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TAX COURT CASE UPDATE

Citation:

James E. Butler, Jr., et ux. v. Commissioner, T.C. Memo 2012-72, March 19, 2012.

Overview:

Mr. Butler and his wife were granted modified charitable contribution deductions for their qualified conservation contributions to land trusts of conservation easements on rural, undeveloped property.

The Facts:

In 2003 and 2004, the taxpayers conveyed conservation easements to a qualified conservation organization. The easements covered all of one tract and most of another tract. Although the conservation deeds significantly restricted the taxpayers' use of the properties, they allowed limited farming and recreational use and reserved a total of 12 lots for development, along with other rights.

The taxpayers filed their tax returns for 2003 and 2004 and were assessed income tax deficiencies, along with Section 6662(a) penalties. The issues at trial were as follows:

1. Whether the conservation easements that the petitioners donated constituted qualified conservation contributions under Code Section 170(h);
2. The proper values of those conservation contributions;
3. Whether the taxpayers are liable for an accuracy-related penalty.

This trial covered both tax years, so these issues were relevant to both years.

During the process of donating these easements, the taxpayers relied on an attorney, their CPA and advisors from Conservation Advisors, LLC, a firm specializing in conservation conveyances. The taxpayers filed their tax returns and included appraisal reports which determined the values of the conservation easements. These valuations were done using a before and after methodology, which is an approved methodology when comparable sales transactions cannot be located.

On audit, the IRS determined that the taxpayers failed to established that their contributions were qualified conservation contributions pursuant to Code Section 170(h). In the alternative, the IRS determined that the appraisal reports failed to establish the proper value of the conservation easements.

Discussion:

The Court began its analysis by discussing the rules under Code Section 170(h) which states the following:

> For a contribution to constitute a qualified conservation contribution, the taxpayer must show that the contribution is (1) of a 'qualified real property interest' (2) to a 'qualified organization' (3) exclusively for conservation purposes.

The parties agreed that the first two prongs of the requirements were met. The question was whether the third prong was met. Conservation purposes are defined in the code section as follows:

- (i) The preservation of land areas for outdoor recreation by, or the education of, the general public,
- (ii) The protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem,
- (iii) The preservation of open space (including farmland and forest land) where such preservation is---
  - a. For the scenic enjoyment of the general public, or
  - b. Pursuant to a clearly delineated Federal, State, or local governmental conservation policy, and will yield a significant public benefit, or
- (iv) The preservation of an historically important land or a certified historic structure.

The parties agreed that the taxpayers did not meet purposes (i) and (iv), and despite arguments put forth by the IRS, the Court ruled that the easement qualified under (ii).

The next area of contention was the value of the contributions. The taxpayers submitted three valuation reports, one that was attached to the tax return when filed and the others prepared for trial. The IRS provided the report of one expert.

The Court reviewed and analyzed the reports and determined that the amounts the taxpayers claimed were based on partly flawed or otherwise unpersuasive expert estimates that needed to be adjusted. In particular, the experts failed to account for items such as value-diminishing lot size restrictions and other sizing issues. They also mischaracterized the topography of certain property and used partly flawed or incomplete comparability analyses. The Court also had to exclude the report and testimony one expert who passed away before trial. The Court ultimately re-determined the before and after values of each property and determined the various easements' values.

The final issue was whether Code Section 6662 penalties were appropriate since the Rule 155 computations exceeded 10 percent of the tax required to be shown on the taxpayers' returns. The Court ruled that the taxpayers had established reasonable cause and good faith and had relied on their longtime counsel and accountant throughout the donation process. In addition, they relied on a real estate firm for advice on who to hire as appraisers, who in turn were qualified and had access to sufficient information to issue the valuation reports.

Conclusion:

Although the Court did not agree with the valuation reports submitted by the taxpayers, they ruled that qualified charitable contributions were made to qualified conservation organizations. In addition, based on the evidence provided, the Court determined that no accuracy-related penalties were appropriate.