

REAL ESTATE

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Kiva Dunes—Making and Substantiating the Value of Conservation Easements

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The Tax Court not only upheld a deduction for a conservation easement on a golf course but also substantially adopted the taxpayer's valuation of the property, both before and after the grant. The case is instructive on the steps taxpayers should take to increase the likelihood of having a claimed deduction for such an easement upheld, and also on how the Tax Court will view valuation appraisals.

The Tax Court's opinion in *Kiva Dunes Conservation, LLC*, TC Memo 2009-145, RIA TC Memo ¶2009-145, addressed a question that has been hotly debated in the conservation easement community—whether a conservation easement can be granted on golf course property. The decision also dealt with several other important issues, including valuation methods applicable to conservation easements. *Kiva Dunes* is a valuable guide for taxpayers seeking to make conservation easement contributions. An in-depth understanding of the case and the issues examined by the court will be useful for anyone involved with conservation easements, whether such involvement is in one's capacity as a potential donor, tax advisor, appraiser, or recipient of a conservation easement.

THE CASE

Kiva Dunes involved a taxpayer's gift of a conservation easement over certain property—which included a golf course—to an eligible donee.

The taxpayer was an LLC taxed as a partnership for federal income tax purposes. On 12/31/02, the taxpayer donated a conservation easement to the North American Land Trust (NALT) by a grant (the "easement declarations"). The conservation easement was

granted on 140.9 acres owned by the taxpayer (the "property"), which was located on Alabama's Fort Morgan Peninsula.

The Fort Morgan Peninsula is 22 miles long and ranges between 1.2 and 3.1 miles wide. The property was between, but did not abut, the Gulf of Mexico on the south, and Mobile Bay and Bon Secour Bay on the north. The tract's widest dimension from east to west was approximately 3,600 feet, and its widest dimension from north to south was approximately 2,300 feet.

The conservation easement was located between two segments of the Bon Secour National Wildlife Refuge. One Refuge segment was approximately 0.85 miles west/northwest of the easement, and the other Refuge segment was approximately 1.55 miles east of the easement. The property included the Kiva Dunes Golf Course. As discussed below, however, it had many unique attributes that made it well suited for a conservation easement.

The easement declarations restricted the development of the property, the practical effect of which was to limit the use of the property to a golf course, a park, or a low-density agricultural enterprise. Specifically, the easement declarations limited the use of the property to protect relatively natural habitats for fish, wildlife, and plants, and to preserve open space for scenic enjoyment of the general public and for the advancement of governmental conservation policies. The easement declarations also preserved land areas for outdoor recreation use by the general public.¹

The LLC claimed two charitable contribution deductions on its partnership return. One was a deduction for a \$35,000 cash contribution to NALT.² The other was for the qualified conservation contribution of a conservation easement on the property to NALT in the amount of \$30,588,235.

Key Issues

The week-long trial brought forth evidence that included 103 exhibits, testimony of 18 witnesses, and numerous charts, photographs, and videography.

At trial, the taxpayer had the burden of first proving that the conservation easement met one or more of the conservation purposes necessary for a deduction of a qualified conservation contribution. Specifically, the taxpayer had to establish that the easement accomplished one of the following purposes specified in Section 170(h)(4)(A):

- Preservation of land areas for outdoor recreation by, or for the education of, the general public.
- Protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem.
- Preservation of open space either for the scenic enjoyment of the general public or pursuant to a clearly delineated federal, state, or local governmental conservation policy.

Next, the taxpayer had the burden of establishing the value of the conservation easement. Specifically, the taxpayer attempted to substantiate that the value of the property before imposition of the conservation easement (the "before value") was equal to \$31,938,985, and that the value of the property after the imposition of the conservation easement (the "after value") was \$1,050,750.³

The Tax Court opinion was favorable to the taxpayer and to the use of conservation easements generally. Specifically, the court found the taxpayer was entitled to a charitable deduction of \$28,656,004, which was 94% of the deduction the taxpayer claimed on its income tax return. In coming to its decision, the Tax Court addressed several different issues.

Conservation purpose. The Service initially challenged whether the easement constituted a permissible "conservation purpose." This "threshold issue" was strongly contested by the IRS throughout the trial. The IRS was skeptical as to whether an easement restricting golf course property could constitute a permissible conservation purpose.

Much of the trial was devoted to testimony on the conservation purpose issue, after which the IRS conceded the issue in its brief to the Tax Court. Why, one might ask, would the IRS concede the conservation purpose issue in this case? Later in this article we will address the property's unique qualities that made it particularly well-suited for a conservation easement.

Valuation. After the IRS conceded the conservation purpose, the primary issue left was the value of the easement. The experts agreed that the FMV of the easement was equal to the difference between the FMV of the property before and after the easement was granted, reduced by the increase in the value of other nearby property, owned by the taxpayer or a related party, as a result of granting the easement.

The "before value" of the property was based on its potential highest and best use as a residential development. In order to derive the before value, both experts used a discounted cash-flow analysis of estimated revenues and costs associated with the development and sale of lots in their hypothetical subdivisions (the "subdivision method"). The two appraisers' assumptions regarding the number of lots available for sale, average sale price of the lots, and rate at which the lots would sell differed significantly.

The taxpayer's expert's determination that 370 lots could be developed for sale (as opposed to the 300 lots projected by the Service's expert) accorded with the testimony of the county zoning director. Ultimately, the court ruled that the Service's expert misinterpreted the local zoning regulations in concluding that only 300 lots could be built.

