land areas in conjunction with other factors that demonstrate [a] public benefit or the preservation of a unique land area for public employment may yield” such a benefit.⁴⁸ To illustrate, “[t]he preservation of a vacant downtown lot would not, by itself, yield a significant public benefit; but the preservation of the downtown lot as a public garden would, absent countervailing factors, yield” such a benefit.⁴⁹ Other examples of contributions cited within the Treasury Regulations that may, “absent countervailing factors, yield a significant public benefit” include:

- The preservation of farmland pursuant to a state program for flood prevention and control;
- The preservation of a unique natural land formation for the enjoyment of the general public;
- The preservation of woodlands along a public highway pursuant to a government program to preserve the appearance of the area so as to maintain the scenic view from the highway;
- The preservation of a stretch of undeveloped property located between a public highway and the ocean in order to maintain the scenic ocean view from the highway.⁵⁰

47. *Id.*

48. Treas. Reg. § 1.170A-14(d)(4)(iv)(B).

49. *Id.*

50. *Id.*

The fourth conservation purpose involves conservation easements that are intended to preserve a "historically important land area" or a "certified historic structure."⁵¹ While the preservation restrictions to preserve a building or land area may allow future development on the protected site, "a deduction will be allowed . . . only if the terms of the restrictions require that such development conform with appropriate local, state, or federal standards for construction or rehabilitation within the [historic] district."⁵²

The term historically important land area includes:

- An independently significant land area including any related historic resources (for example, an archaeological site or a Civil War battlefield with related monuments, bridges, cannons, or houses) that meets the National Register Criteria for Evaluation in 36 CFR 60.4 (Pub. L. 89-665, 80 Stat. 915);
- Any land area within a registered historic district, including any buildings on the land area that can reasonably be considered as contributing to the significance of the district; or
- Any land area (including related historic resources) adjacent to a property listed individually in the National Register of Historic Places (but not within a registered historic district) in a case where the physical or environmental features of the land area contribute to the historic or cultural integrity of the property.⁵³

A certified historic structure includes "any building, structure, or land area which is: (A) listed in the National Register, or (B) located in a registered historic district (as defined in § 48(g)(3)(B)) and is certified by the Secretary of the Interior . . . as being of historic significance to the district."⁵⁴ A structure, for purposes of the regulation, "means any structure, whether or not it is depreciable."⁵⁵ As such, easements on private residences may qualify if they satisfy all other requirements of the regulation. In addition, a structure would be considered to be a certified historic structure if it were certified either at the time the transfer was made or at the due date (including extensions) for filing the donor's return for the taxable year in which the contribution was made.⁵⁶

51. Treas. Reg. § 1.170A-14(d)(5)(i).

52. *Id.*

53. Treas. Reg. § 1.170A-14(d)(5)(ii).

54. Treas. Reg. § 1.170A-14(d)(5)(iii).

55. *Id.*

56. *Id.*

To qualify for a deduction under this conservation purpose, “some visual public access to the donated property is required.”⁵⁷ “In the case of [a] historically important land area, the entire property need not be visible to the public for a donation to qualify under this section.”⁵⁸ However, the deduction may be denied in cases where “only a small portion of the property is so visible.”⁵⁹ In cases where the subject property is not visible from a public way (e.g., the property view is obstructed by a structure or vegetation, the property is located too far from a regular public access route, or where interior characteristics and features of the structure are the subject of the easement), “the terms of the easement must be such that the general public is given the opportunity on a regular basis to view the characteristics and features of the property which are preserved by the easement to the extent consistent with the nature and condition of the property.”⁶⁰

Drafting Considerations. Conservation easements may be created, conveyed, and recorded as most other types of easements.⁶¹ For drafting purposes, the deed of conservation easement will describe the conservation purpose(s), the restrictions on use, and the permissible uses of the property. The deed will be recorded in the public record and must contain legally binding restrictions enforceable by the donee organization under state law.⁶² In respect to the typical conservation easement, the property owner must give up certain rights, but will retain ownership of the underlying property.⁶³ The extent and nature of the donee organization’s control depends on the terms of the conservation easement.⁶⁴ With respect to all conservation easements, however, the donee organization must be granted an interest in the encumbered property that runs with the land, which means that the land use restrictions protecting the conservation values of the underlying property are binding not only on the landowner who grants the easement, but also on all future owners of the property.⁶⁵

As stated previously, fee simple ownership and certain reserved rights will generally be retained by the donor of the easement. Depending upon the conservation purposes, rights such as ranching, farming, hunting, fishing, skeet shooting, timbering, and delineated residential use may be retained in the easement so long as those

57. Treas. Reg. § 1.170A-14(d)(5)(iv).

58. *Id.*

59. *Id.*

60. *Id.*

61. Timothy Lindstrom, *Income Tax Aspects of Conservation Easements*, 9 Wyo. L. Rev. 397, 404 (2009).

62. Treas. Reg. § 1.170A-14(g)(1).

63. Treas. Reg. § 1.170A-14(f).

64. *Id.*

65. Treas. Reg. § 1.170A-14(g)(1).

rights are consistent with the conservational purposes of the easement.⁶⁶ Notwithstanding, care must be taken within the drafting of the easement not to allow the donor to retain certain rights that are inconsistent with the easement's conservational purposes.⁶⁷ Examples of rights retained by a donor that could be construed as inconsistent with the purposes of the easement would include (i) the right to build homes, limited occupancy vacation and lodging structures, and recreational use structures on the property unless the locations of the sites are specifically delineated in the easement, (ii) the unrestricted use of recreational vehicles on the property that may interfere with wildlife and plant habitats (with uses of recreational vehicles on a property arguably being less regulated than hunting activities, which are regulated by various federal and state laws), and (iii) the use of insecticides on the property that harm protected wildlife or plants.⁶⁸

A deductible conservation easement must be made in perpetuity, permanently restricting the use of the property.⁶⁹ This means that the deed of easement must provide that the restriction (i) remain on the property forever, and (ii) be binding on current and future owners of the property.⁷⁰ An easement is not enforceable in perpetuity if it allows amendments to property being protected by the easement. Thus, reserved rights allowing a property owner and easement donee to modify the boundaries of residential or commercial building areas situated within a protected area violate the perpetuity requirement.⁷¹ An easement is not enforceable in perpetuity if it ends after a period of years, or if it can revert to the donor or another private party.⁷² However, if a remote future event (e.g., an earthquake or flood) could extinguish the easement, the donation would nevertheless be treated as in perpetuity.⁷³

The Treasury Regulations address cases whereby an easement is terminated or extinguished by judicial proceedings or eminent do-

66. See *Butler v. C.I.R.*, 103 T.C.M. (CCH) 1359, No. 1752-09, 2012 WL 913695, at *5 (T.C. Mar. 19, 2012) (providing an example of an easement where numerous property use rights were retained by the donor, including small scale farming, building home sites on a defined number of tracts, and a number of non-commercial recreation activities such as hunting, fishing, horseback riding, boating and hiking).

67. Treas. Reg. § 1.170A-14(e)(2).

68. See Treas. Reg. § 1.170A-14(f) (providing examples of reserved rights deemed by the Treasury Department as inconsistent with an easement's conservational purposes).

69. Treas. Reg. § 1.170A-14(b)(2); Treas. Reg. § 1.170A-14(g).

70. I.R.C. § 170(h)(2)(C) (2014); I.R.C. § 170(h)(5)(A)(2014); Treas. Reg. § 1.170A-14(b)(2).

71. *Bosque Canyon Ranch, L.P., v. C.I.R.*, T.C.M. (RIA) 2015-130, No. 1067-09, 2015 WL 4237654, at *4 (T.C. July 14, 2015).

72. Treas. Reg. § 1.170A-14(g)(1).

73. Treas. Reg. § 1.170A-14(g)(3).

main. In the event of a termination pursuant to a judicial determination and order, then upon any subsequent sale, exchange, or involuntary conversion of the conservation area, the easement must require the donee to be paid “a portion of the proceeds at least equal to the proportionate value that the easement at the time of the gift bears to the value” of the conservation area as a whole.⁷⁴ Any proceeds paid to the donee as a result of any sale, exchange or involuntary conversion of the property must also be used “in a manner consistent with the conservation purposes of the [easement].”⁷⁵ A mistake sometimes encountered in relation to this requirement relates to the failures of donors to obtain lender subordinations in cases where a property is encumbered by a mortgage.⁷⁶ In such cases, a lender mortgagee must unconditionally subordinate its interest to the easement in all events, including condemnations and insurance recoveries relating to casualty events, and such subordinations must be in place at the time the easement is granted.⁷⁷ Note that a donor’s failure to procure such subordinations *before* the easement is granted is fatal and will negate the tax deduction in its entirety.⁷⁸

Easements may provide for future assignments of the easement rights by the donee under certain conditions. If a donee of the easement can assign its rights to the property, then (i) the donee must require, as a condition of any transfer, that the conservation purposes for which the easement was intended to support be carried out, and (ii) subsequent transfers must be limited to organizations qualifying as a qualified donee at the time of such transfer.⁷⁹

According to a leading law firm within the conservation easement practice area, there is some controversy at this time as to whether

74. See Treas. Reg. § 1.170A-14(g)(6)(i) (stating that “[i]f a subsequent unexpected change in the conditions surrounding [a] property that is the subject of a donation . . . can make impossible or impractical the continued use of the property for conservation purposes, the conservation purpose can nonetheless be treated as protected in perpetuity if the restrictions are extinguished by judicial proceeding and all of the donee’s proceeds . . . from a subsequent sale or exchange of the property are used by the donee organization in a manner consistent with the conservation purposes of the original contribution”); see also Treas. Reg. § 1.170A-14(g)(6)(ii) (explaining that “when a change in conditions gives rise to the extinguishment of a perpetual conservation restriction . . ., the donee organization, on a subsequent sale, exchange, or involuntary conversion of the subject property, must be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction, unless state law provides that the donor is entitled to the full proceeds from the conversion without regard to the terms of the prior perpetual conservation restriction”).

75. Treas. Reg. § 1.170A-14(g)(6)(i).

76. Mitchell v. C.I.R., 138 T.C. 324, 332 (2012); Kaufman v. C.I.R., 136 T.C. 294, 307 (2011).

77. *Id.*

78. *Id.*

79. Treas. Reg. § 1.170A-14(c)(2).

amendment provisions within an easement document run afoul of the Code's perpetuity requirement.⁸⁰ This recent controversy appears to have arisen from certain arguments posed by the IRS contesting the legitimacy of an easement deduction in cases where the easement contains a provision allowing the parties to amend the easement provisions through mutual agreement.⁸¹ In view of the controversy, our firm has observed a recent drafting practice among some program sponsors to preclude amendment or modification provisions from the easements.⁸²

III. FEDERAL INCOME TAX DEDUCTIONS OF CONSERVATION EASEMENTS

In many cases, landowners that donate conservation easements can receive significant federal income tax benefits in the form of charitable deductions that are based upon the economic benefits given up as a result of the land use restrictions associated with the easement. For charitable contributions by individuals of property other than cash, the amount of the deduction a taxpayer may claim is subject to percentage limitations based on (i) the type of property donated, (ii) the type of qualified organization to which the gift is made, and (iii) the use of the property by the qualified organization. The amount of a contribution in property (including conservation easements) is the donated property's fair market value.⁸³ For most individuals, the amount of the charitable contribution deduction from the donation of a conservation easement to a qualified organization is limited to thirty percent of the individual's contribution base (i.e., adjusted gross income, computed without regard to any net operating loss carry-back), over the amount of all other allowable charitable contributions for that year, with a carryover period of five years.⁸⁴ In the absence of an action by Congress to extend the fifty percent contribution base limitation with a fifteen-year carry-forward into 2016, income tax deduc-

80. David Wooldridge and Gregory Rhodes, *Amendment Clause in Conservation Easement Kills Tax Deduction, Says IRS: LTA Protests*, SIROTE & PERMUTT, PC, Nov. 12, 2015, www.sirote.com/blog/conservation-easement/amendment-clause-in-conservation-easement-deed-kills-tax-deduction-says-irs-lta-protests.

81. *Id.*

82. *Id.* It would seem nonsensical to disallow a conservation easement deduction in cases where an amendment was consistent with Federal tax policy. Examples would seem to include and would not necessarily be limited to easement provisions that (i) allow future amendments removing rights previously reserved by the landowner, (ii) provide additional easement enforcement rights to the donee, (iii) add acreage to the protected area, or (iv) allow corrections of non-material drafting errors. Notwithstanding, the exclusion of amendment provisions may be a safer practice until this issue is ultimately resolved.

83. Treas. Reg. § 1.170A-1(c)(1).

84. I.R.C. § 170(b)(1)(C), (D) (2014).

tions for individuals will be limited to the thirty percent contribution base limit previously described.⁸⁵

For Subchapter C corporations, in general, the maximum amount allowable as a charitable contribution deduction for any taxable year is ten percent of the corporation's taxable income for that year, computed with certain adjustments described in section 170(b)(2)(C)-(D) of the Code. As the tax deductions of an S-corporation are passed through to its shareholders, the percentage limitations of the pass-through deductions would follow those that apply to individuals as explained above. In respect to Subchapter S corporations, the charitable deductions associated with conservation easements were historically limited to the shareholder's basis in its corporate shares prior to 2010. However, this rule was relaxed to a significant extent by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010,⁸⁶ which allows such charitable deductions to be used without regard to the shareholder's basis to an extent (based upon the part of the deduction that is attributable to the value of the conservation easement in excess of its basis).⁸⁷

The deduction for a charitable contribution of property generally is equal to the fair market value ("FMV") of the property, but in some cases, the deduction may be limited to the lesser of FMV or basis. In the case of tangible property, the deduction is limited to the lesser of FMV or basis if the use of the property transferred is unrelated to the charitable purpose of the qualified organization (e.g., a donation of a piece of art work to a conservation land trust).⁸⁸ If the property is ordinary income property or short-term capital gain property, the deduction generally is also limited to basis.⁸⁹ Property is ordinary income or short-term capital gain property if its sale at FMV on the date of contribution would result in ordinary income or short-term capital gain. An example of ordinary income property is real property (land

85. The liberalizations of the higher deduction limit expired at the end of 2009 pursuant to I.R.C. § 170(b)(1)(E)(vi), but was extended through Dec. 31, 2014. Tax Increase Prevention Act of 2014, Pub. L. No. 113-295, § 106(a), 128 Stat. 4010, 4013 (Dec. 19, 2014). In view of the extended law, taxpayers granting easements in 2014 were allowed to amend their tax returns to get the benefits of the higher 50% contribution base and longer carry-forward period.

86. Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, 124 Stat. 3296 (Dec. 17, 2010) (codified as amended in scattered sections of 19, 26, and 45 U.S.C.).

87. Pub. L. No. 111-312, H.R. 4853, 124 Stat. 3296 (Dec. 17, 2010); see also C. Timothy Lindstrom, *Developments in the Law Affecting Conservation Easements: Renewed Tax Benefits, Substantiation, Valuation, Stewardship Gifts Recent, Subordination, Trusts, and Sham Transactions*, 11 Wyo. L. Rev. 433 (2011) (providing a comprehensive explanation of the federal income tax rules that apply to conservation easements for individuals, corporations and trusts).

88. I.R.C. § 170(e)(1)(B)(i)(I) (2014).

89. I.R.C. § 170(e)(1)(A).

and anything built on it) held by a real estate dealer/developer, if the donated real property is primarily held for sale to customers in the ordinary course of trade or business. If the property is ordinary income property in the hands of the donor, then the deduction would be limited to basis. As the ability to maximize income tax deductions in partnership-structured real estate investment programs may depend upon the contributing partner's holding purpose (for reasons to be clarified in the following section of this Article),⁹⁰ a prudent practice from a program due diligence perspective would be to request and review a tax opinion issued by a law firm or accounting firm that opines to the income character of the property being held by the program under review.

A common example of property subject to ordinary income taxes is capital gain property (such as real estate held for investment) held for a year or less. In determining how much of a property's basis should be allocated to an easement, the amount of basis allocable to the conservation easement bears the same ratio to the total basis of the property as the FMV of the conservation easement bears to the FMV of the entire parcel. Examples of how the character of a property affects the easement deduction are provided below:

Example #1: Jefferson contributes a conservation easement on a parcel that he held for 11 months. The conservation easement is short-term capital gain property, and Jefferson's deduction is limited to the lesser of his basis in the easement or its fair market value.

Example #2: Mary paid \$80,000 for a parcel held for investment, which has a FMV of \$100,000. She decides to donate a conservation easement with a FMV of \$5,000. If Mary's parcel is held for less than one year, her deduction for the easement is limited to the basis, or \$4,000 ($\$5,000/\$100,000 \times \$80,000 = \$4,000$). However, if Mary held the property for more than a year, her deduction is the easement's FMV or \$5,000 (i.e., the FMV of the easement).

If property is long-term capital gain property, the deduction generally is not limited to basis and may be as much as FMV.⁹¹ Property is long-term capital gain property if its sale at FMV on the date of the contribution would result in long-term capital gain. Long-term capital gain property includes real estate held for more than a year for investment purposes or as a personal residence.

A taxpayer must itemize to claim a deduction for a conservation easement. A conservation easement deduction is reported on Schedule A, Line 17 ("other than by cash or check"), and any carryover of

90. See *infra* notes 99-100, 113 and accompanying text.

91. See I.R.C. § 170(e)(1) (2014).

charitable contributions originating from earlier tax years appears on Schedule A, Line 18 ("carryover from prior years"). Taxpayers must also satisfy numerous statutory provisions to claim a noncash charitable contribution deduction for the donation of a conservation easement. Some examples of deficiencies revealed in the government's examinations of conservation easements include (which have been extrapolated from the IRS' *Conservation Easement Audit Techniques Guide*):

- A failure to include supporting information with the tax return (e.g., a failure to include a Form 8283 and required accompanying statements, appraisal summary, or full qualified appraisal if required);⁹²
- A failure to procure a contemporaneous written acknowledgment from the donee in a timely manner (i.e., by the earlier of the tax return due date including allowed extensions or the filing date) or that complies with the requirements of the Treasury Regulations;
- Inadequate conservation value documentation being provided by the donor to the donee prior to the time of the donation or lack of sufficient conservation purpose (e.g., baseline report explaining a property's conservation values contains outdated property information⁹³ or is provided to the donee after the donation date, or the property in question is an ordinary tract of land that lacks significant habitats or fails to otherwise support a significant public conservation-related purpose);⁹⁴
- Lack of easement conveyance into perpetuity as evidenced by deeds allowing for a termination of the easement (with the ability to move the boundaries of retained building zones relative to protected areas being prohibited by the perpetuity rule);⁹⁵
- Reserved property rights are inconsistent with the claimed conservation purposes of the property (e.g., the easement allows

92. *Conservation Easement Audit Techniques*, INTERNAL REVENUE SERVICE (Jan. 3, 2012), <https://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Conservation-Easement-Audit-Techniques-Guide> (explaining that a full appraisal must accompany the federal income tax return in cases where the charitable deduction is more than \$500,000).

93. A baseline report is a document that includes maps, pictures, site visit inspection notes, and other information that describes the overall conservation value of the property that will be subject to an easement. This information is required to be finalized and certified by the donor property owner prior to the time of the easement.

94. See *Bosque Canyon Ranch, L.P. v. C.I.R.*, T.C.M. (RIA) 2015-130, No. 1067-09, 2015 WL 4237654, at *5-6 (T.C. July 14, 2015) (noting significant problems with the baseline report, including outdated maps and a site visit and inspection of the subject property undertaken several months after the easement was granted).

95. *Id.* at 4. In addition to the problems with the baseline report, the donor was able to move boundaries of building zones with approval of the land trust donee. *Id.*

the property to be used in a way that compromises the conservation values stated in the appraisal and baseline report);

- A failure to comply with the Treasury Regulation subordination rules in cases where the property has a mortgage;
- Uses of improper appraisal methodologies and overvalued conservation easements; and
- A failure within the appraisal to consider any increases of value within property held by the donor or a party related to the donor.

IV. SECURITIZED TRANSACTIONS

While a substantial majority of conservation easement transactions have historically been structured between private landowners and land trusts or governmental units, a trend has emerged within the financial services market whereby investment programs that provide opportunities for federal income tax benefits associated with conservation easements are presented to higher income investors.⁹⁶ Our firm understands through industry dealings that perhaps twenty-five to thirty companies are syndicating offerings on a regular basis to investors that involve the granting of conservation easements to land trust entities (also referred to as “program sponsors” or “sponsors”). Of the program sponsors we have reviewed, the investment programs of the sponsors involved roughly sixty syndicated partnerships and investments collectively of a low nine-figure amount (i.e., roughly \$300 million in subscriptions) over a five to six year period. According to a program sponsor that was recently interviewed by Mr. Updike, of the twenty-five to thirty sponsors that regularly offer such program opportunities, *only about a handful are probably raising capital through financial service firms that are regulated by the Financial Industry Regulatory Agency (“FINRA”).*⁹⁷

These investment programs are syndicated as private placements and are structured for state law purposes as limited liability companies. The pass-through tax structure of the investment programs helps to facilitate the ability of the programs to allocate significant charitable deductions to the investor partners. The equity of the enti-

96. *Conservation Easements*, Moore, Ingram, Johnson & Steele, LLP, http://www.mijs.com/practice_class/con_easements.html (suggesting the use of private placements involving conservation easements); see also *Do Conservation Easements Belong in Your Tax Strategy Arsenal?*, Habif, Argeti & Wynne LLP, <http://www.hawcpa.com/insights/articles/do-conservation-easements-belong-in-your-tax-strategy-arsenal->; CONSERVATION EASEMENT ADVISORS, LLC, <http://www.conservationeasementadvisors.com/> (last visited Oct. 15, 2015) (advertising firm’s role as a consultant to companies seeking assistance with conservation easement private placements).

97. Interview with Matthew Campbell, President of Evr-Green Management Group, Inc., in Rome, Ga. (Sept. 9, 2015).

ties is syndicated to investors that fall within the definition of an “accredited investor” under Rule 201(b) of Regulation D of the Securities Act of 1933. Accredited investors must possess \$1 million in net worth or \$200,000 of gross income (or \$300,000 of gross income if a husband’s and wife’s income is considered) to qualify as such under Regulation D. Non-liquid assets, such as homes, automobiles, and household furnishings are excluded from the assets considered for qualification. While the accredited investor standard generally provides the floor net worth and income suitability qualifications, so to speak, for such programs, most investors that participate in such programs will have significantly higher levels of net worth and income than the minimum requirements due to the nature of the investment (i.e., real estate), limited liquidity associated with the program interests acquired, and the audit risks.

In respect to many of these programs, the investors will contribute money to a limited liability company that has already acquired, or will in the future acquire, an interest in a pass-through entity holding land that contains commercial development potential *and* conservation value. In most cases, the land will be contributed to a property holding entity by an individual or entity that has held the property for investment purposes for a number of years and is seeking to monetize a majority of its interest in the land, while also retaining a minority equity interest in the holding company for possible future benefit. Once the property has been contributed to the holding entity, the holding entity will distribute all of its interests to the original land owner. At the investor level, the program entity will acquire a substantial majority (generally ninety to ninety-five percent) of the holding entity founder’s interest at a price negotiated by the property entity founder and the program sponsor. At this point, the program entity holds a substantial majority of the equity in the holding entity and coincidentally controls the use of the land. After the program acquires its interest in the holding entity, the investors of the program will generally be given a power by form of voting right to (i) hold the property for investment purposes (referred to as an “investment option”), (ii) develop the property commercially (referred to as a development option”), or (iii) grant a conservation easement to a qualified Code section 501(c)(3)⁹⁸ organization or trust formed for conservation support purposes (referred to as an “easement option”).

If the easement option is selected, the value of the charitable federal income tax deductions can be fairly significant for the program investors depending upon the highest and best use of the real estate and the value of the development or investment rights given up by the

98. I.R.C. § 501(c)(3) (2014).

program and its investors. Note that by structuring the investment program transaction as a contribution by the original owner to a property holding entity that is followed by a later acquisition of that land owner's interest in the property holding entity by the program entity, the property contributed to the property holding entity will get the benefit of the land owner's holding period and holding purpose by virtue of section 1223(2) of the Code, which allows for a partnership property contributor's holding period and holding purpose to be tacked to the partnership.⁹⁹

The "tacking" of the holding period and purpose enables the program entity and its investors to claim a conservation related income tax deduction derived from a property's fair market value (as opposed to being limited to the investment contribution basis) if the program were to effectuate an easement transaction quickly (as opposed to holding the property for more than a year). Based upon our personal knowledge of these transactions, the tacking of the holding period and holding purpose appear to be important elements of the program as easements are often, *in fact*, approved by the investors and granted within less than a year of the program offerings (with year-end tax planning being a possible motivation for some or perhaps many of the investments). As will be discussed in Section VI of this article, however, it is this feature of the program structure that could become jeopardized if a program's structure as a tax partnership is disregarded pursuant to a government attack in an audit (thereby possibly limiting the deduction to the investor's capital contribution in the absence of supportable economic substance).¹⁰⁰

While the granting of a conservation easement within the context of a privately syndicated partnership or limited liability company is not disallowed by the Code *per se*, the Internal Revenue Service ("IRS") has publicly warned that such transactions going forward will be closely scrutinized for technical rule compliance and possibly for economic substance issues at the partnership/company level.¹⁰¹ For this

99. I.R.C. § 1223(2) (2004).

100. See *infra* notes 132-216 and accompanying text.

101. See I.R.S. Notice 2004-41, 2004-1 C.B. 31 (stating an intent to review promotions of transactions involving improper deductions for conservation easements and to subject promoters, and other persons involved in these transactions, to penalties under I.R.C. §§ 6700, 6701, and 6694); see also *Partnerships Next Area of IRS Scrutiny for Conservation Easements*, BNA DAILY TAX REPORTS (Feb. 19, 2013), <http://www.bna.com/partnerships-next-area-n17179872418> (explaining the IRS's intent to focus upon abusive conservation easements in transactions involving partnerships); *Conservation Easement Audit Techniques*, INTERNAL REVENUE SERVICE (Jan. 3, 2012), <https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Conservation-Easement-Audit-Techniques-Guide> (citing the presence of partnership guarantees of economic benefits tied to a purported tax deduction as an audit concern of the IRS, while explaining the potential liability of promoters and selling representatives that are involved in the syn-

reason, a careful due diligence review of (i) the economic substance of the program in question, (ii) the issuer's compliance with the technical requirements of section 170(h) of the Code and its related Treasury Regulations, and (iii) the data supporting the conservation values of the subject property and appraised value of the property's highest and best use before and after the granting of the easement are important factors *that should be reviewed* for those who are required to evaluate and approve of these transactions on behalf of their financial service firms. A list of program documents that relate to syndicated investment programs that are prepared by sponsors in connection with many of these real estate investment programs includes (and is not necessarily limited to) the documents described below.¹⁰²

Private Placement Memorandum ("PPM"). The PPM is the disclosure document provided to investors that describes (i) the property, (ii) the formation and legal structure of the issuer program, (iii) transactional terms under which the program acquired its property rights, (iv) the possible future uses of the property, (v) the feasibility of future construction and development activities concerning the property, (vi) the terms under which the property may be subjected to a conservation easement, (vii) the process to be followed by investors in respect to determining how the property will be used in the future, and (viii) the investment risks associated with the possible investment options (i.e., including audit risks and the possible consequences of lost deductions if an easement transaction is successfully challenged by the government). This document should also explain to the investors the uses of their contributed funds and the allocation of those funds to offering costs, property acquisition costs, and other business expenses.

Issuer Program's Organizational Documents. These documents include: (i) a certificate issued by the state where the program is organized that evidences the program's formation; and (ii) an operating agreement or Limited Liability Company ("LLC") agreement explaining (a) the investor's voting rights, (b) investor's distribution privileges, and (c) rules pertaining to future allocations of income, gain, expenses, and losses among the investors and sponsor. Among the explained investor rights *should* be a description of the procedure whereby the investors may determine how the property is used in the

dication of abusive tax shelters involving fraud or gross valuation overstatements under I.R.C. §§ 6700 and 6701).

102. A number of offering documents mentioned are prepared in an effort by the sponsor to explain the business development potential associated with a property. These business purpose related documents include development agreements, development maps and plans, market feasibility studies, and pro formas. As will be explained in Section VI of this Article, and assuming further that the development is feasible in the area the property is located, the presence of these documents can help to establish a program's business purpose.

future. While mentioning that some organizational agreements we have reviewed give investors some rights to determine a property's use through a procedure whereby investors are given a *right of rejection* following a sponsor's use proposal (with the lack of a majority rejection serving as a negative consent in favor of the sponsor's proposal), we believe that the issuance by sponsors of neutral property use proposals followed by a vote by the investors to affirmatively approve one or more courses of action better serves the investors from a business substance perspective.

