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Since 1973, the **Toledo Community Foundation** has provided individuals, families and businesses interested in the well-being of our community with an *efficient, effective, low-cost, professionally managed* mechanism to achieve their charitable goals.

For philanthropists wishing to maximize the impact and life of their charitable gifts, the Foundation provides *resources for thoughtful giving*. Using its expertise and personalized services, **Toledo Community Foundation** helps donors transform their philanthropic impulse to measurable

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Charitable Gifts of Conservation Easements

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What's it all about, Alfie? First a quick overview of the tax rules on charitable gifts of conservation easements, followed by a recent Tax Court case on the valuation of easements.

Overview of Tax Rules

A qualified conservation contribution is a gift of a qualified real property interest to a qualified organization to be used only for conservation purposes. Let's run down all these qualifieds.

Qualified organizations: governmental units; publicly supported charitable, religious, scientific, literary, educational, etc., organizations; and organizations that are controlled by, and operated for the exclusive benefit of, a governmental unit or a publicly supported charity. Key requirement: The organization also must have a commitment to protect the conservation purposes of the donation and must have the resources to enforce the restrictions.

Qualified real property interests—any of the following: donor's entire interest in real estate other than a mineral interest (subsurface oil, gas, or other minerals, and the right of access to these minerals); a remainder interest; or a restriction granted in perpetuity on the use that may be made of the real property.

Conservation purposes: preserving land areas for outdoor recreation by, or for the education of, the general public; protecting a relatively natural habitat of fish, wildlife, or plants, or a similar ecosystem; preserving open space, including farmland and forest land, if it yields a significant public benefit and must be either for the scenic enjoyment of the general public or under a clearly defined federal, state, or local governmental

community impact. Beyond the gifting of assets, the Foundation helps donors identify issues of importance to them and *inspires engagement* with community organizations addressing these issues, thereby maximizing the impact of charitable gifts and creating a greater sense of fulfillment.

conservation policy; or preserving a historically important land area or a certified historic structure.

Building in a registered historic district. If a building in a registered historic district is a certified historic structure, a contribution of a qualified real property interest that is an easement or other restriction on the exterior of the building is deductible only if it meets all of the following three conditions:

Rehabilitation credit wrinkle. If the donor claimed the rehabilitation credit on Form 3468 for the building for any of the five years before the year of the contribution, his or her deduction is reduced. See IRC §170(f)(14).

Filing fee. If the donor claims a deduction of more than \$10,000, the deduction will not be allowed unless he or she pays a \$500 filing fee. See Form 8283-V, Payment Voucher for Filing Fee Under Section 170(f)(13), and its instructions.

Case: Donor Wins Big Time

This conservation easement case is an excellent primer on valuation and appraisals. Kiva Dunes Conservation LLC (sometimes called "Kiva Dunes," sometimes "Donor") granted to the North American Land Trust a perpetual conservation easement covering a golf course that it owned. The Internal Revenue Service (IRS) disallowed the \$30,588,235 charitable deduction in its entirety; it also imposed an IRC §6662 accuracy-related penalty. Kiva Dunes appealed to the Tax Court.

After the trial (but before the court's decision), the IRS conceded that Kiva Dunes was, after all, entitled to a charitable deduction—so the amount had to be determined by the court and whether an Internal Revenue Code (IRC) §6662 accuracy-related penalty applied.

We're not talking chopped liver. Kiva Dunes claimed a \$30,588,235 charitable deduction for the easement based on an appraisal prepared by its expert, Claud Clark (more about him soon). Donor also claimed a \$35,000 cash contribution. The IRS also disallowed that deduction, but we are not told why.

The Tax Court sets the stage for its decision by reciting some long-established rules for deductibility and valuation (case citations omitted):

Where, as in this case, there was no established market for similar conservation easements and no record existed of sales of those easements, the regulations give a method for determining fair market value:

The IRS and Donor agreed that the before-and-after methodology was in this case the appropriate valuation method for determining fair market value.

Adjustment to before-and-after valuation (or any other valuation method). Any enhancement in the value of a donor's other property resulting from an easement contribution, or of property owned by certain related persons, reduces the value of the charitable deduction. Reg. §1.170A-14(h)(3)(i).

Enter the valuation gladiators—the appraisers. The court noted that valuation is not a precise science, and the fair market value of property on a given date is a question of fact to be resolved on the basis of the entire record. In this case, each party offered the report and testimony of an expert witness to establish the value of the easement.

What do courts look for in evaluating an expert's opinion? For openers, an opinion is admissible if it assists the trier of fact to understand the evidence or to determine a fact at issue. An expert's opinion is evaluated in the light of the expert's demonstrated qualifications. Where experts offer competing estimates of fair market value (this case), courts decide how to weigh those estimates by, among other things, examining the factors the experts considered in reaching their conclusions. Courts aren't bound by the opinion of any expert witness, and may accept or reject expert testimony. A court may also reach a decision on the value of property that is based on its own examination of the evidence.

This conservation-easement case demonstrates the importance of selecting an expert who not only has excellent general qualifications, but also knows, as we shall see, the facts on the ground (pun intended?).

Donor's expert. He is a professional real estate appraiser and has decades of experience in Baldwin County, Ala., the location of the contributed easement. He has lived and worked in the immediate vicinity of the subject property for 22 years and owns and has owned property in the area. He performs more appraisals in Baldwin County than any other appraiser, and has a great depth of knowledge of the comparable properties used in valuing the easement and of the surrounding local real estate market.