The Tax Court also accepted the taxpayer's expert's average lot price of \$170,000. The Service's expert's estimate of \$85,000 per lot was based essentially on the value of two of the least desirable interior lots in the hypothetical subdivision that had no gulf or lake view and were far removed from the amenities. The taxpayer's expert's assumed sales absorption rate of 37 lots per year was also accepted over the estimate of 20 lots per year by the Service's expert.

The parties agreed, for purposes of determining the value of the property after it was encumbered by the easement, that the property's highest and best use was its continued operation as a golf course. The Service's expert used an income approach to determine such value, while the taxpayer's expert determined the after value by analyzing sales of comparable but unimproved properties that were purchased for recreational uses. The court rejected the income approach valuation used by the Service's expert because he failed to take into account significant expenses, such as salaries and wages, employee benefits, repairs and maintenance, taxes, licenses, and depreciation reserves, in calculating the net income from the course.

The after value determined by the taxpayer's expert through the comparable sales method was accepted by the court. This aspect of the Tax Court's decision was significant because the IRS had argued that the taxpayer's comparables, which had different characteristics and uses than the subject property as encumbered by the easement (e.g., as a golf course), were inadmissible. The Tax Court, however, accepted the use of the comparables, with the exception that an upward adjustment be made to the value of the comparables to reflect the expense necessary to convert the unimproved land into comparable golf course property.

Penalties. The IRS claimed that the taxpayer was subject to a valuation penalty. The Tax Court found the penalty was inapplicable, however, in light of the court's determination that the taxpayer's charitable contribution valuation did not exceed 200% of the determined value of the easement.

LESSONS FROM THE CASE

Kiva Dunes contains a wealth of information for individuals or entities that are considering making a contribution of a conservation easement, and for tax professionals advising these individuals in the contribution process, or in defending an attack on such easements by the IRS.

Technical Requirements

Many issues involved with the *Kiva Dunes* conservation easement were never challenged by the IRS because they were handled properly at the front end. Correctly confronting and resolving these issues is crucial to receiving a contribution for a conservation easement.

Qualified donee. The first thing that a taxpayer must do in order to obtain a deduction for the contribution of a conservation easement is to make the donation to an "eligible donee." Reg. 1.170A-14(c)(1) requires that in order to be eligible a donee must meet the following requirements:

- (1) The organization must be a governmental agency or a qualified public charitable organization.
- (2) The organization must have a "commitment to protect the conservation purposes of the donation."
- (3) The organization must "have the resources to enforce the restrictions."

There are many qualified donees available to accept conservation easements, although they may vary in their interests and requirements. In *Kiva Dunes*, the donee was the North American Land Trust. NALT is both a public charity and an "accredited" organization. The accreditation is a distinction received from the Land Trust Alliance, a nationally known land conservation organization.⁴

Where a contribution is made to a non-accredited organization, taxpayers and practitioners should pay special attention to documenting the proposed donee's commitment to protecting the conservation purpose of the donation. In addition, documenting and establishing that the organization has the resources to enforce the conservation easement restrictions will be essential.

Baseline documentation. Another issue of critical importance to conservation easement contributions is whether the donor of the easement has created or received proper "baseline documentation" detailing the contribution.

Baseline documentation is a report that documents the condition of the easement property at the time an easement is completed and provides a baseline for future monitoring of the property and determining whether there are any violations of the easement. Reg. 1.170A-14(g)(5)(i) requires this baseline property report when the landowner reserves the ability to exercise a right that might interfere with the conservation value of the property. Under the Code and Regulations, it is technically the landowner's responsibility to create this report, although it is typically required by a land trust for all easements, and it is normal for the land trust to prepare the report.

Baseline documentation must consist of all of the following items:

- (1) The appropriate survey maps from the U.S. Geological Survey, showing the property line and other contiguous or nearby protected areas.⁵
- (2) A map of the area drawn to scale showing all existing man-made improvements or incursions and natural species on the property.⁶
- (3) A contemporaneous aerial photograph of the property.⁷
- (4) On-site photographs taken at appropriate locations on the property.⁸
- (5) The condition of any protected property.⁹
- (6) A statement signed by the donor and a representative of the donee clearly referencing the documentation and stating that the baseline documentation is accurate.¹⁰

Taxpayers should identify an experienced and reputable donee when making a donation of a conservation easement in which the taxpayer desires to retain some rights. This is especially important when the taxpayer is attempting to make a donation of a conservation easement over golf course property, because generally the rights sought to be retained in order to run and operate a golf course will be fairly extensive.

Although baseline documentation need only satisfy the minimum requirements discussed above, if done properly the documentation can provide a great opportunity to record the state of the property as it exists at the time of the contribution. Specifically, pictures, videography, and other tangible evidence of the property as it existed at the time of the contribution can paint a convincing picture of the conservation preservation attributes of the property. This evidence can play a vital role if the conservation purpose of the contribution is eventually challenged by the IRS.

Qualified appraisal. There are two key issues relating to conservation easement appraisals:

- (1) Whether the appraisal meets the technical requirements of a "qualified appraisal" under the Code and Regulations.¹¹
- (2) Whether the appraisal substantiates the value of the conservation easement claimed by the donor.

Careful pre-contribution planning can help a taxpayer avoid challenges by the IRS as to the first issue. The Service frequently challenges valuations, however, and—whether merited or not—often will be capable of presenting a serious challenge to the valuation derived by a taxpayer's expert.

