S. HRG. 109–1006

THE TAX CODE AND LAND CONSERVATION: REPORT ON INVESTIGATIONS AND PROPOSALS FOR REFORM

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

JUNE 8, 2005

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THE TAX CODE AND LAND CONSERVATION: REPORT ON INVESTIGATIONS AND PROPOSALS FOR REFORM

WEDNESDAY, JUNE 8, 2005

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:08 a.m., in room SD–628, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Present: Senators Lott, Snowe, Thomas, Santorum, Bunning, Crapo, Baucus, Rockefeller, Lincoln, and Schumer.

Also present: Mark Prater and Theresa Pattara, Republican Staff; John Angell, Pat Heck, and Bill Dauster, Democratic Staff.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. Thanks, everybody, for being patient.

Today the Finance Committee will hear testimony on two very significant reports. The first is the report on The Nature Conservancy prepared by the staff of the committee.

The second report is prepared by the Department of Interior's Inspector General, discussing the Department of Interior's proposed purchase of mineral rights in Florida from a private organization.

The report on The Nature Conservancy provides the committee and the public a window into the workings of not just The Nature Conservancy, but large charities in general. The report and attached documents show that The Nature Conservancy at times participated in tax planning activities affecting it and its donors that can result in substantial tax benefits.

Charities have gone far beyond raising money by just having Santa ring a bell. Santa now has often engaged some of the Nation's top tax lawyers and accountants with the sharpest pencils.

The exhibit that just was put up is a copy of a document, which I am submitting for the record, used by The Nature Conservancy in discussions with potential donors involving a bargain sale to The Nature Conservancy.

[The exhibit appears in the appendix on p. 67.]

The CHAIRMAN. In this document, the charitable deduction is based on the slippery slope of the donor's own appraisal. The kicker is, the calculation shows that a better deal can be had by using what is referred to as "plus value of tax shelter from charitable

contributions," as you can see near the bottom of the right-hand column.

Now, I am troubled enough when I see the words "tax shelter" appearing in tax planning documents of for-profit corporations. When I see "tax shelter" being used in documents of charities, we ought to really be worried. But not only are charities engaged in sophisticated tax planning, they are also at times engaging in complex transactions and joint ventures. The staff report discusses and educates us on The Nature Conservancy's actions in this area.

While doing such deals are not in themselves good or bad, they raise issues about whether charities are acting within the laws governing them as Congress intended, and within a manner that justifies their tax-exempt status to the public.

There is also a very real concern highlighted by the staff report that complex transactions can shift a charity's focus far away from their areas of competence, while potentially wasting contributors' dollars.

These concerns are well-articulated in the memorandum of The Nature Conservancy's Director of Internal Audit to Mr. McCormick, president of The Nature Conservancy, who will be testifying today.

The report which I am also submitting for the record primarily talks about a lawsuit involving The Nature Conservancy's oil and gas exploration activities in Galveston, TX.

[The report appears in the appendix on p. 68.]

The CHAIRMAN. The report states, "The Nature Conservancy Texas's attempt to balance the welfare of the prairie chicken with gas and oil exploration at the Galveston Bay Prairie Preserve seems to be a picture postcard strategy of the new Conservancy. However, were the events that transpired at the preserve to become public knowledge, the Conservancy's good reputation could be badly damaged."

It goes without saying that this is not what should be happening at The Nature Conservancy, or any charity, for that matter. The Nature Conservancy and all charities should be operating with a view that all transactions and activities will withstand public scrutiny.

I am going to come back to this internal audit memorandum during the questioning time, but I strongly encourage everyone to read it very closely. It provides a great deal of caution of the dangers to charities when they operate outside of their areas of core competence and core values.

While the report discusses at length areas of concern, I should also note that I recognize, and I surely appreciate, that The Nature Conservancy has engaged in significant reforms since the Finance Committee announced its investigation months ago.

While there are still improvements that can be made, I appreciate the leadership of Mr. McCormick and Mr. Paulson on behalf of The Nature Conservancy. Reforms their organization have undertaken are informative as the Finance Committee considers changes in the law, particularly in the area of land and easement donations, as well as governance of charities.

Now, for the Inspector General's report. The country is well-served by having Mr. Devaney serving at the Department of Interior, and he is at the table with us right now.

He is, without question, one of the finest IGs that we have ever worked with over the years. It is because of his excellent work and that of his staff that we have had him before the committee several times in recent years.

This is the second report that I have recently received on the problems of land transactions with the Department of Interior. To be candid, Mr. Devaney, I thought that you had already found the bottom of the cesspool when it comes to land transactions at Interior, but this new report that you present to us shows that it is even deeper than we ever thought, and particularly first thought.

It appears that since the mid-1990s, the Department of Interior has basically thrown out the rule book when it comes to this deal for the Florida mineral rights.

If that was not bad enough, I would note that, once again, we have another Federal agency basically undermining the work of the Department of the Treasury and the Internal Revenue Service. The IG reports in detail about the Interior officials happily and ignorantly signing off on whatever tax planning is requested by the private party.

We have seen several problems with the Department of Transportation in the LILO and SILO transactions that we legislated on in the FSC/ETI bill last year, and the SEC and other agencies on fines and penalties, and the Department of Interior's own facade easements.

I would hope that the administration recognizes the need to make sure that the rest of government does not make the Internal Revenue Service's tough job even tougher and raise this issue of uncollected revenue coming in that ought to be coming in to the Federal treasury that Senator Baucus so often brings before our committee.

I thank you all who are going to participate today for presenting these two sweeping reports, and also thank the enormous number of staff who have made these reports possible.

Now, Senator Baucus?

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you, Mr. Chairman. Thank you very much for holding this hearing.

When I see the natural beauty of Montana, I often think of the words in the book of Job: "Stand still and consider the wondrous works of God." You can see the hand of Providence when you stand at the edge of the Blackfoot River, when you stand at the base of Grinnell Glacier, when you look out across the field of Winter Creek on a cloudless day near Glasgow, MT.

Montanans are close to the land. It is what it means to be a Montanan. We are an outdoors people. We are a people very attached to the land. There are wonderful, clean rivers and streams, abundant fish and wildlife, and farmers and ranchers committed to the proud western heritage of responsible stewardship of the land. That is what farmers and ranchers want to do, and that is what means most to them. Protecting Montana's and America's natural legacy is a commitment to which I hold fast.

Today's oversight hearing looks at gifts of land. We will hear about two investigations involving the potential improper use of charitable tax deductions for land donations: the Finance Committee staff investigation into The Nature Conservancy and the Inspector General's investigation into the Department of Interior's proposed purchase of mineral rights in Florida.

These investigations show why it is so essential to maintain the integrity of our tax incentives for conservation. Americans must be able to trust that, when they give land for a conservation purpose, that land will serve a conservation purpose.

Americans must be able to see that their tax dollars are being used wisely, and they must be able to see that tax deductions have a reasonable relationship to the value of donations claimed.

The tax code allows people to claim a deduction for the fair market value of land that they donate to a charitable organization. Fair market value means what a willing buyer and seller would agree on as a price for the land if it were not donated.

In addition, people could claim a charitable deduction for the fair market value of part of their interest in the land, and they donate that partial interest as long as the interest serves an important conservation goal. People call this a conservation easement.

People may deduct up to 30 percent of their adjusted gross income for these donations, whether they are donations of full interests or conservation easements. Adjusted gross income is the amount of income that a person pays tax on.

Let me give an example of how it works. A farmer who owns 100 acres of undeveloped lands decides that he wants his land to stay as productive farmland forever and not allow the land to be developed or subdivided. The farmer appreciates the open space that is created by his farm and wants to pass the farm on to his children or grandchildren.

One way that the farmer or rancher can accomplish this goal is to donate a conservation easement that prohibits future generations from building on or subdividing the farm.

The farmer would be required to donate the easement to either a qualified organization, like a land trust, or an arm of the government, Federal, State, or local. The value of the deduction would reflect how much the restriction on development and subdivision reduced the price of the farm.

In a place like the Bitterroot Valley in Montana where developers are buying up farms to build vacation homes, such a restriction could be valuable. In other places where there is less demand to develop, the value may be small or non-existent.

Now, the law requires the farmer to have a qualified appraisal for any donation of more than $5,000. Finally, in order to qualify, the farmer must prove that the restrictions placed on the farm serve a real conservation purpose. It is not a qualifying conservation purpose to allow just 15 subdivisions instead of 20, nor is it a qualifying conservation purpose to place an easement over a golf course.

In order to meet a conservation purpose for an open-space easement, the farmer needs to show that the easement benefits the scenic enjoyment of the public or is pursuant to a Federal, State, or

local conservation policy. In either case, the farmer has to show that the easement will yield a significant benefit to the public.

The laws allow the farmer to continue using the farmland productively as long as the productive use is consistent with conservation goals. This policy has allowed thousands of farmers to maintain the great American tradition of the family farm.

As you can see, current law has significant hurdles in place to prevent abuse in land conservation, but unfortunately these obstacles have not prevented some from gaming the system.

The staff report on The Nature Conservancy and the Inspector General's testimony show how lax procedures by land trusts and improper valuations can give conservation efforts a bad name. The Nature Conservancy report shows that some conservation properties sold by the Conservancy were made available only to Nature Conservancy insiders and not the general public.

Such collusion diminishes the ability of a land trust to fairly assess the conservation value of easements that are donated to a land trust, and dims public confidence in tax deductions claimed for land conservation.

I am glad that The Nature Conservancy has taken steps to address deals with insiders with reforms that they adopted last year. This step, among others, should help to restore the public confidence needed in The Nature Conservancy. Mr. McCormick, I look forward to hearing from you on what additional steps you are taking.

Mr. Devaney, welcome back. Mr. Devaney last came to the committee to testify on the abysmal state of jails run by the Bureau of Indian Affairs. Today he has come to shine the spotlight on another shameful episode, this time the Department's attempted acquisition of mineral rights from the Collier Resources Company.

In short, the report shows that the political leadership of the Department of Interior agreed to purchase mineral rights held in Florida, held by the Federal Government, for an amount that was over-valued by roughly $70 to $80 million. It also shows that the Department failed to follow its normal appraisal procedures in arriving at a value for the interests.

Finally, after paying tens of millions of dollars too much for the mineral rights, the administration agreed to sign a form allowing Collier Resource Company to take a charitable deduction for selling the property to Interior at a discount. That is, right, a discount. Apparently, the Department allowed the taxpayers to be fleeced for $70 to $80 million, and then authorized a big tax deduction for the fleecing.

This transaction is an outrage. It is a terrible waste of taxpayer dollars. It is an unmitigated outrage. Thankfully, the IG stepped in, noticed the problem, spotlighted it, and stopped this transaction from moving forward. Were it not for the IG, this transaction would have gone forward.

I look forward to your testimony, Mr. Devaney. I am also interested in your opinion as to who should ultimately be held accountable. I doubt, frankly, that it was the bureaucrats in the Department. I suspect it was somebody else telling the bureaucrats what to do, and I will be interested in your thoughts on all that.

I am not going to give the rest of my statement, Mr. Chairman. It is a little lengthy. For the interest of getting to the heart of the matter here, I will stop. But I would just say, thank you for doing this.

I thank you, Mr. Devaney and others, who have worked so hard on this. You have kind of put your reputation on the line, Mr. Devaney. There are IGs in this town, and there are IGs. Some are worth their salt, some are not. Some do not do anything, you do. Thank you.

[The prepared statement of Senator Baucus appears in the appendix.]

The CHAIRMAN. Yes. I want to obviously associate myself with what Senator Baucus just said about the IG.

More importantly, I want to thank him for the months of cooperation that Senator Baucus and his staff have given us, working together in a bipartisan way on this. Thank you very much.

This is also evident in the fact that our first panel has the Democratic staff and Republican staff making the presentation.

So, I would also introduce Mr. Jonathan Selib, Tax Counsel on the Democratic staff, and Mr. Dean Zerbe, Tax Counsel and Senior Counsel on my staff. They will each have 5 minutes to present the staff report on The Nature Conservancy.

Then we are going to give Mr. Devaney 10 minutes to present the Office of Inspector General's report on the investigation regarding the Department of Interior's agreement with the Collier family to purchase the family's mineral rights.

So, however you folks worked out your testimony, Mr. Selib, then Mr. Zerbe, then Mr. Devaney.

STATEMENT OF JONATHAN SELIB, TAX COUNSEL, U.S. SENATE COMMITTEE ON FINANCE, WASHINGTON, DC

Mr. SELIB. Chairman Grassley, Senator Baucus, members of the committee, my name is Jon Selib, and I am a Tax Counsel on the Democratic Staff for the Senate Finance Committee.

I am here with my colleague, Dean Zerbe, Tax Counsel and Senior Counsel to the Chairman, to walk through the Finance Committee's staff information into The Nature Conservancy.

Let me begin by stating that, given the ongoing IRS audit of The Nature Conservancy, the staff has made no specific determination whether any particular Nature Conservancy activity did or did not comply with the relevant technical requirements of the Internal Revenue Code.

In May of 2003, a series of newspaper stories was published on The Nature Conservancy that raised serious questions about the policies and practices of The Nature Conservancy, including issues of corporate governance, charitable contributions, commercial activity, unrelated business income, and arrangements with insiders.

In the wake of those articles, the committee undertook an investigation of The Nature Conservancy to better understand the questions raised by the articles, and their significance regarding the administration and enforcement of Federal tax laws governing exempt organizations and charitable donations.

In conducting its extensive investigation, the committee reviewed three types of sources: (1) IRS forms and filings; (2) internal Na-

ture Conservancy documents; and (3) interviews with Nature Conservancy staff and outside experts.

A review of IRS documents included all of The Nature Conservancy's annual informational returns to the IRS: the Form 990, including information on their primary activities, executive compensation, and expenditures for the past 11 available years; The Nature Conservancy's IRS annual form showing business taxable information, the Form 990–T, for the past 4 available years; IRS forms relating to various charitable contributions of non-cash property made to The Nature Conservancy during the past decade; and IRS forms and related financial statements for tax-exempt and taxable entities affiliated with The Nature Conservancy.

A review of Nature Conservancy internal documents included narrative responses and documents relating to hundreds of transactions that The Nature Conservancy engaged in; internal Nature Conservancy policies and operating procedures; various internal audits, reports, and studies pertaining to The Nature Conservancy; publicly available information relating to The Nature Conservancy, including annual reports and financial statements; tax opinions from The Nature Conservancy's outside legal counsel provided to The Nature Conservancy with respect to various transactions and activities; and documents, policies, and procedures relating to reforms implemented by The Nature Conservancy after commencement of the committee's investigation.

Our outreach to Nature Conservancy staff and experts included engaging the expertise of the staff of the Joint Committee on Taxation, as well as the staff of the IRS Exempt Organizations national office, with respect to document review, technical explanations of present law pertaining to charitable organizations and charitable contributions, and preparation of information and document requests from The Nature Conservancy.

The staff provided The Nature Conservancy the opportunity to review and offer comments on Parts I, II, III, and IV of the report prior to publication. Finally, the staff also conducted meetings of The Nature Conservancy personnel during the course of the investigation and periodically updated The Nature Conservancy personnel about the status of the investigation.

The committee's investigation confirms that The Nature Conservancy's reputation as a leading and innovative conservation organization is well-deserved. The Nature Conservancy has grown to become a worldwide conservation organization that, through a variety of creative approaches and strategies, attempts to preserve many of the world's most valuable lands and resources.

The Nature Conservancy is proud of its innovation, especially of its use of public/private partnerships to attempt to achieve its conservation goals and objectives.

However, some of the activities that The Nature Conservancy conducted in the past are potentially inconsistent with the policy considerations behind the rules governing tax-exempt status under section 501(c)(3), and charitable contribution deduction rules of the code.

The report addresses the following issues, among others: The Nature Conservancy's involvement in mission credit arrangements with for-profit partners; conservation buyer program transactions;

The Nature Conservancy policies on easement modifications; The Nature Conservancy's reporting to the IRS; and joint ventures with for-profit entities.

Mr. Chairman, that concludes my testimony. I am happy to answer any questions the committee may have.

My colleague, Dean Zerbe, will now cover issues raised in the report.

STATEMENT OF DEAN ZERBE, TAX COUNSEL AND SENIOR COUNSEL TO THE CHAIRMAN, U.S. SENATE COMMITTEE ON FINANCE, WASHINGTON, DC

Mr. ZERBE. Mr. Chairman, Ranking Member Baucus, Senators, the staff report discusses a number of significant issues. However, given the focus of today's hearing, I will discuss four issues that directly affect conservation easements: monitoring, enforcement, valuation, and modifications, as well as proposed staff recommendations.

Enforcement of easements limiting modifications for appropriate cases and providing adequate funding to ensure enforcement of proper valuation are important concerns with respect to conservation easements. Organizations are required to enforce, in perpetuity, the terms and conditions of the easements to ensure that conservation goals are not compromised.

Failure to enforce these restrictions increases the risk that easement-restricted property will not be conserved in perpetuity, or that the actual conservation benefits will be less than what was claimed when the amount of the resulting charitable contribution was calculated.

The staff's review indicates that TNC's monitoring and enforcement practices were not always consistent or adequate with respect to site visits and documentation of these visits. These results, as to the historical monitoring effort by TNC, are mixed and failed to comply with TNC's current standards.

In addition, TNC's conservation easement compliance efforts failed to meet the tests established in Land Trust Alliance standards and practices set forth in the LTA guidebook.

Not only is monitoring important, but, given that these easements are in perpetuity, it is vital that organizations have adequate funds set aside for monitoring and enforcement. TNC generally does not establish a specific stewardship fund with respect to a specific easement, but instead relies on an aggregate endowment fund of $200 million for this purpose.

While staff are not in a position to determine whether this is a sufficient endowment, it is significantly better than many other interests that have little to nothing in the way of an endowment fund to monitor and enforce in perpetuity.

The determination of the value of the conservation easement or restriction is critical to determining the amount of any charitable deduction claimed as a result of the donation of the easement or the restriction. Valuation of land generally involves a straightforward process: willing buyer, willing seller, comparable sales of similar property.

In contrast, valuation of conservation easements is more difficult because of the absence of a market for their trade and the variety

and differences of restrictions that may be imposed on a particular property.

In addition, valuations of easements must reflect any increase in value of other properties owned by the taxpayer contributing the easement and must consider whether the tax benefits accruing to the taxpayer as a result of the contribution exceed a benefit that inures to the public.

The difficulty in completing these valuations of conservation easements also poses significant challenges and costs to the IRS in assessing whether the appraisal that forms the basis for a qualified conservation contribution is reasonable.

Finally, modifications to an easement held by a conservation organization may diminish or negate the intended conservation benefits and violate the present-law requirements that a conservation restriction remain in perpetuity. The TNC agreed to 75 easement modifications since 1994, but under current law there is no provision for reporting to the IRS about such modifications.

Mr. Chairman, staff made several recommendations to the committee for consideration in this report. Those relevant to the issues I have just discussed include: (1) that the IRS consider revoking or suspending the tax-exempt status of a conservation organization that regularly and continuously fails to monitor and enforce conservation easements; (2) that the IRS consider modifying Form 990 to require conservation organizations to provide information regarding its ongoing policies for monitoring and enforcement; (3) implementation of an accreditation system for conservation organizations—this may be a particularly effective means to ensure best practices with respect to monitoring and enforcement of easements, as well as compliance with section 178's requirements under the code; and (4) that the committee consider limiting charitable deductions for certain small easement donations and consider providing, in some cases, the IRS with authority to require pre-approval of tax deductions for such donations.

Finally, Mr. Chairman, we would like it to be clear that, after this investigation, we believe that there remains a real benefit to the Nation's environment and communities by encouraging charitable gifts of conservation easements and that the committee should continue to seek changes in the law that will encourage the gifts of conservation easements that were included in the CARE Act.

Thank you, Mr. Chairman. That concludes the staff testimony.

The CHAIRMAN. Thank you.

Now, Mr. Devaney?

STATEMENT OF HON. EARL E. DEVANEY, INSPECTOR GENERAL, U.S. DEPARTMENT OF THE INTERIOR, WASHINGTON, DC

Mr. DEVANEY. Mr. Chairman and Ranking Member Baucus, I want to thank you for your kind remarks earlier. I really appreciate them. It is true that if you have seen one IG you have seen one IG, and most IGs are only as good as their staffs, and I am blessed with an excellent staff. So, I appreciate your remarks.

I also want to thank you and the rest of the members of the committee for inviting me here today to talk about the results of our

recent investigation into the agreement to buy the mineral estate owned by the Collier Resources Company in the Big Cypress National Preserve.

Mr. Chairman, with your permission I would like to submit my full testimony and redacted special report for the record, make some brief remarks, and answer any questions.

The CHAIRMAN. It is accepted.

[The prepared statement of Mr. Devaney appears in the appendix.]

Mr. DEVANEY. The attempted acquisition by the Department of the Collier Company's mineral rights in the preserve has been years in the making. This was an acquisition supported by the Clinton administration, as well as the present Bush administration. It was heralded by environmentalists and enjoyed the enthusiastic backing of the citizens and leadership in Florida.

The intentions behind the attempted acquisition have always appeared to be firmly grounded in the Department's righteous desire to protect the environmentally sensitive Everglades from potential harm. The means by which these intentions were advanced, however, were very troubling.

The Colliers have been the driving force behind the Department's potential acquisition of their mineral rights from the start. Collier representatives initiated discussions with the Department in the mid-1990s, renewed them in January of 2000, and again with the present administration in 2001.

By the time they approached the Department in 2001, they had positioned themselves nicely for another round of negotiations, having embarked on a public outreach effort to signal that they were about to exercise their rights to explore for subsurface oil and gas in the preserve. In fact, between 1997 and 2001, the Collier's had submitted 27 separate plans of operations to explore within the preserve. Not unexpectedly, this caused great concern in the environmental community, which in turn captured the attention of the new Secretary of Interior.

Ignoring career appraisers in the National Park Service and over the objection of the Mineral Management Service, senior officials and attorneys for the Department pushed MMS to once again evaluate the mineral interests in the preserve. Unable to determine what percentage of those interests actually belonged to the Colliers, MMS evaluated all of the mineral reserves in the preserve at a mean value of $68 million.

Unable to reach the Collier's absolute minimum of $130 million, a senior attorney from the Office of the Solicitor sought the assistance of an outside contractor to develop a range of value around the MMS mean of $68 million.

Using an approach that has no specific provision in economic theory, the contractor determined that a range of value around the $68 million mean was $31 million to $140 million, for 100 percent of the preserve's mineral rights. Using this range, the Department's negotiators then justified the final offer contained in the agreement of $120 million.

Here, I would like to state that our investigation revealed that the Collier Resource Company has never certified to the Department any specific percentage of mineral rights ownership in the

preserve. We did hear during the course of our investigation estimates that they might own about 63 percent, but certainly not 100 percent.

Despite the difficulties that the Department had to go to to reach the $120 million price tag, the Colliers continued to insist that their sub-surface mineral rights were considerably more valuable. In keeping with this position, they insisted that the agreement include language that would allow it to do two additional things: first, to claim credit for a donation for any amount it could sustain with the IRS over the $120 million figure, and second, to reap the tax benefits associated with the sale of the property in lieu of condemnation, which would potentially allow them to defer or avoid capital gains.

With few questions and little analysis, the Department's negotiators agreed to these terms. With respect to the tax treatments in the agreement, we sought the assistance of the staff on the Senate Joint Committee on Taxation. Committee staff opined that it seemed like the Colliers wanted it both ways. That is, they not only wanted to secure the benefits of donating a portion of their mineral rights under IRS code section 170 which applies to charitable donations, but also wanted to claim the tax benefits associated with IRS code 1033, which contemplates involuntary conversion.

Committee staff explained to us that tax treatment under those two code sections is essentially mutually exclusive. One of the attorneys who drafted the agreement justified inclusion of these tax terms because he claimed the Department had used similar language in a prior exchange. Another attorney who helped draft the agreement said that, while he was aware of the donation aspect of the agreement, he did not understand it.

Like the failed agreement itself, this tax treatment today might be dismissed as "no harm, no foul." However, I take exception to that for the following reasons.

First, it represents a careless practice to conclude that something is appropriate simply because it has been done before. Without factual basis and analysis, it is reckless to draw such a conclusion and then advise decision makers.

It represents a compartmentalization view of responsibility that has haunted and thwarted other transactions investigated by my office. This compartmentalization results in a wholesale lack of accountability, with the various participants pointing to one another as being responsible for whichever aspect of this transaction turns bad.

Taking compartmentalization one step further, it represents the view that the Department acts only in its own self-interests and not in the interest of the Federal Government and the American public.

It represents yet another aspect of the deal that was being driven and controlled by the Colliers, with the acquiescence and assistance of the Department. By including in lieu of condemnation language in the agreement, the Department was acceding to a statement that was factually false.

Finally, including both aspects of the tax treatment that the Colliers insisted upon, aspects that are mutually exclusive, causes the Department to look, at best, foolish, and at worst, complicit.

Simply stated, Mr. Chairman and members of the committee, this is not the substance of a sound agreement in the best interests of the Federal Government and the American public.

Having said all of this, however, I would like to compliment the Department for some significant changes it recently made to the land appraisal program in process.

In November of 2003, following the issuance of our report, concerning the troubled San Raphael land exchange, the Secretary directed the consolidation of the Department's real estate appraisal functions and established an appraisal services directorate within the Office of the Secretary to ensure appraiser independence, accountability, high standards, and proper oversight.

I am confident that these reforms will, if strictly adhered to, correct most, if not all, of the problems we discovered during this investigation.

Mr. Chairman and members of the committee, before I conclude I would like to credit the two case investigators who are present with me here today behind me. They have worked tirelessly on this matter for 21 months, and in the end I firmly believe that these two civil servants helped save the American taxpayers $120 million.

This concludes my formal testimony. Thank you for the opportunity to appear. I will be happy to answer any questions you have.

The CHAIRMAN. I appreciate all of the testimony we have received on the first panel.

I am going to start my questioning with Mr. Devaney. There will be 5-minute rounds for each of us.

I take it from your remarks and from the report that has been presented to us, that with respect to the bad actors, you have focused on two senior lawyers in the Solicitor's Office. Is that true?

If so, what have you recommended to the Secretary that she do with them? And by the way, was one of these lawyers not also involved in the San Raphael land deal that you told us about within the last 2 years?

Mr. DEVANEY. Yes, Mr. Chairman, they were the focus of most of the attention we gave to this matter. One of them was, in fact, involved in the San Raphael matter several years ago.

An IG's role, from my perspective, is to report the facts of the matter and make a recommendation to the Secretary or the deciding official, other officials in the Department, to take administrative action. What that administrative action ends up being is entirely on their side of the aisle. It is up to them what that action is.

I rarely ever make recommendations of specific actions, but I have, in fact, recommended that the Secretary provide the report to the appropriate Department officials for review for taking some administrative action.

The CHAIRMAN. Based on this matter as well as a bad situation that I had come to my attention a little while back, I would ask that you inform the Secretary that she can expect a letter from me asking for a complete statement of what actions are going to be taken to hold these individuals accountable in regard to this. You will do that, right?

Mr. DEVANEY. I will, sir.

The CHAIRMAN. Thank you.

Mr. Zerbe, the report raises several concerns about insider deals, and I need to have you elaborate for the committee on that point.

Mr. ZERBE. Yes, Senator. The report discusses at length some of the issues we saw on insider deals. They really were of two types. One, we had a series of insider deals with board member-related affiliates that involved a conservation buyer program, and those had their own difficulties.

But I think what particularly caught our attention was those deals that were more of kind of a business transaction nature, say the emissions credit which Mr. Selib has spoken to, issues regarding trademark, royalty usages, and things like that. What concerned us, is several points.

The Nature Conservancy was very good at getting legal opinions of, was this appropriate, is this a proper thing, in terms of what they are engaging in, in terms of nonprofit law. We asked them directly on this and were told that they had not gotten any legal outside opinion on the propriety of these activities.

Second is that, unlike the land deals where at least there was an effort to get appraisals in almost all cases, there was never a case where we were seeing an appraisal of the transaction to determine whether or not it made sense for The Nature Conservancy and if it was going to give them a fair value for what they were providing.

I think the last issue that was of concern to us was on the 990s. This also reflects, to be honest, some limitations of the 990 as well. But it was, at best, a very thin discussion of what was going on in these transactions. You would not be able to read the 990 and be able to understand in any real sense what was going on with this transaction.

The CHAIRMAN. All right.

Also for you, Mr. Zerbe, the report contains significant discussion and analysis about current IRS reporting and public disclosure requirements. So, tell us and the committee here about some of the staff's observations in this area.

Mr. ZERBE. Thank you, Mr. Chairman. I think that, just going off of what I had just made a point about, not only was the 990—and just to remind the Chairman and all the Senators here, the 990 is the cornerstone of so much of what we try to do in this area. The 990s are a publicly available record. They are not only the filing with the IRS, these are publicly available. They are easily available on the Web, and reporters and other folks, donors, all take advantage of them, so getting it right is important.

But, unfortunately, what we would see again is that The Nature Conservancy, on a lot of major transactions, be it the conservation buyer, the emissions credit, trade lands, issues like easement monitoring and enforcement, there just is really not anywhere approaching a robust discussion.

And again, I told you, that is not something that is just at the feet of The Nature Conservancy. Jon and I spent a lot of time looking at a lot of 990s of a lot of different organizations. That is something that we see time and time again in terms of problems.

I would just state to you—and I think, Mr. Chairman, your quote from the internal memorandum said it exactly right. Not only is it

a benefit for sunshine; I think the more that organizations know that they are going to have to be very up-front about what they are doing perhaps will keep them from doing a bad deal in the first place, and really thinking twice about how they are doing it brings a benefit as well, too.

The CHAIRMAN. Thank you very much.

Now, Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Devaney, these decisions made by the Department with respect to the minerals rights of the Interior that the Collier family owns are not made in a vacuum. I mean, there is a reason why, I am supposing, the Interior came up with these kinds of valuations.

The question is, who is really running the show there? I know that your report spotlights Mr. Roth and Mr. Shomberg, but my guess is that the lawyers there were told what to do by some outside political influence.

Let me just mention some names, and I want you to tell me what you know about these people and what part they played.

Ann Klee. She is a political appointee who headed the Interior Department's Working Group on the Collier Big Cypress transaction. What is her role? What did she do?

Mr. DEVANEY. Ann Klee was the principal person that the Secretary turned to to oversee this transaction. When the Secretary and Ann Klee came into office, one of Ann Klee's principal portfolios was the Everglades. I think it was a natural thing for the Secretary to turn to her to oversee this.

Senator BAUCUS. And she is a political appointee?

Mr. DEVANEY. She is.

Senator BAUCUS. What about Steven Griles? He is the Deputy Secretary who attended a White House meeting on the Collier deal. What was his role?

Mr. DEVANEY. Former Deputy Secretary Griles——

Senator BAUCUS. Excuse me. Sorry.

Mr. DEVANEY [continuing]. In fact, was the individual from the Department who actually went over to the White House and had conversations over there.

Senator BAUCUS. I know you do not know definitely, but what is your best guess as to the nature of those conversations?

Mr. DEVANEY. Well, I think the report chronicles, as opposed to his memory, that he had several appointments over there to discuss this issue, which I do not think is unusual. But they were on his calendar.

There were memos briefing him before he went over there. One memo in particular was written as sort of a, you need to think about this and here are some issues we see that are problematic before you go over there. Quite frankly, I was somewhat disappointed by his loss of memory about all these events.

Senator BAUCUS. Was there an announcement of this transaction at the White House attended by the President, and also by Governor Bush from Florida?

Mr. DEVANEY. There was. And the Secretary and other officials were there as well.

Senator BAUCUS. I do not understand how the Interior Department gets in the business of granting tax breaks. I mean, is that an Interior Department function?

Mr. DEVANEY. Well, as I mentioned earlier, one of the principal negotiators here was told, in the distant past, that the Department had allowed that to be in a previous agreement. The other fellow understood it was in the agreement, but did not understand it. So, they should not be in that business.

I think it is fair to say that the language is in the agreement because the Collier Resource Company wanted it in the agreement, put it in the agreement, and the Department did not object to it being in there because they knew that that was part of a deal. That is the way that the Collier's would accept the $120 million, which was considerably less than they thought the mineral rights were worth.

Senator BAUCUS. Right. But why do you suppose the Collier family never told the Department, as far as you know, their percentage ownership interest? I do not quite understand how the Department can pay the family without knowing what percent of the mineral rights they own.

Mr. DEVANEY. Well, when I think of this, Senator, I think of it as sort of, I have a house for sale and you may come along and want to buy it, and you ask me where the property line is and I say, it is over by that big tree. You ask me, well, do you have a survey or can you prove that? I say, no, and I am not going to. Then would you buy the house?

Senator BAUCUS. Are you saying that perhaps their percentage interest was significantly less than 100 percent or that it was maybe the tree next to the boundary line, so maybe it was 99 percent? Or do you know?

Mr. DEVANEY. Well, we do not actually know. We have heard that they may own as much as 63 percent. They have never certified that to the Department. In fact, any proposed agreement with the Department has always—and if I could just briefly read a small paragraph in a confidentiality agreement that the Department signed with them: "The Collier Resource Company makes no warranty, expressed or implied, as to the accuracy, correctness, or completeness of the above-listed proprietary data. This data is supplied for the convenience and information of the evaluator, and any reliance on this data is at the evaluator's sole risk." They have always insisted that that be in the agreement.

Senator BAUCUS. Just a couple of quick questions here, Mr. Chairman.

The Office of Mineral Management. Is that the name?

Mr. DEVANEY. Right.

Senator BAUCUS. What is their reputation? Are they generally within the ballpark or not in the ballpark when they give estimates of mineral rights?

Mr. DEVANEY. Well, that is their job. The folks who are chronicled in our report from the Minerals Management Service, they are the Department's experts on oil and gas exploration and any evaluations or appraisals of those kinds of things.

Senator BAUCUS. And their estimate was about, what, $68 million?

Mr. DEVANEY. Well, their estimate, or their valuation, not an appraisal, was a mean value of $68 million, which is sort of an average and where they would probably start an auction if this was offshore minerals.

Senator BAUCUS. And that would be for the full value, not a percentage value.

Mr. DEVANEY. All of the valuations we came across in our investigations had been for 100 percent.

Senator BAUCUS. What is the tie between the independent contractor that gave the much wider range? Where do they come from? How often is an outside contractor called in?

Mr. DEVANEY. Well, he was called in, as I mentioned earlier, because $68 million was obviously not a figure that was going to work. He was called in to, first, verify that MMS had come up with the $68 million in a proper way, and then he was subsequently asked to develop this range, which he had never done before and he said he would never do again.

Senator BAUCUS. Do you think the outside contractor is competent to value mineral rights? Is that the business of that particular contractor? Do they do that customarily?

Mr. DEVANEY. Actually, I think he is a very reputable contractor, but his specialty is offshore oil and gas, not onshore. It is apples and oranges, really. He had never done that before.

Senator BAUCUS. I appreciate that.

My time is way over, Mr. Chairman. Thank you for your indulgence.

The CHAIRMAN. Yes. Thank you.

One sentence I would like to give before I go to Senator Thomas. That is that, remember that these negotiations started in the mid-1990s, going on through this administration, but actually started in the previous administration.

Senator Thomas?

Senator THOMAS. Thank you, Mr. Chairman.

I would like to get on to a little broader aspect of it, I guess, as opposed to analyzing individual behavior. Do we need changes in the law or do we simply need better oversight and adherence to the law as it exists? I would like each of you to give me a short reaction to that.

Mr. ZERBE. Yes, Senator. I think you raise a good question. It may be a little bit different, the issues for the Interior Department than the issues that we are facing in the tax code, but I think the staff has recommended certain areas where we do think the law can be changed, and it would be benefitted from being changed in ensuring that the intentions of the code, that conservation easements are actually being used for their intended purpose and that we are getting a good valuation on it and that we are ensuring that they are being monitored and that they are being enforced, and that if they are being modified, that it is done within a certain framework, or things that we think that would be helpful.

I guess I would also add that in some ways The Nature Conservancy has done a fine job with a lot of reforms. A lot of things that they have done we think would be beneficial as best practices across the industry, and have been working very closely with the

Land Trust Alliance, who will be on the second panel, and other organizations on that. So, I think it is a little bit of both.

Yes, the IRS has been active and it has been enforcing, but I think we also recognize that this is a very difficult area right now for them to get their arms around and to work.

Jon?

Mr. SELIB. Senator, I think one thing that is important to keep in mind is the majority of conservation easements that are done in this country are completely above the board and are done by very good land trusts that do good work.

I think that there are changes that could be made to the law that would make it easier for the IRS to administer the law. For example, there is not a lot of expertise within the IRS regarding conservation value. They are not environmentalists by nature, they are tax collectors.

So perhaps the creation of some sort of expert panel within the IRS, like they have currently for art valuations, may be helpful to the IRS in order to discern what type of easement is really providing a good conservation value and what type of easement is not. I think that could be helpful to land trusts as well as the government.

Senator THOMAS. There are lots of experts on appraisals outside of the government, however.

Yes, sir?

Mr. DEVANEY. Senator, I think there is a host of expertise in Interior in various bureaus that have the expertise and have been doing this for years. In this particular matter they were sort of put aside and were not allowed to be involved in it, so I think it is not a matter of changing laws as much as it is trying to correct the process within Interior. As I mentioned earlier, the Secretary has done some things in the last year that I think will prevent this from happening again.

Senator THOMAS. All right.

Is this matter primarily one of TNC or is this broader than that?

Mr. ZERBE. Right. Yes. Good question, Senator. I think that is one of the points we would probably like to most emphasize, and Jon was touching on it earlier, is that the issues and problems we are seeing in conservation, we certainly look far beyond TNC.

But in terms of the land issues you are focusing on, this is not unique to TNC. In other words, the fact that TNC has done a good job of getting themselves squared away does not mean that we still do not have significant issues out there.

Fortunately, you will get very good testimony from the South Carolina Department of Taxation on the second panel. While Jon is certainly right that a good majority of folks are doing the right thing, we do have folks who are really kind of involved in very aggressive things.

We have testimony of someone wanting to claim, well, I have open space on my golf course, and I should get a $40 million tax deduction because my golf course is open space, as an example. So, that is really is kind of outside the bounds of what we were really intending when the tax code was passed in this area.

Senator THOMAS. All right. Well, thank you.

Open space is very important, and this whole project is important. But I hope we deal with the basis and not so much the individuals. When we look at open space in Wyoming, I cannot see Montana from where we are, but I like it. [Laughter.] Thank you, Mr. Chairman.

Senator BAUCUS. You have to get up on top of the Tetons there. [Laughter.]

The CHAIRMAN. Senator Rockefeller is next. If Senator Crapo or Senator Schumer comes back, I am going over them right now. So, Senator Rockefeller?

Senator ROCKEFELLER. Thank you, Mr. Chairman. I want to thank the panelists for doing a very thorough and comprehensive review of this.

A couple of things occur to me. The Nature Conservancy is taking a lot of hits on this simply because they have a lot of ink in the *Washington Post,* and because they committed some errors which they have since, for the most part—or all, from my point of view—cleared up. It was a real learning experience for them, and perhaps for the whole conservation/conservation easement movement.

I think they were horrified by what had happened. In the last hearing, I referred to them as now having kind of a gold standard.

I say this because government spending on conservation is going down because of our budget crisis, the trade deficit, and debt problems, and it will continue to for a number of years.

So, my motivation is not just The Nature Conservancy and organizations like it, but also the fact that others are not going to be doing this and that they need to be foundations, and the private sector has to be encouraged as much as possible to fill in where the government is simply not going to be there, and that, I could go over 25 different fields.

So I have a specific question for you, Mr. Zerbe, just to clarify.

Mr. ZERBE. Yes, sir.

Senator ROCKEFELLER. And then one for you, Mr. Selib. I think it is one of your criticisms that The Nature Conservancy failed to report to the IRS modifications to easements. Is that correct?

Mr. ZERBE. It is not a criticism that they failed to report, just to be correct, Senator. We note that they did not report it. We also noted that there is not a requirement, under current law, for them to report. Senator Grassley accuses me often of talking fast. I apologize if my speed did not make that clear.

Senator ROCKEFELLER. Well, you do actually talk fast.

Mr. ZERBE. I apologize. But to make that clear, no, there is no current legal requirement. To give you the full flavor of that——

Senator ROCKEFELLER. I do not want to use up all my time here, or for you to use up all my time. [Laughter.]

Senator LINCOLN. Well, he is talking fast. [Laughter.]

Senator ROCKEFELLER. Yes, I know. But I am not. [Laughter.] So that is the point I wanted to make. I understand that there is not that requirement.

Mr. ZERBE. And we think there should be a change in law that there is a requirement. Yes, sir.

Senator ROCKEFELLER. Now, are you aware of whether The Nature Conservancy has reported such easement modifications to State governments that do require it?

Mr. ZERBE. My understanding, Senator, is that what has happened is this. Since they have undertaken reform, since the Finance Committee has begun its investigation, one of the reforms they have done internally now is to notify the States that, previous to the 2003 time period, if you will, they had not notified.

Sometimes they might because there was a court action, but basically they were not. But now it is their practice to notify States if they are engaged in a modification.

Senator ROCKEFELLER. My further understanding is that there is a sort of four-part test on easement requirements, and that what they are doing is perhaps a little bit more stringent than the law in those States requires.

Mr. ZERBE. I cannot speak to specifically that, but what I would say is, that could very well be the case. A good learning experience for us is the problem is out there in this, and that there has not been good notice for the tax authorities at the State and Federal level.

So, I think what we are looking at is the reforms that they have taken are something that may serve as a good model across the board in terms of notification at the State and Federal level in terms of modifications.

Senator ROCKEFELLER. And I appreciate that.

Now, if I could ask both of you my final question. That is, in the last hearing we had on this, there was a good deal of criticism about very much smaller foundations that are trying to do this and do not have either the staff or the money, or whatever, to do the reporting requirements.

Now, what I have just said constitutes something which is not good. What is the answer? I mean, not everybody can be big. We heard examples the last time of people who were using it to enrich members of their own family, put cousins, nephews, nieces on boards. That kind of thing is clearly, clearly wrong.

What can be done? What do you recommend for those that are not large, have good intent, but do not necessarily have the resources with which to carry out that good intent?

Mr. ZERBE. I would say, Senator, briefly, then turn it to Mr. Selib, this is an issue that plays on all minds of the staff, given very much our bosses, and they, just like in your State, have a lot of small trusts. We are in very good discussions with them.

I would say, too, very much with the Land Trust Alliance, which represents over 1,000 organizations, many of them very small organizations—and Mr. Wentworth will be testifying—I think it is trying to get that balance of what is reasonable in terms of the requirements that we can place on these smaller land trust organizations.

But I think there is, further, wide agreement that situations like reporting on modifications is really a pillar. If you let that slip, then we do not know what is going on in modifications.

All the good work that you so much want to see of conservation and protection of the environment can be lost if we are not making sure it is being monitored and it is being enforced, because you can

take that great deduction saying, I am not going to put two homes on that property, but if no one is there to monitor and enforce it and it gets modified, it does not get you there.

But I think we feel we are working on that balance. I think we feel, with the Land Trust Alliance, we can strike that. But we are aware that, for some of these organizations, they are very much a one-man shop, or something like that, and trying to do it. I think it may actually help them, also in terms of an accreditation process.

In some ways, they want to do the right thing, and giving them the education, the tools, and what-have-you to say, here is what we are expecting of you, will actually put them in a better place.

Jon?

Mr. SELIB. My colleague took the words right out of my mouth. I mean, I agree, Senator, with Mr. Zerbe here that education for these groups is essential. The laws are complicated. The requirements are difficult to navigate.

To the extent that groups like the Land Trust Alliance, either under the auspice of some government-created accreditation system or just on a voluntary basis, can provide that type of guidance to these smaller land trusts, that will make a big difference.

Senator ROCKEFELLER. Thank you, Mr. Chairman. I will have a few questions to submit to the next panel.

The CHAIRMAN. All right. Thank you very much.

Now it is Senator Bunning's turn.

Senator BUNNING. Thank you, Mr. Chairman.

I would like to go to the two staff people, Mr. Zerbe and Mr. Selib. I wanted to ask you a little bit about your findings and thoughts regarding unrelated business income in the areas of land conservation organizations.

What are your thoughts with regards to charities that routinely help to preserve unique lands by buying them when they first go on the market, and then holding them until a State or Federal Government can appropriate the funds to buy those properties? Do you feel that that type of activity would produce taxable unrelated business income to the charity?

Mr. ZERBE. Senator, let me try to answer you in a couple of ways. One, you are raising a very significant issue. Just The Nature Conservancy alone engaged in over $900 million in sales of land to Federal, State, and local governments over the last 10 years, and we see this trust for public land. Other land conservation groups are active in this area as well, too, so it is not unique to The Nature Conservancy that you see that.

The question about whether it is UBI is one we have also wrestled with, because so often, particularly in the scenario that you are laying out, what you will see is that, setting aside The Nature Conservancy, a land organization will get a grant from, say, Fish and Wildlife Foundation or some other government or quasi-government entity to purchase the land, or basically purchase the land at the request of the government so that at a later time, when there are funds available, they can then basically purchase it from the organization. I think it is something that we have wrestled with and have not made a conclusion. I think our concern, and other members', looking at the history of this issue, have expressed

a concern about, are we comfortable with the idea of an organization getting a grant of $500,000, say, from the government, buying land, and then later selling that land to another government agency, say, for $500,000. How do we want to treat that?

Senator BUNNING. Or a plus.

Mr. ZERBE. Yes, sir. Or a plus. I guess I would say it is an area we have wrestled with. I do not know. Maybe Jon can respond.

Senator BUNNING. Do we need new tax laws in regard to this or do you think that the IRS should be involved in clarification of what we now have?

Mr. ZERBE. It is a difficult area for the IRS, I think. We have looked at this and talked about it in some ways with trade lands, of whether this is an ongoing business for them, that they are, in a sense, engaging it in a business-like manner.

I am not directly answering your question. I apologize. UBI is a very, very difficult area. I think the easy answer is always to say, could there be clarification? Yes, absolutely.

Senator BUNNING. Mr. Selib?

Mr. SELIB. I would agree with Mr. Zerbe. It is a complicated issue. I think what a lot of land trusts would say is that it is important to look at the aggregate of the transactions for the government.

In other words, that on some sales to the government, land trusts or the nonprofit would actually take a loss on the transaction, and on some they may make money in some situations, and that at the end of the day, it would balance out and there would be no income.

Senator BUNNING. Well, I do not think that is the job of the government, to balance out. I think the individual persons or the trust would have to make that decision along individual cases with the Federal Government.

Mr. SELIB. That is right, Senator. And the report does not delve into this issue or make recommendations on it, but it is an issue.

Senator BUNNING. The committee understands that there are a lot of factors that go into figuring out if a gift to a charity should be deductible, and how much can be deducted. The first hurdle, however, is getting a decent appraisal of in-kind donations, particularly land donations.

Could you address the ideas or ways that the IRS, the State governments, or the Federal Government can make sure that the appraisers themselves are qualified and that the particular appraisals are accurate?

Mr. ZERBE. Senator, this is an issue we struggle with a lot, and we do have recommendations in the report. Some of the basic recommendations—and I think there is wide agreement—are having certified appraisers, appraisers that are blessed under their local State rules, that they are using Uniform Standards of Professional Appraisal Practice (USPAP) standards, appraisal standards.

I think, also getting potential penalty regimes more accurate. Right now there is a significant safe harbor for someone who has a very aggressive posture in valuation that they take. It is very difficult to bring penalties in that area.

I think the other interesting idea—you would appreciate this from your past—is baseball arbitration, is what we call it. You would probably know it better than we do.

But right now, what we see is people kind of coming in with a high valuation as their first negotiating point with the IRS, and the idea being a little bit of a variant of saying, well, what you are going to do is come in at closing, and whatever you come to the table with, you with that number, the IRS comes in with their number, and we will not split the baby. The judge will choose between one of the two numbers.

Senator BUNNING. In other words, not have any in between?

Mr. ZERBE. Right. Not have any splitting of the baby, enforce people's behavior.

Senator BUNNING. That is exactly like baseball arbitration is right now. It is a lousy set-up. [Laughter.]

The CHAIRMAN. All right.

Senator BUNNING. No. It really is. It is bad that you cannot negotiate somewhere in the middle.

Thank you. Thank you very much. Thanks, Mr. Chairman.

The CHAIRMAN. Yes. Thank you.

Now we have two left of the people who are here, Senator Lincoln, then Senator Santorum.

Senator LINCOLN. Thank you, Mr. Chairman, and thanks to this panel. I know the Finance Committee staff has put a tremendous amount of work into this, and I am grateful.

In our home State of Arkansas, I know that there are many organizations whose land conservation work really depends on the kinds of donations, both of easement and of property outright, that we are talking about today.

So, it has been a tremendous benefit for our State. We all know that there may well be instances where those tools were used badly or incorrectly, but we also know, too, that there are others where a lot of good has been done, particularly in our State.

One of the specifics my colleagues may see that comes to mind from our State, or be aware of, is that in Arkansas we did recently discover the existence of the Ivory-billed woodpecker, which is a bird long thought to be extinct, in the Cash River Refuge, which is not far from where I grew up.

I think it is important just to note, because it is a huge product or evidence and a confirmation that conservation programs are very important and they do a tremendous job. Whether it is land easements, conservation easements, or the outright purchase of those properties, to be put into conservation is important.

But with that said, again, I do appreciate all of the hard work of the Finance Committee staff, and I especially thank Mr. Zerbe and Mr. Selib for all their hard work in helping us look to make sure that things are done correctly so that we do not lose these types of opportunities.

We do not want the baby out with the bath water. We want to make sure that we do maintain these opportunities, and, as Mr. Devaney has mentioned, the American public gets good value for that. I am enormously grateful for what you all have done in that.

Just a couple of quick questions for Mr. Zerbe and Mr. Selib. In terms of The Nature Conservancy's case, the stated mission of The

Nature Conservancy has been preservation and conservation. In the outline of your report, there are certainly some activities from The Nature Conservancy that raise concerns.

I guess, going back to that, would you all, in your opinion, in terms of those questionable activities, are they inconsistent with The Nature Conservancy's purpose in terms of something other than conservation or preservation, and were they widespread? Were they just small pieces in different areas, and have they been addressed by The Nature Conservancy?

Mr. ZERBE. Yes, Senator. I guess, in terms of inconsistent, it is a little bit sweeping. I guess I would say it is one thing for the charity's mission, it is another thing that the charity needs to operate itself in a manner that is consistent with its tax-exempt status.

I think part of the concerns we get to at times is, are they, when they are engaged in certain insider transactions, doing those in a manner that is consistent with their kind of bigger requirement, which is that they operate like a charity.

I would say that at times we certainly raised concerns about whether that is the case. I think I understand your question of, other times, say the conservation buyer program, or what have you, is that inconsistent. I can see your point that, yes, it is within the overall framework of what they are trying to accomplish at times.

In terms of widespread, that is a difficult one to answer. I certainly would not want to leave the impression that The Nature Conservancy has problems under every rock. I think if your sentiment is that most of the land deals that they look at seem fine, yes, that is the case.

I would note that that is, unfortunately at times, a contrast. We do see—and again, this is the kind of report that talks not only about The Nature Conservancy, but also illuminates land issues in general, and also big charitable issues in general—other charities—and again, you will hear from other witnesses on the second panel—that are, unfortunately, very consistently active in areas that we would view as inappropriate and not in keeping with the law.

Jon, do you want to respond?

Mr. SELIB. I will start off with, in terms of widespread. I believe the conservation buyer program constitutes about 2 percent of The Nature Conservancy's activities, and some of the emissions credit arrangements represent about $34 million worth of their activities out of a $4-billion organization.

So, I would say that there are isolated cases, and The Nature Conservancy is an organization that engages in a lot of very run-of-the-mill conservation activities that are, without a doubt, clearly within their conservation agenda.

I am wary about talking specifically about whether or not the activities they have engaged in are related to a conservation purpose because they are in the midst of an audit right now, so I do not want to give a specific opinion as to whether those would fall into that category.

Mr. ZERBE. If I could add just one more point, Senator Lincoln. I guess I would encourage you to review the internal memo that the Chairman mentioned at the very beginning, which, I think, does give a cautionary note that The Nature Conservancy, unlike

a lot of land organizations, likes to term it "entrepreneurial," is their phrase.

But they engage and are very active, albeit it is a small percentage. But it is certainly their cutting edge. They did the conservation beef program. They are involved in cattle, involved in oil drilling, involved in forestry, involved in emissions credits/transfers. There are a lot of things that are kind of their cutting edge.

It again raises the questions of kind of the core activities of what they are doing, but also that memo does an excellent job of laying out that, when they get outside of their core activities, problems arise and they arise very quickly, and they find themselves perhaps not keeping in terms of the best stewardship for their work and what their donors are hoping when they give that money, if that helps you.

The CHAIRMAN. Senator Santorum?

Senator LINCOLN. The last question I asked, which neither of you got to, is, do you feel like they have gotten to a reasonable amount of addressing those issues?

The CHAIRMAN. A short answer.

Mr. ZERBE. Yes, Senator. I think they have done a good job. I think there are some additional things that the Chairman has mentioned, but, yes, they certainly have. Yes, ma'am.

Senator LINCOLN. Right.

Thanks, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Santorum?

Senator SANTORUM. Mr. Zerbe, you just mentioned that The Nature Conservancy gets in trouble when they get outside of their core activities. How pervasive if this problem throughout these other charitable organizations?

For example, I have 140 organizations in my State alone that deal with land trusts, and most of them are very, very small. I understand this is a huge organization and they are entrepreneurial, as you suggest. This audit obviously was well-deserved.

My question is, how pervasive is this problem with all my little land trusts in Pennsylvania who are just trying to do their little part to keep their community from being overrun by development?

Mr. ZERBE. I think that is a fair point, Senator, and I guess I would answer in two ways. The issues that we see here regarding The Nature Conservancy—again, that word "entrepreneurial," just kind of new ways of doing things, joint ventures, and all sorts of things that are out there. For big charities, we are seeing that more and more. I think that is one of the most important things that we are trying to bring to the committee and bring illumination to, is that for big charities they can be involved in very—and that is not to say it is bad, good, or indifferent. It is just, the law has not changed since 1969.

But charities and how they operate really have changed dramatically. So, I would say to you, for big charities, what we are seeing with The Nature Conservancy in kind of style and form, would not be that different from other big charities.

I think for the smaller land groups, just going back to your other question, I would be surprised that we would see that, although I would say things like the conservation buyer program are not an

uncommon activity for a lot of charities to engage in, and that is something that we have paid some attention to.

But I think my sense would be, from having looked at some of the smaller charities, smaller land groups, that that would be uncommon that you would see that. I would say that they would probably have their own problems.

A great example would be, are they monitoring properly? Are they making sure there are no modifications? Really, most critically, do they have stewardship funds available to ensure that they are going to be able to monitor and enforce these easements in perpetuity?

We have seen reports repeatedly of land groups that basically disband, and there is no one there to pick it up, and unfortunately it falls on State or local government to pick up the burden of ensuring that these enforcements are there.

So, the small ones may have their own difficulties, but I think you are right, Senator, that our hope would be that we probably would not see that much activity for those organizations.

Senator SANTORUM. All right. I guess the concern is, at least the concern I am hearing from a lot of our land groups, is what is being proposed here is already having a chilling effect on them, on people, and their willingness to come forward and participate.

I guess, if most of these groups are not getting involved in some of these entrepreneurial activities, does it make any sense for us to sort of have a broad-brush approach to how we deal with this problem, or do we need to segment it out, or is there some way for us to make sure that my little community land trust that has no paid staff, that is run by all volunteers, that is community-based, is not going to basically lose their ability to be able to survive in the future?

Mr. ZERBE. Right. I think that is a fair point, Senator, and it is one that we are cognizant of. I think what we are trying to do is respect the balance. Obviously, I think some of the rules that we may be looking at would that would touch on The Nature Conservancy just would not even kind of show up on the map for these organizations in terms of being concerned about. I think for the smaller ones, I think there are a variety of issues.

In some ways, I think it will be a two-fold benefit. One, I think giving them best practices will give them a road map of how they should be behaving and what we are expecting of them.

Senator SANTORUM. Is there not an organization that does that already?

Mr. ZERBE. Yes, sir. There is the Land Trust Alliance.

Senator SANTORUM. Right

Mr. ZERBE. Yes, sir. One of the things we are looking at is, for instance, having an accreditation regime with an education so that they could be members of that and they would get benefits of being a member and engaging in those best practices out there. Right now, it is a voluntary system.

Unfortunately, a lot of the bad actors are not complying with what the rest of the good organizations are doing, and are actually putting the good organizations at a disadvantage in terms of encouraging people to give, because, of course, some other fellow across the street—as you mentioned, there are 140 out there. There

are a lot of land organizations out there who would be willing to, say, lower their standards.

So, by giving a kind of a common playing field with best practices, we can help organizations know where they stand, what they need to be doing. And, most importantly, just to step back, ensuring that the goal of conserving the property is preserved.

In other words, if we do not do monitoring, if we do not do enforcement, if we do not watch for modifications, the whole reason we are doing this will be lost and the good work that your groups are trying to accomplish would be lost because, 10 years from now, that land will have been developed because no one was there to monitor it and check easements, and enforce them.

The CHAIRMAN. Senator Schumer, did you come back for this panel?

Senator SCHUMER. Yes, I did.

The CHAIRMAN. All right. Then take your 5 minutes now.

Senator SCHUMER. I do not mind if somebody has to go.

Senator LINCOLN. I just would like to ask unanimous consent to include my statement and other questions in the record, if that is appropriate.

The CHAIRMAN. Yes. And let me make it clear to this panel, because I had another set of questions, but I am going to go to the next panel when Senator Schumer is done, I will have some questions for answer in writing.

So let me announce then to the next panel that might not be familiar with how things go here. If every member does not show up, or even for members who do show up, you will get requests for answers in writing.

Yes?

Senator LINCOLN. I just also wanted to compliment the staff on such a thorough job. They have been very helpful with their memos. Thank you.

The CHAIRMAN. They have done very well.

[The prepared statement of Senator Lincoln appears in the appendix.]

[The questions appear in the appendix.]

The CHAIRMAN. Senator Schumer?

Senator SCHUMER. Thank you, Mr. Chairman. I will make a brief statement, then I have a couple of quick questions for two of the witnesses.

First, I want to thank you for calling this hearing. As I read the report, The Nature Conservancy has undergone, itself, an exhaustive, 2-year review. There have been some problems with some of TNC's transactions in the past, that is clear.

But I think the report shows that The Nature Conservancy has emerged from this investigative process with its reputation for good work intact. They have cooperated fully with the committee. They have provided more than 50,000 pages of documents.

They asked one of the preeminent experts, someone whom I know, Ira Millstein, to make a series of recommendations to improve its governance and operation. The Conservancy has adopted all of those recommendations and is well on its way to fully implementing them. As a result, TNC is clearly at the forefront of chari-

table organizations. They have done more than just about anybody else.

I urge the committee to keep the big picture in mind as it considers changes to the nonprofit sector. The staff report on The Nature Conservancy focuses on a handful of transactions among tens of thousands.

No question, these transactions are important, and any wrongdoing should be changed, exposed, and punished, but they need to be considered in the context of the extraordinary record of accomplishment that The Nature Conservancy has achieved over its 50-year history.

The Conservancy has a strong New York base, and I am familiar with the organization. Its first chapter was in New York. It completed its first land transaction in 1955 in New York and remains very active in my State.

It just recently protected a very important part of the Long Island Pine Barrens and has helped fight invasive species in the Adirondacks. More broadly, as we know, it has protected 15 million acres of wildlife habitat in all 50 States.

So, its record of doing a great job is clear, and I want to congratulate Mr. Paulson, the chairman of the board, as well as Mr. McCormick and the employees who have accomplished all of these things.

Now I have a few questions for Mr. Zerbe. Because I have limited time, if you could answer them quickly, that would be great. I wonder why I have limited time? Anyway, I am concerned that the report gives short shrift to the reforms that the Conservancy has adopted. They are included in the text of the report but do not appear prominently in the executive summary. So, let me just ask you a few questions about these reforms.

First, have they reduced the size of their board and changed the structure of the committees and responsibility of directors?

Mr. ZERBE. Yes, they have. I am sorry Ira Millstein will not be here to testify. That is kind of an ongoing process, though, of what they are ultimately doing. But, yes, they have reduced their board size.

Senator SCHUMER. All right.

Have they adopted the Sarbanes-Oxley standards for auditing?

Mr. ZERBE. They have stated to us that they have, is my recollection, Senator.

Senator SCHUMER. Yes.

Have they created a position of chief compliance officer who administers an organization-wide compliance program?

Mr. ZERBE. Yes, they have. Mr. Millstein himself commented on that, that he was concerned, though, on two factors. One, that this person was from inside the organization and was not an outsider, and also that this individual is not based in their Washington headquarters. Just like you respect Mr. Millstein, I do, too, and I would just note his comments that were in his testimony on that.

Senator SCHUMER. Right. All right. Thanks. That is relevant.

Fourth, have they strengthened their conflict of interest policy?

Mr. ZERBE. Yes, I believe they have. I think we still have some concerns, but, yes.

Senator SCHUMER. So they have made real progress, no question about that. Is that fair to say?

Mr. ZERBE. I think they have certainly made progress. Absolutely, Senator.

Senator SCHUMER. All right.

The last question, before my time is up, for Mr. Selib. One of the issues that I am visited about most often as it relates to the reforms the committee is considering involves how the tax code treats donations of property. I understand the desire of the committee to tighten the rules in some cases to eliminate abuses, no question about that, and I support that effort.

It seems to me, however, that moving to a deduction of one's basis in the property, whether we are talking about conservation easements, restricted stock, or other gifts of property, may well move too far in the direction of reducing charitable activity rather than closing abusive shelters.

There is always a balance. We have it in the criminal justice system. I always disagreed with the Civil Liberties Union, for instance, because they would let 1,000 guilty people go free so you should not convict one innocent person. I think most Americans would have the balance somewhere else.

So, there is a trade-off here between good charitable activity and closing the abusive shelters. Could you please comment on how the committee is likely to handle these donations of property? Are we likely to see a shift to a basis deduction or will we tighten the ways in other rules and still allow the deduction for the fair market value of the donation?

Mr. SELIB. Thank you, Senator. Well, at the end of the day, that will obviously be your choice.

Senator SCHUMER. What do you think?

Mr. SELIB. But I think you are referring, I believe, to the Joint Committee on Taxation's proposal. I think there are a lot of very smart people over there who worked on that proposal. With all due respect to them, I think it would have a significant impact on the donations of, for example, conservation easements and other conservation property, and other gifts of real property.

Senator SCHUMER. Reductions. Significant reductions.

Mr. SELIB. It could have a significant reduction. For that reason, it may go too far, but I think it is a discussion that the committee should have.

Senator SCHUMER. Mr. Chairman, thank you.

The CHAIRMAN. You bet. Thank you very much.

Now I have to say thank you to this panel, because they did a very, very good job, not just now, but each of you over a long period of time.

Now we have a chance to hear from our second panel. In the first case, we invited Mr. Ira Millstein, a well-recognized expert in the area of corporate governance. But he was called away by the Governor of New York to fulfill his duties for a board on which he sits, and so was unable to testify today as originally scheduled. However, he has submitted very good testimony, and I encourage everyone to read his testimony closely.

[The prepared statement of Mr. Millstein appears in the appendix.]

The CHAIRMAN. Now we have Mr. Steven McCormick, president and CEO of The Nature Conservancy on the reforms recently undertaken with that organization; Mr. Rand Wentworth, president of the Land Trust Alliance, to discuss conservation donations to charitable organizations; Mr. Timothy Lindstrom, director of protection and staff attorney for the Jackson Hole Land Trust, to provide another perspective on land trust issues; Mr. Burnet Maybank, Director of the South Carolina Department of Revenue, to discuss his department's experience in auditing land and conservation easement donations; and, finally, Mr. Steven Miller, Commissioner of Tax Exempt and Government Entities Operating Division of the Internal Revenue Service, to discuss the laws that relate to deductibility of contributions for conservation easements and how the Internal Revenue Service would enforce those laws.

Welcome, Mr. McCormick.

Senator THOMAS. Mr. Chairman?

The CHAIRMAN. I would just have you go in the way that we introduced you. I am sure my staff suggested that your printed statement, if it is longer than 5 minutes, will be included in the record, and we would ask you to summarize in 5 minutes.

Senator THOMAS. Mr. Chairman?

The CHAIRMAN. Yes?

Senator THOMAS. May I just welcome Mr. Lindstrom, who came all the way from Jackson, WY to be with us today. For 5 minutes of reporting, why, that is quite a long trip, and we appreciate it. Thank you.

The CHAIRMAN. Yes. I would have been glad to let you introduce your constituent. I did not give it a second thought. Welcome, everybody here.

Mr. McCormick?

STATEMENT OF STEVEN J. McCORMICK, PRESIDENT AND CEO, NATURE CONSERVANCY, ARLINGTON, VA

Mr. MCCORMICK. Mr. Chairman, Senator Baucus, and members of the committee, thank you very much for the opportunity to present the views of The Nature Conservancy this morning.

We are an international nonprofit organization dedicated to conserving the world's biological diversity. We are known, and proud of that reputation, for achieving tangible, lasting results, securing conservation of places that are carefully and scientifically selected.

Our on-the-ground conservation work is carried out by 3,000 employees, working in all of the 50 States and in 27 countries around the world, and we are supported by over a million members and donors.

We have helped conserve nearly 15 million acres in the U.S. and more than 100 million acres with local partners globally.

I must say that the last 2 years have been a particularly challenging time for The Nature Conservancy. The actions and projects by our people have been subject to the closest scrutiny.

But based on that examination and our own internal reviews, I can say with confidence that all of our work is, and has been, in compliance with the law and applicable regulations, and motivated by the sincerest dedication to our mission.

On occasion we have made mistakes, but all of our work has always been done in genuinely good faith. Nonetheless, we have come to realize that we must hold ourselves to a higher standard beyond mere compliance with the law and devotion to our mission.

In this spirit, over the past 2 years we conducted an extensive and rigorous internal review to strengthen our governance, enhance management oversight, increase accountability to all of our constituencies, and make our actions more transparent to our supporters and to the public.

As a result of this comprehensive effort, The Nature Conservancy improved, and significantly added to, our policies and procedures, including those applicable to our newer conservation strategies.

As was mentioned, we convened a panel of independent experts, led by Ira Millstein, to assist in an extensive review of governance. The panel presented a far-reaching set of recommendations that are detailed in my written testimony.

The Conservancy's board and management acted quickly to adopt and implement virtually all of the panel's recommendations. Among the many steps we have taken are changes in the size and structure of our board of directors to provide increased strategic guidance and more active and engaged oversight, and adoption of many of the governance principles embodied in the Sarbanes-Oxley Act, including a whistle-blower policy and prohibitions on related-party transactions.

I will say that implementation of these reforms has not been easy. We are a highly decentralized organization with our conservation work done by State and country programs that have been given wide latitude for decision making. We have flourished with a culture that encourages risk-taking and bottom-up innovation.

Still, we are now committed to instilling a culture imbued with the principle that doing good is simply not enough. We must carry out our work against a higher standard of integrity and public trust. We understand that, as we continue to innovate, we must also continue to refine and enhance our policies, procedures, and practices to keep pace with that innovation.

In that regard, the staff report on The Nature Conservancy issued yesterday makes recommendations for a few additional changes in our policies and procedures. I promise you that we will take a very careful look at those recommendations and let the committee know what we will do to respond to them.

In that regard, I do want to add, on behalf of myself and my colleagues, a note of admiration and respect for the hard, long, and good work that committee staff did in preparing the report.

Now, the subject of this hearing, Federal tax incentives encouraging the donation of conservation lands and easements, is of great importance because conservation easements have become one of the most effective and widespread tools for protection of lands that provide a variety of public benefits.

At a time when the Nation has become more sensitive to the rights of private landowners and more fully appreciates the need to provide financial incentives for wise management of private lands, the many attractive features of conservation easements, as a public policy tool, are quite clear.

For example, under conservation easements, property remains privately owned, and therefore on local tax rolls. In addition, many types of private use that are compatible with the underlying purpose and benefit to the public, such as farming and ranching, can continue. In that regard, the land can remain productive, generating jobs and revenue for local communities.

Although the vast majority of conservation easements benefit the public significantly and have been done properly, as with any charitable endeavor, there have been abuses.

To ensure that conservation easements are used only in the manner intended by Congress, The Nature Conservancy submitted a series of recommendations for specific reforms. These are more fully described in my written testimony.

I believe that our proposals effectively address all of the concerns that we have heard expressed by members and staff of the committee as we prepared for this hearing.

In closing, let me again say that The Nature Conservancy has a very strong fidelity to its mission of protecting natural diversity, and in our steadfast adherence to that mission we are constantly experimenting with new approaches to achieve more effective, more efficient land conservation, including activities that demonstrate the linkage between conservation and human use.

But we are a charity. We are allowed to do our work under the policy framework that this committee creates and oversees. What we recognize is that changes may be warranted in that public policy.

We stand ready to work with you to shape those changes to ensure that proper incentives are in place for conservation of our irreplaceable natural heritage, and therefore for the unique quality of life that we all enjoy in this Nation.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Yes. Thank you, Mr. McCormick.

[The prepared statement of Mr. McCormick appears in the appendix.]

The CHAIRMAN. Now, Mr. Wentworth?

STATEMENT OF RAND WENTWORTH, PRESIDENT, LAND TRUST ALLIANCE, WASHINGTON, DC

Mr. WENTWORTH. Thank you, Mr. Chairman and members of the committee.

My name is Rand Wentworth and I am the president of the Land Trust Alliance, the national organization that provides training, information, and standards for the 1,500 land trusts conserving lands in America. Thank you for the opportunity to testify today.

I want to take this opportunity also to thank the committee staff, Dean Zerbe and Jon Selib. In our discussions over the past 18 months with committee staff, they have challenged virtually every aspect of land trust operations, but they have also been responsive to our suggestions for more practical ways to address their concerns.

Private land conservation is a stunning success story for tax policy. In the 25 years since Congress first enacted the current law governing conservation easements, land trusts have protected over

34 million acres of important wildlife habitat with farms, ranches, and forests.

All are, on a voluntary basis, working directly with private landowners. This is an extraordinary legacy of land for future generations, actually more land than is in all of the national parks in the lower 48 States.

Conservation easements protect land at a fraction of what it would cost the government to buy it. A conservation easement keeps land in private hands, on the tax rolls, supporting local schools. It contributes to strong rural economies and keeps working farms and ranches in the family.

This is only possible because of land owners who make an extraordinary charitable gift to conserve their lands in a way that benefits all of us. Today, there are several of those land owners who have made these donations here with us today, and I would like to recognize two of them: Jim Cruise from Mississippi, if you could stand, and John Lundt, who has a ranch in Wyoming, if you could stand.

We want to thank all of the generous land owners across the country who have made sacrificial gifts to promote conservation in America.

The vast majority of conservation donations are properly valued and have clear benefit for the public, but there have been problems, primarily from two sources: from small, volunteer groups that have good intent but limited resources; and, second, an emerging small, but troubling, group of private enterprises abusing the incentives for private gain.

The solution to these problems requires a coordinated approach between the government and the private sector each doing their part, with three steps: (1) strong accreditation; (2) strong enforcement; and (3) strong reform legislation. Let me briefly address each of those.

First, I think it is the responsibility of the private sector to do our part and develop a standards, training, and accreditation program. The Land Trust Alliance first developed the ethical standards for land trusts in 1987, and this is our 564-page manual that provides detailed guidance on the legal, ethical, and governance issues for land trusts.

Last year, in response to the Senate's concerns, we completely rewrote those standards, and we require all of our member land trusts to adopt them.

We are now setting up a training and accreditation program that will create a national seal of approval to identify those land trusts that meet high standards. I am pleased to report that, just yesterday, we signed a memorandum of understanding with the Appraisal Institute and the National Appraisal Standards Board to develop specific standards, training, and certification for the appraisers who do conservation easement appraisals.

Point number two, strong enforcement. In April, IRS Commissioner Everson acknowledged that his agency had paid too little attention to these problems in the past 8 years.

The good news is, he and Commissioner Steven Miller, here with us today, have demonstrated strong leadership and they are now reviewing hundreds of easements. This increased enforcement actu-

ally is in the benefit, and serves the interests, of legitimate charities.