Property Entity Organizational Documents. As mentioned previously, the original property owner will contribute real estate to a property holding entity for the equity of the holding entity. Once capital is raised by the issuer program, the program will acquire a substantial majority of the holding entity's equity from the original property owners (i.e., who will retain a minority interest in the holding entity). At the property holding entity level, these documents should include a state-issued formation certificate, as well as an LLC agreement or operating agreement explaining (i) the rights of the investment program to control the use of the property in accordance with the voting procedure set forth within the program's organizational documents, (ii) distribution privileges among the investment program and the original property owner, and (iii) the rules pertaining to future allocations of income, gain, expenses, and losses among the program and original property owner.

Deed. Proof of property ownership should be evidenced within a deed explaining who holds title to the property. This document confirms the issuer/property entity's ownership of the real estate from which the investors hope to derive future economic benefits. Alternatively, and in cases where the property interest will transfer after capital is raised from investors, a deed may be used to confirm that the property entity founder owns the subject real estate and has the ability to contribute such property to the property entity.

Title Commitment. As a cautionary matter, the presence of pre-existing mortgages against a property can be fatal to the investor's tax deductions if the rights of a mortgagee are not subordinated to the legal rights of the easement donee.¹⁰³ The title commitment confirms whether a pre-existing mortgage needs to be dealt with through payoff or a subordination agreement. Note that a title commitment will also reveal whether prior owners of the property retained rights to develop the minerals of the real estate. In such cases, the legitimacy of the easement donation would depend upon the "remote probability" of developing such minerals through surface mining methods (i.e., with a

103. Treas. Reg. § 1.170A-14(g)(2).

remoteness in terms of future development probability required to justify a future deduction).¹⁰⁴

Draft Qualified Appraisal. A qualified appraisal is used to establish the economic value of the property and does this by considering the property's future commercial development potential. The qualified appraisal is also used to establish the value of the property before and after an easement is contributed to a qualified donee.¹⁰⁵ These values, in turn, are used to formulate the basis for the amount of the charitable deduction associated with the easement, which is the difference in the values just described. Once the deduction is established, each investor should be allocated a share of the deduction according to its equity percentage in the issuer.

Development Pro Forma. In many cases, the program sponsor will have undertaken its own assessment of the economic return potential of the property considering information provided within the qualified appraisal, market feasibility studies, and/or based upon the sponsor's own knowledge of the real estate market where the property is situated. The pro forma provides an overview in the sponsor's belief of the potential economic returns that investors might receive if the property were developed into condominiums, apartments, hotels, or other commercial building structures. An itemized estimate of the property's future revenues, costs, expenses, and cash flows on an annual basis over an estimated project period should be provided within this document.

Draft Baseline Report. The baseline report documents the conservation values of the property to be conserved, and describes the existing conditions of the property's features that are relevant to the conservation easement.¹⁰⁶ A baseline report is also a valuable guide that enables the easement donee to monitor the property and to ascertain compliance with the terms of the easement. The information provided within a baseline report includes an explanation: (i) of how the easement will address one or more of the conservation purposes described in the Code, and, if applicable, (ii) what federal, state, or local policies are being addressed as a result of the easement.¹⁰⁷ The baseline report and its documentation should also provide a detailed description of the property based upon photos, maps, and a recent site

104. I.R.C. § 170(h)(5)(B)(ii) (2014). In cases where a retained mineral interest, as revealed by the title commitment, is held by a prior property owner, it, in many cases, will be wise to require a program sponsor to furnish an opinion from a mineral valuation professional that discusses the geologic features of the property and the remoteness of future mineral development activities through surface mining. *Id.*

105. Treas. Reg. § 1.170A-14(h)(3)(ii).

106. Treas. Reg. § 1.170A-14(g)(5)(i).

107. *Id.*

visit inspection conducted by the donee.¹⁰⁸ Such property description may include an explanation of the property in terms of (i) its location and legal description, (ii) acreage size, (iii) watershed, (iv) topography, (v) climate, (vi) geophysical characteristics, (vii) soil, (viii) zoning, (ix) water rights, (x) land use, (xi) vegetation, and (xii) wildlife.¹⁰⁹ Through maps and written guidance, the baseline report should describe areas where the property may be accessed or viewed by the public, and should also describe the nature of any endangered or threatened species of wildlife or vegetation existing upon the property.

Phase I Environmental Study. In cases where a development plan is being comprehensively developed by the sponsor, this is a report that can be used to identify potential or existing environmental contamination liabilities. The analysis contained within the report typically addresses both the underlying land as well as physical improvements to the property. As the presence of contamination liabilities could impact the future development potential for a property, these studies may be procured to support the property's appraised values from a development feasibility perspective. Acknowledging that not all program sponsors go so far as to procure these reports, the reports can arguably be helpful in establishing that a development option is being considered in earnest.

Zoning Status. The zoning status of a property will often be explained within both the qualified appraisal and market feasibility report, and, in some cases, the baseline report.¹¹⁰ Additionally, building and construction engineers and outside legal counsel may be engaged by a program sponsor to provide written opinions concerning (i) the present zoning status of a property, or alternatively (ii) the feasibility of obtaining a change in zoning status from the local government to enable the property to be developed in the future.

Market Feasibility Report. In some cases, the program sponsor will procure a feasibility study from a real estate development consulting firm regarding the prospects for future economic success if the property were developed commercially.¹¹¹ These studies will generally describe, in the view of the consultant, the conditions under which the property's development would have better chances of future success in terms of building type, consumer options, unit pricing/amenities.

108. *Id.*

109. *See id.*

110. Treas. Reg. § 1.170A-13(c)(3)(ii); Treas. Reg. § 1.170A-14(h)(3)(ii). Within qualified appraisals, zoning is typically described to justify the method of valuation and the fair market value of the property considering its highest and best use.

111. Treas. Reg. § 1.170A-13(c)(3)(ii). Market feasibility reports are often referenced by the appraisers to justify the method of valuation and the highest and best use of the property.

ties, etc. In some cases, these reports may be relied upon by the appraiser to justify the opinion of property value.

Developer's Agreement. This document explains who will be responsible for supervising the entitling, financing, construction, and marketing of the property's development if that option were to be pursued by the investment program in the future. In some cases, an affiliate of the program sponsor may be tasked with the developer role. This document defines the scope of the developer's work responsibilities and the compensation to be paid to the developer if future development is approved by the program. In cases where a developer has committed significant time and resources to preparing a comprehensive development plan, this agreement may also provide for an agreement termination fee to be paid to the developer in the event that the development option is ultimately not pursued by the investors (with the fee based upon a percentage of the developer's pro forma compensation expected to be realized had the property been developed).

Management Agreement. In some cases, a separate management agreement will be entered into between the program sponsor and the investment program that explains (i) the sponsor's role in managing the program's business relating to the property regardless of the property's future use, and (ii) the sponsor's responsibilities in providing information to the program's investors regarding the financial/operational affairs of the property. Under this agreement, the sponsor may undertake a responsibility to research and analyze the property's future potential uses and to report its findings to the investors. If the property is developed, the sponsor may be responsible under the management agreement for monitoring the developer's activities set forth under the developer's agreement.

Tax Opinion. The tax opinion will opine to the investment program's structure and supporting transactions, and whether the transactions will suffice to formulate a business that is eligible to receive charitable income tax deductions in the event a conservation easement was granted to a qualified donee. In some cases, the tax opinion will also discuss (i) the donee's ability to accept an easement as a qualified donee, (ii) whether the easement has been established for proper conservation purposes, and (iii) whether the property appraisal satisfies the Code requirements of a qualified appraisal.¹¹² While the tax opinion may be helpful in understanding whether the sponsor has structured the program and its supporting business transactions in a way that would give rise to a valid charitable property contribution, *these opinions do not go so far as to state an assessment of whether the*

112. See Treas. Reg. § 1.170A-13(c)(3)(ii) (explaining the requirements of a qualified appraisal).

appraiser's fair market valuation would be upheld if challenged by the government.

Proof of the Prior Property Owner's Holding Purpose. As the status of the subject property as long-term capital gain property in the hands of the prior owner could be crucial to establishing the amount of the charitable income tax deduction (i.e., as opposed to land inventory that is subject to ordinary income taxes and that would limit the deduction to the property's basis), the confirmation of the prior owner's holding intent is important.¹¹³ As such, an attorney or an accountant hired by the original property owner should be requested to make a written representation regarding the manner in which the property was held by the original property owner prior to its contribution to a property entity.

Maps/Artistic Renderings. These documents provide a visual description of what the property would look like in a fully developed state, and will describe the boundaries of structures, parking lots, ponds, landscaping details, and open space within the property.

Draft Easement. This document is used to convey legal rights to a qualified donee by placing use restrictions upon the fee property owner (i.e., the property holding entity in the case of a syndicated real estate investment program).¹¹⁴ This document should provide a legal description of the property subject to the easement and should provide a detailed description of land use restrictions and reserved rights.¹¹⁵ As is the case in respect to the baseline report, the easement should likewise recite the conservation values of the property by providing an explanation in detail (i) how the easement will address one or more of the conservation purposes described in the Code, and, if applicable, (ii) what federal, state, or local policies are being addressed as a result of the easement. The general provisions of an easement document include and are not limited to (i) a background clause explaining the purposes for the easement, (ii) a granting clause that confers the perpetual easement rights to the donee that will be binding upon the donor's successors, (iii) a declaration of covenants and restrictions explaining several types of activities that are not permitted, (iv) a reserved rights provision explaining the activities the donor may still conduct and, when applicable, the rights of the donee to supervise and approve such activities, (v) the donee's covenants, that include a warranty by the donee to monitor the donor's activities and to enforce the

113. See I.R.C. § 1223(2) (2014) (authorizing a tacking of holding period and purpose to a partnership for property contributed by a partner).

114. See Treas. Reg. § 1.170A-14(g)(1) (explaining the easement conveyance act as the recording of the easement in the county real estate records where the property is located).

115. See *id.*

property use restrictions, and (vi) a provision explaining the donee's legal remedies if the donor violates the restrictions of the easement including rights to collect damages, litigation expenses, and to compel specific performance of the easement restrictions.

For purposes of meeting the definition of the qualified conservation contribution, note the property must be contributed to a qualified organization.¹¹⁶ The term "qualified organization" means, generally, a Code section 501(c)(3) organization that (i) has a commitment to protect the conservation purposes of the contribution, and (ii) has the resources necessary to enforce the restrictions.¹¹⁷ *As such, the number of organizations that are qualified to accept donations of conservation easements is a smaller universe than what one might initially be inclined to contemplate* and does not include every tax exempt organization with a favorable IRS determination letter. Evidence of a bona fide commitment to conservation might include (i) the organization's mission and purposes articulated within its organizational documents (i.e., stating a business purpose relating to environmental protection through the acceptance and enforcement of easements), and (ii) descriptions of the organization's business activities reported within its recent Form 990 federal income tax returns (i.e., accepting easement donations, providing environmental research and assessment services, and conservation monitoring activities). Evidence of an ability of the organization to enforce the easement would include an examination of the organization's staffing resources (i.e., biologists, botanists, forestry professionals, and other employees with background in environmental support work and disciplines) and financial resources (i.e., from the assets, liabilities, equity, revenues, expenses, and liquidity reported within the Form 990s and financial statements).

Conservation easements have been utilized by high net worth individuals and families for income tax planning purposes outside of the syndication context for many years. Notwithstanding this observation, the suitability of real estate investment programs that use conservation easements should be determined at the investor level, in significant part, based upon (i) the utility of the federal income tax benefits to the taxpayers if a conservation easement would be selected by the investors as a group (i.e., requiring an examination of the investor's income and deductions), (ii) the taxpayer's willingness to hold a long-term investment in the real estate acquired by the program, and (iii) the risk tolerance of the taxpayer in respect to a future IRS audit (for reasons to be explained in Section VI of this Article).¹¹⁸ Al-

116. I.R.C. § 170(h)(1)(B).

117. I.R.C. § 170(h)(3); Treas. Reg. § 1.170A-14(c).

118. See *infra* notes 132-216 and accompanying text.

though there is no hard and fast rule as to what level of income is appropriate for these investments, some financial service firms I am familiar with have established an annual income guideline of \$500,000 for suitability determination purposes. Assuming the investor in question could benefit from a financial perspective under multiple property use proposals presented by the program (i.e., developing the property commercially or granting a conservation easement to a qualified organization) and is not risk adverse to the risks associated with commercial real estate development or, alternatively, the possibility that the transaction may be audited if an easement is granted, then the proposed offering might be a suitable alternative. As such, and assuming the transaction in question is properly structured with sufficient economic substance, syndicated easement transactions are niche securities that can potentially be used by sophisticated high net worth investors (i.e., who must also be higher tax bracket investors in terms of income *and* not opposed to undertaking audit risk).

V. IS A SYNDICATED EASEMENT A REPORTABLE TRANSACTION?

According to Code section 6111(a), “[E]ach material advisor with respect to any reportable transaction [is required to] make a return” in a form prescribed by the Treasury Secretary (“Secretary”) “setting forth information identifying and describing the transaction” and any potential tax benefits expected to result from it, together with other information as the Secretary may prescribe.¹¹⁹ A reportable transaction is any transaction for which information is required in a return or a statement because the transaction “is of a type which the Secretary determines as having a potential for tax avoidance or evasion.”¹²⁰ For this purpose, a “transaction includes all of the factual elements relevant to the expected tax treatment of any investment, entity, plan, or an arrangement, and includes any series of steps carried out as part of a plan.”¹²¹

While the Internal Revenue Service (“IRS”) has stated in prior published guidance that it will closely scrutinize the promotions of transactions involving improper conservation easement charitable deductions as well as the activities of appraisers and promoters that syndicate such transactions, the undertaking of a conservation easement within the context of a private placement offering is not specifically

119. I.R.C. § 6111(a) (2014).

120. I.R.C. § 6707A(c)(1) (2014).

121. Treas. Reg. § 1.6011-4(b)(1) (2010).

described as a reportable transaction by the IRS.¹²² Note that transactions of interest that are considered by the IRS to be substantially similar to the types of transactions specifically described as listed, and therefore reportable transactions (i.e., which would include the thirty-four specified transactions set forth within IRS Notice 2009-59), are subject to the special disclosure rules described above.¹²³ According to the instructions for IRS Form 8886 (Rev. 11/2001) a transaction is substantially similar to another transaction if it is expected to obtain the same or similar types of tax consequences and is either factually similar to or based upon the same or similar strategy. Generally, persons entering into transactions of interest on or after November 2, 2006, must disclose their participation in the transaction as described in the Treasury Regulations.¹²⁴ Taxpayers who fail to disclose may be subject to penalties under sections 6662A and 6707A of the Code.