Technical requirements regarding appraisals. Reg. 1.170A-13(c)(2)(i) contains specific requirements that must be met before an appraisal will be deemed a "qualified appraisal." Specifically, in the context of a contribution of greater than \$5,000, a taxpayer must do all of the following:

- (1) Obtain a qualified appraisal for such property contributed.
- (2) Attach a fully completed appraisal summary to the tax return on which the deduction for the contribution is first claimed (or reported) by the donor.
- (3) Maintain records containing certain required information. ¹²

A "qualified appraisal" is defined in Reg. 1.170A-13(c)(3), which provides a host of requirements. The appraisal report must:

- Relate to an appraisal made not earlier than 60 days before the date of contribution of the appraised property. ¹³
- Be prepared, signed, and dated by a qualified appraiser. ¹⁴
- Include all information that is required to be included in a qualified appraisal (as discussed in the Regulations). ¹⁵
- Not involve a prohibited appraisal fee. ¹⁶

Moreover, for appraisals performed after 8/17/06 for contributions made after that date, Section 170(f)(11)(E)(i)(I) requires that an appraisal must comply with generally accepted appraisal standards and any Regulations or other guidance prescribed by the Service. "Generally accepted appraisal standards" refers to the substance and principles of the Uniform Standards of Professional Appraisal Practice (USPAP).

Notwithstanding the fact that USPAP standards are generally adhered to by most experienced appraisers, the IRS has tended to argue with increasing frequency that the standards have not been followed. The problem with countering such allegations is that USPAP provides general standards and principles which, by their very nature, are somewhat ambiguous. To counter such an assertion, appraisals should reference and adhere to the USPAP standards as closely as practicable.

The *Kiva Dunes* easement was contributed long before 8/17/06.

Nonetheless, the Service initially argued that the appraisal should have been performed in accordance with USPAP, and that the appraisal failed to meet this standard. The IRS ultimately abandoned this argument. Nevertheless, it is not uncommon for the Service to misapprehend this rule and attempt to argue, at least within IRS Examination and Appeals, that appraisals relating to contributions made prior to 8/17/06 must be performed in accordance with USPAP.

Substantiation of value. *Kiva Dunes* illustrates that no matter how informative or detailed an appraisal is, it will always be subject to some challenge by the Service. When an appraisal is performed in accordance with all of the applicable Regulations, is performed in accordance with USPAP principles, and is thorough and complete, the IRS often will nonetheless challenge the conclusions in the appraisal by presenting its own valuation expert with a contrary opinion.

In many instances, as in *Kiva Dunes*, the value of the conservation easement will evolve into a "battle of the appraisers." In such a situation, it is important that the taxpayer's appraiser be able to support the appraisal conclusions with knowledgeable and persuasive analysis, as well as detailed fact finding. (A description of this process is described later in this article.)

Qualified appraiser. The Regulations provide a complex framework of provisions governing who will constitute a "qualified appraiser" for purposes of the Code. Due to the patchwork nature of congressional legislation in this area, the appraiser requirements differ depending on the year of the appraisal and the type of property being appraised.

Currently, Section 170(f)(11)(E)(ii) defines a qualified appraiser¹⁷ as an individual who meets all of the following requirements:

- The appraiser has earned an appraisal designation from a recognized professional appraiser organization¹⁸ or has otherwise satisfied minimum education and experience requirements set forth in Regulations.¹⁹
- The appraiser regularly performs appraisals for which compensation is received.
- The appraiser satisfies such other requirements as may be prescribed by in Regulations or other guidance.²⁰

Moreover, under Section 170(f)(11)(E)(iii),²¹ an individual cannot be treated as a qualified appraiser unless the following criteria are met:

- The individual demonstrates verifiable education and experience in valuing the type of property subject to the appraisal.²²
- The individual has not been prohibited from practicing before the IRS under 31 U.S.C. section 330(c) at any time during the three-year period ending on the date of the appraisal.

Although in *Kiva Dunes* the IRS conceded that the taxpayer's appraiser was a "qualified appraiser," the Service is generally quick to dispute this issue in audits of conservation easements. Moreover, as a result of the enactment of the PPA, the definitions and standards for a "qualified appraiser" have become much more complex. Accordingly, it is important for taxpayers to have a comprehensive understanding of the qualifications their appraiser must meet, as well as the process the appraiser must engage in.

It is generally advisable for taxpayers to hire an appraiser that has substantial experience in valuing conservation easements. Such appraisers are more likely to have knowledge of the applicable appraisal requirements. Moreover, *Kiva Dunes* illustrates (as is discussed below) that, although an appraiser's technical education and licenses are very important, it is at least equally important that the appraiser has an extensive knowledge of the specific geographic area and market of the property being appraised. Indeed, in *Kiva Dunes*, the Tax Court gave great weight to specific knowledge about the local area.

Subordination agreement. A recurring issue in IRS examinations of easement deductions involves existing mortgages that encumber conservation easement property. Unless such mortgages are subordinated to the rights of the donee to enforce the conservation easement, the conservation easement will not be deductible. Reg. 1.170A-14(g)(2) provides that "no deduction will be permitted under this section for an interest in property which is subject to a mortgage unless the mortgagee subordinates its rights in the property to the right of the qualified organization to enforce the conservation purposes of the gift in perpetuity."

Although the IRS has sometimes contended that subordination agreements must be entered into prior to the date on which the easement is contributed, the Regulations do not appear to expressly require this. It would, however, be advisable to avoid this potential issue by assuring that any subordination agreement is entered into before the contribution occurs, and in all events before the tax return for the applicable year is submitted.

The Service also has contended in some audits that a subordination agreement must be recorded in order to satisfy the Regulations. As quoted above, however, Reg. 1.170A-14(g)(2) requires only that the mortgagee subordinates its rights to the right of the donee to enforce the conservation purposes of the gift. Thus, the Regulations do not expressly require that the mortgagee subordinate its rights to third parties or that the subordination must be recorded. Accordingly, it is possible that when state law provides that an unrecorded mortgage will be effective as to the parties to the agreement, the Regulations will be satisfied by the existence of a subordination agreement, regardless of whether it is recorded or enforceable against third parties.