The States also can play a major role in education and enforcement, as Director Maybank is demonstrating in South Carolina. This new enforcement activity will have a major effect on discouraging abuses, and it is absolutely essential to the success of whatever rules we have.

Finally, reform legislation. Given the success of the current tax incentives, we are understandably reluctant to change the rules. But we cannot turn a blind eye to abuses that, while limited, threaten our credibility.

We have proposed a number of changes to the committee, with the approval of many conservation organizations, including The Nature Conservancy, which has played a very constructive role.

There is a detailed list in my written testimony. But, in short, let us insist on real standards for appraisers, let us have real penalties for abuses, and let us have simple rules that exclude the worst abuses, golf courses and backyards.

In closing, 2 decades ago, Congress passed a far-sighted bill to encourage private land owners to donate for public benefit. It is a great idea that is working, and it has great promise for the future.

Let us not allow a few bad apples to spoil a highly successful program. We in the private sector will do our part with standards, training and accreditation. We support strong IRS enforcement, and we support common-sense reform legislation targeted at the worst abuses.

Thank you.

The CHAIRMAN. Thank you, Mr. Wentworth.

[The prepared statement of Mr. Wentworth appears in the appendix.]

The CHAIRMAN. Now, Mr. Lindstrom?

STATEMENT OF TIMOTHY LINDSTROM, DIRECTOR OF PROTECTION AND STAFF ATTORNEY, JACKSON HOLE LAND TRUST, JACKSON, WY

Mr. LINDSTROM. Mr. Chairman and members of the committee, thank you very much for inviting me to come today. I especially want to thank Senator Thomas, not only for his role in this visit, but also for all of the work he has done with land trusts in Wyoming.

I am speaking on behalf of the Wyoming Stock Growers Agricultural Land Trust, the Green River Valley Land Trust, as well as the Jackson Hole Land Trust. These are the three local land trusts operating in Wyoming.

For the past 5 years, I have been, and still am, the staff attorney and director of protection for the Jackson Hole Land Trust. I will tell you, it snowed all day yesterday, which is why it took me 16 hours to get here. [Laughter.]

I am also speaking from my experience as the donor of two conservation easements on farms that my family has owned in Virginia and Michigan. I have taught, lectured, and written extensively around the country on conservation easements and conservation easement tax benefits to ranchers, farmers, land trusts, and

lawyers, and have spent a considerable amount of the past 10 years involved in the tax code.

I will not repeat what Mr. McCormick and Mr. Wentworth have said about the importance of easements, except to say that I spent a long time teaching planning law, and a long time as an elected official at the local level in Virginia. Conservation easements are the most effective long-term conservation method that we have in the United States, and the tax benefits are central to that.

My personal belief is that the existing law is adequate to address the abuses that we have heard. I know that there are abuses. Now, I am speaking of conservation easements on land. I am not talking about historic facade easements or some of these other transactions.

I believe that much of this abuse can be effectively addressed by more vigorous enforcement of existing law. I recently wrote a *Law Review* article in Wyoming, and as part of that I had to do some research. I researched all of the reported cases in which the IRS has challenged the deductibility of a conservation easement, and there were about 115 cases we could find.

Of those 115 cases, only 3 dealt with the substance of the conservation easement and not just the value of the easement. Valuation is a very difficult thing for the IRS to tackle. They are dealing with local values and local appraisers and local knowledge. But compliance with the law—is there a valid conservation purpose, are there inconsistent uses reserved in the easement, is it in perpetuity, et cetera, and so forth—is a very clear compliance matter.

I have looked at hundreds of conservation easements in the United States, and I can guarantee you, if the IRS was to look at the substance of those documents, its record would be substantially different.

The message to land trusts, lawyers that represent land owners, land owners, and appraisers, would be very different. It would be, you must comply. A tax deduction is not a matter of right, it is a matter of legislative grace. I know from sad experience, if you do not get it exactly right, you do not get it at all.

So, I think that if the IRS were to focus on compliance with the law that we have—and this is not to be critical; I recognize there is a huge amount on their plate—if they were to compare the documents with the bright line requirements of the law, which are very elaborate, with lots of examples and lots of details, I suspect that we would see a much different attitude towards compliance.

I have to say that you have gotten everybody's attention. The *Washington Post,* the Joint Committee on Taxation, and the Treasury Department really have made it clear that we have to pay attention. I do not truly believe there are very many organizations or people involved in this business in the United States that are out to rip off the system.

I just do not think people ever really have paid attention. They think they are conservationists. They do not realize they are dealing with a very technical area of tax law that requires compliance.

I have taught, and taught, and taught, and said you have to do it the way it says in the book. If you do not, you could get screwed. Excuse me, but that is the fact. People have not truly followed that.

I think, today, people are willing to listen. I have some specific suggestions for following up on that. One is, I think that we need to create, within the Internal Revenue Service—and this is totally out of my province, but it has just been my observation—a group of folks who are trained to deal with conservation easements. This is not rocket science. Frankly, it is not half as complicated as most of the tax code.

In one week of seminars on conservation easement requirements and conservation transactions and conservation buyer programs, I will bet you could create a solid core of folks who could audit easements effectively, knowledgeably, and in way that would be convincing, and I do not think it would take a huge amount of money or allocation of resources.

Second, I think that, while I agree thoroughly with Rand and I am pleased that the Land Trust Alliance feels that it can deal with accreditation, which I think is very important, I think right now we can start mandatory continuing education for land trusts.

At least one official at every land trust holding a tax-deductible easement in the United States ought to have to take a lesson in compliance every year. I have to do it as a lawyer in three States. There are millions of lawyers who have to get accredited.

I do not think it is a huge issue. I think it is something that the Land Trust Alliance is set up to do, and is doing. If we mandate that, I think it would do a lot. I say the same for appraisers.

Finally, I would suggest that we create a new form for reporting conservation easement tax deductions. The current form is Form 8283, which is a generic form for all non-cash contributions.

The details of conservation easements are so specific that there ought to be a specific form for that deduction, and that form ought to require some certifications specifically from the appraiser that are not now required, from the land owner who is donating the easement, or his advisor, and from the land trust that holds that easement. I think those certifications will make people look at the law.

Finally, and in closing, I would just like to say, we have heard a lot about conservation buyer transactions. They are critical to land conservation today. The IRS issued a notice last July which has cast a pall over virtually every conservation buyer transaction in the United States.

We cannot tell from that notice what is intended to be bad and what is intended to be good. I wrote an article, which is attached to my written statement which was submitted, that goes into that in some detail.

Thank you very much. I just want to end by saying that I truly believe conservation easements in the United States are advancing what virtually no other government program has done, and I think you all support it. It is bipartisan. It is something everybody likes.

The abuses have been spectacular, but the abuses are the exception. If we enforce the law and give people incentives to follow the law, I believe you will have done a great service to conservation and to compliance. Thanks very much.

The CHAIRMAN. Thank you for your positive statement, Mr. Lindstrom.

[The prepared statement of Mr. Lindstrom appears in the appendix.]

The CHAIRMAN. Now, Mr. Maybank?

STATEMENT OF BURNET R. MAYBANK, III, DIRECTOR, SOUTH CAROLINA DEPARTMENT OF REVENUE, COLUMBIA, SC

Mr. MAYBANK. Thank you.

My name is Burnet Maybank, director of the South Carolina Department of Revenue, appointed by Governor Sanford. In addition to being a lawyer, I have co-authored two books on conservation easements, one published in 1996, the other a few months ago.

While a vast majority of easements are very good, and South Carolina, I think, is a leading success story in that regard, and the vast majority of land trusts are very good, there are a small percentage of easements which are bad. The problem is the valuation on those very small percentages is astonishing. I think, even at the IRS levels, the numbers we have seen are simply astonishing.

We have looked at probably about 100 easements in South Carolina from 2001 to 2003, and the charitable deductions of those cumulatively is about $300 million.

South Carolina is well ahead of many other States on conservation easements. We have a much more mature, professional land trust community than many other States, so we are probably overrepresented in terms of the dollars.

I do think, however, that additional audit resources alone are not going to solve the problem. No amount of audit resources, standing alone, is going to solve the abusive easements. I do think we do need some legislative solutions, which I will get to.

In drafting the legislative fixes, I would urge the committee not to be distracted at all by The Nature Conservancy. That was a unique situation. I have never seen anything remotely like it anywhere in the U.S., and it would appear to be largely fixed. So, in expending the committee's value time, I would not be distracted by The Nature Conservancy.

I do think there are a couple of areas that the environmental community, the Treasury, elected officials, and the tax collectors will agree on: (1) excessive valuations; (2) quid pro quo; (3) golf courses; (4) small lots or someone's backyard; and, last, (5) strengthening the standards for land trusts.

Excessive valuation hurts not only the Congress, but it hurts the States in two ways. One, the charitable deduction flows through and reduces the amount of income subject to State taxation, and South Carolina, like many States, has a State tax credit, so it is a double-dip, so to speak, in South Carolina.

We have seen astonishing appraisals. We routinely see appraisals that claim that the value of the easement exceeds the original acquisition cost of the property; remember, when you give a conservation easement, you keep the property. We have routinely seen, for golf courses, MAI appraisals that claimed that the value of the golf course has been reduced by 95 percent.

We have seen in many cases—many cases—an appraisal that says that the value of the easement is worth 4 to 5 times more than the original property cost, even though the easement is only a very small percentage of the land.

Now, how can you possibly do that? How can you put an easement on 10 percent of the land and claim it is worth 5 times more than what the entire property cost? It is done through an appraisal technique called the Subdivision Development Analysis.

It is according to *The Appraisal of Real Estate,* which is an appraisal bible. It can be the least accurate raw land valuation technique; however, we see it routinely in South Carolina.

Basically, what it says is, you take a hypothetical subdivision, develop it to the maximum extent legally and economically feasible, and it produces astonishing valuations.

We would encourage the committee to either ban its use or simply adopt in statutory form the numerous cautionary language which is found in *The Appraisal of Real Estate,* the bible that appraisers use, and just simply adopt that cautionary language in legislation.

We would also urge that the 8283 be amended to contain the valuation when signed by the land trust, even though the land trust does not vouch for it. We would also urge, as previous speakers have, that 8283 should be greatly expanded, perhaps an 8283 just for conservation easements over $100,000 to prevent administrative burden on others.

Quid pro quo is another issue we are seeing. Conservation easements have been turned on their head. They are being used as a tool to promote development of natural property rather than inhibiting that.

What developers are doing, they are giving an easement to buy preferential zoning. They are given easements in order to comply with State and Federal environmental requirements. There is nothing wrong with that, but then they are taking charitable deductions.

So, the concept of donative intent and quid pro quo needs to be returned to the Internal Revenue Code. It is now just a valuation swearing match. I have given you a bill, draft legislation, in my package which I think will accomplish that.

The next thing is golf courses. As I have mentioned, in a rough aggregation, we have seen about $300 million worth of conservation easements given in South Carolina. Of that, $125 million of that $300 million is from golf course easements. We would urge you to either narrow the definition of public recreation or to revisit the definition of protection of a relatively natural habitat.

I see my time is ending, so I am going to rapidly end.

Small lots is another issue. We would ask you to take a look at restricting charitable contributions on easements of less than 10 to 15 acres.

Land trusts is another area. We have seen strong land trusts. We have seen real estate developers establish land trusts. Currently, there is no minimum commitment and resource standards on land trusts, and we would urge something of that nature. We would urge you to simply adopt the land trust standards for land trusts. Just take the land trust standards and put them into the Federal law.

Lastly, with my time up, I would urge you to do a conservation panel. The problems I have discussed today crept up on us. We started our audit based on a single *Washington Post* article by re-

porters Joe Stephens and David Ottaway. The vast majority of the tax collection community was not aware of that until that *Washington Post* article.

Obviously, audit selection based upon the *Washington Post* is not the best system, and I think a conservation easement panel would go a long way to identifying abuses before they become national in scope.

The CHAIRMAN. Thank you, Mr. Maybank.

[The prepared statement of Mr. Maybank appears in the appendix.]

The CHAIRMAN. Now, Mr. Miller?

STATEMENT OF STEVEN T. MILLER, COMMISSIONER, TAX EXEMPT AND GOVERNMENTAL ENTITIES OPERATING DIVISION, INTERNAL REVENUE SERVICE, WASHINGTON, DC

Mr. MILLER. Thank you, Mr. Chairman, members of the committee.

Conservation easements are becoming a matter of greater concern and attention at the Service. From a practical point of view, we are primarily concerned about two aspects: first, whether the easements are being created exclusively for conservation purposes; second, whether the appraisals that determine the value of the deduction are reasonable as opposed to fanciful and inflated.

I have outlined them all in my written testimony, and I will touch on it here, but I want to concentrate on our enforcement efforts and some challenges we face.

Today, I will also talk a little bit about the preservation of open space for the public's scenic enjoyment. To qualify for deductibility, an open space easement must restrain development and there must, at a minimum, be visual access to or across the property.

Most importantly, the open space conservation easement has to yield a significant public benefit. If the contribution meets these requirements, the question then becomes how to value the easement. Generally, the amount is limited to the fair market value.

With that background, let me turn to our compliance program. To increase our information about conservation easements, we are modifying our tax forms to identify conservation easement programs and their donors. These changes will better inform the Service and the public about the solicitation, receipt, use, and protection of these easements.

We have also established a cross-functional team to lead our efforts in this area. The team is responsible for case selection, training, acting as a resource for field personnel, and ensuring consistency in our case work.

Currently, the team is leading a review of donors, charities, promoters, and appraisers. The IRS has over 240 open space easement donors under audit, and these are high-dollar cases in our inventory.

The IRS is also examining a number of charities involved in the area concerning their easement practices. We are also looking at promoters, because we have seen pass-through entities use the conservation easement as an investment tool. To date, we have recommended five promoters for investigation under section 6701.

Finally, we are working with our Office of Professional Responsibility on possible future referrals of at least three appraisers who appear to have prepared grossly unreasonable easement valuations.

It is still too early to draw conclusive findings about practices in this area, but I have some preliminary observations I would like to make.

As others on the panel have mentioned, the rules here are difficult and present opportunities for abuse and manipulation. We are seeing problems in several areas: cases where we do not believe there is any public access, visual or otherwise, to open space; cases where the contributed tract appears ordinary in character; and cases where no conservation purpose is served.

We also face very difficult valuation issues. Appraisal valuation assumptions are based upon the facts and circumstances of each case, and each case is unique. Appraisal assumptions concerning future development have been particularly problematic.

In some cases, appraisers are inappropriately assuming major zoning changes, aggressive timing of development, and low or nonexistent development costs. For example, in some cases the appraisal has assumed extensive development in an arid area where the developer does not have water rights. Thus, the economic feasibility of the development may not have been adequately evaluated. Other assumptions may similarly be unrealistic.

So, although the conservation contribution serves a vital role in the preservation of our open spaces, the work we have done so far leaves us concerned. Our work raises the question of whether rules governing appraiser qualifications, appraisal standards, and the standards for referral to the Office of Professional Responsibility, are sufficient.

I would also ask you to consider the questions that were outlined by Commissioner Everson in his April 5th testimony before this committee. Those questions included, first, whether there are gaps in the statutory or regulatory framework.

Examples in this area are whether current appraisal standards are sufficient and whether the current barriers to referral for disciplinary action are workable; second, whether the IRS has the flexibility it needs to respond appropriately to compliance issues. An example in this area is whether there should be an intermediate sanction for those charities that do not monitor the easements in their care. That was outlined in the administration's 2006 budget proposal.

Third, whether more should be done to promote transparency. This includes not only the forms changes that we have discussed today and in our written testimony and the need for enhanced electronic filing, but the possible ability of the IRS to leverage its resources with those of the States and the Federal Government who co-administer these provisions.

I will be happy to take any questions.

The CHAIRMAN. Thank you very much.

[The prepared statement of Mr. Miller appears in the appendix.]

The CHAIRMAN. I am going to call on Senator Thomas and Senator Snowe before I ask questions because they have to go. I will probably have more than 5 minutes of questions, myself, and I will finish up.

So, Senator Thomas, then Senator Snowe.

Senator THOMAS. Thank you. I will be short.

Mr. Lindstrom, do you have any particular basic comments on the issues raised by the staff in the context of the TNC investigation?

Mr. LINDSTROM. Yes. The staff, Mr. Zerbe, made four specific suggestions regarding easements. I thought most of them were ones I support and agree with. I am a little bit concerned about the issue of de minimis deductions.

As I mentioned in my written testimony, in Jackson Hole, we look at a number of inholdings in the national park, which may often be less than 10 acres in size. Also, along sea coasts and lake shores, you have small parcels. Protecting those parcels can be very important. So, just saying anything under 10 acres ought not to get a deduction would raise a problem. I think maybe different standards for that would be appropriate.

Also, I would like to just mention the issue of conservation buyer programs, again, which was touched on in the staff suggestions. I think that there is a concern that when somebody structures a transaction so that, before they buy land, they are committing that they will conserve that land, that they do not have donative intent and should not get a tax deduction, that that is the essence of these transactions that ensures that conservation will occur after the sale has happened.

So, I think, while there may be a lot of smoke around that issue that needs to be pierced, I really think at the heart, those are valid conservation transactions that we should continue to allow. It would be great if we could get some clarification in terms of the Service's concerns.

Senator THOMAS. Thank you very much.

Mr. LINDSTROM. Thank you.

Senator THOMAS. Mr. Miller, it seems kind of interesting that most of this debate, discussion, and so on was sort of unearthed by the media looking into the 990s. Why did IRS not see these things, review these filings, and enforce the current law?

Mr. MILLER. Well, Senator, I think it is fair to say that the media was ahead of us in this area, and I acknowledge that. We obviously have a lot of ground to cover in our work, and believe that we are doing a better job on reviewing forms. But there are some 700,000 Forms 990 filed each year with us.

Senator THOMAS. Really?

Mr. MILLER. That represents a significant barrier.

Senator THOMAS. I see. Well, get Mr. Grassley to get you some more money. [Laughter.]

The CHAIRMAN. Thanks a lot.

Mr. MILLER. Thank you, Senator. [Laughter.]

Senator THOMAS. Thank you, sir.

The CHAIRMAN. Thank you.

Now, Senator Snowe?

Senator SNOWE. Thank you, Mr. Chairman.

I appreciate it, because I think this is obviously a very important question with respect to these conservation easements, and as a tool, certainly, that has been used in Maine by The Nature Conser-

vancy, I think it has worked exceptionally well, both from the conservation benefits, and also the economic benefits.

I think, really, we need to get to the heart of the issue as to how we resolve these transactions, in a way, because they are extremely sophisticated, to ensure that there is public benefit and that there are not abuses and that it is a transparent process.

So, I would like to ask the panel—I will start with you, Mr. Miller, because the source is recognizing whether or not on these IRS forms, where they make the details of all these transactions of these charitable organizations available—what information or data would you all recommend be on this form? I guess it is IRS Form 990.

What should be available on those forms? What should we require to be made available so that these transactions not only are transparent, but I think have full disclosure for the activities that are involved with respect to these transactions, to make sure, if there is anything questionable regarding these transactions, that they are transparent?

Mr. MILLER. Yes, Senator. I think we are of one mind on this panel, no doubt, that the 990 does not do what it needs to do at this point in putting this into the public domain. We have taken steps to improve the 2005 return. I have outlined that in my testimony. And into the future, hopefully we will be able to do more. Right now, there is nothing specific, other than very general program service discussion that is required on the 990.

As we move forward, we will have to, first, identify those organizations that are actually doing this line of charity, and even beyond that, figure out how we can get more information. Because I do not know that you want 10,000 transactions outlined on the Form 990. And we will be working on what that balance will be, to try to get enough information to us, to the States, and to the public, to make a judgment as to whether this is a worthy organization to contribute to, whether we should be taking a look at it, and those sorts of matters.

Senator SNOWE. Would others respond? I think the question is whether or not we sort out what is going to be readily apparent on the IRS forms to make sure, if there are any questionable activities, that they are detected, and whether or not the penalties should be increased for abuses as well for these activities.

Mr. MAYBANK. If I might respond. The form we would like to see expanded is the Form 8283. That is a form that goes along with the specific charitable deduction. It is not a public record. However, that would be the form we would look at. For ease of administration, perhaps an expanded Form 8283 only when the donation is more than, say, $100,000 or $250,000.

Stephen J. Small, a tax analyst, in an article I have attached to my testimony, submitted 11 things he thinks that form could use. For example, have you owned the property for less than 24 months? If so, are you claiming a deduction more than 2½ times what you paid for it?

To the auditor, that is an obvious audit selection. You just bought the property and you are claiming that the easement is worth more than 2½ times what you bought it for. That would be the kind of thing we could use for audit selection.

Mr. MCCORMICK. I would pick up on Mr. Maybank's observation about the Form 8283, because that is required currently to be signed by the recipient organization. So, the nonprofit that receives a conservation easement signs that form simply to signify that it has actually received the gift.

We, in our new reforms, require now that we see the appraisal that has been done by the land owner before we sign that form. We require that that appraisal be conducted by a certified appraiser. We require that all elements of the appraisal that is required by the IRS are in place. We now, as a matter of policy, have to conclude that the value put on the easement passes a good judgment test.

Mr. LINDSTROM. Senator Snowe, great ideas seem to all come at the same time. I had not seen Steve Small's suggestions when I wrote mine. But in my written testimony, I outlined some specific questions that the appraiser should be required to address on the Form 8283.

I am currently reviewing five appraisals for private clients, and I can guarantee you that not a single one would pass muster in an audit. It is not because somebody is trying to take advantage of the system, it is because the appraiser does not understand the rules.

Second, one exception I would make to what was suggested about validating the values is, land trusts should not be put in a position of saying, yes, we agree the value is correct.

We are not appraisers. What we should be in a position of certifying is, yes, we have a proper stewardship program, yes, we are compliant with the organizational requirements for holders. The donor should also have a checklist, such as Mr. Small suggested, and some other things, to focus these folks on what the law requires.

Because I think a lot of them, when they are asked to sign their name to something where they are certifying that they have complied with this, that, and the other thing, are going to ask a lot of questions.

I, finally, think they should have a chance to amend their easement before they take their deduction if they discover, in the compliance process, that they have screwed up. So, this compliance test works for them as well as for the government.

Senator SNOWE. Well, can I just follow up on that? In terms of qualified appraisers, should there not be a standard that is uniform, or is there currently in law?

Mr. LINDSTROM. The law requires that they meet a standard, yes.

Senator SNOWE. With these standards, though, why is there such variation? What is the issue there?

Mr. MILLER. Well, Senator, the law—and you all have modified most recently in the JOBS Act some of these rules—for certain appraisals, there is a requirement that they be done by a qualified appraiser.

At this point, that only means that they are in that business, that they know that if they state something wrong, they can be subject to penalties not related to the specific transaction or to the parties of the transaction. Those are fairly minimal requirements.

Senator SNOWE. So should we enhance those requirements in law?

Mr. MAYBANK. The problem is, appraisals are more of an art than a science. Different appraisers can come up with quite different values.

Mr. WENTWORTH. It is our recommendation to the committee, speaking for the Land Trust Alliance, that the committee pass reform legislation requiring the USPAP standards for appraisers. As I said earlier today, we will go one step further in working with the National Appraisal Standards Board and develop specific standards for conservation easements.

Mr. LINDSTROM. If I might add just one last thing. I agree that there is a lot of subjectivity with appraisals, but I would say that the current tax code and regulations contain a number of bright-line requirements that that appraiser is taking into account, including quid pro quo, enhancement of other property owned by the donor, and so forth. I do not think a lot of those requirements are fully appreciated by the appraiser, or even acknowledged.

So if the appraiser had to certify, yes, there is other property that is not restricted, it is not enhanced or it is enhanced, and go down that checklist, I think it would make that appraiser stop and think: I am certifying something here; is it really true? Because, while it is subjective, there are some very clear bright-line standards that have to be complied with which are not often complied with.

Senator SNOWE. Well, maybe that is something that we ought to look at that could help to minimize this problem being readily evident in these transactions. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much.

I have a few questions. They will not take forever to ask, so you will be able to go in just a little while.

Before I ask questions, though, I would like to give some compliments. And though I give compliments, I do not want them to detract from the seriousness of what we are talking about and proposed changes we have made, and even some criticisms that have been expressed today.

I think they fall into the category of the strong statement that Mr. Lindstrom made, I think, at the end of his comment about the message being received. But, for instance, for The Nature Conservancy and referring back to a meeting I had with Mr. Paulson way back in the members' dining room for breakfast January of 2004, and he came in with a long letter expressing changes that he was going to make, and realizing that things were not right, and going to right them. That shows good intent, and I appreciate that very much.

I do not know whether it was Mr. Wentworth or somebody with your organization that, maybe 6 months ago, came to my office and talked about your self-policing and the standards you were setting. That shows very good intent, and I want to thank you for that.

We have been working beyond just the land issue and the easement issue. We have been working with the Independent Sector as they have held meetings around the country trying to bring attention to this, and to help us in the drafting of legislation. We have had the help of the Internal Revenue Service in the strong letter

that we got from the Director of the Internal Revenue Service. All of this, it seems to me, emphasizes what Mr. Lindstrom said.

So, having said those things, we just have to work our way through this. I think you folks are helping us work our way through it. So, now I will go to some questions that will probably detract from what I just said, but I say it from my heart, what I have said. I think my staff felt the same way as time went on, and you have even said positive things about the staff.

So I am going to start with you, Mr. McCormick. I note that the TNC has been unique and innovative when finding new ways to fund conservation programs. I am concerned, when your internal auditors state that there are inherent risks associated with moving away from your core competency to engage—and I have this quote—"in the business that the TNC has little expertise."

This was stated by your internal auditor who reviewed the oil and gas activity in Galveston, TX. She highlights other areas in which TNC staff are not experts, such as eco-tourism, cattle grazing, and timbering operations.

So, I think, Mr. McCormick, it is safe to say that the oil and gas and cattle grazing activities, while intended to further your exempt purpose, were failures and raised questions about whether such activities are justifiable in the name of furthering your tax-exempt purpose.

How do you think the TNC and other exempt organizations should manage such activities, and what does TNC plan to do to ensure that it attains appropriate levels of expertise before conducting those activities? And before you answer, I want to put something out here then for Mr. Miller to comment on.

I would also like for Mr. Miller to comment, in general, on what we should be doing to ensure that nonprofit activities that are only a different shade of gray when compared to for-profit activities are receiving adequate scrutiny by the IRS and the general public.

First, Mr. McCormick?

Mr. MCCORMICK. Thank you, Senator. You raise a very, very good question. Let me say, too, that that memo that our internal auditor prepared was done as a consequence of my request that she go look at that situation in Texas.

Shortly after I became president, I heard about this activity and heard about some of the concerns that, even inside The Nature Conservancy, were being raised. So I asked our internal auditor, Cheryl Place, because she is very good at sizing things up, to go down there and not conduct a formal audit, which is done at the request of the board, but on my behalf, just to size up what had happened, what had gone wrong, what lessons we would learn.

I also sent down an outside scientist to review the decision that we had made to engage in that activity to make sure that the staff and trustees were using good science before going into that project, because we claim that is what we do.

Dr. Temple verified that the science was sound. He said we should have done a better job at monitoring activities over time against original assumptions, and I concur.

With respect to Ms. Place's report, I think, in that case, we did get ahead of ourselves. We got involved in an activity where we

really did not have sufficient internal expertise to make good judgments about what was appropriate.

I will say, as I mentioned in my testimony, that our desire to work there was very much based on our mission, and that we were concerned about the imperiled status of the Atwater's Prairie Chicken, in the midst of a large oil drilling activity.

The desire was to try to see if oil drilling could be conducted in that area, because it was already happening, in a fashion that would not have a detrimental long-term effect on the bird. I am happy to say, today, that the population of the bird has actually gone up.

We believe at The Nature Conservancy that our mission compels us to develop new core competencies over time. Scientists have come to the conclusion that traditional protected areas, parks and refuges, at best, worldwide, will capture only about 5 percent of the globe's biological diversity.

And inasmuch as our mission commits us to conserving biological diversity, we have felt compelled to reach beyond some of the things that we have done traditionally—land acquisition, including conservation easements, particularly in the arena of demonstrating, or attempting to demonstrate, that land use can be designed and carried out in a way that maintains the economic vitality of local communities, but also is compatible with conservation of biological diversity.

Outside the United States, that is our core competency. We are working in the Zahada region of Brazil with the farmers who are doing conversion to soybean production. We are working with indigenous peoples in the Amazon to make sure that their lands are managed for economic activity as well as for conservation of forest systems. We are working in China on improving how energy is produced in a fashion that does not result in continued cutting of pine forests.

But from time to time, we do get a little outside of our own headlights. In those cases, we should step back and make sure that we are doing a better job at developing core competencies rather than moving too far, too fast.

In that regard, in our current set of reforms, a project like that in Texas would go through a very enhanced vetting process internally, including review by a new risk assessment committee. We also have heightened standards for management to review projects of this nature. With our current changes in governance, a project of that nature would come to the board of directors. It did not at the time. The decision was made locally.

So, I do think it is important for us to expand our competencies. I think we have to do that thoughtfully, carefully, and with outside input. I think in that case we did not get enough outside judgment as to what we could have been doing down there, and how we could have done it better.

But I do think we need to expand our competencies, and I can assure you that, in our new standards and our processes, procedures, and policies, a project like that would not spring up on its own locally. It would get very careful, thorough review and would be designed, I am convinced, in a way that would not compromise the kind of organization that we are.

The CHAIRMAN. Now, Mr. Miller, would you respond to my question to you?

Mr. MILLER. Certainly, Mr. Chairman. The slippage or the drift of some nonprofits, some exempts, into for-profit areas has been a concern, and continues to be a concern. Commissioner Everson spoke about it on April 5th. He has spoken about it since.

Some of that mission drift, I think it is fair to say, is a good thing. I think we need to foster some innovation in the way we do business, in both the exempt sector and elsewhere.

Some of it is more problematic. I mean, the Commissioner speaks about credit counseling as his most difficult situation, where we have organizations masquerading as nonprofits, and that is an extreme, possibly. But joint ventures with for-profits is another example that is extremely commonplace today in the exempt sector, and does cause us considerable concern.

In terms of what we could ask you to do, I would again go back to the Commissioner's testimony, which is, we would ask as we move forward here to think about whether there are gaps in the regulatory framework or with the statute. The law has not changed in 30 years.

I think it is fair to say that the nonprofit sector has changed dramatically. We need to look at that. We need to ask whether we, as the Service, have the tools we need. Are there additional things we need?

The example I have used in my testimony is what I would say here, which is, one of the issues is, are land trusts following up on these easements? Well, in point of fact, if we check on that, it may be an indicator that there is a problem, but it is not necessarily going to go to the exemption of the organization.

So, the administration proposed, in their 2006 proposal, a penalty on the organization which would drive that sort of behavior, which would ensure that, when we showed up and said you are not following the law, that we could actually do something about it. That is the second piece.

The third piece is what we have talked about, and that is the transparency issue, enhancing as much transparency as we can in the sector. Finally, I will go back to what Mr. Thomas was talking about. The final question is, do we have the resources we need? The Commissioner would be upset with me if I did not say, please support the administration's budget proposal. [Laughter.]

The CHAIRMAN. I have never met a bureaucracy that ever had enough resources. [Laughter.]

Mr. MILLER. I think that is fair as well.

The CHAIRMAN. Yes.

A question on a different point to you, Mr. Miller. In your testimony you stated that the IRS is considering changes to Form 8283. So, your thoughts on the staff's recommendation that the IRS consider adopting rules similar to those adopted by the TNC? Specifically, should donors be required to complete the appraisal information on Form 8283 before submitting it to a charity for signature?

Mr. MILLER. I think it is something that we should look at. I do not know whether we will end up doing it or not. It really goes to, what is the donee's responsibility? What are you expecting from the donee?

Originally, on the 8283, the reason for the donee's signature was, one, establish the fact of the gift, and two, the donee needed to be reminded that if and when it subsequently sold the donated property within a 2-year period, that it had reporting obligations, and to help us do some matching in that regard.

If we are moving to the point—I am not saying we should not—where we are expecting the donee, the charity, to take a look at what is on that form to give it an eyeball test, or to do more than that, then it makes abundant good sense to modify the requirements.

Right now, it is not a requirement that someone who gives a parcel and hands over an 8283 for signature has a fully filled out 8283. That is something we will take a look at, but it really does depend on the question of what you expect that charity to do.

The CHAIRMAN. So your caution is based upon too big of a burden on the charity?

Mr. MILLER. I think that is one thing to think about, and exactly what do I do as a charity when I receive something that has a number on it, and some appraisal information, and I have no real way of coming to a conclusion on that?

The CHAIRMAN. Mr. Wentworth, your testimony indicated that the Land Trust Alliance is in the process of designing an accreditation program that could be used to improve easement monitoring and enforcement by conservation organizations.

Please explain how that program might work and how it would help ensure that the conservation purposes justifying the charitable deduction will not be diminished or will exist in perpetuity?

Mr. WENTWORTH. Thank you for that question. Senator Grassley, again, I appreciate the good work of your committee, as we have had a long dialogue about the appropriate role of private sector leadership and accreditation. It is our strong feeling that the private sector is the right place for an accreditation program to be rooted.

For the past 20 years, we have developed very detailed standards and practices on a wide range of governance issues, including conflicts of interest and other issues addressed today, but specifically to the work of land trusts, this very complicated legal instrument called the conservation easement.

What an accreditation program would do for land trusts, for the public, and perhaps as a new tool for the IRS, is it would take these standards, which to date have been essentially voluntary—we now, for the first time, are requiring all of our members to adopt these new standards. But accreditation, for the first time, would provide third-party verification of compliance. There are some dozens of documents for proper tracking of easements, proper design of an easement, records of annual monitoring. Mr. Zerbe's testimony raised concerns about the resources to enforce and regularly monitor those easements.

An accreditation program does not solve all the problems, but it does provide a third-party oversight to confirm and get into the infrastructure of how a land trust is organizing its conservation easement business, and probably at a level of detail and at a breadth, in looking at organizations, that the IRS would never contemplate.

The CHAIRMAN. Now, to Mr. McCormick and Mr. Miller. First, Mr. McCormick, with respect to TNC's reporting of payments pursuant to emission credit agreements, we understand that TNC reports these payments as contribution revenues on Form 990, Line 1. However, TNC does not classify these contributions as charitable contributions.

Could you tell me what other types of revenue TNC might include in the category of non-charitable contribution revenues?

For Mr. Miller, tell me if my understanding is correct that, in general, non-charitable contribution revenues reported on Form 990, Line 1, are not required to be disclosed or explained elsewhere on Form 990, including Schedule B. Maybe you should answer first, Mr. Miller, before I go to Mr. McCormick.

Mr. MILLER. What I can say about Line 1 on the 990 is, it does include all contributions, so that would include deductible and nondeductible. It does not include anything where there would be a quid pro quo to the transaction, or at least you have to net that out.

I do not know, and will have to get back to you in writing, whether it is required or would not be required on the Schedule B. If you look at the instructions on the Schedule B, they say you need to explain Line 1. So, on its face, I cannot say. I think you would have to include that, but that is asking me for a level of specificity that I could be specifically incorrect on. So, I will have to get back to you on that one.

The CHAIRMAN. Well, then answer in writing, would you please?

Mr. MILLER. All right.

[The information appears in the appendix on p. 224.]

The CHAIRMAN. Mr. McCormick?

Mr. MCCORMICK. We can get you much more detail, but the kinds of things that would be reported as non-contribution revenue would be—and this is very rare cases—fees that we derive from providing some management services, and lease income derived from some properties where we have a lessee in place. Those would be the sorts of things that would be described.

The CHAIRMAN. Would you feel more comfortable answering in writing?

Mr. MCCORMICK. Yes, I would. Off the top of my head, I just cannot give you the full list. We can provide that.

The CHAIRMAN. Yes.

[The information appears in the appendix on p. 209.]

The CHAIRMAN. My last question would be to Mr. Maybank. In your written testimony, you make several suggestions to address abuses in the area of conservation easements, particularly with respect to over-valuations, absence of donative intent, and cases involving developers and golf course easements.

You point out that these abuses affect State tax collections in addition to Federal tax benefits. Could you explain which of your suggested reforms would have the most immediate and dramatic impact on addressing abuses in that area?

Mr. MAYBANK. Well, in South Carolina several years ago, for example, Congress had outlawed charitable contributions for golf courses. With that, there would be 125 million less charitable deductions taken by South Carolina residents.

So, clearly, one-third of the charitable deductions taken in South Carolina for conservation easements were taken by golf course developers. So that would obviously have the greatest impact.

In terms of across the board, adopting language that basically just, verbatim, quotes the Appraisal Institute book on use of subdivision development analysis, would have an immediate, across-the-board impact.

It would not limit contributors to basis, a long way away from basis, but it would prohibit them from taking a deduction based upon a hypothetical subdivision that nobody would ever envision would be built.

The CHAIRMAN. In addition to thanking this panel, I would like to give this summation. I think this hearing has been of very great benefit to our committee. As you know, most hearings are not well-attended. This one was very well-attended, so there is a lot of interest in it. It has provided a detailed look at the realities of today's major charities, and will inform members and the public as we look at reforms.

In addition, we have had a good discussion about the problems and issues facing us as we look at ensuring that the tax code provisions that encourage donations of conservation easements are effective.

Senator Baucus and I have been in close discussions on this matter over a long period of time, as I indicated when I introduced the first panel, which included two of our staff. So, I am hopeful that, in the next few weeks, Senator Baucus and I will be able to propose reforms in the area of conservation easements.

Issues that we would look at, and that you maybe would want to comment on with my staff in the future, would be valuations, especially improving appraisals; adequate monitoring and enforcement of easements; ensuring conservation purposes of easements; proper reporting and limitation on modifications of easements; accreditation of land trusts; and greater transparency in reporting by land trusts. We thank you very much.

[Whereupon, at 12:42 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Committee On Finance

Max Baucus, Ranking Member

NEWS RELEASE **http://finance.senate.gov**

Statement of U.S. Senator Max Baucus
United States Senate Finance Committee Hearing
"The Tax Code and Land Conservation: Report on Investigations and Proposals for Reform."

Thank you, Mr. Chairman. When I see the natural beauty of Montana, I often think of the words from the book of *Job*: "Stand still, and consider the wondrous works of God."

You can see the hand of Providence when you stand at the edge of the Blackfoot river, when you stand at the base of Grinnell Glacier, and when you look out across a field of winter wheat on a cloudless day in Glasgow, Montana.

Montanans are close to the land. Montana has wonderful, clean rivers and streams. We have fish and wildlife in abundance. And we have farmers and ranchers who are committed to the proud Western heritage of responsible stewardship of the land.

Protecting Montana's and America's natural legacy is a commitment to which I hold fast.

Today's oversight hearing looks at gifts of land. We will hear about two investigations involving the potentially improper use of charitable tax deductions for land donations:

- the Finance Committee staff investigation into the Nature Conservancy,
- and the Inspector General's investigation into the Department of the Interior's proposed purchase of mineral rights in Florida.

These investigations show why it is so essential to maintain the integrity of our tax incentives for conservation. Americans must be able to trust that when they give land for a conservation purpose, that land will serve a conservation purpose. Americans must be able to see that their tax dollars are being used wisely. And they must be able to see that tax deductions have a relationship to the value of donations claimed.

The tax code allows people to claim a deduction for the fair market value of land that they donate to a charitable organization. Fair market value means what a willing buyer and seller would agree as a price for the land, if it were not donated.

In addition, people can claim a charitable deduction for the fair market value of part of their interest in the land when they donate that partial interest, as long as the interest serves an important conservation goal. People call this "a conservation easement."

People may deduct up to 30 percent of their adjusted gross income for these donations, whether they are donations of full interests or conservation easements. Adjusted gross income is the amount of income that a person pays tax on.

Let me give an example of how a conservation easement works. A farmer who owns 100 acres of undeveloped land decides that he wants his land to stay as productive farmland forever, and not allow the land to be developed or subdivided. The farmer appreciates the open space that is created by his farm, and wants to pass the farm on to his children and grandchildren.

One way that the farmer can accomplish this goal is to donate a conservation easement that prohibits future generations from building or subdividing the farm. The farmer would be required to donate the easement to either

- a qualified organization, like a land trust,
- or an arm of the government, federal, state, or local.

The value of the deduction would reflect how much the restriction on development and subdivision reduced the price of the farm.

In a place like the Bitterroot Valley in Montana, where developers are buying up farms to build vacation homes, such a restriction could be valuable. In other places, where there is less demand to develop, the value may be small or nonexistent. The law requires the farmer to have a qualified appraisal done for any donation of more than $5,000.

Finally, in order to qualify for a tax deduction, the farmer must prove that the restrictions placed on the farm serve a real conservation purpose. It is not a qualifying conservation purpose to allow just 15 subdivisions instead of 20. Nor is it a qualifying conservation purpose to place an easement over a golf course.

In order to meet a conservation purpose for an open space easement, the farmer needs to show the easement benefits the scenic enjoyment of the public, or is pursuant to a federal, state, or local conservation policy. In either case, the farmer has to show that the easement will yield a significant benefit to the public.

The laws allow the farmer to continue using the farmland productively, as long as the productive use is consistent with conservation goals. This policy has allowed thousands of farmers to maintain the great American tradition of the family farm.

As you can see, current law has significant hurdles in place to prevent abuse in land conservation. Unfortunately, these obstacles have not prevented some from gaming the system.

The staff report on The Nature Conservancy and the Inspector General's testimony show how lax procedures by land trusts and improper valuations can give land conservation efforts a bad name.

The Nature Conservancy Report shows that some conservation properties sold by The Nature Conservancy were made available only to Nature Conservancy insiders, and not the general public. Such collusion diminishes the ability of a land trust to fairly asses the conservation value of easements donated to the land trust, and dims public confidence in tax deductions claimed for land conservation.

I am glad that The Nature Conservancy has taken steps to address deals with insiders with the reforms that they adopted last year. This step, among others, should help to restore needed public confidence in The Nature Conservancy.

Mr. McCormack, I look forward to hearing from you what additional steps The Nature Conservancy should take to heal its reputation, and to ensure the American people's confidence.

While I believe that The Nature Conservancy is now basically on the right path, I am deeply troubled by the issues raised in the report by the Department of the Interior's Inspector General.

Mr. Devaney, welcome back to the Committee. Mr. Devaney last came to the Committee to testify on the abysmal state of jails run by the Bureau of Indian Affairs. Today, he has come to shine the spotlight on another shameful episode within the Department of Interior: the Department's attempted acquisition of mineral rights from the Collier Resources Company.

In short, the report shows that the political leadership at the Department of the Interior agreed to purchase mineral rights held in Florida for an amount that was overvalued by roughly $70-to-$80 million. Further, it shows that the Department failed to follow its normal appraisal procedures in arriving at a value for the interests.

Finally, after paying tens of millions of dollars too much for the mineral rights, the administration agreed to sign a form allowing the Collier Resource Company to take a charitable deduction for selling the property to Interior at a discount. A discount? Apparently, the Department allowed the taxpayers to be fleeced for $70-to-$80 million, and then authorized a tax deduction for the fleecing. This transaction is an outrage. It is a terrible waste of taxpayer dollars.

I look forward to Mr. Devaney's testimony today. I am also interested in his opinion on who should ultimately be held accountable for this charade at the administration, and how we can prevent something like this from happening again.

I am pleased to see that the second panel contains thoughtful experts on the issues we are discussing today. I look forward to hearing from you on what steps need to be taken in order to preserve the legacy of land conservation efforts in America.

Finally, I would like to make special mention of a person who had a significant hand in producing the Report on the Nature Conservancy. Ron Schultz left the Joint Committee on Taxation last December to re-join his family in Minneapolis. He's been in private practice there since. But he has volunteered his time pro-bono to the Committee in order to help finish the report. It has meant many late nights, early morning conference calls, and flights back to Washington on his own dime. Ron, thank you for your service.

At its core, this hearing is about preserving the last, best places on earth. Preserving the unique character of America's unspoiled wilderness and farmland is a responsibility we have to the next generation. We must be scrupulous about ensuring that the tax dollars devoted to this endeavor are not wasted.

A few years ago, I had the opportunity to work on a small project to restore Bull Trout habitat. It was on a ranch owned by a fellow named Geoff Foote, outside Ovando, about 70 miles west of Missoula, along the Blackfoot river.

A stream had been straightened, which had the effect of reducing the amount of gravel that Bull Trout need to spawn. We stabilized stream banks, added some streamside cover, and used dirt, stones, and stumps to make the stream meander.

This project was part of a program called the Blackfoot Challenge. The Blackfoot Challenge is a landowner-based group that coordinates management of the Blackfoot River, its tributaries, and adjacent lands. It is nationally recognized, and The Nature Conservancy has been a part of it. But unless we address abuse in the sector, this terrific effort will be overshadowed by articles in the newspaper. We must act together to protect this important work.

This may mean enacting targeted reforms to prevent abuse of the tax laws in the future. I am committed to working with the Chairman and members of the Committee to do this. I look forward to the testimony today.

STATEMENT FOR SENATOR BUNNING

SENATE COMMITTEE ON FINANCE

"The Tax Code and Land Conservation: Report on Investigations and Proposals for Reform."

8 June 2005

Thank you, Mr. Chairman.

I am very interested to hear the results today of the almost one year investigation that this committee has undertaken into some of the questions that have been raised about the policies and practices of The Nature Conservatory. It is my understanding that The Nature Conservatory has been cooperative with the Committee investigators and has been pro-active in addressing a large number of the problems that have been identified. Learning more about both what the Committee investigators have uncovered and the responses of The Nature Conservatory will, I think, be very informative to the Committee members as we examine possible reforms in the charitable giving arena. It is my hope that the example of this one organization will enlighten us as to both the type of abuses that we must help to guard against and the types of enforcement or legislative improvements required.

I support the efforts that this Committee is undertaking to ensure that charitable contributions go toward the charitable purposes which the donor intended and which the public expect of those organizations to which we grant special privileges through our tax laws. I look forward to working closely with Chairman Grassley and Senator Baucus on these issues in the coming months in order to achieve the goal of shutting down abusive practices. As we examine proposals, however, I plan to work to make sure that while we go after bad actors, we do not impede the millions of individuals who are providing necessary services to our country and its citizens.

I look forward to hearing today's testimony. Thank you.

Statement of Senator Mike Crapo
Senate Finance Committee hearing on:
"The Tax Code and Land Conservation: Report on Investigations and Proposals for Reform"
June 8, 2005

Mr. Chairman, thank you for holding this important hearing. I also appreciate the bipartisan efforts by the Finance Committee staff in preparing the report that has been presented today.

I share the views reflected by many at this hearing that, as we seek necessary reform to the tax code, we must not throw the baby out with the bathwater. In some instances, the abuses and questionable activities that have been brought to light can be addressed by more vigorous enforcement of existing law. In other cases, the conservation community has begun taking its own steps to voluntarily establish stronger ethical, fiscal and governance training and accreditation programs. Ultimately, it may also be necessary for this Committee to propose some legislative solutions to fill any gaps that still remain. In this effort, we must ensure that the tax incentives we have provided for private conservation efforts continue to be available for all of the well-meaning landowners, land trusts and other conservation organizations.

The Nature Conservancy is well known for its conservation projects in Idaho, which have helped protect some of Idaho's most prized natural landscapes such as Silver Creek, Thousands Springs, Henry's Fork and Lake Coeur d'Alene. The Conservancy is also a partner of mine in Owyhee County, where we are developing a breakthrough agreement among environmental groups, ranchers, off-road vehicle enthusiasts and local government.

One of my top legislative priorities is improvement of the Endangered Species Act. The record is clear that conservation easements have been an important tool that has allowed landowners and private sector groups to play an important role in species and habitat conservation without the need for the federal government to step in and impose its own one size fits all regulations.

I look forward to continuing to work with you, Mr. Chairman, and the rest of this Committee, to take the necessary steps ensure the abuses we have seen do not happen again. I will also continue to support the ongoing efforts of the conservation groups in Idaho and across the country to protect our land, water and wildlife.

Thank you, Mr. Chairman.

TESTIMONY OF THE HONORABLE EARL E. DEVANEY
INSPECTOR GENERAL FOR THE DEPARTMENT OF THE INTERIOR
BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE
JUNE 8, 2005

Mr. Chairman, I want to thank you and the members of the Committee for inviting me here today to talk about the results of our recent investigation into the "Agreement for the Acquisition and Donation of the Mineral Estate between the United States of America and the Collier Family."

The Office of Inspector General (OIG) initiated its investigation in September 2003, after receiving allegations from a confidential source that the Collier Resources Company (CRC) took advantage of the politically charged situation surrounding drilling in the Florida Everglades and "bluffed" the Department into executing an agreement to purchase CRC's mineral interests in the Big Cypress National Preserve (BCNP) in Florida for $120 million.

The attempted acquisition by the Department of the Interior of CRC's mineral rights in the BCNP has been years in the offing. This was an acquisition supported by the Clinton Administration as well as by the present Bush Administration. It was heralded by environmentalists and enjoyed the enthusiastic backing of the citizens and leaders of the State of Florida. The intentions behind the attempted acquisition have always appeared to be firmly grounded in the Department's righteous desire to protect the environmentally sensitive Everglades from potential harm. The means by which these intentions were advanced, however, were very troubling.

The statutory backdrop for Big Cypress National Preserve is both complex and complicated. The statute, however, is simplistically clear on one thing: an appraisal is required for acquisition by the government of property interests in BCNP. Yet, prior to the Agreement between Interior and the Colliers, no appraisal was ever done, or even undertaken. The reason, I believe, is because from the genesis of negotiations, while the Colliers made known that they viewed the value of their subsurface mineral interests in the hundreds of millions of dollars, the negotiators for the Department knew a traditional appraisal would not get them to a dollar amount that would be agreeable to the Collier family.

The Colliers have been the driving force behind DOI's acquisition of their BCNP mineral rights from the start. Representatives of Collier Resource Company (CRC) initiated the discussions with the Department in the mid-1990s; they renewed them in January 2000 and, yet again, with the present administration in 2001. By the time CRC approached the Department in 2001, it had positioned itself nicely for another round of negotiations, having embarked on a public outreach effort to signal that it was about to exercise its rights to explore for subsurface oil and gas in the BCNP. Between 1997 and 2001, CRC had submitted 27 plans of operation to explore within the BCNP. Not unexpectedly, this caused an uproar in the environmental community, which naturally captured the attention of the new Secretary for the Department.

In the clamor, however, the following facts were lost: 1) none of the plans of operation were complete; 2) the plans were designed to suggest the most extreme impact possible on the Preserve's environment, 3) approval of the plans – once complete – would be subject to regulations governing activity on the Preserve which strictly limit

exploration; and, as such, 4) several decades would likely pass before CRC could incrementally actualize the 27 plans that it had filed with the Department.

Thus, the stage was set with two critical assumptions: first, the Collier's had a specific dollar goal for the Department to acquire their subsurface mineral rights; second, if the Colliers could not achieve their dollar goal, they would assault the Preserve with oil and gas exploration.

Because Department negotiators believed that a traditional appraisal could not reach the Colliers dollar goal, they used an alternative approach to evaluating the mineral interests. Ignoring career appraisers in the National Park Service (NPS) and over the objection of the Minerals Management Service (MMS), senior officials and attorneys for the Department pushed the MMS Resource Evaluation Division to evaluate the mineral interests in BCNP. Unable to determine what percentage of those interests belonged to the Colliers, MMS evaluated **all** the mineral resources in BCNP.

Beginning in 1996, and relying almost exclusively on data provided by CRC, MMS developed a mean value of approximately $155 million for 100% of the mineral rights in BCNP. CRC thought that MMS had significantly undervalued the resources, while NPS appraisers questioned the validity of the MMS evaluation.

When no exchange resulted from the 1996 evaluation, MMS was asked to update its earlier evaluation for a newly proposed deal. A different MMS geologist re-evaluated the same data from the 1996 evaluation, and in 2000 adjusted the evaluation **downward** to a mean value of $68 million for 100% of the subsurface mineral rights in BCNP. CRC again objected.

In late 2001, yet another re-evaluation was being considered for yet another round of negotiations. Despite its continuing objection, MMS eventually produced a spreadsheet containing numbers that valued 100% of the mineral rights in BCNP at $68 million.

Unable to reach CRC's absolute minimum of $130 million with these diminishing values, an attorney from the Office of Solicitor sought the assistance of an outside contractor, to conduct a review of the methodology used by MMS. Subsequently, the contractor was also asked by the attorney to develop a "range of value" around the MMS mean of $68 million. Using an approach that had no specific provision in microeconomic theory, the contractor determined that a "range of value" around the $68 million mean was $31 million to $140 million for 100% of the BCNP mineral rights.

Using this range, the Department's negotiators justified the final offer contained in the agreement of $120 million.

During our review of this information, we readily recognized that the OIG did not have the substantive expertise to compare the way in which this valuation was derived against the intricacies and complexities of a formal appraisal process and its attendant rules and standards. Therefore, we contracted with The Appraisal Foundation, an independent, not for profit educational organization, authorized by the Congress as the source of appraisal standards and appraiser qualifications, to review and comment on these valuation reports, as well as the report and conclusions produced by the contractor.

In addition to its conclusion that there are no provisions for "alternative valuation means" where market value determinations [an appraisal] are an element of land acquisitions or exchanges involving private sector entities, the Foundation observed that

the 2000 MMS report, in particular, was misleading in that, without complying with the requirements for federal appraisals, and without appropriate data reasoning, analysis, and conclusions, it was reported in a format that was apparently used as though it were prepared in accordance with federal appraisal standards.

Despite the difficulty with and lengths to which the Department had to go to reach the $120 million price tag, CRC continued to insist that its subsurface mineral rights in BCNP were considerably more valuable. In keeping with this position, CRC also insisted that the Agreement include language that would allow it to do two things: First, to claim credit for a donation for any amount it could sustain with the IRS over the $120 million that the Department was willing to pay, and second, to reap the tax benefits associated with a sale of the property "in lieu of condemnation," which, in summary, equates to the ability to defer or avoid taxation on capital gains.

With few questions and little analysis, the Department's negotiators agreed to these terms.

Since my office has no more expertise in tax issues than it does in appraisals, we sought the assistance of the Senate Joint Committee on Taxation. We met with Committee staff members with expertise in these areas to discuss the matter. After being provided a summary of the facts, Committee staff said the circumstances in this case "sound weird." They explained that it seemed like CRC wanted it both ways. Specifically, CRC not only wanted to secure the benefits of donating a portion of its mineral rights under IRS Code Section 170, which applies to charitable donations and requires "donative intent," but also wanted to claim the tax benefits associated with IRS Code Section 1033, which contemplates "involuntary conversion" and requires that

property be taken away under threat or use of force. Committee staff opined that tax treatment under these two code sections is, essentially, mutually exclusive.

Committee staff further explained that the intent to involuntary convert property should be formed by the Department and not the property owner. Thus, the government would form the intent to initiate or contemplate an involuntary conversion and notify the property owner in writing. They concluded that involuntary conversion did not appear applicable in this case.

On the other hand, they noted that for the charitable donation, the IRS would ask the donor for information such as the history of the deal/negotiations, the values that were asserted, and other information salient to the transaction. They explained that a donee could incur potential criminal or civil liability if its representative signed IRS Form 8283 (acknowledging the donation) knowing the donated property was overvalued.

For the record, Mr. Chairman and members of the Committee, as we noted in our Special Report, we found no evidence that anyone representing the Department signed an IRS Form 8283 in this matter.

One of the attorneys who drafted the Agreement justified inclusion of these terms because the Department had used similar language in a prior exchange. Another attorney who helped draft the Agreement said that while he was aware of the donation aspect of the agreement, he did not understand it. The Secretary's representative handling the negotiations said she was told by one of the two attorneys that similar language had been used in other deals, but that the IRS usually does not grant the donation.

Like the failed Agreement itself, this tax treatment, today, might be dismissed as "no harm, no foul." We felt compelled, however, to comment in the following regards:

- It represents a careless practice to conclude that something is appropriate simply because the Department has done it before. Without factual basis and analysis, it is reckless to draw such a conclusion and advise decision-makers without more. In fact, the OIG has uncovered numerous, serious programmatic failings when one program relies on the precedent of another for justification to act.
- It represents a compartmentalized view of responsibility that has haunted and thwarted other transactions investigated by the OIG. This compartmentalization results in a wholesale lack of accountability, with the various participants pointing to one another as being responsible for whichever aspect of a transaction breaks bad.
- Taking the compartmentalization one step further, it represents a view that the Department acts only in its own self-interest and not the interest of the federal government and the American public – here the IRS and the taxpayers.
- It represents yet another aspect of the deal that was being driven and controlled by CRC, with the acquiescence and assistance of the Department.
- By including "in lieu of condemnation" language, the Department was acceding to a statement that was factually false.
- Including both aspects of tax treatment that CRC insisted upon, aspects that are mutually exclusive in the view of subject-matter experts, causes the Department to look, at best, foolish and, at worst, complicit.

Simply stated, Mr. Chairman and members of the Committee, this is not the substance of which a sound Agreement in the best interests of the Federal Government and American public is made.

Having said all this, however, I must commend the Department for some significant changes it has made to the land appraisal program and process. In November 2003, following the issuance of our Report concerning the San Rafael Land Exchange in July of that year, the Secretary directed the consolidation of the Department's real estate appraisal functions, establishing the Appraisal Services Directorate within the Office of the Secretary, to ensure appraiser independence, accountability, high standards, appropriate training, and oversight of Departmental appraisal functions. Over the course of the next year, an Appraisal Reform Implementation Team conducted a comprehensive review of appraisal policies and practices in the Department, which culminated in a Secretarial Order – "Policy Guidance Concerning Land Valuation and Legislative Exchanges." This Order establishes, among other things, policy on alternative methods of valuation and policy on legislative exchanges, both of which were issues of concern to us in both the San Rafael and the BCNP matter. I am quite confident that these reforms will, if strictly adhered to, correct most, if not all, of the problems we discovered in these instances.

Mr. Chairman and members of the Committee, before I conclude, I would like to credit the two case agents who have worked on this matter tirelessly for nearly 21 months. Beginning without any background in appraisals, land exchanges, mineral interests or tax, these two investigators diligently assembled the multifaceted complexities of this deal, and patiently unraveled them to tell an understandable story.

In the end, I firmly believe that these two civil servants saved the American taxpayers $120 million.

This concludes my formal testimony. Thank you for the opportunity to appear here before the Committee today. I will be happy to answer any questions you may have.

U.S. SENATE COMMITTEE ON
Finance
SENATOR CHUCK GRASSLEY, OF IOWA - CHAIRMAN
http://finance.senate.gov

Opening Statement of Chairman Chuck Grassley
Committee on Finance Hearing, "The Tax Code and Land Conservation:
Report on Investigations and Proposals for Reform"
Wednesday, June 8, 2005

Today, the Finance Committee will hear testimony on two very significant reports. The first is the report on The Nature Conservancy (TNC) prepared by the staff of the Committee. The second report, prepared by the Department of Interior's Inspector General, discusses the Department of Interior's proposed purchase of mineral rights in Florida from a private organization. The report on The Nature Conservancy provides the Committee and the public a window into the workings of not just The Nature Conservancy but large charities in general. The report and attached documents show that The Nature Conservancy at times participated in tax planning activities affecting it and its donors that can result in substantial tax benefits.

Charities have gone far beyond raising money by just having Santa ring a bell. Santa now is often engaging some of our nation's top tax lawyers and accountants with the sharpest pencils. The exhibit here is a copy of a document, which I am submitting for the record, used by TNC in discussions with potential donors involving a "Bargain Sale" to The Nature Conservancy. In this document, the charitable deduction is based on the slippery slope of the donor's own appraisal. The kicker is that the calculation shows that a better deal can be had using the "Plus Value of Tax Shelter from charitable contributions." I'm troubled enough when I see the words "tax shelter" appearing in tax planning documents of for-profit corporations. When I see "tax shelter" being used in documents of charities I really get worried. But, not only are charities engaging in sophisticated tax planning, they are also at times engaging in complex transactions and joint ventures. The staff report discusses, and educates us on, The Nature Conservancy's actions in this area.

While doing such deals are not in of themselves good or bad, they raise issues about whether charities are acting within the laws governing them as Congress intended and within a manner that justifies their tax-exempt status to the public. There is also a very real concern, highlighted by the staff report, that complex transactions can shift a charity's focus far away from their areas of competency while potentially wasting contributors' dollars. These concerns are well articulated in a memorandum from TNC's Director of Internal Audit to Mr. McCormick, President of TNC, who will be testifying today. The report, which I am also submitting for the record, primarily talks about a lawsuit involving TNC's oil and gas exploration activities in Galveston, Texas. The report states: "TNC Texas' attempt to balance the welfare of the prairie chickens with gas/oil exploration at the Galveston Bay Prairie Preserve seems to be a picture postcard strategy of the new Conservancy. However, were the events that transpired at the Preserve to become public knowledge, the Conservancy's good reputation could be badly damaged."

It goes without saying that this is not what should be happening at The Nature Conservancy or any charity, for that matter. The Nature Conservancy and all charities should be operating with

a view that all transactions and activities will withstand public scrutiny. I will come back to this Internal audit memorandum in my questions but I strongly encourage everyone to read it closely. It provides a great deal of caution of the dangers to charities when they operate outside of their areas of core competency and values.

While the report discusses at length areas of concern, I should also note that I recognize and appreciate that The Nature Conservancy has engaged in significant reforms since the Finance Committee announced its investigations. While there are still improvements that can be made, I appreciate the leadership of Mr. McCormick and Mr. Paulsen on behalf of The Nature Conservancy. Reforms their organization has undertaken are informative as the Finance Committee considers changes in the law, particularly in the area of land and easement donation as well as governance.

Now, for the Inspector General's report. The country is well served by having Mr. Devaney serving at the Department of Interior. He is without question one of the finest IG's we've had over the years. It is because of his excellent work, and that of his staff, that we have had him before the Committee several times in recent years. This is the second report I have recently received on problems of land transactions at the Department of Interior. To be candid, Mr. Devaney, I thought you had already found the bottom of the cesspool when it comes to land transactions at Interior, but this new report shows that it is even deeper than we first thought. It appears that since the mid-1990s, the Department of Interior has basically thrown out the rules book when it comes to this deal for Florida mineral rights. If that wasn't bad enough, I would note that once again we have another federal agency basically undermining the work of the Department of Treasury and IRS. The IG reports in detail about the Interior officials happily and ignorantly signing off on whatever tax planning is requested by the private party.

We've seen similar problems with the Department of Transportation in the LILO/SILO transactions, the SEC and other agencies on fines and penalties and the Department of Interior on façade easements. I would hope that the administration recognizes the need to make sure that the rest of the government doesn't make the IRS' tough job even tougher. I thank you all for being here today to present these two sweeping reports and also thank the enormous number of staff who made these reports possible.

Closing Statement of Chairman Grassley

This hearing has been of great benefit to the committee. It has provided a detailed look at the realities of today's major charities and will inform members and the public as we consider reforms. In addition, we have had a good discussion about the problems and issues facing us as we look at ensuring that the tax code provisions that encourage donations of conservation easements are effective. Senator Baucus and I have been in close discussions on this matter, and I'm hopeful that in the next few weeks we will be able to propose reforms in the area of conservation easements. Issues that we will look at in such reforms include: valuation, especially improving appraisals; adequate monitoring and enforcement of easements; ensuring conservation purposes of easements; proper reporting and limitations on modifications of easements; accreditation of land trusts; and greater transparency and reporting by land trusts.

B/S at $2,212,000 ① of ②

Hypothetical Comparison of Sale
on the Open Market vs. Bargain Sale
to The Nature Conservancy
(numbers refer to attached footnotes below)

(Individual)

(See Sec. 1011(b) of the Internal Revenue Code)

SALE AT FAIR MARKET VALUE		BARGAIN SALE TO THE NATURE CONSERVANCY	
Sale Price (based on your appraisal)[1]	$2,343,000	Sale Price	$1,852,000
% reduction for brokers fees, financing, timing or sale subject to contingencies[2]			
Net Selling Price		Net Selling Price	1,852,000
Less Adjusted Basis[3] (Assumed)		Less Adjusted Basis	528,014
Long-term Capital Gain		Long-term Capital Gain	1,323,986
Less Federal LTCG Tax[4] (28% tax rate)		Less Federal LTCG Tax	370,716
(State Income Tax not included)		(State Income Tax not included)	
Return After Taxes		Return After Taxes	953,270
Plus Adjusted Basis 3a		Plus Adjusted Basis	528,014
		Plus Value of Tax Shelter from charitable contributions[5] (36% of $491K donation) ($2,343K - $1,852K)	176,760
NET RETURN AFTER TAXES	1,620,956	NET RETURN AFTER TAXES	1,658,044

MEMORANDUM

TO: Steve McCormick, President

FROM: Cheryl Place, Director of Internal Audit

NOV 18 2003

DATE: September 6, 2002

SUBJECT: Review of the Galveston Bay Prairie Preserve Litigation

At your request, I performed a review of the events leading to the litigation between TNC and the Russell Sage Foundation (RSF) over gas and oil exploration on TNC's Galveston Bay Prairie Preserve (the Preserve) located in Texas City, TX. The purpose of this review was to (1) examine the actions, inactions, and decisions of Texas State Program (TNCT) and Worldwide Office (WO) employees that prompted RSF to sue TNC (and others) for breaching fiduciary duties owed to RSF; (2) determine if current TNC policies and procedures (if followed) are adequate to prevent further such incidents; and (3) make recommendations that could mitigate the risks of similar occurrences. To complete this review, I examined court filings, witness depositions, and other legal documents pertinent to the case and interviewed TNCT, South Central Division, Legal Department, and WO personnel. Additionally, I contacted individuals who were not employed by TNC, but who had peripheral interests in the litigation. My review follows:

BACKGROUND

In 1995 Mobil Producing Texas & New Mexico Inc. (Mobil) donated 2,263 acres located on Galveston Bay in Texas City, TX to TNCT. The donated land, which TNC valued at $2.2 million, is one of the last three remaining sites supporting wild Attwater's prairie chickens, an endangered species. In lieu of giving TNCT an endowment to support management of the property, Mobil donated the mineral rights to the land which gave TNCT claim to an annual income of approximately $20,000 from producing gas wells located on the southern edge of the property.

Following a major gas discovery north of Texas City in the late 1990's, TNCT's then East Texas Program Manger, Ray Johnson, received several inquiries about leasing the preserve for oil/gas exploration. TNCT management decided to allow seismic operations (to determine mineral potential) on the Preserve after discussing the subject within TNCT and with TNCT Advisory Board members. Robert Potts, both the TNCT Director and South Central Division Vice President at the time, strongly believed that the prairie chicken's survival depended on its ability to coexist with oil production. To Mr. Potts this endeavor was exactly what TNC senior management was championing as compatible economic development of conservation land.

Seismic Permit

Before proceeding with gas/oil exploration on the preserve, TNCT hired an outside gas/oil attorney, Mike McReynolds, from the Kleberg Law Firm in San Antonio, TX and met with U.S.

Fish and Wildlife Service (USFWS) representatives. TNC's regional attorney (in the Durham, NC office) and General Counsel were also consulted during this process. In June 1998 Mr. McReynolds drew up a seismic permit between TNCT, Galveston Bay Resources (GBR), and Aspect Management Corporation (Aspect),* two of the companies that had been pursuing TNCT, allowing gas/oil exploration on the preserve subject to a number of restrictions and conditions that the USFWS and TNCT incorporated in the permit. The permit, which gave GBR the right to perform a 3-D seismic survey on 2,104 acres of the preserve with an option to lease, was signed in July 1998 by Mr. Potts and representatives from the two gas/oil companies. At signing, TNCT received $315,600 and an additional $25,000 to cover the legal and USFWS consultation costs associated with writing the permit.

When TNCT was considering executing the seismic permit, a title opinion of the Preserve was prepared by an attorney for one of the oil/gas companies. TNCT learned that the north 1,047 acres of the property was encumbered by a 1/8th non participating royalty interest owned by RSF and numerous other entities (NPRIs). TNC, as the holder of executive mineral rights to the Preserve, was the only entity that could make decisions regarding gas and oil exploration on the property. However, if exploration was successful, royalties paid out from producing wells on the north 1,047 acres would be split: 25% to RSF, 25% to the other NPRI owners, and 50% to TNC. TNCT did not commission a survey to establish the boundaries between the encumbered and unencumbered acreage until October 2001, well after litigation began.

After the survey was completed, TNCT received an eight millimeter tape containing the raw seismic data and a Prospect Summary, which depicted graphically the results of the exploration. Because TNCT did not have the equipment to read the tape or the knowledge to interpret the Prospect Summary, it enlisted the help of Tom Rollins, an honorary member of its Board of Trustees and a retired geological engineer for Shell Oil.

The seismic data was encouraging, showing potential reservoirs of hydrocarbons on both the north and south tracts of the Preserve; GBR and Aspect pursued the option granted in the seismic permit to lease the Preserve for drilling.

Gas/Oil Leases

Many of the decisions that TNCT made regarding the final gas/oil lease documents resonated during the litigation proceedings:

Pooling Agreement:

In February 1999, TNCT was in negotiations with Mr. "Butch" Ballow to acquire 434 acres of his Cross Media property which adjoined the Preserve to the west. TNCT wanted the land to enhance the prairie chicken habitat and was willing to exchange some of the Preserve mineral rights for Mr. Ballow's acreage. The seismic data indicated that mineral reservoirs extended to the Cross Media property. Attempting to encompass the best land surface that would contribute hydrocarbons to a producing well, in March 1999 the lessee oil/gas companies proposed a pooling agreement which included 137 acres

* In November 1998, GBR entered into a Farmout Letter Agreement with Aspect under which Aspect earned interest in the Preserve leases. Aspect agreed to pay all costs of exploring and developing gas and oil on the tracts. Aspect later assigned part of its interests under the agreement to the other lessee defendants in the litigation: Esenjay Exploration, Helmerich&Payne, and Fronner Natural Gas.

from the south lease, 71 acres from the north lease, and 112 acres from the Cross Media tract. Royalty payments from a producing well subject to the pooling agreement would be shared between TNCT, Mr. Ballow, RSF and the other NPRIs. Because Mr. Ballow would not part with his 434 acres unless TNCT paid a sum far in excess of its value, TNCT refused to sign the pooling agreement.

One Lease/Two Leases:

Mr. McReynolds was tasked with drawing up the gas/oil exploration lease agreements. Since the seismic permit had encompassed 2,104 acres of the Preserve, Mr. McReynolds' original lease agreement covered the same acreage. However, because RSF's and the other NPRIs' interests in the north acreage, he included a non communitization clause allowing that if oil/gas was discovered on the southern acres, RSF and the other NPRIs would not participate in any royalty payments from production. Three days before the lease was finalized, a representative from one of the gas/oil companies faxed a legal article to Mr. McReynolds at Mr. Johnson's request. The article indicated that non communitization clauses may not be enforceable. After discussions with TNCT, Mr. McReynolds drew up two, essentially identical leases, one for the north 1,047 acres and one for south 1,057 acres. Both leases, allowing gas/oil exploration on the Preserve, incorporated significant land surface use recommendations, restrictions, and requirements suggested by USFWS to protect the prairie chickens. The leases were signed on March 11, 1999 by Mr. Potts and a GBR representative. TNCT received a bonus payment of $315,600 from the lessees at signing.

TNCT #1

The first well, TNCT #1, was a directional well, drilled from a surface location on the south tract 2,232 feet from the north tract boundary, but with a bottom hole location only 592 feet from that boundary. Although the well was started during the "drilling window" (a time period specified in the lease and based on the breeding patterns of the prairie chickens during which drilling was allowed), it was not completed until November 1999. TNCT #1 started production in January 2000 and continues to produce gas and moderate amounts of oil. By Texas standards TNCT #1 is an extremely productive well which has netted TNCT approximately $8.8 million in royalty payments to date.

Unbeknownst to TNCT, the reservoir from which TNCT #1 was producing spanned the north lease line and was draining hydrocarbons from the north lease. Thus, a portion of the royalties TNCT received rightfully belonged to RSF and the other NPRIs.