Although a syndicated private placement contemplating a conservation easement proposal and potential charitable contribution has not been specifically described by the IRS as a transaction of interest, please consider IRS Notice 2007-72 (August 14, 2007), wherein the IRS defines and explains a transaction of interest which contains characteristics that bear some similarity to a syndication real estate offering with an easement option.¹²⁵ The substance of the transaction set forth in IRS Notice 2007-72 provides:

Facts

In a typical transaction, Advisor owns all of the membership interests in a limited liability company (LLC) that directly or indirectly owns real property (other than a personal residence as defined in § 1.170A-7(b)(3)) that may be subject to a long-term lease. Advisor and Taxpayer enter into an agreement under the terms of which Advisor continues to own the membership interests in LLC for a term of years (the Initial Member Interest), and Taxpayer purchases the successor member interest in LLC (the Successor Member Interest), which entitles Taxpayer to own all of the membership interests in LLC upon the expiration of the term of years. In some variations of this transaction, Taxpayer may hold the Successor Member Interest through another entity, such as a single member limited liability company. Further, the agreement

122. See I.R.S. Notice 2004-41, 2004-1 C.B. 31 (explaining the IRS's intent to scrutinize syndicated conservation easement transactions); see also *Partnerships Next Area of IRS Scrutiny for Conservation Easements*, BNA DAILY TAX REPORTS (Feb. 18, 2013), <http://www.bna.com/partnerships-next-area-n17179872418>.

123. I.R.S. Notice 2009-59, 2009-2 C.B. 170.

124. Treas. Reg. § 1.6011-4.

125. I.R.S. Notice 2007-72, 2007-2 C.B. 544.

may refer to the Successor Member Interest as a remainder interest.

After holding the Successor Member Interest for more than one year (in order to treat the interest as long-term capital gain property), Taxpayer transfers the Successor Member Interest to an organization described in § 170(c) (Charity).

Taxpayer claims the value of the Successor Member Interest to be an amount that is significantly higher than Taxpayer's purchase price (for example, an amount that is a multiple of Taxpayer's purchase price and exceeds normal appreciation). Taxpayer claims a charitable contribution deduction under § 170 based on this higher amount. Taxpayer reaches this value by taking into account an appraisal obtained by or on behalf of Advisor or Taxpayer of the fee interest in the underlying real property and the § 7520 valuation tables.

The Internal Revenue Service and the Treasury Department are concerned about apparent irregularities in this transaction. Specifically, the IRS and the Treasury Department are concerned with the large discrepancy between (i) the amount Taxpayer paid for the Successor Member Interest, and (2) the amount claimed by Taxpayer as a charitable contribution.¹²⁶

If it could be said that a real estate investment program with a development/easement option was substantially similar in nature to the transaction of interest outlined in IRS Notice 2007-72, then the charitable deductions associated with a contribution by investors of a future easement would constitute a reportable transaction and would be subject to the requirements of Code section 6111(a). In that notice, the IRS mentions the difference between the charitable deduction and the amount of the taxpayer's equity contribution to the subject Limited Liability Company ("LLC") as being a concerning factor. Additional concerning facts mentioned by the IRS in the notice included:

(1) a mischaracterization of the ownership interests in the LLC; (2) a Charity's agreement not to transfer the Successor Member Interest for a period of time . . . ; and (3) any sale by the Charity of the Successor Member Interest to a party selected by . . . [the] Advisor or Taxpayer.¹²⁷

In comparison, the investment programs we have reviewed involve situations whereby investors (i) have acquired a present economic investment in a partnership or LLC from the date of their investment, and (ii) have the legal authority to approve or disapprove of the transaction that would give rise to the amount of the charitable

126. *Id.*

127. *Id.*

deduction (and with an economic detriment being imposed upon the investor's ability to develop the real estate commercially if the easement were granted). Moreover, while it is possible that the investors may receive a charitable contribution deduction that exceeds their investment contributions in the program, the valuation of the easement is usually based on an appraisal performed in compliance with specific regulatory guidance issued by the IRS concerning the methodology of valuing such property (i.e., with IRS valuation tables not being applicable to the transaction).¹²⁸ In view of this, there appear to be reasonable grounds to argue that the typical development/easement investment program falls outside the confines of the reportable transaction rules.

VI. IS THE PROGRAM A PARTNERSHIP?

Arguably, an important question of a legal structural nature to consider is whether the real estate investment program in question can pass potential scrutiny under certain partnership "anti-abuse" rules and economic substance doctrines set forth in federal case law and in the Treasury Regulations. This issue has drawn contrasting views from a number of leaders that provide legal expertise within the conservation easement legal arena. On the negative side, some legal commentators have been quick to point out instances of questionable appraisals of property values at high multiples of the property's acquisition price, as well as the fact that certain program-related transactions may amount to the selling of income tax deductions, which is not permitted under federal tax law.¹²⁹ On the other side of the fence, there are commentators that consider donations of easements by syndicated pass-through entities as legitimate transactions *if* the easement is granted by a group of investors in substance and in form after the investors have acquired their interests in the real estate partnership in a bona fide acquisition.¹³⁰ While reasonable minds can and will always differ on property valuation,¹³¹ the first legal hurdle re-

128. Treas. Reg. § 1.170A-14(h)(3)(ii) (2009).

129. Timothy Lindstrom, *Recent Developments in the Law Affecting Conservation Easements: Renewed Tax Benefits, Substantiation, Valuation, "Stewardship Gifts," Subordination, Trusts, and Sham Transactions*, 11 WYO. L. REV. 433, 480-82 (2011).

130. Ronald Levitt and David Wooldridge, *Land Trusts Should Not Assume Donations from Syndicated Partnerships are a Problem*, THE PRESERVER: CONSERVATION EASEMENTS (Oct. 4, 2015), <https://www.sirote.com/blog/conservation-easement/land-trusts-should-not-assume-donations-from-syndicated-partnerships-are-a-problem-2/>.

131. See, e.g., *Kiva Dunes Conservation L.L.C. v. C.I.R.*, 97 T.C.M. (CCH) 1818 (T.C. 2009) (involving a syndicated partnership that prevailed on a valuation challenged by the IRS, with the taxpayer's appraiser assigning a \$30.6 million valuation to the real estate whereas the IRS' expert claimed that the real estate was worth only \$2.6 million).

quires us to consider where the syndicated program in question has a sufficient measure of non-tax motive as opposed to a transaction where the investor is merely acquiring an income tax deduction. The aspect of the offering evaluation is an important one from a due diligence perspective because of the pass-through structure of the programs and also the amount of deduction allowed under the partnership program structure (i.e., due to the tacking of holding period and purpose and the fair market value deduction allowed under the partnership program structure as opposed to basis-related deduction that might arguably apply if the program investments were collectively characterized in substance as direct acquisitions of the property).¹³²

In prior informational releases, the IRS announced it would undertake more diligent efforts to investigate syndicated conservation easement transactions from a partnership substance perspective.¹³³ Based upon our conversations with program sponsors and tax practitioners, this sentiment is, in fact, playing out in the form of an increased level of program partnership audits. In view of these developments, the IRS may challenge certain investment programs in cases where it is clear that the investors are not participating in the program with non-tax intentions.¹³⁴ Two factors courts will often look at when considering a taxpayer's intentions in such regard include (i) whether the transaction had economic benefits and risks to the taxpayer beyond the income tax deduction claimed, and (ii) whether the taxpayer had a non-tax motive for entering into the transaction.¹³⁵ Courts sometimes refer to this two-factor inquiry as the "economic substance" test.¹³⁶ While the attainment of income tax deductions can be a significant and motivating purpose for entering a transaction, the absence of any business or investment-related purpose other than to procure an income tax deduction is fatal to the taxpayer in the ab-

132. See *Winn-Dixie Stores, Inc. v. C.I.R.*, 254 F.3d 1313, 1316 (11th Cir. 2001) (disallowing the partnership taxpayer's interest deductions based upon a lack of business purpose); see also *Historic Boardwalk Hall, L.L.C., v. C.I.R.*, 694 F.3d 425, 461-62 (3d Cir. 2012), *cert. denied*, 133 S. Ct. 2734 (2013) (disallowing the partnership taxpayer's tax credits based upon a lack of non-tax business purpose).

133. I.R.S. Notice 2004-41, 2004-28 I.R.B. 31 (2004) (explaining the IRS's original intent to scrutinize syndicated conservation easement transactions); see also *Partnerships Next Area of IRS Scrutiny for Conservation Easements*, BNA DAILY TAX REPORTS (Feb. 18, 2013), <http://www.bna.com/partnerships-next-area-n17179872418> (explaining the IRS's intent to examine syndicated conservation easement transactions from a partnership substance perspective).

134. *Historic Boardwalk Hall, L.L.C.*, 694 F.3d at 449.

135. *Winn-Dixie Stores, Inc.*, 254 F.3d at 1316; *C.M. Holdings, Inc. v. C.I.R.*, 301 F.3d 96, 102 (3d Cir. 2002).

136. *C.M. Holdings, Inc.*, 301 F.3d at 102 (referencing the "economic substance inquiry").

sence of a congressional mandate clearly authorizing the deduction.¹³⁷ While the potential economic profitability of the transaction in question is considered in such regard, the question of whether income tax benefits may factor into the profitability determination is dependent upon whether the deduction enabling statute was clearly intended to stimulate investment activities.¹³⁸

From our reviews of tax opinions procured by program sponsors, a case that is cited with regularity by tax counsel as justification for the transactional structure of the pre-mentioned real estate investment programs from an economic substance and business purpose perspective is *Sacks v. Commissioner of Internal Revenue*,¹³⁹ a case from the United States Court of Appeals for the Ninth Circuit where a taxpayer invested in a solar energy investment program sponsored by a promoter referred to in the case as BFS Solar Incorporated ("BFS").¹⁴⁰ While the case does not involve a conservation easement deduction, the case is one in which the taxpayer's income tax motivations were high in comparison to the cash flow profitability potential of the investment.¹⁴¹ The taxpayer invested in ten solar water heating units

137. See *Am. Elec. Power Co. v. United States*, 326 F.3d 737, 743-44 (6th Cir. 2003) (explaining that the economic substance issue should be viewed in light of the *pre-tax* consequences and without considering the income tax deductions); *IES Industries, Inc. v. United States*, 253 F.3d 350, 354-55 (8th Cir. 2001) (considering the economic substance of the transaction from a *pre-tax* perspective); *Compaq Computer Corp. v. C.I.R.*, 277 F.3d 778, 783-84 (5th Cir. 2001) (explaining that a subjective intent by the taxpayer to avoid paying income taxes will not, by itself, cause the transaction to lack economic substance where legitimate business activities have been undertaken and where a profit is, in fact, earned on a *pre-tax* basis); *Friendship Dairies v. C.I.R.*, 90 T.C. 1054, 1064 (1988) (explaining that tax-motivated transactions require a careful review of the legislative intent supporting the deduction).

138. *Sacks v. C.I.R. (Sacks II)*, 69 F.3d 982, 991 (9th Cir. 1995). While the court held that the subject investment in the solar water heaters had economic substance on a *pre-tax* basis, the court stated in *dictum* that the absence of *pre-tax* profitability is not fatal in cases where Congress has purposely used tax incentives to encourage investments; but see *C.M. Holdings, Inc.*, 301 F.3d at 105-07 (distinguishing *Sacks* as a case where Congress intended to encourage investments in solar energy by granting tax credits; the Third Circuit in this case considered the economic substance of the insurance transaction by looking at its *pre-tax* consequences); *Friendship Dairies*, 90 T.C. at 1064 (acknowledging that Congress intended certain transactions, such as investments in solar energy and in the renovation of historic structures, to be accorded favorable tax treatment in spite of being primarily tax motivated; the Tax Court explained that the *pre-tax* economic consequences of a transaction must be considered where the tax-motivated transaction was not "unmistakably within the contemplation of congressional intent" to encourage).

139. 69 F.3d 982 (9th Cir. 1995).

140. *Sacks v. C.I.R.*, 69 F.3d 982 (9th Cir. 1995).

141. See *Sacks v. C.I.R. (Sacks I)*, 64 T.C.M. (CCH) 1003, 1007 (T.C. 1992) (suggesting a return on investment, or ROI, on the cash investment of about 189% due to the investment tax credits and equipment depreciation deductions). The record at the Tax Court suggests that the tax credits for the solar water heater units were 60% of the purchase price of each unit. *Sacks I*, 64 T.C.M. (CCH) at 1007.

sold to him by BFS for \$4,800 per unit and he leased the units back to BFS for a fifty-three month term that required a lease payment of \$1,327 per unit for that lease term.¹⁴² While BFS's cost to acquire the units ranged from \$1,080 to \$1,180 (i.e., twenty-five percent of the price the units were sold to the investor/taxpayer), the \$4,800 cost charged to the investor/taxpayer fell within the mid-point of prices that homeowners would typically pay at a retail level to acquire the units for home use.¹⁴³ The taxpayer acquired ten units by making a cash investment of about half of the investment, and he financed the remaining part with a ten-year recourse promissory note bearing nine percent interest per year.¹⁴⁴

In addition to receiving rental income from the lease-back transaction, the taxpayer was entitled to receive a share of the solar unit rental revenues that homeowners paid to BFS to have the solar units installed at their houses.¹⁴⁵ Based upon an assumption that energy costs would escalate 11.5% annually over a twenty-year period (i.e., due to rising oil prices prior to the investment), the investment pro forma provided by BFS to the taxpayer predicted total profits of \$34,776.¹⁴⁶ Depreciation deductions and investment tax credits were claimed by the taxpayer on his 1983, 1984, and 1985 federal tax returns.¹⁴⁷ The facts of the case suggest that the depreciation deductions and federal investment tax credits significantly exceeded the taxpayer's profits and that the investment was a losing one from a pre-tax cash flow perspective.¹⁴⁸ Accordingly, and due to the disproportionality of the income tax deductions and tax credits in comparison to the investment profit, the IRS challenged the deductions and tax credits for lack of business purpose and economic substance.¹⁴⁹ The IRS also asserted that the payments of rent back to the investor taxpayer from BFS and the homeowners were intended to offset the taxpayer's note obligation that, in turn, negated the taxpayer's financial exposure as a bona fide investor in the units (i.e., resulting in an investment transaction whereby the tax benefits were the main economic consequence of the investment).¹⁵⁰ The tax court agreed with the Commissioner at the trial court level.¹⁵¹

142. *Id.* at 1009.