Conservation Purpose

One of the most important issues in *Kiva Dunes* was whether there was a qualified "conservation purpose" for the conservation easement. This issue was only mentioned in passing by the court in its opinion because the issue was conceded by the IRS after the trial of the case and partial briefing. The issue, however, was critical to the case, as it is in many conservation easement controversies.

Section 170(h)(4)(A) and Reg. 1.170A-14(d)(1) identify four different categories of permissible conservation easement purposes, only one of which must be satisfied:

- (1) The preservation of land areas for outdoor recreation by, or the education of, the general public.
- (2) The protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem.
- (3) The preservation of certain open space (including farmland and forest land).
- (4) The preservation of a historically important land area or a certified historic structure.

In *Kiva Dunes*, the taxpayer had alleged that the conservation easement served the first three conservation purposes. The issue is important because the IRS and many experts had been of the opinion that a conservation easement restricting property to use as a golf course could not meet any of the conservation purposes. Nonetheless, after an extensive trial in which the LLC brought forth convincing conservation purpose evidence, the Service conceded that an easement over golf course property in this instance satisfied the conservation easement purposes required in the Code and Regulations. ²³

The three "conservation purposes" that the taxpayer argued the easement satisfied are described below. ²⁴

Relatively natural habitat. Reg. 1.170A-14(d)(3)(ii) provides a non-exclusive list of habitats and natural areas that will satisfy the protection of a "relatively natural habitat":

- Habitats for rare, endangered, or threatened species of animals, fish, or plants.
- Natural areas, such as undeveloped islands, that represent high quality examples of terrestrial or aquatic communities.
- Natural areas included in, or contributing to, the ecological viability of a local, state, or national park, preserve, wildlife refuge, wilderness area, or similar conservation area.

In *Kiva Dunes*, the taxpayer asserted that the easement protected virtually all of the above types of habitats and natural areas. The taxpayer demonstrated—through the use

of pictures, video, and other trial exhibits—the various types of habitats present on the property.

The property and conservation easement were located on a narrow part of the Fort Morgan Peninsula in Baldwin County, Alabama, which shares many characteristics with barrier islands, and is in some instances classified as a "barrier resource" for federal regulatory purposes. The taxpayer was able to demonstrate that the area consisted of unique habitat that helped provide a diverse array of habitats for wildlife.

The taxpayer's ability to describe, in specific detail, the types and quality of habitat and wildlife located on the property was essential to establishing that the easement provided for the "protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem."

Habitat. The conservation easement contained seasonal freshwater wetlands, permanent lakes and ponds, wooded hammocks, and coastal dunes, each of which provided natural and/or relatively natural habitat. The taxpayer was able to demonstrate that the dispersed pattern of the habitat areas did not negate its conservation values.

The taxpayer's experts testified that a particular habitat need not support all phases of species' lives to be termed a "habitat." For instance, wildlife may "nest" in one area and "feed" in another. Many species of birds and animals are migratory, and may only pass through the habitat. Such "stop-over" habitat is often of critical importance, however. "Habitat" includes areas used occasionally by species or areas used in unpredictable patterns that vary over time.

The taxpayer's expert established that 61.15 acres of the 140.9 acre easement (43.4%) could be described as a "primary habitat" for wildlife, and that 49 of these acres (34.8% of the total easement) could be classified as "fully natural." The LLC also established that the remaining 12.15 acres of the "primary habitat" area was a "relatively natural" habitat for fish, wildlife, and plants.²⁵

In addition, the taxpayer demonstrated that the habitat areas within the conservation easement directly contributed to the conservation efforts of the nearby federal wildlife refuge. The taxpayer also argued that the areas of the property that comprised the primary golfing elements of the Kiva Dunes Golf Course (e.g., fairways, greens, rough, and tees) provided habitat and conservation benefits, such as areas for feeding, migration, and protection from storms. Under the Regulations, such property can be deemed to serve a conservation purpose.²⁶

Wildlife. The Regulations and prior Tax Court opinions suggest that the habitats protecting "rare, endangered, or threatened species of animals, fish, or plants" qualify more easily within the habitat conservation purpose.²⁷ Thus, taxpayers should highlight such wildlife when it is located in the preserved habitats.

In *Kiva Dunes*, the taxpayer demonstrated the conservation values of various species of wildlife located on the property, including neotropical migratory birds migrating annually between North America and South America.²⁸ Parts of the property also served as transitional habitat of the endangered Alabama beach mouse. When the primary habitat of the mouse is affected by storms, the availability of areas of the conservation easement for refuge becomes particularly important. Such uses of the property demonstrate the breadth of the term "habitats," including uses beyond mere permanent presence of the species.

Open space. The taxpayer also argued that the conservation easement preserved an "open space," meeting the requirements of the Code. Section 170(h)(4)(A)(iii) provides an alternate sufficient conservation purpose for "the preservation of open space (including farmland and forest land) where such preservation is ... for the scenic enjoyment of the general public,"²⁹ or "pursuant to a clearly delineated Federal, State, or local governmental conservation policy,"³⁰ and "will yield a significant public benefit."

"Open space" is a somewhat ambiguous term, and neither the Code nor the Regulations provide much clarity to the definition. Moreover, there can be significant difficulties to demonstrating the "scenic enjoyment" of an "open space" to the IRS or Tax Court. In *Kiva Dunes*, the taxpayer presented visual evidence at trial in the form of photographs and video of the conservation easement's open space vistas.