All of TNCT's significant decisions relating to the reservoir into which TNCT #1 was drilled were based on TNCT's erroneous assumption that the north and south mineral reservoirs were separated by a fault that essentially paralleled the lease line. The assumption that TNCT #1, could not be draining minerals from the north lease because of the fault was based solely on the advice of Mr. Rollins. Mr. Rollins, who testified that he believed that the lease line ran just south of the main fault, cannot support that belief with any scientific or engineering data. Although the seismic data depicted potential reservoirs of hydrocarbons and fault lines separating the reservoirs, no survey or map indicated the location of the lease lines. However, the lessees provided TNCT with several maps that showed the TNCT #1 bottom hole only 592 feet from the north lease line (an approximation Aspect determined by using a "directional

survey" when it drilled the well). That proximity, which triggered an offset well/drainage protection clause in the leases which required a 675 foot separation from other lease boundaries, should have instigated an inquiry about drainage. However, in spite of evidence to the contrary, no one at TNCT questioned Mr. Rollins' belief.

TNCT #2 and TNC #3

By March 2000, GBR began to consider drilling a second well located on the north tract. Drilling of the second well was problematic for TNCT because of concerns about the prairie chickens whose prime habitat was on the north acreage. At a May 2000 TNCT senior staff meeting to discuss the adverse effects on the birds of the drilling, Matt Williams, Preserve Manager, outlined a number of incidents including gas pipeline leaks, wildfires on the Preserve caused by oil/gas company personnel, and saltwater and hydrocarbon spills that had occurred during exploration, drilling, and production of TNCT #1. Mr. Johnson believed that the delays in completing TNCT #1 adversely affected the safety of captive prairie chickens whose release on the Preserve was likewise delayed. In May, 2000, Mr. Johnson wrote a letter to the attorney, Mr. McReynolds, seeking a legal opinion as to whether TNCT could prevent the lessees from drilling on the north tract. In his letter, Mr. Johnson expressed the same concerns about the negative impact of drilling on the prairie chicken population that had been discussed at the staff meeting. Mr. Johnson also stated his concern that if TNCT prevented drilling on the north tract out of concern for the birds, it would be denying RSF and the other NPRIs their share of potential royalties. Mr. McReynolds' response dated May 4, 2000, indicates that while TNCT could insist on scrupulous compliance with the substantial surface protection provisions in the lease, it could not prevent drilling on the north tract. Additionally, Mr. McReynolds wrote that as long as TNCT was not favoring itself over RSF/NPRIs in its exercise of executive power over the minerals on the north lease (i.e., was not obtaining for itself some mineral benefit that was denied RSF and the others) TNCT could place surface benefits above mineral benefits in its dealings with the lessees.

The lawyer went on to say that the only caveat to this conclusion arose from the possibility of subsurface drainage. In his letter, Mr. McReynolds suggests that if RSF hired a petroleum engineer to review the leases and received a report that hydrocarbons were being drained from the north lease (where TNCT restricted development) to the south lease (where TNCT had been more accommodating of development), RSF could assert a breach of duty of utmost fair dealing by TNCT. Such allegations, suggested Mr. McReynolds, would be bolstered by the fact that TNCT had a substantial incentive to have the gas/oil produced from a well on the south lease where it did not have to share royalty payments. TNCT ignored this warning because of its belief that the north and south leases were fault separated and thus, drainage could not occur.

After over a year delay, TNCT #2 was drilled from a surface location on the south lease (near TNCT #1's surface location), but with a bottom hole location on the north lease in a truly fault separated reservoir. TNCT participated in the drilling costs to prevent the surface location of the well from being located on the north lease property. In October 2001, TNCT #2 came in a dry hole.

TNCT #3 was drilled in the summer of 2001. The bottom hole location of this well is far south of the lease line. TNCT #3 appears to be in a separate reservoir located entirely on the south lease. As of June 30, 2002, TNCT has received royalty revenue from this well's gasl/oil production totaling approximately $300,000.

Purchase of RSF interests

In early 2000 after TNCT #1 had been producing for several months, Mr. Rollins and Mr. Johnson discussed the possibility of purchasing the non participating royalty interests from RSF. They approached Jack Schneider, a principal in an independent company called Chisos Exploration and a friend of Mr. Rollins, about assisting TNCT in making an offer to RSF. Mr. Schneider determined the value of RSF's interest at $26,176 and proposed that he approach RSF. Mr. Potts approved the proposal and the price over the phone. Mr. Rollins and Mr. Johnson discussed partnering to purchase the interests of the other NPRI owners, but dropped the idea when Mr. Potts suggested that such an action would constitute a conflict of interest. Both Mr. Potts and Mr. Johnson later testified that the purpose of the offer was to provide greater operational flexibility in dealing with the lessees and to protect the breeding and nesting habitat of the prairie chickens on the lands covered by the north lease. However, Mr. Rollins testified that TNCT wanted to consolidate its interest in the north tract in order to make more money.

In a letter to RSF dated July 14, 2000, Mr. Schneider represented that Chisos Exploration, after a cursory examination of the public records in Galveston County, had learned of RSF's non participating royalty interest in 1,047 acres. The letter further indicates Chisos Exploration's interest in purchasing those mineral rights for $400 per royalty acre. Mr. Schneider's July 14 letter and subsequent communications with RSF did not disclose that Mr. Schneider was acting as an agent for TNCT, that TNCT #1 had been drilled 592 feet from the lease line and was a strong producer, and/or that drilling on the north acreage was planned for the fall of 2000. Mr. Schneider followed up his offer with a letter dated August 18, 2000 informing RSF that the basis of his offer was a successful gas play six to fourteen miles east of the RSF property. Mr. Rollins testified that that statement was meant to intentionally mislead RSF.

Mr. Schneider's offer letters to RSF were approved by Mr. Johnson and Mr. Rollins. None were reviewed by TNC attorneys or by Mr. Potts.

In their defense, TNCT managers contend that they were assured by both Mr. Rollins and Mr. Schneider that Mr. Schneider's deceptive approach to purchasing RSF's mineral interests was standard industry practice and that the $26,172 value assigned to that interest was based on the speculative nature of drilling a producing well on the north lease which was subsequently drilled a dry hole.

TNCT was unsuccessful in its bid to purchase RSF's mineral interests. None of the other NPRIs were approached about selling their interest. RSF subsequently approached Aspect and solicited an offer for its mineral interests; Aspect offered $100,000 which RSF also rejected.

Litigation

Mr. Schneider's July 14, 2000 offer letter alerted RSF to its ownership of the non participating royalty interest on the 1,047 acres of the Preserve which it had reserved for itself when it (as original owner of the acreage) deeded the north tract to the Superior Oil Company in 1947. In the process of performing due diligence before accepting or rejecting TNCT's offer, RSF researched the deeds and hired an investigative geologist and Texas-based attorneys.

On June 1, 2001 without prior notice, RSF sued TNCT and the oil/gas company lessees alleging that TNCT breached certain duties owed to RSF in connection with the leases on the Preserve, and that the lessees knowingly participated in TNCT's actions. TNCT's exposure in the lawsuit is greatly influenced by its many actions, although innocent and/or uninformed, that nonetheless, appear sinister in litigation. The lawsuit alleged that every action TNCT took as executive rights holder in managing the mineral estate of the Preserve was knowingly taken to deny RSF its benefit as a non participating royalty interest owner.

RSF's allegations included that TNCT: (1) failed to disclose its knowledge that TNCT #1 was draining hydrocarbons from the north lease or to require that the lessees drill an offset well to mitigate the drainage; (2) hindered and delayed drilling a well on the north lease in bad faith; and, (3) conspired with others to buy RSF's royalty interest at a price less than its worth. Specifically:

TNCT # 1 drained hydrocarbons:

RSF argued that others in TNCT should have known or discovered, independent of Mr. Rollins' unsupported assertions, that a significant portion of the TNCT #1 reservoir was north of the lease line. TNCT should have known as early as March 1999 that the north lease contained productive acreage because the pooling agreement proposed by the lessees included north and south lease acreage. Additionally, several maps provided to TNCT show the bottom hole location of TNCT #1 to be only 592 feet from the north lease, a distance that triggered drainage mitigation clauses in the leases. RSF further suggested that TNCT's decision to draw up two leases rather than one was the beginning of a sinister, deliberate, and greedy plot to cheat the RSF and the other NPRIs of their royalty interests. TNCT decided to divide the lease at a time when it knew (or should have known) the lease bisected the main reservoir. Although TNCT is innocent of the allegations, its failure to question Mr. Rollins' assertions that the leases were fault-separated and its subsequent actions based on that assertion, its failure to survey the lease lines, and its failure to heed the warnings of its oil and gas attorney, Mr. McReynolds, who alerted TNCT to the drainage issues in a May 2000 letter, would likely have been viewed by a jury as unreasonable behavior for an executive rights holder.

TNCT hindered drilling TNCT #2:

The lawsuit alleged that TNCT did not want to share any royalties with RSF and the other NPRI's, and, therefore, took actions that delayed drilling of TNCT #2.

TNCT offered to purchase RSF's royalty interest:

The lawsuit's allegation that a former TNC employee (Mr. Johnson left TNC employ in February 2001) conspired with others to buy RSF's royalty interest at a fraction of its value would be difficult to overcome. TNCT's initial communication with RSF in the guise of a letter from Chisos Exploration was admittedly calculated to mislead RSF. Ultimately, RSF did not sell its interest and, therefore, suffered no damages as result of the offer. However, TNCT's action in regards to the purchase attempt directly affected TNCT's credibility on other issues.

TNCT's outside attorneys advised management that TNCT's claims that its focus was on the prairie chickens and that it was not knowledgeable about the gas/oil industry would be

challenged in a court room. RSF could claim that TNCT: (1) used the services of an experienced geologist to evaluate the seismic data; (2) retained an experienced gas and oil attorney to draft the leases and to consult as issues arose; (3) had access to other Board of Trustee members with extensive knowledge of oil and gas issues; (4) had key employees who were lawyers; and (5) demanded and received extensive documentation of all phases of the seismic and drilling operations.

Settlement

When the suit was initially filed in June 2001, TNCT was still convinced that the hydrocarbon reservoirs on the north and south leases were fault separated and that all of its actions on the Preserve had been predicated on protecting the birds. Only after it completed the survey of the lease line in October 2001, did TNCT realize that the RSF claims would resonate with a jury.

Both Mr. Potts and Steve McCormick, TNC President, visited the President of RSF to explain that TNCT's actions had been based on false assumptions and its interest in the birds, not on sinister motives to cheat RSF of its royalty rights. All efforts to settle the lawsuit, including an all day mediation attempt in July 2002 failed. Finally, in August 2002, all parties to the lawsuit agreed to a settlement amount to be paid to RSF in part by the lessees, TNCT, and TNC's insurance company. A motion to dismiss the case was filed on August 30, 2002.

AFTERMATH

TNC is well versed in the risks of buying land and operating with government funding, traditional methods of achieving its mission. The Conservancy's Policies and Procedures address these risks. TNC's sterling reputation is in part a result of its adherence to its mission, its policies and procedures, and its core values. However, the Conservancy is also an entrepreneurial organization whose senior staff are now urged to explore a new mix of strategies to achieve mission, including methods of compatible economic development. TNCT's attempt to balance the welfare of the prairie chickens with gas/oil exploration at the Galveston Bay Prairie Preserve seems to be a picture postcard strategy of the new Conservancy. However, were the events that transpired at the Preserve to become public knowledge, the Conservancy's good reputation could be badly damaged.

In the aftermath of the TNCT litigation, TNC senior management needs to evaluate the policies and procedures that it has in place (or does not have in place) that would/could mitigate the risk of future occurrences such as this one and discuss what limits, if any, enterprising managers should face when they explore new methods of achieving the mission. If TNC does not evaluate the lessons learned from TNCT's ordeal, and share those lessons with others in the Conservancy, it will face risks similar to those posed by TNCT's actions again.

Policies and Procedures

TNCT did not violate any of TNC's current Policies and Procedures in its gas/oil exploration and drilling on the Preserve. Mr. Potts, as TNCT Director, had signatory authority to enter into real estate transactions that did not exceed $500,000. The gas/oil leases were real estate transactions that required no outlay of TNC funds, but instead included cash bonuses at signing. The offer to

purchase RSF's mineral interests, an event that could be interpreted as a real estate transaction, totaled only $26,000.

Although not required, TNC managers are asked to seek legal advice when they consider any real estate transaction. Mr. Potts talked to a TNC's regional attorney and General Counsel before agreeing to the seismic exploration on the Preserve. In accordance with TNC Standard Operating Procedures (SOP), Mr. Potts hired an outside attorney with expertise in gas/oil operations to draft all of the legal documents between TNCT and the lessees. The seismic permit and the leases were reviewed by TNC attorneys. As required by another SOP, TNCT immediately contacted its Regional Attorney when the lawsuit was filed. Litigation proceedings were managed by internal legal staff and by outside attorneys recommended by TNC's insurance company.

One SOP specifically allows compatible human use at conservation sites as long as certain criteria are met.* Although gas/oil exploration on the Preserve arguably may not have met all of the criteria, the SOP allows for approval of an activity that does not meet the criteria by the Division Vice President. In his dual role as TNCT Director and Divisional Vice President, Mr. Potts was vested with the authority to approve compatible economic development at the Preserve. Mr. Potts approved the activity after serious discussions with his Advisory Board, his Board of Trustees, and his senior staff.

As TNC contemplates expanding conservation strategies to accomplish Conservation by Design, senior management will have to revisit the Conservancy's Policies and Procedures to ensure that they are adequate to address the current business climate. Obviously, Mr. Potts' role as both State Program Director and Division Vice President was an inherent conflict of interest that prevented proper oversight of the proposed economic activities at the Preserve. Under TNC's new organizational structure, approval for compatible human use of conservation land must vest at a higher level than Division Vice Presidents.

The risks inherent in engaging in businesses with which TNC has little expertise must be addressed in TNC's Policies and Procedures. Gas/oil exploration, eco-tourism, cattle grazing, and timbering operations are all activities which are already in place or are being contemplated on TNC conservation land. TNC staff are expert in none of these endeavors. Assigning decreased levels of signatory authority and increased levels of consultation should be contemplated for entering into unfamiliar operations.

Consultation

TNC must establish clear lines of consultation and accountability as it moves forward in the new organizational imperative.

Although testimony indicates that TNCT managers consulted with its Board of Trustees about gas/oil exploration on the Preserve, at least one TNCT employee questioned the level of the Board's involvement. Mr. Potts indicated that the Trustees were kept fully informed, but

* The SOP states that the Conservancy may engage in compatible human use at conservation sites: 1) as a strategy to reduce or eliminate threats to conservation targets; 2) when the use is designed primarily to mimic or restore essential ecological processes; 3) when the use is designed to meet other programmatic goals; and, 4) when in all times the use is consistent with corporate values.

minutes from the Trustee meetings during the three plus years that the events transpired contain little mention of discussions about the Preserve. When a presentation about the pooling agreement was made to TNCT's Conservation and Finance Committees of the Board of Trustees in May 1999, the discussion centered around revenue loss issues rather than shared reservoirs and drainage issues. TNCT's Board of Trustees, which included several oil/gas executives, may have offered differing advice from the former Trustee, Mr. Rollins, who was serving as TNCT's expert, had they been more fully engaged in events at the Preserve. At the very least, concentrated discussions may have pinpointed omissions, such as the failure to survey the lease boundaries.

Alternatively, TNC should not solely defer to its volunteer Boards for business advice. In unfamiliar businesses, TNC needs to engage consultants who have current experience in the areas of business operations it is pursuing. Mr. Potts suggests that TNC should not rely on pro bono advice, but should hire experts to advise and consult. The one expert TNCT did engage, its outside oil and gas attorney, was the only person who warned TNCT of the perils of subsurface oil drainage in the early stages of production.

Mr. Potts dual role in the South Central Division did not afford him the luxury of time. In his testimony, he indicated that he deferred much of the decision making at the Preserve to Mr. Johnson and Mr. Rollins. In fact, he indicates in his deposition that he was unaware of many of the details that were cited in the litigation as evidence of TNCT's duplicity and/or had come by the information second hand. He did not even review the correspondence between Chisos and RSF which ultimately precipitated TNCT's legal difficulties. Thus, lack of oversight within TNCT may have contributed to some of its faulty decision making.

TNC's President did not learn about the litigation and the events leading up to it until the spring of 2002, almost a year after the lawsuit was filed. His eventual involvement is credited with preserving a TNC relationship with RSF and with hastening an amicable settlement. The President should remain informed about all activities that pose reputational risks to TNC. TNC also needs to establish some thresh hold at which the President is informed about pending litigation.

Discretionary Revenue

TNCT earned over $9 million in royalties from the gas/oil operations on the Preserve. It received an additional $700,000 for signing the seismic permits and leases. Approximately $7 million of those funds remained recorded as assets (thus, unspent) in various TNCT operating, land, and endowment general ledger centers as of June 30, 2002. TNCT anticipates further royalty revenues from its ongoing gas/oil operations and could agree to further exploration on the Preserve that would have the potential for additional revenues.

In the future, TNC leadership must be made aware of sustainable, compatible economic activities that generate an agreed upon thresh hold level of discretionary income, and should have some voice in how that money is used.

Core Values

TNCT's patently deceptive offer to purchase RSF's royalty interests in the north lease precipitated the litigation and made suspect all of TNCT's other honest, but uninformed, actions

regarding the gas/oil exploration and drilling on the Preserve. Referring to the offer, TNCT's outside litigation attorney advised TNCT that "the harm of this evidence is simply the fact that it will color how the jury will view TNCT's conduct and credibility in general." TNCT's current Director believes that when TNCT "...got into oil and gas, we conducted ourselves aggressively and lost our values." TNCT's failure to act with "integrity beyond reproach" is the gravest mistake that it made.

The further TNC moves from its core competencies, the more risk the organization will assume. Criticism by other conservation leaders of TNC's current willingness to forge closer ties with industry was outlined in a recent LA Times article. One environmental leader is quoted as saying, "..it's possible to compromise your ideology, your reputation, by making too risky choices." TNC must hold its employees accountable for the choices they make and values they disregard.

June 8, 2005

Finance Committee Hearing
The Tax Code and Land Conservation:
Report on Investigations and Proposals for Reform

Blanche L. Lincoln
STATEMENT

As we are all aware, the release of the Finance Committee report on the Nature Conservancy and this hearing today comprise just one portion of the discussion we are now having regarding tax reform in the charitable sector. I appreciate the fact that there are areas in our tax code that need to be tailored so that organizations don't take advantage of our charitable tax incentives for their own gain. However, as we move forward on this issue in the Finance Committee, I hope that we will work together to ensure that any charitable reform is as targeted as possible so that we don't ultimately do more harm than good.

STATEMENT OF TIMOTHY LINDSTROM
Director of Protection and Attorney for the Jackson Hole Land Trust,
Jackson Wyoming

United States Senate Committee on Finance
June 8, 2005

"The Tax Code and Land Conservation: Report on Investigations and Proposals for Reform"

Mr. Chairman and honorable members of the Senate Finance Committee and Staff:

Thank you very much for the invitation to speak here this morning. It is an honor to be asked to participate in discussions of matters critical to the future of the landscape of America. I also want to especially thank Senator Thomas, not just for his role in providing me with this opportunity to speak with you, but also for the long and productive relationship he has held with the Wyoming land trusts that I am representing here today.

I am speaking on behalf of the Wyoming Stockgrowers Agricultural Land Trust, the Green River Valley Land Trust, and the Jackson Hole Land Trust, the three "indigenous" land trusts operating in the State of Wyoming. For the past five years I have been am currently the attorney and Director of Protection for the Jackson Hole Land Trust in Jackson, Wyoming. The Jackson Hole Land Trust, by the way, has through the use of conservation easements protected over 20% of the private land in Teton County, Wyoming in its 25 years of work.

I am also speaking from my experience as the donor of two conservation easements on farms my family and I have owned in Virginia and Michigan, and as an attorney specializing in conservation easements and related tax benefits.

My clients include non-profits and individuals. I have also done a considerable amount of writing and teaching on the subject of the tax aspects of conservation easement donation, including sessions for farmers and ranchers, land trusts, lawyers, realtors and appraisers.

I have divided my statement into sections, which hopefully will allow me to present clearly my many thoughts and concerns about the matters that confront the Committee. My full testimony has been submitted to the Committee for the record.

Importance of Conservation Easements

There are really three general means of land protection in the United States today. These are local land use regulations, such as zoning and subdivision control; public ownership;

and private conservation. Conservation easements, which are private contracts providing for the limitation on future development of land, are the key to private conservation.

Land Use Regulation

Having spent twelve years as an elected county supervisor in Virginia, and having taught land use law at the University of Virginia for over twenty years, I can state personally that land use regulation, such as zoning and subdivision regulations, is really not capable of long-term land conservation, which is not to say that land use regulations do not have a very important role to play. There are three principal reasons why land use regulation cannot effectively provide for the long-term protection of land.

First, as an exercise of the state's police power, land use regulation is subject to the prohibition against uncompensated "takings" imposed by the U.S. and most state constitutions. The Supreme Court has over the years extended the prohibition against takings to include local land use regulations. It is safe to say that the kind of restrictions on future use of land that can be imposed by a conservation easement would be unconstitutional if imposed through a police power-based land use regulation. In addition, some states (e.g. most recently Oregon) have begun to impose additional constitutional and/or statutory limitations on local authority over land use. Finally, such concepts as "Dillon's Rule," and similar limitations on local authority, further limit the ability of land use regulations to preserve land.

Second, government regulation of land is not politically popular, and is typically strenuously resisted by landowners, even landowners with a strong conservation ethic. People simply don't like to be told what to do with their land. This resistance makes extensive regulation of private land politically difficult, if not impossible.

Third, land use regulations are very much subject to the vagaries of local politics. A strong set of land protection regulations, even if they pass legal muster, are really only good until the next local election. Long-term land conservation on a meaningful scale simply cannot be achieved in fits and starts.

Public Ownership

A vast amount of land in the United States, particularly in the West, is already owned by the public. This land represents one of the nation's most valuable and enduring assets. However, in the West, and throughout much of the rest of the nation, further extending public ownership is anathema to many people.

In addition, public acquisition is extremely costly. It is costly in terms of purchase price, costly in terms of maintenance of the land itself once in public ownership, costly in terms of administration, and it takes land off from local tax rolls. It is also politically costly. The demise, at least in the House, of the Land and Water Conservation Fund, one of the most important sources of federal funding for public acquisition, is an indication of the grave difficulties confronting the expansion of public ownership of land.

Private Conservation

Most of the private land in the United States that is truly open is a tribute to the land ethics of its owners. Most of the land in the United States is privately owned and managed. The fact that many landowners reject governmental interference in their ownership does not mean that they are not dedicated to the careful stewardship of their land. Unfortunately, as agriculture becomes less and less a family affair, many of these landowners are the last of the line of such private stewards.

Conservation easements are ***the*** tool that allows these landowners, whose private stewardship has made their land a national asset, to insure the future protection of their land. Conservation easements avoid all of the pitfalls of the other two methods of land conservation previously described: they are private and therefore their terms are up to the landowner, unrestricted by the complex and extensive constitutional and statutory constraints on land use regulation. Conservation easements transcend the tortuous political cycles that prevent consistent conservation by local government. Conservation easements do not involve the costs of public acquisition and, however costly the tax benefits provided to conservation easement donors, this cost will never be more than a fraction of the cost of public acquisition and ownership. Most importantly, conservation easements leave the management of the land up to the owner and, typically, local private conservation organizations.

According to the Land Trust Alliance, private conservation easements have provided long-term, effective protection for over seven million acres of land in the United States over the past several decades. The value of this land can be reckoned in the billions of dollars. In Teton County, Wyoming, alone, we have calculated that the market value of the land protected by conservation easements amounts to nearly $700 million. Nearly all of this value has been ***donated*** by the landowners. And, **there can be no question whatever that without the tax benefits afforded by section 170(h) of the Internal Revenue Code, much of this land would remain unprotected today, or developed.**

Examples of Private Conservation

Over 4 million tourists annually travel from Jackson, Wyoming, west to the little crossroads of Wilson, or north to Teton Village, along Wyoming Highway 22. Highway 22 travels almost entirely through private land and starts only several miles west of the Jackson Town Square. Yet Highway 22 is without a doubt one of the most spectacular roads in America, with sweeping views of meadows, pastures, creeks, ponds, buttes, the Teton Range, the Gros Ventre Wilderness, and the Snake River Range. The preservation of this spectacular highway corridor has been ***entirely*** due to private conservation through the use of conservation easements. Here again, this conservation would never have occurred without the tax incentives provided by section 170(h).

Just south of Jackson Hole lies Sublette County. Sublette is a much different landscape and place than Jackson. It is still dominated by large ranches. Much of this country is

high desert, crisscrossed with verdant river valleys, such as those of the Green and the New Fork Rivers. This land has been made legendary by the accounts of its early history contained in Bernard DeVoto's *Across the Wide Missouri.*

Nobody messes with the ranchers of Sublette County, believe me. However, they are dedicated to their land and they have been permanently conserving it in 1,000-acre and 2,000-acre chunks over the past decade. This conservation is entirely through conservation easements. Again, without the tax incentives, this would not be happening.

One of the conservation easements that my family and I donated was over our farm outside of Charlottesville, Virginia, in the Southwest Mountains just north of Monticello. Our farm was only 110 acres, but it was a unique part of the landscape of the Southwest Mountains. Today, over 7,000 acres of land in these mountains has been protected through private conservation. There is nothing that local government could have done to effectively protect this historic landscape, although it tried. The tax incentives were instrumental.

These are a very, very, few stories of the thousands that could be told illustrating the importance of conservation easements in the private protection of land in the United States.

Flexibility is Key

The popularity and usefulness of conservation easements is due to the flexibility inherent in these private agreements. This flexibility is also the source of increasing criticism in the press, and in Congress. However, while the conservation resulting from conservation easements may not meet everyone's ideal of preservation, it must be remembered that not even the federal government is willing to lock up public lands and throw away the key. Perfect conservation is not consistent with the practical realities of land ownership and management. However imperfect in some people's minds, conservation easements have indisputably protected vast tracts of land from development and sprawl in a way that simply could not have been achieved otherwise.

Conservation easements, to have any chance at effectiveness, must be acceptable to landowners, without whose support easements will simply not be granted.

Unquestionably there have been, and will continue to be, abuses of this flexibility. I believe that much of the abuse, as I will describe later, can be effectively addressed by more vigorous enforcement of existing law. However, like most things, if we tighten the screws on conservation easement deductions to address the concerns of those who believe that effective conservation means putting land in a glass case to look at, but never touch, the program will become useful to only a small handful of landowners who have no need to use their land in the future.

Is There a Need for Reform?

My short answer to this question is: "No." An objective and persuasive case for reform has not yet been made. To my knowledge, the two primary commentaries on the need for reform have come in the form of the series on The Nature Conservancy published by *The Washington Post* just over two years ago; and pages 277 through 287 of the Report issued by the Joint Committee on Taxation early this year ("Options to Improve Tax Compliance and Reform Tax Expenditures," published by the Staff of the Joint Committee on Taxation, January 27, 2005).

Enforcement History

Against these commentaries is set the judicial record of IRS challenges to conservation easement deductions. In preparation for writing an article for the *Wyoming Law Review* which appeared earlier this year, my assistant and I reviewed all of the reported cases involving IRS challenges of conservation easement deductions. There were about 115 or so such cases. Of these cases, there were ***only three*** relating to land conservation that actually addressed the substance of the easement and its compliance with the requirements for deductibility. These were *Great Northern Nekoosa Corporation v. US,* 38 Fed. Cl. 645 (1997); *McLennan v. US*, 994 F.2d 839 (Fed. Cir. 1993); and just last month *Glass v. CIR*, 124 TC 16, 2005. The rest of the reported cases focused almost exclusively on challenging appraisal valuations of easements.

In the *Nekoosa* case the IRS successfully claimed that the right to extract gravel on the 5,000-acre easement property for use in maintaining roads and for construction purposes on the property violated the tax code requirement that deductible conservation easements prohibit surface mining. The court agreed with the IRS, and disallowed the entirety of a $19 million tax deduction. Believe me we pay close attention to gravel extraction provisions in conservation easements as a result of this case.

In *McLennan* the IRS claimed, among other things, that the conservation easement was not "exclusively for conservation purposes" as required by the tax code, because the donor was motivated to obtain a tax deduction by making the donation. The court threw that argument out. The other argument made by the IRS was that the donor had no intention of developing her property anyway, so in valuing the property using the "before and after" valuation method, it was inappropriate for the taxpayer to base the before easement value on the future development value of the property. The court agreed with this position, but allowed a deduction anyway because it found that even comparing the property with other undeveloped property the easement property had lost value due to the restrictions on future use imposed by the easement.

Finally, in May the U.S. Tax Court ruled in favor of the taxpayer in the *Glass* case. In this case the IRS argued that the easement failed to meet the conservation purposes test of the tax code and that the easement was not exclusively for conservation purposes as required by the code. The court in this case was able to find that an easement protecting the habitat of several endangered species, where surrounding land was under considerable

development pressure, passed the conservation purposes test for preservation of a significant, relatively natural habitat. The court also found that an easement held by an established land trust, with substantial assets, staff and experience, and a history of land conservation, was held exclusively for conservation purposes. It is hard to fault this outcome.

In other words, in two of the three cases where the IRS has actually challenged the substance of a conservation easement deduction for lack of compliance, it has been successful, at least in part. This is not, in my opinion, a record supporting the need for reform. Of course, we have no access to the record of audits of conservation easements.

The IRS focus has been, as noted above, almost exclusively on challenges to easement valuations. In this, the IRS has met with mixed results. However, challenging local valuations and locally-knowledgeable appraisers is admittedly difficult. All that we can surmise from the record here is that the presumably objective courts hearing these cases have found that the taxpayers' claims of easement value are often relatively accurate.

From my observation, knowledgeable challenges by the IRS to the compliance of the easement document with requirements of the tax law would be both easier to prosecute and far more likely to succeed. The fact that the IRS has not really examined easement documents, or appraisals, for compliance with the extensive requirements of the tax law and, by its own admission, has largely ignored conservation easement deductions over the past decade, suggests that more challenges directed to compliance, not just valuation, would do much to strengthen compliance.

The Washington Post Series

Only a small part of *The Washington Post* series addressed conservation easement abuses, namely "conservation buyer transactions" involving "insiders." However, the series left out important details about these transactions that would allow an accurate determination of whether or not the transactions were, or were not, in compliance with tax law. For example, if the sales prices were based on valid, independent appraisals, and if the board members involved had no role in the decision to sell, these deals appear to me to be compliant with the law. Such lack of critical detail is not limited to the *Post* series, but appears in other articles that have sensationalized the issue of conservation easement tax benefits.

The *Post* also implied, and a subsequent Notice issued by the IRS last summer (Notice 2004-41 published July 12, 2004), stated, that the type of transactions described in the *Post* series were in violation of existing tax law. I will discuss these transactions later, and I have appended to this Statement a copy of an article that I recently wrote discussing them in detail. For now, let me simply say that I believe that these transactions, assuming proper appraisals, are lawful, and completely consistent with IRS Rulings (e.g., Rev. Rul. 70-15), Regulations (e.g., sections 1.170A-1(d)(1), and 1.170A-14(h)(3)(i)), and a decision by the United States Supreme Court (*U.S. v. American Bar Endowment,* 477 US 105 (1986)).

I also believe that these conservation buyer transactions, and similar ones, are consistent with the policy and intention of Congress to promote voluntary permanent land conservation through the tax code.

The Joint Committee Report

The Joint Committee on Taxations' Report, already mentioned, recommended draconian changes in the tax provisions governing conservation easement deductions. If implemented, these changes would essentially eliminate the federal tax incentive for conservation easement donations, which, as I noted previously, has been the moving force in private land conservation in the United States for over three decades.

I believe that the Report's proposed changes go far beyond a recommendation for improving compliance and are tantamount to a recommended reversal of long-standing national policy to encourage voluntary land conservation through the tax code.

The Report's recommendations are premised upon some questionable and, as yet, unproven assumptions. Let me start by saying that I spent a number of years working with the Joint Committee Staff in connection with what has become section 2031(c) of the Internal Revenue Code, providing an additional estate tax benefit for conservation easement donors. I found the staff to be extremely competent, knowledgeable, and very decent to work with. However, it was clear to me that the staff, at least those members with whom I worked, was skeptical in the extreme of conservation easements.

This skepticism characterizes the Report's treatment of conservation easements. The Report appears to predicate its recommendations on three things. First, easement valuation is very subjective and speculative. Second, taxpayers and land trusts have too much latitude in determining whether conservation easements serve a significant conservation purpose. Third, because easement donors typically would be unlikely to develop their land, the current tax incentives are providing an ineffective "windfall" for landowners, rather an incentive changing the their behavior.

I would like to take a minute to respond to these three points. First, I admit that easement valuation is subjective and somewhat speculative: that is the nature of the appraisal business. However, the current law is quite specific about what things an appraiser must consider in valuing a conservation easement. I believe that whether or not an appraisal complies with these requirements is not subjective and is easily determined. A redirection by the IRS of its approach to easement appraisals is likely to yield significantly better results for the government.

Second, there is no basis in the case law for the Report's position that there is too much latitude available to taxpayers and land trusts in determining public benefits. If there were a record of judicial decisions in which abuses were documented, a change in the law might be appropriate. That record does not now exist. I suggest that the IRS needs to

tackle those cases where it believes that abuse of this part of the law has occurred before we can know if a problem needing a legislative solution exists.

Third, whether or not an easement donor is likely to develop his or her property is not a relevant factor in determining the value and effectiveness of the easement. The fact is that land changes hands, and easements, once donated, bind all future owners regardless of their motivations for owning the land.

Furthermore, the tax benefits of easement donation do not equal the potential profit that can be derived from land development. Therefore, if the landowner is a developer, the incentives are highly unlikely to motivate him or her to donate an easement preventing such development. For this reason it is necessary to capitalize on the owner who has no development intentions – someone for whom the tax benefits represent a meaningful economic incentive.

Because easements are perpetual and bind future owners, the action of a conservation-minded donor effectively protects the land against future owners who may not be conservation minded. This is the key to the success of conservation easements, not evidence that they are ineffective.

The Committee staff also suggests that easements may actually increase the economic value of the land restricted by the easement. I have heard this argument before, and it has recently been repeated in the press. I believe that it is based upon watching the value of land ***adjoining*** easement-protected land increase in response to that protection. It is well established that people will pay a higher price for land that adjoins protected land.

However, I think it a very dubious proposition that a rational buyer would pay a premium for land subject to restrictions that will tie the buyer's hands in the future in using that land. ***Restrictions on the potential uses that can be made of real property simply do not increase the economic value of that property.*** Occasionally, where a group of properties are protected by conservation easements all values in the group will increase, but this is due to the protection against what neighboring landowners can do with their property.

Proposed Reforms

In my invitation to speak here today I was asked to comment upon the reforms being recommended regarding conservation easement tax deductions. When I wrote this statement on Monday of this week these proposals were unavailable for me to review. Therefore, I will address some of the reform proposals which have been rumored. I have already commented on most of the reforms proposed in the Joint Committee's Report. I do support that Report's recommendation of strengthened standards for appraisers, and will elaborate on that at the end of my statement.

Establish a "conservation review board"

Part of my problem in evaluating this recommendation is that I don't know the details. Such a review board, if established as an appeal board for taxpayers whose easements are in audit, might be very helpful in determining whether the easement actually serves a significant conservation purpose, without discouraging legitimate contributions. However, because the resource value of land is often a function of the context in which the land is located, for this recommendation to truly serve such a purpose review boards should be established in every state, rather than being located solely in Washington, D.C., for example.

My second concern about this proposal is insuring that conservation review boards are manned by independent citizens who understand the law and conservation principals and can objectively apply the law and these principals to evaluating conservation easements. The danger is that such review boards would be, or would become, politicized.

However, provided that such review boards are limited to assisting in evaluating conservation easements that are in audit, and that the concerns I have just described are properly addressed, conservation review boards may be beneficial.

If conservation review boards are established as a separate hurdle to easement donation, prior to completion of the donation, or if such boards are allowed to develop their own criteria for evaluating easements that goes beyond the existing law, they could be quite counter-productive to private land conservation.

Fees to Fund Review

It has been suggested that financial support for review boards come from fees imposed on easement donors. Easement donors already face a number of costs in donating an easement, not the least of which is the loss in value of the land due to the restrictions imposed by the easement. Among these costs should be, and often is, a payment to the land trust holding the easement to provide for the perpetual monitoring and enforcement of the easement. Properly endowing these land trust obligations may run $15,000 to $20,000 or more.

Additionally, appraisal costs are already substantial, running between $5,000 and $10,000 in many parts of the country, and if new standards on easement appraisers are imposed these costs are likely to increase. While a fee for a donor with a substantial income is unlikely to be a problem, farmers and ranchers are often not among this class, yet they often own land highly worthy of protection. Because donors with smaller incomes get a smaller benefit from the easement tax deduction to begin with, imposing fees on such donors will even further diminish the incentive to them to donate the easement.

If a fee is to be imposed, I would suggest that it be in the form of a fraction of a percentage point of the amount of the actual tax benefit reflected on that donor's return, and that it reduce that amount on the form, rather than being paid separately. This insures

that the fee would only marginally affect the tax benefit, that it is proportional to the actual benefit, and that it is assessed in a way that does not require an additional out-of-pocket expenditure by the donor. And, of course, such fees should be dedicated to support of the conservation review boards and not simply be counted as additional general revenue.

A fee in the form of a percentage of the value of the easement creates a direct disincentive to the donation of valuable easements. Furthermore, the value of the easement is not a reliable measure of the value of the tax benefit to the donor due to the several existing limitations on the use of the deduction which are tied to the donor's income.

Mandatory Accreditation of Land Trusts.

In principle I believe that land trusts should be accredited. Holding a conservation easement is a very serious and long-term obligation. The tax aspects of easement contributions and related conservation transactions are complex. Land trusts need to know what they are doing, and they need to understand the serious consequences of doing it wrong. However, I believe that imposing a mandatory accreditation requirement that must be met within the next several years for all of the nation's land trusts is a Herculean task that will be extremely difficult and costly to complete. It may be a task that is impossible to accomplish equitably and reliably.

Such accreditation should be done within the land trust community, based upon the existing *Standards and Practices* developed by the Land Trust Alliance, and adopted by many of the nation's land trusts. However, I take LTA at its word that, while it will work to implement a voluntary accreditation program over the next several years, it is not in a position to undertake a mandatory program, compliance with which will govern the ability of individual land trusts to accept deductible easements.

I would also note that the IRS already has, within the law and regulations, the ability to challenge land trusts that it believes are not "qualified organizations" as defined in the law. I have an alternative to mandatory accreditation that I will describe at the end of my statement.

Require that all conservation easements be pursuant to clearly delineated governmental policies.

This recommendation is found in the Joint Committee's Report. This requirement already pertains to open space easements and appears not to have been a problem; however, as there are no recorded cases challenging easement deductions because they fail this test, it is hard to know how attempts to enforce this requirement might play out. In effect, this is a recommendation to expand a requirement that has yet to be tested in court.

Other than the *Glass* case that recently emerged from the Tax Court, there have been no reported cases where deductions have been challenged for failure to comply with any of the conservation purposes tests. This is a very thin record of failed enforcement attempts, or abuses, upon which to base a change in the law.

The problem with expanding this requirement, particularly to conservation easements where the conservation purpose is protection of a relatively natural habitat, is that ***in many parts of the country there are no relevant governmental policies for such protection***. The lack of such a policy does not mean that there are no important habitats that need protection. Lack of policy may simply mean that the public is unaware of such habitats, or that it is politically unpopular for government to make a policy directed at protection of privately owned habitat.

A major issue in Wyoming, and other western states, is the Endangered Species Act. One of the goals of the Wyoming Game and Fish Department is to provide support and protection for wildlife habitat before species get put on the list; in other words, before a species or its habitat becomes a focus of "clearly delineated governmental policy." This makes sense, and is largely dependent upon voluntary action and education. However, if a habitat is so threatened that its protection becomes a "clearly delineated governmental policy" the battle to save the habitat may already be lost.

Require local governmental approval of conservation easements.

From my observation, requiring local governmental approval of conservation easements will scare off a great many potential easement donors: folks (like many western ranchers, for example) who want nothing to do with the political process, and who do not believe that their private contributions should be made part of a local public process.

Such a requirement would add additional burdens to already swamped local government officials. It wrongly assumes that localities have a sufficient level of understanding of land conservation and the conservation purposes established by existing tax law to be helpful. It would inject a true wild card in the easement donation process, one that could delay the processing of easement donations for months. And, it leaves landowners hostage to local political whims.

One of the strengths of the private conservation movement, as I noted earlier, is that it has been apolitical, really apart from politics. This measure would make easement donation a very political process, and subject private conservation to some of the same problems that make local land use regulation ineffective at long-term land protection.

Impose penalties on land trusts that fail to enforce conservation easements.

This recommendation appears on page 112 of the "General Explanations of the Administration's Fiscal Year 2006 Revenue Proposals." Of course, the details of this proposal, and the method of enforcement, are the keys to whether it would be good or bad for conservation. However, I believe it very likely that such a proposal, properly

implemented and enforced, could have a salutary effect. However, it is difficult to know how "failure to enforce a conservation restriction" could be monitored; how large or small the failure would have to be to violate the proposed new requirement; whether land trusts would be allowed to cure such failures before being penalized, etc. These are the details that need to be addressed before this proposal can be practically evaluated.

Require that changes in easements be reviewed by an independent body, such as a court.

Land trusts are precluded from entering into easement amendments that confer private benefits under existing law. The penalty for doing so is an excise tax of 25% of the value of the benefit imposed on the landowner, and a penalty on land trust managers involved in the transaction of up to $10,000. In addition, repeated violations can lead to revocation of tax exempt status. In other words, the law already provides an adequate safe-guard against improper easement changes.

Often easement amendments increase conservation benefits (many land trusts have amendment policies that require that any amendment increase conservation benefits). Would such amendments also have to be reviewed? This measure unnecessarily injects additional uncertainty into easement donation for landowners and, therefore, will discourage donations in the future. Finally, such a process, especially if judicial review were required, could be very lengthy and costly. Easements need to be flexible enough to allow some financially neutral and conservation positive adjustments to accommodate unforeseeable consequences.

Establish a "de minimis" standard, such as a minimum acreage, for deductibility.

The law already requires that a conservation easement confer a "significant public benefit." A uniform, one-size-fits-all standard for easement donations would be incapable of recognizing the unique nature of each property and its context, throughout the country. For example, many in-holdings within the Grand Teton National Park, which the Park Service in anxious to protect but does not have funds to purchase, could be protected by conservation easements, but are less than ten acres in size. Land along seacoasts and lake shores has often been subdivided into small parcels, nevertheless these parcels are rich in scenic and resource value; a *de minimis* standard may preclude protection of such parcels from qualifying for a deduction.

Require a second appraisal for large easement donations

Such a measure is counter-productive because it creates a disincentive to the donation of particularly valuable easements. Here again, for donors with substantial incomes, the cost of a second appraisal is probably not a deterrent to the donation. However, many landowners with conservation-worthy land, such as farmers and ranchers, do not have large incomes to absorb these costs. Existing law, if applied and enforced, already establishes standards for appraisals that should effectively limit abuses.

Conservation Buyer Transactions

Conservation buyer transactions involve the sale of conservation-worthy property in a manner which insures the protection of the property through the use of a conservation easement. Without going into the variations of such transactions (I have appended an article that I recently wrote describing these transactions), they are an increasingly important conservation tool. Conservation buyer transactions have been responsible for the protection of a substantial part of the land protected by conservation easements in my own town of Jackson, Wyoming, and are (or were) being used in other parts of Wyoming and throughout the United States.

The July 2005 IRS Notice, mentioned previously, was critical of the type of conservation transaction described in the *Post* series. That Notice also criticized conservation buyer transactions in general. It is unfortunate that this Notice cast a pall over virtually all conservation buyer transactions. In effect the Notice dictates that a buyer of conservation-worthy land who is willing to commit, prior to the purchase, to protect the land once purchased, is penalized, whereas, the buyer unwilling to make such a commitment is not. This is certainly a counter-intuitive result.

The article that I have appended to this statement deals in some detail with the problems that the Notice poses for conservation buyer transactions, and offers some suggestions.

Some Recommendations

With the publication of the *Post* series on The Nature Conservancy, the publication of the Notice, the Report of the Joint Committee on Taxation, and the Congressional investigations and considerations of reform, I believe folks finally understand that the law is important to easement deductions. The past few years have been a wake-up call for land trusts.

I believe that now is the time to capitalize on the attention that is being given to the need for compliance. I think that most people want to comply and, as I have noted at length earlier in this statement, I believe that existing law is adequate, given effective enforcement, to prevent abuse. Of course, preventing all abuse is impossible, except by eliminating the benefit.

I believe that what is needed now is education all around, ***compulsory*** education, and certification requirements for appraisals and easements that force people to specifically acknowledge the requirements of the law. With that in mind, ***on my own behalf and not for any of the land trusts that I have spoken for thus far***, I suggest the following measures in lieu of changing the existing law:

1. Create a special unit within the IRS, trained in, and knowledgeable about, conservation easements and conservation transactions. Assign these agents to focus on the review of a select number of easements annually. Nothing teaches like example. Currently, even though in most cases they are well-intentioned, many land trusts,

appraisers, donors and their legal counsel simply are not motivated to learn the basics. Knowledgeable audits will create a very effective incentive.

2. Rather than impose a mandatory accreditation program on land trusts impose a **mandatory continuing education requirement** on land trusts that wish to hold deductible easements. Many professions have such requirements. The complexity and importance of the proper administration of a conservation easement program involving tax deductible easements **requires** knowledge.

The Land Trust Alliance already has an extensive education program both nationally and regionally. While the Alliance may not be able to effectively accredit all of the land trusts doing business within the next several years, it is likely that it can provide continuing education programs that are accessible to land trusts throughout the United States within such a period.

A requirement that at least one official of each land trust holding deductible easements annually attend a course on compliance with the tax code and regulations would not be unreasonable. Certifying such attendance, while administratively cumbersome, should be manageable, especially if supported by a reasonable fee for each course taken. Bar associations throughout the nation do this every year for far more lawyers than there are land trusts. The land trust community should be able to implement such a program within a reasonable time.

3. Similar educational requirements, suggested in the Joint Committee Report's recommendations, should be imposed on easement appraisers.

4. I believe that many appraisers, easement donors, and land trusts, simply do not focus on the legal requirements for a deductible easement. One means of getting that focus is to require certification of compliance with, at least, the key provisions of the law. To provide for this I suggest that a new version of Form 8283 "Noncash Charitable Contributions," designed expressly for conservation easement donations, be created. I suggest that, in addition to the relevant provisions of the existing Form, the new form include certifications, more or less along the following lines:

> **By the appraiser:**
>
> If valuing the qualified conservation contribution by comparing the value of the real property subject to the contribution both before and after the contribution (the "before and after" method) I certify, to the best of my knowledge and belief, as follows:
>
> a. I have examined and taken into account the effect upon the value of the real property subject to the contribution of all legal restrictions (zoning, restrictive covenants, environmental regulations, etc.) applicable to such property.

b. If I have assumed the "before" value of the real property subject to such contribution based upon the value of such property as a completed development, I have taken into account the demand for such development, the costs of such development (infrastructure, sales costs, etc.), the absorption time for the development, and reasonable discounts for the holding costs, and developer's profit, as applicable.

c. I have not assumed speculative development approvals, rezonings, or other discretionary land use or environmental approvals, except as specifically noted and explained in the appraisal.

d. In valuing the qualified conservation contribution I have taken into account the effect of the contribution on the value of all of the real property owned by the donor or a member of the donor's family, either contiguous to the property subject to the contribution, and/or other real property owned by the donor or a member of the donor's family the value of which may be affected by the contribution.

By the the donor, or the donor's attorney:

I certify, to the best of my knowledge and belief, that the qualified conservation contribution with respect to which this Form is filed complies with the requirements of §170(h) of the Internal Revenue Code of 1986, as amended, and the accompanying Treasury Regulations, including the requirements that the contribution:

a. Permanently restricts the real property to which it applies and is binding upon the donor's heirs, successors and assigns, in perpetuity.

b. Is contributed exclusively for one or more of the "conservation purposes" as described in §1.170A-14(d) of the Treasury Regulations.

c. That the contribution does not reserve unto the donor any uses of the real property subject to the contribution that would be inconsistent with the conservation purposes of the contribution, or other significant conservation interests, as required by §1.170A-14(e).

d. That if the contribution is for the preservation of open space the contribution confers a significant public benefit within the meaning of §1.170A-14(d)(4)(iv) and (vi)(B) of the Treasury Regulations.

e. That the documentation of the natural resources of the real property subject to the contribution required by §1.170A-14(g)(5) of the Treasury Regulations has been completed and delivered to the organization to which the contribution was made on or before the recordation of the instrument making the contribution.

f. That the contribution grants the donee the right to inspect the real property subject to the contribution on a periodic basis to determine compliance with the terms of the contribution.

g. That the contribution grants the donee the right to enforce the terms of the contribution, including the right to require restoration of the real property subject to the contribution necessary to correct any violation of the terms of the contribution.

h. That the contribution grants to the donee the right to receive a certain proportion of the proceeds of any sale or other transfer resulting from an extinguishment of the restrictions imposed by the contribution, according to the provisions of §1.170A-14(g)(6).

By the donee:

On behalf of the donee organization, I certify, to the best of my knowledge and belief, that the donee:

a. Is either a governmental entity, or a private non-profit organization recognized under §501(c)(3) of the Internal Revenue Code.

b. Has, among its purposes, the purpose to conserve the conservation values of the real property with respect to which the qualified conservation contribution has been made.

c. Has the means and ability to enforce the terms of the contribution.

Along with this new form, I suggest that easement donors be allowed to revise their easement documents to bring them into compliance, even if they have already been put to record, provided that such revisions are completed and recorded prior to the due date (plus extensions) for the return on which the conservation easement tax deduction will first be claimed. This is because the form is often not considered until after the contribution has been put to record. The intent of the revisions to the form is to highlight the importance of compliance. Donors should be able to respond to the certifications included in the form with revisions that will be effective to bring the easement into compliance.

Other Suggestions

In addition to the foregoing recommendations to improve understanding and enforcement of the law governing conservation easement tax deductions, I have two suggestions for steps that would advance private conservation through conservation easements:

1. Clarify the July 2005 IRS Notice pertaining to conservation buyer transactions, as suggested in the appended article, to allow these types of transactions to resume on a reasonable basis, and to reflect the existing law.

2. Enact the proposals made by Chairman Grassley, and Ranking Member Baucus, embodied in the former S. 701. These proposals were to increase to 15 years the carry-forward period for unused portions of easement deductions, and to increase the percentage of income against which such deductions are taken to 100% of the donor's income. These revisions to the law would be limited to those easement donors more than 50% of whose income is derived from farming or ranching.

While we do not have any solid evidence of need for reform to cure perceived abuses, as I have noted previously, there is ample evidence that landowners with valuable land, but small incomes, do not derive the full tax benefit, or even a substantial part of the tax benefit, from donating a conservation easement. These recommendations by Senators Grassley and Baucus would do much to make the conservation easement tax benefits more equitable and more effective for farmers and ranchers.

Conclusion

I would like to thank the Committee and Staff, and especially Senator Thomas, for arranging for my participation in this important hearing. ***I urge you to consider whether the issue before you requires new laws, or rather, whether the few abuses we have heard about could be avoided in the future by strengthening enforcement and knowledge of existing law.***

I truly believe that improving enforcement and understanding of the existing law, rather than the enactment of new laws, is the key to efficiently and economically furthering the clear intention of Congress to encourage private conservation of land in America.

If there is anything that I can do to assist in this effort I would be honored to do so.

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THE IRS AND CONSERVATION BUYER TRANSACTIONS: THROWING THE BABY OUT WITH THE BATHWATER?

By Tim Lindstrom

The Nature of Conservation Buyer Transactions

An increasingly important tool for land conservation is the "conservation buyer transaction." Conservation buyer transactions come in a number of forms, but most

either involve the sale of property subject to a conservation easement put in place just prior to closing, or a sale in which the buyer agrees, before closing, to conserve the property with an easement after closing.

Conservation buyer transactions can occur anywhere, but they are most useful in places where land values are very high, and land buyers are primarily "amenity buyers," seeking peace, quiet, and beauty, rather than development potential, from their land. These areas tend to be areas where conservation values are exceptional, such as Jackson Hole, where I live.

IRS Criticism of Conservation Buyer Transactions

The by now famous Notice, published by the IRS in June, has, among other things, cast a pall over most conservation buyer transactions. This is due to the criticism contained in the Notice of conservation buyer transactions, in particular a type of transaction used by The Nature Conservancy, but by others as well. Quoting from the Notice:

> "Some taxpayers are claiming charitable contribution deductions under §170 [26 U.S.C. §170, pertaining to charitable contribution deductions, including conservation easement donations under §170(h)] for cash payments or easement transfers to charitable organizations in connection with the taxpayers' purchase of property. In some of these questionable cases, the charitable organization purchases the property and places a conservation easement on the property. Then, the charitable organization sells the property subject to the easement to a buyer for a price that is substantially less than the price paid by the charitable organization for the property. As a part of the sale, the buyer makes a second payment, designated as a 'charitable contribution' to the charitable organization. The total of the payments from the buyer to the charitable organization fully reimburses the charitable organization for the cost of the property.
>
> "In appropriate cases, the Service will treat these transactions in accordance with their substance, rather than their form. Thus, the Service may treat the total of the buyer's payments to the charitable organization as the purchase price paid by the buyer for the property" [thereby disallowing any charitable deduction].

Applicable Tax Rules

Before going further, let's have a very short course in tax analysis. The "form versus substance" doctrine, invoked by the Notice, along with the similar "step transaction" doctrine, have been tools used by the IRS, and the courts, to evaluate the appropriateness of tax benefits claimed by taxpayers in various types of transactions, most of them commercial. The substance versus form doctrine is fairly self-explanatory. In an effort to avoid payment of tax, people sometimes create artificial structures, which have no

business purpose. In such cases, tax benefits may be disallowed when the IRS ignores the artificial "form" of the transaction, and evaluates its "substance."

The step transaction doctrine is a more elegant version of form versus substance. The step transaction doctrine is a way of analyzing the structure of a transaction that is made up of a series of steps to determine what really happened. Where the steps have no purpose other than tax avoidance, the IRS will "collapse" them, and evaluate the transaction based upon the result. As already noted, traditionally these two doctrines have been applied to business settings, not charitable transactions. In fact, the courts have made it clear that donating property (including a conservation easement) for the exclusive purpose of obtaining a tax deduction is not a basis for disallowing the deduction.

Neither the form versus substance doctrine, nor the step transaction doctrine, should be used to disallow a charitable deduction where a transaction has a genuinely charitable and publicly beneficial result. In such cases, the *substance* of the transaction is consistent with the public policy behind the charitable contribution deduction, which, simply put, is to encourage charitable contributions.

Lack of Detail in the Notice is Confusing

A major problem with the Notice is its lack of detail. For example, assume that a land trust (for purposes of this article land trusts are presumed to be public charities, recognized as exempt organizations under §501(c)(3) of the tax code) buys a ranch for $2 million, and retains a conservation easement at closing reducing the value of the ranch to $1 million. Also, assume that the buyer paid $1 million for the ranch, and made a $1 million cash gift to the organization. Using the form versus substance doctrine to conclude that the buyer should be treated as having paid $2 million for the ranch (as suggested in the Notice), and denying him a charitable deduction for the $1 million cash payment to the land trust, ignores the true substance of the transaction: the buyer has paid $2 million to a public charity for property valued at $1 million. The charity ends up with a publicly significant conservation easement worth $1 million, and recovers the full value that it paid for the ranch.

However, let's assume that the land trust in the preceding example paid $2 million for the ranch, and retained a conservation easement at closing that reduced the value of the ranch to $1.5 million. Assume that the land trust then sold the ranch for $1 million to the buyer, who made a $1 million cash gift to the land trust, and claimed a $1 million income tax deduction. In this case, the buyer has paid $2 million to a public charity for property valued at $1.5 million, and seeks a $1 million tax deduction. The charity ends up with its investment in the ranch back, and a conservation easement worth $500,000. Clearly, the end result is that there has been a net charitable contribution of no more than $500,000, to which the buyer should be limited.

The lack of detail in the Notice leaves the reader in the dark as to which, if either, of the transactions described in these examples would pass an audit. In other words, legitimate

and phony transactions may both fall within the indefinite language of the Notice. Few conservative tax lawyers (redundant, I realize) familiar with the Notice are likely to advise their clients to engage in either of these transactions until the scope of the Notice is clarified. In the meantime many important, and legitimate, transactions may be dying on the vine.

"Dual Character" Transactions

The criticism contained in the Notice was not just confined to transactions in which a land trust retains an easement, and receives a cash contribution from the buyer. The Notice also refers to "easement transfers to charitable organizations in connection with the taxpayers' purchase of property." This very general criticism could apply to virtually every conservation buyer transaction, not just the type discussed above.

What may be at the heart of the Notice's criticism of easement transfers in connection with land purchases is that the IRS believes that such transactions lack "donative intent." That is, the buyer did not *intend* the easement donation as a charitable contribution, but donated the easement because it was the only way that the property could be acquired. Thus, so the argument goes, the donation of the easement was part of a "quid pro quo" transaction in which the easement was exchanged for something of value (i.e. the privilege of being able to buy the property), which negates the necessary donative intent.

A similar issue is involved in the question of whether the purchaser of tickets to a charity ball is entitled to deduct the price of the tickets. Suppose you want to hobnob with the elite of society by attending the Firefighters Ball. The only way that you can mix with these wonderful folks is to pay $250 for a ticket. The music is poor, the food is worse, but the company is fantastic. The law is clear that you are allowed a charitable deduction for the difference between what you paid for the ticket, and the value of the ticket, in terms of the benefits that you received. The Firefighters tell you that the value of the ticket (i.e., the value of the food, drink, and entertainment) is only $50. Therefore, you are considered to have made a charitable contribution to the Firefighters of $200, for which you are entitled to a deduction.

The IRS and the courts call these types of charitable transactions "dual character" transactions. Part of the payment is charitable, and therefore deductible; part of the payment is for benefits received, and therefore not deductible. The IRS has said that it is only willing to extend "dual character" treatment to payments for tickets to charitable events, and to membership fees for membership in charitable organizations. However, the U. S. Supreme Court has not limited the dual character rule in such a fashion. In a decision rendered since the IRS limited its application of the dual character rule, the Supreme Court has said:

> "A payment of money generally cannot constitute a charitable contribution if the contributor expects a substantial benefit in return. However . . . a taxpayer may sometimes receive only a nominal benefit in return for his contribution. Where the size of the payment is clearly out of proportion to

> the benefit received, it would not serve the purposes of §170 to deny a deduction altogether. A taxpayer may therefore claim a deduction for the difference between a payment to a charitable organization and the market value of the benefit received in return, on the theory that the payment has the "dual character" of a purchase and a contribution. [Emphasis added.] *U.S. v. American Bar Endowment*, 477 U.S. 105, 117, 118 (1986).

The Treasury Regulations pertaining to the valuation of conservation easements for federal deduction purposes also implicitly recognize the dual character rule:

> "If, as a result of the donation of a perpetual conservation restriction, the donor . . . receives, or can reasonably expect to receive, financial or economic benefits that are greater than those that will inure to the general public from the transfer, no deduction is allowable under this section. However, if the donor . . . receives, or can reasonably expect to receive, a financial or economic benefit that is substantial, but it is clearly shown that the benefit is less than the amount of the transfer, then a deduction under this section is allowable for the excess of the amount transferred over the amount of the financial or economic benefit received . . ." [Emphasis added.] 26 C.F.R. §1.170A-14(h)(3)(i).

The sale by a land trust of property to a buyer, on condition that the buyer donate a conservation easement on the property, should be considered a dual character transaction, assuming that the value of the easement exceeds the value of the right to buy the property, and that the buyer intends that difference as a charitable contribution to the land trust.

The question of what value should be allocated to the right to buy the property is beyond the scope of this article (and possibly beyond the scope of appraisal techniques). However, the denial of a charitable deduction to a buyer, who contributes an otherwise qualified conservation easement, requires either a finding that the value of the right to buy the property is at least equal to the value of the easement, or that the easement has no value. To make either of these findings requires the parties to ignore the restrictions imposed by the easement, and the effect on fair market value resulting from those restrictions.

Therefore, I would argue that the purchase of property from a land trust, subject to the condition that the buyer donates a conservation easement, should be eligible for "dual character" transaction treatment. Of course, the easement must otherwise qualify under §170(h) of the tax code, and the value of the easement must be validated by a qualified appraisal. Not only would such a transaction appear to comply with the formal requirements of the tax code, it also produces a result that satisfies the public policy behind the tax code's land conservation incentives, i.e. bona fide, perpetual conservation of the land involved.

Dual character status should also be accorded to cash contributions made in connection with land trust sales on the same principles.

Transactions Involving Private Sellers

So far, this discussion has been confined to transactions in which a land trust, as opposed to a private party, is the seller of the property in question. However, the fact that the seller is a private party should not preclude a deductible conservation buyer transaction. If the conveyance of the easement is the result of a private contractual obligation between the seller and buyer, there is no deduction because the private contract precludes donative intent.

On the other hand, if the conveyance is the result of a contractual arrangement between a land trust and the buyer, there is no reason, all other things being equal, why the conveyance should not be deductible. This is because the tax code recognizes that the fact that a contribution of money or property is made pursuant to a charitable pledge, or other charitable commitment, does not, in and of itself, rob the contribution of "donative intent."

Thus, for example, if Mr. Blue agrees to sell his land to Mrs. Green, subject to a contractual agreement between them that Mrs. Green will convey a conservation easement over the property to a local land trust, there is no deduction. Or, if Mr. Blue grants and records an option, giving the local land trust the right to acquire a conservation easement on Mr. Blue's property, and the option is exercised after Mrs. Green purchases the property, there is no deduction (because Mrs. Green is complying with a private contractual obligation arising from taking title subject to the pre-existing option).

However, before she buys Mr. Blue's property, Mrs. Green could grant an option to the local land trust giving it the right to acquire a conservation easement on Mr. Blue's property when, and if, Mrs. Green purchases the property. Assuming that Mrs. Green buys Mr. Blue's property, and that the land trust then exercises the option, Mrs. Green should be entitled to a tax deduction for the difference between the value of the easement, and whatever the land trust paid to acquire it from her. This is because the commitment to convey the easement is, in effect, a charitable pledge to a public charity by Mrs. Green, not a contract with a private individual or entity. Applying the form versus substance doctrine, let us take a more critical look at this transaction.

In form, the buyer is discharging an obligation to a public charity, which is deductible. However, the obvious question arises: Why didn't the buyer simply purchase the property and donate the easement later? The option must be explained because it appears to have no role in the outcome. One explanation is that the private seller would not sell to any buyer who had not committed to the donation of a conservation easement once the property was purchased. Does this allow the IRS to ignore the option with the land trust, and treat it as a private precondition of sale, thereby negating donative intent? It may. But, should it?

Denying a tax deduction to a buyer because he is willing to commit, prior to acquiring title to property, to permanently conserve that property in the future, creates the odd result that buyers unwilling to make any commitment to future conservation are favored by the tax code over those who are willing to make such commitments. This is inconsistent with the conservation policy behind the tax code provisions, the primary purpose of which is, as already noted, to encourage land conservation.

Because of our progressive tax system, which taxes people with big incomes more than people with small incomes, tax incentives for land conservation work best for those with big incomes. However, a great deal of very conservation-worthy land in the United States is owned by farmers and ranchers who, almost by definition, are folks unlikely to have big incomes. Therefore, the incentive doesn't work very well for them, and important conservation opportunities stand to be lost.

Conservation buyer transactions involving private sellers help to overcome this problem by finding buyers for such properties who can benefit from the charitable deduction for easement donations. Deductions should be allowed to buyers who donate conservation easements as part of the transaction, if the following conditions are met: (i) the end result of the transaction is permanent, publicly significant conservation; (ii) the conservation easement meets the requirements of §170(h) of the tax code; (iii) the value of the conservation easement is validated by a qualified appraisal; and (iv) the value of the conservation easement contribution outweighs any benefits received by the donor. Deductions under such circumstances should be allowed, even though the contribution is the result of a prior commitment made as part of the purchase of the property conserved. Such a commitment is no more, and no less, than an insurance policy that permanent land conservation will result from the sale; it should not be a reason for disallowing the buyer's otherwise valid deduction.

Some Examples

In summary, let me provide some examples, and state what I think the outcome should be, based upon the foregoing discussion (which is not to say that the IRS would agree with me):

A land trust purchases property for $2 million, and offers it for sale for $1 million (its appraised value subject to a retained easement), to any buyer who will pay the purchase price and make a cash contribution to the land trust of $1 million. ***The buyer should be entitled to a tax deduction for the cash contribution for this dual character transaction. The deduction should be for $1 million, less the value of the right to purchase the property.***

A land trust purchases property for $2 million, and offers it for sale for $1 million (its appraised value subject to a retained easement), to any buyer who will pay the $1 million purchase price. ***No contribution is involved; therefore a deduction is not an issue.***

A land trust sells unrestricted property for $2 million, with the hope and expectation (but no legal commitment) that the buyer will donate a conservation easement. Six months

later the buyer does, in fact, donate the easement, which is valued at $1 million. ***The buyer <u>is</u> entitled to a $1 million deduction for the easement donation, which was made free of any obligation to do so.***

A land trust sells unrestricted property for $2 million to a buyer who has, prior to closing, and as a condition of the sale, granted the land trust an option (or pledge) to acquire a conservation easement on the property for $5,000. Two weeks after closing, the land trust exercises the option and acquires the conservation easement, appraised at $1 million, in exchange for the payment of $5,000. ***The buyer <u>should be</u> entitled to a tax deduction, because the conveyance is pursuant to a charitable pledge made by him, and the transaction is a dual character transaction. The deduction should be for $995,000, less the value of the right to purchase the property.***

Mr. Jones sells property, over which he has granted and recorded an option, to a land trust to acquire an easement for $5,000. Mr. Jones sells the property to Mr. Brown, the land trust exercises the option, and Mr. Brown conveys an easement to the land trust appraised at $1 million. ***Mr. Brown <u>is not</u> entitled to a tax deduction, because he is discharging a private contractual obligation assumed with the title to the property.***

Mr. Brown has been looking for a ranch on which to raise his children, and finds Mr. Jones' ranch to be just the property he needs. Mr. Jones tells him that he will only sell the property to him if he grants the local land trust an option to acquire a conservation easement on the property after closing. Mr. Brown enters into an option with the local land trust to sell them an easement for $5,000, if he buys the property. Closing occurs and the land trust exercises its option, acquiring for $5,000 an easement appraised at $1 million. ***Mr. Brown <u>should be</u> entitled to a tax deduction for $995,000, the difference between the value of the easement and the payment from the land trust, because he was legally bound to a public charity by the option, not to the seller.***

The Alternatives to Conservation Buyer Transactions

The ability to include enforceable commitments in conservation buyer transactions is the essence of their usefulness. If enforceable commitments are going to be a poison pill for the deductibility of conservation buyer transactions, land trusts will be pretty much forced to accept one of three alternatives:

1) Allow the sale of conservation-worthy property unrestricted, hoping that buyers will do the right thing and protect the property. Such a strategy is risky, and will inevitably lead to disappointments, and the loss of potentially important conservation values.

2) Only sell conservation-worthy property subject to easements retained by the land trust, or donated by a private seller, prior to closing. This approach will force land trusts to absorb the easement value as a cost of the transaction, making conservation buyer transactions substantially more costly and, therefore, less feasible. This is especially true if buyers cannot make deductible cash contributions to land trusts as part of the sale (as suggested by the Notice).

This alternative is also likely to discourage private sellers, especially those sellers, such as farmers and ranchers, whose limited income precludes the enjoyment of substantial tax benefits from easement donations, from bothering about the conservation of their property.

3) Simply abandon the use of conservation buyer transactions altogether.

A Suggestion and Conclusion

The conservation benefits of conservation buyer transactions are proven and substantial. The commitment to future conservation from buyers that is inherent in such transactions is plainly key to the predictability and, therefore, the usefulness of such transactions. There is nothing about these transactions, or the commitment from buyers to conserve land acquired through them, that is inconsistent with the tax policy behind conservation easement deductions. Therefore, I would respectfully suggest the following:

1) That the IRS clarify the Notice with respect to conservation buyer transactions, to eliminate the uncertainties described above.

2) That the IRS refrain from denying deductions solely because of a taxpayer's commitment to donate cash, or a conservation easement, as part of a conservation buyer transaction.

I respect, and share, the IRS's concern over fraudulent appraisals, sham conservation transactions, and tax shelter operations masquerading as land trusts, and I support the efforts to end these practices. However, I believe that the IRS has done a damaging disservice to legitimate land conservation in the rather vague criticism of conservation buyer transactions contained in the Notice. I hope that this unfortunate situation can be rectified soon, because important and legitimate conservation opportunities are being missed in the meantime.

Responses to Questions for the Record From Mr. Timothy Lindstrom
June 8, 2005

From Senator Hatch

Question: Mr. Lindstrom, you indicated that you see no need for the kind of tax reform of conservation easement deductions suggested by the Joint Committee on Taxation in its January 2005 report. I share your concern that this recommendation goes too far. However, do you think your recommendations for reform would be effective in eliminating much of the abuse that now allegedly takes place in the conservation easement deduction area?

Answer: I believe that the recommendations contained in my written statement submitted to the Committee on June 8 would minimize abuses. As I said in that statement, I believe that virtually every abuse that I have heard of in the past ten years is already addressed by the existing law and regulations. Therefore, I believe that the key to minimizing abuses is to enforce the law knowledgeably, and to require that land trusts and appraisers be familiar with the law through mandatory education. I also think that expanding the reporting requirements on Form 8283 (probably creating a new form) by requiring appraisers, donors, and land trusts to certify compliance with key part of the law would focus these participants in the easement donation process on the requirements of the law.

From Senator Bunning

1. How much would the abuse problems associated with gifts of conservation and facade easements be alleviated by vigorous IRS enforcement and effective appraisal reform?

Answer: As expressed in my written statement and oral testimony, I truly believe that the existing law and regulations governing conservation easement deductions are ample to address abuses, *provided* that the law is enforced. By its own admission, the IRS has neglected easement transactions for a number of years. My own research indicates that of the 115 or so reported judicial decisions involving challenges by the IRS, only 3 actually addressed the substance of the easement, rather than merely challenging the valuation of the easement. I believe that the IRS would be far more successful looking at compliance of the easement document and the appraisal with the requirements of the law than limiting challenges to the valuation of the easement.

2. Would the panelists please give me their best ideas on what the IRS and Congress can do to make sure appraisals for land donations are accurate?

Answer: I believe that the starting point for appraisal reform is mandatory education for easement appraisers *in easement tax law pertaining to appraisals;* requiring appraisers to certify that they have complied with the key requirements imposed by the law in the Form 8283 (or a new form); and having the IRS focus on the several "bright line" standards for easement appraisals already clearly stated in the law and regulations.

3. Should the penalties currently in place for bad appraisals be changed? If so, who should those penalties be assessed against? Appraisers? Charities? Donors?

Answer: Penalties for gross over-valuation of easements could be increased for donors, and imposed on appraisers. I am not certain that such increased penalties would have any more effect, and perhaps less, than instituting regular and knowledgeable audits of conservation easements. In the absence of enforcement by knowledgeable IRS agents, additional penalties are no more likely to be effective than existing penalties.

4. What would you say is the number one area of self-governance where many charities fall short? What is the single change that a charity can make in this area to have the biggest impact?

Answer: I think that lacking key resources (staff and funds to monitor and enforce easements), and a lack of knowledge of applicable tax law and regulations, are the key deficiencies. Mandating annual education in compliance for land trust personnel, and establishing some standards for staffing and funding would improve the quality of conservation.

5. Do our panelists think that more public disclosure and "sunshine" rules will help to curb abuses in charities?

Answer: Perhaps an expansion of Form 990 would be appropriate, as suggested by several participants in the June 8 hearing.

6. Mr. Lindstrom, I've been hearing from many farmers and ranchers who are concerned about the existing incentives which they feel are inadequate to induce easement donations because of the relatively short carry-over period and the other limitations in current law. Can you address these concerns? Are they legitimate, and what changes should be made in this area, if any?