143. *Id.* at 1008.

144. *Id.* at 1008-09.

145. *Id.* at 1009.

146. *Sacks II*, 69 F.3d at 985.

147. *Id.* at 986.

148. *Id.*

149. *Id.*

150. *Id.* at 989.

151. *Sacks I*, 64 T.C.M. (CCH) at 1003.

While the Ninth Circuit recognized the unprofitable outcome of the investment, it disagreed with the IRS' position that the investment was lacking in business purpose and economic substance.¹⁵² In determining the business purpose for the investment, the court acknowledged the installation of solar water heaters as business transactions that were genuine.¹⁵³ The court believed that the investment had economic substance beyond the income tax benefits claimed based upon (i) the taxpayer's personal obligation to pay the notes, (ii) the BFS pro forma that suggested a pre-tax profit might have been feasible in the absence of a depressed energy price market that followed the investment (with a substantial future drop in oil prices after the investment was made affecting all prices in the energy industry), (iii) and that the taxpayer's investment result was affected not only by income tax deductions and credits, but also by the fact that energy costs had, in fact, dropped in a way that negatively affected the investment on a non-tax basis.¹⁵⁴

In dictum, the Ninth Circuit also stated that "[t]he fact that favorable tax consequences were taken into account . . . is no reason for disallowing [the] consequences."¹⁵⁵ While the court believed the investment, in fact, had economic substance on a pre-tax basis, the court stated that the absence of pre-tax profitability within the investment was not per se lacking of economic substance *where Congress purposely created federal tax incentives to motivate investor conduct*.¹⁵⁶ Looking to the legislative intent of the National Energy Act¹⁵⁷ and supporting tax laws, the court stated that the clear public policy adopted by Congress to encourage investments in solar energy would have supported the allowance of the taxpayer's depreciation deductions and investment tax credits in the absence of pre-tax profitability.¹⁵⁸ The *Sacks* dictum is what some legal commentators have relied upon when opining to the economic substance of conservation/development oriented real estate investment programs.

However, the distinguishing feature of *Sacks* from the typical easement/development oriented real estate investment program stems from the *option* of the investors to possibly pursue a business or investment purpose. While *Sacks* involved business activities resulting from the renting of the solar water heaters to homeowners, a real es-

152. *Sacks II*, 69 F.3d at 986, 988.

153. *Id.* at 988.

154. *Id.*

155. *Id.* at 991 (quoting *Frank Lyon Co. v. United States*, 435 U.S. 561, 580 (1978)) (emphasis added).

156. *Id.* at 988, 991-92.

157. Pub. L. 95-619, 92 Stat. 3206 (1978) (codified as amended in scattered sections of 42 U.S.C.).

158. *Sacks II*, 69 F.3d at 991-92.

tate investment program's business activities may be construed as marginal in cases where (i) an easement is granted, and (ii) the program pursues no other material activities other than fulfilling the easement requirements. Thus, *Sacks* would appear to perhaps provide better support for a program's legal structure in cases where a dual development and conservation purpose is pursued, or where there are probable development activities in the future through reserved property use rights. In such cases, there would appear to be (i) a business purpose, (ii) a demonstrated business-related use for the property due to the development itself, and (iii) an economic sacrifice of the investors as to the part of property being subjected to the conservation restriction. As mentioned in *Sacks*, there are statutes enacted from time to time to further special *investment-centric* public policies, such as developments in solar and other alternative energy sources.¹⁵⁹ For reasons identified in the subsequent paragraphs of this section, however, I would question whether the Ninth Circuit's dictum in *Sacks* provides significant legal support for certain real estate investment programs where future development is unlikely or perhaps very questionable.

On a side note, some have questioned the appropriateness of applying business purpose and economic substance-related doctrines to transactions involving Code section 170 regarding charitable deductions on a theory that the deductions are legislatively approved subsidies granted to taxpayers by the will of Congress.¹⁶⁰ Fairly recently, however, the tax court clarified in *RERI Holdings I, L.L.C. v. Commissioner of Internal Revenue*¹⁶¹ that such common law doctrines can, in fact, be applied to *partnerships* in cases where the IRS questions the ability of partners to claim charitable deductions involving gifts of real estate to tax exempt organizations.¹⁶² Similar to the fact patterns of some easement/development oriented real estate investment programs, it is perhaps noteworthy in *RERI Holdings I, L.L.C.* that the partnership's acquisition price for the real estate interest (i.e., \$2.95 million in 2002) and purported appraisal value for determining the charitable income tax deduction (i.e., \$32.935 million in 2003) were separated fairly significantly in terms of value but fairly narrowly in

159. *Id.*; see also *Friendship Dairies*, 90 T.C. at 1064 (recognizing historic building restorations, low income housing investments, purchases of tax-exempt securities, and commercial equipment investments supported through accelerated depreciation deductions as transactions whose capital investments and related income tax deductions are Congressionally supported).

160. *RERI Holdings I, L.L.C. v. C.I.R.*, 107 T.C.M. (CCH) 1488, No. 9324-08, 2014 WL 2136036, at *3 (May 22, 2014) (citing *Skripak v. C.I.R.*, 84 T.C. 285, 293-97 (1985)).

161. 107 T.C.M. (CCH) 1488 (T.C. 2014).

162. *RERI Holdings I, L.L.C.*, 2014 WL 2136036, at *8.

terms of time.¹⁶³ While the case does not directly implicate easement donations, it illustrates that the Tax Court does not consider pass-through entities to be beyond the preview of the economic substance related common law doctrines in cases where the issue involves a charitable deduction *generally (but not specifically)* authorized in the Code (again, with legislative history playing a role *as to how* such common law doctrines will be applied in terms of analyzing the profit potential depending upon whether Congress *specifically intended to motivate investments* by granting income tax deductions and credits).

Unfortunately, a *comprehensive* and detailed record of Congressional intent applied to conservation easements effectuated through investment programs is scant.¹⁶⁴ While the Code did not formally provide a deduction for conservation easements until 1976, the conferences on the part of both Houses of Congress intended in 1969 that gifts of open-space easements to charities be treated as gifts of undivided real property interests thereby allowing such gifts to qualify for federal income tax deductions.¹⁶⁵ Notwithstanding, Congress' intention was not formally codified until the passage of the Tax Reform Act of 1976,¹⁶⁶ in which section 2124 of the Act temporarily codified conservation easement deductions under section 170 of the Code.¹⁶⁷ As reported by a number of legislative experts, that act's legislative history includes no testimony or debate by interested parties concerning the conservation easement provisions enacted in 1976.¹⁶⁸ In 1980, Congress made the conservation easement provisions permanent. In summation, and while we may agree that Congress generally intended to support conservation activities by enacting Code section 170(h) and its predecessor statutes, there is no legislative history to support the

163. *Id.* at *3.

164. Daniel Halperin, *Incentives for Conservation Easements: the Charitable Deduction or a Better Way*, 74 LAW & CONTEMP. PROBS. 29, 34-35 (2011) (explaining that the Congressional intent in adding a conservation easement deduction to the Code in 1976 was intended to simply confirm its desire to treat easements as gifts of undivided interests or real properties to charities).

165. Halperin, *supra* note 164, at 35 n.27. (citing H.R. REP. NO. 91-782, at 292 (1969) (Conf. Rep.)).

166. Pub. L. No. 94-455, 90 Stat. 1520 (1976) (codified as amended in scattered sections of 26 U.S.C.).

167. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976) (codified as amended in scattered sections of 26 U.S.C.).

168. Halperin, *supra* note 164, at 35 n.40. (citing Stephen J. Small, *An Obscure Tax Provision*, in PROTECTING THE LAND: CONSERVATION EASEMENTS PAST, PRESENT, AND FUTURE 55, 56-57 (Julie Ann Gustanski & Roderick H. Squires, eds., 2000)); see also Nancy A. McLaughlin, *Increasing the Tax Incentives for Conservation Easement Donations - A Responsible Approach*, 31 ECOLOGY L. QUARTERLY 1, 10-15 (2004) (providing a narrative of the enactment of easement legislation within the Code from 1964 through the enactment of Code section 170(h)).

notion that Congress specifically intended to support *investment* related activities by enacting such legislation.

In the absence of legislative support, the consideration of economic substance on a non-tax basis arguably becomes a more important consideration. Unlike *Sacks*, where the National Energy Act and supporting tax legislation intended to support speculative investments in solar energy at the early stages of solar energy development,¹⁶⁹ there is no authority to support the Congressional intent question as *specifically* applied to the allowance of conservation easement deductions generated within the confines of real estate investment programs (i.e., or saying it another way, there is no authority to support the idea that Congress specifically intended to stimulate investment activities when it adopted Code section 170(h)). The IRS has also taken issue with the Ninth Circuit's ruling in *Sacks* and continues to believe that the inclusion of income tax deductions within the profitability analysis of economic substance cases is inappropriate.¹⁷⁰ Furthermore, the *exclusion* of income tax benefits in determining whether or not a transaction has economic substance from a profit potential perspective has been applied in other Federal Appellate Courts *outside* of the Ninth Circuit. For these reasons, a consideration of the quality of a program property's future development prospects from a commercial feasibility and objective profit standpoint would appear to be important considerations from a program due diligence perspective.

The Treasury Regulations under Code section 701 contain a partnership anti-abuse rule which states that the IRS has the authority to

169. *Sacks I*, 69 F.3d at 991-92.

170. I.R.S. Gen. Couns. Mem., 20124002F at 16 (Oct. 5, 2012). In a General Counsel Memorandum involving *Historic Boardwalk Hall*, 136 T.C. 1 (2011), the IRS published a non-acquiescence to the Tax Court's ruling. The IRS first questioned the applicability of *Sacks* to *Historic Boardwalk Hall* on the basis that the solar investments involved in *Sacks* were held by the Ninth Circuit to have pre-tax economic consequences. *Id.* at 17. On the question as to whether a court should consider the economic consequences of a transaction on an after tax basis, the IRS stated:

In any event, the notion that a court may consider tax benefits in evaluating the economic substance of a transaction involving—or of a purported partnership engaged in—tax-favored activity finds no support apart from *Sacks*. Two circuits, in analyzing the economic substance of American Depository Receipts (ADR) transactions, determined that it was inappropriate to deduct the cost of foreseeable foreign taxes imposed on the transaction in determining the expected pre-tax profit of the transaction. See *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001) and *IES Industries, Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001). These holdings address the calculation of pre-tax profit to be used in determining whether transactions resulted in pre-tax economic losses; they do not stand for the proposition that United States tax credits may serve as a substitute for economic profit. As such, these cases do not adopt the court's holding in *Sacks* that a court may consider tax benefits in evaluating the economic substance of a transaction involving—or of a purported partnership engaged in—tax-favored activity.

Id.

recast partnership transactions to more accurately reflect the underlying economic arrangement of the partners if it concludes that the transaction attempts to use the partnership in a manner inconsistent with the intent of Code subchapter K.¹⁷¹ These are commonly referred to by tax practitioners as the “Partnership Anti-Abuse Regulations.” If these regulations were applied to a program transaction (or if the federal common law economic substance doctrine was applied), the legal effect could be to ignore the partnership’s formation and to treat (i) the contribution of real estate to the property holding entity, (ii) the investor’s contributions to the investment program, and (iii) the program’s acquisition of member interests in the property holding entity from that entity’s founders, as a sale of the property from the property holding entity’s founders to the program investors.¹⁷² This would prevent the carry-over of the property holding entity founder’s holding period and holding purpose to that entity, which in turn, would ultimately result in the loss of the ability by the program and its investors to use the property’s fair market value as the basis of the conservation easement deduction (unless the underlying property was held for investment for longer than a year prior to becoming subject to the easement). From a perspective of lost deductions, this result works to reduce the after-tax return on investment (“ROI”) of the investment program from 1.40-1.80 to 0.35-0.45 (with easement restrictions being binding on the property holding entity regardless of the tax result). One would be wise to understand these regulations given that they appear to borrow from the common law economic substance doctrine previously described in this Article.

The Partnership Anti-Abuse Regulations clarify that “subchapter K [of the Code] is intended to permit taxpayers to conduct joint business activities (including investment activities) through a flexible economic arrangement without incurring an entity-level [income] tax.” However, this intent encompasses three requirements:

- (1) The partnership must be bona fide and each partnership transaction or series of related transactions . . . must be entered into for a *substantial* business purpose.
- (2) The *form* of each partnership transaction must be respected under substance over form principles.

171. Treas. Reg. § 1.701-2 (1995).

172. Treas. Reg. § 1.701-2(b). Among the government’s powers is to disregard the partnership’s status as a pass-through entity for federal tax purposes and to consider the property otherwise classified as partnership property as owned directly by the purported partners. *Id.* In essence, and in cases where the regulations would apply to an investment program, the regulations would arguably give the government the authority to recast the various transactions giving rise to the investment program’s interest in the property holding entity as a sale to the investors of an interest in subject real estate.