The IRS's expert. He is a member of the Appraisal Institute. He was in no way whatsoever a yokel, but he wasn't a local. He had spent a substantial portion of his appraisal career in Atlanta. Although he recently moved to Alabama, his office is in Birmingham, 250 miles from Kiva Dunes Golf Course. In the court's words, he "has no particular expertise in Baldwin County, and he has been to the Baldwin County, Alabama, area only twice in connection with his appraisal of the easement."

Fair market value of Kiva Dunes Golf Course before the conservation easement. To reach their respective before value estimates, both experts used a discounted cash flow analysis of estimated revenues and costs associated with the development and sale of lots in a hypothetical subdivision. However, some of their assumptions differed in important ways— e.g., the number of lots available for sale, the average sale price of the lots, and the rate at which the lots would sell. The differences in

their assumptions led to a dramatic difference in their respective before value estimates: The Kiva Dunes expert's value was \$31,938,985, and the IRS's expert value was \$10,018,000.

Tax Court's determination of the before value. The IRS had conceded that Kiva Dunes expert's testimony was credible and his assumptions were reasonable and amply supported by the evidence in his report. Thus, the court assigned a before value of \$31,938,985.

Fair market value of Kiva Dunes Golf Course after the conservation easement. The experts agreed that immediately after the charitable contribution, the highest and best use of Kiva Dunes Golf Course was its continued operation as a golf course. However, in determining the after value of Kiva Dunes Golf Course, the experts used different methodologies. The IRS's expert used an income approach. He divided a capitalization rate into a number that he represented was the 2002 net income of Kiva Dunes Golf Course. He determined the after value to be \$8,808,000. In contrast, the Kiva Dunes expert concluded that the economic health of Kiva Dunes Golf Course during 2002 was too poor to support an income capitalization approach. Instead, he found sales of comparable properties that he analyzed and reached an after value of \$1,050,750.

The court put the kibosh on the after value of the IRS's expert. At trial, he admitted that the IRS provided him with Kiva Dunes' tax return before he submitted his appraisal. Therefore the court placed no reliance on his after value determination.

Donor's expert, as noted, used the comparable sales method to reach his after value. That method, said the court, "is based upon the commonsense approach of taking the actual sales prices of properties similar to the subject property and then relating these prices to the subject property."

Under ideal circumstances, said the court, there is an abundance of sales of truly comparable properties made under similar conditions. Then only minor adjustments are required, and the value is easily derived. However, in this case, when such conditions do not exist, many factors come into play and more adjustments are required. As might be expected, the lack of sales of comparable properties results in a more subjective value, highly dependent on the independent judgment of the individual appraiser.

In reaching his after value, Donor's expert identified five sales of properties he considered comparable. On the basis of the average price of his five comparables, adjusted for differences, Donor's expert determined an after value of \$1,050,750.

The court said that it was "mindful of the fact that in reaching his after value, [Donor's expert] did not take into consideration the highest and best use of his comparables in the traditional sense. He instead selected

properties that were purchased for recreational uses that would be permitted on Kiva Dunes Golf Course. In other words, [he] considered the market forces in Baldwin County an accurate barometer of the highest and best use of a comparable property. We do not find [Donor's expert's] analysis in that regard to be 'fatal,' as [the IRS] contends."

More adjustments. After adjusting Donor's appraiser's after value to account for improvements, the court determined that the after value for Kiva Dunes Golf Course was \$2,982,981 (\$1,070,980 comparable value plus \$1,912,001 depreciation adjustment).

Donor's appraiser determined that the conservation easement enhanced other property owned by Donor by \$300,000. And the IRS agreed. So the court adjusted the final value to reflect that enhancement.

Getting close to the end. "On the basis of our review of all the valuation evidence, giving due consideration to our observation at trial of the witnesses for both parties and to the testimony of the experts and their reports, we conclude that the fair market value of the easement is \$28,656,004." That reduced Donor's claimed deduction by \$1,932,231 (\$30,588,235 minus \$28,656,004). Remember that the IRS disallowed Donor's entire deduction. So the court allowed Donor to deduct \$28,656,004 more than IRS's initial zero, zip, nada valuation.

Penalty issue. The IRS had maintained that the Donor was liable for either a substantial or a gross valuation penalty pursuant to IRC §6662(b)(3) and (e) or (h). IRC §6662(a) and (b)(3) imposes a 20 percent penalty on that portion of an underpayment which results from a substantial valuation misstatement. There is a substantial valuation misstatement if the value of any property claimed on the return is 200 percent or more of the amount determined to be the correct amount. IRC §6662(e)(1)(A). IRC §6662(h) increases the penalty to 40 percent in the case of a gross valuation misstatement. There is a gross valuation misstatement if the value is 400 percent or more of the value determined to be the correct amount. IRC §6662(h)(2)(A)(i).

No penalties. "We corrected Kiva Dunes's reported value approximately 10 percent. Accordingly, Kiva Dunes is not subject to a valuation penalty."

Kiva Dunes Conservation, LLC; T.C. Memo. 2009-145.

Comment. In a fair tax world shouldn't the IRS have to pay a penalty to Donor for putting it through the wringer (disallowing the deduction in its entirety and the court then allowing a \$28,656,004 deduction)?

Sometimes (not often) a taxpayer who wins a lawsuit against the IRS can recover his, her or its reasonable litigation costs (e.g., expert witness expenses and legal fees). To qualify, the taxpayer's income must be below specified ceilings and deadlines must be met. For the numerous requirements—plus the ifs, ands, and buts—see IRC §7430 and Reg. §301.7430-1 through 301.7430-6. And, of course, review the cases on

the topic.

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