Answer: Existing easement deductions work well for those with big incomes, but poorly for farmers and ranchers with, typically, modest incomes. S. 701, introduced several years ago by Senators Grassley and Baucus, would have done a great deal to level the playing field and make tax deductions work for farmers and ranchers. The proposal applied to those earning 50% or more of their annual income from farming or ranching, and increased the carry-forward period for unused portions of easement tax deductions for such donors from five to fifteen years. The proposal also increased the percentage of income against which deductions for conservation easements by such donors could be taken from 30% (50% for donations of easements on land owned one year or less) to 100%.

7. One suggestion previously made by the Finance Committee staff is the public disclosure of Form 990-T returns, which report unrelated business taxable income of exempt organizations. Privacy concerns have been raised by some, including the

American Institute of CPAs. Can you comment on the proposal for public disclosure of Form 990-Ts and also on how you think privacy concerns could best be addressed?

Answer: I am not sufficiently knowledgeable about this question to provide a useful answer. I do agree that privacy is crucial to most donors, and that requiring public disclosure of the names of easement donors could discourage future easement donations.

From Senator Rockefeller

Question: The committee report discusses the possibility of requiring accreditation for organizations that receive conservation easements. The notion is that only organizations that have the expertise and resources to monitor and enforce the easements can assure that taxpayers really receive the benefits of the conservation easements.

There has been a great deal of debate about whether it would make sense for the government to create a specific accreditation process for conservation organizations.

I would like each of you to tell me whether you think it would be prudent for this committee to consider legislation to create an accreditation process. And if we should create such a process, how could we accommodate the unique needs of small organizations?

Answer: I believe that accreditation would improve the quality of conservation easements and enforcement. However, I believe that accreditation should be managed by the Land Trust Alliance, not the government. I believe that LTA is working quickly to provide that service.

However, I believe that the heart of accreditation is mandatory education in the requirements for compliance with existing tax law and regulations pertaining to easements. This could be implemented nationally almost immediately. The LTA already has an extensive educational program that is available regionally around the United States. Mandating that every land trust accepting deductible easements meet an annual education requirement in compliance is feasible and would be very effective.

I am concerned about the impact on small land trusts of mandating standards of education and enforcement ability. However, I believe that these standards already exist in the law in the form of the definition of a "qualified organization" under section 170(h)(3) of the Code. Holding a conservation easement imposes a perpetual obligation to monitor and enforce that easement. I don't believe that a land trust with an all volunteer staff and no funds set aside for monitoring and enforcement is a "qualified organization." It may be possible that such small land trusts, valuable for their local knowledge, could contract with larger organizations for some of the services critical to their perpetual obligation. However, this is a very difficult issue and deserves considerable thought before imposing any specific new requirements so that we don't lose the significant contribution to conservation being made by small land trusts.

Statement of Senator Trent Lott
The Tax Code and Land Conservation: Report on Investigations and Proposals for Reform
Senate Finance Committee
June 8, 2005

Thank you, Mr. Chairman, for holding this hearing. We've heard a lot today about problems that exist in the enforcement of current law with regard to the tax treatment of conservation easements. Those problems are real, and need to be addressed in a serious manner.

However, I'd like to focus some attention on the good works of The Nature Conservancy. While the Staff Report focuses on four transactions, let the record reflect that TNC has been a party to 10,000 land transactions over the years covered by the Report. In the vast majority of cases, TNC is doing exactly what it should be doing: working hard using the best science and the conservation tax incentives that we have created in the Internal Revenue Code to protect wildlife, while allowing the land to stay in private ownership.

I want to congratulate TNC for their diligence in accomplishing real conservation results. We should be proud of the work they have done with the tax incentives Congress has enacted.

Mr. Chairman, that is not to say that we can't all learn a lot from the Staff Report, or that we should turn a blind eye to the very real problems that exist with regard to insider dealings, overvaluations of land, UBIT, and so forth. To the contrary, we must both expose problems that exist and move vigorously to fix them.

However, the Committee should not take a "throw the baby out with the bathwater" approach. That type of approach is unacceptable to me, and to the land trusts in my home state of Mississippi that use conservation easements to preserve open space and land. For example, Mississippi Land Trust has 39 easements protecting nearly 30,000 acres. These aren't big corporate bullies using the tax code to shelter income; they are small trusts that rely upon the tax incentives we have enacted to encourage preservation.

I look forward to working with the Committee to draft a balanced proposal. Thank you, Mr. Chairman.

TESTIMONY OF BURNET R. MAYBANK, III, DIRECTOR SOUTH CAROLINA DEPARTMENT OF REVENUE BEFORE THE SENATE COMMITTEE ON FINANCE HEARING: "THE TAX CODE AND LAND CONSERVATION: REPORT ON INVESTIGATIONS AND PROPOSALS FOR REFORM" June 8, 2005

I very much appreciate being given the opportunity to address the Senate Finance Committee and offer my views on conservation easements.

I am the Director of the South Carolina Department of Revenue. I have a law degree and a LLM in Taxation. I am the principal co-author of 2 books on conservation easements published by the South Carolina Department of Revenue. A copy of my biography is attached to my testimony.

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. I attach a copy of our Land Trust desk audit. We also recently published the attached second edition, *Local, State and Federal Tax Incentives for Conservation Easements.* I have been actively involved in this field, both in the public and private sector. My experience has been that conservation easements have been incredibly effective as a land planning tool and the percentage of abuses have been quite small. The dollar value of those few abuses has, however, been very high. Based on the foregoing, I wanted to add my own list of recommendations. I would encourage the Committee to adopt the specialized valuation rules stated below *only* for either conservation easements, or perhaps other non-cash charitable contributions, of over $100,000.

1. EXCESSIVE VALUATIONS

We have examined some 110 easements granted over a 3 year period from 2001-2003 in South Carolina with an appraised value of over $1 million. 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.

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.

While few in number, we have seen valuations which shock the conscience. For example, an easement was placed on a proposed golf course. The land was purchased for several million dollars three years earlier. The appraisal claims the land 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.

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!

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

a. Either total ignorance of the rules, or conduct bordering on tax fraud, by the appraiser;
b. 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 (see pages 105-106 in the attached DOR publication *Local, State and Federal Tax Incentives for Conservation Easements*); lastly, the Land Trust has no motive to question or police valuations;
c. 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;
d. there is an appraisal technique called the subdivision development analysis which can be easily manipulated to provide high valuations (see pages 95-98);
e. 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
f. The IRS has lost the vast majority of conservation easement cases in the Tax Court.

Most of the abuses can be combated by restricting or banning use of the subdivision development analysis.

In addition, the adoption of a specialized Form 8283 for conservation easements which will require disclosure of relevant problem areas will considerably help audit selection by the IRS and state DORs.

2. 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. Developers are also using conservation easements to fulfill certain mitigation and similar requirements imposed by state and federal environmental law. This has become almost a routine practice in the South Carolina low country. And they are taking large charitable deductions.

Indeed, we have seen the use of easements turned on their head. They are now used a tool to promote—rather than hinder—the development of relatively natural habitat.

This issue is covered at length in the *Washington Post* article, "Developers Find Payoff in Preservation" written by Joe Stephens and David Ottaway.

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. The law has, however, gradually changed to 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 in the DOR publication.) Since this is a valuation issue we face the same problems as earlier stated (lack of audit resources, valuation is more an art than a science, etc.)

I encourage the Committee to adopt strict quid pro quo rules applicable to all gifts of non-cash charitable contributions of over $100,000. Attached is Virginia legislation which provides that dedications of land for the purpose of fulfilling density requirements do not qualify for conservation easement treatment.

I would encourage the Committee to adopt legislation which specifically provides that any conservation easement given pursuant to any zoning requests or for the purpose of fulfilling any state or federal environmental requirement does not qualify for charitable contribution purposes. Such legislation would need strong attribution rules. I attach a proposed draft.

3. SPECIAL VALUATION RULES FOR GOLF COURSES AND COMMERCIAL DEVELOPMENTS

I would add at the outset that in South Carolina the great majority of golf course and developer easements that we are aware of seem to involve the same donee and some of the same appraisers and consultants. To me this highlights the fact that the problem of abuse is very limited in scope, although significant where it does occur.

a. 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 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.

b. Commercial Developments

It is not uncommon for real estate developers to place easements on common areas and wetlands. The developer advertises the easement, and clearly it is an attractive feature to prospective buyers.

c. Recommendations

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.

I seriously question whether the U.S. Treasury should subsidize any golf course development, public or private. In particular, I do not believe the U.S. Congress ever intended to give huge charitable deductions for the preservation of a golf course in an exclusive gated community.

Many of the above valuations result from an aggressive use of the subdivision development analysis. If the Committee chooses not to simply ban golf course easements, I would encourage the Committee to severely limit or ban the use of this appraisal technique.

Another idea would be for the Committee to adopt a broader version of the tax rules which apply to real estate "dealers" (see pages 5-6), along with strong attribution rules.

I attach an article by Stephen Small, the foremost attorney for conservation easements in America. He discusses several of the issues raised above.

4. LAND TRUST STANDARDS

The legal requirements to become a land trust (or other entity which accepts conservation easements) under both state and federal law are minimal.

a. Straw Land Trusts

Bingo may only be played under the South Carolina Constitution by a charity. Most, if not all, bingo games are run by for-profit bingo promoters who share a small portion of the revenue with the charity. Bingo promoters long ago discovered that they did not have to put up with pesky demands by real charities. Instead a few set up their own charities while others took over established but defunct charities.

No law requires golf course and commercial developers to utilize any particular land trust. They are largely free to set up their own land trusts, and it is only a matter of time before they do. We have seen commercial developers set up land trusts in South Carolina.

I would encourage the Committee to adopt specific self dealing rules.

In addition, as I noted above, we have seen several land trusts which have the look and feel of a commercial consulting enterprise (very similar to what the IRS is going through with Commercial Credit Counseling agencies.) They are active in golf course easements. There is no easy legislative solution.

b. Lack of Resources to Enforce Easements

Current IRC law (see pages 34-35) requires only that a land trust (or other donee) have a "commitment" and the "resources" to enforce the easements which they receive. There are NO minimum standards under current law. The IRC is almost completely silent regarding a Land Trust's duty to inspect and enforce the easements which they accept. I would encourage the Committee to adopt minimum resource standards, and to legislatively adopt the Land Trust Alliance standards regarding easement monitoring and enforcement. (See pages 79-80.)

5. AUTHORIZE THE STATES TO UTILIZE IRS PENALTY PROVISIONS

The IRS and Congress have been very active in adopting Tax Penalty provisions, and particularly with reference to valuations. The states have been much slower to adopt such provisions, even such states as South Carolina, which annually adopts federal tax conformity. I would encourage Congress to adopt a provision which authorized the states to use IRS penalty provisions.

6. ESTABLISH CONSERVATION EASEMENT ADVISORY COMMITTEE

I would encourage the IRS to establish a Conservation Easement Advisory Committee similar to its Arts Advisory Committee. Such Committee would be composed of state and federal tax agencies, Land Trusts, appraisers and perhaps environmental groups which do not accept easements. The Committee could meet yearly to discuss issues and develop legislative suggestions.

Respectfully submitted,

Burnet R. Maybank, III

State of South Carolina
Department of Revenue
301 Gervais Street, PO Box 125, Columbia, SC 29214

July 21, 2004

Re: Land Trust Desk Audit

Dear

Below you will find the Department of Revenue's annual desk audit of land trusts who have accepted conservation easements or deeds to property for conservation purposes in South Carolina. We understand your group meets this test. (Please advise if you do not.) Unless otherwise indicated, the audit seeks information for the calendar years 1999-2003. Of course, for land trusts who do business in more than one state, the audit seeks information only on the properties located in South Carolina.

Please provide the information requested below by September 1, 2004.

Please let us know if responding to any particular item(s) will cause your organization undue burdens. If so, let us know what information you can readily make available, and we will be happy to discuss alternatives.

A. LAND TRUSTS

1. How long has your organization existed?
2. Please include a copy of your IRS letter of determination stating that you are a tax-exempt organization, if applicable.
3. How long has your organization accepted easements or donations of real property?
4. How many easements do you currently hold?
5. How many pieces of property does your organization own for conservation purposes (in lieu of a conservation easement)?
6. Please list the names of all full time employees from 2001-03.
7. List any ongoing financial arrangements or consulting agreements the land trust has with any outside consultants, specifically including appraisers.

B. CONSERVATION EASEMENTS

8. Please list the names and contact information of all private donors of conservation easements or outright grants of land to your land trust from 1998-2003.
9. Please attach copies of all IRS form 8283 for any easements or property you received from 1998-2003.
10. Please attach copies of all IRS form 8282 for any easements or property you resold from 1998-2003.
11. Please list any documents in your possession relating to baseline data for each easement received by your organization from 2001-2003.

C. ENFORCEMENT

12. Please list all permanent employees, volunteers or independent contractors who perform observation, inspection or otherwise police the easements your organization holds.
13. Please attach copies of the portions of your Articles, Bylaws or Resolutions which pertain to enforcement of conservation easements.
14. Please list in detail any and all inspections of property covered by a conservation easement which the land trust performed (either by itself or through independent contractors) from 2001-03 to ensure compliance with the terms and conditions of the easement.
15. Please provide any other services or steps that your organization takes to monitor or police the conservation easements you hold.
16. Please list all income and expenses for the land trust for 2002-2003.
17. Please estimate which portion of the expenses listed above was spent on monitoring or enforcing conservation easements.
18. Please list any breaches, misuses or other discrepancies you have observed in the enforcement of any easement agreement from 2000 to 2003.

D. CONFLICTS OF INTEREST

19. List the conservation easements or deeds to property which the land trust received from persons who were Board Members, officers, directors or employees of the land trust either at the time of the creation of the conservation easement or transfer of the deed or within one year before or after.
20. If the land trust received conservation easements from Board Members, officers or employees as discussed above, attach copies of all Policies and Procedures adopted by the trust which govern conflicts of interest, Code of Ethics or the like.
21. For 2001-03, list the names of any Board Members, Officers, or Directors (e.g., lawyers, accountants, appraisers, realtors, developers) who represented clients who gave conservation easements to the land trust during their service as a Board Member, Officer, or Director.

E. SELECTED TRANSACTIONS

22. Please list and give details on any easement where you (Board Members, Officers or Directors) had actual knowledge that the conservation easement was granted pursuant to a proposed development for residential, commercial or similar use of the remaining portion of the property not covered by the easement.
23. Please list the names and contact information of all donors of conservation easements or outright grants of land to your land trust in connection with any residential or commercial development, specifically including residential subdivisions and golf courses from 1998-2003, and attach a copy of the easement.
24. Please list all easements on property which is five acres or less.
25. Please identify by (attempted) donor name and property any conservation easements which the land trust declined to accept from 2000-03.

Please note the Department of Revenue will soon publish the 2nd edition of *Local, State, and Federal Tax Incentives for Conservation Easements*. Please let us know if you would like to be emailed a copy either in draft or in final version.

Yours Very Truly,

Burnet R. Maybank, III
Director, SC Dept. of Revenue

tax analysts special report

PROPER — AND IMPROPER — DEDUCTIONS FOR CONSERVATION EASEMENT DONATIONS, INCLUDING DEVELOPER DONATIONS

By Stephen J. Small

Stephen J. Small, Esq., is an attorney at his own firm in Boston. From 1978-1982 he was an attorney-adviser in the legislation and regulations division of the Office of Chief Counsel at the IRS, where he wrote the income tax regulations under section 170(h). Mr. Small is the author of *The Federal Tax Law of Conservation Easements*, Land Trust Alliance, 1986; *Preserving Family Lands (Book I)*, third edition, Landowner Planning Center, 1998; *Preserving Family Lands: Book II — More Planning Strategies for the Future*, Landowner Planning Center, 1997; *Preserving Family Lands: Book III — New Tax Rules and Strategies and a Checklist*, Landowner Planning Center, 2002.

In this article, the author notes that a small number of "bad" conservation easement deals threaten to poison the well for otherwise successful, appropriate, and important private land conservation transactions if IRS enforcement is not targeted at the promoters, appraisers, and others engaged in the bad deals. Small also discusses the main tax and planning hurdles that make it difficult for a real estate developer to get a meaningful income tax deduction for the donation of a conservation easement, including the tricky question of whether a conservation easement is characterized as a capital asset or inventory. Finally, Small makes suggestions for better enforcement in this area, including presenting a list of questions the IRS might ask on a revised Form 8283, "Noncash Charitable Contributions," or other reporting form. A shorter version of this article was originally written for *Exchange*, the quarterly publication of the Land Trust Alliance, and is scheduled to appear in the fall issue.

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More than five years ago I was in Washington on business and had lunch with an old friend, a smart tax guy who was with one of the big accounting firms.

I knew his knowledge of the tax code was broad and deep, and I asked, "What kind of work are you doing now?"

"Selling tax shelters to very rich people," he said as he took another bite of salad. "There's a lot of money to be made."

How sad, I thought, comfortable in the knowledge that in my narrow niche of tax code work the deals were clean, the air was fresh, and the sun shone brightly over preserved meadows, forests, farms, and ranches.

Well, some of that has changed, and while that pleasant field of endeavor has been jolted by more than one event over the past 18 months, the latest shot across the bow came in July with the publication of IRS Notice 2004-41, 2004-28 IRB 31, *Doc 2004-13514, 2004 TNT 127-6*, "Regarding Improper Deductions for Conservation Easement Donations."

But first a little background.

I. Background

Section 170(h) provides an income tax deduction for the donation of a "qualified conservation contribution" to a "qualified organization" for "conservation purposes." Specifically, for purposes of this article, section 170(h) provides a deduction for the donation of a conservation easement to a qualifying charity (or unit of government).

Section 170(h) became law in 1980, and, as an attorney-adviser in the Office of Chief Counsel at that time, I participated in the drafting of the statute and then wrote the income tax regulations under section 170(h). In 1985, three years after I left the IRS, I wrote *The Federal Tax Law of Conservation Easements*, an annotated commentary on the statute and the regulations. In 1985 almost no one cared; I did not expect the book to be a bestseller and it was not. This was a sleepy little field, generally marked

by conservation easements donated by caring landowners on farmland, forestland, or ranchland, and often on property that had been in the family for decades, if not generations.

In 1996, in the Second Supplement to *The Federal Tax Law of Conservation Easements*, I wrote that "the most significant development in the law is simply the *continuing development of favorable law* for easement donors and charitable donee organizations, including land trusts." In the Third Supplement, published in 2000, I said developments in the law continued to be good, "and the pronouncements by the Internal Revenue Service and the courts generally tended to be good." By "good" I meant, again, that developments in the law continued to be favorable to donors.

Before we move to what has gone wrong, here are two fundamental points about how section 170(h) is supposed to work.

First, many people, including many tax professionals, think you can get an income tax deduction under section 170(h) for putting fewer houses on a piece of property than allowed under local zoning. I have heard many people say something like this: "I have one hundred acres, and under local zoning I can put one hundred houses on it. Instead of doing that, I'm going to limit it to twenty houses, and put an easement on it, and take a huge deduction for the eighty houses I give up."

There are many reasons why this statement is not correct, but the fundamental error here is that the code does not give you a deduction for building fewer houses. The code gives you a deduction for protecting open space, protecting wildlife habitat, protecting farmland and forestland and watershed and scenic property. Once you have protected important conservation values, then you can take an income tax deduction for the value you give up.

And that leads to the second important point. As a general rule, the income tax deduction is equal to the fair market value of the subject property before the conservation easement minus the fair market value of the subject property after the conservation easement, or, the "value before" minus the "value after." Fair market value is a carefully defined tax term and the promoters and appraisers the IRS talks about going after in Notice 2004-41 (more on this below) are either unaware of the valuation rules or are disregarding them. Fair market value is a market-based concept: Simply put, fair market value is what a knowledgeable and willing buyer would pay for the property if you put it on the market and sold it.

Even though the rules are clear, the most common appraisal "trick" I have seen is for an appraiser to assume the highest possible level of development that could be approved under local zoning (and where there is no zoning then of course you can build anything) and value the land based on that intense level of buildout, totally without regard for whether there is sufficient and realistic market demand for that product. My favorite illustration is an appraisal of Aunt Sally's farm, 20 or more miles from the nearest city, based on a 3,500-unit planned unit development, with hotel and conference center, that in fact could be approved for that location under local zoning but that no builder in his or her right mind would ever build because the demand simply does not exist.

Through the 1980s and 1990s, the statute generally worked the way Congress intended it to for a simple reason: People were following the rules. The once-sleepy little field grew fast but easement donations were still (and still are) generally made by landowners who care about their land, who understand that these are tax incentives *for land conservation*, and who used generally sensible appraisals.

Beginning around 2000, however, things began to change. Private land protection was growing at exponential rates and real estate developers, tax advisers, and "promoters" outside of the traditional land conservation field started to become more interested in the potential tax advantages provided by section 170(h) for conservation easement donations. This resulted in at least three things: (1) some very creative new conservation transactions; (2) some transactions that generated huge income tax deductions but only questionable conservation benefits; and (3) some transactions that generated important conservation benefits and income tax deductions way out of relationship with reality.

Here are two examples:

Deal #1. Developer/promoter purchases less than 1,000 acres in a rural but growing area. The purchase price is $3 million. The developer plans to syndicate interests in this "deal" to investors, based on an appraisal that says a conservation easement on the land is worth more than $50 million. This is outrageous.

Deal #2. Owner donates a conservation easement on a large and valuable property. All of the relevant facts are complex, and the issues behind the appraisal are complex. The appraiser says the conservation easement is worth more than $90 million. While the property is valuable, more than one knowledgeable person familiar with local real estate values believes the easement is worth no more than $30 million and possibly less than that.

An experienced Washington observer, who asked that I not quote him by name, said this: "The IRS is looking for someone to blame but they are looking in the wrong places." With a little effort, and the notice indicates that effort is beginning, and with a little help, the IRS can find out who is to blame and can clamp down on those deals.

Let me cut to the chase. The only reason I can see why anyone would want to do what we could characterize as a "bad" conservation easement transaction is to be able to take a huge and totally unjustified income tax deduction. This can happen in one of two ways. Either there are no significant conservation values being protected (for example, a conservation easement that allows way too much building to protect anything except the owner's investment; more on this below), or there may be some significant conservation achieved but the appraisal is out of step with reality. I believe there are ways to begin to shut down the bad transactions while allowing the good ones to continue to flourish.

II. The Notice

In the spring of 2003, *The Washington Post* began a series of articles on The Nature Conservancy (TNC) and some transactions the organization had entered into, as

well as some corporate issues relating to TNC. Those stories were followed with others on certain conservation easement "deals." The stories caught the attention of the Senate Finance Committee, which has been looking into the charitable field, and, of course, the IRS. Certainly, at the very least, the notice is an acknowledgement by the IRS that it needs to step up enforcement efforts in this area.

From my perspective, there are three particularly important points in the notice.

Collecting more and better information. Here is the first one, from the text of the notice: "The Service is considering changes to forms to facilitate compliance with and enforcement of the substantiation requirements." In short, the IRS is considering collecting more information on conservation transactions through Forms 8283 and 990, as one means of helping them sort out bad deals from good. (Form 8283, "Noncash Charitable Contributions," is the form that must be filed with the donor's income tax return as part of the substantiation for certain charitable gift deductions; Form 990, "Return of Organization Exempt From Income Tax," is an information return filed by charitable organizations.) More on that point below.

Certain 'conservation buyer' transactions. The second important point in the notice is covered in "Purchases of Real Property from Charitable Organizations" and appears to address certain of the "conservation buyer" transactions, written about in last year's *Washington Post* series, in which TNC was the seller. (Author's note: TNC has long been in the forefront of private land conservation transactions, and TNC continues to do important work. I have known and worked with TNC people since my days at IRS and they are committed to doing good work and doing it right.) Those included transactions in which TNC purchased a property in fee, put a conservation easement on the property, and sold the property to a conservation buyer for the value of the land minus the value of the conservation easement. As part of the transaction, the conservation buyer made a cash contribution to TNC that was roughly equal to the value of the conservation easement; it was reported that many of the conservation buyers took income tax deductions for that contribution of cash. TNC has taken the position that adequate tax authority exists for the way they structured those transactions, and argues that the notice's interpretation, if taken broadly, runs contrary to prior IRS rulings and to principles accepted in the treatment of certain other kinds of charitable donations. However, the notice says, "In appropriate cases, the Service will treat these transactions in accordance with their substance, rather than their form. Thus, the Service may treat the total of the buyer's payments to the charitable organization as the purchase price paid by the buyer for the property."

Insiders, promoters, and appraisers. The IRS notes that it may challenge the tax-exempt status of nonprofit organizations that operate outside the law. Without here going into the technical analysis of the specific tax code rules, the notice seems to target transactions between charitable organizations and "insiders," that is, on one hand staff and board members or trustees, and on the other hand *major contributors*.

More important is the final substantive paragraph of the notice, in which the IRS points the finger at "promotions of transactions involving improper deductions of conservation easements" and targets "promoters, appraisers, and other persons involved in these transactions." My best educated guess is that those transactions, still relatively new to the field, represent less than 2 percent of all conservation easement transactions around the country, but if those transactions are not shut down they have the potential of poisoning the well. People who have been working seriously and quietly in the private land protection field will agree. If you take away the "promoters, appraisers, and other persons involved" in tax-fraud-type transactions (Deal #1 and Deal #2 above), what you have left is an effective private land conservation movement across the country, doing good deals with important conservation results. That is precisely why IRS enforcement that focuses on seeking penalties for appraisers, attorneys, financial advisers, and donee organizations who knowingly take part in transactions the IRS believes abuse the tax law can be a very positive development.

III. What Developers Need to Know

Some of my best clients have been real estate developers, and I want to cover this material in this article because there seem to be a lot of misconceptions, and there seems to be a lot of bad advice, about how easy or how difficult it is for a developer to get a deduction for a conservation easement donation. In the current climate, this is a necessary discussion.

There are five reasons why it is difficult (although not impossible) for a real estate developer to get a meaningful income tax deduction from the donation of a conservation easement:

- the requirements of section 170(h), most particularly (though not entirely) the conservation purposes tests;
- the so-called quid pro quo rule;
- the basis allocation rule;
- the appraisal requirements; and
- the tax character of the conservation easement, that is, whether or not it is a capital asset.

IV. The Requirements of Section 170(h)

As I noted earlier in this article, many people around the country, including many tax professionals, think you can get a deduction under section 170(h) for building fewer houses on a piece of property than you could under local zoning. That is not correct. To qualify for a deduction, you must meet one of the "conservation purposes" tests: protecting property for public outdoor recreation and education, protecting significant wildlife habitat, protecting certain qualifying open space, or protecting historic property. Once you have done that, once you have protected some important conservation values, you get an income tax deduction for the value you have given up. Most "landowners" (as opposed to "developers," who are of course also landowners) who donate conservation easements are motivated in large

part by love of their land and the "conservation" qualities that make it desirable. Most developers are motivated by profit, and that is not a bad thing but it means the developer's mindset about any particular piece of real estate generally starts with building, not conservation. Section 170(h) starts with conservation, not building.

The statute was intended to encourage the protection of open space and property with significant conservation values, and was not intended to be a tax incentive for "conservation development" projects that left a little open space between estate lot building envelopes. While the determination of what works and what doesn't work is subjective, here is one generalization and one clear example of what I mean.

In general, the larger the contiguous block of uninterrupted open space (uninterrupted by driveways, cul-de-sacs, house lots, swing sets, etc.), the more likely a conservation easement is to meet the requirements of section 170(h). A large contiguous uninterrupted block of open space is not a prerequisite but it helps. Also, it is important to understand that the definition of "large" can vary quite a bit from region to region, state to state, and even within states.

Here is an example of what does not work: A "conservation easement" allowing 19 five-acre house lots on 100 acres does not protect the conservation values of that 100 acres. It may protect some of the conservation values, and it will prevent more intense development of the 100 acres, but *it does not protect the conservation values of that 100 acres in a way that meets the requirements of section 170(h) of the tax code.* There comes a time in the life of every piece of land when there are too many house lots (1? 5? 10?) to protect its conservation values, as the tax code defines them, no matter how strategically situated those house lots might be, and anyone who tries to convince you otherwise (either in a debate or with a glossy flora and fauna report) is ill-informed. There is nothing at all wrong with a 19-lot subdivision but the builder is not entitled to an income tax deduction under section 170(h) for doing it.

I have also heard developers say: "I am going to do 40 house lots, and in the middle of the subdivision I am going to keep five acres of woods. I'm going to put a conservation easement on the woods and take a big deduction." Once again, although there may be a number of other problems with this concept, a conservation easement on those particular five acres, the conservation benefit of which accrues only to the homeowners in the surrounding lots, simply does not rise to the level of what the statute is looking for (although it is closer). A larger, voluntary "set-aside" of open space may or may not meet the requirements of section 170(h), depending, of course, on the facts and circumstances. If the protected open space is within a gated development, for example, the conservation "benefit" from the easement may accrue only to homeowners within the development. In that connection, see Example (4) of Treas. reg. section 1.170A-14(f) ("Owners of homes in the clusters will not have any rights with respect to the surrounding Greenacre property that are not also available to the general public.").

Finally, under the "conservation purposes" heading, there is a lot of loose talk these days about conservation easements on private golf courses. This is a generalization, but 98 percent (although not 100 percent) of the proposed "golf course easement" deals I hear about (many of which never come to fruition) simply do not meet the threshold section 170(h) requirement that the easement protect some significant conservation values. I enjoy golf, but most private golf courses, although they look nice for the members, are intensely disturbed environments *for section 170(h) purposes* and have no significant "conservation" values under section 170(h). Also, many golf course easements seem to be the subject of proposed "syndicated" deals, in which ownership interests in the course are proposed to be sold at a remarkably low price to "investors" who are to receive some share of large easement deductions through a new LLC golf course owner.

There is another section 170(h) problem that comes up in a limited number of situations. A developer wants to donate a conservation easement to the local land trust. (I use "land trust" as the generic term for the tax-exempt charitable organization in the business of protecting open space. Some land trusts are local, some are regional or statewide, and some are national.) The land trust tells the developer either that the assumed "conservation values" are not high enough (like the five wooded acres in the middle of the subdivision) or that the conservation easement reserves the right to build too many residences and that that construction will effectively destroy any real conservation values the property may have. The land trust declines to accept the easement. Undaunted, the developer sets up "his own" charitable organization, with a name like "Fox Run Estates Conservation Trust," and donates the conservation easement to it.

Without knowing more, of course, it is impossible to know for sure, but on those facts it is a good guess that the Fox Run Estates Conservation Trust is classified as a private foundation under section 509(a)(1), and while that is generally not a bad thing the developer has made a serious mistake here because under section 170(h)(3) a private foundation is not an eligible donee for a deductible conservation easement.

At the moment I am aware of more than a few situations in which organizations that appear to be private foundations have accepted conservation easements. While the conservation purposes tests under section 170(h) often have some degree of subjectivity ("is the habitat significant enough to qualify?"), the public charity/private foundation issue is almost always clear as a matter of law and can usually be confirmed with only a little due diligence.

V. The Quid Pro Quo Rule

Unlike the conservation purposes test, the *quid pro quo* rule is not unique to section 170(h) but cuts broadly across section 170 charitable contributions law. I could state the rule this way: If I convey an asset to a charitable organization as part of a deal or arrangement to get something from that organization, my "contribution" is not charitable and it is not deductible; it is part of a business deal. See, for example, *Ottawa Silica Company*, Ct. Cl. No. 27-278, 49 AFTR 2d 1160 (1982); *Jordan Perlmutter*, 45 T.C. 311 (1965); and Treas. reg. section 1.170A-14(h)(3)(i).

There is no case law on the application of the quid pro quo rule in the conservation easement field, but there are a number of cases that have come up in the real estate development context. The typical fact pattern involves a developer who conveys land in fee to the town and *as part of that transaction* secures approval for development on an adjacent parcel. Of course, there is nothing illegal or even unseemly about this sort of thing and in one form or another it happens quite a bit, but the conveyance to the town is simply not a charitable contribution.

Similarly, the fact pattern involving conservation easement "contributions" comes up often in the real estate development business. The developer says to the town zoning board, "If you let me put houses on 60 percent of the property I own, I will dedicate the balance of the property to open space." That is workable and again not uncommon or illegal or even unseemly, but when the developer puts the conservation easement on the open space to secure that commitment that is a *quid pro quo*, it is part of a business deal, and it is not a charitable contribution.

The variation on that theme occurs when the developer approaches the town with a plan to put houses on the eastern half of the 100 acres the developer owns and the zoning board says, "We will let you do that, but as a condition of approval we are going to require that you put a conservation easement on the western half of your 100 acres." That is an exaction by the zoning board, and the conveyance of the conservation easement is neither charitable nor deductible because it is required.

VI. Basis Allocation Rule

The income tax regulations under section 170(h) require that when a landowner donates a conservation easement, the donor must allocate to the conservation easement a portion of the basis of the underlying property. Treas. reg. section 1.170A-1414(h)(3)(iii).

The rule works like this. Say Aunt Sally purchased her farm for $100,000, and the farm is now worth $1 million. Aunt Sally donates a conservation easement on the farm that lowers its value to $650,000. Under the income tax rules, the value of the easement is $350,000; that is, the value of the property before the easement minus the value of the property after the easement. Because the value of the conservation easement represents 35 percent of the value of the property, the regulations require that 35 percent of the property's basis, or $35,000, be "allocated" to the easement. In most cases, the basis of Aunt Sally's easement donation will be irrelevant. However, what Aunt Sally has done is lower the basis of her remaining property to $65,000.

Now, if Aunt Sally holds her property until she dies, and if historical tax rules apply, the basis of her property will be "stepped up" to its fair market value as of the date of Aunt Sally's death. If she sells the property 20 years after she has donated the easement, the lower basis will mean she has more gain and therefore more tax to pay, but 20 years is a long time where tax matters are concerned. If Aunt Sally sells the property shortly after she has donated the easement, the lower basis will have a more immediate income tax consequence (although on those numbers and under current code rules the tax benefit of the deduction may well be much greater than the tax cost of the reduced basis).

If the landowner is not Aunt Sally but XYZ Development Co., these rules are the same, but the tax results may hurt more and the numbers are likely to be quite different. Assuming that XYZ has been able to plan for and around the other tax issues (discussed above and below), let's also assume these are the numbers: Assume XYZ's basis is $600,000 and the fair market value of the land is $900,000. XYZ donates a conservation easement that reduces the value of the land to $600,000. The basis allocated to the easement is $200,000 (which may or may not have any income tax consequences; see below). The reduced basis of XYZ's land is $400,000, and assuming XYZ sells lots reasonably soon thereafter, additional income tax may be due because of the basis reduction. There may (or may not) be ways to make the tax results better. My point is simply to point out the rule and the potential tax planning problem.

VII. Appraisal and Valuation

This is a generalization, but a safe one: The highest and best use of most real estate today often involves developing a property to its maximum permissible density. Assume Aunt Sally owns Greenacres. Greenacres is 100 acres, and under local zoning, Aunt Sally, or XYZ, could put 80 houses on that property. If instead Aunt Sally donates a conservation easement on that property, limiting it to two houses, carefully sited to avoid harm to the property's conservation values, the value of that conservation easement could be significant.

Today, in many markets around the country, the maximum allowable number of house lots does not necessarily bring the maximum number of dollars. For example, in some markets the highest and best use of Greenacres might be, for example, ten 10-acre house lots, or even five 20-acre house lots. In those particular markets, the reduction in value attributable to a conservation easement limiting Greenacres to those 10 or those 5 "estate" lots might be nominal.

Some developers also have a tendency to think that the creature called a conservation easement, regardless of how or where imposed, brings with it significant income tax deductions. The question I hear frequently is, "Can I donate a conservation easement on the wetlands I can't build on and take a big income tax deduction?" The answer to that question is, "Yes; no." In other words, a conservation easement on wetlands certainly protects some significant conservation values and would be likely to meet at least one of the conservation purposes tests. But if you can't build on the wetlands anyway, there is no appreciable "dollar value" to give up and therefore little or no income tax deduction.

Finally, the conservation easement regulations, at Treas. reg. section 1.170A-(h)(3)(i), include two appraisal rules of particular concern in many developer easement situations.

The first rule is this: When a landowner donates a conservation easement on a portion of the contiguous real estate owned by that landowner and the landowner's family, the deduction is equal to the value of all the contiguous property owned by the landowner and the landowner's family before the easement minus the value

of all of the contiguous property after the easement. In those situations, the appraisal rule picks up any enhancement or increase in value to land abutting the restricted land and reduces the deduction accordingly. In some situations the "*all* before minus *all* after" rule can have a significant impact on the amount of the deduction (but a longer analysis of that issue is beyond the scope of this article). Finally, the rule also tends to make the appraisal more expensive since the project is a bigger one.

The second appraisal rule is similar, and is also designed to pick up any "enhancement" to certain other real estate as a result of a conservation easement donation. This is the second rule: When a landowner donates a conservation easement and as a result there is an increase in the value of any other land, whether or not contiguous, owned by the landowner, the landowner's family, or a "related party" (broadly defined to include certain partners and partnerships, corporations and shareholders, trusts and beneficiaries, and so on), the value of the deduction is reduced by any such increase in value to such other property.

In many (though not all) "routine" easement situations, involving donations by individual landowners or families on family land, those two appraisal rules usually do not come into play. In most situations involving conservation easement donations by real estate developers, who might be likely to donate a conservation easement on a portion but not all of a particular landholding, one of those rules is likely to be triggered.

VIII. Is It a Capital Asset?

Parsing through all of the tax code definitions and cross-references, simply put for purposes of this article, the relevant rule under section 170(e)(1)(A) is this: If the asset you donate to charity is a capital asset and you have held it for more than one year, you are entitled to a deduction for the full fair market value of the asset (subject of course to other section 170 rules, such as the limitation that individuals can generally take such a deduction only up to 30 percent of adjusted gross income for the year of the gift, with a five-year carryforward of any unused amount). If the asset you donate to charity is not a capital asset, or, for purposes of this article is inventory (again, simply put, property held for sale to customers in the ordinary course of business; the capital asset-inventory analysis is beyond the scope of this article), your deduction is generally limited to your cost or basis of the asset contributed. Also, regardless of whether the asset is inventory or a capital asset, if you donate the asset to charity before you have owned it for more than one year, your deduction is also limited to cost or basis.

In the conservation easement field, most (although not all) donors and donees are aware of the one-year holding period rule.

What about the capital asset/inventory question? It is clear that if a real estate developer is working on a subdivision in Ohio, and donates some of the lots in the subdivision to the town, or to the local land trust, those lots are inventory and the deduction is clearly limited to basis. It is also clear that if Aunt Sally donates a conservation easement on her Virginia farm, or if Uncle Bob donates a conservation easement on his Montana ranch even if Uncle Bob happens to be an investment banker and lives elsewhere, by any stretch or analysis the conservation easement is a capital asset and is not inventory.

But here is the harder question: If a real estate developer is working on a subdivision in Ohio and donates a conservation easement on some of the land within that subdivision, is the easement inventory? Is the easement ordinarily held for sale to customers? Is the tax character of the easement determined by the tax character of the underlying fee from which the easement was "unbundled"? Is the tax character of the easement determined without regard to the underlying fee? Whether a conservation easement is a capital asset or inventory does not appear to have come up in any of the reported conservation easement cases. That is understandable, based on the still-evolving history of the donation of conservation easements in this country: For many years, even decades, it seems that few if any real estate developers were interested in donating conservation easements, so the narrow but important tax issues raised by the capital asset/inventory question rarely if ever came up.

As a participant in the drafting of section 170(h), and as the author of the income tax regulations, I can say that never ever at any time throughout that process did a question come up about whether a conservation easement is a capital asset or inventory. Put a slightly different way, never ever was there any hint or thought that the income tax incentive (deduction) for a conservation easement donation could or should be any different depending on whether the donor was Aunt Sally, Uncle Bob, or XYZ Development Co. In fact, it is safe to say that the thought never even surfaced that XYZ Development Co. could one day be an easement donor. Remember, this was 1980, and to the best of my recollection the terms "conservation easement" and "real estate developer" had at the time never appeared in the same sentence.

Had the question come up, there is no doubt in my mind Congress would have said: "We do not care what the donor of a conservation easement does for a living. We do not care if the donor is a farmer or rancher or investment banker or real estate developer. We believe the test should be whether important conservation values are being protected. If important conservation values are being protected, the donor should be entitled to an income tax deduction for the full fair market value of the conservation easement."

Section 170(h) became law in December 1980 after hearings on the subject and extensive congressional committee reports. There was not a word on the dealer/inventory/capital asset issue because the issue never came up. The statute and the regulations talk about scenic enjoyment, habitat, governmental policy, significant public benefit, and the valuation of conservation easements. It is clear that the emphasis in the statute and the regulations is on meeting the conservation purposes tests, not on the donor's race, religion, sex, or line of business. For purposes of section 170(h), those matters should make no difference.

Also, ample authority exists for the proposition that a perpetual conservation easement and the fee interest are

to be analyzed separately for federal income tax purposes. (A longer discussion of that point is beyond the scope of this article, but see, for example, *Pasqualini v. Commissioner*, 103 T.C. 1, *Doc 94-6784*, *94 TNT 139-11* (1994); I.T. 4003, 1950-1 C.B. 10; *Commissioner v. P.G. Lake Inc.*, 356 U.S. 260 (1958); LTRs 9621012, *Doc 96-15572*, *96 TNT 104-45*, and 200201007, *Doc 2002-337*, *2002 TNT 4-21*; Rev. Rul. 72-601, 1972-2 C.B. 467.)

All that having been said, however, it is now understood that the IRS believes that for capital asset/inventory characterization purposes a conservation easement retains the same character as the underlying fee from which it has been unbundled. What does this mean for a real estate developer? It means that assuming the developer/donor can deal satisfactorily with the other deduction and valuation issues described above, the IRS's belief is that a restrictive conservation easement donated by a developer on 100 acres of land with extraordinary conservation qualities will be deductible at full fair market value only if it can be established that the 100 acres is not inventory.

I do not agree with that position and I believe it makes no sense as a matter of tax policy. Here is an example of a result that makes no sense. Under the regulations, it is clear that some additional limited residential development is permitted under qualifying conservation easements; see Example (4), Treas. reg. section 1.170A-14(f), allowing a number of reserved house sites under a conservation easement. Assume that with careful planning, Aunt Sally could craft a conservation easement allowing two reserved house sites on her 100-acre property, and assume that easement would meet all the requirements of section 170(h). By no stretch of analysis could the 100 acres, or the house sites, or the easement, be considered inventory, and a full fair market value deduction for the easement would be allowed. Should the result be any different if XYZ Development Co. owned the same piece of land and donated the same easement? If the reserved lots are inventory, the IRS seems to believe the result is different under section 170(e)(1)(A).

With the increased level of scrutiny of conservation easement donations announced by the IRS in Notice 2004-41, developers and their advisers need to be aware of these rules and need to understand what works and what doesn't. A conservation easement on a large contiguous block of uninterrupted open space on land that is not held as inventory is a good starting point. That should be accompanied by an accurate appraisal, taking into account the special conservation easement appraisal rules, and assuming a market-based (rather than fictional) level of development that is extinguished by the easement. Finally, of course, in some situations an income tax deduction that is limited to the basis of the asset contributed may be enough of an income tax deduction to make the transaction work for the donor.

Here is a final observation on the capital asset-inventory issue. Unfortunately there is no "silver bullet" in the code or the cases to point to that would substantiate my belief that Congress would have made a different decision had the question been asked in 1980. Perhaps one of the taxwriting committees could resolve this policy matter with the following language in the appropriate committee report.

> The Committee confirms that, consistent with tax policy since 1980, when the tax incentives under Section 170(h) were codified, a perpetual conservation easement that is a qualified real property interest under Section 170(h)(2)(C) shall be treated for purposes of Section 170(e)(1)(A) as an asset separate and distinct from any underlying fee interest. Therefore, such a qualified real property interest shall be treated as a capital asset in all cases (unless the donor is engaged in a regular business of selling conservation easements to customers). The Committee notes that such capital asset treatment is also consistent with established capital asset treatment of a perpetual conservation easement as "like-kind" investment property under Section 1031(a)(1).

IX. Three Suggestions for Better Enforcement

As noted above, I believe the single biggest reason for "bad" conservation easement transactions is an inflated income tax deduction by way of an inflated appraisal. If we want to focus on bad appraisals, my first suggestion is that in its effort to collect more useful information the IRS might think about some additional questions on the Form 8283 (or some other form) specifically for conservation easement transactions.

Here is a short list of some questions that might be asked. It is important to understand that for many transactions that are legitimate and correct in every way the answers to one or more of these questions will be yes. However, it seems to me that if a donor answers yes to, say, four or more of these questions, there are indicia that the transaction might warrant further scrutiny. As always, when a taxpayer claims an income tax deduction the burden is on the taxpayer to substantiate the deduction, and in legitimate transactions done correctly the taxpayer will have no trouble doing that. I further believe that simply the existence of these questions on an IRS form will start to turn the tide against the "promoters" and appraisers who think that this field is another place to make a quick buck.

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?

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 that is different from the 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?

9. Has the property been part of any submission to authorities for zoning or 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?

My second suggestion is that in some states the taxing authorities can assist the IRS in its enforcement efforts in this field. A number of states now have state income tax credits for conservation easement donations; in Colorado and Virginia, those credits are refundable and transferable. In South Carolina, which has a state income tax credit for conservation easement donations, the Department of Revenue has mailed out a "Land Trust Desk Audit" to organizations it believes have accepted conservation easements in South Carolina, requesting copies of Forms 8283, information on monitoring and enforcement of easements, and information on conservation easements that were "granted pursuant to a proposed development. . . ." (I have posted a copy of the Desk Audit letter, with the permission of the Department, on my Web site at http://www.stevesmall.com.) Other states may want to follow suit.

Finally, donee organizations need to step up. Right above the signature on the "Donee Acknowledgment" portion of Form 8283, the form notes, "This acknowledgment does not represent agreement with the claimed fair market value." I understand many donees have executed Form 8283 before the claimed deduction amount has been filled in; although that appears to be legal this practice should stop.

Further than that, however, I have been urging donee organizations to adopt policies on how to deal with a completed Form 8283, presented for signature, when the claimed deduction shocks the conscience of the donee representative who is signing. The form of course means what it says, that the acknowledgment does not represent agreement with the claimed deduction. Donee organizations are not responsible for substantiating the claimed deduction, but they are responsible for doing the right thing. In the good old days that was not an issue but it is now.

Last year The Nature Conservancy appointed an outside governance advisory panel to review certain TNC operations and make recommendations. While the full scope of the panel's work and recommendations is beyond the scope of this article, the panel recommended that TNC review donors' appraisals and, under certain circumstances, refuse to sign a Form 8283. I applaud those recommendations, and I urge other easement donees to take a careful look at them and to adopt appropriate policies to deal with these matters.

Charitable contributions deduction for gift of land

SECTION 43. A. Section 12-6-1130 of the 1976 Code, as last amended by Act 363 of 2002, is further amended by adding:

"(12) The deduction for charitable contributions allowed by Section 170 of the Internal Revenue Code is determined in the same manner as provided in Section 170 of the code except that no deduction is allowed unless, in addition to the requirements of Section 170 of the Internal Revenue Code, the contribution also meets the requirements of Section 12-6-5590."

B. Section 12-6-3515(B)(1) of the 1976 Code, as added by Act 283 of 2000, is amended to read:

"(B)(1) For purposes of this section:

(a) 'Qualified conservation contribution' and a 'qualified real property interest' are defined as provided in Internal Revenue Code Section 170(h);

(b) 'Gift of land for conservation' means a charitable contribution of fee simple title to real property conveyed for conservation purposes as defined in Internal Revenue Code Section 170(h)(4)(A) to a qualified conservation organization as described in Internal Revenue Code Section 170(h)(3); and

(c) No credit is allowed pursuant to this section unless the contribution meets the requirements of Section 170 of the Internal Revenue Code, this section, and Section 12-6-5590."

C. Section 12-43-232(3)(c) and (d) of the 1976 Code is amended to read:

"(c) Real property idle under a federal or state land retirement program or property idle pursuant to accepted agricultural practices is agricultural real property if the property otherwise would have qualified as agricultural real property subject to satisfactory proof to the assessor.

(d) Unimproved real property subject to a perpetual conservation easement as provided in Chapter 8 of Title 27 is agricultural real property if the property otherwise would have qualified as agricultural real property subject to satisfactory proof to the assessor."

D. Article 6, Title 12 of the 1976 Code is amended by adding:

"Section 12-6-5590. (A) No credit under Section 12-6-3515 or deduction under Section 170 of the Internal Revenue Code and Section 12-6-1130(12) shall be allowed for a contribution unless the donor has the donative intent required by Section 170 of the Internal Revenue Code and the regulations and cases interpreting Section 170 of the Internal Revenue Code.

(B) In addition to the donative intent required by Section 170 of the Internal Revenue Code, no credit under Section 12-6-3515 or deduction under Section 170 of the Internal Revenue Code and Section 1-6-1130(12) shall be allowed for any noncash charitable contribution in the claimed amount of $100,000.00 or more unless the donor has the requisite donative intent required by this section.

(C) The requisite donative intent includes the requirement that the donor be motivated by detached and disinterested generosity benefiting a charitable purpose rather than expected economic benefit.

(D) A noncash charitable contribution by a donor given to comply with any state or federal environmental or

other regulatory requirement; for the purpose of obtaining road, water, or sewer services; or in conjunction with obtaining a grant, subdivision, building, zoning, environmental, mitigation, or similar permit or approval from any government, shall be deemed not to have the requisite donative intent absent extraordinary circumstances.

(E) A contribution of an otherwise 'qualified contribution' as defined in Section 170(h) of the Internal Revenue Code shall be deemed not to have the requisite donative intent if the underlying property is used for, or associated with, the playing of golf, or is planned to be so used or associated.

(F) The department shall examine the substance, rather than merely the form of the contribution and related and surrounding transactions, and may use the step transaction, economic reality, quid pro quo, personal benefit, and other judicially developed doctrines in determining whether the requisite donative intent is present."

Local, State and Federal Tax Incentives for Conservation Easements

Second Edition

The Honorable Mark Sanford, Governor
Burnet R. Maybank, III, Director

March 2005

Only selected pages of this report are included. For further information, please see complete report.

qualify for a deduction under this Section. The fair market value of the easement is $25,000 (the fair market value of the property before the easement, $125,000, minus the fair market value of the property after the easement, $100,000). Pursuant to 1.170A -14(h)(3)(iii), the basis allocable to the easement is $10,000 and the basis of the underlying property (building and lot) is reduced to $40,000.

J. Cautionary Note on Valuations

Recent perceived abuses of the valuation of conservation easements has generated considerable scrutiny by the U.S. Senate Finance Committee,[236] the media[237] and the South Carolina Department of Revenue. A desk audit of some 55 land trusts doing business in South Carolina has disclosed breathtaking valuations of conservation easements, some on property which was recently purchased for a fraction of the claimed value of the easement.

> Inflation or ignorance of the valuation rules can lead to enormous and potentially unwarranted tax deductions. Using a transaction described in the national press, suppose a developer purchases a piece of property for $10 million, places some conservation easements on unbuildable ground, e.g. protected wetlands, subdivides the remainder, promotes the protected areas as part of the marketing of the housing project, and then claims tax deductions of over $20 million for the purported reduction in value. This transaction raises several red flags, in my view. First of all, adding an additional layer of protection to the wetlands is unlikely to diminish the value of the property. Second, if the protected areas increased the value of the remaining land, the amount of the charitable deduction must be reduced by the amount of that increase. Finally, if the property was purchased for $10 million, there are only a few scenarios under which the easements could be worth double that, none of which appear likely. First, the purchase could have been from an unsophisticated seller ignorant of the market value of the property. Second, the developer could have purchased property zoned for uses other than a housing subdivision, and obtained favorable zoning variances that resulted in an increase in property values. Although below-market purchases and rezones occur with regularity, the figures in the example strongly suggest an exaggeration of the value of the conservation easement.[238]

In particular, use of the subdivision development analysis can produce aggressive or abusive easement values.

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[236] *See* Options to Improve Tax Compliance and Reform Tax Expenditures, Joint Committee on Taxation, Jan. 27, 2005.

[237] See J. Stephens and D. Ottaway, *Developers Find Payoff in Preservation*, Washington Post, p. A01 (Dec. 21, 2003); John P. McDermott, *Tax Auditors Scrutinize Land Dealings,* Post and Courier, p. A1 (Jan. 16, 2005); John O'Connor and Gina Smith, *Conservation Easements Face Scrutiny*, The State, p. B1 (Feb. 20, 2005); and Paul Alongi, *Fraudulent Preserves Costing Taxpayers*, The Greenville News, http://greenvilleonline.com/news/2005/02/27/2005022759517.htm (Feb. 28, 2005).

[238] H. Barton Thomas, *Conservation Easements: Tax Facts and Fictions*, 47-Mar Advocate (Idaho) 13 (2004). The example is taken from a Washington Post article, *supra.*

> The subdivision development analysis appears to be gaining in popularity as the rigueur method of determining the before-easement value of land in conservation easement appraisal. That is troubling for a number of reasons. First, the subdivision development analysis can produce unrealistically high values if the appraiser overestimates the gross proceeds realizable from the imagined development, or, more importantly, fails to account for all of the costs and risks associated with the development in a detailed and realistic manner. Even minor errors in the discount rate applied to the estimated gross proceeds from the imagined development can create large variances in the ultimate value determined. Second, no matter how much care and skill is employed in preparing a subdivision development analysis, its estimate of fair market value will almost always be more speculative that the estimate obtained using a more traditional appraisal method, such as the sales comparison approach. Third, many, if not most easement appraisers who employ the subdivision development analysis to determine the before-easement value of land are likely doing so in contravention of established appraisal rules, which dictate that such analysis should be used as the sole or primary appraisal method only in relatively rare circumstances. Generally, two conditions must be present before the subdivision development analysis can be used to establish the value of land: (i) the "highest and best use" of the land must not be available because comparable sales do no exist, or are so few and dissimilar to the subject property that a sales comparison approach would involve unacceptably speculative adjustments and assumptions. Finally, the complexity involved in the subdivision development analysis makes abusive before-easement valuations difficult for the IRS to recognize and refute.[239]

Similarly, A Conservation Easement Appraisal Guide[240] published by the Colorado Coalition of Land Trusts, states on page 24:

> (1) There are six interrelated techniques for valuing land as vacant:
>
> (a) Sales Comparison
> (b) Allocation
> (c) Extraction
> (d) Subdivision Development NOTE – This technique results in very misleading indications of property value when it is not used extremely carefully. This technique should not be used unless the highest and best use of a property is for division and development within a reasonably short period of time, when costs of development can be accurately identified, when potential sale prices of resulting parcels can be estimated, and when realistic adsorption rates can be supported by market evidence.
> (e) Land Residual

[239] 31 Ecology L.Q. 1, 84-85 (footnotes omitted).
[240] http://www.cclt.org/downloads/CCLT_Appraisal_Guide_6_01_04.pdf

(f) Ground Rent Capitalization

The leading appraisal treatise, *The Appraisal of Real Estate,*[241] defines the subdivision development analysis as

> [a] method of estimating land value when subdivision and development are the highest and best use of the parcel of land being appraised. Direct and indirect costs and entrepreneurial profit are deducted from an estimate of the anticipated gross sales price of the finished lots and, the resultant net sales proceeds are then discounted to present value at t market-derived rate over the development and absorption period to indicate the value of the raw land.

The Appraisal Institute notes that the "subdivision development analysis is a complex procedure. When used on its own without an abundance of reliable market data, it can be the least accurate raw land valuation technique."[242] Lastly the Institute states that "the use of subdivision development analysis to value vacant land is most applicable when sales data on vacant lots of land is inadequate," which is generally not the case in South Carolina.

A current or prospective value opinion for property subject to completion of proposed improvements (such as a hypothetical subdivision) can be provided in compliance with USPAP.[243] USPAP Advisory Opinion 17 notes, however, that "[a]n appraisal of real property with proposed improvements presents complex analysis and reporting issues because some portion of the property appraised does not exist at the time of the appraisal. Consequently, an appraiser must use particular care when performing an appraisal of such property to ensure that the results are credible and the appraisal report is not misleading."

The subdivision or lot analysis was at issue in a property tax case, *Spartanburg County Assessor v. River Falls Plantation Golf.*[244] The positions of the parties were reversed in that case, with the assessor arguing for a modified subdivision analysis. The litigation involved the valuation of 4.51 acres located in the River Falls Plantation Golf subdivision. The assessor arrived at his valuation using three comparables, all of which were individual lots sold by the taxpayer. Comparable No. 1 was 0.67 acres, which sold for $62,000 ($92,537/acre); comparable No. 2 was 0.57 acres, which sold for $53,010 ($93,000/acre); and comparable No. 3 was 2.34 acres, which sold for $188,100 ($80,385/acre.) After making various adjustments, the assessor determined the fair market value of the 4.13 acres to be $213,000 or $47,228 per acre. The assessor also relied on a preliminary unrecorded plat. The taxpayer appealed and the Board of Assessment Appeals, apparently rejecting the assessor's use of the subdivision analysis, held that the property was only worth $67,650, or $15,000 per acre. The Administrative Law Judge agreeing with the board, stated as follows:

> Fair market value is the measure of true value for taxation purposes. There is no valid distinction between market value for sales purposes and

[241] *The Appraisal of Real Estate* 343 (12th ed., Appraisal Institute).
[242] *Id.* at 342.
[243] *See* USPAP Advisory opinion 17 (AO 17).
[244] 1999 WL 1016066 (S.C. Admin. Law Judge Div.)

market value for taxation purposes under S. C. Code Ann. § 12-37-930 (Supp. 1998).

In this case, the subject property is undeveloped raw land. The condition of this property has not changed since its appraisal in tax year 1997. There is no recorded plat which divides this property into lots and the Assessor has assigned this tract of land one tax map number.

Furthermore, even if the taxpayer had recorded the plat of the property, the South Carolina Supreme Court has consistently held that platting, by itself, does not change the value or nature of property.

Therefore, I find that the Assessor's evidence of the fair market value of the property is not persuasive and that the land should be assessed and valued as undeveloped raw land. Furthermore, I find that the value placed on the subject property by the Board is appropriate.[245]

CHAPTER IX. SUBSTANTIATION AND APPRAISAL REQUIREMENTS

A. General Filing and Appraisal Requirements

In order to deduct the value of a gift of a conservation easement with a fair market value in excess of $5,000, the taxpayer will need to complete and file (1) IRS Form 1040 Schedule A, (2) Form 8283 Part B, and (3) an appraisal summary. The donor will also need to have previously obtained a qualified written appraisal. (Note that the requirements applicable to the substantiation of deductions claimed by an individual, closely held corporation, personal service corporation, partnership or S corporation[246] differ than that for C corporations.[247] Certain of these requirements are discussed below.) In recent Notice 2004-41, the IRS noted that

> [a] charitable contribution is allowed as a deduction only if substantiated in accordance with regulations prescribed by the Secretary. . . . In appropriate cases, the Service will disallow deductions for conservation easement transfers if the taxpayer fails to comply with the substantiation requirements. The Service is considering changes to forms to facilitate compliance with and enforcement of the substantiation requirements.

The American Jobs Creation Act of 2003 (AJCA),[248] codified the substantiation requirements found in the regulations into IRC § 170(f)(11)(B). The AJCA also added a requirement that the *entire* qualified written appraisal, and not just the summary, be attached

[245] 1999 WL 1016066, *supra*, at p. 3 (citations omitted).
[246] Treas. Reg. § 1.170A-13(c).
[247] Treas. Reg. § 1.170A-13(c)(2)(ii).
[248] Pub. Law No. 108-357

Section B of Form 8283 even if the amount allocated to each partner or shareholder does not exceed $5,000.

The partnership or S corporation must give a completed copy of Form 8283 to each partner or shareholder receiving an allocation of the contribution deduction shown in Section B of the partnership's or S corporation's Form 8283.

Partners and shareholders. The partnership or S corporation will provide information about your share of the contribution on your schedule K-1 (Form 1065 or 1120S).

In some cases, the partnership or S corporation must give you a copy of its Form 8283. If you received a copy of Form 8283 from the partnership or S corporation, attach a copy to ~~of~~ your tax return. Deduct the amount shown on your Schedule K-1, not the amount shown on the Form 8283.

If the partnership or S corporation is not required to give you a copy of its Form 8283, combine the amount of noncash contributions shown on your schedule K-1 with your other noncash contributions to see if you must file Form 8283. If you need to file Form 8283, you do not have to complete all the information requested in Section A for your share of the partnership's or S corporation's contributions. Complete only column (g) of line 1 with your share of the contribution and enter "From Schedule K-1 (Form 1065 or 1120S)" across columns (c) – (f).

G. Filing Requirements for C Corporations after AJCA

Previously, prior to passage of the American Jobs Creation Act of 2004, when a C Corporation made a charitable donation of an item valued at more than $5,000 (other than certain artwork), it was required to attach Form 8283, Non-Cash Charitable Contributions, to its return but was generally not required to obtain a qualified written appraisal. The AJCA now requires a qualified written appraisal of any non-cash charitable contributions of $5,000 or more. Note that this provision was made retroactively effective for contributions made after June 3, 2004.

H. Appraisals, Valuations and Land Trusts

As stated above, the Form 8283 is not required to contain the appraiser's valuation of the conservation easement at the time it is executed by the donee/land trust. In many cases, however, the 8283 will contain the valuation, and federal law provides that in such cases the execution of the 8283 by the land trust does not represent concurrence with the appraised value.

As noted above, the Regulations require government agencies and land trusts to sign the appraisal summary for every easement donation they accept, effectively precluding such entities from claiming to be totally ignorant of the values asserted for donated easements. On the other hand, the Regulations do not impose liability on easement donees for abusive or erroneous valuations.

> Thus, the degree of donee involvement in the valuation process is left to the donees.
>
> The guidebook created by the LTA to help land trusts understand and implement the Standards and Practices (the "LTA Guidebook") discusses an easement donee's responsibility with respect to appraisals at some length. The LTA Guidebook essentially advises donees to walk a fine line: they should be as helpful to the donor and the donor's appraiser as possible without taking on liability by purporting to sanction an appraisal. When an easement donee becomes aware of an apparently abusive easement appraisal, the LTA Guidebook suggests the following responses: (i) simply informing the landowner of the donee's opinion that the appraisal is suspect or abusive, (ii) having the land trust's attorney inform the landowner in writing, with explicit reference to the overvaluation penalties the landowner might face, (iii) suggesting the landowner obtain another appraisal, and (iv) refusing to proceed with the transaction.
>
> The LTA Guidebook cautions that easement donees have an interest in discouraging valuation abuse for the following reasons: easement donees will want to avoid the appearance of being a party to a transaction that unfairly benefits a private individual; easement donees will want to maintain their credibility in the community; and easement donees will want to avoid situations where irate donors blame them when the IRS challenges the donors' easement valuations. In addition, the stakes are high for the land trust community in general. If valuation abuse increases to the point where it creates a public opinion backlash, the credibility of the land trust community with the public and Congress could be damaged, and the tax incentives offered with respect to easement donations could be reduced or eliminated.[265]

The Law Review article quoted above makes reference to policies of the Land Trust Alliance. The Land Trust Standards and Practices reads in part:

> Practices
>
> - A. Tax Code Requirements. The land trust notifies (preferably in writing) potential land or easement donors who may claim a federal or state income tax deduction, or state tax credit, that the project must meet the requirements of IRC § 170 and the accompanying Treasury Department regulations and/or any other federal or state requirements. The land trust on its own behalf reviews each transaction for consistency with these requirements.
>
> - B. Appraisals. The land trust informs potential land or easement donors (preferably in writing) of the following: IRC appraisal requirements for a qualified appraisal prepared by a qualified

[265] 31 Ecology L.Q. at 78-79.

PROPOSED AMENDMENT TO § 170(h)

IRC § 170(h) is amended by adding:

(A) No deduction under Section 170 of the Internal Revenue Code shall be allowed for a contribution unless the donor has the donative intent required by Section 170 of the Internal Revenue Code and the regulations and cases interpreting Section 170 of the Internal Revenue Code.

(B) In addition to the donative intent required by Section 170 of the Internal Revenue Code, no deduction under Section 170 of the Internal Revenue Code shall be allowed for any noncash charitable contribution in the claimed amount of $100,000.00 or more unless the donor has the requisite donative intent required by this section.

(C) The requisite donative intent includes the requirement that the donor be motivated by detached and disinterested generosity benefiting a charitable purpose rather than expected economic benefit.

(D) A noncash charitable contribution by a donor given to comply with any state or federal environmental or other regulatory requirement; for the purpose of obtaining road, water, or sewer services; or in conjunction with obtaining a grant, subdivision, building, zoning, environmental, mitigation, or similar permit or approval from any government, shall be deemed not to have the requisite donative intent absent extraordinary circumstances.

(E) A contribution of an otherwise 'qualified contribution' as defined in Section 170(h) of the Internal Revenue Code shall be deemed not to have the requisite donative intent if the underlying property is used for, or associated with, the playing of golf, or is planned to be so used or associated.

(F) The Internal Revenue Service shall examine the substance, rather than merely the form of the contribution and related and surrounding transactions, and may use the step transaction, economic reality, quid pro quo, personal benefit, and other judicially developed doctrines in determining whether the requisite donative intent is present."

June 22, 2005

Per Senator Grassley's letter of June 13th, you will please find below the questions posed by Senators Bunning and Rockefeller, together with my response.

From Senator Bunning

1. HOW MUCH WOULD THE ABUSE PROBLEMS ASSOCIATED WITH GIFTS OF CONSERVATION AND FAÇADE EASEMENTS BE ALLEVIATED BY VIGOROUS IRS ENFORCEMENT AND EFFECTIVE APPRAISAL REFORM?

More vigorous IRS enforcement would obviously be positive but it would not solve the major abuses. Effective appraisal reform would be much more helpful.

2. WOULD THE PANELISTS PLEASE GIVE ME THEIR BEST IDEAS ON WHAT THE I.R.S. AND CONGRESS CAN DO TO MAKE SURE APPRAISALS FOR LAND DONATIONS ARE ACCURATE?

Appraisals are as much an art as a science, so there is no easy answer. Congress and the IRS have already done a good job enacting penalty provisions so this is not the solution. The easy answer would be to simply ban use of the subdivision development analysis as an appraisal technique for charitable donations of real property (both easements as well as outright gifts), and limit valuation to comparable sales of similar tracts of land.

Another would be to statutory adopt the appraisal guidelines promulgated by the Appraisal Institute. (These guidelines are currently not binding on the Tax Court.)

Use of "baseball arbitration" would also be extremely helpful, although the Courts may feel this violates Separation of Powers.

Greater disclosure on the Form 8283 would also help police the appraisal. I attached to my testimony an article by Stephen Small which listed a series of questions which could be included in the 8283 form.

3. SHOULD THE PENALTIES CURRENTLY IN PLACE FOR BAD APPRAISALS BE CHANGED? IF SO, WHO SHOULD THOSE PENALTIES BE ASSESSED AGAINST? APPRAISERS? CHARITIES? DONORS?

I think with one or two exceptions, the penalties for bad appraisals are largely adequate. There are so many judgment calls in the appraisal process that it is very difficult to impose penalties. Under South Carolina law, however, if a charitable (or other) deduction is grossly excessive it can add two years to the statute of limitations. (The statute of limitations is 5, rather than 3, years.) I would encourage Congress to adopt a five year statute under such circumstances.

The IRS could probably make greater use of Circular 230 to police the ranks of appraisers. The South Carolina Department of Revenue certainly intends to do so at the appropriate time. (South Carolina adopts Circular 230 as part of Federal Tax Conformity.)

Current law explicitly provides that the charity is not responsible for the appraisal of a donated item and I think most would agree with this notion, and particularly in reference to easements.

Increased penalties should fall on the appraiser. One exception would be to penalize the taxpayer for failing to adequately disclose quid pro quos to the appraiser.

4. WHAT WOULD YOU SAY IS THE NUMBER ONE AREA OF SELF-GOVERNANCE WHERE MANY CHARITIES FALL SHORT? WHAT IS THE SINGLE CHANGE THAT A CHARITY CAN MAKE IN THIS AREA TO HAVE THE BIGGEST IMPACT?

In the easement area, it would be a lack of enforcement of easements, particularly on the part of smaller land trusts with all volunteer staffs. (Remember that there are NO statutory minimums or even guidelines, for the kind of minimum resources which a land trust must possess before taking an easement, or to what extent they should police the easement.) I would encourage Congress to legislatively adopt the LTA guidelines.

5. DO OUR PANELISTS THINK THAT MORE PUBLIC DISCLOSURE AND "SUNSHINE" RULES WILL HELP TO CURB ABUSES IN CHARITIES?

Yes, but only to a limited extent. As I stated in my testimony the abuses at TNC were completely unprecedented and have apparently been remedied. I do not think the Committee needs to adopt legislation based upon TNC.

6. ONE SUGGESTION PREVIOUSLY MADE BY THE FINANCE COMMITTEE STAFF IS THE PUBLIC DISCLOSURE OF FORM 990-T RETURNS, WHICH REPORT UNRELATED BUSINESS TAXABLE INCOME OF EXEMPT ORGANIZATIONS. PRIVACY CONCERNS HAVE BEEN RAISED BY SOME, INCLUDING THE AMERICAN INSTITUTE OF C.P.A.'S. CAN YOU COMMENT ON THE PROPOSAL FOR PUBLIC DISCLOSURE OF FORM 990-T'S AND ALSO ON HOW YOU THINK PRIVACY CONCERNS COULD BEST BE ADDRESSED?

There is little to no UBIT generated in the land trust/conservation easement/façade easement world. In my opinion, ignoring the UBIT rules regarding debt financed properties, sales by TNC to conservation minded buyers do not generate UBIT. UBIT is a major issue, however, with some charities and is rapidly growing. I personally see no privacy issues.

7. MR. MAYBANK, SINCE MUCH OVERSIGHT OF PUBLIC CHARITIES IS THE RESPONSIBILITY OF THE STATES, WHAT CAN CONGRESS AND THE I.R.S. DO TO MAKE THEIR OVERSIGHT JOB EASIER?

The U.S. Supreme Court, in a series of commercial free speech decisions dealing with charitable fund raising, has limited the states of any substantive review of charities. One important step would be to delegate to the states the ability to revoke the 501(c) status of the charity in that state. For example, the South Carolina Department of Revenue reviewed the activities of a Commercial Credit Counseling Agency in South Carolina. However, since the DOR does not grant 501(c) status we have no authority to revoke it.

From Senator Rockefeller

8. THE COMMITTEE REPORT DISCUSSES THE POSSIBILITY OF REQUIRING ACCREDITATION FOR ORGANIZATIONS THAT RECEIVE CONSERVATION EASEMENTS. THE NOTION IS THAT ONLY ORGANIZATIONS THAT HAVE THE EXPERTISE AND RESOURCES TO MONITOR AND ENFORCE THE EASEMENTS CAN ASSURE THAT TAXPAYERS REALLY RECEIVE THE BENEFITS OF THE CONSERVATION EASEMENTS.

THERE HAS BEEN A GREAT DEAL OF DEBATE ABOUT WHETHER IT WOULD MAKE SENSE FOR THE GOVERNMENT TO CREATE A SPECIFIC ACCREDITATION PROCESS FOR CONSERVATION ORGANIZATIONS.

I WOULD LIKE EACH OF YOU TO TELL ME WHETHER YOU THINK IT WOULD BE PRUDENT FOR THIS COMMITTEE TO CONSIDER LEGISLATION TO CREATE AN ACCREDITATION PROCESS. AND IF WE SHOULD CREATE SUCH A PROCESS, HOW COULD WE ACCOMMODATE THE UNIQUE NEEDS OF SMALL ORGANIZATIONS?

It would be difficult for Congress to legislate an accreditation process, and, were you to do so, a host of accreditation organizations (other than the LTA) would immediately spring up. These new accreditation organizations would naturally be sympathetic to the groups that founded them, i.e., "Golf Course Easement Alliance," "The Martha Vineyard's Backyard Easement Alliance," etc. and little would be accomplished.

I feel that adopting minimum standards for resources and enforcement would accomplish much more than requiring accreditation. Again, I would encourage the

Committee to enact many of the LTA guidelines as law. While the LTA guidelines are not very precise, and it will not be easy for the IRS or the states to enforce them, recall there are NO statutory guidelines today.