(3) Except as otherwise provided in this paragraph (a)(3), the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect each partner's income [(with this factor presumed where the first two factors are satisfied)].¹⁷³

If a partnership is formed in connection with a transaction, a principal purpose of which is to substantially reduce the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the IRS can recast the transaction as appropriate to achieve tax results that are consistent with the intent of subchapter K. This may occur even if the transaction "fall[s] within the literal words of a particular statutory or regulatory provision."¹⁷⁴ Similar to prior cases that discuss economic substance, the above-mentioned regulations require a non-tax business motive for entering into the transaction. While the reference to a substantial business purpose suggests that the business purpose might require an entrepreneurial intent that arguably exceeds what is required of the common-law economic substance doctrine, the Treasury Regulations are not helpful in defining what a substantial business purpose is. Similar to certain economic substance cases that give deference to Congressional intent, however, the Partnership Anti-Abuse Regulations give substantial deference to the Code in cases where a Code provision intends for a legally-formed partnership to be afforded the income tax treatment prescribed in the Code provision.¹⁷⁵

Whether a partnership is formed for a purpose inconsistent with the intentions of subchapter K "is determined based on all of the facts and circumstances"¹⁷⁶ This includes "a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction."¹⁷⁷ The factors to consider in determining whether the regulations should apply to the situation include the following **(with practical applications to the subject real estate investment programs highlighted in parenthesis):**¹⁷⁸

(1) [whether the] present value of the partners' aggregate federal tax liability is substantially less than [it would be if] the partners owned the partnership's assets and conducted the partnership activities directly **[(a factor applicable to**

173. Treas. Reg. § 1.701-2(a).

174. Treas. Reg. § 1.701-2(b).

175. Treas. Reg. § 1.701-2(e)(2)(i)-(ii).

176. Treas. Reg. § 1.701-2(c).

177. *Id.*

178. *Id.*

many of these investment programs due to the use of tacked holding periods)];

(2) whether the present value of the partners' aggregate federal tax liability is substantially less than it would be if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction . . . [(arguably applicable if the various program-related transactions are considered, in substance, as a sale of the property to the investors for reasons previously stated in paragraph (1) above)];

(3) [whether] one or more partners who are [integral] to . . . the claimed tax results either have a nominal interest in the partnership, are substantially protected from any risk of loss from the partnership's activities . . . , or have little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital [(a five percent to ten percent interest retained by the contributing property owner in the property holding entity is more than nominal in our view)];

(4) [whether] [s]ubstantially all of the partners (measured by numbers or interests in the partnership) are related (directly or indirectly) to one another [(the investors and property owners/contributors are usually not legally related in respect to the syndications marketed by financial service firms that we have reviewed)];

(5) [whether] partnership items are allocated in compliance with the literal language of [the regulations governing the partners' distributive shares], but with results that are inconsistent with the purpose of [the applicable statutory and regulatory provisions] [(not usually applicable as program member's and property entity member's shares of income, gains, losses, and deductions are proportional to their interests)];

(6) [whether] the benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained (directly or indirectly) by the contributing partner or a related party [(please note that this could potentially be an issue in programs where either the property contributor to the property holding entity or the program sponsor has an obligation at some point in the future to buy out the investor interests by virtue of put rights given to the program or investors)]; and

(7) [whether] the benefits and burdens of ownership of partnership property are in substantial part shifted (directly or indirectly) to the distributee partner before or after the prop-

erty is actually distributed to the distributee partner (or a related party).¹⁷⁹

For reasons highlighted in the preceding points, one could argue that the Partnership Anti-Abuse Regulations have, in legal theory, an appropriate application to the real estate investment programs this Article addresses. This is *not* to say, however, that the regulations should be applied in a way to chastise *every* such program. The economic/commercial qualities of the subject real estate, the neutrality (or lack of neutrality) in the manner the property options are presented to investors, the practical ability of the investors to choose how the property will be used in the future, and the anticipated duration of the investment are circumstances that would arguably factor into whether the regulations should be applied.

Although federal courts have yet to pass upon the question as to whether a real estate investment program easement reconciles with the legislative intent of Code section 170(h) or the Partnership Anti-Abuse Regulations, a case involving the syndication of interests in a historical federal tax credit program illustrates some income tax principles that should be considered when reviewing these programs. The case also exemplifies the *differences* in how the application of economic substance and business purpose issues can be applied at the tax court and federal appellate court levels.

In *Historic Boardwalk Hall, L.L.C. v. Commissioner*,¹⁸⁰ a case involving a private placement of interests in a pass-through entity formed to invest in the renovation of a historic building, the United States Court of Appeals for the Third Circuit was required to determine whether a corporate investor's contribution to the LLC should be viewed as an interest in a bona fide tax partnership formed for legitimate business purpose (as opposed to a transaction whereby, *and in substance*, historic rehabilitation tax credits ("HRTC") created under Code section 47, were simply sold to the corporation taxpayer).¹⁸¹ The investment program was formed by the New Jersey Sports and Exposition Authority ("NJSEA") for the purpose of restoring the East Hall situated in Atlantic City, New Jersey.¹⁸² The initial budget for the restoration was \$78.522 million, and was intended to be funded through cost reimbursements provided by the New Jersey Casino Reinvestment Development Authority ("NJCRDA") and through the issuance of \$49.915 million in State Contract Bonds.¹⁸³ When the estimated restoration costs increased to about \$90.6 million, NJCRDA

179. *Id.*

180. 694 F.3d 425 (3d Cir. 2013).

181. *Historic Boardwalk Hall, L.L.C. v. C.I.R.*, 694 F.3d 425, 428-29 (3d Cir. 2013).

182. *Historic Boardwalk Hall, L.L.C.*, 694 F.3d at 428-29.

183. *Id.* at 432-33.

again agreed to fund the shortfall of capital not provided by the bond financing.¹⁸⁴ The facts of the case suggest that the two financing sources previously mentioned were sufficient to substantially fund the renovations.¹⁸⁵

As an additional source of financing, NJSEA formed an investment company that was intended to raise additional capital through a private placement transaction.¹⁸⁶ Realizing that income tax credits tied to restoration projects could attract significant investment capital from corporate investors, NJSEA (i) formed Historic Boardwalk Hall, LLC ("HBH"), and (ii) sold member interests in HBH to a subsidiary of Pitney Bowes, Inc. ("PBI").¹⁸⁷ The offering was structured to provide the PBI subsidiary with an investment that would generate a tax-adjusted ROI of \$1 for every \$.80 to \$.90 invested through HBH's allocation of federal tax credits to PBI.¹⁸⁸ NJSEA assigned its rights to a 35-year lease in the East Hall to HBH for a term that exceeded the property's useful life. By doing this, the transaction was treated as a sale of the East Tower to HBH.¹⁸⁹ The \$106.954 million price established for HBH's acquisition of NJSEA's interest in East Tower was comprised of two parts: (i) \$90.6 million for construction-related costs already paid, or to be paid by other parties, for renovations (providing a construction cost related basis for the purchase price, which was financed through a 39-year acquisition loan and a 39-year construction loan), and (ii) \$16.354 million for income tax credits sold to PBI (representing PBI's out-of-pocket cash contribution that was expected to provide \$17.603 million of income tax credits over the first two years of the investment).¹⁹⁰ Of the \$16.354 million of proceeds paid by PBI for the income tax credits, NJSEA received about eighty percent of the proceeds as a project developer's fee (which meant that a minimal amount of PBI's investment actually went to fund hard construction costs).¹⁹¹ PBI was assured of its future realization of the tax credits through written guarantees provided by HBH.¹⁹² PBI was entitled to receive a preferred return of three percent of HBH's net cash flow to be derived from lease revenues associated with the East Hall.¹⁹³ The offering provided a buy-out feature that allowed PBI to put its interest to NJSEA after seven years for an amount equaling the greater of (i)

184. *Id.* at 433.

185. *See id.*

186. *Id.* at 433-35.

187. *Id.* at 429.

188. *Id.* at 434.

189. *Id.* at 433-34.

190. *Id.* at 435.

191. *See id.*

192. *Id.* at 441-42.

193. *Id.* at 435.

the fair market value of PBI's interest in HBH, or (ii) any cumulative unpaid preferred returns.¹⁹⁴ The acquisition and construction loans were also structured to allow for interest-free deferrals of loan payments if operating cash flow from the property was insufficient to cover the payments.¹⁹⁵

Similar to *Sacks*, the income tax benefits from the credits were substantial in relation to the non-tax investment profit, with the tax credits being about 110% of PBI's investment capital.¹⁹⁶ Unlike *Sacks*, however, certain contractual rights were afforded to PBI that arguably eliminated the investor's economic risk exposures, including (i) a right to a refund of principal if certain income tax benefits were not achieved, and (ii) an ability to defer the capital contribution until development activities assuring the project's completion were accomplished.¹⁹⁷ At the tax court level, the IRS challenged the structure of that offering on the following grounds (i) substance-over-form (i.e., the mere sale of HRTCs to an investor as opposed to a transaction whereby PBI made an investment in an enterprise), (ii) that the arrangement was a sham and the investor did not hold a bona fide interest in an LLC, and (iii) the real estate giving rise to the HRTC's was never substantively transferred to the limited liability company.¹⁹⁸

The tax court believed that the subject transactions possessed sufficient economic substance because of PBI's monetary contributions to the project (which the court believed provided some funds to support the project), which was coupled with a three percent preferred return stated within the LLC organizational documents (which arguably provided "an opportunity" for PBI to realize distributions beyond the tax benefit of the credits).¹⁹⁹ Noting that the legislative purpose of Code section 47 was intended to motivate what would otherwise be considered unprofitable investments in historic rehabilitation projects, the tax court followed the Ninth Circuit's dictum guidance in *Sacks* and analyzed the economic substance of the investment by considering both the tax credits and the preferred return.²⁰⁰ Additionally, the tax

194. *Id.* at 441.

195. *Id.* at 440.

196. *See id.* at 434.

197. *Id.* at 434, 451-52. Thus, the presence of financing sources other than PBI is what assured the completion of the subject renovations that were relied upon to justify PBI's tax credits. *Id.*

198. *Historic Boardwalk Hall, L.L.C. v. C.I.R.*, 136 T.C. 1, 2 (2011).

199. *Historic Boardwalk Hall, L.L.C.*, 136 T.C. at 38-39.

200. *Id.* at 41-42. The court stated,

The legislative history of section 47 indicates that one of its purposes is to encourage taxpayers to participate in what would otherwise be an unprofitable activity. Congress enacted the rehabilitation tax credit in order to spur private investment in unprofitable historic rehabilitations. As respondent notes, the East Hall has operated at a deficit. Without the rehabilitation tax credit,

court believed the taxpayer was exposed to certain non-taxation economic risks associated with the project, which were perceived by the court to include (i) the risk that the rehabilitation project would not be completed (which might jeopardize PBI's tax credits and opportunity for a preferred return), and (ii) that PBI faced potential environmental risks from the project.²⁰¹ The tax court used similar reasoning to reject the IRS's second and third arguments stated above.²⁰²

In the Third Circuit's review of the case, however, the court focused upon a "bona fide partner theory" analysis that weighed heavily upon PBI's equity interest in the transaction and exposure to economic risks from a substance over form perspective.²⁰³ While the court did not go so far as to say that the transaction in question lacked any economic substance, the court distinguished the federal common-law economic substance and substance-over-form arguments of the IRS as separate issues requiring differing legal analysis. On this point, the following passages exemplify the court's analysis in such regard:

The substance-over-form doctrine is applicable to instances where the substance of a particular transaction produces tax results inconsistent with the form embodied in the underlying documentation, permitting a court to recharacterize the transaction in accordance with its substance. On the other hand, the economic substance doctrine applies where the economic or business purpose of a transaction is relatively insignificant in relation to the comparatively large tax benefits that accrue²⁰⁴

Even if a transaction has economic substance, the tax treatment of those engaged in the transaction is still subject to a substance-over-form inquiry to determine whether a party was a bona fide partner in the business engaged in the transaction.²⁰⁵

Pitney Bowes would not have invested in its rehabilitation, because it could not otherwise earn a sufficient net economic benefit on its investment. The purpose of the [tax] credit is directed at just this problem[.]

Id. at 46-47.

201. *Id.* at 44.

202. *Id.* at 45.

203. See *Historic Boardwalk Hall*, 694 F.3d at 449-60.

204. *Id.* at 448 n.50 (internal quotations omitted) (citations omitted). The Third Circuit appears to suggest in this case that the "substance over form" inquiry is perhaps tied *more closely* with the legislative "spirit of the Code" as opposed to an economic substance inquiry as to profit potential. *Id.* at 448.

205. *Id.* This passage suggests that a "substantial business purpose" cited in the Partnership Anti-Abuse Regulations is perhaps a greater threshold than what has otherwise been required in cases that apply an economic substance inquiry. See *id.*

A partnership exists when . . . two or more parties in good faith and acting with a business purpose intend to join together in the present conduct of the enterprise.²⁰⁶

The sine qua non of a partnership is intent to join together for the purpose of sharing in the profits and losses of a genuine business.²⁰⁷

Even if there are indicia of an equity participation in a partnership, we should not accept at face value artificial constructs of the partnership [agreement]. Rather, we must examine those indicia to determine whether they truly reflect [] intent to share in the profits or losses of an enterprise or, instead, are either illusory [or] insignificant.²⁰⁸

In essence, to be a bona fide partner for tax purposes, a party must have a meaningful stake in the success or failure of the enterprise.²⁰⁹

The Third Circuit reversed the tax court's ruling upon the issue as to whether the investor taxpayer had a bona fide interest in a tax partnership.²¹⁰ The Third Circuit believed the HBH private placement offering and accompanying transactions and agreements were *in substance* a sale of tax credits by HBH to PBI as opposed to a valid tax partnership formation.²¹¹ In reversing the tax court's ruling, the following circumstances were mentioned by the Third Circuit as supporting facts:

- PBI was provided with a monetary guarantee if the purported tax benefits were not achieved, which weighed against the argument that PBI had any investment funds at risk in the transaction.²¹²
- The court took notice that PBI was not required to make its contribution until such time when the developer verified that it had achieved a certain level of progress in the renovations that would generate enough tax credits to at least equal the sum of PBI's contribution.²¹³
- The court took notice that the planned renovations were funded in full by other financial sources prior to the time PBI made its contribution to HBH, and the court therefore believed that

206. *Id.* at 449 (internal quotation omitted).

207. *Id.* (quoting *Southgate Master Fund, L.L.C. v. United States*, 659 F.3d 466, 488 (5th Cir. 2011)).

208. *Id.* at 449.

209. *Id.*

210. *Id.* at 463.

211. *Id.* at 460-63.

212. *Id.* at 456.

213. *Id.* at 455.

