

Federation of Tax
Administrators
Annual Meeting 2005
San Antonio, Texas

Burnet R. Maybank, III
Director, SC Department of Revenue
P.O. Box 12265
Columbia, SC 29214
(803) 898-5040
MaybankB@sctax.org

ABUSIVE
CONSERVATION
EASEMENT TAX
SHELTERS

SC DOR Efforts

- The South Carolina Department of Revenue is in the midst of an audit of conservation easements granted in this state over a 3 year period, principally from 2001-03.
- We have examined some 110 easements granted over a 3 year period from 2001-2003 in South Carolina. Collectively, they add up to over \$240 million in charitable deductions. We are in the early stages of examining another 50. They total some \$50 million. We expect easements granted during the last 2 years in South Carolina to easily surpass this amount.

MAJOR ISSUES

- Excessive Valuations
- Quid Pro Quo
- Lack of Conservation purpose
 - Golf Courses
 - Small Lots

OTHER ISSUES

- Technical errors in the appraisal
- Charitable Deductions limited to basis
 - Short term capital gain (holding period less than one year)
 - Dealer Property
 - S Corporation gifts

Excessive Valuations

- States like South Carolina suffer from excessive valuations in two ways: (1) the charitable deduction taken on the federal return flows through to the state tax return, and thus lowers the taxable income subject to state income tax; and (2) South Carolina, like many states, has its own state tax credit for conservation easements.

Excessive Valuations

- While few in number, we have seen valuations which shock the conscience. For example, an easement was placed on a relatively small portion of a proposed golf course. The entire tract was purchased for several million dollars three years earlier. The appraisal claims the land covered by the easement was worth \$20 million before the easement and only \$1.5 million after the easement – a reduction of 95%. The appraisal entitles the golf course developers to a deduction of \$18.5 million. This is one of several golf course easements we have seen with a claimed 95% reduction in value.

Excessive Valuations

- Another example is a 4 acre lot on deep water in a residential subdivision in Charleston County. The donor reserved the right to build a 6,000 square foot home on the lot. The appraiser claimed the land was worth \$1.5 million before the easement and only \$6,000 after the easement – notwithstanding the donor's right to build a 6,000 square foot home on deep water in a very nice subdivision!

Excessive Valuations

These excessive valuations result from a variety of factors, including:

- a. By law, the donor is not required to list the valuation of the easement on the IRS Form 8283 at the time the Land Trust signs it; even if he does, and the valuation troubles the Land Trust, the federal tax law specifically states the Land Trust does not vouch for the value;
- b. The Land Trust has no motive to question or police valuations. An appraisal is as much an art as a science; Appraisers who do not reliably provide high valuations will not receive valuation assignments for golf courses and commercial developments from the Land Trusts who specialize in such easements;

Excessive Valuations

- c. Lack of audit resources together with the difficulty of challenging a MAI Appraisal of real estate when combined with the natural instinct of many tax court judges to “split the difference” inevitably leads to a lack of enthusiasm to audit or challenge valuations on the part of the IRS and state taxing authorities; and
- d. There is an appraisal technique called the subdivision development analysis which can be easily manipulated to provide high valuations.

Excessive Valuations

Subdivision Analysis:

Values land by assuming hypothetical subdivision using maximum density legally and economically feasible.

Excessive Valuations

Subdivision Analysis:

The Appraisal of Real Estate states that without an abundance of reliable market data it can be the least accurate raw land valuation technique.

See pages 95-98 of the DOR publication, *Local, State and Federal Tax Incentives for Conservation Easements*, 2nd Edition.

Quid Pro Quo

- Real estate developers are using conservation easements as a tool to obtain preferential zoning, in most cases to increase the density of their proposed developments of farm land.

Quid Pro Quo

- Developers are also using conservation easements to fulfill certain mitigation and similar requirements imposed by state and federal environmental law.

Quid Pro Quo

- In theory, a donor is required to have the requisite donative intent in order to take a charitable deduction. Few would argue that a real estate developer who gives a conservation easement on a small percentage of his proposed development in order to settle a zoning dispute with the county as well as the neighbors has *any* donative intent.

Quid Pro Quo

- The law has, however, gradually changed to arguably allow a charitable deduction in the amount of the net difference between that which the developer has received (preferential zoning, mitigation) and that what he has given up (the conservation easement.) (See pages 63-66 of the DOR publication, *Local, State and Federal Tax Incentives for Conservation Easements*, 2nd Edition)

Golf Courses

- The largest easements we have seen from a dollar standpoint have involved golf courses. In some cases the easement is granted before the golf course is built, in others an easement has been placed on an established course. In some cases the easement encompasses the course together with associated wetlands. In other cases the easement covers common areas.