Yours very truly,

Burnet R. Maybank, III
Director

BRM/afw

Statement of Steven J. McCormick
On Behalf of The Nature Conservancy
Hearing before the Committee on Finance
United States Senate
The Tax Code and Land Conservation
June 8, 2005

Mr. Chairman, Senator Baucus and members of the Committee, thank you for the opportunity to present the views of The Nature Conservancy at this hearing on tax incentives for land conservation and on your report on our organization and our conservation practices. I am Steve McCormick, the President and CEO of The Nature Conservancy.

The Nature Conservancy is an international, nonprofit organization dedicated to the conservation of biological diversity. Our mission is to preserve the plants, animals and natural communities that represent the diversity of life on Earth by protecting the lands and waters they need to survive. Our on-the-ground conservation work is carried out in all 50 states and in 27 foreign countries and is supported by approximately one million individual members. We have helped conserve nearly 15 million acres of land in the United States and Canada and more than 102 million acres with local partner organizations globally.

The Conservancy owns and manages approximately 1,400 preserves throughout the United States—the largest private system of nature sanctuaries in the world. We recognize, however, that our mission cannot be achieved by core protected areas alone. Therefore, our projects increasingly seek to accommodate compatible human uses, and especially in the developing world, to address sustained human well-being.

The past two years have been a challenging time for The Nature Conservancy. Having just run the triple gauntlet of a newspaper series, a Senate committee investigation and an IRS audit, I want of all my colleagues at the Conservancy to know how proud I am of the way they have responded to the challenge. Thousands and thousands of actions and transactions conducted by the people in our organization over the past decade have been held up to the closest scrutiny and, based on that examination, I am confident in saying that all of our work is, and has been, in compliance with the applicable laws and regulations and motivated by the sincerest commitment to our

mission. Not everything we tried has succeeded and on occasion we made mistakes, but all of our work was done in good faith.

During this period, we have come to realize that we must hold ourselves to a higher standard—one beyond mere compliance with the law and service to our mission. In this spirit, over the past two years we have conducted an extensive and rigorous internal review to strengthen our governance, increase accountability to our mission and make our actions more transparent to our donors and the public. Therefore, I can also tell you with confidence this morning that, today, we consistently meet higher standards of ethical conduct and organizational efficiency than we did two years ago.

These internal reforms have not been easy. Our structure is highly decentralized with the work and the responsibility located principally in the state and country programs. We have thrived on a culture that provided freedom for risk-taking and celebrated bottom-up innovation. These changes have challenged us.

It takes a real commitment of resources and diligence to train thousands of employees and volunteer trustees in new policies and procedures, so that a new standard of conduct is actually reflected in every day practice.

And we have had to realize that, occasionally, we must turn away from attractive opportunities that would be in full compliance with the law and would provide highly valuable land or water conservation because the deal cannot be made to reach the highest ethical standards.

So, it's been tough work. But we are doing it. And we will need to continue to work at it, because we have learned along the way that our efforts to reach for the very best practices will never be fully completed. An organization truly committed to the highest ethical standard must never think that the goal has been reached.

Now that the inquiry conducted by the Finance Committee staff has finally come to a conclusion, it is with some sense of commitment honored that we tell the Committee that we have fully complied with every information request made by your staff over the past two years. From the outset we made every effort to meet all deadlines and address all of the concerns that you have raised. In addition to supplying the requested information, we have also provided narrative and background material to enable the Committee to better understand the often complex transactions that are sometimes needed to protect highly-threatened biodiversity on lands that are privately owned.

It has not been easy. People all across our organization added nights and weekends to their workloads in order to carry on with the mission and at the same time provide the thousands of documents necessary to inform your oversight. I cannot thank the many, many Conservancy staff involved in this effort enough. I especially want to acknowledge the work of Karen Berky, our Chief Compliance Officer, and Phil Tabas, our General Counsel, who led the effort from inception and gave most of their professional lives over the past two years to this inquiry, for the meticulous work they have done in proving our record. We at the Conservancy owe them our deepest gratitude, respect and admiration.

I would also like to thank the thousands of donors, trustees and members of the Conservancy who have never flagged in their commitment and generosity during this period. It has been truly rewarding to have their friendship and to know that their support for our work has been sustained over these many months.

The Importance of Land and Easement Donations as Conservation Tools

The subject of your hearing this morning, the federal tax incentives encouraging the donation of conservation lands and easements, is of vital importance to the environmental health of our country. I would dare say that, today, conservation easements are the principal tool that is advancing the cause of environmental protection in the United States. Our nation experienced a very public revolution in its view of the natural environment in the 1970s and Congress responded with a series of laws from the Clean Air and Clean Water Acts to the Endangered Species and the Fisheries Management and Conservation Acts. The government agencies and regulatory programs they launched allowed us to make significant progress improving the quality of our environment through the early 1990s. But in the minds of many, that approach seems to have reached the limit of its effectiveness and for the last decade and a half the nation has been searching for new tools that are market-based and landowner-friendly.

A second environmental revolution is underway right now, and conservation easements are a principal tool in that work. Easements are one of the most powerful and effective means available for the conservation of private lands and the biodiversity they support. Easements are successfully protecting millions of acres of wildlife habitat, natural areas and a way of life for many farming and ranching families in the United States and many other countries.

A conservation easement is a restriction placed on a piece of property to protect its ecological or open-space values. It is a voluntary, legally-binding agreement that limits certain types of uses or prevents development from taking place in perpetuity. The easement is an agreement between a landowner, who voluntarily agrees to donate or sell certain rights associated with his or her property (such as the right to subdivide and develop) to a private organization or public agency that agrees to hold the landowner's promise not to exercise those rights.

As public policy is becoming more sensitive to the rights of private property owners, and we appreciate the need to provide financial incentives for the contribution they make through their wildlife stewardship practices, the many attractive features of conservation easements as a public policy tool are clear. Under conservation easements:

- Property remains privately owned and landowners often continue to live on the property;
- Many types of private land use, such as farming, ranching and timber harvesting, can continue;
- The land can remain productive, generating jobs and tax revenues to support local government services; and
- The tax benefits are a flexible financial incentive for good stewardship that a landowner can tailor to meet his or her own needs.

There has been dramatic growth in the use of easements as a conservation tool since the beginning of the 1990s. This growth is supported by the tax incentives that Congress, under the leadership of this Committee, has thoughtfully enacted, by the support of similar incentives in the tax laws of many states and by the success that easements have realized in practice.

- There are now more than 1200 land trusts in the United States and more than 600 accept and manage easements as one of their activities;
- As of 2000, local and regional land trusts had protected nearly 2.6 million acres of lands through easements—a fivefold increase since 1990; and
- Between January 1997 and June 2003, the easement holdings of The Nature Conservancy grew from 645,000 acres to more than 2 million acres.

The Nature Conservancy is an organization dedicated to the protection of biodiversity pursuing its work by protecting the lands and waters that provide habitat for

the plants and wildlife that share our Earth. We are a charity. We do that work using the tools that this Committee has enacted. We want you to know how very important the tax incentives for conservation land and easement donations are to the future environmental health of our nation. They are the foundation for a second generation of environmental protection—a new era of biodiversity conservation on private lands is underway because of these incentives.

The Nature Conservancy's Mission and Method

How do we apply these tools in our work?

The Nature Conservancy was first incorporated as a nonprofit organization in 1951 and has grown to be the world's largest private land conservation and biodiversity protection organization with operations in all 50 states and 27 other countries. The Conservancy launched the first biological inventory of the United States in 1970 that became the basis for the Natural Heritage data system now maintained in each state and has been a leader in the science of biodiversity protection ever since.

The Conservancy takes a systematic, science-based approach to identifying sites for protection. Called *Conservation by Design,* this approach begins by identifying distinct divisions in the natural landscape defined by climate, geography and species – known as ecoregions. For each ecoregion, the Conservancy identifies a portfolio of high priority sites – those places that collectively capture the biological diversity of the region. The Conservancy then develops customized conservation strategies, ranging from outright acquisition, to environmental education, to working in partnership with private landowners to ensure lasting protection of these target sites.

The following principles describe The Nature Conservancy's approach to land conservation:

- The Nature Conservancy works collaboratively with partners – communities, businesses, government agencies, multilateral institutions, individuals and other nonprofit organizations.
- We employ the best available scientific information and practices to guide our conservation actions.
- We pursue non-confrontational, pragmatic, market-based solutions to conservation challenges.
- We tailor our conservation strategies and tools to local circumstances.

- We work across landscapes and seascapes at a scale large enough to conserve ecological processes and to ensure that protected lands and waters retain their ecological integrity.
- We work with willing sellers and donors, both public and private, to protect plants and wildlife through purchases, gifts, exchanges, conservation easements and management agreements and partnerships.
- Outside the United States, we work with government agencies and like-minded partner organizations to provide scientific information, infrastructure, community development, professional training and long-term resources.

The Conservancy has protected nearly 15 million acres of wildlife habitat in the United States. Some of these lands are in the more than 1,400 preserves owned and managed by the Conservancy. Other protected lands have been left in private ownership with permanent conservation easements or transferred to government agencies for management.

The Conservancy is a decentralized organization with its conservation activities focused in chapters in each of the 50 states and more than 400 offices around the world. The Conservancy employs more than 3,000 people, including 700 scientists engaged every day in research and management activities to improve habitat functions at high priority sites.

The work of the Conservancy is legally governed and guided by a 21-member national Board of Directors. The Conservancy also benefits from more than 1,500 unpaid, volunteer trustees who provide leadership and guidance to our programs.

The Conservancy has grown to be the largest conservation organization and one of the largest charities in the United States with assets of more than $3 billion (reflecting primarily the value of the land we own and manage) and a 2003 budget of nearly $350 million. By far, the most significant source of support and revenue to the Conservancy comes from its approximately one million members and other individual supporters. In fiscal year 2004, individuals contributed 64 percent and foundations 22 percent to the Conservancy's donated revenue. Business donations were 6 percent of our contributions and 8 percent came from other sources. In addition to gifts, the Conservancy receives funding from a wide variety of sources including government grants, investment income, and contracts.

Recently, the Conservancy launched a series of five initiatives reflecting the principal threats to important wildlife habitat at our sites including programs to address

invasive species, global climate change, impairment of freshwater quality, threats to marine life, and the alteration of natural fire regimes.

For several decades the Conservancy has worked closely with federal, state and local government agencies to assist them in acquiring key conservation lands for the benefit of the public. These projects help public agencies meet their mandate to conserve key natural resources and wildlife habitat. These projects also significantly help advance the Conservancy's mission. The Conservancy has had in place for nearly a decade a specific written policy of "no net profit" on sales of conservation lands to governmental entities. Over the years, the Conservancy has spent substantially more on land sales and associated costs on land transactions with the government than it has received in return.

The Nature Conservancy's work has resulted in gains not only for the natural world but for communities, private landowners and the public:

- In Maine's Katahdin Forest, our conservation approach led to the protection of core wilderness surrounded by ecologically compatible timber harvesting – and the preservation of local forestry jobs.

- In the Malpai Borderlands of New Mexico, Arizona and Mexico, it led to the creation of a public-private partnership that has effectively protected 800,000 acres from development and helped re-establish the natural fire regime across huge swaths of public and private lands.

- In the Blackfoot Valley of Montana, the Conservancy accepted the state's first conservation easement on 1,800 acres in the mid-1970s. Today, more than 50 river miles and 85,000 acres in the Blackfoot are covered by easements and it is one of the most intact landscapes in all of Montana.

- In Northwest Florida, The Nature Conservancy, the Department of Defense and the State of Florida have joined in a formal partnership to protect a 100-mile corridor of forest, rivers and wetlands that will buffer military bases and military flight paths while preserving the plant and animal life of these undeveloped lands. The first conservation easement fostered by this partnership, for more than 18,000 acres on the Nukose Plantation, was purchased in February 2005.

- And, in the Big Woods of Arkansas, as we all have recently learned, The Nature Conservancy's conservation approach led to the protection of essential habitat for the ivory-billed woodpecker, heretofore presumed extinct. There, more than 20

years ago, The Nature Conservancy began working with duck hunters, legislators and state and federal agencies to conserve rapidly disappearing bottomland hardwood forest – the shelter and lifeline into the 21st century for this extraordinary bird on the brink of extinction.

We are proud of this record.

Governance, Accountability and Transparency Reforms

The Conservancy has been and remains committed to carrying out this mission in accordance with the letter and spirit of all applicable laws and its organizational values, which speak to "integrity beyond reproach." In recent years, the Conservancy has grown substantially, both in absolute size and in the number and complexity of the transactions it undertakes to carry out its conservation mission. During this same period, policymakers and others have properly focused increased attention on the governance and activities of nonprofit organizations, including the Conservancy. We recognized a need to review and update our governance and accountability policies and procedures. We had undertaken that effort well before the series of reports on the Conservancy appeared in the *Washington Post.* Needless to say, our efforts to improve governance and accountability procedures within the Conservancy were accelerated by that examination and the inquiry of this Committee.

In June 2003, the Conservancy initiated a comprehensive effort to strengthen its general governance and its specific policies and procedures, including those applicable to its conservation programs. We convened a panel of independent experts to assist us with our governance review. The Governance Advisory Panel began its work in September 2003 and completed its review the following March. The panel presented a set of far-reaching recommendations to the Conservancy's Board of Directors. The Board and the Conservancy's management acted quickly to adopt and implement virtually all of the panel's recommendations. The panel's distinguished chairman, Ira Millstein, has just completed a one-year audit of the measures we have taken to implement the panel's recommendations. We are pleased that he is here this morning to describe that work to you.

The recommendations of the Panel and the changes we have made are intended to achieve the following goals: (1) enable the Conservancy's Board of Directors to provide increased strategic guidance and undertake more active oversight; (2) incorporate many of the governance principles contained in the Sarbanes-Oxley Act; (3) promote tax law

compliance by all parties to conservation transactions in which the Conservancy is a participant; (4) address on a comprehensive and consistent basis issues involving actual or potential conflicts of interest; (5) provide more specific rules guiding key conservation programs such as easements, conservation buyer transactions and sales to governments; and (6) ensure high-level advance review of transactions that may present financial, legal, ethical or other reputational risk to the Conservancy as a whole.

The Conservancy is proud of the results of its efforts. The organization believes it has significantly raised the bar, both in terms of governance and specific policies and procedures. We have communicated these new policies and procedures to the Finance Committee staff and welcome the positive treatment these reforms received in the Committee's report.

Board structure and role. The Board of Directors has been reduced in size from 41 to 21 members and has increased its day-to-day organizational oversight of the Conservancy by creating a more active Executive Committee and by restructuring its other committees to provide strategic guidance; to conduct active oversight; and to define and manage the relationships with the chapters.

New Board committees are addressing financial and governance issues while the entire Board considers conservation strategies. This new management and Board structure also enhances the Board's ability to carefully and thoroughly assess and manage organizational and reputational risks, as well as financial risks.

Trustees. Governance issues arising from the Conservancy's decentralized structure have been addressed through a new Trustee Council, written standards for trustee boards and a comprehensive set of operating principles for trustee boards.

Sarbanes-Oxley. The Conservancy has adopted aspects of the Sarbanes-Oxley Act of 2002 that are relevant to nonprofit organizations: the Conservancy has audited financial statements; auditors are selected by the Board's Audit Committee; and the lead audit partner is rotated at least every five years. Under the supervision of the Audit Committee the scope of internal audits has been expanded and internal auditors are authorized to perform investigatory functions similar to those performed by governmental inspectors. The Conservancy recently enacted procedures to ensure that internal audit findings are acted upon. The Board is involved in executive compensation issues. No loans can be made to directors, officers or employees. The Conservancy has implemented a whistleblower policy.

Compliance officer. The Conservancy has created a new position of a Chief Compliance Officer, independent of the General Counsel, who is responsible for organization-wide compliance and training programs. The Chief Compliance Officer has created an ethics and compliance program. All key managers attend training and execute an annual certification saying that they and their staff have complied with the Conservancy's policies and procedures and certifying that any conflicts of interest have been disclosed.

Transparency. The Conservancy has taken important steps to improve the transparency and public understanding of its Form 990 filings. The Conservancy's Form 990 for Fiscal Year 2003 included more information about the Conservancy's governance and its direct charitable programs and accomplishments. Key examples of increased transparency include: a complete list of every grant the Conservancy awarded; expanded reporting of executive compensation; extensive information about the Conservancy's performance including its approach to projects, the work performed and conservation results; and information about the Conservancy's governance structure and new policies and procedures that were put in place over the last year.

The Conservancy adopted a policy requiring Board approval for the formation and operation of any related organizations to ensure that the related entities are consistent with the Conservancy's goals and objectives and that related risks are identified and appropriately managed.

Risk assessment committee. The Board created a new Risk Assessment Committee in early 2004 to supplement the Board's review process and specific policies and procedures applicable to programs and operations. The Risk Assessment Committee has 10 members from senior staff representing all relevant disciplines. The purpose of the Committee is to provide advance review from a legal, ethical, and reputational perspective of proposed transactions, projects, and other matters that are exceptionally complex or that are precedent setting.

The Committee is patterned after similar committees used by many financial services organizations and reflects the fact that, to accomplish its mission, the Conservancy engages in a broad range of complex projects and joint ventures, as well as integrating compatible human uses on conservation lands. The staff Committee reports directly and regularly to the Conservation Practices and Projects subcommittee of the Audit Committee of the Board of Directors.

Conflict of Interest policy. The Conservancy's long-standing conflicts policy has been strengthened in several respects that go well beyond legal requirements, including expanding the definition of who is considered a related party to include major donors, and the immediate families of Board members, trustees and staff.

Some classes of transactions have been prohibited completely (e.g., purchases and sales of land, including easements, involving related parties such as directors, officers, trustees, employees and their families, and cause related marketing agreements between the Conservancy and Board members or their companies).

Land and other transactions involving major donors are subject to advance review and approval under the conflicts procedure. A Board member or his/her company may not claim a tax deduction for a gift of land unless the transaction is independently reviewed, scrutinized and approved by the Board.

The process for reviewing conflicts has also been expanded beyond the General Counsel's office to involve review by a high-ranking staff Conflicts Committee. Cases involving Board members and major donors require review and approval from the Board's Audit Committee.

Training programs have been initiated to enable staff to spot and properly address cases that involve even the appearance of a conflict.

Conservation easements. The Conservancy accepts conservation easements only on lands that fall within scientifically-identified, ecologically-important priority landscapes. Based on a thorough review of our practices by our Conservation Easement Working Group, the Conservancy is strengthening its policies and procedures on the documentation, monitoring and enforcement of easements.

New polices and procedures regarding conservation easements include: standardized decision-making on location, terms and conditions of easements; a stricter set of standards for approving easement modifications involving related parties; particularly large, risky or potentially controversial easement donations will be referred to the Risk Committee for review; and the Conservancy will inform prospective donors of the terms and conditions for acceptance of easements to ensure a clear understanding of mutual expectations and obligations.

Continuing its long standing policy, the Conservancy will not agree to a substantive modification of an easement unless the original conservation purpose of the

easement is not compromised, the General Counsel's office determines that the modification does not result in a net private economic benefit and approval is granted from the relevant state authority.

In addition, we have recently enhanced the policies and procedures for monitoring and enforcement of Conservancy easements to ensure that conservation goals are met and easement terms are enforced. Now as part of routine audits, the Conservancy's internal audit staff checks to see if easements are being monitored and that monitoring site reports are being filed.

Form 8283. To promote tax law compliance by donors, the Conservancy will not sign IRS Form 8283 certifying receipt of a land contribution, such as an easement, unless the Conservancy receives the 8283 with all required information filled out, a copy of the appraisal to be used by the donor in establishing tax values is included, and there is a written certification by the appraiser that IRS "qualified appraisal" standards have been followed. Additionally, in situations involving donations from members of the Board of Directors, trustees, staff, the immediate family of those three groups, and major donors the appraiser must also certify that the relationship did not influence his or her appraisal. (These policies contrast with existing tax law that requires only that the Conservancy certify receipt of the gift.)

The Conservancy will not participate in transactions in which the appearance of the transaction is suspect or unreasonable, or where the transaction does not conform to the 8283 policy.

Tax compliance. Other than providing general tax information, the Conservancy has consistently prohibited its staff from making any oral or written statement to any third party concerning the tax consequences to that person of a specific contribution to the Conservancy. That policy was strengthened to provide that any new type of land transaction must be approved in advance by the Legal Department, that the Conservancy will not participate in tax shelters, and that the Conservancy will not provide tax indemnities.

Land sales to governments. The Conservancy's long-standing "no net profit" policy is designed to ensure that the organization recovers only its costs, even if the land has increased in value while held by the Conservancy. The organization strengthened this policy to better account for the direct and indirect costs associated with acquiring, holding, and managing land pending a sale to the government. The policy also was strengthened to ensure that the value of a gift received and restricted to the property, any

government funding related to the acquisition of that property, and any other significant income derived from the property are passed on to the government.

Conservation buyer transactions. Conservation buyer transactions are designed to keep conservation lands in private hands. In these transactions, the Conservancy acquires a piece of property and sells it to a private buyer subject to a conservation easement designed to permanently preserve the land's ecological values. The easement reduces the value of the land and the Conservancy sells the property for its new fair market value reflective of the easement encumbrance. All of the Conservancy's conservation buyer transactions serve important conservation purposes and comply with all applicable laws. Of the 10,000 Conservancy land transactions conducted over the past 10 years, 169, or less than two percent, were conservation buyer transactions. Of those 169, only 19 were with trustees or employees of The Nature Conservancy. All of these properties were sold for fair market value and subjected to conflict of interest reviews. Nevertheless, the Conservancy no longer engages in conservation buyer transactions with related parties. In order to ensure that there is a conservation benefit to the public, all conservation buyer properties must be in a priority site as identified by Conservancy scientists. The organization now widely advertises each property to provide a fair purchase opportunity to all, relies on independent appraisals to ensure it receives fair market value and follows specific procedures to make transactions more transparent and to promote appropriate tax treatment.

Compatible human uses. The Conservancy continues to take steps to ensure that human uses on lands it owns or manages are compatible with conservation objectives. This includes review of available scientific studies in consultation with the U.S. Fish and Wildlife Service and surveys of existing uses of Conservancy lands based on the recommendations of independent scientists. Although mineral exploration on Conservancy property was extremely rare, in 2003 the Board prohibited new oil, gas or hard-rock mineral activities on lands the Conservancy owns (unless required by contract or law). In addition, innovative, large-scale or untested human uses are subject to advance review by the Conservancy's new Risk Assessment Committee.

Better Business Bureau Standards for Charity Accountability. On April 4, 2005 the Better Business Bureau Wise Giving Alliance completed a comprehensive review of The Nature Conservancy's governance, financial and accountability policies and procedures and determined that the Conservancy meets all of its Standards for Charity Accountability. The Better Business Bureau Wise Giving Alliance is a national charity watchdog affiliated with the Better Business Bureau system. The Alliance and its predecessor organizations have over a century of combined experience in charity

evaluation. Unlike other charity monitoring groups that focus solely on a review of charity finances, the Alliance completes comprehensive, in-depth evaluations of the charity's governance, fundraising practices, solicitations and informational materials, as well as how it spends its money.

A one-year review. To get an independent assessment of our progress to date, we asked Ira Millstein, the chairman of our Governance Advisory Panel, to come back a year after the delivery of the panel's report to review our progress. Mr. Millstein has attached the results of his one-year review to his testimony for this hearing today and we are pleased that he is here to testify before the Committee on his work with the Conservancy.

His one-year review concluded that the Conservancy has made a significant, good faith effort to consider and implement the panel's recommendations. The report praises the changes the Conservancy has made and the progress we continue to make to strengthen our organization. Mr. Millstein's assessment found that the Conservancy's Board and senior leadership are more engaged in the oversight and management of the organization, are paying greater attention to managing risk and conflicts of interest and are making solid progress in enhancing transparency and accountability. He recognized our commitment to ongoing improvement and noted that while work remains to be done, significant advancement has been made implementing systems that will enable the Conservancy to promote and track compliance with policies and procedures, such as those governing conservation easements.

The Conservancy is grateful to Mr. Millstein for his commitment to help us achieve our goal—making the Conservancy a recognized leader in the areas of nonprofit governance, accountability and transparency. He has given generously of his time and has provided a great service to our organization.

As Mr. Millstein noted in his report, there remains work to be done. We've learned that governance, accountability and transparency require perpetual diligence and review. We have made these areas an organizational priority, and they will remain so in the years ahead.

Tax Code Reforms for Conservation Easement and Land Donations

Conservation easements are one of the most cost-effective and important tools available for the permanent conservation of private lands. Conservation easements are protecting millions of acres of critical wildlife habitat and natural areas, keeping these lands in private hands and generating significant public benefits.

A conservation easement is a voluntary agreement between a landowner and a conservation organization or government entity in which the landowner promises to limit the use of his or her lands to activities that are consistent with conservation purposes. The Nature Conservancy strongly supports conservation easements and targeted tax incentives designed to encourage their use.

Although the vast majority of conservation easements protect important natural areas and produce significant public benefits, as with any charitable endeavor, there have been limited, but clear, cases of abuse. To eliminate the opportunity for abuse, to ensure conservation easements are used only in the manner intended by Congress and to ensure that every easement produces significant conservation and public benefits, some of the laws governing conservation easements and related tax incentives should be strengthened.

To that end, on April 6, 2005, The Nature Conservancy submitted to Congress a series of recommendations for specific reforms. These reforms are designed to address potential areas of abuse, while preserving the flexibility and integrity of the existing laws that have helped make conservation easements such a valued option for private landowners. I believe that our proposed reforms effectively address all of the concerns that have been raised by members and staff of the Committee in our visits as we prepared for this hearing.

Issue: Appraisals. A donation of a conservation easement or land may entitle the donor to a significant tax deduction; therefore it is imperative that the public is assured that the value of a land-related gift eligible to be claimed as a tax deduction is fair and appropriate. Determining the value of a donation of a conservation easement or land requires a thorough, experienced appraiser, one who is well-versed in the complexities of conservation easements, understands how protected land may affect the value of adjacent properties and is properly certified and uses uniform appraisal standards.

To strengthen and improve the valuation process for gifts of easements and land, Congress should enact reforms that:

- Require appraisers to be state certified.
- Require appraisers to follow the highest professional appraisal standards.
- Create penalties for appraisers who produce inflated appraisals.

- Codify the "value enhancement" rule, the existing IRS rule that requires appraisals to consider whether an easement donation increases the value of neighboring property owned by the donor.
- Require two appraisals to substantiate the value of a large conservation land gift.
- Increase penalties for donors who submit inflated appraisals to the IRS to justify tax deductions taken for gifts of land or conservation easements.

Issue: Conservation purpose and public benefit. Congress enacted tax incentives to encourage the use of conservation easements with a requirement that easements must serve significant conservation purposes and provide public benefits.

To ensure every conservation easement serves a conservation purpose and provides public benefits, Congress should enact reforms that:

- Require public disclosure on a charity's annual IRS Form 990 of donated easements for which a donor takes a tax deduction.
- Prohibit tax deductions for specific types of conservation easement transactions, such as easements on golf courses.
- Permit the Secretary of the Treasury to select a private organization that will establish and manage a formal, uniform and voluntary system for accrediting organizations holding conservation easements.

Issue: Monitoring and enforcement. Conservation easements are designed to remain in effect in perpetuity, as are the conservation purposes they serve and the public benefits they produce. To ensure a conservation easement continues to achieve its desired conservation and public outcomes, easement terms must be followed, regularly monitored and enforced.

To ensure landowners and conservation organizations fulfill the obligations that come with donating and accepting a conservation easement, Congress should enact reforms that:

- In cases where a donor intends to take a tax deduction for a conservation easement gift, prohibit any modifications to the easement that reduce the conservation values the easement was designed to preserve. In cases where a modification's effect on the conservation value of an easement is neutral or improves the conservation value, the modification must be approved by a third party and any financial benefit to the landowner must be addressed.

- Require easement-holding charities to annually certify on their IRS Form 990s that they have an appropriate easement compliance and monitoring program in place.
- Create penalties for donors and donees that violate the terms of conservation easements.

Further, Congress should provide additional resources to the IRS to support conservation easement and land donation oversight activities.

Issue: Additional incentives to encourage donations. The Nature Conservancy strongly supports passage of additional incentives for private landowners who voluntarily choose to protect their land for conservation purposes. Such incentives have been sponsored by Senators Grassley and Baucus and are included in the current version of the CARE Act (S. 6, introduced by Senator Santorum in the 109th Congress). These incentives are needed to ease the landowners' financial burden and to enhance the net after tax return to the typical 'land-rich, cash-poor' private landowner for whom the current set of incentives is not meaningful.

These incentives would reduce the capital gains tax on sales of land or interests in land for conservation purposes and would enable the landowner who makes a living from his/her land to use all of the available tax benefits from a gift of an easement against his/her income.

President Bush has included the proposal to reduce the capital gains tax on sales of land or interests in land for conservation in the Administration's current budget proposal, as he has done since he was elected President.

Conclusion

As the Conservancy has responded to close public scrutiny and strengthened its internal governance, we have learned some lessons that may be valuable for others in the charitable sector to consider:

- Governance must keep pace with growth. Every charity must have an active, engaged board committed to continuously reviewing, adapting and strengthening its oversight to meet the changing needs of the organization.

- Charities need individuals on their boards that bring specific professional skills and expertise beyond the traditional and almost exclusive roles of door-opening and fundraising. In today's world, board expertise in areas such as the law, government policy, accounting and management are not a luxury—they are a necessity.

- Because charities trade on their reputations, it's not enough to simply meet minimal levels of compliance. For charities, perception is everything, and charities can't afford even the appearance of impropriety.

- Openness and transparency must be organizational priorities for nonprofits. Since the performance of charities can't be judged on quarterly earnings statements, the public must have access to information to help them make judgments about the effectiveness of the charities they may support.

- Senior leadership and boards at nonprofits must be attentive to the full range of potential risks with policies and procedures in place to assure that we thoroughly respond promptly to challenges before they become crises that undermine public trust.

A sector-wide commitment to this approach will ensure that charitable institutions remain among the most trusted elements of our society.

Mr. Chairman and members of the Committee, The Nature Conservancy has made such a commitment. I firmly believe that the changes we have implemented over the last 20 months have made the Conservancy a far stronger institution and brought our organization into full alignment with expectations befitting a trusted nonprofit institution.

The Northwest Florida Greenway

Conservation Easements Conserve Land, Water and a Way of Life

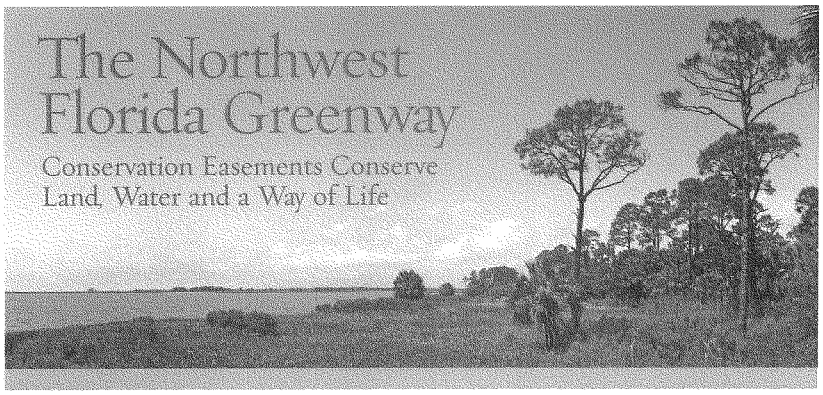

Photo ©Eric Blackmore

The Northwest Florida Greenway is a collaborative partnership among the military, government and nonprofit organizations to conserve a 100-mile corridor of forest, rivers and wetlands that will buffer military bases and protect military flight paths. On November 12, 2003, the state of Florida, the U.S. Department of Defense (DoD) and The Nature Conservancy signed a groundbreaking Memorandum of Partnership to establish the Northwest Florida Greenway and preserve the undeveloped lands between Eglin Air Force Base and the Apalachicola National Forest.

Photo ©Jeff Ripple

The Greenway project illustrates what can be accomplished when non-traditional partners work together. The partners were able to literally identify "common ground."

The Greenway's goals are to:

- Preserve the region's lands, waters and way of life for the benefit of all
- Promote the sustainability of the military mission in northwest Florida to meet national defense testing, operational and training requirements
- Work with communities to plan for future development that will protect the natural resources, military mission and sustain the traditional regional economy
- Conservation easements are expected to play a major role in the Northwest Florida Greenway, as they are a cost-effective and highly efficient way of protecting private land from encroaching development

Conservation easements enable landowners to keep their land and ensure its long-term preservation.

Easements in the Greenway

Because more than 60 percent of the properties located within the Greenway are in active timber production, they do not all meet the state's criteria for conservation land acquisition. These timberlands are important as they buffer pristine lands and waterways and connect natural areas. An effective way to protect private timberland is through conservation easements, a voluntary conservation agreement that keeps the land in private ownership, on the tax rolls and in forest production while meeting the conservation and military goals of the Greenway.

Congress appropriated $12.5 million in the 2004-2005 budget for national military base-buffering projects, citing the Northwest Florida Greenway as an example of the kind of partnership that will protect military readiness while preserving ecosystems. The use of conservation easements stretches conservation dollars as easements cost less than full acquisition of the property. In Florida, many DoD base-buffering expenditures may be leveraged by the state's land acquisition program, Florida Forever. For instance, to purchase the Greenway's first conservation easement, on the Nokuse Plantation, the state spent $16.2 million and the DoD $1 million.

Jan Larkin, Office of the Secretary of Defense (OSD); Florida Governor Jeb Bush; Phil Grone, DoD; and Bruce Beard, OSD; at the Governor's Mansion after signing the Greenway Memorandum of Partnership in 2003.

"Florida is among the first in the nation to join forces with the Department of Defense to increase security for important military installations while at the same time protecting valuable natural resources. This ground-breaking partnership affirms Florida's resolute commitment to the environment and our nation's military."

– Jeb Bush, Florida Governor

The Greenway project is helping to sustain the quality of life and environmental richness of northwest Florida.

National Security and Economic Importance

Five military installations in northwest Florida, including Eglin and Tyndall Air Force bases, Whiting Field, Pensacola Naval Air Station, and the Naval Surface Warfare Center, collectively represent one of the nation's largest open-air military testing and training areas. In 2002, these military installations contributed $5.9 billion to Florida's economy. Additionally, defense spending accounts for 34 percent of northwest Florida's regional output. The Northwest Florida Greenway will protect a buffer zone between nearby communities and critical flight paths needed for military personnel training.

Environmental Significance

Only five other places in the United States harbor the rich variety of plants and animals found in Florida's Panhandle. Its vast expanse of longleaf pines, white-sand beaches and pristine rivers support 75 percent of Florida's plant species and dozens of endangered and threatened plants and animals. Hundreds of miles of wilderness remain unfragmented, enabling black bear to spend their lives unnoticed. When completed, the Greenway project will have preserved the connection between the extensive forests that stretch from southern Alabama all the way to the Apalachicola National Forest, a forest system of more than two million acres.

The Northwest Florida Greenway is one of ten projects selected from around the country to be presented at the White House Conference on Cooperative Conservation in August 2005.

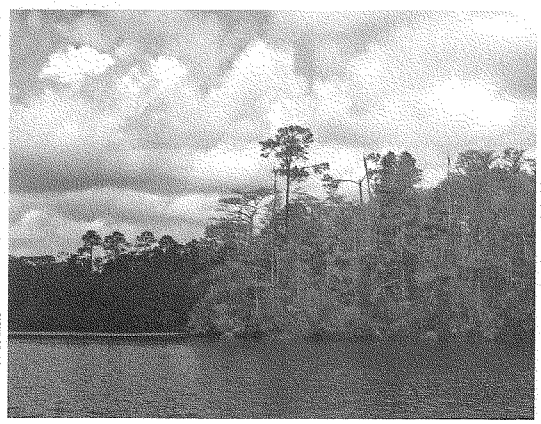

Photo ©Eric Blackmore

Florida's natural habitats and water systems will only survive human population growth if we protect large, functioning natural areas that are connected by corridors of undeveloped land.

"It is ... essential that we protect our ability to use our military test and training ranges from encroachment.... [The] Northwest Florida Greenway Corridor [is] an effort that will benefit our soldiers, sailors, airmen and marines, while at the same time preserving some of our country's most unique natural areas."

– Phil Grone, Deputy Undersecretary for Installations & Environment U.S. Department of Defense

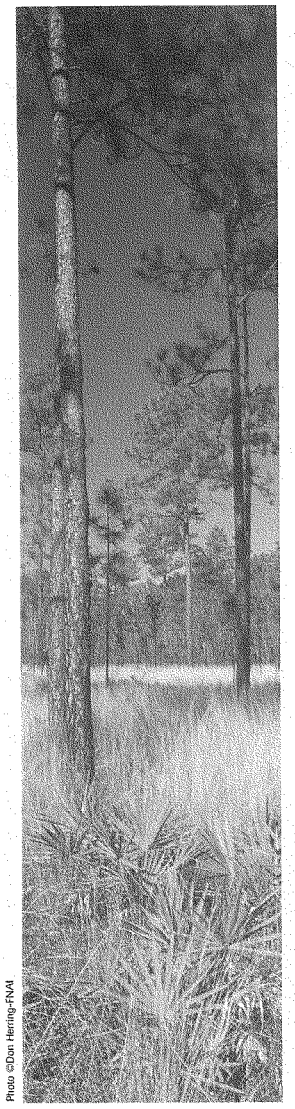

Photo ©Don Herring-FNAI

Nokuse Plantation Easement

As CEO of Fountain Investments, M.C. Davis wears two hats. He is equal parts business entrepreneur and conservationist. "I lead two lives," says Davis. "I try to recycle most of my resources back into conservation projects." Davis is also CEO of the Nokuse Plantation, which was founded to restore and preserve North Florida's ecological integrity and biological diversity for "the well-being of ourselves and future generations."

Conservation easements are Davis' land protection tool of choice. In February 2005 he put a perpetual conservation easement over more than 18,000 acres of his Nokuse Plantation, which lies within the Northwest Florida Greenway. To Davis, the combined donated and purchased easements mean that he and his family will be able to keep and enjoy the land in its natural state for generations to come. To the state, it means an important piece of conservation land was preserved at significantly lower cost than it would have been to purchase the land. And to conservationists and the military, it means that their shared vision for the Northwest Florida Greenway is becoming a reality.

"For nature to have a reasonable chance of continuing to function as the source of all wealth and life for man, and all other species, then our conservation planning and execution, when possible, must be on the landscape and ecosystem level. This can be accomplished by drawing upon the skills of the entrepreneur, the power of the government and the passion of the individual, with all directed by the knowledge of science."

– M.C. Davis, landowner

Conservation easements have enabled M.C. Davis to preserve more than 18,000 acres of prime black bear habitat in north Florida.

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The Nature Conservancy

SAVING THE LAST GREAT PLACES ON EARTH

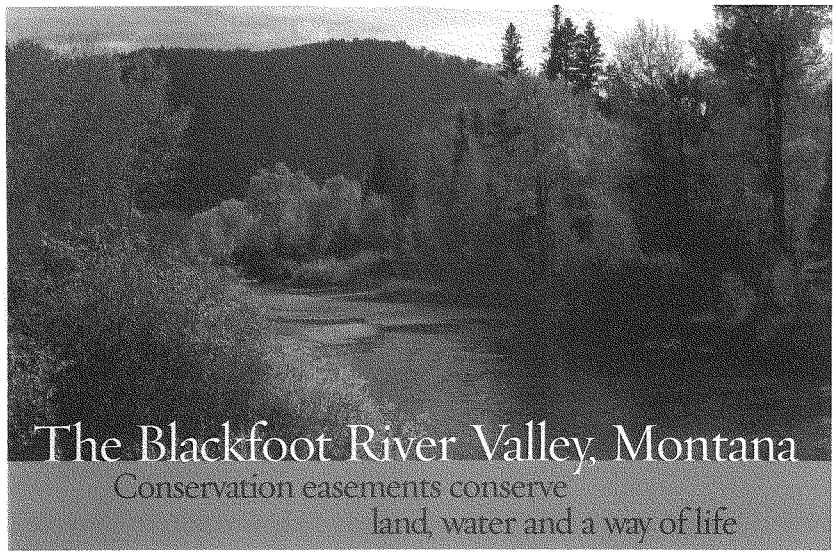

Photo ©TNC

The Blackfoot River Valley, Montana

Conservation easements conserve land, water and a way of life

The 132-mile, free-flowing Blackfoot River Valley has inspired people for centuries. Meriwether Lewis passed through here during his journey of discovery. The valley's native trout fishery inspired the late author and fly fisherman Norman MacLean to write *A River Runs through It.*

Rich wetland complexes in the Blackfoot River Valley attract breeding and migratory birds such as trumpeter swan. Moose, bald eagles, sharp-tailed grouse and grizzly bear reside here, underscoring the area's importance as a link between the Bob Marshall–Scapegoat Wilderness complex and wild lands to the south, east and west.

Unlike so many mountain valleys in the West that have seen rapid development, the Blackfoot River Valley remains rural and wild, much like it was when the first of four generations of ranch families moved into the valley. This is no accident. Those who call the Blackfoot home, who love it and whose livelihoods depend on it, have banded together to conserve the rural and natural values of this place.

Nearly 30 years ago, landowners, public agencies and conservation groups, including The Nature Conservancy, embarked on cooperative projects to restore wetlands and streambanks, control weeds, conserve wildlife habitat and improve grazing management. In 1976, the Conservancy and a Blackfoot landowner signed the first conservation easement in the state of Montana. Since then, more than 50 river miles and 85,000 acres in the watershed have been placed under these voluntary conservation agreements.

In 1976, the Blackfoot River Valley (above) was the site of Montana's first conservation easement. Since then, more than 50 river miles and 85,000 acres in the watershed have been protected by easements.

The Blackfoot Challenge and the Blackfoot

In 1993, landowners in the Blackfoot River Valley formally founded the Blackfoot Challenge to coordinate conservation in the watershed. The group, composed of local landowners, federal and state land managers, local government officials and corporate landowners, has become nationally known for its conservation vision and leadership.

In 2001, in anticipation of the Plum Creek timber company's plans to sell mid-elevation lands surrounding the valley, the Blackfoot Challenge rallied the local communities to action. Led by rancher and Blackfoot Challenge Board President Jim Stone, the Challenge developed a plan to purchase and re-sell 88,000 acres of those lands according to a community plan. The Nature Conservancy agreed to take on the risk of borrowing the funds and, to date, has purchased almost 43,000 acres.

Now the Conservancy and the Challenge are working together to re-sell the lands to both public and private buyers. About half of the lands will be sold with conservation easements to local ranchers to help them expand their operations and make their ranches more economically viable. Other lands will be sold to public agencies, particularly those with adjacent lands, as a way to preserve public recreational access.

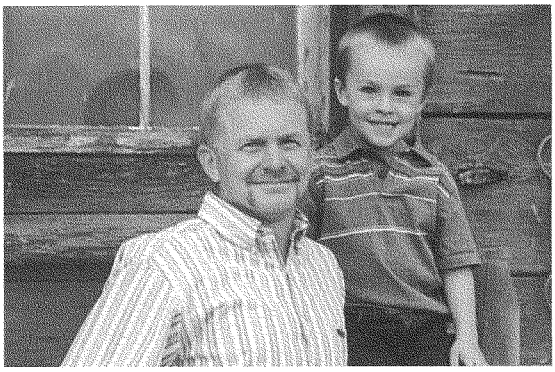

Photo ©TNC

Jim Stone, here with his son Brady, spearheaded the Blackfoot Challenge's plans to purchase 88,000 acres of forestlands in the valley. About half of the land will be re-sold with conservation easements in place to local ranchers.

"We want to keep these lands intact for ranching and allow the ranchers to expand their operations, while still maintaining the important wildlife habitat."

– Jim Stone, rancher; chair, Blackfoot Challenge

"This is no 'Buffalo Commons' kind of effort to return the land to its pristine, pre-human condition. Instead, it's an effort to retain and perpetuate the rural lifestyle.... It's a role model of cooperation that should be copied throughout the West wherever people strive to preserve the land, its wildlife and their local values."

– Helena Independent Record editorial, Oct. 12, 2003

Community Project

"I've supported this purchase from its beginning because giving Montana the power to decide its own economic future is really what the federal government is about. There is nothing more important to me than maintaining the integrity of our lands in the eyes of those who live, work and play on it."

– Sen. Conrad Burns (R-MT)

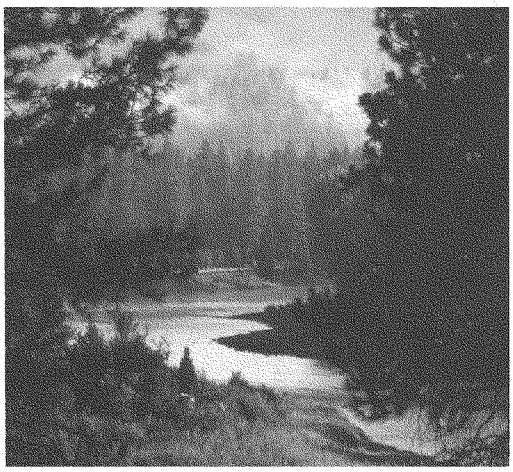

Photo ©TNC

"Important projects like the Blackfoot Community Project are great examples of what we can accomplish when we work together to protect Montana's resources for our children and our grandchildren."

– Sen. Max Baucus (D-MT)

E Bar L Ranch

In 1998, the owners of the E Bar L Ranch donated a conservation easement to The Nature Conservancy that covers the ranch's 4,000 deeded acres. The easement protects the scenic ranch from subdivision and formalizes owner Bill Potter's philosophy of sustainable management of the ranch's roughly 2,000 acres of forest. That management involves some timber cutting to create layers of different-aged trees, an approach that minimizes insect damage and the potential for catastrophic fire. The easement created a long-term partnership between the E Bar L, the University of Montana and The Nature Conservancy. It called for the university's School of Forestry to continue its 18-year-old forestry research program on the E Bar L.

Photo ©TNC

Bill Potter donated a conservation easement on his E Bar L Ranch to The Nature Conservancy.

"I wanted an arrangement that made sure any future owners of this place would continue to use sustainable management methods on this property."

– Bill Potter

Mannix Ranch

In 2000, Burt and Darlene Mannix signed a conservation easement with the U.S. Fish and Wildlife Service that covers 1,100 acres of their ranch along the Blackfoot River. Funding to pay the Mannixes for the development rights on that land came from an appropriation from the Land and Water Conservation Fund and a grant to the Conservancy from the Plum Creek Foundation.

Photo ©Jim Steinberg

"My grandparents, David and Edith Raymond, and their six children – and then my parents – were the stewards of the land. It has been well-loved through the years. I think they would be happy with this collaboration."

– Darlene Mannix

The Mannixes placed a conservation easement on their ranch along the Blackfoot River, funded in part by the Land and Water Conservation Fund.

Public benefits of conservation easements

- Preserve ranchland and timber land by restricting inappropriate subdivision
- Help maintain the character of rural communities
- Protect private lands that serve as important wildlife habitat and linkage to high-elevation public lands
- Easement lands that restrict use to agriculture often generate more in local property tax revenues than they require in community services
- Conservation easements conserve watersheds and aquifers, helping ensure a clean supply of water for public use

Landowner benefits of conservation easements

- Private property subject to a conservation easement remains privately owned and landowners often continue to live on the property
- The option to place conservation easements on private land is an important private property right that comes with land ownership in the United States
- Conservation easements are individually tailored to protect targeted conservation values and to meet the landowner's needs
- Tax benefits from donated conservation easements help enable good management
- Conservation easements guarantee that future owners will care for the land

For more information contact Jamie Williams, director, Montana program The Nature Conservancy (406) 443-0303.

The Nature Conservancy

SAVING THE LAST GREAT PLACES ON EARTH

The Malpai Borderlands, Arizona and New Mexico

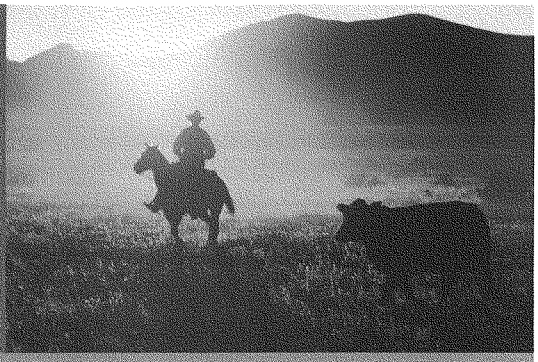

Photo by: Will Van Overbeek

Conservation Easements Protect American Family Ranching Traditions and Jaguar Pathways

The Malpai Borderlands, with their long vistas of mountains, deserts and big sky, have been compared to a Georgia O'Keeffe painting. At work in this 836,000-acre canvas on the U.S.-Mexico border is a community of private property owners whose ranches are embedded in a patchwork of private, state and federal lands where urban dwellers from Tucson, Phoenix and beyond come to hike and hunt. Four hundred and fifty-two thousand acres are in private ownership and 385,000 are in state and federal ownership. Many ranch families have lived in the Malpai Borderlands for more than 100 years, settling here when Arizona was still a territory. The name "Malpai" comes from the Spanish word "malpais," meaning "badlands." Because of the rough terrain, most cattlework is still done on horseback.

Conservation easements protect open space, which is vital to the cattle ranching way of life.

This intact ranching landscape has maintained a vastness that provides sanctuary for an extraordinary array of native wildlife. The Malpai Borderlands have remained wide open and free from development because of a handful of committed ranchers and other private landowners who banded together in 1994 to form the Malpai Borderlands Group, a land trust that has created a common vision for the conservation management of this landscape. Of the 452,000 acres of private land, 307,000 acres are under conservation easement, a voluntary conservation agreement that protects wildlife habitat while keeping the land in cattle grazing.

Conservation and easements in the Borderlands

Part of the storied "Sky Islands," the Malpai Borderlands' valleys and mountains were created by the Sierra Madre range of Mexico colliding with the southernmost point of the Rocky Mountains. In this landscape of oaks and ocotillos, animals from the far northern and southern reaches of the continent meet, such as black bears and the occasional Mexican jaguar. Today the region supports an abundance of game and non-game animals, including bighorn sheep, antelope, javelina and sandhill crane.

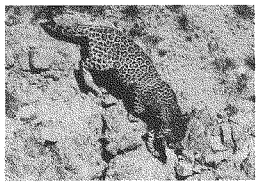

Photo: Warner Glenn, Malpai Ranch

The open spaces of the Malpai Borderlands attracts the occasional Mexican jaguar.

The Nature Conservancy's interest in this area began in 1979 with the purchase of land that eventually became the San Bernardino National Wildlife Refuge, and continues with partnerships with individual ranchers to monitor rare species such as the marble-sized pincushion cactus.

Photo: Will Van Overbeek

Conservation easements protect the settings upon which much of Arizona and New Mexico tourism depends. Tourism and outdoor recreation in the Malpai Borderlands is steadily increasing as city dwellers across the country search for authentic nature-based vacation destinations. According to the state office of tourism, more than 50 percent of Arizona tourists want to tour the countryside and visit small towns and national parks.

In 1989, The Nature Conservancy purchased the 502 square-mile Gray Ranch. Shortly thereafter, the Conservancy sold the Gray Ranch with a conservation easement covering 227,000 acres. This easement positively affects another 95,000 acres of leased land. Almost all of the Gray Ranch was purchased by The Animas Foundation (a nonprofit working in part to sustain the regions' ranching heritage and economy). The Animas Foundation and the Malpai Borderlands Group work closely together, and are located in adjoining valleys in the project area.

Today the Malpai Borderlands Group works with more than 20 state, federal and private partners, including The Nature Conservancy, and has grown into an international showcase demonstrating the power of ranching leadership in conservation. One of their primary tools is conservation easements. To date, 77,000 acres on 13 family ranches are managed by conservation easements. In turn, nearly 200,000 acres of grazing allotments of state and public land are positively affected by the easements, which allow for a natural fire regime across these contiguous open lands, improved wildlife habitat and well-distributed water sources for cattle and native animals.

The Glenns, Malpai Ranch

"Both our families came to Arizona in the 1890's and have been here ever since. We love this country. Open space is good for everything – wildlife, plant species and ranching.

At first we didn't really know what an easement was, so we donated a 10-year easement on 4,000 acres just to see how it worked. It was the first easement that the Malpai Borderlands Group held, and much of the wording in all the other easements has come from this one. What we did was pretty new to ranchers out here. In October of 2002, before the ten years was up, we felt confident enough to put a perpetual easement on our property. In addition to permanently protecting our private land of 4,000 acres, this affects 11,000 acres of our state land grazing leases: now and in the future that land will be managed to protect wildlife and the ranching way of life. It isn't just about ranching; it affects the wildlife habitat too. With subdivision and sprawl you end up with wildlife that can adapt to people and that's the only kind of wildlife you have. You get a lot of coyotes, raccoons and crows, but not deer, bighorn sheep, antelope or sandhill cranes. They need open space so they move away from populated areas.

Photo: Milli Van Overbeek

Wendy Glenn, conservation easement holder, Malpai Ranch.

Conservation easements have been around for a long time, but it's only now that a lot of farmers and ranchers are more and more interested in using them because they see how much open space and habitat is being lost every year. When we pass on, because of the easement, the inheritance taxes on our place will be less than they would without the easement. But the most important thing is that it lets our children and our granddaughter know that the ranch will be open space for them in the future."

– Wendy Glenn, conservation easement holder, Malpai Ranch

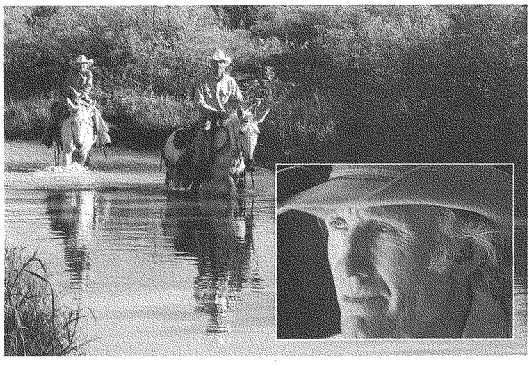

Photo Kelly Glenn Kimbro

Conservation easements protect open space that allow for natural water regimes to flow freely. Nine-year old Mackenzie Glenn-Kimbro and grandfather Warner Glenn ride the creek after a storm. Rancher Warner Glenn (inset) and his wife Wendy placed the first easement in the Malpai Borderlands on their ranch in the 1990s.

Easements contribute to improved rangeland health

For nearly 80 years, fire had been suppressed in the Malpai Borderlands, something that the Malpai Borderlands Group set out change. A natural fire regime was needed to restore grassland choked by invasive species and woody growth. The group saw conservation easements as an important means to help re-establish a natural fire regime, which can improve grassland health. The large areas of open space protected by conservation easements allow land-management agencies and ranchers to plan for and safely execute wide-ranging prescribed fires with confidence. Coordinated fire planning also sets up economies of scale that are estimated to save taxpayers millions of dollars in the region each decade. A prescribed fire plan now operates in coordination and regulatory compliance with two states, two countries, six agencies and several ranches.

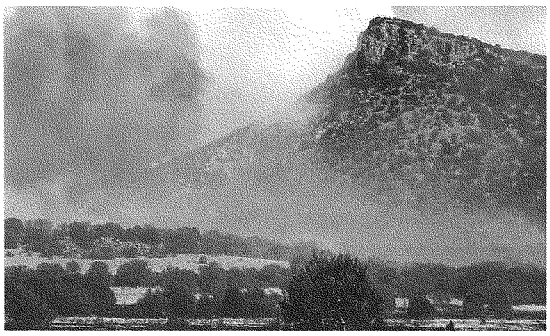

Photo Peter Warren

Much needed prescribed and natural burns are able to safely take place in the area due to an open landscape made possible by conservation easements. To date, close to 70,000 acres have burned, increasing grassland health.

Public benefits of conservation easements in the Malpai Borderlands:

- Protecting open spaces needed for ranching and wildlife habitat
- Preserving character of rural and historic communities
- Preserving vistas that attract tourists
- Keeping land on tax rolls
- Forging a common vision between private ranchers and public agencies
- Maintaining large landscapes for safe prescribed burns that restore grassland health
- Contributing to healthy game populations and remote hunting areas
- Promoting better state and federal agency/private landowner coordination
- Increaseing coordination between different federal agencies at the landscape level

Landowner benefits of conservation easements in the Malpai Borderlands:

- Property remains privately owned and future generations can engage in livelihoods that require open spaces, such as ranching
- Proceeds from the sale of easements or tax relief from the donation of easements provide much-needed funds for ranchers who are "land-rich, cash-poor"
- Families can continue to live on their land instead of selling out to the highest bidder
- Owners can tailor easements to protect conservation and agricultural values while meeting the landowner's needs
- Open space is protected
- Ranchers can work collaboratively with public agencies to plan the future of the land.

For more information contact Kelly Cash The Nature Conservancy (510) 409-4224.

MALPAI BORDERLANDS GROUP

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The Nature Conservancy

SAVING THE LAST GREAT PLACES ON EARTH

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June 28, 2005

Honorable Charles Grassley
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Honorable Max Baucus
Ranking Member
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Chairman Grassley and Ranking Member Baucus:

This letter has been prepared to correct and/or clarify certain statements in the Report of the Staff of the Senate Finance Committee on The Nature Conservancy, dated June 7, 2005 (the "Staff Report"). We respectfully request that this letter be included in the record of the Committee's hearing on June 8, 2005.

EXECUTIVE SUMMARY

Page 10, second full paragraph.

The Staff Report states that the Conservancy does not establish a specific stewardship fund for each specific easement and compares the merits of separate and aggregate approaches to funding. The current Treasury Regulations (§1.170A-14(c)) state: "A qualified organization need not set aside funds to enforce the restrictions that are the subject of the contribution." Thus, there is no current requirement that separate endowment funds for each easement be created and the Conservancy has concluded that an aggregate funding approach is preferable.

Page 12, first full paragraph, 4th sentence.

The Staff Report states that, in many conservation buyer transactions, the "purported" value of the conservation easement was used to determine the portion of the cash purchase price to be treated as a charitable contribution, and suggests that valuations of such easements is critical whether the ultimate contribution is of cash or the easement itself. The use of the term "purported" suggests that the Conservancy did not exercise care with respect to the valuation process. In all cases, the Conservancy arrived at a valuation based on objective valuation information, most often an appraisal from an independent qualified expert. However, in some cases, the valuation was based on a staff analysis that was prepared by someone with direct knowledge about local real estate market conditions.

Page 12, last paragraph.

The Staff Report suggests conservation buyer sales and other transactions could be structured to avoid the requirements of section 170(h) of the Internal Revenue Code. In theory, this could occur if property was sold to a conservation organization without any arrangement for imposing a tax-compliant restriction on the property involved.

However, as the Staff Report indicates, the Conservancy's conservation buyer transactions were *not* structured to avoid section 170(h). Specifically, in each such transaction, the property was and remains subject to a conservation easement created in one of two ways. First, in some cases, the Conservancy placed the easement on the property and sold the property subject to those restrictions. In these cases, the Conservancy's conservation requirements were scientifically based and either met or exceeded the requirements otherwise imposed by section 170(h). Second, in the other cases, the buyer purchased the property and then conveyed the easement to the Conservancy either at closing of the sale or subsequently pursuant to a binding agreement to make such gift. In either of these cases, the easement would of course be directly subject to the requirements of section 170(h) as well as to the Conservancy's own science-based standards.

Page 13, second paragraph, last sentence.

The Staff Report notes that certain Conservancy conservation buyer transactions involved related parties and were thus potentially subject to the excess benefit transaction rules of section 4958 of the Code if the related party paid less than the fair market of the property involved. While this is an accurate statement of the applicable legal principle, in fact, as the Staff Report itself states (Part Two, page 19, first paragraph), in each case in which property was sold to a related person, the Conservancy's sales price was supported by either a third party appraisal or a professional staff evaluation of an outside appraisal information in order to ensure that the sales price was *not* "...less than the value of the easement restricted property."

Page 16, second full paragraph.

The Staff Report, in describing the Conservancy's emissions credit arrangements, states that "100% of the emissions credits or allowances accrue to the for-profit entities" and a similar statement is made in Part Two at page 25. These statements are inaccurate and, as the Staff Report itself correctly states (Part Two, page 25), a portion of the offset credits are allocated to the government of Bolivia.

Page 17, third full paragraph.

The Staff Report suggests that the Conservancy's emission credit arrangements furthered one exempt purpose (land conservation), but frustrated an environmental purpose (reduction in greenhouse gases) by assigning potential emissions credits to for-profit participants. The Conservancy disagrees with this characterization. The Conservancy believes it is highly likely that these projects will result in a net reduction in greenhouse gas emissions and they were

consciously designed to ensure that, at a minimum, the land conservation purpose would be achieved without adverse effect on greenhouse gas emissions.

It should also be emphasized that, as the Staff Report acknowledges, the emission credits involved are "potential" credits. They do not exist and will not exist unless the U.S. Government creates a regulatory framework within which such credits can be established and used or transferred. The Conservancy itself thus has no authority to create emissions credits and it simply allowed project participants and others (such as Bolivia) to retain the rights to those credits (if any) that might be created in the future by appropriate government action.

Page 17, fourth paragraph.

The Staff Report states that "certain" emissions credits are difficult to value because there is no "regulated market for them." In fact, in the case of the credits involved in the Conservancy's transactions reviewed by the Staff, the credits do not even exist.

Page 18, fourth paragraph.

The Staff Report states, "large transactions such as these [the emissions credit programs] should not escape the scrutiny of the public," and suggests that Form 990 disclosures may not be adequate to do so. The Conservancy agrees that the Form 990s are not currently a suitable tool for many disclosures, but the Conservancy did not shield the emissions credit arrangements from public scrutiny. Indeed, the projects are featured prominently on the Conservancy's Web site and have been for many years. In addition, each of these projects has been described in detail in the Conservancy's magazine at one time or another; several of them have received publicly announced and publicized awards; many have been discussed openly in international climate negotiations; and the Conservancy has provided dozens of public presentations describing the transactions.

Pages 19-20.

The Staff Report suggests that the Conservancy may not have obtained the advice of outside tax counsel in a number of instances where it might properly have done so. In fact, the Conservancy has sought and does seek outside legal opinions and advice in those cases where the law is unclear, or when faced with a new or novel transaction or project. In many cases, such advice is provided in oral communications rather than formal legal opinions. The Committee was provided with copies of such opinions and legal memoranda. For example, the Conservancy hired an outside legal firm to provide advice regarding easement monitoring, documentation, and enforcement. These recommendations were utilized by the Conservancy in setting its own current requirements for conservation easements.

Moreover, the Staff Report does not indicate that the Conservancy has expended significant resources in employing experienced lawyers on a full time basis. The Conservancy's in-house legal staff includes professionals with extensive tax expertise. These in-house legal advisors provide day-to-day guidance to the Conservancy on the appropriateness and tax implications of programs and projects. Indeed, under the Conservancy's written procedures, all

transactions require specific legal and tax review by the in-house staff. In short, the Conservancy has always included appropriate "tax due diligence" in its transaction and program approval process.

The Staff Report incorrectly states that the Conservancy has "often obtained" tax opinions that address tax consequences to other parties *for the purpose of* marketing transactions. For example, prior to initiating its conservation buyer program the Conservancy obtained outside legal advice both with regard to the concept of conservation buyer transactions generally, and with regard to certain transactions specifically. These opinions and advice were sought not to market transactions, but specifically to ensure that the Conservancy understood the relevant tax law, and that its actions were in accordance with the law. In **all** cases, potential conservation buyers were advised that the Conservancy could not, in accordance with its long-standing policy, provide any tax or legal advice and that the parties should confer with and rely on their own legal and tax advisers.

Page 22, second paragraph.

The Staff Report states, "In some cases TNC provides the financing to the buyer at zero or below market interest rates." This is incorrect. To the best of the Conservancy's knowledge, its Trade Lands Program has never sold a property at zero percent interest. In fact, most promissory notes in such sales by the Conservancy are negotiated at one or two points above prevailing interest rates at the time of the sale.

Page 22, second full paragraph.

The Staff Report suggests that certain internal e-mails indicated that the Conservancy had concerns that its Trade Lands sales could generate taxable unrelated business income (commonly referred to as UBIT). This is not correct. The e-mails were intended to illuminate the boundaries between existing Trade Lands business practices and certain other activities which, if engaged in, could result in potential UBIT liability. The Conservancy did not engage in those activities identified as taxable.

Page 25, second full paragraph.

The Staff Report states that the Conservancy's disclosures with respect to transactions with Board members were "in a few instances, misleading." The Conservancy has made every effort to report such transactions completely and accurately. There has been no intention to "mislead" by the Conservancy with respect to reporting such transactions, and the Staff Report cites no specific examples of such.

Page 25, third full paragraph, first sentence.

The Staff Report identifies a series of perceived deficiencies in the Conservancy's Form 990s and suggests these deficiencies were the result of a lack of clear guidance from the Internal Revenue Service and the Conservancy's own "reporting attitudes." The Conservancy's "reporting attitude" has been and remains one of full compliance with all reporting requirements

and, to that end, the Conservancy's returns have been prepared with the assistance of its independent auditing firm to ensure their accuracy and completeness. Moreover, the Conservancy filed all required unrelated business income tax returns (Form 990-T) after a thorough process that involved staff from inside the Conservancy as well as outside consultants. The Conservancy devotes considerable resources to the completion of these returns as more fully described in materials submitted to the Finance Committee staff. Every attempt was made to properly account for and report income-producing activities undertaken by the Conservancy. As the Staff Report itself notes, and as Steven Miller, Director of IRS Exempt Organizations Division, readily admitted at the June 8, 2005 Finance Committee hearing, there is a lack of guidance with respect to Form 990.

Page 25, fourth full paragraph and second full paragraph, first sentence.

The Staff Report states that the Conservancy's Form 990 tax return for 2003 is "not materially different from its earlier reporting," specifically with respect to the description of program services and accomplishments. In fact, the 2003 tax return reflects significant changes made by the Conservancy in its return for the purpose of providing greater disclosure of its activities. The 2003 tax return, for example, includes an attachment approximately 20 pages in length describing in great detail the Conservancy's conservation programs, activities, and accomplishments. This detailed statement was not included in tax returns in earlier years, which were all completed in accordance with the relevant IRS instructions. The Conservancy's move to provide fuller information actually runs counter to the instructions, which direct the reporting organization be "clear, concise, and complete in your description. Avoid adding an attachment." The Conservancy now routinely attaches this more detailed program services and accomplishes statement.

Pages 26 and 27, page 38, first full paragraph.

The Staff Report states that "TNC did not solicit tax advice from outside counsel on the Federal income tax treatment of trade land sales." This is not correct. The Conservancy did consult with outside counsel on the trade land concept and received a written opinion that revenues from the trade land program, as structured, were not subject to UBIT tax. Unfortunately, the opinion was discovered subsequent to the completion of the Conservancy's document production process, and thus was not given to Committee staff. This opinion, which supports the Conservancy's position that its trade lands sales are not subject to UBIT, is attached. The Conservancy's Trade Land Program was structured on and operates in accordance with this outside legal opinion.

Pages 26 and 27.

It is incorrect to say that the Conservancy "classified income from non-conservation activities that generated small amounts of income as unrelated so that TNC would have bargaining power in an IRS audit." The report cites no evidence that the Conservancy employs this practice. This statement does not reflect Nature Conservancy policy or strategy. Rather, this observation is based primarily on a couple of internal Conservancy e-mails written by a staff attorney with no authority to determine the organization's strategy regarding its UBIT activities.

In the e-mail referenced, the small amount of money involved was not, in fact, reported as UBI, and properly so.

Page 28, second full paragraph.

The Staff Report states that "TNC's preference to (was to) deal with insiders to acquire CBP." This is not accurate. In fact, so-called related party buyers numbered only 19 out of the 169 conservation buyer transactions reported to the Committee. Moreover, in many of those 19 cases, these were the only interested parties, even when efforts were made to find other prospects. Finally, as a group, these buyers were demonstrably "conservation minded" buyers who would appreciate and would abide by the conservation limitations on the use of the property. Nevertheless, the Conservancy revised its procedures in 2003, as the Staff Report acknowledges, to preclude purchases and sales of conservation lands from and to related parties.

Page 28, fourth full paragraph and page 29, first recommendation.

The Staff Report states that the Conservancy's numerous new policies and procedures do not specifically address certain transactions, including emission credit arrangements. In fact, the Conservancy's new Standard Operating Procedure on Significant Business Interests does address such cases, as they are acquisitions of less than a controlling interest in an entity. In such cases, the Procedure requires the Conservancy's President and Chief Financial Officer to approve such transactions, in addition to the advance legal and conflicts review required in all appropriate cases. It is also important to note that, with respect to the eight climate change projects reported to the Committee, six were presented to and approved in advance by the Conservancy's Board of Directors.

PART TWO

Pages 2-7, monitoring and enforcement of conservation easements.

The Staff Report describes the Conservancy's procedures for monitoring and enforcing easements and is accurate in its assessment that in the past the Conservancy's monitoring and documentation of the results thereof has not always been consistent across the organization. It is important to note, however, that the current tax laws and regulations do not prescribe standards for the frequency of monitoring or the manner in which the results of monitoring activities should be documented. Moreover, as the Staff Report notes, the Conservancy now has in place a comprehensive standard operating procedure that sets forth detailed monitoring and documentation requirements that are being applied throughout the organization.

The Staff Report's characterization of the Conservancy's practices with regard to easement enforcement is inaccurate. The Conservancy believes its enforcement activities have been consistent and rigorous across the organization. The Staff Report focuses solely on whether the Conservancy engaged in formal litigation and notes only one example where the Conservancy "came to the conclusion that it would not be a good idea for TNC to bring suit against an elderly home town widow of moderate means." As with monitoring, current tax laws and regulations do not prescribe specific standards either for the enforcement of easements or

modifications to the terms of easements. The Conservancy has, however, sought outside legal advice in the development of its own procedures in order to ensure that its standards will reflect best practices as well as be tax law compliant.

Page 6, Bullet Point 2.

The Staff Report states that, in connection with modification of a conservation easement on a shoreline project in Maine, owners were allowed to construct five residences on the property and that the modification also strengthened protection of an area abutting one of the Conservancy's preserves. In fact, the construction of a number of residences was permitted by the three original easements and this number was not changed by the modifications. Instead, as noted in the Staff Report, the easement modifications strengthened language in the original easements to ensure that a 100 foot buffer to the Conservancy's abutting preserve must be kept "forever wild." In exchange, the modifications permit some cutting of vegetation and the locating of the previously permitted structures along the shoreline (provided this activity would be in compliance with Maine's shoreline zoning law).

Page 9.

The Staff Report states that the Conservancy's voluntary modifications of conservation easements "appear" to be inconsistent with guidelines contained in a Guidebook published by the Land Trust Alliance (the "LTA"). The Conservancy believes that its standards for easement modifications are not only consistent with, but are arguably stronger than, those that the LTA's Standards and Practices recommend with respect to matters such as documentation; prohibition on policy documentation; private inurement; compliance with conflict of interest standards; funding requirements; and ensuring that modifications result in a positive, or at least neutral, conservation outcome. The Conservancy's procedures also now impose a requirement for securing appropriate approvals pursuant to state law by state agencies with responsibility for oversight of charitable organizations in the state.

Page 12, first full paragraph, last sentence.

The Staff Report indicates that, with respect to the fourth type of conservation buyer transactions, "[u]nder general tax principles, this option should probably be viewed as exercised by TNC at the time that TNC acquired the option, because TNC holds at that time the ability to compel the grant of the easement for nominal consideration." This statement is inconsistent with the long-standing legal principle established by the Internal Revenue Service in Revenue Ruling 82-197 (1982-2, C.B. 72), which holds that the charitable deduction arises in the tax year that the option is exercised and not in the tax year that the option was granted. Application of this principle in the context of the conservation buyer transaction discussed in the Staff Report is appropriate because the buyer has the discretion and is free to make the donation of the easement at any time prior to the exercise of the option by the Conservancy. Moreover, if for any reason, the Conservancy chooses not to exercise its option and the landowner chooses not to convey an easement, no deduction would be allowable.

Page 17.