PBI's contribution was not necessary for the project to be completed.²¹⁴

- The court believed that PBI's exposure to environmental risks was non-existent due to the presence of an environmental guarantee and PBI's right to receive insurance proceeds in the event of such claims.²¹⁵
- The court believed that the presence of a certain contractual option requiring a three percent cumulative preferred return to be paid to PBI if it released its interest rendered PBI's interest at the entity level as comparable to a debt investment as opposed to a partnership equity interest.²¹⁶

In comparison with certain easement oriented syndications we have observed in our work, there are facts mentioned within the *Historic Boardwalk Hall* that are distinguishable from these offerings. Unlike the above mentioned case, the programs our firm has reviewed to date do not go so far as to guarantee the investors that they will be indemnified or compensated financially if any income tax deductions associated with the contemplated easement are disallowed. These programs also require capital contributions to be made to an entity that, in turn, will acquire a substantial majority of the economic interests associated with real property with conservation values and varying levels of development potential.

Most if not all of these programs, however, have significant income tax benefits associated with the conservation options offered. The obvious question in our view is whether the development possibilities of the real estate acquired by these programs are viable in a legal and economic sense. A harder question the IRS may focus upon in the near future is whether the partnership program in question has, in substance, any purpose other than to grant an easement and deliver tax deductions to the investors. *As legislative history and fact-specific case law fail to support or chastise investment driven conservation easements*, the phrase *caveat emptor* becomes increasingly relevant due to the uncertain nature of the law.

In view of the lack of legal authority on the issue, cases that have addressed economic substance issues within the context of other investments would suggest that we should consider the pure economics associated with the subject real estate if the tax oriented easement component of the program were erased from the picture. The levels to which the development of a program's real estate is objectively feasible and arguably approvable among reasonable investors *vary signifi-*

214. *Id.* at 456.

215. *Id.* at 457 n.58.

216. *Id.* at 458.

cantly from sponsor to sponsor. A reasonable level of legal support would appear to favor those investment programs where the real estate has real non-tax economic profit potential as illustrated by independent appraisals and market studies, and where a group of investors could conceivably pursue an investment or development option based upon the information provided to them. In such regard, a balanced presentation of the property options by the sponsor to the program investors accompanied by (i) an affirmative ability of a majority of investors to choose the option, and followed by (ii) an uncertain investment holding period would be additional facts that would help support the viability of the investment from a partnership substance perspective. The strongest support level would include programs that undertake a hybrid holding purpose (i.e., part development and part easement). While some, *but not all*, programs we are familiar with would fall within the first level of support, none that we have seen, to date, have gone so far as to effectuate a hybrid holding purpose (*which presents, in our view, an opportunity for a future program sponsor to develop a program with superior features from a tax support perspective*).

In cases where significant development activities are necessarily going to take place, such cases represent the ones with the highest level of confidence in terms of business purpose and economic substance. For most programs where development becomes a matter of choice, however, we would encourage one to perhaps look at the program offering in the absence of the conservation option and to consider whether the development and/or investment plans are ones that are at least capable of (i) being funded by a group of investors in a separate offering, and (ii) being executed profitably at a reasonable return for the risk (with the use of independent property-level underwriting and due diligence being helpful tools in such regard). In addition to possessing development feasibility and profit potential (i.e., economic substance), the manner the options are presented to investors, as well as the economic benefits and risks associated with the conservation election, could weigh into a consideration as to whether there is a sufficient non-tax purpose. As such, (i) the level of neutrality of the sponsor's offering documents and marketing materials as to the property options provided, (ii) the manner in which the vote may be exercised (i.e., affirmative vote recommended where a majority of investors control the outcome as opposed to a negative consent vote), (iii) the absence of mandatory put rights allowing investors to get out of the program after the income tax benefits have been enjoyed, and (iv) opportunities for the program to possibly realize some future revenues from retained rights if an easement were granted would be factors that may affect an inquiry regarding economics and purpose.

In summation concerning real estate investment programs that utilize conservation, the decision given to the investor group as to whether they will choose a development or investment option over an easement option should be a meaningful one after careful consideration of property-level information supporting multiple options. Although the following points are not an exhaustive list on this question (and the proposals in some offerings may not necessarily address all these points), certain facts that would arguably help to motivate an investor to select a development or investment option include the following:

- a reasonable IRR (“Internal Rate of Return”)/ROI determined by a valuation consultant;
- an established budget of anticipated capital costs of developing the property;
- a plan of financing relating to how future construction will be funded;
- the presence of retained working capital by the program to pursue commercial development activities;
- the presence of commercial development entitlements (i.e., construction permits) and the ability to develop the property under current zoning laws;
- an estimate of the investor’s capital call exposure if the development option is chosen;
- a written plan that identifies who will supervise the property’s development;
- the presence of a written contract with a developer;
- facts indicating that the sponsor or developer chosen by the sponsor actually has a track record of developing other projects successfully for similar commercial purposes;
- a presentation of the property’s market in terms of competition and future market demand in the offering documents;
- the quality of the commercial appraisal and appraiser;
- whether the sponsor is affirmatively pushing the easement option within the offering documents;
- whether the federal charitable income tax benefits are being touted by the sponsor over the potential economic benefits of commercial development;
- the amount of time and effort spent by the sponsor to present the alternatives to the investors (based upon the length of explanation provided in the offering documents as to all alternatives and time spent developing documents relating to all alternatives);

- whether the risks of one proposal are highlighted more heavily in the offering materials; and
- whether a retained developer will be paid for its time and effort in preparing a plan regardless of the option chosen.

In cases where investors are presented with viable non-tax options with opportunities for commercial profit, such a program would arguably be on better footing to withstand a potential IRS attack from a business intent or economic substance perspective.

VII. VALUATION PROCESS

Assuming the substance of the program partnership can be reasonably established, the second significant due diligence hurdle within the context of the previously mentioned syndicated programs would involve a comprehensive review of (i) how the property's value was determined, and (ii) the qualification of the appraiser making that value determination. From a foundational perspective,

valuation, as defined by the *Dictionary of Real Estate Appraisal, Fifth Edition*, is the process of estimating the Fair Market Value ("FMV") of an identified interest in a specific parcel or parcels of real estate as of a specified date. It is a term used interchangeably with appraisal. The valuation process is a systematic procedure and entails:

- Defining the problem/scope of work;
- Data collection and property description;
- Data analysis;
- Application of the approaches to value;
- Reconciliation of value indications and final opinion of value; and
- Reporting the defined value.

Critical to the completion of any valuation assignment, especially the valuation of a conservation easement, is clearly defining the problem and determining the scope of work. A detailed scope of work should be presented in the appraisal to allow a reader to understand exactly what steps and procedures were utilized by valuation experts in their analyses and FMV determinations. Appraisers must have a thorough understanding of which rights were "given up" or relinquished and which rights were retained by the donor in order to properly value the conservation easement.²¹⁷

217. *Conservation Easement Audit Techniques Guide*, INTERNAL REVENUE SERVICE (Jan. 3, 2012), https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Conservation-Easement-Audit-Techniques-Guide#_Toc202.

Appraisers must also possess a thorough understanding of the underlying real estate market where the property is located, whether the property is located within a discernible path of natural development, and whether the property's development is feasible under reasoned economic and market related assumptions and also taking into account the development activities that may or may not be allowed under zoning law and pre-existing use restrictions.

The value of a conservation easement contribution is the FMV of the easement at the time of the contribution.²¹⁸ The qualified appraisal must state, among other things, the date or expected date of the contribution.²¹⁹ The value of the donated easement must meet the definition of FMV as defined by the Treasury Regulations, which describes such value as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."²²⁰ The FMV of the property must decrease as a result of the granting of the conservation easement in order for a taxpayer to claim a charitable contribution deduction. In some instances, the grant of a conservation easement may not have a "material effect on the value of the property."²²¹

The best evidence of FMV of a conservation easement is the sale price of easements comparable to the donated easement. An appraiser should research the market to determine if there are any sales of comparable easements; however, in many instances, there are no comparable easement sales.²²² If there are no comparable easement sales, the "before and after" method of valuing a conservation easement may be used.²²³ This requires the property's FMV to be determined twice: first, without regard to the conservation easement (the "before value"), and then again after considering the specific restrictions imposed on the property by the easement document (the "after value").²²⁴ While the appraiser must consider the property's highest and best use ("HBU"), an appraiser must *also* consider whether or not the property's HBU would be considered by unrelated parties in determining the purchase price in an arm's length transaction.²²⁵ Thus, FMV in-

218. Treas. Reg. § 1.170A-14(h)(3)(i) (2009).

219. Treas. Reg. § 1.170A-13(c)(3)(ii)(C) (1996).

220. Treas. Reg. § 1.170A-1(c)(2) (2008).

221. Treas. Reg. § 1.170A-14(h)(3)(ii) (2009).

222. See *Stanley Works and Subsidiaries v. C.I.R.*, 87 T.C. 389, 399 (1986).

223. *Stanley Works*, 87 T.C. at 399; *Symington v. C.I.R.*, 87 T.C. 892, 895 (1986).

224. *Id.*

225. *Whitehouse Hotel Ltd. P'ship v. C.I.R.*, 139 T.C. 304, 331-32 (2012) (citing *Boltar, L.L.C. v. C.I.R.*, 136 T.C. 326, 336 (2011)) (explaining that "the highest and most profitable use for which a property is adaptable and needed or likely to be needed in the

incorporates the HBU for property *if* the demand for such use will affect the purchase price.²²⁶

In determining the before value of the property, an appraiser must consider the current use of the property *but* also objectively assess (i) the likelihood that the property could be developed absent the conservation easement restriction and (ii) the likelihood the property would be developed in the near future given the demand for the HBU.²²⁷ Thus, in the absence of being able to demonstrate that there is a market demand for the property, a property's second best use, or some other use consistent with market demand conditions could prevail. Existing zoning, conservation, historic preservation, or other laws and restrictions may limit the property's potential HBU.²²⁸ In determining the after value of the property, an appraiser should consider the specific restrictions being imposed, "individually and collectively, and compared to existing zoning regulations and other controls . . . to estimate whether and the extent to which, the easement will affect current and alternate future uses of the property."²²⁹

The amount of the charitable contribution deduction due to the granting of a conservation easement "covering a portion of a contiguous property owned by the donor and the donor's family (as defined in Code section 267(c)(4)) is the difference between the [FMV] of the entire contiguous parcel of the property before and after the granting of the restriction."²³⁰ Code section 267(c)(4) defines the term "family" as including an individual's "brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants."²³¹ Parents, children, grandparents, grandchildren, half-brothers and half-sisters are included in the definition of family, but cousins, nieces, nephews, in-laws, and step relations are not included.²³²

An appraiser must also consider any enhancement to the value of any other property owned by the donor or a related person resulting

reasonable near future is to be considered, not necessarily as the measure of value, but to the extent that the prospect of demand for such use affects market value").

226. *Whitehouse Hotel*, 139 T.C. at 331-32; *see also Stanley Works*, 87 T.C. at 401 (explaining that "before an additional element of value may be attributed to a potential property use of property . . . , the taxpayer must establish that there existed a reasonable probability the land would be so used for such purpose in the reasonably near future"). Note that in *Stanley Works*, the court explained that "elements affecting value that depend upon events or combinations of occurrences which, while within the realm of possibility, are not fairly shown to be reasonably probable, and should be excluded from consideration" *Id.*

227. *Id.*

228. Treas. Reg. § 1.170A-14(h)(3)(ii) (2009).

229. *Nicoladis v. C.I.R.*, 55 T.C.M. (CCH) 624, 627 (1988).

230. Treas. Reg. § 1.170A-14(h)(3)(i).

231. I.R.C. § 267(c)(4) (2014).

232. *See id.*

from the conservation easement.²³³ The amount of the conservation contribution deduction is “reduced by the amount of the increase in the value of the other property, whether or not that other property is contiguous.”²³⁴ A related person, for purposes of applying the enhancement rule, is defined in Code sections 267(b) or 707(b).²³⁵

There are two important distinctions between the contiguous parcel and the enhancement rules. First, the contiguous rule applies only to contiguous property, but the enhancement rule can apply to both contiguous and noncontiguous property. Second, the contiguous rule only applies to contiguous property owned by the donor or the donor’s family (as defined in Code section 267(c)(4)), but the enhancement rule applies to contiguous or noncontiguous property owned by a related party under Code section 267(b) or section 707(b), which are broader. Therefore, the appraiser must consider the impact the easement has on both contiguous and noncontiguous parcels.

The determination of the property’s HBU is vital to the valuation of any real estate, including conservation easements if there is a reasonable likelihood that the market will demand such use of the property in the near future. To qualify as the HBU, a use must satisfy four criteria:

- **Physically Possible** - The land must be able to accommodate the size and shape of the ideal improvement. What uses of the subject site are physically possible?
- **Legally Permissible** - A property use that is either currently allowed or most probably allowable under applicable laws and regulations. What uses of the subject site are permitted by zoning, deed restrictions, environment restrictions, and government restrictions? If the use is not currently permitted, how likely is it that zoning laws could be changed to permit the HBU contended?²³⁶

233. Treas. Reg. § 1.170A-14(h)(3)(i).

234. *Id.*

235. *Id.*; I.R.C. §§ 267(b), 707(b) (2014).

236. See *Palmer Ranch Holdings Ltd. v. C.I.R.*, T.C. Memo. 2014-79, *22-36 (2014) (concluding that the property’s HBU could be determined by an *assumed* zoning classification as “moderate density residential” zoned real estate even though (i) the property was not zoned as such at the time of the easement, and (ii) the zoning board denied the taxpayer’s initial application for a zoning change of the property to reflect such classification). Although the zoning board denied the taxpayer’s rezoning request, the court took into account the idea that rezoning could possibly occur in the future based upon sentiments articulated by the zoning board that rezoning might be granted if certain actions were undertaken by the taxpayer to preserve environmentally sensitive areas such as wetlands and an eagle nesting area situated on the property. *Id.* at *10. Although the IRS disallowed \$16.965 million of the taxpayer’s charitable deduction, the court upheld roughly \$20 million of \$24 million, or about 83% of the claimed deductions and denied the implementation of a tax penalty. *Id.* at *41. This case is representative

- **Financial Feasibility** - The ability of a property to generate sufficient income to support the use for which it was designed. Among those uses that are physically possible and legally permissible, which uses will produce a net return to the owner?
- **Maximally Productive** - Among the feasible uses, which use will produce the highest net return or the highest present worth?²³⁷

An appraiser's HBU analysis and conclusion should be documented in the appraisal report, with a comprehensive discussion supported by relevant market data or other information sources to adequately support his or her conclusions.²³⁸ Again, the failure of the appraiser to establish with credible evidence that a property's HBU is needed or likely to be needed for such use in the reasonable near future could be fatal to the overall determination of a property's value in a litigation setting (i.e., in which case, a less profitable use, such as agriculture or recreation, may be adopted by the court in the absence of a demand for residential or commercial development).²³⁹

Assuming a syndicated program can satisfy scrutiny as a bona fide partnership, the second potential hurdle that the investors may face relates to the reasonableness of the property value purported by the appraisal. Given that the HBU backed value of a property may be multiples of the acquisition price to the syndicate investment program, the IRS may be inclined to challenge the reasonableness of the appraisal upon multiple grounds. If the IRS is successful in its efforts of challenging the appraisal's valuation, the same could result in thousands to potentially millions of dollars in lost tax deductions to investors. Certain factors courts have taken notice of in relation to an appraisal's quality in respect to valuation issues include:

- The appraiser's years of industry experience;
- The appraiser's years of experience evaluating conservation easement properties;

of one where the court ultimately sided more closely with the taxpayer's qualified appraisal despite a fairly significant difference in opinion by the taxpayer and the IRS as to what deduction should be allowed. *Id.* at *14.

