TAX COURT CASE UPDATE

Citation:

Esgar Corporation, et al. v. Commissioner, T.C. Memo 2012-35, February 6, 2012.

Overview:

The taxpayers granted qualified conservation easements to a qualified conservation organization in 2004 reporting noncash charitable contributions on their tax returns. The IRS determined deficiencies in income tax as well as a Section 6662(a) accuracy-related penalty.

The Facts:

The taxpayers were owners of land covering 2,200 acres of real estate near Holly, Colorado. In 1998, the Colorado Division of Minerals and Geology issued a permit for mining gravel, rock and sand on the property. Some of the property was mined by a third party. In 2004, a lease was signed that allowed a mining company to mine virtually all of the property covered by the mining permit. The royalty rate in 2004 was 45 cents per ton for rock and gravel, and 22.5 cents per ton for sand and fill dirt.

In December 2004, the property was divided among the taxpayers in various like-kind exchanges. The property was zoned "irrigated, agricultural" and was historically used as farmland. Only one of the properties had legal access to public roads. None of the properties had mining permits, but those permits could have been obtained. Each taxpayer donated a conservation easement on their property to the Greenlands Reserve, a 501(c)(3) land trust. Each easement specifically prohibited the mining or extraction of sand, gravel, rock or other minerals, which is required for a conservation easement to be deductible.

The taxpayers hired an appraiser to determine the values of the various properties. They also retained a geotechnical engineering firm to perform core sampling to determine the amount of sand and gravel beneath the properties. The appraiser concluded that gravel extraction was the highest and best use for the properties and included the value of the mineral deposits in his appraisal. The taxpayers claimed a charitable conservation contribution in the amount of their appraisals.

Discussion:

The primary issue for the Tax Court was the value of the easements, the difference between the before and after value of the property. The IRS had concluded that agriculture on the surface was the highest and best use, not subterranean gravel mining, and therefore the easements essentially had no value, and therefore, the taxpayer's entire deduction was disallowed. The parties agreed about the value of the properties after the easement was granted but disagreed about the before value.

The taxpayers first relied on the opinion of a licensed real estate broker to argue that no comparable sales existed and presented the testimony of a certified appraiser and professional geologist for their expert opinion that the highest and best use of the property was gravel mining. The taxpayer's expert stated that the three parcels comprising the subject property could be assembled and used for mining. He further opined, without asking the coal companies, that the gravel could be backhauled on nearby coal trains. The taxpayers presented the opinion of another geologist as to the value of the gravel. He calculated value based upon the quantity of gravel multiplied by the current market price; he did not consider the costs of extraction.

The IRS's expert was a real estate appraiser with experience in appraising gravel operations and conservation easements. He determined that the highest and best use for the properties was agriculture. He found that there was an adequate supply of gravel in the area from other gravel mine operators and no additional demand for the foreseeable future. The IRS's expert used the comparable sales approach to valuation.

The Court held that: "Where the asserted highest and best use of property is the extraction of minerals, the presence of the mineral in a commercially exploitable amount and the existence of a market 'that would justify its extraction in the reasonably foreseeable future' must be shown." The Court agreed with the IRS that the highest and best use of the property before the easement was agriculture and rejected the idea that a hypothetical willing buyer in 2004 would have considered the properties for construction of a new gravel mine.

The Court found that the taxpayers' experts did not analyze supply, namely the other gravel mines in the vicinity of the taxpayers' property, and that they failed to opine as to when demand for the gravel would mature given the availability of other gravel supplies. In the absence of such evidence, the Court concluded that the projection of income from mining the property was "little more than speculation and conjecture." The Court found that even if demand for gravel was increasing, there was no evidence that the other existing mines could not handle the increasing demand and that there was not an adequate supply of gravel to be mined elsewhere. The Court also identified several technical problems with the taxpayers' idea for backhauling the gravel and found that the taxpayers' plan for transporting the gravel was impractical. Since the Court found agriculture to be the highest and best use for the property, it used comparable sales of agricultural land to determine fair market value.

Although the Court's determination of the value of the easements was a fraction of that claimed by taxpayers, the Court declined to assess accuracy-related penalties, finding that the taxpayers had reasonable cause for the underpayment and they acted in good faith. This conclusion was based upon the fact that the taxpayers relied upon their advisors and an accounting firm, engaged an outside law firm to review the donation and its substantiation, commissioned a core sampling report of the underlying gravel, and obtained a qualified appraisal from a qualified appraiser.

Conclusion:

While this decision does not spell out exactly what a taxpayer must show to claim a deduction for a charitable contribution of minerals, the decision does provide an outline of some of the elements of such a donation. The taxpayer must show that a hypothetical willing buyer would consider the property more valuable for mining and would pay more for the property because of its mineral reserves. As part of this showing, the taxpayer must establish the existence of minerals on the property. This requires core sampling and engineering reports to calculate the quantity and quality of underlying minerals. If there are sufficient comparable sales, those sales should serve as the basis for determining fair market value because courts have said that comparable sales are generally the most reliable indicator of value. If there are inadequate comparable sales, the taxpayer may use a discounted cash flow analysis which requires a good deal more evidence.