The Staff Report notes that, on several occasions in connection with conservation buyer transactions, the Conservancy either failed to "obtain" or "file" a Form 8283. Under current tax laws and regulations, it is the donor's responsibility to prepare and file Forms 8283 to verify any claimed tax deduction. A conservation organization such as the Conservancy has no legal obligation with respect to Forms 8283 other than to execute the Form, if presented to it by the donor, confirming receipt of the land or interest in land from the donor. Nevertheless, as the Committee knows, the Conservancy has revised its own procedures with respect to processing Forms 8283 received from donors.

Page 20, first paragraph and page 55, last paragraph.

The Staff Report indicates that the Real Estate Disclosure Form now required under the Conservancy's procedures was not prepared in connection with some of the conservation transactions reviewed by the Staff. This occurred because, at the time the Conservation Buyer Procedure was adopted, there were a number of transactions already in process. In those cases, the Conservancy was legally obligated to proceed to closing and did not have the legal right to impose new procedural requirements on the buyers in those transactions.

Pages 32-34.

The Staff Report describes the Conservancy's participation in transactions involving Conservation Beef, LLC and Forest Bank, LLC. In the Conservancy's view, these were neither a "dual purpose arrangement," nor a "teaming up with for-profit parties to carry out activities that generate profits as a return to investors" (p. 33, paragraph one). These entities were created for the purpose of working with landowners to show landowners how their land could continue to be used for economic activities that were compatible with public conservation goals. Both of these projects were intended as pilot projects to test innovative conservation strategies designed to promote conservation on private lands. Moreover, Conservation Beef was a partnership between two *nonprofit* entities and was not a venture with any for-profit entities. Furthermore, and contrary to the suggestions in the Staff Report, neither the Conservation Beef nor the Forest Bank ventures were undertaken by the Conservancy as a fundraising activity and there was never any expectation that either of these ventures would generate funds to benefit the Conservancy.

As noted above and discussed with the Committee staff, the Conservation Beef project was a venture with another nonprofit partner, not a for profit entity. Because the costs of running the program proved to be high relative to the conservation gains, the Conservancy eventually withdrew from the project. As envisioned, the Forest Bank was to be wholly owned and operated by the Conservancy and was designed to work with small woodlot owners to optimize conservation practices on these private lands. The feasibility studies undertaken by the Conservancy did not support the conservation benefits relative to the potential costs, so the Forest Bank, LLC project was never implemented.

Page 36, first full paragraph.

In its discussion of the Conservancy's Trade Lands Program, the Staff Report states that "[T]rade Lands are critically important to TNC's Mission and are handled through its State offices." This is not correct. The trade lands program has since its inception been administered by the Conservancy's central office.

Moreover, it is difficult to conclude that the Trade Lands Program is "critical" to the Conservancy's mission since the gross proceeds received by the Conservancy from the sale of trade lands over the past three years represents less than 1.8 percent of total Conservancy revenue and, excluding one large sale, less than 1.1 percent of revenue. Indeed, as noted in the Staff Report schedule shown on Page 37, the Conservancy has sustained an aggregate net loss over the last five years.

Finally, the Staff Report indicates that, in some cases, trade lands buyers were provided financing by the Conservancy at zero or below market interest rates. The Conservancy was unable to discover any instance in which trade lands were sold in exchange for notes bearing a zero interest rates and believes that in general most notes provided for interest rates at one or two points above the then prevailing interest rates.

PART THREE

Page 12, numbered observation 4.

The Staff Report states that the Conservancy "apparently did not regularly seek or obtain appraisals or fairness opinions with respect to these [related party] transactions." This statement, apparently based on the Committee Staff's review of the Conservancy's Form 990 information returns should not be read to suggest that the Conservancy does not review or confirm the value of the goods, land, or services that it purchases involving a related party. While it is fair to say that (in accordance with the IRS instructions for completing Form 990s) that the Conservancy does not include details of the appraisals and the backup information in its Form 990, it is inaccurate to conclude from this fact that the Conservancy does "not seek or obtain appraisals or fairness opinions with respect to these transactions." The Conservancy obtained appraisals for all related party transactions listed in its Form 990s that involved land, or interests in land, where the Conservancy was giving anything of value in return. The Conservancy also lists gifts of land, services, and other tangible goods from related parties in its Form 990. In such pure gift cases, the Conservancy would normally not obtain an independent appraisal.

The Conservancy's Forms 990 also reports goods or services purchased from a related party for less than fair market value. While the Conservancy would not necessarily obtain an appraisal in these bargain purchase transactions (unless it were a land transaction), it would ascertain and document the fair market value of the goods or services received, the amount of the payment by the Conservancy, and the value of the resulting gift or bargain to the Conservancy. Consistent with reporting requirements issued by the Internal Revenue Service, the Conservancy's Form 990 would not include all of this background information. The Conservancy does, however, complete these due diligence activities and maintains appropriate

back-up information to reflect transactions with related parties to ensure that those transactions do in fact comply with all the substantive requirements of current tax laws and regulations.

Page 12, numbered paragraphs 1 and 4 and page 3, Executive Summary.

In connection with the Staff Report's discussion of transactions with related parties, it should be emphasized that, during the time period covered by the Staff Report, the Conservancy participated in more than 10,000 land transactions. During that same time period, there were 169 conservation buyer transactions and, of these, only 19 involved "related parties." In addition, the Conservancy is not aware of any "side deals" or verbal agreements, and believes all documents required under current tax laws and regulations were obtained.

The Conservancy agrees with the suggestion in the Staff Report that in complex transactions, it is often difficult to separate those parts of a transaction that may be relevant from a tax standpoint from those that have no tax significance. As the Committee is aware, the Conservancy's Board of Directors adopted requirements more than two years ago that all transactions be documented in such a way as to clearly link and document all components of a transaction, without regard to whether some components did or did not have tax significance. While not legally required to do so then or now, the Conservancy adopted these requirements in its quest to set practices that go beyond current legal requirements. The Conservancy follows these requirements to provide greater transparency and clarity.

***Martha's Vineyard*:**

Page 17, Observation 4 and page 24, first full paragraph.

The Staff Report suggests that the Conservancy provided a tax indemnity to a private party in connection with this transaction, but correctly notes that no Conservancy funds could be lost under the indemnity because Roger Bamford provided an indemnification agreement to the Conservancy that provided, in part, that Mr. Bamford would reimburse the Conservancy for any payments made by it under the indemnity.

Page 17, Observation 5, Line 5 and 6 and Page 19, Footnote 24.

The statement that the Wallace family transferred the preemptive right to HCAC only a few months before in December 2000 appears to be inaccurate. In fact, the Cohan family acquired these rights from the Wallace family when they sold the land to the Wallace family in 1969 and the Cohan family then transferred these rights to HCAC. Thus, when the transaction was being negotiated by the Conservancy, the preemptive rights were held by HCAC and, if exercised, would have precluded the transaction.

The Wallace family insisted that the Conservancy negotiate directly with HCAC to secure a waiver of its preemptive rights. At the time of the transaction, the Wallace family and HCAC (and its predecessors) had been in litigation with respect to their respective rights and obligations under various agreements dating originally from the purchase of the land by the Wallace family in 1969. Had the Conservancy not undertaken to deal directly with HCAC as a

separate transaction, it is unlikely that the acquisition and preservation of Herring Creek could have been completed.

Page 18, Observation 8.

The Staff Report states that the Conservancy informed the Committee Staff that the Conservancy "had knowledge of the identity of the owners of HCAC early on in the negotiations." To clarify, the Conservancy knew that Erik Aldeborgh signed the initial agreement with the Conservancy on behalf of HCAC and that by virtue of being the original holders of the preemptive rights, the Cohan family was likely involved with HCAC in some capacity. Rob Hughes also took part in the negotiation for HCAC.

Page 19, Overview, third full paragraph, last line.

The Staff Report states that the conservation restriction encompassed only "a portion" of the property. In fact, the conservation restriction covered the entire property.

Page 24, Footnote 47.

The language in the body of the document to which this footnote is attached refers to HCAC preemptive rights. The footnote itself references a letter from the Conservancy to Stuart Johnson. These are two separate matters and the footnote incorrectly refers to "the full fair market value stated in HCAC's appraisal." The Conservancy believes that the appraisal referred to by the Staff Report should be either the "Wallace" or the "Herring Creek Farm Trust" appraisal.

Lake Huron:

Page 37, Observation 3.

The Staff Report states, in part, "[b]ecause TNC did not provide Forms 8283 or 8282 with respect to Harmon for either the Shillingburg or the Chi-Mac tracts, the Staff could not determine whether Harmon claimed a charitable deduction with respect to either of these properties." On March 7, 2001, the Conservancy did send Harmon a blank 8283 following the transaction involving the former Shillingburg tract. Harmon never returned the Form 8283 to the Conservancy for signature, and it is the Conservancy's understanding based on conversations with Harmon that he ultimately decided not to claim a charitable deduction the transaction. The Staff Report infers that the Conservancy failed to supply the Committee Staff with the Forms 8283, but in fact there were no completed forms.

Page 37, Observation 4.

The Staff Report states that, regarding the Shillingburg charitable contribution to the Conservancy, "TNC's letter dated March 7, 2001, included a blank Form 8283 and stated the property transaction was a bargain sale. There is no record of Shillingburg providing TNC a signed Form 8283 or claiming a deduction for any bargain sale component." In fact, there was

never any suggestion in the transaction that Shillingburg was making a gift or would be able to claim a charitable deduction. The March 7, 2001 acknowledgement letter with blank 8283 was addressed to Harmon, not to Shillingburg, and (as noted above) Harmon did not ever return a completed 8283 form to the Conservancy for signature.

Page 37, Observation 5.

The Staff Report states, "The Staff does not expect TNC or other charitable organizations to discern donative intent. However, it questions whether it is appropriate for charitable organizations in general to provide acknowledgements that a gift was made when an organization itself questions donative intent in a particular instance." In fact, The Conservancy never sent Chi-Mac a letter acknowledging any charitable contribution in connection with its sale of the property to the Conservancy. This was a complex transaction that was made more difficult by contentious litigation. The Conservancy did ultimately sign the Form 8283 supplied by Chi-Mac to acknowledge receipt of the land, but only after expressing skepticism about the availability of a charitable deduction. In this connection, it is important to emphasize that, by executing a Form 8283, conservation organizations such as the Conservancy are merely acknowledging the receipt of property and are not taking a position either that any charitable deduction is allowable or the amount of any such deduction. As the Staff Report notes, the Conservancy has modified its Form 8283 procedures to promote tax compliance by all parties to transactions in which the Conservancy is a participant.

Davis Mountains:

Page 58, Observation 1.

The Staff Report states that Caroline Alexander was a member of the Board of Governors for the Conservancy, Texas. In actuality, she was a member of the Board of Trustees of the Conservancy's Texas chapter. As a chapter trustee, Ms. Alexander had no legal or fiduciary responsibility, or decision-making authority with respect to transactions undertaken by the Conservancy. Such authority resides in the Conservancy's Board of Directors. A trustee of a Conservancy chapter cannot meet the strict definition of an insider. Nevertheless, the Conservancy has changed its policies and procedures to prohibit all purchases and sales of conservation lands from and to Chapter trustees.

Page 58, "Overview."

The Staff Report contains several incorrect statements as follows:

a. In the first paragraph, the Staff Report describes the Conservancy's acquisition of 32,529 acres in the Davis Mountains and then in the second paragraph, states that the Conservancy subsequently sold "most" of the property to Caroline Alexander Forgason. This is incorrect. In addition, the Staff Report fails to describe the Conservancy's second acquisition of 27,319 acres from a different seller, of which most of that acreage was transferred to Caroline Alexander Forgason's company. The correct characterization of the transactions is:

(i) In 1997, the Conservancy acquired 32,529 acres at the Davis Mountains from the McIvor family. Of that acreage, only 5,854 acres were sold to Forgason. The Staff Report is correct that the Conservancy's purchase price was $10.7 million, with an appraised value of $11.4 million.

(ii) In 1999, the Conservancy acquired 27,319 acres from Dean Ranch Properties, Ltd. This property is known as the Caldwell Ranch. The Conservancy's acquisition price was $6.4 million, with an appraised value of $7.5 million. Most of this property (27,133 acres) was sold to Davis Mountains Land & Cattle Company, which is owned by Forgason.

b. In the third paragraph, the Staff Report states that the Conservancy's sales price was $1,160,834, and the appraisal on the property on disposition was $1,170,000. Any inference that the Conservancy sold the property for less than fair market value is incorrect. The Staff Report fails to include the additional information from the summary that the sales price was reduced by $10,000 due to encroachments and acreage in the highway. The Conservancy had received a reduction of $30,000 in its acquisition price due to the encroachments and highway acreage. Upon the sale of the land to the various conservation buyers (including to Forgason), the reductions were passed along to them to the extent the land they were purchasing was affected by the encroachments and highway acreage.

Page 69, last sentence, third full paragraph.

The Staff Report suggests that a verbal agreement with PM Holdings over a short period of time to perform some specific marketing and processing operations "may have had the effect of creating a joint venture among TNC, AWF, and PMH." This suggestion is incorrect and is apparently based on a draft document that was never executed by the parties and that happened to be labeled "Joint Venture Agreement." The fact that CBL and PM Holdings never executed this document confirms that there was no joint venture because terms could never be worked out to the satisfaction of both parties.

PART FOUR

Page 6, second paragraph.

The Staff Report states that "TNC commenced several new activities that it had not previously reported to the IRS, and that were significant in terms of level of expenditure." The Conservancy does not believe that the three listed activities (Virginia Eastern Shore Development project, the emissions arrangements, or the Conservation Beef program) could reasonably be considered significant in terms of levels of expenditures. The investments in the Virginia Eastern Shore Development and Conservation Beef projects involved fractions of a percent of the Conservancy's financial resources. The emissions activities were not only financially insignificant (less than one percent of revenue over the stated periods), but were also in support of forest conservation, an activity carried on in direct furtherance of the Conservancy's conservation goals and employed methods that the Conservancy uses in conservation projects on a daily basis.

Page 18, fifth paragraph.

The Staff Report states that "Conservation Beef, LLC was a taxable subsidiary." This is incorrect because it was structured as a joint venture between two tax-exempt organizations and thus is a tax-exempt entity.

Page 30, paragraphs one, two, and three.

Based on a review of certain e-mail communications, the Staff Report suggests that the Conservancy did not analyze the UBIT consequences of certain programs such as timber sales, consulting services, and trade lands. As noted above, the Conservancy obtained an opinion of counsel concerning the UBIT aspects of the trade lands program. The Conservancy believes that the relevant e-mail communications do in fact contain some "analysis involving the application of UBIT law to the pertinent facts" regarding timber sales, consulting services, and the Trade Lands program.

* * *

The Conservancy appreciates this opportunity to correct and clarify certain matters discussed in the Staff Report.

Very truly yours,

Philip Tabas
Vice President/General Counsel

Attachments as stated

cc: Dean Zerbe (w/o attachments)
Jonathan Selib (w/o attachments)

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December 1, 1989

Mr. Clifford F. Messinger
Chairman of the Board
The Nature Conservancy
Post Office Box 334
New Berlin, Wisconsin 53151

Dear Cliff:

You have requested our opinion of the Federal tax consequences of The Nature Conservancy's "Tradelands" program, under the facts presented below. Specifically, we have addressed the issues of the extent to which this program may affect The Nature Conservancy's exemption under §501(c)(3) of the Internal Revenue Code of 1986 (the "Code"), as well as whether activities undertaken as part of the program may give rise to unrelated trade or business income under the Code. We have also considered the extent to which the risk of exposure on either of these issues may be minimized by the adoption of certain precautionary measures.

FACTS

The Nature Conservancy ("TNC") was incorporated in the District of Columbia in 1951, and is classified as exempt from Federal income tax under §501(c)(3) of the Code. The purposes of TNC include the following:

> " (a) to preserve or aid in the preservation of all types of wild nature, including natural areas, features, objects, flora and fauna, and biotic communities; (b) to establish nature reserves or other protected areas to be used for scientific, educational, and esthetic purposes; (c) to promote the conservation and proper use of our natural resources; (d) to engage in or promote the study

> of plant and animal communities and of other phases of ecology, natural history, and conservation; and (e) to promote education in the fields of nature preservation and conservation."[1]

One of TNC's programs is called "Tradelands", pursuant to which TNC accepts gifts of real estate without significant natural values so that it can sell the land and use the proceeds to purchase lands with significant natural values. These former properties are called "trade lands". Occasionally, where a potential donor cannot afford, or does not wish, to make an outright gift of trade lands to TNC, TNC may purchase the land for less than its fair market value in a "bargain sale". Trade lands purchased in this manner may also be resold to raise funds for use in TNC's exempt programs.

In all instances, valuation and appraisals are in accordance with applicable IRS requirements. TNC does not participate in the valuation process nor does it counsel donors on the tax implications of their contributions (beyond describing its experience in similar prior transactions). TNC conscientiously avoids any improprieties or abusive tax practices.

Not all trade lands received or purchased by TNC consist of raw land suitable for immediate resale. In some instances, any such sale may depend upon the availability of zoning or other approvals. In many cases, structures, which may or may not be in need of repair, are donated along with property, and in other cases, construction has begun, but has not been completed, on development projects on the property. Other properties may be subject to existing cropsharing arrangements or mineral leases, and/or may have potential disclosed or undisclosed liabilities associated with the property with respect to environmental hazards.

TNC historically has been reluctant to accept gifts of property which would require significant development or

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[1] These purposes include those stated in an Amended Certificate of Incorporation filed by TNC in the District of Columbia in 1959.

management activities prior to sale. TNC is also concerned about the possible exposure to liability for failure to act with respect to environmental hazards which may exist with respect to the properties. For the foregoing reasons TNC has often referred these types of gifts to an independent organization, The Conservation Fund ("The Fund")[2], for disposition. In addition, TNC has used The Fund to handle the marketing aspects of such dispositions.

The Fund is a separate §501(c)(3) organization whose purposes are broader than those of TNC, and include the conservation of human resources as well as land areas, by undertaking demonstrative land use projects to further local community land use planning and existing economic development efforts. In pursuance of these purposes, The Fund is able to undertake the management and development of property which may be without significant natural values, and/or may present significant risks from an environmental or financial viewpoint.

CONCLUSION

The determination of whether an organization is engaged in an unrelated trade or business depends upon three elements: First, the activity must constitute a "trade or business"; second, the activity must be "regularly carried on"; and last, the activity must be one that is not "substantially related" to the organization's exempt purpose. It is our opinion that the acquisition and sale of real property pursuant to the Tradelands program, is "regularly carried on" by TNC within the meaning of the Code. Further, we believe that the Internal Revenue Service could successfully contend that this activity is not "substantially related" to TNC's exempt purpose, which may generally be described as the conservation and improvement of the natural environment. The primary issue posed in the context of this opinion, therefore, is whether the activities of TNC in conducting the Tradelands program rise to the level of a "trade or business" within the meaning of applicable Internal Revenue Service laws and regulations.

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[2] The Conservation Fund's full name is "The Conservation Fund, A Nonprofit Corporation".

Whether a program or activity rises to the level of a "trade or business" in turn depends primarily upon the extent to which the taxpayer's activities with respect to the program may be described as "active" or "passive". This question is analogous to that posed when the issue is whether a particular piece of real property would qualify as capital gain - i.e., "investor" - property, as opposed to ordinary income - i.e., "dealer" - property, under rules generally applicable to taxable business entities. Since the answer to this question is inherently factual, the tax characterization of the Tradelands program is, to a large extent, within TNC's control. Therefore, we recommend the following:

(1) Because the primary determinant of "trade or business" status depends on the degree of activity undertaken by a taxpayer with respect to a particular piece of property, we recommend that TNC's activities be limited to accepting contributions of trade lands. All other activities to be undertaken with respect to contributed property prior to sale should be handled by an independent, outside agency, such as The Fund.

(2) In keeping with its status as a passive investor, TNC should not be involved in the rezoning, subdivision or development of property, prior to resale or similar acts, except in isolated cases where it may be argued that such activities are absolutely necessary to enable TNC to dispose of the property. Even in this instance, it would be advisable for TNC to convey property requiring substantial efforts prior to sale to an outside entity, thereby preserving the passive nature of TNC's holding. The Fund, because of its broader charter, is well able to undertake such activities.

(3) Similarly, where land is subject to existing cropsharing or mineral leases, TNC should take care that the terms of such leases do not, by reason of requiring sharing of expenses or extensive management activities, rise to the level of a trade or business.

(4) "Tradelands" currently is conducted as a separate program of TNC, in contrast to other, program-related real

estate activities, which are under the centralized control of TNC's General Counsel's office. We would advise that you consider, as you already are considering, placing Tradelands activities with the other real estate activities under the control of TNC's General Counsel's office. This recommendation is being made, in part, because, as already noted, the General Counsel's office is responsible on a centralized, nationwide basis for all real estate. In addition, because of the unusual liability concerns that surround some of these properties, the General Counsel's office would appear better able to handle their contribution and disposition.

(5) It may also be advisable to encumber properties, wherever appropriate, with conservation easements prior to sale, or otherwise arrange for their preservation in order to establish a "substantial relationship", with respect to such properties, vis a vis the exempt purposes of TNC.

(6) Finally, we note that the name "Tradelands" may be connected, in the minds of those accustomed to dealing with Federal tax issues, with the term "trade or business". For this reason, we suggest that you consider changing the name of this activity to something more innocuous, having no unfavorable Federal tax connotations.

We believe that it is unlikely that the operation of the Tradelands program will jeopardize TNC's exemption from Federal income tax under §501(c)(3), since it is our opinion that, given the current scope of the Tradelands program, the primary purpose of TNC will continue to be environmental conservation, even if that program is at some point determined to be an unrelated trade or business.

Finally, we have noted your concerns with TNC's potential exposure to liability for environmental hazards which may be present, although undisclosed, on contributed property. We suggest that all property be scrutinized prior to the acceptance of its donation to minimize the possibility of such exposure. An environmental assessment of the property should be required of each donor prior to the acceptance of any real property donation by TNC.

DISCUSSION

A. Unrelated Trade or Business Income.

1. Generally.

Income realized by a tax-exempt organization from an "unrelated trade or business" is subject to tax, at regular corporate rates, under §511 of the Code. The Code defines the term "unrelated trade or business" to mean a

> "trade or business the conduct of which is not substantially related (aside from the need of [the] organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its [exempt]. . . purpose."[3]

This definition encompasses three requirements, as follows:

(1) The activity must constitute a "trade or business";

(2) The activity must be "regularly carried on"; and

(3) The activity must be one that is not "substantially related" to the organization's exempt purpose.

2. The "Trade or Business" Requirement

Section 513(c) of the Code defines the term "trade or business" when used in the context of the unrelated business income tax as including "...any activity which is carried on for the production of income from the sale of goods or the performance of services."

The regulations under §513 further provide that

> "[I]n general, any activity of a §511 organization which is carried on for the

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[3] Code §513(a). See also Regs. §1.513-1(a).

> production of income and which otherwise possesses the characteristics required to constitute a 'trade or business' within the meaning of §162 -- and which, in addition, is not substantially related to the performance of exempt functions -- presents sufficient likelihood of unfair competition to be within the policy of the tax. Accordingly, for purposes of §513 the term 'trade or business' has the same meaning it has in §162. . ."[4]

In applying these rules, some courts have focused on the "profit motive test", i.e., whether an activity is "carried on for the production of income from the sale of goods or the performance of services,"[5] while others have focused more broadly on the purpose underlying the enactment of the unrelated business income tax, i.e., the elimination of unfair competition by exempt organizations.[6] The Supreme Court, however, in United States v. American Bar Endowment,[7] decided in 1986, appears to have decided that the proper approach to be used in determining whether income-producing activities of a tax-exempt organization constitute a trade or business for purposes of the unrelated business income tax, is the "profit motive test".[8] In that case, the Supreme

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4 Regs. §1.513-1(b).

5 Section 513(c).

6 Compare Professional Insurance Agents of Michigan v. Commissioner, 726 F.2d 1097 (6th Cir. 1984); Carolinas Farm and Power Equipment Dealers v. United States, 699 F.2d 167 (4th Cir. 1983); and Louisiana Credit Union League v. United States, 693 F.2d 525 (5th Cir. 1982), all adopting the "profit motive" test to determine whether an activity constitutes a trade or business, with Disabled American Veterans v. United States, 650 F.2d 1179 (Ct.Cl. 1981); Hope School v. United States, 612 F.2d 298 (7th Cir. 1980); and Carle Foundation v. United States, 611 F.2d 1192 (7th Cir. 1979), which utilized the unfair competition test.

7 477 U.S. 105, 91 L.Ed.2d 89 (1986).

8 477 U.S. at 111, 91 L.Ed.2d at p. 97.

Court concluded that the insurance programs operated by the American Bar Endowment constituted an unrelated "trade or business" within the meaning of §513. In its decision, the Court focused on the literal words of §513(c), defining trade or business as "any activity which is carried on for the production of income from the sale of goods or the performance of services."[9]

Under this standard, virtually all activities undertaken for profit would qualify as a trade or business. Section 512(b) of the Code, however, sets forth several modifications to the definition of unrelated business taxable income which may be pertinent here. Under that section, unrelated business taxable income does not include, among other things, rent from real property (except to the extent attributable to property which is debt-financed),[10] royalties[11] and gains from the sale, exchange or other disposition of capital assets[12]. In addition, under §513(a)(3), any trade or business which consists of the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions, is excluded from the term "unrelated trade or business".

What all of these exceptions have in common, as may be seen from the discussion below, is that they relate to activities which are essentially passive in nature, requiring little in the way of active business participation on the part of the exempt organization which benefits from their conduct.

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9 Id. See also Illinois Association of Professional Agents v. Commissioner, 801 F.2d 987, 990-991 (7th Cir. 1986).

10 §512(b)(3). We do not address the issue of "debt-financed income" in this letter, since we understand that the properties in question are not subject to any acquisition, or other, indebtedness.

11 §512(b)(2).

12 §512(b)(5).

(a) Rents

Section 512(b)(3) of the Code provides that rents from real property (together with certain rents from personal property) are excluded from the term "unrelated business taxable income" so long as the determination of the amount of rent does not depend in whole or in part on the income or profits derived by any person from the rented property (other than an amount based on a fixed percentage of receipts or sales).[13] Where the amount of the rental is based on the income or profits derived from the leased property, the Service may determine that the arrangement constitutes a joint venture or partnership rather than a rental arrangement.

You have indicated that, in some instances, property contributed to TNC is subject to standard crop-share leases. Whether these leases will produce unrelated business income depends on their terms. In Rev. Rul. 58-482,[14] for example, the Service found that farms and orchards operated by charitable trusts were operated as profit-making enterprises, and their operation constituted the operation of an unrelated trade or business by the trust. However, the Service further ruled that amounts received in the form of produce by the trust from a crop-share lease with a tenant who bore all the operating expenses of his portion of the farms and orchards constituted "rent" payments, and, therefore, were not unrelated business taxable income under the Code.[15]

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[13] See Regs. §1.512(b)-1(c)(2)(iii)(b) which states that the specific rules contained in ¶¶(b)(3) and (b)(6) (other than (b)(6)(ii)) of Regs. §1.856-4 should govern the interpretation of whether a payment constitutes "rent" under §512(b)(3)(B)(ii) of the Code. Under Regs. §1.856-4(b)(3), the term "rents from real property" includes rents computed with reference to different percentages of receipts from differing departments or separate floors of a retail store, so long as each percentage is fixed at the time of entering into the lease, and may not be renegotiated in a manner which has the effect of basing the rent on income or profits.

[14] 1958-2 C.B. 273.

[15] Cf. United States v. Myra Foundation, 382 F.2d 107 (8th Cir. 1967) and State National Bank of El Paso v. United

Rev. Rul. 58-482 was distinguished by the Service in a recent Technical Advice Memorandum (LTR 8808003, October 29, 1987), which held that income from a standard crop-share lease would be includible in the calculation of a charity's unrelated business taxable income where the charity was obliged to pay one-half of the costs for seed, fertilizers, herbicides and insecticides, as well as one-half of the cost of combining (i.e., mechanically harvesting) small grains. In addition, the trust was required to decide whether to participate in any government programs, and was entitled to participate in the profits from the operation to the same extent as was the tenant. The IRS felt that these activities were indicative of the charity's active participation in the production of income, rather than a passive receipt of rental income.

It is this distinction between active and passive participation in the generation of income which is the distinguishing factor in determining whether most types of income, not limited solely to rent, constitute unrelated trade or business income to an exempt organization. For this reason, we suggest that any land received subject to cropsharing or similar arrangements be scrutinized with an eye toward limiting the obligation of TNC to share expenses and/or otherwise actively participate in the management of the property.

(b) Royalties

The Internal Revenue Code and regulations provide that royalties, including overriding royalties, and all deductions directly connected with such income, are excluded in computing unrelated business taxable income.[16] You have indicated that some properties received by TNC are subject to mineral leases. Internal Revenue Service

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States, 509 F.2d 832 (5th Cir. 1975), both of which conclude that cropsharing arrangements between a charity and a tenant do not, as matter of law, produce unrelated business taxable income.

16 Code §512(b)(2) and Regs. §1.512(b)-1(b).

regulations provide specifically that mineral royalties are excluded from the computation of unrelated business taxable income whether measured by production or by gross or taxable income from the mineral property. One exception to this occurs where an organization owns a working interest in a mineral property, and is not relieved of its share of the development costs by the terms of any agreement with the operator.[17]

(c) Gains from the Sale, Exchange or Other Disposition of Capital Assets

Section 512(b)(5) of the Code provides that there shall be excluded from the definition of unrelated business taxable income gains or losses from the sale, exchange or other disposition of property other than:

> "(A) Stock in trade or other property of a kind which would properly be includible in inventor if on hand at the close of the taxable year, or
>
> "(B) Property held primarily for sale to customers in the ordinary course of the trade or business."

With respect to real property, this exception applies essentially to all realty held by a tax-exempt organization which would qualify as capital gain property (including property used in a trade or business), as opposed to "dealer property" under rules generally applicable to taxable business entities. The issue of whether property qualifies as capital gain property as opposed to "dealer property" is often referred to as a "question of fact", which must be resolved on the basis of examination of all of the "facts and circumstances", no one of which is controlling.

Some of the relevant "facts and circumstances" include:

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[17] In LTR 8839016, the IRS ruled that an exempt organization's net profit interest in mineral properties was not unrelated business taxable income since the organization's liability for costs was limited to the amount of production. Cf. Rev. Rul. 69-179, 1969-1 C.B. 158.

(1) the purpose for which the property was acquired;

(2) the frequency, continuity and size of sales;

(3) the extent of improvements to the property;

(4) the activities of the owner in improving the property;

(5) the purposes for which the property is held; and

(6) the proximity of the purchase and sale.[18]

Rev. Rul. 55-449,[19] for example, holds that the construction and sale of 80 houses by a foundation over a period of 18 months for the purpose of raising funds for the support of a church was an unrelated trade or business within the meaning of §513 of the Code, notwithstanding that the organization did not plan to engage in further similar activities.

This ruling was applied by the IRS in Technical Advice Memorandum 8717002, (January 17, 1987)[20]. In that ruling, a religious organization amended its charter to include among

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[18] LTR 8734005 (Apr. 27, 1987), citing Adam v. Commissioner, 60 T.C. 996, 999 (1973), Houston Endowment, Inc. v. United Stated, 606 F.2d 77 (5th Cir. 1979), Biedenharn Realty Co. v. United States, 526 F.2d 409 (5th Cir 1976) and Buono v. Commissioner, 74 T.C. 187 (1980).

[19] 1955-2 C.B. 599.

[20] See also LTR 8028117 (April 21, 1980)(holding that the construction and sale of condominium apartment units in a building constructed by a labor union as its headquarters facility constituted the conduct of an unrelated trade or business); and LTR 8346005 (Technical Advice Memorandum)(Undated) (holding that a social club which sold improved residential lots to members was engaged in an unrelated trade or business even where such lots were part of an original package of land purchased by the social club to construct a golf course).

its activities the buying and selling of real estate. In order to obtain additional funds to carry on its exempt purposes, the organization purchased 629 acres of land for resale. The land was subdivided into residential lots, cleared and surveyed. Streets were cut in and water and power lines extended. During one calendar year, the organization sold an unspecified number of lots, producing approximately $500,000 in sales income.

The IRS ruled that the organization continued to be exempt under §501(c)(3), since the authorization to engage in real estate activities in order to raise additional funds was insubstantial in relation to its exempt, and primary purpose of promoting and spreading the gospel of Jesus Christ. It nevertheless ruled that the sales produced unrelated business taxable income since the subdivision of the land and its subsequent sale would have produced ordinary income derived from the regular course of a trade or business had it been conducted by a taxable organization. In so holding the IRS stated:

> "In the subject case, A acquired the land for later sale to individuals for the purpose of raising funds for its exempt purposes. In order to make the land more attractive to prospective purchasers substantial improvements were made to the land. A did some advertising at the site of the tracts. Also, the frequency and number of sales could be considered substantial. Lastly, A derived large amounts of revenue from the sales which resulted in net profits inuring to it.
>
> "In light of the fact that the sales of the lots by A could not be considered a gradual and passive liquidation of previously owned land which it had no use for, the sales cannot be characterized as an incidental sale of property. It appears, rather, that the land was acquired undeveloped for later sale to individuals in a manner similar to a real estate company operated for profit purposes."[21]

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[21] LTR 8717002. Compare LTR 8841041 (July 20, 1988), in which an organization formed, in part, for the purpose of acquiring land suitable for use as a prairie chicken habitat,

In another Technical Advice Memorandum,[22] the Internal Revenue Service noted that

> "The disposal of real property no longer needed for an organization's exempt activity generally would not result in income subject to unrelated business income tax. When, however, significant capital improvements are made to the property, the characterization of the transaction can change. Although Rev. Rul. 55-449 deals with more extensive improvements [i.e., homebuilding] to property than is the case here, language similar to I.R.C. 512(b)(5) appears in I.R.C. 1221 and 1231 relating to capital gains and losses. Those Code sections have generated several revenue rulings and court cases, including Rev. Rul. 59-91, which states that capital improvements of the type undertaken by the organization are of sufficient magnitude to place a taxable corporation in the business of real estate development and thus exclude the gain on sale of the property from preferential capital gains treatment."[23]

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sold all of the land owned by it to the Wisconsin Department of Natural Resources which previously had managed the land on behalf of the organization. The IRS ruled that this sale did not produce unrelated business taxable income: First, because the proposed transfer was substantially related to the organization's exempt purposes; and second, because the sale was a one-time transaction which did not amount to a "trade or business" within the meaning of §513(a) of the Code.

22 LTR 8346005, supra.

23 See also Rev. Rul. 59-91, 1959-1 C.B. 15, in which a corporation engaged in the rental real estate business acquired a tract of raw land in a foreclosure, and was held to be engaged in selling real estate to customers when it subdivided and improved (but did not build on) the land, and Parklane Residential School, Inc. v. Commissioner, 45 T.C.M. 988 (1983) (Twenty-two simultaneous purchases and sales of real estate by school for retarded children over a two-year period produces unrelated business taxable income).

In contrast to the foregoing Technical Advice Memorandum, the Service, in Technical Advice Memorandum 8734005,[24] ruled that the development and sale of lots by an orphanage was not an unrelated trade or business, where the land in question was no longer needed by the orphanage in the performance of its exempt function, and the development activities were undertaken solely because of the difficulty of selling the property as an undeveloped unit. In essence, the Service reasoned that the "primary purpose" of the sale of the property was "the orderly liquidation of [the] property no longer needed to carry on [the orphanage's] exempt purpose."[25]

An analysis of these rulings leads us to conclude that TNC, if it is to be engaged on a continuing basis in the sale of contributed property, should severely restrict its activities with respect to that property prior to sale. This means that activities such as rezoning, resubdivision, construction, or any improvement should be the responsibility of the subsequent purchaser of the property. In some cases, it may be desirable to take title to the property only for the purpose of reconveying it to The Conservation Fund, whose broader charter would enable it to engage in activities which bear more of a relationship to those of a for-profit real estate development entity without running afoul of the unrelated business income tax.

(d) Sales of Contributed Merchandise

Code §513(a)(3) removes from the category of "unrelated trade or business" any trade or business which consists of the selling of "merchandise" substantially all of which has been received by the organization as gifts or contributions. This is sometimes referred to as the "thrift shop" exemption. The regulations, for example, state that

> ". . . [This] exception applies to so-called 'thrift shops' operated by a tax-exempt

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[24] April 27, 1987.

[25] LTR 8734005, citing Malat v. Riddell, 383 U.S. 569 (1966).

> organization where those desiring to benefit such organization contribute old clothes, books, furniture, etc., to be sold to the general public with the proceeds going to the exempt organization."[26]

It is true that, in the instant case, TNC receives a substantial part of the real estate which it sells in the form of "gifts or contributions". There is some question, however, as to whether real property falls within the intended meaning of the term "merchandise" in the "thrift shop" exemption.[27] There is an argument to be made, however, that, if one is to be considered a "dealer" in real property, one's "merchandise" must necessarily consist of that real property.

3. The "Regularly Carried On" Requirement

Unrelated business taxable income must be derived from an activity which is "regularly carried on" by the exempt organization.[28] The regulations state that

> "In determining whether trade or business from which a particular amount of gross income derives is 'regularly carried on', within the meaning of §512, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued. . . Hence, for example, specific business activities of an exempt organization will ordinarily be deemed to be

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26 Regs. §1.513-1(e)(3).

27 Cf. Parklane Residential School, Inc. v. Commissioner, 45 T.C.M. 988, 992, n. 10 (1983). (Court found "thrift shop" exception not to be applicable as no evidence was introduced to permit conclusion that "merchandise" was contributed to school for retarded children.)

28 Code §512(a)(1).

> 'regularly carried on' if they manifest a frequency and continuity, and are perceived in a manner generally similar to comparable commercial activities of non-exempt organizations."[29]

Under this provision, the conduct of an activity over a period of a few weeks, which, if conducted by a taxable entity, would be conducted on a year-round basis, would not constitute the regular carrying on of a trade or business. Similarly, an activity such as an annual charity ball would not constitute an activity which is "regularly carried on".[30]

In the instant case, where TNC is receiving and reselling property on a fairly regular basis in a manner and with a frequency with which such sales would be made by other profit-making entities, it would be difficult for us to conclude that such an activity would not be considered to be "regularly carried on" within the meaning of the unrelated business income statutes.

4. The "Substantial Relationship" Requirement

In elaborating on the "substantially related" requirement, the regulations state that a trade or business is substantially related to an organization's exempt purposes if the activity "contributes importantly to the accomplishment of those purposes."[31] The regulations also suggest that a trade or business may be treated as unrelated to an organization's exempt functions solely by reason of the size of the business.[32] That is, where an exempt organization realizes income from activities related to its

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29 Regs. §1.513-1(c)(1).

30 But see National Collegiate Athletic Association v. Commissioner, 92 T.C. No. 27 (1989), wherein the Tax Court concluded that advertising sales in a program published for an annual athletic event was regularly carried on and, therefore, constituted an unrelated trade or business.

31 Regs. §1.513-1(d)(2).

32 Regs. §1.513-1(d)(3).

exempt function, but where the activities are conducted on a "larger scale than is reasonably necessary for performance of such functions," at least a portion of the income from the activities will be treated as unrelated trade or business income.

In order to determine whether TNC's sales of contributed property are related to its exempt purposes, it is first necessary to examine those purposes and then to determine in what respect the sales advance those purposes (other than through the production of income). For example, in Rev. Rul. 86-49,[33] the Service ruled that an organization that was formed for the purpose of preserving the historical and architectural character of a community through the acquisition and occasional restoration of historically or architecturally significant properties, could subsequently dispose of those properties by sale without affecting its exemption. The disposition of the properties in this ruling took place at fair market value on arm's length terms, and the continued preservation of a property after sale was guaranteed by means of restrictive covenants that were tailored to assure the preservation of the historic or architectural character of the structures and communities involved.[34]

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[33] 1986-1 C.B. 243.

[34] See also LTR 8321148 (Feb. 18, 1983)(participation by tax-exempt public charity, as a limited partner, in a partnership formed to acquire, develop and lease a shopping center complex and related facilities in a blighted area is not an activity considered to be an unrelated trade or business within of §513(a) of the Code); LTR 8437009 (May 29, 1984)(Technical Advice Memorandum)(501(c)(3) organization which participates as managing general partner in a limited partnership formed to purchase and renovate a building for use as low and moderate income housing for elderly persons, is not subject to unrelated business income tax on such activity); LTR 8437010 (May 29, 1984)(Technical Advice Memorandum)(fees for services performed by exempt organization in syndicating and managing low income housing facility constructed and operated by partnership in blighted area is not subject to unrelated business income tax under §511); LTRs 8243217 and 8245001, as modified by LTR 8637120 (June 19, 1986)(loan made by private foundation to limited

TNC's primary purpose may generally be described as the preservation of the natural environment. The Internal Revenue Service has recognized that the protection and improvement of the environment is an exempt "charitable" purpose within the meaning of §501(c)(3).[35] In order to more closely relate TNC's sales activities with its exempt purposes, we would suggest that, where appropriate, the property sold might be encumbered with conservation easements to ensure its future dedication to conservation purposes.

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partnership for purpose of constructing a hotel in the downtown blighted area of a city does not affect the exempt status of the organization and is a "program related investment" and a "qualifying distribution" under Chapter 42 of the Code, because the project was related to the exempt purposes of the organization); LTR 8430082 (April 26, 1984)(loan to a limited partnership by a private foundation for the purpose of redeveloping a downtown area in order to facilitate the elimination of community deterioration, crime, juvenile delinquency and disease is a program related investment under Chapter 42 of the Code).

[35] See, e.g., Rev. Rul. 80-278, 1980-2 C.B. 175 (organization which expends funds for litigation to protect and restore environmental quality by enforcing environmental legislation is operated exclusively for charitable purposes); Rev. Rul. 76-204, 1976-1 C.B. 152 (organization formed to preserve the natural environment by acquiring ecologically significant undeveloped land and either maintaining the land, or transferring the land to governmental or conservation agencies, is engaged in charitable activities); and Rev. Rul. 70-186, 1970-1 C.B. 128 (nonprofit organization formed to preserve and improve a lake used for public recreational purpose is performing a charitable activity). See also Rev. Rul. 72-560, 1972-2 C.B. 248 (educating public regarding environmental deterioration due to solid waste pollution); Rev. Rul. 67-391, 1967-2 C.B. 190 (development and distribution of urban land use plan); and Rev. Rul. 68-14, 1968-1 C.B. 243 (preservation and development of beauty of a city).

B. Tax-Exempt Status.

While the conduct of an unrelated trade or business will cause an exempt organization to be subject to tax on the net income arising from the trade or business, the Federal income tax regulations[36] provide that:

> "An organization may generally meet the requirements of §501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business as defined in §513."[37]

Thus, an exempt organization may carry on an unrelated trade or business without affecting its exempt status, even where that trade or business constitutes a substantial part of its activities. The operation of the trade or business may not, however, be its "primary purpose."[38] The regulations suggest that a determination as to whether an unrelated trade or business is the primary purpose of an organization should be based upon all the relevant circumstances, including a comparison of the relative size and extent of the trade or business and the organization's exempt activities.[39]

Based on our understanding of the nature and extent of TNC's ongoing charitable activities, we believe that it is unlikely that the real estate activities undertaken as part of the Tradelands program could jeopardize, under any

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[36] Regs. §1.501(c)(3)-1(e). This regulation applies to organizations exempt under §501(c)(3) by reason of their charitable, religious, educational, etc. purposes.

[37] Id. (emphasis added).

[38] See LTR 8717002 supra (at n. 20).

[39] Regs. §1.501(c)(3)-1(e)(1).

circumstances, the organization's tax-exempt status. Analogous authorities interpreting the term "primary" suggest that, even if TNC's real estate transactions were viewed as an unrelated trade or business, the organization would retain its Federal tax exemption unless more than 50 percent of its total net revenues or activities (in terms of man hours) in any given year were allocable to the unrelated real estate activities.[40]

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[40] See Malat v. Riddell, 383 U.S. 569 (1966)(Concluding that, for purposes of the definition of capital asset, the term "primarily" means "of first importance"); See also Rev. Rul. 60-86, 1960-1 C.B. 198 (operation of cocktail lounge by exempt agricultural organization constitutes an unrelated trade or business; no indication that exempt status jeopardized, even though lounge generated more than 50 percent of organization's annual income); Rev. Rul. 57-313, 1957-2 C.B. 316, in which the Service ruled that an organization whose unrelated activities produced 75 percent of its gross income would be entitled to retain its exemption; and Louisiana Credit Union League v. U.S., 693 F.2d 525 (5th Cir. 1982), in which the IRS did not argue that an organization's exemption should be revoked, even though approximately 50 percent of its income came from unrelated activities. Compare LTR 7902006 (Technical Advice Memorandum)(Sept. 22, 1978), in which a Section 501(c)(6) organization formed to promote the common business interests of retail dealers in a certain industry lost its exemption where between 66.48 percent and 70.38 percent of its gross income during the period in question was derived form the sale of particular goods and services to members, where such sales constituted an unrelated trade or business to the organization.

If you have any additional questions after reviewing this letter, please do not hesitate to call us.

Sincerely,

SILVERSTEIN AND MULLENS

Leonard L. Silverstein

LLS:she
cc: William Weeks
Michael Dennis

Questions for Record Submitted to
The Nature Conservancy
With Respect to SFC Hearing of June 8, 2005

Questions from Senator Orrin Hatch

1. Mr. McCormick, how important would you say are conservation easements to the mission of The Nature Conservancy?

Answer. Easements are a most important tool in our work and over the past few years have played an increasingly important role. Easements allow us to tailor a set of wildlife management practices with a private landowner that both protects biodiversity and allows the land to remain in productive use.

2. What effect would you expect on the willingness of donors to be willing to make contributions of easements if the law changed to eliminate the deduction for such easements?

Answer. The deduction is a financial incentive provided by the government to a landowner because the landowner is providing a public benefit—wildlife protection, open space, recreational opportunity or historic preservation. Elimination of the deduction would almost certainly eliminate the donation of easements. Although we would surely continue to purchase easements with funds received from other donors and grants from public agencies, it would mean reduced availability of already limited funds for other pressing conservation purchases. It would also greatly complicate our work and significantly diminish the amount of conservation work that could be carried out.

3. What about if the law is changed to require extra compliance steps, such as getting a second appraisal?

Answer. On April 6, the Conservancy sent the Committee a set of proposed reforms to the portions of the tax code that provide incentives for the donation of conservation easements including a requirement to get a second appraisal in come cases. We believe that those reforms, if enacted, would curb abuses without undermining the conservation work that is being accomplished with this tool.

4. Mr. McCormick, you mentioned that the Conservancy is quite decentralized in its operation. Does this mean that each of your field offices has quite a lot of autonomy? Has this changed as a result of the restructuring the Conservancy has undertaken in the past couple of years?

Answer. The Conservancy is a very decentralized organization. It remains so. Our work depends on the leadership of our state and country programs, on the detailed knowledge that they have of the conservation targets in their jurisdictions and on the partnerships that they have created with land owners and others to make conservation work. Strong field offices are the essential ingredient in the on-the-ground results. Some, of the changes we have made will provide additional oversight for those decentralized activities.

For instance, we have established a risk assessment and review process that will provide a second layer of review for highly complex transactions that present financial or reputational risks.

Questions from Senator Olympia J. Snowe

1. I want to compliment The Nature Conservancy on its cooperation with the Committee as our staff compiled the report we have before us. As I understand it, after carefully examining thousands of conservation transactions, we found that the Conservancy was in compliance with the laws controlling those activities. However, the report finds fault with current law and criticizes some of the Conservancy's business decisions. Still, it gives you a fundamentally clean bill of health. Would you agree with that?

Answer. Yes. As I said in my testimony, this close scrutiny has demonstrated to me that all of our transactions were entirely legal and carried out in good faith for the purpose of furthering our mission.

2. I was pleased to see that you highlight in your testimony the conservation of the Katahdin Forest surrounding the Millinocket area in Maine. This was a complex transaction that involved a number of private and public parties. What was most noteworthy, I think, is how it brought both private and public investments together to achieve both conservation and economic benefits for the people of Maine. It was among the nation's very first uses of federal New Markets Tax Credits, a program that I was pleased to help create. I did so because I knew it could bring substantial investment to underserved communities, many of which are in rural states like Maine. The Katahdin Project does this by including a conservation easement that preserves jobs by protecting 200,000 acres of forestland for sustainable timber production. It both protects wildlife habitat and guarantees public recreation. The Conservancy is certainly a national leader in what you call in your testimony these "pragmatic, market-based solutions to conservation challenges facing both local communities. Would the changes you have implemented and the reforms you are proposing change the way you pursue projects of this type?

- **Answer**. There is one change that we have made that might affect the project you describe. We have established a risk review process within The Nature Conservancy to examine transactions that have a great deal of financial complexity or that involve actions that may have some potential for public controversy. In the future, transactions that have the potential for financial or reputational risk will go before a newly established Risk Assessment Committee for review and then will be reviewed by a subcommittee of our Audit Committee. The design of transactions will be modified to mitigate these risks where it is appropriate. However, the Conservancy will continue to pursue "market-based" approaches to address the important problem of loss of habitat and biodiversity.

3. Why have you implemented the substantial changes to your governance structure and organizational policies that you describe in your testimony, even though, after the exhaustive review that we conducted, we found no violations of the law?

- **Answer.** We have come to realize that we must hold ourselves to a higher standard—one beyond mere compliance with the law and service to our mission. Because charities trade on their reputations, it's not enough to simply meet minimal levels of compliance. For charities, perception is everything, and charities can't afford even the appearance of impropriety. In this spirit, over the past two years we have conducted an extensive and rigorous internal review to strengthen our governance, increase accountability to our mission and make our actions more transparent to our donors and the public. We consistently meet higher standards of ethical conduct and organizational efficiency than we did two years ago.

4. By voluntarily adopting these new policies and practices, you appear to have established very high standards for the ethical and transparent operation of an organization that, as a charity, operates in the public interest. Are these changes reflected in your proposed legislative reforms?

> **Answer.** Our legislative proposals address only issues related to conservation easements and do not go to questions of nonprofit governance, generally. In the area of easements some of our proposed legislative changes, for instance to establish policies with respect to the modification of easements, reflect our own practices that were strengthened as the result of an internal review. However, most of the reforms that we suggest are intended to correct abuses in the areas of appraisals and public purpose that have been brought to light by other investigations such as the work of Mr. Maybank. The Conservancy has not made legislative proposals for governance changes because this is not a "one size fits all" area.

5. How would the reforms you are recommending to the tax code alter land conservation activities? We have heard other reforms offered: what is the most important difference between your proposed reforms and those proposed by others?

> **Answer.** There is wide agreement in the conservation community about a set of reforms that might be enacted to curb abuses without restricting the very important work of the land trust community. There is, for instance, not a great deal of difference between the proposals we have made and those proposed by the Land Trust Alliance. On the other hand, our proposals are very different from those that have been made by the Joint Committee on Taxation. The proposals contained in their January report would do very great damage to this conservation tool by greatly reducing the incentive realized by the donor who makes the gift.

Questions from Senator Jim Bunning

1. How much would the abuse problems associated with gifts of conservation easements and façade easements be alleviated by vigorous enforcement and effective appraisal reform?

> **Answer.** Over valuation of appraisals may be the largest single factor in the abuses that have come to light in other investigations. Assuring that appraisals of easements are done by state-certified appraisers using the highest standards would go a long way toward curing the problems that have come to light.

2. Would the panelists please give me their best ideas on what the I.R.S. and Congress can do to make sure appraisals for land donations are accurate?

Answer. We have suggested reforms that would require that all appraisers be state certified and that they use the highest professional appraisal standards. We have also suggested the penalties on appraisers and donors who prepare and submit inflated valuations be increased. Finally, we suggest that a second appraisal might be required where the land donation has a very high value.

3. Should the penalties currently in place for bad appraisals be changed? If so, who should those penalties be assessed against? Appraisers? Charities" Donors?

Answer. In the package of reforms that we transmitted to the Committee on April 6, the Conservancy proposed that penalties for appraisals that are significantly over-valued be increased and that they be imposed both on the appraiser and on the donor.

4. What would you say is the number one area of self-governance where many charities fall short? What it the single change that a charity can make in this area to have the biggest impact?

Answer. I believe that our experience points to the role of the Board of Directors in the day-to-day management of a charity. Every charity must have an active, engaged board committed to continuously reviewing, adapting and strengthening its oversight to meet the changing needs of the organization. Charities need individuals on their boards that bring specific professional skills and expertise beyond the traditional and almost exclusive roles of door-opening and fundraising. In today's world, board expertise in areas such as the law, government policy, accounting and management are not a luxury—they are a necessity.

5. Do our panelists think that more public disclosure and "sunshine" rules will help to curb abuses in charities?

Answer. Although some aspects of the tax code's provision for tax deductible, charitable gifts have been abused, one ought not to conclude that there is some general condition of across-the-board abuse out there that needs correcting. We believe that more transparency is good for us and that it will help us by increasing the confidence of our members and donors. We have increased the amount of information that we include in our Form 990 and that we make available on our Web site. But there is no one-size fits all rule that can be applied across the entire sector.

6. One suggestion previously made by the Finance Committee staff is the public disclosure of Form 990-T returns, which report unrelated business taxable income of exempt organizations. Privacy concerns have been raised by some, including the American Institute of C.P.A.'s. Can you comment on the proposal for public disclosure of form 990-T's and also on how you think privacy concerns could be addressed?

Answer. The Conservancy's Form 990-T's have been made available upon request, which the Conservancy is not currently required to do and we have no problem with that. But we cannot speak for every charity in that regard. Since it is taxable income, it would seem appropriate that this tax return should be handled in the same way that an income tax return of a taxable entity is handled.

Questions from Senator Jay Rockefeller

1. The Committee report discusses the possibility of requiring accreditation for organizations that receive conservation easements. The notion is that only organizations that have the expertise and resources to monitor and enforce the easements can assure that taxpayers really receive the benefits of conservation easements. There has been a great deal of debate about whether it would make sense for the government to create a specific accreditation process for conservation organizations. I would like each of you to tell me whether you think it would be prudent for this Committee to consider legislation to create an accreditation process, how could we accommodate the unique needs of small organizations?

Answer. In the package of reform proposals that we submitted to the Committee on April 6, we recommended that IRS be authorized to select one or more private organizations that would implement an accreditation program for conservation organizations that accept tax deductible easement donations. It might be possible to establish organizational pools or partnerships that would assist small organizations in monitoring and enforcing easements. These activities could be assigned to or contracted out with other nonprofit entities or public agencies.

Questions from Senator Blanche Lincoln

1. In response to concerns raised, generally, what are the key changes that you have made and what lessons have you learned?

Answer. My testimony details the changes that we have made in organizational governance and in our conservation easement transactions. The changes have been extensive affecting all aspects of our day-to-day work. The principal lesson that we have learned is that our effort to improve will never be complete. An organization truly committed to the highest ethical standard must never think that the goal has been reached.

2. Based on your recent experiences, what advice would you give to other conservation organizations, particularly small organizations that might not have all of the resources of The Nature Conservancy?

Answer. Even today, many people at the Conservancy have a hard time understanding why this happened. Our transactions were all legal and carried out in good faith and for legitimate conservation purposes. We hadn't strayed from our mission although we took risks and tried to innovate.

But organizations that are doing well can do better. And in the nonprofit world merely being legal and meeting the prevailing practice is not enough.

We have to take special measures to make sure that our members and donors have confidence in our work because they cannot use the measures of profitability and return that are used as yardsticks for private firms.

Openness and transparency must be organizational priorities for nonprofits. Since the performance of charities can't be judged on quarterly earnings statements, the public must have access to information to help them make judgments about the effectiveness of the charities they may support.

Senior leadership and boards at nonprofits must be attentive to the full range of potential risks with policies and procedures in place to assure that we thoroughly respond promptly to challenges before they become crises that undermine public trust.

The search for improvement must be continuous because expectations and best practices are always changing.

Be alert for risks and deal with them immediately.

From the transcript—Question by Senator Charles Grassley

1. Mr. McCormick, with respect to TNC's reporting of payments pursuant to emission credit agreements, we understand that the TNC reports these payments as contribution revenues on Form 990, Line 1. However, TNC does not classify these contributions as charitable contributions. Could you tell me what other types of revenue TNC might include in the category of non-charitable contribution revenues?

Answer. In accordance with the instructions for IRS Form 990, the Conservancy reports the gross amounts of contributions received, including those from corporations, on line 1a. The classification of these contributions are consistent with the classification of the same amounts in our annual audited financial statements and do not reflect the tax treatment claimed by any person or entity from whom the contribution is received. They include all contributions of cash, stock, land, land interests and other non-cash items reported in our audited financial statements. The only significant difference between those contributions recorded in the audited financial statements under Statement of Financial Accounting Standards No. 116 "Accounting for Contributions Received and Contributions Made" and those reported on line 1a of the Form 990 relate to contributed services, required to be reported as a contribution under SFAS #116, but not pursuant to the instructions for Form 990, line 1a.

PREPARED TESTIMONY OF
STEVEN T. MILLER
COMMISSIONER
TAX-EXEMPT AND GOVERNMENT ENTITIES DIVISION
INTERNAL REVENUE SERVICE
BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE
HEARING ON THE TAX CODE AND LAND CONSERVATION
JUNE 8, 2005

Thank you, Mr. Chairman, Ranking Member Baucus, and distinguished Members of the Committee, for the opportunity to discuss the law relating to the deductibility of contributions for conservation easements, and the steps the Internal Revenue Service is taking to enforce the law in this area. Congress has allowed an income tax deduction for owners of significant property who give up certain rights of ownership so that their land or structures might be preserved for future generations.

The conservation contribution provisions of the Internal Revenue Code play a vital role in the preservation of property with unique public value. However, conservation easements – dependent as they are on issues of public benefit and the appropriate valuation of tangible and intangible assets – warrant our attention. In our work to date in this area, the IRS has seen abuses that compromise the policies and the public benefit that Congress intended to promote. Later, I will discuss these problems in more detail, and explain what we are doing about them. But first, let me explain how the tax provisions relating to conservation easements work.

Legal Requirements for Deductions for Conservation Easements

In general. First, let me distinguish between donations of ownership of real property and donations of conservation easements. Under general income tax rules, to be eligible for a deduction for a charitable contribution, a taxpayer must give his or her entire interest in the property to the charity that receives the gift. For example, if I own a parcel of land, or a boat, or anything else, I must give up all rights of ownership to the charity, and can reserve no substantial rights for myself. Under these rules, when ownership of real property is transferred to a charity, the donor gives up all title and interest in the property and the recipient charity becomes the new owner. The donor generally may take a charitable contribution deduction for the fair market value of the property. In these cases, as with other gifts of property, our main concern generally is whether the donor has valued the gift correctly.

Conservation Easements. There are only a few exceptions to this general rule, and a conservation easement is one of them. Section 170(f)(3)(B)(iii) allows a deduction for a qualified conservation contribution, even though it is only a gift of a partial interest in property.

Section 170(h) defines a "qualified conservation contribution." It is a contribution:

- Of a qualified real property interest, including an easement granted in perpetuity that restricts the use that can be made of the property. Section 170(h)(2)(C).

- To a qualified organization. Generally, these are public charities and governmental units. Section 170(h)(3). Importantly, the recipient charity must have the resources and commitment to monitor and enforce the restrictions.

- Exclusively for conservation purposes.

With respect to the last requirement, there are four allowable conservation purposes. Section 170(h)(4). A conservation contribution must be for:

- The preservation of land areas for outdoor recreation or education of the general public;

- The protection of a relatively natural habitat of fish, wildlife, plants, or similar ecosystem;

- The preservation of open space (including farmland and forest land) for either the scenic enjoyment of the general public, or pursuant to a clearly delineated governmental conservation policy. In either case, the conservation contribution must yield a significant public benefit; or

- The preservation of an historically important land area or a certified historic structure.

From discussions with your staff, I understand that the Committee is concerned today primarily with easements that address the third conservation purpose, the preservation of open space, and my remarks will focus on such easements.[1] I

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[1]The following is a brief description of the other allowable conservation purposes:
a). **Easements for recreational or educational purposes.**
The donation of easements to preserve land areas for the recreational use of the general public or for the education of the public is a recognized conservation purpose. Examples include the preservation of a water area for public recreation such as boating or fishing, or the preservation of land for a nature trail or hiking trail. Unlike easements for the other conservation purposes listed

would also note that, as we move forward, we are doing considerable work in the area of façade easements. In addition, as we work on what we believe are open space issues, we expect to find that some easement donations fall into other categories, e.g., easements for recreation and for the protection of a relatively natural habitat.

Specific rules relating to open space easements. Easements for the preservation of open space must either be for the scenic enjoyment of the general public, or pursuant to a clearly delineated governmental conservation policy. In either case, they must also yield a significant public benefit.

Scenic enjoyment of the public.

To determine that an easement will protect the scenic enjoyment of the public, it must be shown that development of the land would result either in an impairment of the scenic character of the landscape, or would interfere with a scenic view that can be enjoyed from a public place. Scenic enjoyment is determined by a flexible facts and circumstances test, which takes into account regional variations in topography, geology, biology, and cultural and economic conditions. Section 1.170A-14(d)(4)(ii) of the Income Tax Regulations sets out factors to be considered in determining scenic enjoyment. These include the following:

- The compatibility of the land use with other land in the vicinity;
- The degree of contrast and variety produced by the visual scene;
- The openness of the land;

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here, these easements necessarily require regular and substantial physical access by the general public.

b). **Easements for the protection of wildlife and habitat.**
The second category of conservation easements is to protect a significant natural habitat or ecosystem in which fish, wildlife, or plants live in a relatively natural state. Significant natural habitats include the habitats of rare, endangered, or threatened species of animals, fish, or plants, or natural areas that represent high quality examples of a terrestrial or aquatic community, or natural areas that contribute to the ecological viability of a park, nature preserve, wildlife refuge, or wilderness area. Limitations on public access to these areas will not render an easement donation nondeductible. For example, a restriction on access to the habitat of a threatened species is consistent with the conservation purpose of the easement.

c). **Easements for historic land or structures.**
Historical preservation easements are intended to preserve historically important land areas or historic structures. This provision contemplates properties listed in the National Register of Historic Places, or a land area that is independently significant historically, or that is located in a registered historic district, or that contributes to the historic or cultural integrity of a registered historic district. Easements to preserve historic land or buildings will not qualify as qualified conservation contributions unless there is at least some visual access by the public.

- The degree to which the land use maintains the scale and character of the urban landscape; and

- The consistency of the view with state programs and landscape inventory.

At a minimum, visual access to or across the property is required. Under the terms of an open space easement on scenic property, the entire property need not be visible to the public, although the public benefit from the donation may be insufficient to qualify for a deduction if only a small portion of the property is visible to the public.

Significant public benefit.

There must also be a significant public benefit that arises from an open space easement. The regulations contain a non-exclusive list of eleven factors that may be considered. Section 1.170A-14(d)(iv)(A). Some of these factors involve the uniqueness of the land; the intensity of current or foreseeable development; the likelihood of development that would lead to the degradation of the scenic, natural, or historic character of the area; the opportunity for the general public to use the property or appreciate its scenic values; and the importance of the property in maintaining a local or regional landscape or resource that attracts tourism or commerce to the area. These factors indicate the kind of open space contemplated as having a significant public benefit.

The preservation of an ordinary tract of land will not in and of itself yield a significant public benefit, but the preservation of ordinary land areas in conjunction with other factors that demonstrate significant public benefit or the preservation of a unique land area for public enjoyment will yield a significant public benefit. For example, the preservation of a vacant downtown lot will not by itself yield a significant public benefit, but the preservation of the downtown lot as a public park will, absent other factors, yield such a benefit.

The following are other examples of contributions with a significant public benefit: the preservation of farmland pursuant to a state program for flood prevention and control; the preservation of a unique natural land formation for the enjoyment of the general public; the preservation of woodland along a public highway pursuant to a government program to preserve the appearance of the area so as to maintain the scenic view from the highway; and the preservation of a stretch of undeveloped property located between a public highway and an ocean in order to maintain the scenic ocean view from the highway.

A deduction will not be allowed for the preservation of open space if the terms of the easement permit a degree of intrusion or future development that will interfere with the essential scenic quality of the land.

I have mentioned that, as we expand our work in this area, we may find that we have issues with respect to the deductions claimed for gifts of conservation easements for purposes other than open space. For example, issues may arise regarding the degree of development that is consistent with conservation purposes. We recently lost a case in Tax Court in which the taxpayer claimed a deduction for donating a conservation easement to limit development on two sections of a parcel of lakeshore property. Access to the property was not available to the public. The taxpayer provided testimony that bald eagles had been sighted on the property and that at least one species of endangered indigenous plants could be found there. The court upheld the taxpayer's position that a deduction was allowable, not on the basis that it was a qualified open space easement, but on the alternative ground that the easement protected a relatively natural habitat of wildlife and plants. The IRS had argued that the deduction failed on this basis as well. *Glass v. Commissioner*, 124 T.C. No. 16, Docket No. 17878-99 (May 25, 2005). No decision has been made whether the IRS will appeal or seek reconsideration.

Amount of the deduction - Valuation rules. If the contribution meets all requirements of section 170, and qualifies as a conservation contribution, then the question becomes how to value the easement. Generally, the amount of the deduction may not exceed the fair market value of the easement on the date of the contribution (reduced by the fair market value of anything received by the donor in return). Fair market value is the price at which the contributed property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and each having reasonable knowledge of relevant facts.

If there is a substantial record of sales of easements comparable to the donated easement (such as purchases pursuant to a governmental program), the fair market value of the donated easement is based on the prices of the comparable sales. If no substantial record of marketplace sales is available to use as a meaningful or valid comparison, as a general rule (but not in all cases) the fair market value of a conservation restriction is equal to the difference between the fair market value of the property before the granting of the restriction and the fair market value of the encumbered property after the granting of the restriction.

Under the regulations, if such before-and-after valuation is used, the fair market value of the property before contribution must take into account not only the current use but also an objective assessment of how immediate or remote is the likelihood that the property, absent the restriction, would in fact be developed. The valuation also must take into account the effect of any zoning, conservation or historic preservation laws that already restrict the property's potential highest and best use. Additionally, if before-and-after valuation is used, an appraisal of the property after contribution of the restriction must take into account the effect of restrictions that reduce the potential fair market value represented by highest

and best use but will, nevertheless, permit uses of the property that will increase its fair market value above that represented by the property's current use.

If the donor reasonably can expect to receive financial or economic benefits greater than those to be obtained by the general public as a result of the donation of a conservation easement, no deduction is allowable. If development is permitted on the property to be protected, the fair market value of the property after contribution of the restriction must take into account the effect of the development.

The recipient of the easement - Qualified Organizations. To be qualified to receive a conservation easement, an organization must be a governmental unit, or one of several types of public charities. In order to be a qualified organization, the organization also must be committed to protect the conservation purposes of the donation, and must have the resources to enforce the restrictions. However, it need not set aside funds for this purpose.

As with any charity, a qualified organization is subject to certain rules described in section 501(c)(3); the organization must operate exclusively for charitable, educational, or other tax-exempt purposes. It cannot serve private interests unless such interests are only incidental to its exempt purposes, and it cannot serve a substantial nonexempt purpose. If the organization becomes derelict in its duties to ensure that donated easements continue to serve an exempt purpose, or if the organization subordinates the interests of the public to the interests of the donor, the organization's tax exemption may be open to question.

Internal Revenue Service Enforcement of Open Space Conservation Easements

Overview. In this portion of my testimony I will outline the enforcement actions the IRS has taken in this area, and what we have found to date. First, I will discuss the reporting requirements for exempt organizations and their donors, and steps the IRS is taking to improve such reporting. Then, I will discuss our examination activity in the area.

Reporting. As we moved from dealing with these issues on a case-by-case basis to approaching them in an organized, comprehensive fashion, we recognized that we needed to enhance the capacity to determine systematically which organizations and individuals have been involved in conservation easement transactions. To address this, we are modifying our tax forms to gather more information about organizations with conservation easement programs, and their donors. We recently modified Form 1023, *"Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code,"* to add new questions that will help us identify organizations with conservation easement donation programs in order to ensure that they meet the requirements for exemption, including the ability to meet conservation responsibilities.

Charities and other tax-exempt organizations annually file Form 990, *"Return of Organization Exempt From Income Tax"*, an information return that reports income, expenses, assets, and liabilities of these organizations, along with specific information about their operations and programs. We are concerned that the public is not getting enough information from Form 990 to understand what activities many of our charities are engaged in. As an interim step, the 2005 Form 990 will be modified so that both the IRS and the public have a better understanding of which organizations receive easements. We expect that this will be in the form of a new checkbox that will identify those organizations that received a conservation easement donation during the year.

All exempt organizations can now file their annual returns electronically. Electronic filing was available for Form 990 and 990EZ filers in 2004, and is available this year for private foundations, which file Form 990-PF. We want to encourage e-filing because it reduces taxpayer errors and omissions and allows us, and ultimately the public, ready access to the information on the return. For this reason, we have required e-filing in certain cases. Under proposed and temporary regulations, by 2007 we will require electronic filing for larger public charities and all private foundations.

We also are working on larger scale improvements to the Form 990. The current form could be more "user-friendly" and elicit more information that we need. We anticipate that the revised form will have specific questions or separate schedules that focus on certain problem areas. For example, filers should not be surprised to find specific schedules or detailed questions relating to credit counseling activities, supporting organizations, compensation practices, and organizational governance. The easement area is also under consideration. The timing of the revision of the Form 990 is dependent on our partners, including the states, 37 of which use the Form 990 as a state filing, and software developers.

When donors make gifts of property in one year that exceed $500, they file Form 8283, *"Noncash Charitable Contributions"*, with their income tax returns. On the form donors list the property they are donating. For most donations that exceed $5,000, the form requires a written appraisal and the identity and signature of the appraiser, along with a signed acknowledgement of the gift by an officer of the charity that receives the gift.

We are modifying Form 8283 to provide a new checkbox to identify donors of conservation easements, and we are modifying the form's instructions to better describe what is permissible and to obtain better information on the type of property donated. The revised form also will reflect new qualified appraisal requirements enacted by Congress last year in section 170(f)(11). Where the donation is in excess of $500,000, the form will require taxpayers to attach the complete appraisal to the return.

Once implemented, these changes will enable us to better identify the universe of organizations and donors who are involved in conservation easement transactions, and they will allow us to better target our future enforcement efforts. In the meantime, we will pursue the active enforcement program we have in place now.

Examination activity in the area of conservation easements - Review and findings to date.

Formation of a cross-functional team. Earlier this year, we formed a cross-functional team to attack all aspects of the problem of conservation easements, including any conservation buyer programs as described in Notice 2004-41, discussed below. The team includes members from three IRS business units (Large and Midsize Business, Small Business and Self-Employed, and Tax Exempt and Government Entities), as well as representatives from the IRS Appeals Office, Chief Counsel, and the Office of Professional Responsibility.

Our team has set workload priorities. It has trained and is continuing to train IRS agents and appraisers on conservation easement issues, and will serve as a resource for legal questions for our field personnel.

We are looking not only at donors and recipient charitable organizations, but also at promoters. The team will be alert for developing patterns of abuse and will identify promoters of potentially abusive easement donations. In the course of our examinations we are finding appraisers that appear to be associated with abusive promotions on a recurring basis. We are going to shine a searchlight in their direction, and will use all civil and criminal tools at our disposal to combat abuses.

Inventory of cases and findings to date.

Donor Audits.

Currently we have over 240 donors under audit because they have taken an open space easement deduction. These are high dollar cases. An additional 100 donors are being considered for audits as well. As indicated, we also have façade easement cases, both residential and commercial, under way, though the number currently active is lower.

While our audits are under way, it is still too early to draw reliable conclusions or make clear findings about taxpayer practices in this area. Nonetheless, I am comfortable in offering some comments and expressing some concerns. In the open space easement area, valuation can be difficult and can present opportunities for abuse and manipulation. As I have said, the value of a donated easement generally is the difference in the value of the underlying property before and after the donation. This essentially means the property must be

valued twice, based on what a willing buyer would pay to a willing seller before and after the donation of the easement.

In these cases, we are seeing several issues. In terms of whether the donation meets the threshold requirements for deductibility, we have seen cases where we do not believe there is any public access (visual or otherwise), where the tract appears to be ordinary in nature and where there does not appear to be a conservation purpose being served (for example, there are cases involving the donation of easements on pieces of a golf course).