In *Kiva Dunes*, the majority of the visual evidence presented by the taxpayer (other than what was in the baseline documentation) was prepared specifically for the trial. Nevertheless, it may be prudent for grantors of conservation easements to go above and beyond the usual baseline documentation photos and record the most favorable images possible of their open space vistas *at the time the easement is granted*. Although professional videography is certainly not a requirement for baseline documentation, it is great preparation for defending a conservation easement if the easement is challenged at a later time.

Education or outdoor recreation of the general public. Finally, the taxpayer argued that the conservation easement provided outdoor recreation for the general public, and, therefore, satisfied the conservation purpose provided for in Section 170(h)(4)(A)(i).

That section states that "the preservation of land areas for outdoor recreation by, or the education of, the general public" constitutes a permissible conservation purpose. Reg. 1.170A-14(d)(2)(i) elaborates on this definition, as follows:

"The donation of a qualified real property interest to preserve land areas for the outdoor recreation of the general public or for the education of the general public will meet the conservation purposes test of this section. Thus, conservation purposes would include, for example, the preservation of a water area for the use of the public for boating or fishing, or a nature or hiking trail for the use of the public."

When dealing with a golf course easement, taxpayers who want to use the encumbered property as a *private* golf course will need to establish a public benefit other than those described in Section 170(h)(4)(A)(i).³¹

Although the Code requires only that conservation easements meet one of four conservation purposes, it is important for taxpayers to present evidence that as many of these purposes are met as is possible. In *Kiva Dunes*, the taxpayer presented evidence that the easement met three out of four conservation purposes.

Valuation—Battle of the Experts

If a taxpayer can establish that it has made a "qualified contribution" to a "qualified donee" for a permissible "conservation purpose" and that all of the technicalities regarding the contribution are satisfied, the last and final issue is the value of the easement.

The value of a conservation easement is one of the areas the IRS is likely to challenge, primarily because of the inherently subjective nature of the determination of value. No matter how well a taxpayer documents the contribution, the issue of value will always be in play for the Service.

Kiva Dunes demonstrates that a taxpayer's selection of a qualified and experienced appraiser will likely be critical to the taxpayer's ability to withstand an IRS challenge of the value of the conservation easement. It is helpful to hire an appraiser with experience in valuing charitable contributions because such appraisers are more likely to have knowledge about the various appraisal and appraiser requirements. Moreover, *Kiva Dunes* provides a good illustration that, although an appraiser's technical education and licenses are very important, it is equally if not more important that the appraiser has extensive knowledge of the actual geographic area being appraised. Indeed, in *Kiva Dunes* the Tax Court seemed as impressed with the taxpayer's expert's knowledge of the local area as his technical certifications.

FMV. The amount of a charitable contribution is determined by the FMV of the contributed property at the time it is contributed.³² Where there is a substantial record of sales of easements comparable to a donated easement, those comparables are used to determine the FMV of the easement.³³ Where no such comparables exist, as in *Kiva Dunes*, the FMV of a conservation easement is determined with the "before and after" methodology prescribed in the Regulations.³⁴ Specifically, Reg. 1.170A-14(h)(3)(i) provides as follows:

"If no substantial record of market-place sales is available to use as a meaningful or valid comparison, as a general rule (but not necessarily in all cases) the fair market value of a perpetual conservation restriction is equal to the difference between the fair market value of the property it encumbers before the granting of the restriction and the fair market value of the encumbered property after the granting of the restriction."

When applying the before and after methodology, the Regulation provides that all property contiguous to the encumbered property that is owned by the taxpayer or the taxpayer's family must be taken into account in the valuation.³⁵ This has the effect of reducing the value of the deduction to the extent that the value of any contiguous property is enhanced by the easement. Additionally, any economic benefit that accrues to the donor or a related party as a result of the contribution must be taken into account. These rules could conceivably have a drastic effect on the deduction where the donor or a related party has retained a significant amount of property surrounding a golf course easement, if such property appreciates in value as a result of the easement.

FMV in *Kiva Dunes*. In *Kiva Dunes*, the experts' opinions of the before value, after value, and enhancement involved critical, subjective judgments and assumptions. The key elements of the valuation issue in *Kiva Dunes* are described below. The taxpayer presented evidence, at trial and in brief, that its expert was the most experienced and respected appraiser in the region surrounding the property, and that his judgments and assumptions reflected this experience. As evidenced by its opinion, the Tax Court generally agreed with the taxpayer's expert. Specifically, the court stated that the expert "perform[ed] more appraisal work in Baldwin County than any other appraiser, and [had] a great depth of knowledge of the comparable properties used in valuing the easement and of the surrounding local real estate market."

In contrast, the court stated the Service's expert "ha[d] no particular expertise in Baldwin County, and he ha[d] been to the Baldwin County, Alabama, area only twice in connection with his appraisal of the easement."

Both appraisers determined the before and after values of the conservation easement, to arrive at the FMV of the easement.

Before value. Both appraisers agreed that the development of a residential subdivision would have been the highest and best use of the property at the time of the contribution. In its opinion, the Tax Court focused on the differences in three assumptions made by the experts³⁶ that led to the drastic difference in their before value conclusions—\$31,938,985 and \$10,018,000. The assumptions focused on by the court were:

- (1) The number of lots available for sale.
- (2) The average sale price of the lots.
- (3) The rate at which the lots would sell.

Number of lots for sale. The taxpayer's expert determined that 370 lots could be developed in the hypothetical Kiva Dunes subdivision. The Service's expert determined that only 300 lots could be developed, based in part on his misinterpretation of a county zoning regulation. The planning and zoning director of the zoning board testified about such regulation. His testimony essentially confirmed the taxpayer's interpretation of the regulation.

