Caplin & Drysdale

Kiva Dunes and Golf Course Conservation Easements: Important Implications for Tax Deductibility of Conservation Easement Contributions

By Charles M. Ruchelman and Matthew C. Hicks[1]

Charles M. Ruchelman is a member of Caplin & Drysdale, Chartered, a boutique tax law firm in Washington, D.C.

Matthew C. Hicks is an associate at Caplin & Drysdale, Chartered, a boutique tax law firm in Washington, D.C

- - - - -

Mr. Ruchelman and Mr. Hicks are members of the tax controversy and litigation practice group. Their practice focuses on representing clients during Internal Revenue Service examinations, before the IRS Office of Appeals, in cases before the U.S. Tax Court, U.S. district courts, the U.S. Court of Federal Claims, and the U.S. appellate courts.

- - - - -

Several months ago, the Tax Court decided *Kiva Dunes Conservation, LLC v. Commissioner*,[2] a case concerning valuation of a golf course conservation easement for purposes of a charitable contribution deduction. The case is likely to influence future conservation easement controversies.

Conservation Easements Generally

In general, to receive a deduction for a charitable contribution under Section 170 of the Internal Revenue Code (the "Code"), a donor must give up his entire interest in the property.[3] An exception exists, however, for conservation easements.[4] Conservation easements are restrictions on the development or use of real property that promote open space, historic preservation or protection of natural resources. The donee of a conservation easement has the right to enforce the restrictions, while the donor retains all other ownership interests.

To qualify for a charitable deduction under Section 170, a contribution of a conservation easement must meet three statutory requirements. First, the easement must be granted in perpetuity.[5] Second, the easement must be donated to a "qualified organization."[6] A qualified organization is typically a government agency or public charity that is dedicated to conservation and has the means to enforce the easement. Third, the easement must satisfy a "conservation purpose" as defined by the Code.[7] If such requirements are met, the donor may deduct up to the fair market value of the easement.[8]

Since 2004, the IRS has increasingly targeted conservation easements. The IRS is primarily concerned that some easements may lack a conservation purpose and/or have inflated values. Both of those concerns were raised in *Kiva Dunes*.

Significance of *Kiva Dunes*

In *Kiva Dunes*, the petitioner, Kiva Dunes Conservation, LLC, placed a conservation easement on an up-scale Alabama golf course prohibiting uses other than that of a golf course, park, or agricultural enterprise. It donated the easement to the North American Land Trust and claimed a charitable contribution deduction in the amount of $30,588,235. The IRS disallowed the deduction and petitioner brought suit in the Tax Court.

After trial, the IRS conceded that the petitioner was entitled to a deduction. The only issue remaining for decision was the valuation of the conservation easement. Ultimately, the court relied heavily on the taxpayer's valuation expert and decided the easement was worth $28,656,004.

The Tax Court case is significant in two respects. First, in conceding the deductibility of the contribution, the IRS recognized that golf course conservation easements may satisfy a conservation purpose. Second, the court promoted greater consistency in valuation standards by prohibiting the use of post-donation information to determine a property's value.

Golf Course Conservation Easements

In *Kiva Dunes,* the IRS initially argued the easement did not satisfy a conservation purpose. Four conservation purposes are recognized under the Code: (1) outdoor recreation by, or for the education of, the general public; (2) protection of relatively natural habitat; (3) preservation of open space; and (4) historic preservation.[9] The petitioner in *Kiva Dunes* sought to qualify under all but the "historic preservation" category. Without further discussion, the opinion notes that the IRS conceded the point after trial.

The concession is refreshing given the perceived controversy surrounding golf course conservation easements.[10] On account of the negative publicity, golf course conservation easements became a political target and a rallying cry for reform. At a hearing before the Senate Committee on Finance, speakers criticized golf course conservation easements.[11]

The IRS responded by devoting increased resources to the issue. After publishing Notice 2004-41, IRS audits of conservation easements, including those on golf courses, significantly increased. Notice 2004-41 essentially warned taxpayers that charitable deductions related to conservation easements would be closely examined.