Valuation issues are even more difficult because we must review and critique underlying assumptions that do not appear reasonable. The rules on valuation are based upon the facts and circumstances of each case, including prior restrictions on the use or modification of the property, as well as upon the restrictions detailed in the easement, and each case is unique. In some cases, the easement restrictions may have no effect on the value of the property.

Assumptions concerning future development have been particularly problematic. Generally, the owner of the property restricts the amount of development to a degree that is less than that allowed by local zoning or regulatory policy. However, in some cases, development is assumed that takes into account major zoning changes, and in other cases, non-existent water rights have been assumed. The economic feasibility of the development may not be adequately considered, and there may be other unrealistic assumptions.

Audits of the recipient charity.

We are also looking at a number of charities that are engaged in the receipt of conservation easements. This includes some charities that we believe may have been involved in particular abuses. Currently, we have seven organizations under examination, and four more examinations will begin shortly.

In Notice 2004-41, 2004-28 I.R.B. 31, we outlined another abuse. In this situation, a charitable organization purchases property and places a conservation easement on the property. The charity then sells the property subject to the easement for a price that is substantially less than the price paid by the charity for the property. As part of the sale, the buyer makes a second payment designated as a charitable contribution to the charity. The total of the payments fully reimburses the charity for its cost. In some cases, the second payment is really part of the negotiated purchase price of the property and therefore is not a contribution. The Notice says that the IRS will treat these transactions in accordance with their substance rather than their form, and will look at the operations of the charity.

Promoter Referrals and Audits. We are seeing promoted investor syndications seeking to profit from conservation easements. This may be more prevalent in

certain states that allow transfers of tax credits. Some of these states have provided referral information to us on questionable easement donations. In a typical case, investors pool funds to buy a property. After one year, a conservation easement will be placed on the property using an appraised value for the property before the contribution that is much higher than the purchase price. The result is an easement deduction that is many times the value of the original purchase price.

We are currently looking or have looked at the activities of more than twenty promoters, and five promoters involved in easements have been recommended for investigation. Promoters and other persons involved in these transactions may be subject to penalties under sections 6700, 6701, and 6694, or an injunction under section 7408.

Sanctions against Appraisers. Before 1984, attorneys and accountants, but not appraisers, could be barred from practice before the IRS. In 1984, Congress modified the law, and Circular 230 was modified to include appraisers. Circular 230 currently requires that the section 6701 penalty, aiding and abetting in the understatement of tax, be imposed before action may be taken against the appraiser. The IRS must demonstrate, by a preponderance of the evidence, that the appraiser had actual knowledge that the taxpayer would rely on a document that would lead to an understatement of tax by the taxpayer.

When a section 6701 penalty is asserted against an appraiser, an information referral to the Office of Professional Responsibility is mandatory. We have alerted the Director, Office of Professional Responsibility, of possible referrals of three appraisers arising out of questionable valuations of donated easements.

IRS Challenges

Although the conservation contribution provisions of the Internal Revenue Code play a vital role in the preservation of our open spaces, we are concerned with valuations of property that appear to be primarily influenced by tax considerations rather than actual property values. In challenging such valuations, our outstanding but small staff of appraisers (48 in all, 20 of whom work wholly or in part on 170(h) cases) must perform the detailed appraisal work using accepted and recognized valuation standards. It is not easy or quick work. Our work to date raises the question of whether rules governing appraiser qualifications, appraisal standards, and the standards for referral to the Office of Professional Responsibility are sufficient.

As you discuss changes in this and other areas involving the tax exempt sector, I also ask you to recall and consider the focus areas outlined in Commissioner Everson's testimony before this Committee on April 5. You may recall that these focus areas include whether there are gaps in the statutory or regulatory framework; whether the IRS has the flexibility it needs to respond appropriately to

compliance issues; whether more should be done to promote transparency; and whether we have the resources we need to do the job. In this regard, please consider the intermediate sanction recommended by the Administration when taxpayers claim charitable contribution deductions for contributions of perpetual conservation restrictions, but the charities that receive those contributions fail to monitor and enforce the conservation restrictions for which the charitable contribution deductions were claimed.

The Administration has made this recommendation in its FY 2006 budget proposals.[2] Specifically, the proposal would impose significant penalties on any charity that removes or fails to enforce a conservation restriction for which a charitable contribution was claimed, or transfers such an easement without ensuring that the conservation purposes will be protected in perpetuity. The amount of the penalty would be determined based on the value of the conservation restriction shown on the appraisal summary provided to the charity by the donor.

The Secretary would be authorized to waive the penalty in certain cases, such as if it is established to the satisfaction of the Secretary that, due to an unexpected change in the conditions surrounding the real property, retention of the restriction is impossible or impractical, the charity receives an amount that reflects the fair market value of the easement, and the proceeds are used by the charity in furtherance of conservation purposes. The Secretary also would be authorized to require such additional reporting as may be necessary or appropriate to ensure that the conservation purposes are protected in perpetuity.

In conclusion, the IRS remains committed to doing all it can to make the land donation and conservation easement provisions of the tax code work in the manner Congress intended. Legitimate conservation easements serve an important role in the preservation of our open lands and our cultural heritage. However, what began as a laudable program to save our open space, natural habitats, and historic sites may have become distorted. We are committed, as we progress through our enforcement program, to determine the size of this distortion and to take all steps necessary to stem abuse. Clearly, the public should be able to expect that only those land donations that result in an identified public good will result in favorable tax treatment.

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[2] *General Explanations of the Administration's Fiscal Year 2006 Revenue Proposals*, Department of the Treasury, February, 2005, pp. 112 - 113.

Mr. Steven T. Miller
Internal Revenue Service

From Senator Bunning:

1. MR. MILLER, I THINK ONE OF THE MAJOR ITEMS THAT WE NEED TO TAKE A LOOK AT IS PUBLIC DISCLOSURE. IN A PRIOR HEARING THIS YEAR, THE UNITED WAY SUGGESTED THAT NONPROFITS BE ASKED TO REPORT "CONCRETE RESULTS ANNUALLY THAT ARE TIED DIRECTLY TO THEIR MISSIONS" AND NOT JUST BE ASKED TO REPORT ON THE LEVEL OF ACTIVITY THAT THEY ENGAGE IN. COULD YOU COMMENT ON THIS SUGGESTION?

FROM A PRACTICAL POINT OF VIEW, HOW COULD SUCH INFORMATION BE QUANTIFIED AND REPORTED?

ANSWER
We are looking at how to improve Form 990, the form used by exempt organizations to report their activities, and toward that end we have a team that is considering ideas for a complete overhaul of the form both to make it a better enforcement tool as well as to provide the public and the states with information more relevant to their concerns.

We are also looking at Brian Gallagher's remarks in his April 5, 2005 testimony on behalf of the United Way. We understand from his suggestions that he envisions an annual report on accomplishments from each organization, which we believe may entail a substantial narrative section if placed on Form 990. It is unclear whether such a narrative will produce useful comparison data, but we will consider his comments as we proceed with the revision of the form.

2. HOW MUCH WOULD THE ABUSE PROBLEMS ASSOCIATED WITH GIFTS OF CONSERVATION AND FAÇADE EASEMENTS BE ALLEVIATED BY VIGOROUS IRS ENFORCEMENT AND EFFECTIVE APPRAISAL REFORM?

ANSWER
Our observation is that a fundamental weakness in this area is the lack of quality appraisals in support of the deductions that taxpayers are claiming. A tightening of appraisal standards is an area that is ripe for discussion, and we note with great interest the recommendations of the Panel on the Nonprofit Sector on these questions. Effective appraisal reform is one approach that, combined with active IRS enforcement, could substantially reduce the potential for abuse in this area.

3-4. WOULD THE PANELISTS PLEASE GIVE ME THEIR BEST IDEAS ON WHAT IRS AND CONGRESS CAN DO TO MAKE SURE APPRAISALS FOR LAND DONATIONS ARE MORE ACCURATE? SHOULD THE PENALTIES CURRENTLY IN PLACE FOR BAD APPRAISALS BE CHANGED?

ANSWER

As I mentioned in my testimony, our work to date raises the question of whether rules governing appraiser qualifications, appraisal standards, and the standards for referral to the Office of Professional Responsibility are sufficient. We will be happy to work with the Congress and with the Treasury Department in any discussion of possible reforms.

5. WHAT WOULD YOU SAY IS THE NUMBER ONE AREA OF SELF-GOVERNANCE WHERE MANY CHARITIES FALL SHORT? WHAT IS THE SINGLE CHANGE THAT A CHARITY CAN MAKE IN THIS AREA TO HAVE THE BIGGEST IMPACT?

ANSWER

The IRS does not statistically track governance failings, but a common problem with some organizations that we have observed is a failure to distinguish adequately between charitable interests and the interests of those in charge of the charity. This may manifest itself by problems such as higher compensation for officers than appears reasonable, or lucrative service contracts with entities controlled by insiders.

There may not be one single change that will cure these ills, but a charity will have a better chance of avoiding these problems with an independent board of directors selected from the community, a strict conflict of interest policy, an annual financial review by an independent accounting firm (or an independent CPA, for smaller organizations), and executive compensation reviewed by the board of directors with advice from independent compensation consultants (or, for smaller organizations, with a review of compensation practices at similar organizations of comparable size). In their review of their own governance practices, we would encourage charities to look at various industry guidelines, including the Standards of Excellence promoted by the Independent Sector, as well as the recommendations of the Panel on the Nonprofit Sector in the governance area.

6. DO OUR PANELISTS THINK THAT MORE PUBLIC DISCLOSURE AND "SUNSHINE" RULES WILL HELP TO CURB ABUSES IN CHARITIES.

ANSWER

From the point of view of regulators, we believe that the more transparency there is in the sector the more likely there will be a corresponding

improvement in compliance. In his April 5, 2005 testimony before this Committee, Commissioner Everson stressed the importance of improved transparency and outlined the steps we are taking to get there. I would refer the Committee to his testimony, and particularly to his remarks on our need for assistance in order to establish mandatory e-filing of Form 990. Our ability to mandate e-filing is limited at this time by statutory restrictions that prevent us from mandating electronic filing for any organization that files fewer than 250 returns with us. The Administration's 2006 Budget proposal echoes this concern. The Administration's proposal would lower the current 250-return minimum for mandatory electronic filing, but would maintain the minimum at a level high enough to avoid imposing undue burden on taxpayers.

7. ONE SUGGESTION PREVIOUSLY MADE BY THE FINANCE COMMITTEE STAFF IS THE PUBLIC DISCLOSURE OF FORM 990-T RETURNS, WHICH REPORT UNRELATED BUSINESS TAXABLE INCOME OF EXEMPT ORGANIZATIONS. PRIVACY CONCERNS HAVE BEEN RAISED BY SOME, INCLUDING THE AMERICAN INSTITUTE OF C.P.A.'S. CAN YOU COMMENT ON THE PROPOSAL FOR PUBLIC DISCLOSURE OF FORM 990-T'S AND ALSO ON HOW YOU THINK PRIVACY CONCERNS COULD BEST BE ADDRESSED.

ANSWER

The disclosure of Forms 990-T would be a departure from the general principle that protects the confidentiality of returns and return information. Accordingly, we will work with the Department of the Treasury to determine the policy implications involved.

From Senator Rockefeller

THE COMMITTEE REPORT DISCUSSES THE POSSIBILITY OF REQUIRING ACCREDITATION FOR ORGANIZATIONS THAT RECEIVE CONSERVATION EASEMENTS. THE NOTION IS THAT ONLY ORGANIZATIONS THAT HAVE THE EXPERTISE AND RESOURCES TO MONITOR AND ENFORCE THE EASEMENTS CAN ASSURE THAT TAXPAYERS REALLY RECEIVE THE BENEFITS OF THE CONSERVATION EASEMENTS.

THERE HAS BEEN A GREAT DEAL OF DEBATE ABOUT WHETHER IT WOULD MAKE SENSE FOR THE GOVERNMENT TO CREATE A SPECIFIC ACCREDITATION PROCESS FOR CONSERVATION ORGANIZATIONS.

I WOULD LIKE EACH OF YOU TO TELL ME WHETHER YOU THINK IT WOULD BE PRUDENT FOR THIS COMMITTEE TO CONSIDER LEGISLATION TO CREATE AN ACCREDITATION PROCESS. AND IF WE SHOULD CREATE SUCH A PROCESS, HOW COULD WE ACCOMMODATE THE UNIQUE NEEDS OF SMALL ORGANIZATIONS?

ANSWER
As we stated, we have seen problems in this area. Without additional details regarding such a program, it is not clear whether such a program in the area would be practical or helpful. We are prepared to work with Committee staff on this proposal.

Question from Senator Grassley

Mr. Miller, tell me if my understanding is correct that, in general, non-charitable contribution revenues reported on Form 990, Line 1, are not required to be disclosed or explained elsewhere on Form 990, including Schedule B.

ANSWER
Line 1 on the Form 990 includes all contributions, both deductible and nondeductible. Line 1 does not include amounts for which there was a quid pro quo.

In general, each type of income has a line on Form 990. Line 1 of Form 990 is intended for reporting amounts received by an organization for which no consideration is supplied by the organization in return, in other words, contributions, gifts, grants and similar amounts ("gifts").

For a gift properly reported on Line 1, if the gift is small enough, no further reporting with respect to that gift is required. However, for gifts of $5,000 or more from any one contributor, the organization must list the contributor and describe the gift on Schedule B of Form 990. There is a special rule for charities described in section 170(b)(1)(A)(vi), which receive substantial support from the general public: these organizations need not report on Schedule B gifts from any contributor unless the gift exceeds the greater of $5,000 or 2 percent of the total amount on Line 1.

The instructions for Schedule B indicate that the purpose of the Form is to provide information on contributions reported on Line 1. Consequently, if a gift meets the reporting threshold, donor information must be provided on Schedule B.

If a gift meets the reporting threshold for Schedule B, the name, address, and aggregate donation amount of the contributor is reported on Part I of the schedule, and a description of the property, its estimated value, and the date received are reported on Part II. Although information on Schedule B is available to authorized IRS personnel, except in the case of private

foundations the names and addresses of donors are not available to the public under section 6103 and section 6104(b) of the Code. Consequently, donors to public charities are not publicly identified.

Amounts received that are not gifts are not reported on Line 1 and are not reported on Schedule B. These amounts are listed instead on lines 2 through 11 of Form 990, depending upon the type of income involved. Certain information with respect to these amounts is reported in more detail on Part VII of Form 990, most notably an analysis of whether the amounts result in unrelated business income. Such reporting does not ordinarily show the specific party or parties that were the source of the income.

Statement of Ira M. Millstein
Weil, Gotshal & Manges LLP
before the
Committee on Finance
United States Senate

June 8, 2005

Mr. Chairman, Senator Baucus, distinguished members of the Committee, I am pleased to appear before you as the former Chair of a Governance Advisory Panel (the "Panel"), appointed by The Nature Conservancy's ("TNC") Board of Governors. To begin, I would like to compliment both of you, this Committee and its staff, especially Dean Zerbe and Jon Selib, on the thorough and substantive work they have done over the last year or longer.

The TNC Panel I chaired was established in August 2003 to prepare a report concerning issues of governance, transparency, and accountability. These were and are critical issues not only for TNC, but also for all nonprofit organizations. Indeed, studies show that the public trust in nonprofit organizations has eroded since 2001.[1] As for-profit corporations have worked to restore public confidence and increase investment in the wake of several highly public governance failures at major corporations, now nonprofit organizations must work to reassure potential contributors that their money will be well spent in furtherance of their intended missions. Because private donations fund most nonprofits' activities, restoring the public trust is, as the Independent Sector

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[1] The Brookings Institution reported in September 2004 that public confidence in charitable organizations was roughly 10 – 15% lower than it was in the summer of 2001. *See* Paul C. Light, *Fact Sheet on the Continued Crisis in Charitable Confidence*, BROOKINGS INSTITUTION, Sept. 13, 2004 at 1.

explained in its recent report, "essential to a viable nonprofit sector."[2] The question is how. I believe that the answer lies with ensuring that each nonprofit organization has an active and engaged of board of directors.

There are many parallels between the governance of nonprofit and for-profit organizations. In both cases the organizations are tasked with managing other people's money and in both cases they are judged by their success in doing so. Yet, there is a very key difference: in the for-profit context shareholders are able to hold corporate directors and officers accountable, whereas in the nonprofit context there is no mechanism by which the organization can be held accountable when it fails to act in furtherance of its mission.

In her recent article, *Reforming Corporate Governance: What History Can Teach Us*, Georgetown University Law Center Professor Margaret Blair explains that while certain provisions of corporate law make it possible for corporations "to lock in capital, and may occasionally lead to abuses by directors and managers, they do not lock in particular investors, since individual investors can sell their shares to other investors."[3] Investors may also sue a corporation's officers and directors for breaches of their fiduciary duties. The threat of a shareholder action can serve as an important deterrent to corporate mismanagement and abuse. In addition, in theory -- and occasionally in practice -- shareholders may be able to remove directors.

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[2] Panel on the Nonprofit Sector, convened by Independent Sector, INTERIM REPORT PRESENTED TO THE SENATE FINANCE COMMITTEE, March 1, 2005 at 14.

[3] Margaret M. Blair, *Reforming Corporate Governance: What History Can Teach Us*, Vol. 1.1 BERKELEY BUS. L.J. 1, 29 – 30 (2004).

The same mechanisms by which for-profit officers and directors are held accountable for their actions are missing in the nonprofit context. Once a nonprofit organization receives a contribution there is no one to hold the organization accountable for how that money is spent. Indeed, while officers and directors have a fiduciary duty to fulfill the mission of their organization, that mission cannot hold them accountable in the same way that shareholders can in the for-profit world.

Although government does play an important role in policing and monitoring nonprofits' activities, specifically the Internal Revenue Service and various state Attorneys General, no agency or state actor has the capacity to oversee every action taken by every organization.[4] Further, while it may also be possible to create a private right of action for a nonprofit organization's donors or beneficiaries to sue the organization, I believe that doing so would deter too many good people from serving on nonprofit boards.

Thus, a body within the organization must be able to fill the void left by the absence of shareholders -- and that body must be its board of directors. Every nonprofit needs a board that is committed to continuously reviewing, adapting and strengthening its oversight responsibilities to meet the changing needs of the organization. Increasing transparency, adopting conflict of interest policies and whistleblower procedures, and

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[4] *Exempt Organizations: Enforcement Problems, Accomplishments, and Future Direction Hearing Before the Senate Committee On Finance* (statement of Mark W. Everson, IRS Commissioner,) *available at* http://finance.senate.gov/hearings/testimony/2005test/metest040505.pdf (stating that IRS' exempt organization master-file data lists 1.8 million tax-exempt entities, up 300,000 from 2000. Collectively, it is estimated that these organizations file more than 800,000 annual returns).

recruiting individuals with financial or other skills necessary for the organization are all important, but underlying such reforms is a fundamental need to make boards understand their role. Typically, those individuals who serve on nonprofit boards believe in the organization and they want to help fulfill its mission. If they appear to be lax in exercising their fiduciary duties it is not necessarily a result of bad behavior, but rather of lack of understanding of what they are supposed to do. Thus, I recommend that any reform effort -- legislative or self-regulatory -- include a requirement that directors receive training in how to be effective directors.

Each nonprofit organization is unique -- size, composition, and missions vary greatly. However, there are certain key principles which all organizations should be able to follow. For example, smaller boards, meeting in person more frequently (at least quarterly) and utilizing standing committees focused on specific issues relevant to the organization are more effective than overly large boards which meet infrequently, and whose members view their service as honorary or focused on fundraising. Directors need to understand the role they play in the organization, the kinds of issues they should examine, and the kinds of questions they should ask of management. Once these principles are in place, they should be able to do the necessary to ensure transparency, governance and accountability.

My specific comments related to TNC are contained in my April 19, 2005 Progress Report which is attached to this testimony.

Thank you.

Weil, Gotshal & Manges LLP
MEMORANDUM

April 19, 2005

To: Board of Governors
The Nature Conservancy

From: Ira M. Millstein

Re: Progress Report on The Nature Conservancy ("TNC")

Summary

In March 2004, a Governance Advisory Panel (the "Panel"), appointed by TNC's Board of Governors (the "Board"), submitted its final Report (the "Report") containing a number of far-reaching recommendations for improving the organization's governance.

Since that time the Board and Management of TNC have made a significant good faith effort to consider and implement the Panel's recommendations, including modifications when considered appropriate.

The Panel did not suggest that its recommendations were cast in stone; it believed them to be subject to modification based on experience and necessity. Moreover, the Panel recognized that many improvements were underway as the Panel began its work, and that additional progress was made during the months the Panel was preparing its Report.

When the Board asked me in February of this year, about a year after the Report was filed, to review TNC's response to the Panel's recommendations, the most important facts I searched for were whether the Board and Management had been activated and energized to face the difficult issues, and were earnestly continuing the process of

improvement. I find that this has happened: the Board and Management have clearly undertaken, and promise to continue to undertake, a good faith continuous review of all of TNC's activities and responsibilities, in order to assure the public of TNC's integrity in carrying out its important mission.

Introduction

In June 2003, the Board of TNC resolved "to enlist independent, outside advisors to assist it in achieving the aspiration of making the Conservancy a recognized leader in governance and oversight."[5]

In August 2003, the Board established a Governance Advisory Panel which included myself as Chair, along with Derek C. Bok, Claudine B. Malone, Richard T. Schlosberg III, and Thomas J. Tierney, to prepare a report concerning issues of governance, transparency, and accountability. While the Panel was undertaking its work, the Board and the Management of TNC made many changes and improvements in its policies and practices. At the time the Panel submitted its Report to TNC's Executive Committee and Board on March 19, 2004, TNC's approach to changes was still evolving, and could be thought of as a work in progress. But in my view, governance was improving.

In the Report, the Panel commented on the current environment in which non-profit organizations operate and on TNC's evolving practices in the areas of

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[5] The Nature Conservancy, *Actions Taken by the Board of Governors* (June 13, 2003) <http://nature.org/pressroom/links/art10309.html>.

governance, transparency, and accountability, and made further recommendations in these and other areas.

In February of this year, the Board of Governors asked if I would examine the progress that TNC had made in the intervening year. This Progress Report is a summary of what I found, and where I think TNC is headed. It is organized in three sections, as was the original Report.

I found that TNC had made substantial progress in implementing many of the initiatives which it had undertaken in the second half of 2003 and the beginning of 2004. In some instances – particularly with respect to the organization of the Board itself – it appears that TNC came to believe that Panel recommendations did not result in TNC's best use of its Board. The Board assessed the situation and developed an alternative approach for reorganizing the Board, which is being acted upon this month.

With respect to improving transparency and accountability in its programs, I believe that TNC has successfully implemented many of the initiatives which were contemplated by the Panel's Report or which were independently underway at the time. In some instances, however, TNC has adopted policy initiatives, but is still in the process of implementing systems which would allow it to track its progress in meeting these objectives.

I wish to thank my partners David B. Hird and Robert C. Odle, Jr. for their assistance in preparing this Progress Report.

I. The Board

As noted in the Report, there has been a dramatic shift in recent years in public expectations concerning the responsibilities of governing boards of non-profit organizations such as TNC. In order to meet these expectations, the governing boards of these organizations have had to adopt structures that are similar to those employed by for-profit corporations. Generally, the non-profit sector, like the commercial sector, has come to recognize that smaller boards – which meet more frequently and have standing committees focused on particular issues relevant to the organization – are more effective than overly large boards which meet infrequently, often by telephone, and whose members sometimes regard board service as an honorary function.

As part of its work, the Panel made preliminary recommendations to the Board about its structure and organization on January 28, 2004 and refined those recommendations through iterative discussions with the Board between that date and the March 19, 2004 date of its final Report.

One of the challenges at the time was to develop an approach which would marry the institutional history of TNC's Board of Governors with a modern perspective on board structure. Historically, like many other large, non-profit organizations, TNC had a large Board of approximately 40 members. Many of the Governors had long personal histories of involvement in TNC programs and strong commitments to TNC's mission. TNC rightfully sought to encourage the continued involvement of these individuals. At the same time, a 40-member Board could not govern effectively, no matter how qualified the members were; there were simply too many of them to operate as a modern, hands-on board.

In its Report, the Panel tried to address this problem by proposing the creation of an 11-member Executive Committee, which would function as a "board within a board." The Panel's concept was that the Executive Committee would be the true governing board. The Panel's proposal also included the creation of six standing committees: Audit, Strategy, Governance, Conservation Project Review, Finance, and Marketing and Philanthropy, making use of the members of the larger board. The chairs of each of the standing committees would have been members of the Executive Committee, along with the Chair, two Vice Chairs, Secretary/Treasurer, and the President, for a total of 11 members. Thus, a larger board would remain, but the "work" would be accomplished by an Executive Committee and active functioning committees.

TNC's Board attempted to follow the Panel's recommendation, but came to believe that the plan could not work in practice as it had been envisioned in theory. The whole Board – then about 35 members – believed that it should function as a governing, not an advisory, body, and that the Executive Committee should act in an emergency role when the whole Board could not be quickly convened. At the same time, the concept of six standing committees appeared to be unwieldy, and in addition, Board members believed that some of those functions were better handled by the Board as a whole or by management and staff.

As the larger Board came to believe that the Panel-recommended structure would not work for TNC, it began to consider modifications to the structure that we had recommended.

At the present time, a resolution is being prepared to submit to the Board of Governors at its meeting later this month, to alter its structure in order to enable it to

govern more effectively. The key component of this proposal is for the Board to reduce its authorized maximum size from 41 to 21 members (including the President).[6]

Reducing the board membership from 36 (its current actual size) to 21 members will be an important step in restructuring the board to better discharge its responsibilities. Although, generally, "best practices" suggest that boards of both commercial and non-profit organizations should range in size between 9 and 15 members, there is little empirical proof of an ideal number. It is anticipated that the size of the Board will continue to shrink as members retire or resign. In fact, I am told that three Board members will complete their terms by early 2006, two in September of 2005, and one in January of 2006, thus probably bringing the number of Board members to 18.[7]

I recognize that ultimately the Board will adjust its size to fit its needs (e.g., enough members to fill out more active committees, representation from TNC's various constituencies, fundraising, and the like), and yet not be unwieldy or overly large. Experience going forward will determine the appropriate size from time to time, as needs vary.

At the same time as it is shrinking its size, TNC's Board of Governors is in the process of adopting a resolution to specify more particularly the responsibilities of the Board and the duties of Board members in governing the organization.

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[6] The proposal also calls for reducing the size of the Executive Committee.

[7] TNC has also a practice of limiting the number of chapter trustees who may serve on the Board of Governors so that not more than 50% of the board members at any given time may also be chapter trustees. As I understand it, TNC expects that this 50% limitation on the percentage of board members who also serve as chapter trustees will continue to apply to the proposed 21-member board, so that no more than ten members of the Board of Governors will be chapter trustees.

The proposal before the Board would also substantially change the Board's committee structure. Three standing committees would remain: Audit, Finance, and Governance and Nominating. The functions of two standing committees – Strategy, and Marketing and Philanthropy – would be reinvested in the Board as whole. This is a fair choice for the Board to make, since at a smaller size, it can take up serious matters such as these.

The sixth of the original six standing committees was the Conservation Project Review Committee, which has jurisdiction to review specific conservation projects. In its Report, the Panel considered it important to have a separate board-level committee to serve this function. Although TNC has addressed this function at the management level through the creation of the Risk Assessment Committee, I continue to believe, as did the Panel, that it is important that a standing committee at the board level have oversight over specific conservation projects.

To that end, the proposal that the Board has developed would transfer the functions of the Conservation Project Review Committee to a new standing subcommittee of the Audit Committee, to be called the Conservation Practices Subcommittee. This, to me, is a satisfactory resolution.

Although TNC believes the Panel's proposed board structure did not work as planned, it is encouraging that the Board is taking steps to develop an alternative structure to improve its ability to govern consistent with the spirit of the recommendations. No specific structure is a panacea; what is most important is that a board understand its responsibilities and develop policies and practices to discharge them.

And the Board, after some experience and much consideration, has selected reforms it considers better suited to TNC.

II. The Field

A section of the Report was devoted to the respective roles of the TNC's Board of Governors and TNC's various advisory boards of trustees in its State chapters.

The Report recognized that while the chapter boards did not have legal authority, the volunteer boards played an important role in TNC's history and development, and continue to provide valuable human resources in setting and achieving goals on a local level, promoting local conservation projects, and fundraising. Thus, TNC draws much of its strength from active and involved chapter boards.

While the Report recognized the importance of the various chapter boards of trustees to the future of the organization, the Report also acknowledged that it was critical for the effective governance of the organization as a whole that the different roles of the Board of Governors and the various boards of trustees be clearly defined and that TNC maintain a centralized management structure to allow for transparency and accountability.

To these ends, the Report recommended that TNC:

- Establish uniform governance standards for each chapter board;
- Clarify the decision-making roles and responsibilities among the Board of Governors, local chapter boards, and senior staff, especially with respect to strategic decisions; and
- Enhance transparency and communications among the Board of Governors, chapter trustees and staff.

Since the Report was issued, TNC adopted a policy in September 2004 concerning the "Roles and Minimum Standard for Governing The Nature Conservancy," setting forth the functions of both the Board of Governors and the individual boards of trustees. This policy specified that the Board of Governors maintained legal and fiduciary responsibility for governance of TNC and that those responsibilities could not be delegated to the individual chapter boards. The policy also set forth the specific responsibilities of the individual chapter boards, which include:

- Reviewing and recommending for approval the chapter's annual operating plan and budget;
- Reviewing and recommending for approval major conservation projects and activities;
- Reviewing, recommending for approval, and providing guidance for the chapter's government relations agenda;
- Reviewing results of the internal audit of each chapter's operations and working with chapter staff to ensure recommendations are addressed;
- Working with chapter staff to ensure that chapter activities are consistent with the chapter's strategic plan and financially feasible within the chapter's budget and financial resources; and
- Working with chapter staff to ensure long-term effectiveness of conservation projects, through appropriate stewardship and measurement of results.

These functions are consistent with an advisory role, which is more appropriate for the local chapter boards than the governance role, which should be exercised only by the Board of Governors.

Moreover, the list of responsibilities identified makes it clear that the chapter boards advise and assist the staff of the chapter, rather than supervise them. Although the chair for each chapter board will participate on an advisory basis in decisions relating to the employment, annual evaluation, and termination of the chapter director, ultimate authority to hire and fire chapter directors will remain a staff function.

The policy did not address certain issues relating to the composition of trustee boards, such as trustee selection, trustee term limits, the size of trustee boards, board officers and terms, committee structures and charters, attendance and participation requirements, and the number of meetings per year. TNC is in the process of developing model Operating Principles to be adopted by each of the boards of trustees as a framework for addressing these issues, which should be completed by late spring.[8]

The current draft of the Operating Principles specifies that the trustees operate as "volunteer advisors" to the Board of Governors, and that the Board of Governors has the power to remove any trustee. To put these statements into the Operating Principles adopted by each chapter board is an important step in clarifying the roles of the Board of Governors and the chapter boards.

TNC has also recently produced an orientation document explaining the process by which TNC identifies and sets priorities for its conservation work and describes the development and implementation of a conservation project that advances those priorities. Called "How The Nature Conservancy Works: Anatomy of a Nature Conservancy Conservation Project," the document specifies the steps TNC takes in planning and

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[8] The current draft proposes to limit a trustee to serving three successive three-year terms.

setting conservation priorities, developing conservation strategies, taking action and measuring the success of individual projects. Project authority has been delegated by the Board of Governors to the President with certain financial limits; however, the Board of Governors retains the authority to approve projects requiring significant financial investment or those which pose unique risks or challenges.

TNC's President has re-delegated project authority to the Chief Conservation Officer ("CCO"), who reviews each project requiring CCO approval based on criteria relating to the conservation worthiness of the project, the certainty of obtaining financial resources needed to complete the project, staff capacity, long term commitments and other considerations. Projects are initially reviewed by the appropriate state or country director. Projects that exceed certain dollar amounts or transcend state or country boundaries are reviewed by one of TNC's eight regional directors. If issues of conflict of interest are raised, projects are further reviewed by TNC's Conflict of Interest Committee, and if a project raises an issue of legal compliance or reputational risk, the project is reviewed by TNC's Risk Assessment Committee.

Successful implementation of these procedures will promote transparency and accountability by enabling more effective centralized oversight of project decision-making.

III. Programs, Transparency and Accountability

At the request of the Board, the Panel examined TNC's programs and practices with respect to transparency and accountability. At the same time this review was underway, TNC on its own initiative made many significant changes to allow for greater transparency and accountability in the management of its programs and how it

decides to enter into various transactions. Therefore, when the Panel issued its Report, it recognized TNC's initiatives in developing such programs and practices. The Panel also recommended additional steps in these areas.

In the intervening year, I believe TNC has made good and substantial progress with respect to improving accountability and transparency. In several instances, TNC has implemented practices and procedures which allow it to effectively monitor how its efforts in these areas have fared. In other instances, however, TNC has not yet fully implemented systems which properly track its efforts to promote greater accountability. Every indication is that, although more work remains to be done by TNC, the organization remains committed to improving its systems, processes and procedures to ensure that its programs meet the goals of transparency and accountability.

Viewed as a work in progress, TNC's efforts in these areas show significant advancement, but, as noted above, there is still more to be done.

a. *Valuations and Appraisals for Land Donations and Conservation Easements*

This is an area in which TNC had been subjected to the most extensive criticism; it is also an area in which TNC has made significant progress in implementing practices to improve accountability and transparency.

In its Report, the Panel recommended that TNC put in place careful, systemic, and strict procedures to ensure compliance with the spirit and letter of the rules with respect to charitable donations of land and property interests.

On March 12, 2004, TNC adopted its "Revised Policy and Standard Operating Procedure for IRS Forms 8282 and 8283." The Standard Operating Procedure

requires donors to submit the following information at the time a gift is made to TNC: (a) a completed Form 8283, (b) an appraisal report, and (c) a signed certification from the appraiser stating, among other things, that: (1) he or she is a certified appraiser in the State in which the property is located; (2) his or her appraisal report conforms to the specified professional standards for appraisers; (3) he or she applied generally-accepted appraisal standards, including those established for gifts under section 170(h) of the Internal Revenue Code; (4) the appraisal has taken into account any increase to other real property owned by the donor as a result of the gift; and (5) the donor is covered by TNC's conflict-of-interest policy. For gifts of "qualified conservation contributions," such as easements, a supplemental statement is required setting forth the conservation purposes furthered by the gift and the fair market value of the property before and after the gift of the easement.

Since March of last year, TNC has effectively implemented this program. It has developed a set of forms, including notice letters and certifications, which are routinely used in these transactions. Also, TNC adopted a strict and more elaborate procedure that its employees not offer tax advice to potential donors. This procedure elaborates upon a previous procedure that was adopted by TNC in 1995. In addition, TNC conducted training programs to implement that procedure.

As the Panel recognized in its Report, relying on appraiser certifications, while helpful, is not enough. Accordingly, the Panel recommended that TNC undertake a "desk review" of all aspects of a proposed transaction, including the donor's appraisal, and that TNC demonstrate that it is willing to "walk away" from an otherwise advantageous transaction if all aspects do not meet TNC's standards (e.g., when a donor

wishes to claim a tax deduction on an appraisal value that is not justified). These recommendations are similar to those of the Independent Sector's Interim Report,[9] presented to the Senate Finance Committee on March 1, 2005 ("Interim Report"), which recommends that non-profit organizations undertake close examination of the appropriate valuation and disposition of non-cash contributions.

TNC has also demonstrated an institutional willingness to look closely at transactions. TNC's Standard Operating Procedure with respect to IRS Forms 8282 and 8283 provides that "the Conservancy will not participate in transactions in which the appearance of the transaction is suspect or unreasonable or does not conform to" TNC policy. Not only have staffers performed "desk reviews" of some individual projects, but a system has been put in place to refer potentially unreasonable transactions to a senior management-level Risk Assessment Committee for review. In at least one instance, TNC rejected a proposed gift because of concerns about the validity of the appraisal.

However, the practice of conducting a "desk review" has not been fully institutionalized. While several staffers have conducted "desk reviews" with respect to particular transactions, they are not formally required for all donations in the manner that the appraiser certification is required. In short, "desk reviews" are performed on an ad hoc basis and no standard forms are used to record whether "desk reviews" have been performed. TNC should take further steps to make sure that the "desk review" is a routine

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[9] Panel on the Non-profit Sector (convened by Independent Sector), *Interim Report Presented to the Senate Finance Committee* (March 1, 2005) <http://www.non-profitpanel.org/interim/PanelReport.pdf>.

component in considering any transaction, and the results of such "desk reviews" should be routinely documented.

b. *Monitoring and Enforcement of Easements*

In the Report, the Panel recommended that TNC regularly monitor compliance with easements, require property owners to disclose plans for changes in easements, and take rigorous enforcement action where landowners act inconsistently with the terms of easements. Specially, the Panel recommended that TNC's General Counsel and Compliance Director take steps to implement enforcement programs.

TNC has made important first steps in implementing such programs. TNC formed a Conservation Easement Working Group comprised of senior TNC managers from all parts of the organization. On April 29, 2004, the Working Group issued a report discussing all issues relating to easements and it contained a series of important recommendations, including: (1) the standardization of decision-making with respect to the appropriate location, terms, and conditions of easements; (2) the use of conservation science for easement location and design; (3) the adoption of a process for decision-making with respect to complex easement projects; (4) the development of standard practices for informing prospective donors of the terms and conditions for accepting easements; (5) the strengthening of policies with respect to the valuation of conservation easements; and (6) the adoption of procedures to ensure consistent monitoring of conservation easements.

As a result of the work of the Conservation Easement Working Group, TNC developed institutional guidelines with respect to the types of easements which are acceptable and which are not, and formalized the process for making decisions about

easements. In reviewing proposed easements, TNC uses the same standard operating procedures as it does for appraisal and valuation issues, which were discussed in the preceding subsection of this Progress Report. Finally, TNC implemented training programs to make staffers more familiar with the organization's policies and practices in this field.

TNC has not yet fully implemented an institutional program for monitoring easements. As of February 22, 2005, TNC made available to users an upgraded version of its Conservation Land System database, which included enhancements to capture monitoring information about conservation easements. The default tab on the system would call for monitoring every 12 months, and would indicate the compliance status of the easement. TNC has indicated that it considers the development of these programs to be important and plans to have its information system appropriately upgraded by the end of June 2005.

c. *Conflicts-of-Interest*

On March 12, 2004, TNC adopted a revised conflict-of-interest policy and standard operating procedure. The Panel noted this accomplishment in its Report and commended TNC for doing so. The Panel believed, as did the authors of the Independent Sector Report, that it is important for modern non-profit organizations to adopt and enforce a conflict-of-interest policy.

The Panel made a recommendation that the definition of a "major donor" as used in the policy be modified to include a donor who contributed $100,000 or more in

cash or assets over a prior five-year period,[10] and TNC adopted that recommendation. Since the time of the Panel's Report, TNC has also institutionalized procedures to review matters involving allegations of conflicts-of-interest and has conducted training programs with respect to those procedures.

The Panel further recommended that the Audit Committee of TNC's Board of Governors be actively involved in overseeing implementation of TNC's conflict-of-interest policy. During the last year, TNC's Audit Committee has been actively involved in addressing conflict-of-interest issues, has made adjustments to certain transactions to eliminate potential conflicts-of-interest, and has provided oversight of the organization's processes for handling conflicts-of-interest. In Fiscal Year 2004, the TNC conflicts committee addressed and successfully resolved 143 cases involving actual or potential conflicts-of-interest.

d. *Transactions with Governmental Entities: the "No Net Profit Policy"*

For many years, TNC has had a "No Net Profit Policy" in connection with its transactions with governmental entities. Often TNC would acquire conservation properties which were transferred to governmental entities authorized to preserve them. In some instances, TNC would act at the behest of governmental entities which could not act as quickly as TNC in acquiring the property. In connection with these transactions, TNC established a policy of recovering only its costs from the governmental entity and not making a profit; hence the "No Net Profit Policy."

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[10] The original definition of a "major donor" was limited to an individual who contributed at least $100,000 in cash or assets in a single transaction.

In its Report, the Panel noted that it was important for TNC's reputation not only that it continue to comply with the "No Net Profit Policy," but also that it document its compliance with the policy in a transparent manner. Finally, the Panel recommended that relevant data about government transactions be fully described in TNC's Form 990 which is filed annually with the IRS so that compliance with the "No Net Profit Policy" can be assured.

Since the Report was filed, TNC has restated this policy as its "Recovery of Costs in Government Real Estate Transfers" Policy. TNC has also adopted a new and detailed Standard Operating Procedure, which provides guidance for project managers on how to calculate TNC's cost basis with respect to property sold or otherwise transferred to governmental agencies. Project managers are then instructed not to recover more than TNC's cost basis from the government agency. Finally, project managers prepare documentation to substantiate the calculation of cost basis and sale price, and when this is complete, it is placed in the project file.

e. *Compatible Human Use*

Prior to the issuance of the Panel's Report, TNC adopted policies to address issues relating to compatible human use of its conservation properties. In its Report, the Panel stressed the importance for TNC to demonstrate that it is following a policy of only allowing those human uses that are compatible with TNC's conservation goals. The Panel further suggested that the policy (with examples) be included in TNC's Form 990. The Policy is now found at statement 29 of the 2003 Form 990.

TNC successfully continues to implement its compatible human use policy. Review begins with TNC's scientific staff, which evaluates the proposed human

use to determine whether it is consistent with TNC's programmatic goals. Subsequent reviews are conducted by business and legal staff and sign-off is required by the Conservation Region Director. TNC has upgraded its computer systems to address compatible human use and has developed a form to record information relating to proposed human uses.

Compatible human use is authorized: (a) as a strategy to reduce or eliminate threats to conservation targets; (b) to mimic or restore essential ecological processes; (c) to meet other programmatic goals; and (d) where it is consistent with TNC values. TNC will not allow any new oil, gas, or hard rock mining activities to be initiated on its properties unless they are already required by existing contracts or other legal obligations to third parties.

f. *Executive Compensation*

The Panel recommended that TNC maintain a consistent policy of paying executives compensation comparable with the compensation paid by other similar non-profit organizations. The Panel further recommended that the Governance Committee of the Board play an active and independent role in reviewing the performance of and setting the compensation for senior staff. The Panel suggested that the Governance Committee directly retain a compensation consultant and that the compensation of the President and senior staff be disclosed on TNC's Form 990.

Because information about the compensation of executives of other non-profit organizations is publicly available, information was assembled by TNC's Human Resources Department – without the involvement of TNC's President and other executives – and transmitted to the Board of Governors. The Board used this information

to make its decisions. Compensation information about senior staff may be found in statement 20 of TNC's 2003 Form 990.

g. *Lobbying*

The Panel's Report noted that the Board of Governors approved a ceiling on lobbying expenditures of 2% of its charitable budget. The Panel considered this ceiling to be consistent with the letter and spirit of IRS policies.

A year later, the 2% ceiling remains in place and TNC lobbying expenditures do not approach this limit nor have they in past years. TNC continues to follow this policy. Also, over the past year and a half, TNC has conducted a series of training programs taught by an outside legal counsel expert in this area of the law to ensure that TNC staff are aware of the legal limitations and TNC's own policies and procedures.

Expenses incurred by TNC in responding to the Senate Finance Committee's request for information about TNC have not been treated as lobbying expenditures by the organization because TNC is of the view that those expenses were incurred pursuant to a specific letter(s) from the Committee requesting such information and therefore do not constitute lobbying. On the other hand, the costs associated with TNC's work on possible legislation growing out of the response to the Senate Finance Committee inquiry have been characterized by TNC as lobbying, and have been and will continue to be allocated to the organization's lobbying expenditures and subject to the cap set by the organization.

h. *Compliance*

The Panel recommended that TNC hire a permanent Compliance Director who would be recruited from outside TNC in order to obtain a fresh perspective on compliance issues. The Panel also indicated that the Compliance Director's office should have adequate staff support.

Although it appears that several applicants from outside TNC applied for the position, it was disappointing to learn that TNC chose an internal candidate. On the other hand, virtually all senior managers within the organization have now received ethics and compliance training, and have signed a written certification documenting their adherence to TNC's policies and procedures and conflict-of-interest policy. This training and certification is now mandatory for all TNC senior managers, and beginning July 1 will be mandatory for all staff, Board of Governors members, and trustees on an annual basis. TNC also adopted in January 2004 and has effectively implemented a whistleblower policy, which is administered by the Compliance Director, the General Counsel and the Director of Human Resources. TNC has also conducted a review of its policies, procedures and practices using Sarbanes-Oxley requirements and has made a number of changes to respond to those requirements. Finally, TNC has hired additional staff in its internal audit department and has increased the rotation schedule for conducting audits of its programs.

At this point, the Compliance Director has no substantial staff support other than an administrative assistant. TNC believes, however, that adequate staffing for the compliance program is being provided from other offices throughout the organization. This arrangement should be monitored carefully by the Board. Consistent with the

Panel's recommendation, the Compliance Director reports directly to the Board. Should a vacancy develop in this position at some point in the future, I believe an effort should be made to recruit an outside candidate.

i. *Reputation and Transparency*

The Panel recommended that TNC disclose as much information as practicable on its Form 990, that TNC disclose its newly adopted practices and policies on the Form 990, and that the Form 990 include a report from the Conservation Project Review Committee. The Independent Sector Interim Report recommends that Form 990s be signed by the CEOs and CFOs of non-profit organizations.[11]

TNC has not yet issued its Form 990 for 2004. The 2003 Form was signed by TNC's CFO. TNC's 2003 Form 990 included a number of changes to increase disclosure, including a narrative describing the policy changes made by the organization (statement 29); a list of a sub-awardees; a detailed, 18 page statement of the organization's mission, strategy and values, and programmatic accomplishments (statement 10); and a specific delineation of the TNC President's compensation. TNC intends to make additional changes to and disclosures in its annual Form 990 submission to achieve greater transparency.

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[11] The Independent Sector Report further recommends that each such organization establish policies and procedures to encourage individuals to come forward with credible information on illegal practices or violations of adopted policies of the organization, and to protect such individuals from retaliation. TNC adopted such a policy in January 2004.

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July 6, 2005

The Honorable Charles E. Grassley
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510--6200

Dear Chairman Grassley:

I want to thank you and the other members of the Committee again for the invitation to testify before you on June 8, 2005. I regret that I was unable to attend in person because my responsibilities as Chair of the Governor of New York State's Commission on Public Authority Reform required my attention on short notice. I appreciate that the Committee extended me the opportunity to submit written testimony.

I am pleased to respond to the additional questions of various Committee members submitted to me in your letter of June 13, 2005.

Senator Hatch's Questions

Senator Hatch asks the following questions:

1. Mr. Millstein, you mentioned the importance of an effective and functioning board of directors for a tax-exempt organization such as The Nature Conservancy ("TNC"). Do you believe that the changes made by the Conservancy have resulted in an effective governing board, or are further improvements still needed?

Answer: There has been a dramatic shift in recent years in public expectations concerning the responsibilities of governing boards of not-for-profit organizations such as TNC. In order to meet these expectations, the governing boards of these organizations have had to adopt structures that are similar to those employed by for-profit corporations. Generally, the larger organizations in the not-for-profit sector, like those in the commercial sector, have come to recognize that smaller boards – which meet more frequently and have standing committees focused on particular issues relevant to

the organization – are more effective than overly large boards which meet infrequently, often by telephone, and whose members sometimes regard board service as an honorary function.

As part of its work, the Governance Advisory Panel that I chaired made preliminary recommendations to the Board of Governors of The Nature Conservancy about its structure and organization on January 28, 2004 and refined those recommendations through iterative discussions with the Board between that date and the March 19, 2004 date of its final Report.

One of the challenges at the time was to develop an approach which would marry the institutional history of TNC's Board of Governors with a modern board structure. Historically, like many other large, not-for-profit organizations, TNC had a large Board of approximately 40 members. Many of the Governors had long personal histories of involvement in TNC programs and strong commitments to TNC's mission. TNC rightfully sought to encourage the continued involvement of these individuals. At the same time, a 40-member Board could not govern effectively, no matter how qualified the members were.

In its March 19, 2004 Report, the Panel addressed this problem by proposing the creation of an 11-member Executive Committee, which would function as a "board within a board." The Panel's concept was that the Executive Committee would be the true governing board. The Executive Committee would be comprised of the chair of each of six standing committees, along with the Chair, two Vice Chairs, and Secretary/Treasurer of the Board, and the President, for a total of 11 members. We also recommended standing committees. Thus, the larger board would remain, but the "work" would be accomplished by an Executive Committee and active functioning committees.

TNC's Board attempted to follow the Panel's recommendation, but in practice came to believe that the plan could not work as it had been envisioned in theory. The whole Board – then about 35 members – believed that it should function as a governing, not an advisory, body, and that the Executive Committee should act in an emergency role when the whole Board could not be quickly convened. At the same time, the concept of six standing committees was considered to be unwieldy; in addition, Board members believed that some of those committee functions were better handled by the Board as a whole or by management and staff.

The larger Board began to consider modifications to the structure that we had recommended, while recognizing the problems we had seen in the original board structure.

Recently, the Board adopted a proposal to alter its structure in order to enable it to govern more effectively. The key component of this proposal reduces the authorized maximum size of the Board from 41 to 21 members (including the President), thus recognizing our basic concern with an oversized board.

Reducing the board membership from 36 (its current actual size) to 21 members is an important step in restructuring the board to better discharge its responsibilities. Although, generally, "best practices" suggest that boards of both commercial and not-for-profit organizations should range in size between 9 and 15 members, there is little empirical proof of an ideal number. It is anticipated that the size of the Board will continue to shrink as members retire or resign. In fact, I am told that three Board members will complete their terms by early 2006, two in September 2005, and one in January 2006, thus probably bringing the number of Board members to 18.[1]

Moreover, the Board is adjusting it's Committee structure. I recognize that ultimately the Board will adjust its size to fit its needs (e.g., by having enough members to fill out more active committees, representation from TNC's various constituencies, fundraising, and the like), and yet not be unwieldy or overly large. Experience going forward will determine the appropriate size and mechanics from time to time, as needs vary.

Adapting and modernizing not-for-profit boards is a new and an ongoing process. If board members understand, as the TNC Board does, the object to be achieved, it is a healthy process. There truly is no one board formula to fit all sizes and types of the multitude of not-for-profits. But if the board members understand their responsibilities, they will experiment until they achieve their own best practice. I believe the TNC Board is now engaged and understands it's responsibilities.

2. Mr. Millstein, do we need to change the laws governing tax-exempt entities to further discourage improper insider dealing?

Answer: My focus has not been on changing the laws, but on changing the practices, infrastructure and corporate culture of not-for-profit organizations. By better

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[1] TNC has also a practice of limiting the number of chapter trustees who may serve on the Board of Governors so that not more than 50% of the board members at any given time may also be chapter trustees. As I understand it, TNC expects that this 50% limitation on the percentage of board members who also serve as chapter trustees will continue to apply to the proposed 21-member board, so that no more than ten members of the Board of Governors will be chapter trustees.

training not-for-profit boards and executives, and by adopting institutional structures and policies that promote accountability and transparency, not-for-profit organizations will create environments in which insider dealing would be far less likely to occur.

My work has been oriented toward educating board members as to their responsibilities and accountability – and – the "tone at the top." It is my belief that "laws" operate after the fact, and are deterrents. But, I prefer reforms in practice which operate to prevent, by attitude, accountability and transparency, "bad" deeds from occurring in the first place. In the long run these reforms are more likely to result in the widespread improvements we all seek.

Whether or not additional laws are adopted to regulate not-for-profits, my effort is devoted to creating a trend within the not-for-profit sector to voluntarily adopt these reforms.

3. Do you believe that the executive compensation levels at the Conservancy are in line with similar organizations of its size and complexity? Do we need more or better disclosure by tax-exempt entities?

Answer: In its March 19, 2005 Report, the Governance Advisory Panel recommended that TNC maintain a consistent policy of paying executives compensation comparable with the compensation paid by other similar not-for-profit organizations. The Panel further recommended that the Governance Committee of the Board play an active and independent role in reviewing the performance of and setting the compensation for senior staff. The Panel suggested that the Governance Committee directly retain a compensation consultant and that the compensation of the President and senior staff be disclosed on TNC's Form 990.

Because information about the compensation of executives of other not-for-profit organizations is publicly available, information was assembled by TNC's Human Resources Department – without the involvement of TNC's President and other executives – and transmitted to the Board of Governors. The Board used this information to make its decisions. Compensation information about senior staff may be found in statement 20 of TNC's 2003 Form 990.

I am not a compensation expert, but based on my understanding of the process, it appears that TNC has made efforts to ensure that the compensation of its executives is in line with that paid to executives of other comparable not-for-profit entities and that the information has been publicly disclosed.

As a general matter, I believe that the compensation paid to senior executives of not-for-profit organizations should be publicly disclosed, just as is the compensation paid to senior executives of publicly-owned for-profit companies. I also think that the Form 990 should be used as a principal disclosure document for not-for-profit organizations in the same way that the Form 10-K is used for for-profit public companies.

Senator Bunning's Questions:

1. How much would the abuse problems associated with gifts of conservation and façade easements be alleviated by vigorous IRS enforcement and effective appraisal reform?

Answer: I recognize that this is one of the important questions before this Committee. As a general matter, it falls outside my areas of background and experience. I have concentrated on corporate governance, and do not generally practice in the areas of easements, appraisals and tax deductions.

In the course of preparing its 2004 Report on TNC, however, the Governance Advisory Panel identified several practices that TNC (and other land trusts) could take, to prevent abuses when receiving a donation of land or an easement. These practices include: (1) ascertaining whether donor's appraiser is state-certified, not barred from practicing before the IRS, and has experience appraising conservation lands and easements; (2) making sure the appraiser uses generally accepted professional appraisal standards; (3) determining whether the appraiser has accounted for any enhancement that the donation would have on the value of any neighboring property owned by the donor (such enhancement would reduce the value of the gift); and (4) ascertaining whether the appraiser has identified any conflict of interest. The Panel further recommended that TNC conduct a "desk review" of the transaction as a whole to determine the appropriateness of the transaction. Finally, the Panel urged that TNC take these actions before the gift is accepted.[2] In my 2005 Progress Report, I observed that TNC was generally following these practices.

I believe that if land trusts in general followed similar practices, abuses in this area would be further limited. I would respectfully defer to the views of the other

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[2] Because Form 8283 need not be completed until the donor files its tax return, there is a potential for a significant delay between the time when a land trust accepts a gift and when it would acknowledge the gift on a Form 8283.

panelists who are more experienced and knowledgeable about the benefits of more vigorous IRS enforcement and appraisal reform.

2. Would the panelists please give me their best ideas on what the I.R.S. and Congress can do to make sure that appraisals for land donations are accurate?

Answer: This question asks for views on how to ensure the quality of appraisals for land donations. Since this question asks for information outside of my expertise, I would defer to other panelists who are more knowledgeable about the topic. But, I recognize that it is an important question. As noted in my answer to the previous question, my work in this area has been on helping not-for-profit organizations themselves to develop an institutional culture and adopt practices to avoid accepting donations based on questionable appraisals.

3. Should the penalties currently in place for bad appraisals be changed? If so, whom should those penalties be assessed against? Appraisers? Charities? Donors?

Answer: For not-for-profit organizations, I believe that the most effective sanction is the injury to the organization's reputation when an abuse has been exposed. With the public attention to these issues in the last two years, I believe that most not-for-profits have become more careful to avoid accepting donations based on questionable appraisals.

With respect to changing the penalties imposed by law for bad appraisals, that question also outside my areas of expertise, and therefore I defer to other panelists who are more knowledgeable.

4. What would you say is the number one area of self-governance where many charities fall short? What is the single change that a charity can make in this area to have the biggest impact?

Answer: Many not-for-profits fall short in effective self-governance simply because the members of their boards of directors do not properly understand their roles. As mentioned in my written Statement submitted to this Committee, the board of directors serves a vital function in governing not-for-profits. Indeed, the role of the board may be more important for not-for-profit organizations than for public for-profit companies because not-for-profits do not have shareholders to hold management accountable. Too often, the members of the boards of not-for-profits view their function as honorary, not supervisory. The most important significant steps that a not-for-profit can take to improve its governance is to make sure that its board comprised of individuals

who understand that their fiduciary responsibility is to oversee the actions of the organization to achieve its mission, comply with the law, and follow best practices. This is a major responsibility – not an honorarium. Therefore, the most important change that can be accomplished in this area is for not-for-profits to cause their board members to understand their jobs.

Based on my experiences with a number of non-for-profits, training and education of Board members is essential and currently missing.

5. Do our panelists think that more public disclosure and "sunshine" rules will help to curb abuses in charities?

Answer: I believe that disclosure, transparency and accountability are key to promoting effectiveness and integrity in the management of not-for-profits. They are the "best practices" for every type of organization. Whether such requirements are promulgated as legal rules or adopted by not-for-profit organizations voluntarily as best practices, they are essential to the proper functioning of these types of organizations. In my work, I have seen many organizations adopt disclosure policies as a means to encourage and implement reform and enhance public communication. Many of the best run not-for-profits have moved voluntarily ahead of the federal and various state legislatures to implement effective disclosure polices. Whether or not there are new legislative initiatives in this area, leading not-for-profits are likely to continue promote a corporate culture of disclosure.

6. One suggestion previously made by the Finance Committee Staff was the public disclosure of Form 990-T returns, which report unrelated business taxable income of exempt organizations. Privacy concerns have been raised by some, including the American Institute of C.P.A.s. Can you comment on the proposal for public disclosure of Form 990-Ts and also how you think privacy concerns could be best addressed?

Answer: As mentioned in my response to previous questions, I believe that disclosure in general is beneficial to the proper management of not-for-profit organizations and that the Form 990 should be used as a vehicle for such disclosures similar to the use of the Form 10-K for for-profit publicly owned companies. However, I have not studied the privacy issues relating to Form 990-Ts. I would therefore defer to other panelists who are more knowledgeable about such issues.

Senator Rockefeller's Question

Senator Rockefeller asks the following question:

The committee report discusses the possibility of requiring accreditation for organizations that receive conservation easements. The notion is that only organizations that have the expertise and resources to monitor and enforce the easements can assure that taxpayers really receive the benefits of the conservation easements.

There has been a great deal of debate about whether it would make sense for the government to create a specific accreditation process for conservation organizations.

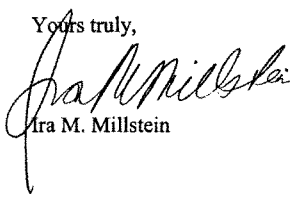
I would like each of you to tell me whether you think it would be prudent for this committee to consider legislation to create an accreditation process. And if we should create such a process, how could we accommodate the unique needs of small organizations?

Answer: Respectfully, I have not studied this issue and it falls outside of my area of expertise, which is corporate governance, not conservation and easements. I would note, however, that, whether or not Congress imposed an accreditation process, the land trust community as whole is likely to develop standard practices for enforcing easements, which will become the norm for these organizations. With respect to the question of whether legislative action is desirable, I defer to other panelists who are more knowledgeable in this area.

* * *

Once again, I would like to thank the Committee for the opportunity to testify before it.

Yours truly,



Ira M. Millstein

STATEMENT OF SENATOR ROCKEFELLER

SENATE FINANCE COMMITTEE

JUNE 8, 2005

Mr. Chairman and Senator Baucus,

I want to congratulate you and your staffs for raising some very important questions at this hearing today. You have done a very thorough investigation of some questionable practices in the tax exempt sector. And while I do not necessarily agree with all of the characterizations made in the report presented today, I appreciate your commitment to a fair process and to making sure that our tax laws are not abused for personal gain.

The Nature Conservancy in West Virginia has done tremendously valuable work. And since questions were first raised about some of the practices at The Nature Conservancy, I have been very impressed with their commitment to address any problems and their dedication to the highest ethical standards. The Nature Conservancy has already enacted tremendous reforms to their governance structure and taken important steps to prevent abusive transactions. Like most tax exempt organizations that are truly dedicated to the public good, The Nature Conservancy fully understands the need to avoid any abusive transactions that would only serve to undermine all of the good work they do.

This hearing today is extremely important, because Congress needs to understand and examine the current tax laws that apply to the donation of land or conservation easements. This committee must evaluate past actions based on compliance with existing policies, and if need be, amend those policies. It may well be that some of these laws need to be tightened to protect taxpayers and truly promote environmental or historic preservation.

Mr. Chairman, Senator Baucus, I look forward to working with you to make sure that our laws governing the donation of land and the activities of land conservation organizations serve the public interest. I believe that sound conservation policies have been of great benefit to Americans over the generations.

Statement
Sen. Rick Santorum
Senate Finance Committee Hearing
June 8, 2005

Mr. Chairman, my strong support for charitable giving brings me here to ask for a more thoughtful approach to charitable contributions of property and conservation easements.

The elimination of fair market value deductions for the general contribution of property to charities is a problematic proposal that will deter charitable giving. The Joint Committee on Taxation (JCT) report recommends that any donor receive only the basis for such a contribution. While I understand that there is legitimate concern over excessive evaluations in some cases, clearly we don't have to effectively throw out this incentive altogether. Doing so would not be a reform, but a tax increase and a barrier to charitable giving. We should instead be seeking narrowly targeted solutions for clearly demonstrated problems once the government has established that enforcement of current law alone is inadequate. One example might be stronger enforcement on our current appraisal system. No one can deny that inflated proposals for larger tax deductions are a serious abuse of the system. But surely we can think of better ideas that address the issue rather than eliminating fair market value deductions all together.

Limits on fair market value deductions can have a serious impact on conservation initiatives. Pennsylvania alone is home to over one hundred and forty organizations that take part in conservancy initiatives, one of which, the Western Pennsylvania Conservancy (WPC) has submitted written testimony for today's hearing. WPC is Pennsylvania's oldest regional 501(c)3 conservation organization. They have partnered with hundreds of community groups, conservation organizations, government agencies, and individuals over their seventy-three year history. Since 1932, WPC has protected 216,000 acres in Pennsylvania, West Virginia, and New York. Most of that land is now publicly owned and includes some of Pennsylvania's premier parks, forests, game lands, and natural areas. WPC has contributed lands to the Allegheny National Forest in north central Pennsylvania; over 40 miles of riverbank land along the Clarion River now designated Scenic and Recreational under the National Wild and Scenic Rivers Act; numerous scenic and recreational areas in the Laurel Highlands of southwestern Pennsylvania; and six of Pennsylvania's state parks. These recreational and scenic assets are enjoyed by millions of residents and tourists, and will be permanently preserved for enjoyment by future generations of Pennsylvanians.

Located in southeastern Pennsylvania, the Heritage Conservancy has also relayed its concerns to the Finance Committee. Heritage Conservancy has become a respected leader in protecting the natural and historic resources of this region and beyond. One example of the good work that Heritage Conservancy does is the Hendrick Island project. Purchased in 1955 by PECO Energy as a potential site for a hydroelectric power plant, Hendrick Island is an important habitat for fisheries and neo-tropical migratory birds. In 1996, Heritage Conservancy facilitated the transfer of ownership of Hendrick Island from

PECO Energy to the Pennsylvania Department of Conservation and Natural Resources (PA DCNR). The 112-acre island located in the Delaware River north of New Hope, Pennsylvania is now an important scenic resource and enhancement to the Delaware & Lehigh National Heritage Corridor. The conservation easement donation of Hendrick Island provided PECO Energy with a tax benefit and preserved this important natural resource for generations to come.

In Pennsylvania, preserving farmland and other land resources is a critical way to encourage smart growth and combat urban sprawl. In addition, our economy depends on the crops that farmland produces. Plant life and wildlife need clean water that is free of pollutants, and future generations should be able to enjoy the abundant resources and national treasures that make Pennsylvania and the United States unique. The JCT proposals could potentially undermine these conservation initiatives rather than limit current abuses.

I appreciate the Chairman's commitment to ensure the public's trust and look forward to working with him on these issues. I urge Members of the Committee to carefully evaluate the impact these proposals will have on charitable contributions of property and deductions for contributions of conservation easements. It is important that we work together to develop proposals that will target abusers rather than discourage legitimate contributions that are important to charity, conservation, and historic preservation.

Preserving our Natural and Historic Heritage

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18901-2489

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www.heritageconservancy.org

June 7, 2005

Honorable Charles Grassley
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Honorable Max Baucus
Ranking Member
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Chairman Grassley and Senator Baucus:

We wish to thank you for the opportunity to provide comments on the policy recommendations recently published by the Joint Committee on Taxation (JCT). Two of these proposals would dramatically reduce voluntary donations that have played a major role in conservation over the past thirty years, through gifts of land and interests in land, including gifts of conservation and historic preservation easements.

In our view, legislation based on sections VIII-F and VIII-H of the JCT report JCS-02-05 would represent a sharp and unwarranted reversal of almost 30 years of Congressional policy to encourage preservation of natural, recreational, and historic resources in a manner that is non-regulatory, voluntary and compatible with traditional economic uses such as farming, ranching and sustainable timber management. We believe that such legislation would be inconsistent with both the public interest and the public will, as evidenced by your own leadership in expanding conservation incentives in the charities legislation the Senate approved in 2003; by the passage in recent years of numerous state laws to provide tax incentives for easements; and by hundreds of state and local referenda approved by voters over the past several years to provide public funding for land protection.

As the use of conservation easements has expanded, it has become clear that there have been abuses of the deductions provided for these donations, and we agree that the Congress, the Internal Revenue Service and the states should seek to prevent and punish them. We support action by Congress and the Internal Revenue Service to target abuses.

The measures proposed by the JCT, however, do not target abusers. Instead, they decrease tax deductions for all conservation donors. This will not end abuses, but it will actively discourage legitimate contributions that are ever more important to conservation and historic preservation.

We stand ready to work with you and your colleagues in the Congress and the Administration to develop, enact and implement effective means to ensure that gifts of land and interests in land for conservation and historic preservation serve the national interest, and to ensure that the tax laws recognizing those donations are not abused.

Thank you.

Sincerely,

Clifford C. David Jr.
President

TESTIMONY TO
SENATE FINANCE COMMITTEE
ON LAND CONSERVATION ACTIVITIES AND
RELATED PRIORITIES AND PROCEDURES

JUNE 8, 2005
by
DENNIS McGRATH
PRESIDENT
WESTERN PENNSYLVANIA CONSERVANCY
209 FOURTH AVENUE, PITTSBURGH PA 15222

Mr. Chairman, Senator Baucus, and distinguished members of this Committee. I am grateful for the opportunity to register comments and testimony today on behalf of the Board of Directors, staff, and members of Western Pennsylvania Conservancy.

Western Pennsylvania Conservancy (WPC) is Pennsylvania's oldest regional not-for-profit 501(c)3 conservation organization. During the past 73 years, we have partnered with hundreds of community groups, conservation organizations, government agencies and individuals in more than 45 counties stretching from Pennsylvania's borders with Ohio, West Virginia and New York, and east across the state to Harrisburg and beyond. We have approximately 17,700 members and involve more than 5,000 volunteers every year in community conservation initiatives.

In accordance with our mission, WPC conserves land of ecological, scenic, and recreational significance. Today, our work is perhaps more urgent and necessary than ever before. The past four decades of suburban sprawl has changed our natural landscapes and open spaces, and we are now beginning to fully understand the negative repercussions of wholesale land conversion. We at WPC seek to use science-driven land conservation planning coupled with the engagement with communities, businesses and government partners to develop conservation approaches that work for all involved.

WPC's land conservation initiatives have had a significant impact on the communities and landscapes of western Pennsylvania. Our work has enabled the permanent protection and stewardship of important natural, scenic and recreational assets. Since 1932, we have protected 216,000 acres. Most of that land is now publicly owned and makes up some of our state's premier parks, forests, game lands, and natural areas. They include lands integral to and within Allegheny National Forest in north central Pennsylvania, over 40 miles of riverbank land along the Clarion River now designated Scenic and Recreational under the National Wild and Scenic Rivers Act, numerous scenic and recreational areas in the Laurel Highlands of southwestern Pennsylvania, and six of Pennsylvania's state parks. These recreational and scenic assets are enjoyed by millions of residents and tourists, and will be permanently preserved for enjoyment by future generations of Pennsylvanians.

WPC's current land conservation portfolio includes full title ownership of approximately 10,160 acres and 28,725 acres in conservation easements. Of the easement acres, 9,500 represent gifts to the WPC.

Conservation Tools

In order to implement meaningful, sustainable land conservation initiatives, the Western Pennsylvania Conservancy has relied on a variety of land conservation tools. Over the years, we have witnessed first hand the evolution of these tools and the ways in which they are applied.

Purchase

The most direct, widely used acquisition approach is outright purchase from willing sellers. Such purchases are most often funded through a combination of public and private funds. On occasion, when beneficial to the seller, we enter into bargain sale agreements. Bargain sales are purchases below the fair market value that allow the seller/donor to take tax deductions permissible and allowable by law.

Donation of Land

Donation of land to a conservation organization such as WPC is one of the most generous legacies a landowner can leave for future generations. Donors are eligible to take tax deductions to extent permissible and allowable by law.

Conservation Easements

During the past 30 years or so WPC and many other conservation organizations use conservation easements as an effective means to accomplish land and water conservation goals. Conservation easements have proven attractive and effective because they are voluntary, legally binding and enforceable, and permanently limit or restrict uses and activities that are inconsistent with the conservation purposes intended for the property.

Through the use of conservation easements, we have protected thousands of acres of ecologically important land in western Pennsylvania. Many of these lands– such as the 11,300-acre Crawford Reserve in Venango County - are privately owned but open for public recreation as a condition of the landowner's conservation easement.

Since we are responsible for enforcing the restrictions that are detailed in conservation easement documentation, WPC monitors our easement properties on a regular basis, typically once a year. WPC staff or volunteers visit the restricted properties, often accompanied by the owner, to determine whether the property has been maintained in the condition prescribed by the easement and documented at the time of the easement acquisition. WPC maintains written records of the monitoring visits. Volunteer land stewards, now numbering 80, assist WPC staff in monitoring responsibilities each year.

On a national level, according to data compiled by the Land Trust Alliance, voluntary donation of conservation lands and easements have resulted in the permanent and voluntary protection of 35 million acres of agricultural lands, working forests, wildlife habitats, historic landscapes, and parklands during the last 25 years. Collectively, these

transactions are achieving their intended purpose: to conserve land and water in a voluntary, effective way.

The Western Pennsylvania Conservancy believes these hearings provide an ideal opportunity to improve the conservation easement as an effective, enduring conservation tool for wide application across the United States. WPC is committed to working with Congress and all involved to improve conservation easements, the easement process and all related policies and standards/practices. To that end we provide a few comments on best practices and governance.

Conservation easement best practices and governance

With nearly 30 years of experience, the conservation community is far better equipped to structure conservation easements with clear and concise language, tighter legal reviews and Board scrutiny. The conservation community in general has developed excellent models and guidance materials focused on document preparation, appraisals, baseline information, monitoring and enforcement, amendments, and building stewardship funds to adequately cover long-term responsibilities. We need to recognize and adopt those practices, regularly review them and strive to make them better and more effective.

While the conservation community has come a long way in the evolution of conservation easements, we also acknowledge the need for improvement to prevent and identify abuses of the existing laws and provide an effective transparent system of checks and balances.

WPC's approach to ensuring adherence to ethical and technical policies, procedures, and practices regarding conservation easements and donations of land

As the conservation easement tool evolved over the years, WPC has continually refined its internal policies and procedures to ensure absolute compliance with applicable laws and regulations. WPC has adopted, and strictly adheres to the Land Trust Alliance Standards and Practices. The WPC Board is committed to maintaining high ethical and technical standards of operating. This includes a gift acceptance policy requiring that all gifts of land and conservation easements further existing and well-defined Board adopted conservation target areas.

WPC has implemented and is committed to strict policies and organizational guidelines in carrying out our land conservation activities. These include:

- Organizational Guidelines on the acceptance of gifts of land and divestment of non-mission related lands (attachment A)
- Guidelines on the acceptance of gifts of conservation easements (attachment B)
- Guidelines on amendments to conservation easements (attachment C)
- Board Adoption of the Land Trust Alliance's standards and practices as amended December 2004.
- Independent legal review and Board approval of each real estate transaction prior to the execution of the transaction.