Average sale price of the lots. The taxpayer's appraiser determined that the initial sales price of lots in his hypothetical subdivision would average \$170,000, while the Service's expert determined that the lot price would have been only \$85,000. The court agreed with the taxpayer's expert and noted that the Service's expert arrived at the \$85,000 value by "averaging the 2001 sales prices of just two interior lots sold at the Kiva Dunes subdivision."

The court's acceptance of the taxpayer's expert's conclusions highlights the importance of a sound conceptual plan supporting a subdivision analysis. The court noted that the conceptual plan used by the taxpayer's expert proposed the enlargement of several lakes, and the creation of several pool and recreation areas on the property—all of which significantly increased the lot value.

Absorption rate. The parties in *Kiva Dunes* differed on how long it would take to sell out the hypothetical subdivision, i.e. the period over which cash flow was projected to be received (the "absorption rate"). The court relied on the taxpayer's expert's local experience and specific examples of actual nearby subdivisions. The Tax Court adopted the taxpayer's absorption rate of 37 lots per year for ten years, and stated: "Considering that the proposed plan would have had more than three times as many lots available for purchase as [a nearby subdivision], we conclude that a sales forecast of 37 lots per year is reasonable."

Ultimately, the court adopted the taxpayer's before value of \$31,938,985.

After value. One lesson from the Tax Court's value analysis is that value is based on the highest and best use of the property on the date of the donation, and the highest and best use is not necessarily the current use. Although the property was being used as a golf course, the Kiva Dunes course, like many golf courses around the country, was making little or no profit and its continued operation was not assured.

In determining the value of the property, the experts agreed that the highest and best use of the property after being burdened by the easement was its continued operation as a golf course. The taxpayer's expert used comparable properties to reach an after value, and the Service's expert used an income capitalization approach, which was ultimately

rejected by the court. The Tax Court rejected the income approach because the Service's expert had omitted essential categories of expenses that "when subtracted from [the Service's expert's] computed 2002 net income, result[ed] in a negative number." These omitted expenses included (1) salaries and wages, (2) employee benefits, (3) repairs and maintenance, and (4) taxes and licenses.³⁷

The Tax Court ultimately relied on the taxpayer's comparables approach. Even though the comparable properties used by the taxpayer's expert were not developed as golf courses at the time, the court determined them to be potentially suitable for such a use. The taxpayer's expert adjusted the sales prices of his comparables to reflect differences in market conditions, location value, access and visibility, size, availability of utilities, topographical and wetland characteristics, and financing terms. The court made its only significant adjustment to the taxpayer's expert's values by adjusting the after value upwards to reflect the cost associated with converting the comparable properties into golf course properties akin to the Kiva Dunes property. Ultimately, the Tax Court concluded that the after value for the Kiva Dunes Golf Course was \$2,982,981 (\$1,070,980 comparable value plus \$1,912,001 for the cost of the golf course improvements).

The Tax Court also accepted the taxpayer's expert's conclusion that the conservation easement had enhanced nearby property owned by the taxpayer by \$300,000. Finally, the court concluded that the FMV of the conservation easement was \$28,656,004. This holding constituted an unusually high percentage of claimed value (approximately 94%). The IRS had asserted a gross overvaluation penalty of 40%, although the court denied it.

The taxpayer's success in *Kiva Dunes* demonstrates that, especially in the context of conservation easements, a thorough and knowledgeable appraisal expert can make all of the difference. It is important that the appraiser, in addition to being well qualified and knowledgeable, spends the time necessary to investigate, examine, and understand the property being valued. Additionally, the hypothetical subdivision used in many of these appraisals requires careful attention to every detail, including potential development analysis.

CONCLUSION

Although *Kiva Dunes* is probably most noteworthy for demonstrating that a conservation easement can be legitimately granted on property operated as a golf course, the case is instructive on many issues. The case emphasizes the need to carefully select an appraiser with many years of experience, preferably in the local area, and the need for the appraiser to thoughtfully and carefully choose valuation methods and comparable properties suitable to the analysis. The taxpayer in *Kiva Dunes* also benefited greatly from detailed planning of the proposed subdivision used in the before value analysis, and careful attention to feasibility and costs of the proposed plan.

There are many pitfalls and nuances in planning and defending conservation easements, but with the help of good advisors and a capable land trust, a landowner can successfully negotiate the treacherous path through the conservation easement rules. By applying expertise at the front-end in the areas of planning, drafting, and defending conservation easements, the taxpayer is in the best possible position for success, even if the taxpayer's conservation easement deduction is challenged.

Practice Notes

- Where a contribution is made to a non-accredited organization, taxpayers and practitioners should pay special attention to documenting the proposed donee's commitment to protecting the conservation purpose of the donation.
- Documenting and establishing that the organization has the resources to enforce the conservation easement restrictions will be essential.
- Taxpayers should identify an experienced and reputable donee when making a donation of a conservation easement in which the taxpayer desires to retain some rights.
- It may be prudent for grantors of conservation easements to go above and beyond the usual baseline documentation photos and record the most favorable images possible of their open space vistas *at the time the easement is granted*.

Other Conservation Easement Cases

In addition to *Kiva Dunes*, practitioners contemplating the benefits of a conservation easement might consider the following decisions.