In *Kiva Dunes*, the IRS recognized that golf course conservation easements may serve a conservation purpose. While Kiva Dunes is not the first golf course conservation easement that has qualified for a deduction,[12] it is the first to be recognized at trial. The IRS' concession indicates a more even-handed approach to golf course conservation easements. It serves as recognition that golf course conservation easements are not inherently improper and, in some cases, will serve legitimate conservation goals.[13]

Consistency in Valuation

There is disagreement over the use of post-valuation-date information in determining fair market value.[14] *Kiva Dunes* is the latest case to address the issue. In *Kiva Dunes,* the court prohibited the taxpayer's use of post-valuation-date information in valuing a golf course conservation easement. Ironically, the prohibition cost the taxpayer very little but could have important consequences for the IRS.

Conservation easements are typically valued using the "before and after" method.[15] Under this method, the value of the easement equals the fair market value of the property before it was encumbered by the easement minus the fair market value of the property after it was encumbered by the easement.[16] Fair market value is defined 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 a reasonable knowledge of relevant facts."[17] The fair market value must be based on the property's highest and best use.[18]

In *Kiva Dunes*, the taxpayer's expert argued that, after encumbrance by the easement, the property's highest and best use was not continued operation as a golf course. He based this argument on new information regarding golf course closures, a decline in rounds being played, and losses sustained at local courses. The court rejected the argument because it was based on information that was unavailable at the time of the contribution. In footnote 29, the court explained that, in determining the property's highest and best use, information "must be limited to information that would have been available to the hypothetical buyer or seller on the date of the donation."

The Tax Court's prohibition of post-donation information accords with the plain language of the Treasury regulations. Treas. Reg. § 1.170A-14(h)(3)(i) states that the value of a conservation easement is its value "at the time of the contribution." Because the property is being valued *at the time* of the contribution, not before or after, the only relevant facts are those that a willing buyer and seller could have known on the contribution date.[19] Subsequent events are, for the most part, irrelevant.[20]

This is also the approach adopted by the Uniform Standards of Professional Appraisal Practice ("USPAP"). USPAP are the generally accepted standards for professional appraisal practice in North America. USPAP states that, in conducting a retrospective appraisal, it would be misleading to use only comparable sales information that did not exist as of the effective date of the appraisal "because it would not reflect information available to the marketplace during that time period." [21]

Notably, the IRS has issued proposed regulations adopting the "substance and principles" of USPAP.[22] Adoption of the substance and principles of USPAP necessarily means adoption of USPAP's prohibition of post-donation information. To date, however, the IRS has not consistently followed such an approach.

The IRS commonly uses post-valuation-date sales as comparables in assessing a deficiency.[23] At the same time, the IRS prohibits taxpayers from relying on such information. In Publication 561, which provides valuation guidance to taxpayers, the IRS states:

> You may not consider unexpected events happening after your donation of property in the valuation. You may consider only the facts known at the time of the gift, and those that could be reasonably expected at the time of the gift.[24]

Thus, the IRS creates one set of rules for taxpayers and another for itself. This double standard is rarely challenged and allows the IRS an unfair advantage in valuation disputes.

Kiva Dunes argues against that advantage by prohibiting the use of most post-valuation-date information. Importantly, *Kiva Dunes* does mandate a blanket prohibition against *all* post-valuation-date information. It recognizes that such information may be helpful, for example, to "measure the reasonableness of the [appraisers'] assumptions." [25] Where such a purpose is not being served, however, *Kiva Dunes* requires that the information "would have been available…on the date of donation." This conclusion may be cited against the IRS when it departs from its own guidance. Accordingly, *Kiva Dunes* is a step toward greater consistency in valuation.

Conclusion

Kiva Dunes is an important case that will have an impact on future controversies regarding conservation easements. It serves as a reminder that golf course conservation easements may satisfy a conservation purpose and it promotes more consistent valuation standards. Taxpayers and their advisers should be aware of the opportunities afforded by these new developments.

Endnotes

1. Charles M. Ruchelman is a member of Caplin & Drysdale, Chartered, a boutique tax law firm in Washington, D.C. Matthew C. Hicks is an associate at Caplin & Drysdale, Chartered. Their practice focuses on representing clients during Internal Revenue Service examinations, before the IRS Office of Appeals, in cases before the U.S. Tax Court, U.S. district courts, the U.S. Court of Federal Claims, and the U.S. appellate courts.