Golf Courses

We have seen astonishing valuations placed on these easements. Seven of the nine largest easements (from a dollar standpoint) currently under audit involve golf course developments. The appraisals include:

- \$40,000,000
- \$20,000,000
- \$18,000,000
- \$17,000,000
- \$16,000,000
- \$7,000,000
- \$7,000,000

All of the golf courses above are private, although several are currently open to the public. The five largest, however, are all in exclusive gated communities.

Golf Courses

- Golf course easements purportedly qualify on several grounds under IRC 170(h).
- Golf courses, which are open to the public, may qualify under the IRC § 170(h) provision for preservation of land areas for outdoor recreation by the general public. Golf courses not open to the general public may qualify under preservation of a relatively natural habitat.

Golf Courses

- Look for:
 - Lack of Conservation purpose
 - Excessive Valuations
 - Easement on wetlands
 - Highest and best use is as a golf course before and after easement
 - Excessive Densities

AUDIT SELECTION

AUDIT SELECTION

- The DOR should obtain:
 - List of non-cash charitable contributions over \$100 K from the IRS
 - Conservation Easements are filed with Deeds at County recording offices
 - Send Desk Audit to local, state and national land trusts (see attached)

AUDIT SELECTION

- Land Trust Desk Audit:
 - Request 8283s
 - Golf Courses
 - Real Estate Developments
 - Land less than 10 acres
 - Easements declined

AUDIT SELECTION

- After analyzing responses, send desk audit to Donors

Request:

- 8283
- Qualified Appraisal
- Recorded Easement
- Quid Pro Quo

See Desk Audits for various entities attached

AUDIT SELECTION

- Examine Appraisal for:
 - 1) Basis of Property
 - 2) Valuation techniques
 - 3) Use of Subdivision Development Analysis
 - 4) What are before and after uses

AUDIT SELECTION

Questions by Stephen J. Small

1. Has the Taxpayer owned the Property for less than 24 months?
2. If the answer to question 1 is yes, is the claimed deduction greater than two and one-half times the cost basis?
3. Is the taxpayer a limited liability company or partnership?
4. If the answer to question 3 is yes, did the taxpayer purchase the property from one of its members or partners or a party related (under section 707(b)) to one of its members or partners?
5. If the answer to question 3 is yes, does the taxpayer or a party related to one of its members or partners own abutting land, or land in the immediate vicinity of the property, that is being used (or that will be used) for real estate development purposes?

AUDIT SELECTION

Questions by Stephen J. Small

6. Does the conservation easement reserve the right to build more than six (or five, or eight, etc.) new residences on the property?
7. Is the principal place of business of the appraiser in a state in which the property is located?
8. Is the principal place of business of the donee in a state that is different from the state in which the property is located?

AUDIT SELECTION

Questions by Stephen J. Small

9. Has the property been part of any submission to authorities for zoning of subdivision approval in the 18-month period before the donation?
10. Are any of the comparable sales relied on by the appraiser for the conclusion of value more than 50 (30? 20?) miles from the property?
11. What was the fee for the appraisal?

TAX NOTES, October 11, 2004 (attached)

QUID PRO QUO

- Closely look for Quid Pro Quo in any real estate development
- Was the easement given in conjunction with any zoning or environmental permit requests
- Check Newspaper articles and with local zoning office.

QUID PRO QUO

- If Quid Pro Quo is present, maybe no donative intent, and arguably, no charitable deduction allowed.
- If Quid Pro Quo is not identified in appraisal, maybe a defective appraisal.

RECOMMENDED LEGISLATION

- Adopt IRC Valuation Penalties including § 6701
- Ban Golf Course Easements
- Ban or limit “backyard” easements

RECOMMENDED LEGISLATION

- Adopt strict Quid Pro Quo rules

See attached Virginia and South Carolina Legislation.

ATTACHMENTS

- SC DOR Land Trust Desk Audit
- SC DOR Individual Desk Audit
- SC DOR LLC Desk Audit
- SC DOR S Corporation Desk Audit
- SC DOR Partnership Desk Audit
- Virginia CE Statute
- South Carolina HB.3768 – Section 43
- Tax Notes, October 11, 2004
- Portions of *Local, State and Federal Tax Incentives for Conservation Easements*, 2nd Edition. The entire document can be downloaded at www.sctax.org under Publications.