- *Turner*, 126 TC 299 (2006) (providing a thorough discussion of the "open space requirement" and finding that such requirement is not satisfied where a conveyance of an easement does not limit the size of the homes developable on the eased property).
- *Glass*, 124 TC 258 (2005), *aff'd* 98 AFTR 2d 2006-8309, 471 F3d 698 (CA-6, 2006) (seminal case on conservation easement purpose, particularly the purpose of protecting a relatively natural habitat).
- *Bond*, 100 TC 32 (1993) (finding substantial compliance with the "qualified appraisal" Regulations is sufficient to receive a charitable contribution deduction).
- *Symington*, 87 TC 892 (1986) (explaining that the "before and after method" of valuing conservation easements is generally appropriate because of the scarcity of sales of conservation easements that can be used as comparables).
- *Thomason*, 2 TC 441 (1943) (distinguishing between private and "public benefit").
- *Hughes*, TC Memo 2009-94, RIA TC Memo ¶2009-094 (recent case denying the Service's ever more pervasive "zero value" argument that conservation easements have no value).
- *Simmons*, TC Memo 2009-208, RIA TC Memo ¶2009-208 (applying the substantial compliance doctrine in the context of the qualified appraisal and contemporaneous written acknowledgment requirements with respect to the donation of a facade easement).
- *Herman*, TC Memo 2009-205, RIA TC Memo ¶2009-205 (conservation easement restricting development of air rights above historic apartment building was not exclusively for conservation purposes where easement allegedly failed to provide for maintenance of the property or prevent alteration or demolition of the building).
- *Daniel*, TC Memo 1997-328, RIA TC Memo ¶97328 (applying the substantial compliance doctrine in context of the requirements of Regs. 1.170A-13(b)(2) and (3)).
- *Satullo*, TC Memo 1993-614, RIA TC Memo ¶93614 (discussing the mortgage subordination requirement of Reg. 1.170A-14(g)(2), and indicating an unsubordinated mortgage might not result in a disallowed deduction in limited instances in which the mortgage is unlikely to be enforced).
- *Schapiro*, TC Memo 1991-128, PH TCM ¶91128 (Tax Court determined, based on the subdivision analysis, that the value of the conservation easement was greater than taxpayer had claimed on its return).
- *Bruzewicz*, 103 AFTR 2d 2009-1428, 604 F Supp 2d 1197 (DC Ill., 2009) (stating substantial compliance doctrine might not apply in the Seventh Circuit).

[1](#)

Among the key restrictions of the easement declarations were the following: (1) the property could not be used for residential or commercial purposes; (2) few structures could be built; (3) the owner had to apply the best environmental practices then prevailing in the golf industry; (4) no ground removal was allowed other than golf course irrigation practices; (5) no cutting, removal, or destruction of trees was allowed; (6) no signs or billboards were allowed; (6) no filling in or removal of soil or mining was allowed; (8) dumping was prohibited; (9) no material change in topography was permitted; (10) manipulation of natural water courses was prohibited; (11) soil erosion was to be minimized; (12) no introduction of non-native plants was permitted; and (13) the property was not to be used to meet zoning requirements on outside property.

[2](#)

Before trial, the IRS stipulated that the deduction of the \$35,000 cash contribution to North American Land Trust was proper.

[3](#)

Additionally, the taxpayer had the burden of establishing that the enhancement in the value of other property owned by the taxpayer or related parties as a result of the conservation easement was not more than the \$300,000 amount determined by the taxpayer.

[4](#)

See www.landtrustalliance.org.

[5](#)

Reg. 1.170A-14(g)(5)(i)(A).

[6](#)

Reg. 1.170A-14(g)(5)(i)(B).

[7](#)

Reg. 1.170A-14(g)(5)(i)(C).

[8](#)

Reg. 1.170A-14(g)(5)(i)(D).

[9](#)

Id.

[10](#)

Id.

[11](#)

The technical requirements in the Regulations create a complex web of potential traps. The IRS has frequently argued that the failure by a taxpayer to meet any one of the requirements will result in a total disallowance of a charitable contribution deduction. The courts, however, have provided taxpayers leeway in many instances by requiring only "substantial compliance" with the Regulations. See, e.g., *Simmons*, TC Memo 2009-208, RIA TC Memo ¶2009-208 .

[12](#)

The information required, listed in Reg. 1.170A-13(b)(2)(ii), consists of the following: (1) the name and address of the donee organization to which the contribution was made; (2) the date and location of the contribution; (3) a description of the property in detail reasonable under the circumstances (including the value of the property); (4) the FMV of the property at the time the contribution was made, the method used in determining FMV, and, if the valuation was determined by appraisal, a copy of the signed report of the appraiser; and (5) the terms of any agreement or understanding entered into by or on behalf of the taxpayer that relates to the use, sale, or other disposition of the property contributed. Finally, if the property contributed consists of ordinary income property (for example, if it was not held for a year or more prior to the donation of the easement), or if less than the entire interest in the property is contributed in the same year, the Regulations require additional information regarding the contribution.

[13](#)

Reg. 1.170A-13(c)(3)(i)(A).

[14](#)

Reg. 1.170A-13(c)(3)(i)(B). See the discussion in the text, below.

[15](#)

Reg. 1.170A-13(c)(3)(i)(C). Reg. 1.170A-13(c)(3)(ii) sets forth a host of information that must be provided.

[16](#)

Reg. 1.170A-13(c)(3)(i)(D). Reg. 1.170A-13(c)(6) lists the requirements pertaining to appraisal fees.

[17](#)

Section 170(f)(11)(E)(ii) was enacted by the Pension Protection Act of 2006 (PPA), P.L. 109-280, 8/17/06, effective for appraisals prepared with respect to returns or submissions filed after that date.

[18](#)

Notice 2006-96, 2006-46 IRB 902, provides in section 3.03(1) that an appraisal designation from a recognized appraisal organization is sufficient to satisfy this requirement if it relates to valuing the type of property for which the appraisal is performed.

[19](#)

For returns filed before 10/20/06, the education and experience requirements are satisfied if the appraiser is a "qualified appraiser" within the meaning of Reg. 1.170A-13(c)(5). For returns filed after 10/19/06, the minimum education and experience requirements depend on the type of property to which an appraisal relates. For real property appraisals, the appraiser must be licensed or certified for the type of property being appraised in the state in which the real property is located. See Notice 2006-96, *supra* note 18, section 3.03(b)(ii).