2. T.C. Memo. 2009-145, 97 T.C.M. 1818 (2009).

3. Treas. Reg. § 1.170A-14(a) (2009).

4. *Id.*

5. I.R.C. § 170(h)(2)(C) (2009).

6. § 170(h)(1)(B).

7. § 170(h)(1)(C).

8. Treas. Reg. § 1.170A-1(c)(1).

9. I.R.C. § 170(h)(4)(A).

10. For example, between 2003 and 2004, the Washington Post published a series of articles about charitable deductions for conservation easements. *See* Stephens & Ottaway, *Developers Find Payoff in Preservation*, Wash. Post, Dec. 21, 2003, at A01.

11. *The Tax Code & Land Conservation: Report on Investigations & Proposals for Reform: Hearing Before the S. Comm. on Finance*, 109th Cong. 3 (2005) (statement of U.S. Senator Max Baucus) ("Nor is it a qualifying conservation purpose to place an easement over a golf course.").

12. *See* William E. Ellis, *Conservation Easements for Golf Courses – Fact or Fantasy*, 9 NewsLinks 1 (Winter 2005) (describing several successful golf course conservation easements).

13. Another favorable development for golf course conservation easements is the redesign of Form 990. Previously, the form included questions related specifically to golf course conservation easements. *See* 2007 Instructions to Form 990 Schedule A (requiring the filer to indicate the number of easements held that "encumber a golf course or portions of a golf course"). The new Form 990, however, has omitted all such references. *See* 2008 Instructions to Form 990 Schedule A.

14. *See*, *e.g.*, *Polack v. Comm'r.*, 366 F.3d 608, 612 (8th Cir. 2004) ("[S]ubsequent events that shed light on what a willing buyer would have paid on the date in question are admissible…"); *Estate of Wilson v. Comm'r.*, 23 T.C.M. (CCH) 87, 90 (1964) ("Subsequent sales may not be an evidence of value unless the transaction could have been foreseen.").

15. Treas. Reg. § 1.170A-14(h)(3).

16. *Id.*

17. § 1.170A-1(c)(2).

18. § 1.170A-14(h)(3)(i), (ii).

19. See First Nat'l Bank of Kenosha v. United States, 763 F.2d 891, 893-94 (7th Cir. 1985) ("Because property is valued as of the date of death, the only relevant facts are those that this hypothetical buyer and seller could reasonably have been expected to know at that time.").

20. *See*, *e.g.*, *First Nat'l Bank,* 763 F.2d at 894 ("Under this traditional definition of relevance, evidence of most subsequent events would be excluded); *Cent. Trust. Co. v. United States*, 158 Ct. Cl. 504, 520 (1962) ("The valuation of the stock must be made as of the relevant dates without regard to events occurring subsequent to the crucial dates").

21. USPAP, *Frequently Asked Questions* F-43, #91 (The Appraisal Foundation, 2008-2009 ed.).

22. *Substantiation and Reporting Requirements for Cash and Noncash Charitable Contribution Deductions*, 73 Fed. Reg. 45908, 45917 (Aug. 7, 2008) (to be codified at 26 C.F.R. pt. 6, § 1.170A-17(a)(2)).

23. *See*, *e.g.*, *Noble v. Comm'r.*, 89 T.C.M. (CCH) 649, 654 (2005); *Estate of Jung*, 101 T.C. 412, 430 (1993).
IRS Publication 561, *Determining the Value of Donated Property*, 4.

24. *Kiva Dunes*, T.C. Memo 2009-145, n.9 (using the 2005 purchase price of the Woodlands Golf Course as a "tool with which to measure the reasonableness of the experts' assumptions," even though the donation of the Kiva Dunes easement occurred on December 31, 2002).

25. *Kiva Dunes*, T.C. Memo 2009-145, n.9 (using the 2005 purchase price of the Woodlands Golf Course as a "tool with which to measure the reasonableness of the experts' assumptions," even though the donation of the Kiva Dunes easement occurred on December 31, 2002).