237. See *Whitehouse Hotel*, 138 T.C. at 331 (explaining that the HBU is the reasonably probable and legal use of the property that is "physically possible, appropriately supported, and financially feasible"); Treas. Reg. § 1.170A-14(h)(3)(ii) (providing that "if before and after valuation is used, the fair market value 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 restriction, would in fact be developed, as well as any effect from zoning, conservation, or historic preservation laws that already restrict the property's potential highest and best use.").

238. Treas. Reg. § 1.170A-13(c)(2)(i) (1996).

239. See *Whitehouse Hotel*, 139 T.C. at 331-32.

- The appraiser's knowledge and research of the property's underlying real estate market;
- Whether the appraiser considered local or non-local properties as sales comparables in determining fair value;
- Whether the appraiser's report considers the property's access to water and other utilities needed to effectuate future development;
- Whether the appraiser's report considered appropriate zoning, building or sub-division restrictions in respect to the property's HBU before the easement was granted; and
- Whether the appraiser's report addressed the effects of easement restrictions upon the value of the property after the easement is granted.²⁴⁰

In cases where the appraisal's evaluation of value is litigated in a judicial proceeding, outcomes vary widely from the taxpayer's deduction being completely upheld to completely rejected. When considering the valuation opinion of the taxpayer's and government's experts, a court is not bound by the opinion of any one witness, and a court may extract findings from multiple experts' opinions.²⁴¹ One of many cases involving valuation disputes between taxpayer/easement donors and the government is *Kiva Dunes Conservation, LLC v. Comm'r*,²⁴² in which the taxpayer's appraisal and the assessment of the IRS' valuation expert differed by almost \$30 million.²⁴³ The case is an example of one in which the tax court agreed, in substantial part, with the taxpayer's assessment based upon the appraiser's years of experience of evaluating conservation easement property and the appraiser's significant knowledge of the geographic area and commercial real estate market where the property was located. On the other hand, courts have been quick to note the flaws of an appraisal in cases where it is apparent that the appraiser has a very superficial understanding of the real estate market of the subject property and of conservation easements in general.²⁴⁴ It is in such cases where very drastic reduc-

240. See *Butler*, 103 T.C.M. (CCH) 1359 (2012) (upholding about fifty percent of the easement deduction claimed by the taxpayer); See *Mountanos v. C.I.R.*, 105 T.C.M. (CCH) 1818 (2013) (finding no value in the easement at issue); See *Kiva Dunes Conservation, L.L.C. v. C.I.R.*, 97 T.C.M. (CCH) 1818 (2009) (upholding over 90% of the appraisal value asserted by the taxpayer even though the taxpayer's and IRS' purported property values differed by about \$30 million).

241. *Fannon v. C.I.R.*, 52 T.C.M. (CCH) 1113, 1117 (1986).

242. 97 T.C.M. (CCH) 1818 (2009).

243. *Kiva Dunes Conservation, L.L.C. v. C.I.R.*, 97 T.C.M. (CCH) 1818 (2009) (holding that the taxpayer was entitled to a \$28.656 million charitable donation, which was about 90% of the deduction opined to by the taxpayer's appraiser).

244. See *Butler v. C.I.R.*, 103 T.C.M. (CCH) 1359 (T.C. 2012) (giving virtually no analytical weight to one of four appraisers that had 20 years' experience in valuing real

tions to the valuation and related charitable deduction will often occur.

On a final note in regard to valuation, particular care is warranted regarding investment programs that are structured to acquire mineral properties in which the proposed business option involves surface mining of coal or other natural resources. While these types of programs are not problematic per se, they can present valuation challenges on multiple fronts; the first issue of which relates to the true highest and best use of the real estate acquired. Until a property has been appropriately entitled by government authorities for subsurface mining, the IRS may contend that the undertaking of coal mining or gravel quarry operations is too speculative to classify surface mining as a reasonable probable future use of the real estate.²⁴⁵ Other issues that may be reviewed closely by the IRS and Tax Court in the event of an appraisal challenge would include (i) the appraiser's work experience involving mineral properties, with specialized work experience in geology, coal mining, or quarry operations preferred; (ii) aggressive uses of the capitalized income method of valuation in cases where the property is raw land that has not been permitted for future mining; (iii) the location of the mineral property from end-users in relation to competitors (i.e., which would affect the property owner's transportation costs and needed sales prices in relation to competitors); (iv) the actual need for additional mineral suppliers in the target market; and (v) the quality of core data used to prove up the mineral reserves (e.g., where an insufficient number of mineral core samples were taken to prove up the thickness of the minerals believed to be situated over the property).²⁴⁶ The question as to whether the program sponsor has the expertise or close business relationships needed to effectuate the future development of a mineral property could also be an important question to consider from a valuation and tax substance perspective.

estate, although he had almost no experience with conservation statements or with the area where the property was located).

245. See Arthur Pincomb, *Your Reserves: What are They Worth?* PIT & QUARRY (June 2004) (questioning the appropriateness of surface mining operations as a highest and best use of real estate in cases where the property has not been permitted for such uses).

246. *Id.*; see also Robert Paschall, *Appraisal of Construction Rocks*, AMERICAN INSTITUTE OF PROFESSIONAL GEOLOGISTS, (2007) (suggesting the sales comparison method as a preferred valuation approach in cases where the property is unentitled land); Resource Technologies Corporation, *Valuation of Aggregate Operations for Banking Purposes*, <http://www.resourcetec.com/Portals/0/Publications/Valuation%20Aggregate.pdf> (website visited Jan. 4, 2015) (explaining risks relating to valuations of unpermitted land).

VIII. FEDERAL ESTATE TAX PLANNING

On a tax planning note, another important tax benefit of conservation easements is the possible reduction of federal estate taxes. Because estate taxes are based on the highest economic use of the parcel, these taxes can be substantial even if the land is being used as a farm or ranch. This can put considerable financial strain on heirs and in many circumstances may force them to sell all or part of the real estate in order to pay estate taxes. Conservation easements can help prevent this result. By granting away development rights, the value of the real estate is decreased, which lowers the value of the property for estate tax purposes and can provide a significant reduction in the estate tax burden on family members. This is particularly helpful in situations where the cultural, sentimental, and historical uses of the real estate are more important to the heirs than its economic value.

Under the 1997 Taxpayer Relief Act,²⁴⁷ a qualified conservation easement granted upon real estate owned by a decedent may reduce his or her federal estate taxes on the estate by up to forty percent of the difference between the gross value of real estate minus the value of the easement, up to a maximum of \$500,000 if the easement meets the requirements for a qualified conservation easement.²⁴⁸ While it would be prudent to consult a tax professional to determine if a conservation easement qualifies as a qualified easement, some of the key conditions are: (i) ownership of land for more than three years prior to death; (ii) donation of the easement occurred by the decedent or a member of his family; and (iii) the easement must prohibit more than minimal commercial recreational use of the land.²⁴⁹ Additionally, conservation easements relating to historic structures are *prohibited* from using the benefit of the estate tax exclusion rule.²⁵⁰

Note that if the value of the easement granted is less than thirty percent of the gross value of the property, the forty percent exclusion will then be reduced by two percent for each one percent (or fraction thereof) for which the easement's value is less than thirty percent of the gross value of the subject property.²⁵¹ Some examples that help illustrate the estate tax exclusion rule are provided as follows:

Example #1: Halfacre is worth \$1.5 million, and a qualified conservation easement worth \$500,000 is granted on it. The gross value of the property (or \$1.5 million) minus the value of the easement (or \$500,000) equals \$1 million which, multi-

247. Pub. L. 105-34, 111 Stat. 788 (1997) (codified as amended in scattered sections of 26 U.S.C.).

248. I.R.C. § 2031(c)(1)-(3) (2014).

249. I.R.C. § 2031(c)(8)(A)-(C).

250. I.R.C. § 2031(c)(8)(B); I.R.C. § 170(f)(13)(A) (2014).

251. I.R.C. § 2031(c)(2).

plied by 40%, equals \$400,000. As such, \$400,000 is excludable from the gross estate.

Example #2: Whiteacre is worth \$4 million, and a qualified conservation easement worth \$2 million is granted on it. Without the limitation, 40% of the post-easement value of the property (i.e., 40% of \$2 million), or \$800,000, would be excludable under the exclusion rule. Because of the limitation of \$500,000 under Code section 2031(c)(3), only \$500,000 can be excluded.

Example #3: Shadyacre is worth \$4 million, and a qualified conservation easement worth \$500,000 is granted on it. Because the conservation easement is worth only 12.50% of the gross value of the property (i.e., \$500,000 is 12.50% of \$4 million), the amount that can be excluded from the estate is only \$175,000 (i.e., calculated as: 30% less 12.50% = 17.50% x 2 = 35%; 40% - 35% = 5%; 5% of \$3.50 million = \$175,000).

The federal estate tax exclusion does not apply if the subject real estate is "debt-financed property" or if the decedent retained a development right with respect to the real estate subject to the conservation easement.²⁵² However, heirs who have received an interest in the subject property may terminate a development right that was formerly held by the decedent.²⁵³ The estate tax exclusion also applies to an interest in a partnership, corporation, or trust so long as at least thirty percent of the entity was owned directly or indirectly by the decedent.²⁵⁴ In this case, the amount excluded under Code section 2031(c) is reduced on a pro rata basis by the percentage not owned by the estate.²⁵⁵ Ownership in these circumstances is determined under the same rules governing qualified family owned business interests in section 2057(e)(3) of the Code.²⁵⁶

There is also a charitable deduction rule applicable to an estate that is *separate* from the estate exclusion rule. The deduction rule permits an estate to take an estate tax charitable deduction under Code section 2055(f) for a qualified conservation easement gifted to a qualified organization.²⁵⁷ Under this rule, estate taxes will be assessed only against the net value of property subject to the qualified conservation easement.²⁵⁸ Unlike the estate tax exclusion rules, there is no limit on the allowed deduction and the transfer subject to

252. I.R.C. § 2031(c)(4)-(5).

253. I.R.C. § 2031(c)(5)(B).

254. I.R.C. § 2031(c)(10).

255. *See id.*; *see also* I.R.C. § 2057(e)(3) (2014).

256. I.R.C. § 2057(e)(3).

257. I.R.C. § 2055(f) (2014). The deduction rules apply to qualified easement contributions that meet the requirements of section 170(h). I.R.C. § 170(h) (2014).

258. I.R.C. § 231(c)(1) (2014).

the deduction can be made on a post mortem basis. An example of how the deduction applies to an estate situation is presented below:

Example: A decedent died in 2015 and his gross estate totaled \$10 million, comprised of Blackacre (worth \$5 million) and \$5 million in other assets. Absent a qualified conservation easement, approximately \$4.57 million of the estate would be subject to federal estate taxes. Assume, however, that a qualified conservation easement worth \$2 million is granted on the property. Under the exclusion rule, \$500,000 will be excluded from the gross estate, and under the deduction rule, the \$2 million easement will be entitled to an estate tax charitable deduction. After the application of these two rules, the estate tax liability will be figured on \$7.5 million instead of \$10 million. The taxes saved as a result of the exclusion and deduction is \$1 million (i.e., \$2.5 million excluded from the tax multiplied by the 40% rate).

IX. CONCLUSION

As our executive administration will probably move forward in efforts to enlarge the size of the federal government and to coincidentally increase federal income taxes to support the activities of a robust government, high income individuals will continue to seek investment alternatives that offer or purport to offer competitive income tax planning consequences. One such area that may begin to see more traction is private placements of investment real estate programs that offer possible charitable tax deductions through conservation easement conveyances. Again, while we believe that the general idea of these programs are not *on their face* abusive or lacking of economic substance, great care must be taken to determine whether the investment or development proposals contained within the program offers are viable under the guidance set forth in Section VI of this Article.²⁵⁹ This, in turn, will ultimately determine whether the program has a purpose outside of merely providing a sizable tax deduction to investors. In the absence of a finding of facts that would help to support such a purpose, the basis under which such income tax deductions can be claimed may be challenged under the Partnership Anti-Abuse Regulations and federal common law doctrines explained in Section VI of this article.²⁶⁰

Assuming a syndicated easement transaction has a valid business purpose, the issue of arguably the second highest significance is to determine whether a reasonably qualified appraiser with experience in

259. See *supra* notes 132-216 and accompanying text.

260. See *supra* notes 132-216 and accompanying text.

evaluating commercial/conservation quality property has followed appropriate appraisal methods and has issued an appraisal that meets the federal tax code requirements. As property valuation is a factual determination that can be subject to multiple interpretations, even the most experienced appraiser's work can be subject to IRS scrutiny in cases where the charitable deduction is substantial. For this reason, investors that are risk intolerant from a tax audit perspective should not be offered such products. Other technical aspects of the conservation transaction that would require careful review in the due diligence process would likewise include a determination as to whether (i) the easement donee is a qualified donee that has the ability to enforce the easement, (ii) the easement deed grants a perpetual conveyance of a qualified property interest, and (iii) whether there is a detailed baseline report that specifically outlines the conservation qualities of the property. While the technical requirements for granting valid easements are fairly straightforward, the number of requirements that must be followed can sometimes lead taxpayers to overlook steps in the transaction execution and tax filing steps of the process. As such, these transactions, while arguably serving a benevolent purpose from a public policy perspective, should be approached with considerable legal care.