[20](#)

No additional Regulations have been issued at this point. Until such Regulations are issued, Notice 2006-96, *supra* note 18, governs.

[21](#)

Section 170(f)(11)(E)(iii) is also in effect for appraisals prepared with respect to returns or submissions filed after 8/17/06.

[22](#)

The appraiser is required to make a designation in the appraisal that, because of the appraiser's background, experience, education, and membership in professional associations, the appraiser is qualified to make appraisals of the type of property being valued. See Notice 2006-96, *supra* note 18, section 3.03(2).

[23](#)

It is possible that the IRS had planned to use Kiva Dunes as a test case to demonstrate that granting an easement on golf course property cannot support a permissible conservation purpose. The Service's concessions reflect that the IRS was concerned that the court would determine the issue in the taxpayer's favor. By conceding the issue, the IRS effectively prevented the court from addressing the issue head-on, although the Service's concession in Kiva Dunes will undoubtedly be cited by taxpayers for the proposition that conservation easements can permissibly be granted over golf course property.

[24](#)

The only conservation purpose not argued by the taxpayer was that the easement preserved a historically important land area or a certified historic structure. This conservation purpose is generally not applicable in golf course easement situations. It is most commonly used in situations involving facade easements. See, e.g., Dorsey, TC Memo 1990-242, PH TCM ¶90242 (conservation easement deduction for a facade easement restricting development of facade of historic commercial building); but see Herman, TC Memo 2009-205, RIA TC Memo ¶12009-205 (conservation easement restricting development of air rights above historic apartment building was not exclusively for conservation purposes where easement allegedly failed to prevent

alteration or demolition of the building). It is anticipated that Herman will be appealed as it addresses an arguably novel concept regarding the deductibility of "development rights." Additionally, Herman is facially contradictory to Dorsey, although the Tax Court attempted to distinguish the case in its opinion.

[25](#)

As often will be the case when an easement encumbers a geographically large area, it was virtually impossible for the taxpayer to prove that the entire portion of the property that was encumbered by the easement provided a "relatively natural habitat of fish, wildlife, or plants, or similar ecosystem" as described in the Regulations. The taxpayer, however, was able to rely on prior case law indicating that the entire eased area did not need to provide conservation benefits, as long as a significant portion of such easement satisfies the requirement. See, e.g., *Glass*, 124 TC 258 (2005), *aff'd* 98 AFTR 2d 2006-8309, 471 F3d 698 (CA-6, 2006).

[26](#)

The Regulations provide that an easement need protect only a "relatively" natural habitat. Accordingly, the Regulations permit easements over property that has been partially altered by human development to satisfy the conservation easement purpose requirement. See Reg. 1.170A-14(d)(3)(i).

[27](#)

Reg. 1.170A-14(d)(3)(ii); *Glass*, *supra* note 25.

[28](#)

The Fort Morgan Peninsula is a critical stop-over habitat for these birds when they fly over the Gulf of Mexico. The passage often takes 18 to 24 hours. Prior to their crossing, the birds feed and prepare physically. They often collapse and rest following the passage. The higher dune ridges of the easement provide regions of tree, shrub, and grass vegetation of particular importance to these birds.

[29](#)

See also Reg. 1.170A-14(d)(4)(ii)(A) ("A contribution made for the preservation of open space may be for the scenic enjoyment of the general public ... if development of the property would impair the scenic character of the local rural or urban landscape or would interfere with a scenic panorama that can be enjoyed from a park, nature preserve, road, waterbody, trail, or historic structure or land area, and such area or transportation way is open to, or utilized by, the public...").

[30](#)

See also Reg. 1.170A-14(d)(4)(iii)(A) ("The requirement that the preservation of open space be pursuant to a clearly delineated Federal, state, or local governmental policy is intended to protect the types of property identified by representatives of the general public as worthy of preservation or conservation. A general declaration of conservation goals by a single official or legislative body is not sufficient. However, a governmental conservation policy need not be a certification program that identifies particular lots or small parcels of individually owned property...").

[31](#)

See Reg. 1.170A-14(d)(2)(ii), which states that the "preservation of land areas for recreation or education will not meet the test of this section unless the recreation or education is for the substantial and regular use of the general public."

[32](#)

Additionally, Section 170(e)(1) requires a donor to reduce the amount of his charitable deduction in appreciated property by the amount of gain that would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its FMV (e.g., the donor's deduction will be limited to his basis in the contributed property). Section 170(e)(1) applies to conservation easements if the property on which the easement is granted is "dealer property" in the hands of the contributor or has not been owned by the taxpayer for the applicable holding period (currently one year). Accordingly, it is important that taxpayers verify the date of their original acquisition of the property, and that the acquisition was properly recorded.

[33](#)

Id. See also Reg. 1.170A-14(h)(3)(i).
[34](#)

Although the Tax Court prefers the use of comparables when they are available, often in the context of conservation easements there will not be "comparable properties" because properties encumbered by conservation easements are not frequently exchanged.
[35](#)

This also can lead to computational uncertainties, especially when gifts are made from the same tract over several years.
[36](#)

The court concluded the other variables used by the appraisers had an immaterial effect on the final value.
[37](#)

It appears that the IRS expert, like the IRS engineer before him, used the tax return schedule of "other" expenses, which schedule did not include the expenses on specific lines of the return. He disregarded a schedule provided to him detailing the income and expenses of the golf course operations. Although the reason for the error was debated in court, the error evidently harmed the expert's credibility.