WPC's organizational governance policies

Because we are a land transaction-based organization, WPC's Board of Directors views real estate transactions, particularly conservation easements, among the most important aspects of its governance responsibilities. Our Board has modified governance practices to conform to the highest standards in the conservation sector. In addition to our land transaction policies and guidelines, the WPC Board of Directors has also adopted policies and procedures to ensure adherence to the highest standards of overall organizational governance. These standards include:

- All members of the Board of Directors are elected by the membership for three-year terms.
- A professionally diverse Board representing the communities served by WPC.
- Signed compliance with the organization's conflict of interest policy by each Board director, officer, and senior administrative staff, renewed annually.
- Board adopted policy prohibiting any board director, officer, WPC employee, and any member of his or her family from purchasing directly or indirectly any WPC-owned property listed for sale.
- Timely submission of IRS Form 990.
- Distribution of IRS form 990 to the full board of directors.
- Disclosure of IRS form 990 to the public via the internet.
- An audit committee (with no overlap with the board's finance committee) appointed by the board of directors to oversee an annual audit.
- Periodic rotation of appointed external auditors.
- Audit report circulated to the full board.

Conclusion

The Western Pennsylvania Conservancy appreciates the opportunity to provide testimony to the members of this committee and we want to recognize the important work you have undertaken to engage the conservation community to make our work better and our organizations fully accountable to the public trust which we serve. WPC is committed to excellence in the governance and execution of its land conservation work. We want to work with all involved to support responsible, effective legislative and regulatory reforms to ensure the integrity and credibility of the transactions of all land conservation organizations, and to continue building on the trust placed in us by our public and private sector partners, members and other supporters.

Specifically, WPC supports conservation easement reforms ensuring clear conservation and public benefit, improving appraisal and amendment standards, and ensuring enforcement by a conservation organization with adequate capacity. However, any reforms must maintain reasonable and fair tax incentives, which are essential for voluntary conservation to continue in the United States.

The Western Pennsylvania Conservancy supports self-regulation within the land trust community. To this end, WPC supports the Land Trust Alliance's proposals for development of training and accreditation programs based on the Land Trust Standards and Practices issued by the Land Trust Alliance.

ATTACHMENT A:

Guidelines on Acceptance of Gifts of Land and Divestment of Non-Strategic Lands

Western Pennsylvania Conservancy (WPC) will accept gifts of land to advance WPC's strategically identified conservation priorities in accordance with the following guidelines.

1. WPC will accept gifts of land which advance WPC's strategically identified conservation priorities as follow:

    a. Enhancement to existing WPC conservation land holdings
    b. Conservation of forestland within WPC identified priority forest blocks
    c. Conservation of riparian land in WPC identified priority areas
    d. Conservation of agricultural land in WPC identified priority areas
    e. Conservation of ecological resources in WPC identified priority areas
    f. Conservation of land identified as priority by government agencies providing the land is also in a WPC identified priority area and providing the government agency is willing to subsequently hold title to the land

2. WPC will accept gifts of land that do not meet the above criteria providing the donor is in agreement that the land can be sold and the proceeds applied to WPC conservation priority projects. Gifts of land having conservation values would be sold with appropriate restrictions protecting such values. An appraisal of value or a third party professional opinion will be obtained to set the selling price.

    Note: By policy adopted by the WPC Board of Directors no land may be sold to a Board member or staff member or otherwise as stated in Appendix E.

3. Should a proposed gift of land be in accordance with the criteria stated above, the following procedures will be strictly adhered to:

    a. WPC staff will meet with the landowner.

    b. WPC will submit a letter to landowner confirming that proposed gift of land meets WPC criteria. Letter to be reviewed and approved by WPC counsel and executive staff prior to delivery.

    c. Letter will be mailed to landowner explaining appraisal requirements, instructions for completing Form 8283 (if seeking tax deduction) and notification that WPC makes no representation or warranty as to deduction.

d. WPC will require that an appraisal be completed in accordance with the following stipulations:
    i. Appraiser is MAI certified by the Appraisal Institute
    ii. Appraiser has followed the Uniform Standards of Professional Appraisal Practice recognized in the United States as the generally accepted statement of standards of professional appraisal practice
    iii. Appraiser has expertise and experience to make appraisals of conservation lands
    iv. Appraiser is not barred from practice before the IRS or Treasury Department or other administrative bodies
    v. Appraiser has accounted for any value enhancement issues to nearby property of the donor or parties related to the donor
    vi. A copy of the appraisal is submitted to WPC.

    If WPC believes the appraised value is significantly overstated or the project does not conform in some other way with the tax law, WPC will share its concerns with the donor and decide whether to proceed with the transaction. WPC will not participate in a transaction if it appears WPC is a party in a transaction that unfairly benefits a private individual or perpetrates tax fraud.

e. Staff will conduct a site visit and complete land exam report (see Appendix B). The landowner will submit a survey (preferred) or map (copy of the relevant USGS topographic quad map), with the property boundary identified. Staff will utilize this information when assessing the area in and around the property. If liabilities are noted during the site visit, WPC's counsel and WPC's insurance company will be contacted for an opinion.

f. Staff will prepare a document describing intended purpose of gift, use of property and roles, rights and responsibilities of all parties involved in acquisition and management.

g. Consideration and approval by WPC Board of Directors

h. Order a title search and insurance policy

i. Inform WPC insurance company regarding acceptance of gift

j. Require the landowner to obtain a phase one environmental assessment

k. Work with landowner to draft deed

l. Sign and record deed

m. Sign Form 8283 providing all appraisal requirements are met.

ATTACHMENT B:

Guidelines on Acceptance of Gifts of Conservation Easements

Western Pennsylvania Conservancy (WPC) will accept gifts of conservation easements to advance WPC's strategically identified conservation priorities in accordance with the following guidelines:

1. The proposed easement must meet the conservation purposes test and the related criteria as defined by the Internal Revenue Service regulations under Section 170 (h) to determine if a proposed gift meets the requirements as follows:

    a. The preservation of land areas for outdoor recreation by, or the education of the general public,
    b. The protection of a relatively natural habitat of fish, wildlife or plants, or similar ecosystem,
    c. The preservation of a historically important land area of a certified historic structure:
        i. the term "certified historic structure" means any building, structure or land area which is listed in the National Register, or is located in a registered historic district and is certified by the Secretary of the Interior as being of historical significance to the area,
    d. The preservation of open space (including farmland and forestland) where such preservation is:
        i. for scenic enjoyment of the general public, and will yield a significant public benefit, or
        ii. pursuant to a clearly delineated Federal, State, or Local governmental conservation policy, and will yield a significant public benefit.

2. WPC will accept a gift of a conservation easement, which advances WPC's strategically identified conservation priorities as follows:

    a. Enhancement to existing WPC conservation land holdings
    b. Conservation of forestland within WPC identified priority forest blocks
    c. Conservation of riparian land in WPC identified priority areas
    d. Conservation of agricultural land in WPC identified priority areas
    e. Conservation of ecological resources in WPC identified priority areas
    f. Conservation of land identified as priority by government agencies providing the land is also in a WPC identified priority area

3. Should a proposed easement meet the above criteria, the following procedures will be strictly adhered to:

    a. WPC staff will meet the landowner

b. WPC will submit a letter to landowner confirming that proposed gift of a conservation easement meets WPC criteria and requesting stewardship contribution toward WPC's stewardship fund intended for monitoring and enforcement.. Letter to be review and approved by WPC counsel and executive staff prior to delivery.

c. Letter will be mailed to landowner explaining appraisal requirements, instructions for completing Form 8283 (if seeking tax deduction)

d. WPC will require that an appraisal be completed in accordance with the following stipulations:
   i. Appraiser is MAI certified by the Appraisal Institute
   ii. Appraiser has followed the Uniform Standards of Professional Appraisal Practice recognized in the United States as the generally accepted statement of standards of professional appraisal practice
   iii. Appraiser has expertise and experience to make appraisals of conservation easements and conservation lands
   iv. Appraiser is not barred from practice before the IRS or Treasury Department or other administrative bodies
   v. Appraiser has accounted for any value enhancement issues to nearby property of the donor or parties relate to the donor
   vi. For federal projects, the Appraiser has followed all federal requirements
   vii. A copy of the appraisal is submitted to WPC

e. If WPC believes the appraised value is significantly overstated or the project does not conform in some other way with the tax law, WPC will share its concerns with the donor and decide whether to proceed with the transaction. WPC will not participate in a transaction if it appears WPC is a party in a transaction that unfairly benefits a private individual or perpetrates tax fraud.

f. Staff will conduct a site visit and complete a land exam report (see Appendix B). The landowner will submit a survey (preferred) or map (copy of the relevant USGS topographic quad map) with the property boundary identified. Staff will utilize this information when assessing the area in and around the property.

g. Staff will prepare a document describing intended purpose of easement, intended use of property and roles, rights and responsibilities of all parties involved in acceptance of the gift of a conservation easement.

h. Work with landowner to draft easement document

i. Consideration and approval by WPC Board of Directors

j. Order title search

k. Obtain mortgage subordination (if applicable)

l. Complete baseline documentation and share with landowner

m. Sign and record easement

n. Sign Form 8283 providing all appraisal requirements are met

j. Develop annual review and monitoring plan.

ATTACHMENT C:

Guidelines on Amendments to Conservation Easements

The Western Pennsylvania Conservancy recognizes the need from time to time to revisit and perhaps amend the terms of conservation easements to clarify vague language, to correct an error in the easement, the survey, or the baseline documentation, to allow for minor modifications consistent with the conservation purposes in the program area, or to add restrictions that allow for greater protection of the land.

To that end, Western Pennsylvania Conservancy has adopted the following guidelines when considering amendments to easements.

1. No amendment shall be allowed that will affect the qualification of the easement or status of Western Pennsylvania Conservancy under any applicable laws, including section 170(h) of the Internal Revenue Code, and any amendment shall be consistent with the purpose of the easement, and shall not affect its perpetual duration.

2. No amendment shall be granted if it would result in an increase in property value or other benefit to the landowner or other private party. Such situations may create "private inurement," which is forbidden by the U.S. tax code.

3. A party requesting an amendment shall pay all costs including staff time and legal fees for reviewing the request, whether or not it is granted, and of implementing the amendment if approved.

4. Any request for amendment must be made in writing to Western Pennsylvania Conservancy with appropriate supporting documentation (property description, maps, drawings, etc.) specifying why the amendment is needed or warranted. This information will be reviewed by executive staff and WPC's legal counsel.

5. Western Pennsylvania Conservancy staff will make the initial review of the written amendment requests, consult with the landowner seeking the amendment and conduct necessary site visits within a reasonable amount of time after receipt of the written amendment request.

6. Western Pennsylvania Conservancy may consult with a committee of community stakeholders (which would include other easement holders) as to the negative and positive effects of granting the proposed amendment.

7. Any amendment must be in compliance with local planning and zoning ordinances.

8. The full board or a two-thirds majority of the executive committee of the Western Pennsylvania Conservancy Board of Directors must approve all amendments. The board has the right to approve, reject or approve with modification, the request for amendment.

9. Any amendment will be legally recorded at the Recorder of Deeds office of the appropriate Pennsylvania County.

LAND TRUST ALLIANCE

TESTIMONY OF RAND WENTWORTH
President, Land Trust Alliance

SENATE FINANCE COMMITTEE HEARING
"The Tax Code and Land Conservation:
Report on Investigations and Proposals for Reform"
June 8, 2005

Mr. Chairman, Senator Baucus, and Members of the Committee:

I am the President of the Land Trust Alliance, the national 501(c)(3) organization that provides training, research and standards for the 1500 land trusts in America. We were formed 23 years ago by land trust leaders to help improve the skills and practices of land trusts throughout the country. Land trusts are publicly supported charities that conserve land for public benefit, and they count on charitable gifts of land or conservation easements to accomplish their mission. The Land Trust Alliance is a non-partisan organization that does not engage in real estate transactions, own land, or hold easements.

Thank you for the opportunity to testify on the conservation donations which make the work of these charities possible. I also want to thank Dean Zerbe and Jonathan Selib of the committee staff for taking the time over the past year and a half to discuss a host of ideas about how to improve the laws governing conservation donations. They have studied this from every angle, and, while they have challenged virtually every aspect of our members' operations, they have also been responsive to our suggestions for more practical ways to address their concerns.

A TAX POLICY SUCCESS

Encouraging landowners to donate conservation lands is a stunning success story of tax policy. Private landowners hold 70 percent of the undeveloped land in America and they are essential for the conservation of Americas' natural heritage. The Congress enacted the current law governing tax deductions for donations of conservation easements 25 years ago. Under that law, land owners can donate the development rights to their land to protect resources important to the public, through a legal tool known as a conservation easement.

A conservation easement keeps land in private hands, supports rural economies, and keeps land on the tax rolls. It is politically attractive because it is voluntary, non-regulatory and respects private property rights, and it is only possible because of generous private landowners who have been good stewards of their land and have made extraordinary charitable gifts to provide public conservation benefits.

Since Congress enabled tax deductions for those donations, land trusts have protected more than 9 million acres of important wildlife habitat, farms, ranches, and forests with this tool. In combination with other tools, including the acquisition and management of preserves, partnerships with government conservation agencies, and a host of other means, land trusts have protected a total of 34 million acres in the US. This is an extraordinary legacy of land, more than the National Park Service holds in the lower 48 states, an area larger than Pennsylvania. It represents the commitment of more than 3 million Americans who support these nonprofits with their memberships and donations.

I would like to briefly recount two stories about conservation easement gifts.

Sinclair Farm, Lancaster County, Pennsylvania:

In Drumore Township, Pennsylvania, Joseph Sinclair donated a conservation easement on his land to the Lancaster Farmland Trust to preserve a significant component of the region's historical and natural legacy.

The 133-acre farm, which Mr. Sinclair works with his grandson, is a famous Underground Railroad station that protected escaped slaves in the mid-nineteenth century. Mr. Sinclair and his grandson offer tours to school and community groups of the stone vault where escapees once stayed, and are proud that the scenic farm will remain in agricultural use in perpetuity.

Hass Ranch, Las Animas County, Colorado:

Tony and Connie Hass purchased their 5,500 acre ranch in southeastern Colorado in the early 1990's when Tony retired from professional rodeo. Their ranch includes several miles of Timpas Creek, an oasis for wildlife in the area, including wild turkey, pronghorn antelope, swift fox, and trophy mule deer. In addition, the historic "Hole in the Wall" stop on the Santa Fe Trail is on the property and remnants of the thousands of wagons that crossed the plains in the 19th century are still visible.

Poor cattle prices and crippling drought tested Tony and Connie, who are raising their two children on the ranch. The ranch income is supplemented by Connie's job as a school teacher in town. In 2002, the family began to explore conservation easements as a way to help them stay on the ranch and avoid selling it to a developer. In 2003, they placed 1,600 acres into an easement held by the Colorado Cattlemen's Agricultural Land Trust – one of a number of land trusts associated with their states' cattle growers associations. In 2004 they added another 1,500 acres to the easement. Their intent is to protect the entire ranch.

The tax incentives have allowed them to reduce debt on the property and purchase a nearby hay farm which allowed them to expand their cattle operation.

There are thousands of stories like these, stories of valuable resources that have been protected for the long-term benefit of the public by private landowners working with a land trust.

The tax incentives that Congress has provided for gifts like these have leveraged extraordinary charitable giving, worth more than $1 billion each year. The value of these gifts to the public will rise each year as land values increase and as development moves further and further into the countryside. As our nation builds and grows, we need to set aside land before it is too late to provide a legacy of wildlife habitat, clean water, working farms, and quality of life for the future.

ADDRESSING THE PROBLEMS

In the 25 years since Congress enacted section 170(h) of the Internal Revenue Code, conservation transactions have grown in size and complexity. It would be surprising if a close examination did not reveal a need for changes. While the vast majority of conservation transactions are properly structured, there are problems that require immediate attention, especially improper appraisals and transactions that do not have a legitimate conservation purpose.

These problems come from two distinct sources. One is caused by well-intentioned people with limited resources, trying to do as much as they can for a good cause – and not paying careful enough attention to the rules as they go. With two new land trusts being formed every week in America, some land trusts have not yet instituted strong policies and ethical safeguards. This is something we believe that we, in the private sector, can and must take primary responsibility for fixing. The second source of problems comes from people abusing conservation tax incentives to maximize personal gain, a problem that requires government action.

We were taken aback by the approach the Joint Committee on Taxation took to solving these problems in its report JCS-02-05, because they basically took the approach of stopping this program, rather than examining specific problems and tailoring solutions. I want to thank those Senators on the Committee who have expressed concern about the Joint Committee on Taxation recommendations to deny deductions for most conservation easement donations, and to reduce deductions for those donating land from the land's fair market value to the landowner's basis in that land. If these proposals were enacted into law, they would virtually stop all conservation donations, and would bring an end to this great success story.

There are solutions that will correct and prevent the problems we have seen in conservation donations without undermining the incentives for legitimate donations.

Those solutions require a coordinated approach between the government and the private sector with three clear steps:

1) Strong private sector standards, training, and accreditation;
2) Strong enforcement; and,
3) Strong reform legislation.

STANDARDS, TRAINING AND ACCREDITATION

The Land Trust Alliance has been concerned with these problems for many years. We first developed the *Land Trust Standards and Practices* in 1987 and later published a 564 page manual providing detailed guidance on legal, ethical and governance issues. Recognizing the rapid change in conservation practices and the law, the Land Trust Alliance initiated in 2003 an extensive public participation process to completely rewrite the standards. These new standards set a high bar for ethical and professional practices, and directly address the issues raised by the Senate Finance Committee staff at this hearing. The Board of the Land Trust Alliance approved these standards in October 2004 and now requires each of our member land trust to adopt the new *Land Trust Standards and Practices* as their guiding principles. Recognizing the concerns about proper conservation easement practices, the Land Trust Alliance - in partnership with the Trust for Public Land - recently published *The Conservation Easement Handbook,* a comprehensive resource on the design and management of conservation easements.

We are now designing an accreditation program to provide objective, third-party verification of ethical practices. Our goal is to encourage and recognize excellence in conservation practices and to give the public a "seal of approval" that clearly indicates those groups that meet rigorous standards. We have just completed an extensive series of meetings and surveys to solicit comments from our members. When asked if a land trust would apply for accreditation if an acceptable program were offered, 94 percent said yes. This is clearly a community that is committed to ethical practices and ensuring the public trust.

We believe that accreditation should be managed by the private sector and we are grateful for grants from the Doris Duke Charitable Foundation, the National Fish and Wildlife Foundation, the Surdna Foundation and many other funders for their support for our work on this. For the past six months, a 19-member committee of land trust leaders has worked on the design of the program and we expect to have the business plan complete by September 2005. It will take time to assess hundreds of organizations, but, assuming we can identify the necessary funds, we could begin the process as early as 2007.

To help land trusts prepare for accreditation, we are creating a comprehensive core curriculum based on the *Land Trust Standards and Practices.* We are also developing books, articles, sample policies, model documents, and an online database to help land trusts improve their practices. Once we have launched an accreditation program, the Land Trust Alliance plans to offer professional certification for individuals who have completed the core curriculum and demonstrate broad competence in land conservation.

THE IMPORTANCE OF ENFORCEMENT

Government enforcement is simply essential to discourage unwarranted tax deductions. In his testimony to this Committee on April 5th, Internal Revenue Service (IRS) Commissioner Everson acknowledged that his agency had not paid much attention to this and related areas of the law over a period of 6-8 years. That has had real consequences, including a growth in exaggerated appraisals and claims for gifts that were never actually made.

Commissioner Everson has demonstrated strong leadership in focusing investigative and enforcement resources on improper deductions for land conservation donations. He testified that more than 400 conservation easement donations were under review by his staff, and that 48 easement donations were already under audit. The IRS issued a formal Notice 2004-41 a year ago, informing both taxpayers and their own personnel about their concerns in this area. The agency conducted a training session for their personnel from around the country, and they are boosting their expertise in real estate appraisals.

We in the private sector can help, by providing greater transparency and information to the IRS and the states, and we are very willing to do that through additions to the Forms 8283 and 990. Over the past year, we have met with Commissioner Steven Miller and his staff to discuss appraisal standards, easement amendments, and increased enforcement. We invited IRS personnel to our national conference last year, both to present and to learn, and their participation was greatly appreciated by our members. This partnership is now being expanded to advance additional training programs.

The states can also play a major role in education and enforcement, as Director Maybank is demonstrating in South Carolina. He has audited every land trust doing business in his state – but he is a true friend of conservation. He believes that the long term success of conservation depends on land trusts playing by the rules, and he has published a text on conservation donations to help land trusts and easement donors comply with the law.

We think that this new enforcement activity will have a major effect on discouraging future abuses. There is no question that, whatever the rules are, they will require enforcement.

REFORM LEGISLATION

Given the success of the current tax incentives, we are understandably cautious about changing the rules. This represents a risk for us, because the current rules have worked reasonably well over the past 25 years. But we cannot turn a blind eye to abuses that, while limited, threaten the credibility of a successful tax policy that has a record of providing valuable conservation, and that holds the promise of doing so much more in the years to come.

After careful consideration, the Land Trust Alliance has decided to support reform legislation provided that it:

- Targets the worst abuses
- Is cost-effective for small, all-volunteer charities
- Protects the incentives for legitimate gifts;
- Clarifies rules, rather than complicates them; and
- Complements what the private sector and state governments can do to prevent abuses.

After discussions with many in the land trust community, we propose the following changes in federal law. In short, we believe that we must stop improper appraisals and easements that lack true conservation value, especially those on golf courses and back yards.

Strict rules that establish minimum qualifications for appraisers and appraisals.

1. Require the appraiser to be state licensed as a "general certified real estate appraiser" under the licensing required by Title XI of the Financial Institutions Reform Recovery and Enforcement Act of 1989 (FIRREA). To protect the banking industry from overvaluation of mortgages, the Congress required the states to license appraisers. That licensing system is in every state. "General certified real estate appraisers" are the highest license level, qualified by training and experience to appraise any type of real estate.

2. Require the appraiser to certify that he or she has not been subject to disbarment from practice before the IRS by the Secretary of the Treasury pursuant to 31 U.S.C. sec. 330(c).

3. Require that appraisals meet the Uniform Standards of Professional Appraisal Practice (USPAP) as required for federally-related real estate appraisals by Title XI of FIRREA. Virtually every agency in the federal government other than the IRS requires that real estate appraisers and appraisals comply with the Uniform Standards of Professional Appraisal Practice, which were created under the direction of Congress. These standards are also the standards enforced by state licensing authorities – so that requiring compliance with these standards brings state licensing authorities into action as well.

4. Request the Appraisal Standards Board and the Appraisal Foundation to establish standards for conservation easement appraisals.

5. Require that the appraiser certify in the appraisal that (1) the specific restrictions and obligations imposed by the easement and (2) the effect of existing zoning and other local ordinances, including local historic preservation ordinances, if any, have been expressly disclosed and taken into account in the valuation.

Stricter penalties for inflated appraisals.

1. Cut the thresholds for valuation misstatement penalties for charitable easement donations. Currently, under code section 6662(e)(1)(B)(i) a substantial valuation misstatement penalty applies if the deduction claimed is 100% greater than the amount determined to be correct. Under code section 6662(h) a gross valuation misstatement penalty applies if the value claimed is more than 300% greater than the amount determined to be correct. Under this proposal, the substantial valuation misstatement penalty would apply if the charitable deduction claimed is more than 50% greater than the correct amount and the gross valuation misstatement penalty would apply if the charitable deduction claimed is more than 100% greater than the correct amount.

2. Require the IRS to report all appraisals where a gross or substantial valuation misstatement is determined to the appraiser's state certification board.

3. Provide the Secretary of the Treasury with the authority, after notice and a hearing, to bar an appraiser from practice before the Department of the Treasury under 31 U.S.C. sec. 330(c) when the appraiser has issued three or more appraisals determined to be subject to substantial or gross valuation misstatements.

4. Increase the penalty for aiding and abetting understatement of tax liability under IRC 6701(b) from $1,000 to $10,000.

Prohibit deductions for donations most subject to abuse.

1. Prohibit deductions for the donation of a conservation restriction on a golf course or similar properties. This would cover similar commercial recreational areas, such as batting cages, miniature golf courses, driving ranges, etc.

Numerous reputable conservation organizations hold conservation easements on golf courses, protecting important conservation values other than outdoor recreation. But recently, we have seen golf course industry consultants recommending that every golf course owner should donate an easement on their property, without reference to any special values. We do not believe that the drafters of section 170(h) had golf in mind when they made outdoor recreation for the public a qualifying conservation purpose for conservation donations.

2. Prohibit deductions for the donation of a conservation easement on a backyard or other very small property unless it meets additional tests of its public benefit.

The committee staff have indicated their concern that easements can be placed on an ordinary back yard. We do not think that such an easement would qualify under the current law and regulations, because it lacks a clear conservation purpose.

We put this proposal forward very reluctantly, and believe that the details of the legislation need to be carefully drafted. There are hundreds of land trusts across the

country operating in jurisdictions in which most if not all land ownerships are less than 10 acres, and where the landscape is changing in front of people's eyes. Local, community-based land trusts may be the best hope for land conservation there, and we urge the committee not to propose a minimum size for easements without exclusions. We are very open to discussing specific conditions that would better ensure that smaller easements are, in fact, serving an important public purpose.

Make the tax code fair for working farmers and ranchers.

1. Encourage conservation donations by working farmers and ranchers by allowing deductions to be a higher percentage of their adjusted gross income over a longer period of years, so that deductions from these donors are not unduly restricted by their modest incomes (as in section 106 of S. 476 in 2003, as approved by this Committee and the full Senate). We are grateful that the committee approved these provisions in the past, and want to particularly thank Senator Baucus for his leadership on this.

The current code is structured to prevent people from using deductions to entirely avoid paying taxes. But that same structure – limiting deductions to a percentage of the donor's annual gross income – unfairly reduces the deductions available to moderate income farmers and ranchers. For land rich, cash poor farmers and ranchers, a gift of development rights may be worth ten or twenty times their annual income. These landowners are making extraordinary donations, and deserve fair treatment. Increasing the percentage of gross income such a taxpayer can take as a deduction in any one year, and extending the number of years they can carry over unused deductions, allows such donors to get a tax benefit that, while still far less than the value of their gift, is at least proportional to the gift.

2. We support the President's proposal to provide capital gains tax relief to landowners selling their land to a charity or government agency that will hold it for conservation purposes. This would help a great many local and state government conservation programs, which will always be strapped for cash, to deliver a fairer return to those landowners. We want to thank the Administration for advancing this idea, and recommend that you adopt it. This committee and the Senate approved a version of this proposal as section 107 of S. 476 in 2003.

THE NATURE CONSERVANCY

Since this hearing has considered the activities of the Nature Conservancy, it is appropriate for me to comment on their role in the larger land trust community. The Nature Conservancy is a member of the Land Trust Alliance and is widely respected as the largest holder of conservation easements in the country, managing easements on over 2 million acres of biologically significant lands and helping land trust partners and government agencies conserve another 1.3 million acres with easements. In response to the concerns raised by this committee, they commissioned outside experts to conduct an unbiased assessment of their policies on ethics, governance and transactions, and they have implemented a wide range of internal reforms. The Conservancy has been very

supportive of the new *Land Trust Standards and Practices* and our accreditation program. They have submitted to the Senate Finance Committee a very thoughtful proposal for potential reforms which demonstrates their commitment to proper conservation easement practices. From my conversations with both board members and staff, I believe that the Nature Conservancy is committed to genuine reforms.

CONCLUSION

Two decades ago, Congress passed a far-sighted bill to encourage private landowners to donate their land for public conservation purposes. This program has worked well thanks to the generosity of thousands of landowners and the hard work of 1500 land trusts throughout America. We can not allow a few bad apples to spoil a highly successful program, and we will do our part by implementing a strong program of standards, training and accreditation. In addition, we support strong reform legislation targeted at the worst abuses and consistent IRS enforcement.

In closing, I want to thank the committee for holding this hearing, for paying attention to these important issues, and for helping to encourage reforms that will ensure the public confidence in the work of land trusts. America is a vast and beautiful land, and the measures we have discussed today will help conserve this natural legacy for the future generations.

# # #

Responses from Rand Wentworth, President, Land Trust Alliance
Questions from Members of the Senate Finance Committee
Hearing of June 8, 2005
June 22, 2005

Question from Senator Hatch

You suggested that the Committee ought to consider prohibiting deductions for the donation of a conservation easement on a backyard or other small property unless it meets additional tests of public benefit. How big a problem do we currently have with people taking such deductions, and how might we set up an objective standard for tests of public benefit?

> Many of our member organizations solicit and accept donations of easements of less than 10 acres that clearly protect resources of great importance to the public, and we believe it is very important that such conservation can continue.
>
> We have no empirical information on the extent of problems with small easements, but committee staff have raised this issue repeatedly with us, and we recognize that their concern that people not be allowed to take a deduction for an easement that has little or no value for the general public is a legitimate one.
>
> We would suggest that there are some obvious safe harbors that would clearly qualify an easement as protecting an important public value, regardless of size. Those might include the protection of habitat of a state or federally listed species; sites of specific historic importance; riparian buffers and shorelines; and trails or places providing public access to recreational resources.
>
> If a smaller easement did not qualify for such safe harbors, we think it appropriate that the donors have the opportunity to argue their specific case for qualifying under IRC 170(h).

Does this tie into the concept of taxpayers being able to deduct a contribution of an historical easement on the façade of their home?

> The questions raised by the press (and by the Internal Revenue Service in Notice 2204-41) regarding historic preservation easements on structures are actually quite different from those raised by staff regarding conservation easements on small land areas.
>
> The question raised by staff about small easements is whether they protect resources important to the public. Easements on historic structures are clearly placed on important properties, as in order to qualify the structure must be certified as being of historic significance by the Secretary of Interior.

Instead, the questions raised about these easements have revolved around the validity of their appraisals. In particular, the IRS has questioned whether certain appraisals have properly taken account of the substantial regulatory protection already provided to these properties by local government in areas such as Washington, DC.

Questions from Senator Bunning

1. How much would the abuse problems associated with gifts of conservation and façade easements be alleviated by vigorous IRS enforcement and effective appraisal reform?

The vast majority of abuses we are aware of in this area, including the abuses testified to by the South Carolina Director of Revenue at the hearing, are closely and directly linked to inflated appraisals. New standards and penalties related to appraisals and appraisers, and IRS enforcement directed specifically at challenging inflated appraisals – which is now underway, after 6-8 years of minimal enforcement in this area – would, in our opinion, eliminate the vast majority of abuses associated with gifts of conservation and historic façade easements.

2. Would the panelists please give me their best ideas on what the IRS and Congress can do to make sure appraisals for land donations are accurate?

My written testimony laid out a series of suggestions for changes in the law in this area. To summarize, we believe the law should be changed to:

-- Require appraisals of real property to meet the Uniform Standards of Professional Appraisal Practice. The Congress required appraisals used for federally-supported mortgage lending to meet these standards, and all appraisals for federal acquisitions of real property are required to meet them. It simply makes sense for the IRS to require appraisals to meet these standards as well.

-- Require that appraisals be done by state-licensed appraisers. The Congress required states to set up licensing systems for real property appraisers to protect the mortgage lending system. Using this licensing system also adds a tier of state investigative and enforcement authority to that of the IRS. We feel it is entirely appropriate that appraisers of conservation donations be required to be state "general certified" – the highest level of state license.

-- Allow the IRS, with due process, to debar an appraiser who has submitted multiple appraisals that are found to be "misstatements" or "gross misstatements".

3. Should the penalties currently in place for bad appraisals be changed? If so, who should those penalties be assessed against? Appraisers? Charities? Donors?

Yes. The current maximum penalty for an appraiser guilty of a misstatement or gross misstatement of value is only $1,000. That is far less than the cost of an appraisal, and so trivial a penalty that the IRS doesn't pursue it.

Donors already face significant penalties for using bad appraisals, through the penalties on failure to pay taxes they ought to have paid.

Current law is clear that a charity is not responsible for the valuation of a gift it receives.

4. What would you say is the number one area of self-governance where many charities fall short? What is the single change that a charity can make in this area to have the biggest impact?

We can't answer for all charitable institutions. Standard 4 of the Standards and Practices for Land Trusts, which the Land Trust Alliance promulgates for use by land conservation charities, is entirely about conflicts of interest, and requires that a land trust "has a written conflict of interest policy to ensure that any conflicts of interest or the appearance thereof are avoided or appropriately managed...." We believe that having an appropriate, written conflict of interest policy is a keystone for the avoidance of the appearance – or the reality – of charities serving private ends, rather than public good.

5. Do our panelists think that more public disclosure and "sunshine" rules will help to curb abuses in charities?

While disclosure of specific donors and donations is obviously a sensitive matter for all charities, disclosure of charitable programs and accomplishments could be very helpful, and expansion of the Form 990 is one way to accomplish this.

6. One suggestion previously made by the Finance Committee Staff is the public disclosure of Form 990-T returns, which report Unrelated Business taxable income of exempt organizations. Privacy concerns have been raised by some. Can you comment on the proposal for public disclosure of form 990-T's and also on how you think privacy concerns could best be addressed?

We have not studied this issue, and do not feel qualified to comment on it.

Question from Senator Rockefeller

I would like each of you to tell me whether you think it would be prudent for this committee to consider legislation to create an accreditation process. And if we create such a process, how could we accommodate the unique needs of smaller organizations?

The Land Trust Alliance has spent two years intensively studying how we might create a private-sector accreditation program for land trusts. Our conclusions include:

1. Land trusts want an accreditation program that demonstrates accomplishment far in excess of legal minimums. The purpose of the program we are designing is to help land trusts excel at the protection of lands and resources important to the public.

2. A private-sector accreditation program can be an important informational tool for the Internal Revenue Service, and for donors to land trusts. It is important to remember that land trusts, like most other charities, rely on cash donations from individuals to support their ongoing operations.

3. Making accreditation a legal requirement for receiving a tax deductible donation will force it to measure legal minimums, rather than the achievement of excellence. It could not do more without the private accreditor or the IRS assuming the power to create new legal standards out of whole cloth.

We strongly believe that the public would be best served by letting the private sector proceed with an independent accreditation program. Such a program would provide both donors and the IRS with valuable independent verification that accredited charities are operating well above legal minimum standards.

When we asked land trusts if they would participate in a private sector, voluntary accreditation program, 94% of those who responded indicated they would. That included many smaller organizations. Smaller land trusts will, of course, take very much longer to accumulate and implement the education, skills, and practices they will need to be accredited, especially if they are all-volunteer organizations.

A mandatory accreditation program would be particularly problematic for smaller land trusts, regardless of their competence. It would demand time and money that may take a good deal of time to accumulate, and which would come at the expense of other activities.

In addition, a mandatory program would force an accreditor to change its plans to accommodate as many applicants as fast as possible. As there are currently more than 1,500 land trusts, this would very likely seriously impact the quality of the accreditation, and particularly the quality of third-party review – the essence of the accreditation process.

Responses to Questions for the Record From Dean Zerbe
The Tax Code and Land Conservation: Report on Investigations and Proposals for Reform
June 8, 2005

Bunning Questions for the Record:

1. In your report, you talk quite a bit about the need to make sure that organizations can enforce conservation easements that they accept – particularly the ability to enforce the easement rules against future owners of the property. One issue that you mention is that future property owners might be more likely to comply with the rules of an easement if they know that a charity is willing to enforce the easement rules through the courts.

(a) What should charities be doing to monitor and enforce easements?

Monitoring and enforcement are vital if the public policy of conservation easements is going to be realized. Best practices of charities involves regular (e.g. yearly) monitoring and inspection. For some conservation and open space easements it may be possible to use satellite technology as a low-cost alternative to on-site monitoring every year.

It is my view that the boards of charities should be reviewing the monitoring and enforcement procedures and those procedures should be published in the Form 990 and website. The board also has a responsibility to ensure that the charity has adequate funds set aside to provide for adequate monitoring and enforcement in perpetuity. Finally, the charity should ensure that new owners are properly and fully aware of the easements that run with the property. These are some of the better practices that can ensure proper monitoring and enforcement of easements. In general, I think the Committee and the public would benefit in considering the issues in this area by also reading The Nature Conservancy's June 19, 2006 response to Senator Grassley's June 8, 2006 letter which I have included at the end of my questions (without the attachments).

(b) How can the IRS be sure that charities are doing their job in this area?

The IRS first needs to have something to enforce. The regulation and guidance in this area are wholly inadequate. The IRS should develop guidance for what is expected of charities in the area of monitoring and enforcement. In addition, the IRS should consider requiring such monitoring and enforcement protocols established prior to granting exempt status for a charity.

The IRS would do well to look at the accreditation process that is being implemented by some conservation charities under the leadership of the Land Trust Alliance. Encouraging accreditation and best practices is a low-cost way for the IRS to determine better where to focus its examination activities, and the same holds true in other sectors.

Congress could greatly assist the IRS by also providing better definitions of what are not allowable easements or better defining what is an allowable easement, such as was done with facade easements in the Pension Protection Act. For example, Congress should consider simply banning, or placing a very high threshold (such as requiring a private letter ruling) for certain classes of highly suspect donations – such as golf courses.

The IRS also needs to do a better job using the Form 990 in this area. The new Form 990 redesign with Schedule D, Part II contains a section on conservation easements – questions 5-7. This section addresses monitoring, inspection and enforcing easements. The IRS should be commended for this action, but it's important that the answers be a guide for enforcement action and also for donors.

(c) How can a charity insure a "credible threat of litigation"?

As discussed above, foremost having adequate funds set aside in perpetuity is a vital step in this direction. Second is to practice it. Public actions will go far in focusing the public's mind that easements are more than just words on paper.

2. Assuming the IRS does become aware of violations of easements for which a prior tax deduction has been granted, does the IRS have any enforcement power or recourse against either the charity or the land-owner?

The IRS' authority is limited – particularly by the statute of limitations. Typically, unless fraud is involved (a very high burden for the IRS to prove) there is a three-year statute of limitations on the ability to assess tax against the donor. Practically, it may be even more difficult for the IRS to be informed of a violation in the first place since it is a contract between two parties with the IRS having limited information on details. This may argue for making the easements public knowledge (publicly announced and posted) so that the IRS could be informed by interested outsiders of violations of an easement.

As to any action the IRS may have against the charity, the IRS is very limited in what actions it can take. Currently the IRS is pursuing charities that are "bad actors" that are engaged in aggressive behavior with land easements. It is difficult enough to bring action against the donor claiming the deduction; it is even more difficult to take action against a charity and its managers that are engaged in inappropriate action. If the charity managers are knowingly engaged in fraud, that may be a possibility, but again the reality is these are difficult cases for the IRS to bring and they effectively are not being brought. Senator, you have identified an area that is ripe for legislative review. We did change the laws regarding penalties to managers of charities involved as accommodating parties in corporate tax shelters a few years ago, and perhaps a similar response should be considered in actions where a charity manager is knowingly (or should have known) engaged in a fraudulent action.

A more limited proposal, and also more practical, might be to require the charity to inform the IRS that there has been a violation (or modification) of an easement and provide penalties for failure to do so. This would place the IRS on notice of a violation and also perhaps

help address your second question to a certain extent. A new three-year statute of limitations could start to run with the notification provided by the charity to the IRS of the violation or modification.

3. Could you please address how you feel that current unrelated business income tax rules apply to a situation in which a company donates land to a charity, the charity then sells the land on the open market and uses the proceeds for its charitable purpose?

How is this situation different than a donation and subsequent charitable sale of appreciated stock?

The concern of the Finance Committee staff in terms of sales of land was that in conducting its investigation staff often found instances where charities (not just The Nature Conservancy) were engaged in a level of land transactions in both quantity and involvement that gave concerns that effectively this was a real estate operation running under the guise of a public charity. These transactions would involve at times subdividing land, placing easements on land and other actions. It was after these activities that the land was then sold. By contrast, the donation of publicly traded stocks rarely involves any active business-like activity by the charity prior to the stock being sold. It is my understanding that the IRS is exploring various UBIT issues in its upcoming colleges and universities compliance study. Hopefully, the results of that work should be of great benefit to policymakers.

There is no real excuse for not publishing a guidance document on this issue. When pressed, the common explanation from the IRS is that "there is no guidance from court cases specific to IRC 512(B)(5) and the sale of land." (See "UBIT: Sale of Land," 1994 CPE text 89,96.) The obvious rejoinder is that if you never litigate the question you're not going to get an answer. Alternatively, the IRS could look at issuing their own guidance. In addition, I am worried that the IRS has not devoted sufficient resources to enforcement in UBIT.

My hope is that the information that is now becoming available through the Form 990T being made public for the first time (thanks to the work of this Committee) will allow for a closer study of UBIT issues and provide better information that can guide policymakers in Congress and Treasury.

4. In your oral testimony, you mentioned the importance of endowments to allow charities to have the resources to continue to monitor easement compliance in the future.

Do you have any specific suggestions on what Congress, the IRS, or an industry "best practices" approach could and should require regarding the need for endowments in this area? Could you particularly address this issue as it arises in the context of smaller land conservation organizations?

As mentioned earlier, having an endowment devoted to monitoring is vital. The "best practice" should be sufficient funds that will allow monitoring and enforcement of the easements in perpetuity. The estimate of what amount should be required is an issue that leading

organizations such as the Land Trust Alliance can provide good guidance on. The IRS should have authority to enforce this "resource test."

As to small charities engaged in conservation, consideration could be given to providing a two-year grace period to have sufficient funds available in the endowment or conversely that the charity has made succession arrangements with another charity that does have the financial capacity to shoulder the responsibility in perpetuity. It is important for policymakers to bear in mind that "small" is not an inoculation from bad actors. In our review of abuses in this area, it was just as often small charities that raised questions.

5. Your report spends a lot of time talking about the disclosure and the Form 990, in particular. In a prior hearing this year, the United Way suggested that nonprofits be asked to report "concrete results annually that are tied directly to their missions" and not just be asked to report on the level of activity that they engage in.

Could you comment on this suggestion?

From a practical point of view, how could such information be quantified and reported?

The IRS has recently made significant changes to the Form 990. In there, the IRS has provided more guidance and direction on nonprofits reporting on their work and activities. There has been a growing movement in the charity sector to have results reporting. I think this has much merit but am uncertain whether this would be best accomplished by requiring it through a mandate in the Form 990.

Another approach would be for outcome reporting to be required by accreditors of charities or for donors (particularly private foundations and community foundations) to make it a requirement prior to receiving funds. There is an enormous amount of good that could be accomplished in the charitable sector if leading donors encouraged best practices not only here but in many other areas as well. Coupled with that, donors need to recognize the need to provide funding for such good governance practices.

As to what information would be reported, it raises many questions given the tremendous range of activities in the charitable sector. However, I think that for certain subsectors there could be found (or already exist) common reporting standards. The reporting would be best accomplished on-line through the annual report so it is easily accessible. The delays in Form 990s being filed and made available to the public are a real hindrance in providing current information to the public (although Congress should require electronic filing and posting on the internet for major charities). In addition, it would be a useful activity of community foundations, charity watchdog groups and others to categorize and disseminate the information reported from charities so that donors can be better informed.

It should also be emphasized in this context that there is a great benefit from knowing what hasn't worked. Failures can often provide more illumination than success. Too often charities do not want to talk about how things have gone wrong – leaving other well-intentioned

charities to fall into the same hole. Open and frank discussions will strengthen the charitable sector and most importantly provide better assistance to those they serve.

6. What would you say is the number one area of self-governance where many charities fall short? What is the single change that a charity can make in this area to have the biggest impact?

The top area where charities fall short in self-governance is the work of their board. Time and time again in the oversight work of the Finance Committee we have seen where the board just is not paying attention to business. In some ways, this is the thread of the story of the problems at The Nature Conservancy – the failures of the board. Most recently we have seen board failure with the Smithsonian. This concern about the lack of board involvement was echoed by IRS Commissioner Mark Everson in his 2004 letter to the Chairman and Ranking Member of the Finance Committee about problems he is seeing in the area of tax-exempts.

I think a single change that could be made by the board of a charity would be to read and review all the recommendations of the Nonprofit Panel and implement those that are applicable to their organization – taking the toughest standards advocated by the Nonprofit Panel and ignoring the caveats and qualifications that unfortunately crept into the final consensus document.

The IRS also has made good governance and its connection to tax compliance an area of transparency in its redesigned Form 990, which added several new questions about an organization's governing body, practices, policies and public accountability. This is a good step in the right direction in this area, and I am very pleased that the IRS was responsive to the written concerns of Chairman Grassley and Senator Baucus in this area.

Thank you, Senator, for the opportunity to respond to your thoughtful and considered questions.

The Nature Conservancy
SAVING THE LAST GREAT PLACES ON EARTH

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STEVEN J McCORMICK
President and Chief Executive Officer

COPY

June 19, 2006

The Honorable Charles E. Grassley
Chair
Committee on Finance
United States Senate
Washington, D.C. 20510-6200

By Hand

Dear Mr. Chairman:

This letter contains the responses of The Nature Conservancy (the "Conservancy" or "TNC") to the questions contained in your letter of June 8, 2006, which was addressed to Mr. Henry M. Paulson, Jr., in his capacity as Chair of the Conservancy's Board of Directors.[1]

As the Committee is aware, in June 2003, the Conservancy initiated a comprehensive effort to strengthen its general governance and its specific policies and procedures, including many of the policies and procedures applicable to issues examined by the Committee in its 2003-2005 inquiry. The resulting changes were intended to (1) enable the Conservancy's Board of Directors to provide increased strategic direction and undertake more active oversight; (2) incorporate many of the governance principles contained in the Sarbanes-Oxley Act; (3) promote tax law compliance by all parties to conservation transactions in which the Conservancy is a participant; (4) address on a comprehensive and consistent basis issues involving actual or potential conflicts of interest; (5) provide more specific rules governing key conservation programs such as conservation easements, conservation buyer transactions and sales of conservation lands to governments; and (6) ensure high-level advance review of transactions that may present financial, legal and ethical or reputational risks to the Conservancy as a whole.

When I testified before the Committee at its public hearing on June 8, 2005, I stated that the Conservancy was proud of the results of its efforts and welcomed the positive treatment that our reforms received in the report on the Conservancy prepared by the Committee's staff. We nevertheless recognized then, and recognize now, that our commitment to governance, accountability and transparency require ongoing diligence and review. I am therefore pleased to provide you with an update on our continued progress at the Conservancy in ensuring that we

[1] We ask that the Committee consider this letter and all enclosed documents as "confidential/proprietary," in accordance with the prior agreements reached between the Committee staff and the Conservancy in connection with the Committee's 2003-2005 inquiry. Please also note that, in order to provide you with as accurate statistical information as possible, certain responses contained in this letter are limited to the period beginning July 1, 2005 (the beginning date of the Conservancy's fiscal year) and ending on April 30, 2006, as that is the most recent date as of which complete information has been entered into the Conservancy's data retrieval systems.

continue to carry out our conservation mission in accordance with the letter and spirit of all applicable laws and our organizational values.

As our responses to your questions demonstrate, we have, since the publication of the Committee's staff report, continued to strengthen our policies and procedures. For example, within the area of federal tax law compliance, which is of special interest to the Committee, we have significantly strengthened our program for monitoring compliance with the terms of the more than 1600 conservation easements we hold; continued to implement procedures to promote compliance with IRS valuation regulations by those from whom we receive non-cash contributions; made significant improvements to our IRS Form 990 filings to increase their utility as a disclosure device to the general public as well as to the IRS; taken steps to ensure that the tax policies and procedures we adopted in April 2005 to ensure that the Conservancy would not participate in abusive tax shelters of the type specified by Congress in enacting section 4965 of the Internal Revenue Code (the "Code") in 2006; reviewed our conservation buyer program in light of the guidance issued by the IRS in Notice 2004-41; and created the position of Director of Tax Services. The Director is leading a broad review of all our tax compliance activities and established procedures to ensure continued proper reporting with respect to the tax on unrelated business income.

CONSERVATION EASEMENTS

1. ***Explain what TNC has done over the past year to improve its monitoring of conservation easements to assure that each easement achieves dedication of the real property for conservation purposes. In particular, I would be interested in learning about any local, regional, or national monitoring programs or initiatives that you have established or undertaken during this time.***

As described more fully in the Conservancy's prior submissions to the Committee, in 2003 the Conservancy chartered an Easement Working Group (EWG) to conduct a comprehensive review of its easement practices. One of the key recommendations contained in the EWG's report addressed the question of enhanced monitoring of conservation easements. Among other things, the EWG recommended the adoption of specific monitoring timetables (annually in most cases) and that monitoring activities be tracked through the Conservancy's Conservation Land System (CLS). The CLS is the Conservancy's computerized data base of land and easement information.

In accordance with the EWG's recommendation, the Conservancy updated its conservation easement monitoring standard operating procedure (SOP) and added a monitoring tab (easement data information fields) to the CLS. As so modified, the CLS enables the Conservancy to take prompt remedial action on issues that arise during the monitoring process. In addition, the Conservancy conducted two training sessions for its staff focused upon the new

easement monitoring SOP and monitoring implementation. With these tools in place, the Conservancy set a goal of having the new easement monitoring process fully implemented for all its easements by January 3, 2006.

Based upon information that has been entered by the Conservancy's field staff who have direct responsibility for monitoring easements, the CLS can generate reports showing the status of easement monitoring within the Conservancy. These reports give management a simple and readily accessible tool to determine the current monitoring status of easements held by the Conservancy. As of December 2005, there were monitoring reports in the CLS for 96 percent of the approximately 1600 easements held by the Conservancy. A portion of the remaining four percent of the easements was acquired in 2005 and is not scheduled to be monitored until 2006. In other cases, the operating units have monitored the easements but have not yet entered the data into CLS. As of June 14, 2006, there were monitoring reports for 99 percent of the TNC-held conservation easements. The data base will be revised officially as of the end of each calendar year so that the Conservancy will be able to have an annual easement monitoring status report.

2. *Explain what TNC has done over the past year to enforce the terms and conditions of its conservation easements to assure that each easement achieves dedication of the real property for conservation purposes. Has TNC commenced any litigation or contacted any landowners during this time regarding enforcement of such easements?*

As noted above, as of December, 2005, the monitoring results for 96 percent of the approximately 1600 conservation easements held by the Conservancy had been entered into the CLS. Each monitored easement was assigned to one of three categories of compliance status: in compliance, in review or "in violation." As of January, 2006, there were 18 easements that were categorized as "in violation." As of June, 2006 the number of easements "in violation" status had been reduced to 13 by virtue of corrective actions taken by landowners, pursuant to contacts with the Conservancy. For each of the 13 easements so identified, a Conservancy lawyer and a representative from the Conservancy's operating unit responsible for overseeing the easement contacted the easement landowner to discuss the status of the easement violation and develop a plan for resolving the violation.

Conservation easements identified as being "in violation" fall into four broad categories: (1) situations where the landowner has undertaken vegetation management activities (such as cutting trees, or applying herbicide) not in accordance with the terms of the easement; (2) situations where the landowner has conducted inappropriate activities or uses on the land (such as use of ATV's, grazing, or dumping) not in accordance with the terms of the easement; (3) situations where the landowner has constructed structures on the property (such as a house, a dock or other outbuildings) not in accordance with the terms of the easement; and (4) situations where there is some dispute as to an interpretation of a term of the conservation easement.

Easement violations and a plan to address the violations are presented periodically to the Board of Directors' Audit Committee for review and approval.

The majority of the 13 easement violations fall into categories one and two. The Conservancy has issued demand letters or cease and desist letters in nine cases, has entered into settlement discussions in one case, and is preparing to enter litigation in one case. In the remaining two cases, the Conservancy is in negotiations with the landowner.

3. *Explain what steps TNC has taken to improve the valuation of conservation easements for purposes of donors claiming the proper charitable contribution amount on their tax returns.*

As described more fully in the Conservancy's prior submission to the Committee, the Conservancy has taken specific steps to promote compliance with IRS regulations governing the valuation of gifts of land (including interests in land such as conservation easements). Specifically, in 2003, the Conservancy adopted, and continues to apply, a standard operating procedure (SOP) under which it will execute an IRS Form 8283 for a donor (as required under IRS regulations to substantiate receipt of the gift) only if:

(a) the form contains all information required to be provided by the donor to the IRS;

(b) the donor provides to the Conservancy a copy of the appraisal to be used by the donor to establish the tax value of the gift shown on the form;

(c) the donor's appraiser provides the Conservancy with a written certification that he or she (i) is State-certified; (ii) has used generally accepted appraisal standards in making the appraisal; (iii) has the requisite expertise and experience to make appraisals of conservation lands and conservation easements; (iv) is not barred from practice before the IRS, the Department of the Treasury or other administrative bodies; (v) has taken into account any value enhancements to other property of the donor or parties related to the donor; and (vi) has otherwise satisfied all of the requirements for a "qualified appraisal" prescribed by the IRS; and

(d) if the donor is a related party or a major donor (as defined by the Conservancy's internal standards that are more restrictive than those required by the Code) with respect to the Conservancy, the appraiser must also certify that he or she is aware of this fact and that it did not influence the appraiser's valuation.

As the Committee staff is aware, these procedures exceed the requirements of existing federal tax law, which require that donees such as the Conservancy execute IRS Form 8283 only to certify actual receipt of the gift.

VALUATION OF NONCASH CONTRIBUTIONS

1. ***Provide summary information regarding the aggregate reported values of the following categories of charitable contributions received by TNC since June 1, 2005:***

a. ***Conservation easements***
b. ***Intellectual property***
c. ***Stocks and other publicly traded securities***
d. ***Closely held stock and other closely held business interests***
e. ***Cars, planes, and boats***
f. ***Trade lands***
g. Other non cash contributions
h. ***Total noncash contributions***
i. ***Total cash contributions***

From July 1, 2005 through April 30, 2006, the Nature Conservancy received a total of $385,836,250, of that amount $100,522,555, consisted of noncash contributions. The total amount is comprised of the following:

- Gifts of Conservation Land $17,482,913
- Gifts of Conservation Easements $55,641,836
- Gifts of Publicly Traded Securities $20,332,342
- Gifts of Closely Held Securities $496,236
- Gifts of Trade Lands $4,438,803
- Gifts of other goods and services* $2,130,425
- Gifts of Cash $285,313,695

* The gifts of other goods and services are of the type required to be reported pursuant to the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 116. This amount, representing 2.3 percent of the total above, includes numerous transactions and cannot be easily categorized by type of good/service without considerable additional analysis that was not feasible with the specified response time.

2. Describe the steps TNC has taken to improve the accuracy of appraisals relating to noncash contributions made to TNC.

The most significant volume of non-cash contributions that the Conservancy receives are in the form of gifts of land and of conservation easements in land. The steps the Conservancy has taken to improve its review of appraisals relating to those gifts are described above. With respect to other forms of non-cash gifts, the Conservancy ensures that all relevant IRS gift substantiation forms are complete and accurate and that appropriate supporting documentation,

including appraisals, is attached. In accordance with current legal requirements, the Conservancy does not certify as accurate the donor's appraisal but reviews such appraisals to ensure that they are prepared by qualified appraisers and that the facts and circumstances surrounding the appraisal are reasonable.

CONSERVATION BUYER PROGRAM

1. ***Provide the number of CBP transactions TNC has completed since June 1, 2005. Of this number, how many have been with TNC's directors, officers, local chapter officials, or employees?***

During the period July 1, 2005 through April 30, 2006, the Conservancy completed 30 "conservation buyer" transactions. None of these transactions were between the Conservancy and its directors, officers, local chapter officials or employees. Such "related party" transactions have been prohibited by action of the Conservancy's Board of Directors since June 2003.

a. ***In addition, provide the total purchase paid by TNC, total sales price received by TNC, and total purported charitable contributions received or to be received by TNC, with respect to each category (total, insider) of these transactions referred to above.***

Number of Conservation Buyer Transactions	Number with TNC Directors, Officers, Chapter Officials, Employees	Total Purchase Price Paid by TNC	Total Sales Price Received by TNC	Total purported Charitable Contributions Received by TNC
30	0	$26,285,595.52	$50,227,177.59	$534,988.49

b. ***Provide the information described in item a. above for each of the 5 largest such transactions completed by TNC.***

	ST	Project Name	Conservation Buyer	Total Purchase Price Paid by TNC	Total Sales Price Received by TNC	Total purported Charitable Contributions Received by TNC
1	AZ	Black River Headwaters (Taylor)	GOC, LLC	$3,000,000.00	$2,700,000.00	$0.00
2	WY	Upper Wind River Landscape (Eastman)	ANK, Inc.	$2,687,612.00	$2,974,000.00	$0.00
3	CA	Merced Grasslands/San Luis NWR Complex (Conservation Farms & Ranches-Merced) Amend	Urrutia, Leon And Grace I Revocable Trust	$0.00	$3,433,062.50	$0.00
4	WY	Upper Wind River (Fox) Upper Wind River (Parker 1-3) Upper Wind River Landscape (Winchester Land & Cattle Company, Inc.)	Lucas, Robert L	$6,479,480.00	$4,964,341.00	$0.00
5	WY	Snake River Floodplain Corridor (Moulton)	Linger Longer West, LLC	$0.00	$19,900,000.00	$0.00

2. Provide the number of CBP transactions in which TNC presently is in negotiations. Of this number, how many involve TNC's directors, officers, local chapter officials, or employees?

Because of the decentralized nature of the Conservancy's operations with its 363 state and local offices, it is impossible to determine precisely the number of CB transactions in preliminary negotiations and which have not yet begun the process of formal review and approval. Regardless of the number of transactions which may be in negotiations, the Conservancy's policy prohibiting sales to or purchase from related parties would apply.

There is one conservation buyer transaction with a state chapter advisory board member that received specific and advance approval by the Conservancy's Board of Directors in January, 2006, but that transaction has not closed. This matter was reviewed carefully by the Audit Committee and based on the merits of the case, was approved by the Board of Directors as an exception to the policy. Advisory board members are not compensated for their services, have no legal or fiduciary duties with respect to the organization and do not meet the definition of a related party contained in the Code.

a. ***In addition, provide the total purchase paid or to be paid by TNC, total sales price received or to be received by TNC, and total purported charitable contributions received or to be received by TNC, with respect to each category (total, insider) of these transactions referred to above.***

See above.

b. ***Provide the information described in item a. above for each of the 5 largest such transactions pending and in which TNC is or expects to be a party.***

See above.

3. ***Provide the Board and committee documentation supporting TNC governance review of these transactions under TNC's CBP review policy.***

Under the CBP review policy adopted by the Board in June, 2003, and as previously described to the Committee, all CB transactions must comply with requirements to ensure that such projects achieve legitimate conservation purposes, are based on proper valuations, are adequately exposed to the market, meet community standards and do not involve a "related party." Depending on the dollar size of the transaction, such projects are completed by state and local offices of the Conservancy under delegated authority by the Board to TNC regional managing directors. The documentation supporting conformance with TNC CB procedures is contained in many files and databases throughout the Conservancy. The Conservancy would be happy to provide additional information with respect to specific transactions.

4. ***Has TNC had conversations, formal or otherwise, with the IRS regarding CBP and the IRS settlement initiative? If so, please summarize TNC's actions to cooperate with the IRS and TNC's CBP participants relating to the IRS settlement initiative.***

Conservancy personnel have not had any conversations with the IRS regarding CB transactions and the settlement initiative. Conservancy personnel have notified participants in its CB transactions of Notice 2004-41 and responded to questions and appropriate requests for information from CB participants.

5. ***Has TNC sought or obtained any tax opinions or other tax advice regarding the federal income tax treatment to TNC or to any other party to a CBP transaction since the issuance of Notice 2004-41? If so, please provide copies of such requests and any advice provided to TNC in response to such requests. If not, please explain why TNC has not sought such advice, given the IRS position with respect to such transactions.***

The Conservancy has not sought any further tax opinions with respect to this issue, but did present the issue to its internal Risk Assessment Committee which, after reviewing the matter, concluded that the Conservancy would continue to pursue CB transactions, advise all parties to such transactions about the existence of the IRS Notice, and require a certification from CB buyers that they obtain and rely on their own tax advice with respect to the tax treatment in such transactions. The Conservancy also decided to suspend its participation in the one specific form of CB transaction identified in the Notice unless and until the IRS issues guidance to clarify the issues associated with transactions structured in the manner described in the Notice.

6. ***Describe the steps taken by TNC to assure that, consistent with its recently enacted policy changes, CBP properties are available for acquisition by the general public rather than limited as a practical matter to purchase by TNC insiders or friends or relatives of local chapter officials.***

It is the Conservancy's Board policy that the property be placed on the open market for a minimum of 30 days to ensure adequate exposure of the property to the market prior to sale. One way to do this is to place the Conservation Buyer property on the Conservancy's internet site (http://www.nature.org/conservationbuyer/). The Conservancy currently has 29 properties listed for sale on its website.

7. ***Has TNC given consideration to terminating its conservation buyer program? If not, why not, given the potential and significant abuse relating to improper charitable contribution deductions?***

The purposes of the Conservancy's conservation buyer program, the opinions of independent tax counsel received with respect to the program and the reforms adopted by the Conservancy with respect to the program have been described fully in the Conservancy's prior submissions to the Committee. Moreover, as discussed above, the Conservancy has reviewed Notice 2004-41 and concluded that its program, which includes types of transactions outside the scope of the Notice, conforms to the position of the IRS set forth in the Notice. The Conservancy has not terminated its conservation buyer program. The program is an important tool to enable the Conservancy to accomplish meaningful conservation objectives and has been structured in accordance with relevant laws and IRS regulations and rulings.

EMISSIONS CREDIT ARRANGEMENTS

1. ***Provide the number of emissions credit transactions TNC has completed since June 1, 2005. Of this number, how many have been with TNC's directors, officers, local chapter officials, or employees, or entities related to such persons by ownership or by representation on the entity's governing body" Name the other parties to such arrangements?***

The Conservancy has not completed any emissions credit transactions since June 1, 2005.

2. ***Provide the number of emissions credit transactions in which TNC presently is in negotiations. Of this number, how many involve TNC's directors, officers, local chapter officials, or employees, or entities related to such persons by ownership or by representation on the entity's governing body? Name the other parties or potential parties to such arrangements.***

The Conservancy is not in negotiations for any emissions credit transactions.

3. ***Provide the Board and committee documentation supporting TNC governance review of these transactions under TNC's policies.***

Not applicable.

4. ***Provide the amount of fees, compensation, or other payments TNC has received or expects to receive under the transactions described in items 1 and 2.***

None.

5. ***Has TNC had conversations, formal or otherwise, with the IRS since June 1, 2005, regarding TNC's emissions credit arrangements? If so, please summarize the content and nature of these discussions.***

The Conservancy has not had any conversations with the IRS with respect to such arrangements during the time period covered by this letter.

6. ***Has TNC sought or obtained any tax opinions or other tax advice regarding the federal income tax treatment to TNC or to any other party to an emissions credit arrangement since June 1, 2005? IF so, please provide copies of such requests and any advice provided to TNC in response to such requests. If not, please explain why TNC has not sought such advice, given the staff's concern with these transactions as expressed in its June 2005 report.***

No such tax opinions have been sought.

7. ***Do any of the transactions described in items 1 and 2 above involve the alleged charitable contribution of amounts by another party to TNC?***

Not applicable.

8. ***State whether TNC intends to continue to report payments it receives from such arrangements as contribution revenue on line 1 of the Form 990.***

As the Conservancy has not completed any new emissions credit transactions since July 1, 2005 and no such transactions are presently in negotiation, no action has been taken with respect to the reporting of this income. The Conservancy is considering whether to report payments from emission credit arrangements as program service revenue on line 2 of the Form 990 in the future.

JOINT VENTURES AND FOR-PROFIT SUBSIDIARIES

1. ***Provide the number of joint venture transactions TNC has completed since June 1, 2005. For this purpose, use the definition set forth in TNC's governance policies. Of this number, how many have been with TNC's directors, officers, local chapter officials or employees, or entities related to such persons by ownership or by representation on the entity's governing body?***

The Conservancy has a "Related Entity" Policy and a standard operating procedure (SOP) for "Significant Business Interests in Separate Legal Entities". The Policy requires notification to and approval by the Conservancy's Finance Department of any joint venture where the Conservancy owns a greater than 50 percent interest. Since July 1, 2005, there have been no such notifications. The SOP requires notification to and approval by the Conservancy's Finance Department of any joint venture where the Conservancy has a "significant business interest". Since July 1, 2005, there have been no such notifications.

2. ***Provide the number of for-profit subsidiaries formed by TNC since June 1, 2005, and state the nature and purpose of such entities.***

There have been no for-profit subsidiaries formed by the Conservancy since July 1, 2005.

3. ***Describe the internal review process used by TNC to approve or disapprove TNC's involvement in the joint ventures or for-profit formations described above, and to assure that its participation in such arrangements substantially furthers TNC's exempt purposes.***

In 2004, the Conservancy's Board of Directors adopted a policy requiring Board approval for the formation and operation of any related organizations to ensure that the related entities are consistent with the Conservancy's goals and objectives and that related risks are identified and appropriately managed. (Related entities where the Conservancy has a significant business interest, i.e. $100,000+ investment, but not a controlling interest must be approved by the President.) Implementation of the Policy and Procedure is the responsibility of the

Conservancy's Finance Department, which reviews proposals and monitors Conservancy activity in this area.

4. ***Describe the nature of the joint venture and identify the names of the other parties to any joint venture described in item 1 above.***

Not applicable.

5. ***Has TNC amended any of its governance and review policies to address those situations in which TNC may own less than a controlling interest in the arrangement or entity, or for which TNC's interest in the arrangement is not a formal equity interest in an entity (e.g., emissions credit arrangements).***

As described more fully in the Conservancy's prior submissions to the Committee, the Conservancy's Board of Directors adopted a specific policy with respect to such matters on January 30, 2004. Revisions to that policy were adopted by the Board on June 10, 2005. In addition, a related standard operating procedure (SOP) was issued in February 2004 following review and approval by the Audit Committee of the Board.

UNRELATED BUSINESS INCOME

1. ***Provide a copy of TNC's Form 990-T for its most recently completed taxable year for which such form has been filed with the IRS.***

Issues with respect to disclosure of Form 990-T are under consideration by the Committee staff in response to Conservancy's letter to the staff dated June 14, 2006.

2. ***Describe the internal process used by TNC to assure that it properly reported all unrelated business income on its Form 990-T for such year. If TNC used outside counsel or accountants as part of such process, describe the outsider advisor's role in the process.***

The Conservancy's internal process, as currently in effect, for ensuring that it properly reports all Unrelated Business Income (UBI) on its Form 990-T is based on its standard operating procedure (SOP) for Unrelated Business Income Tax (UBIT), as first adopted in June, 1996 and revised in February 2000 and 2001. This SOP requires that before entering into any transaction that potentially could result in UBIT liability, an operating unit must first contact the appropriate member of the Conservancy's legal staff. In consultation with the Conservancy's Director of Tax Services (a newly created senior level position in the Finance Department), a final determination is made as to whether UBIT liability will in fact be created. The Chief Financial Officer (CFO) or the President must approve in advance activities giving rise to UBI expected to be no greater than $100,000. The Conservancy's Finance Committee of the Board

must approve in advance activities giving rise to UBI over a threshold of $100,000. If there is UBIT, all revenue and expenses with respect to that activity are separately tracked in the Conservancy's financial records. This process is, in the Conservancy's view, adequate to identify and properly report all UBI with respect to new activities.

In addition to the procedure now in place to identify and properly report UBIT liability attributable to new activities, the Conservancy has undertaken an internal review of its current activities for UBIT exposure as part of an ongoing overall tax review being conducted by the Director of Tax Services and others. In addition to enhancing Form 990-T compliance, the results of this review are being used as a basis for educational outreach to operating unit personnel in order to assist them in identifying in the future activities that may generate UBIT.

The Form 990-T itself is prepared by the Director of Tax Services and reviewed by members of Senior Management for accuracy and completeness. Additionally, items of income and deduction are also independently verified for accuracy by the Conservancy's [internal] audit function prior to filing the return with the IRS.

3. ***Has TNC sought or obtained tax advice or a tax opinion with respect to its trade lands program since June 1, 2005?***

No.

4. ***Has TNC sought or obtained tax advice or a tax opinion with respect to any of its joint ventures or its management services fees since June 1, 2005?***

No.

5. ***Has TNC sought or obtained tax advice or a tax opinion with respect to its travel tour programs sine June 1, 2005?***

No.

INSIDER DEALS AND EXECUTIVE COMPENSATION

1. ***Describe how TNC has improved its transparency, Form 990 reporting, and internal approval process, with respect to transactions with insiders.***

A policy approved by the Board of Directors on September 30, 2004, prohibits both the purchase of real estate (or any interest therein) from and the sale of real estate (or any interest therein) to any "related party". For this purpose, a related party includes:

a. Any individual who is, or who was at any time during the 12-month period ending on the date of the purchase or sale, a member of the Board of Directors, Trustee, or an employee of the Conservancy;

b. Any individual who is a close relative of such an individual; or

c. An entity in which the individual owns and/or his close relatives own directly or indirectly more than five percent of the equity interest therein.

In addition, the Conservancy strengthened its Conflict of Interest policy through the adoption of Standard Operating Procedures and by including Board members, Chapter Trustees/Advisors, close relatives, major donors, related organizations, and other insiders as covered persons.

The Board of Directors, working with the Conservancy's executive management team, instituted a number of management systems to ensure the Conservancy remains in compliance with its policies and procedures governing transactions with local chapter trustees and officials. In appropriate cases projects reviewed by senior staff are presented to the Board of Director for their prior review and approval. These management systems include:

1. Conflicts review committee comprised of senior staff.

2. Project review committee comprised of senior staff.

3. Risk Assessment committee comprised of senior staff.

4. Conservation Projects and Practices Review Committee comprised of members of the Board of Directors that review all projects requiring Board approval prior to submitting its recommendation to the Board's Audit Committee for approval by the full Board of Directors.

5. The Board of Directors has mandated that all staff receive training on the organization's policies and procedures and provide a signature that they fully understand and will comply with all policies and procedures. As of July 15, 2006, 97 percent of the Conservancy's 3600 employees will have completed such training.

6. The Board of Directors has mandated that all Chapter Trustees complete compliance certification.

7. The Audit Committee of the Board of Directors meets in executive session with the Chief Ethics and Compliance Officer during each meeting of the Committee.

8. Any transactions approved as a result of this process between the Conservancy and an Officer, Director of Key Employee, as defined by the Code if forwarded to the Director of Tax Services for inclusion of the Conservancy's Form 990.

2. *How many transactions have been reviewed under TNC's conflict of interest policy since June 1, 2005? Of such number, how many have been approved without modification, approved with modification, disapproved, or are pending?*

During the period July 1, 2005-April 30, 2006, the Conservancy reviewed 235 matters that potentially involved a conflict of interest or the appearance of such a conflict. Each matter details the actual conflict or an appearance of conflict and includes a plan for the disposition of the conflict which may include prohibition, modification, recusal and or disclosure as actions to address the conflict or appearance thereof. Of that number, 145 were approved without modification; 78 were approved with modification; 8 were disapproved and 4 are still pending.

3. *Describe the steps taken by TNC to improve its oversight of transactions involving local chapter trustees and officials.*

See response to question 1 under Local Chapters.

4. *Provide all documentation supporting TNC's efforts to comply with Section 4958 and, if applicable, the rebuttable presumption standard. If TNC has not undertaken to satisfy the rebuttable presumption standard, explain why it has not done so.*

The Conservancy retained PricewaterhouseCoopers (PWC) in September 2005 to conduct an Executive Total Compensation Assessment and to provide specific suggestions/recommendations for an optimal executive total compensation program for the Conservancy. A planning session with the Conservancy's Board of Directors' Committee on Governance, Nominating and Human Resources was held on September 20, 2005. Subsequent meetings were held with PWC, Conservancy personnel, and the chair of the Board's Committee on Governance, Nominating and Human Resources Committee, James C. Morgan.

This five-phase project includes a thorough review of the Conservancy's executive compensation philosophy, a diagnostic of current executive compensation practices and peer/comparator and published compensation survey data obtained on key executive positions. The compensation data will be used to inform Board and management decisions on executive compensation.

On June 15, 2006, the Governance, Nominating and Human Resources Committee reviewed the findings of PWC. Based on the preliminary findings from PWC, it appears that PWC will provide the Conservancy with an opinion letter stating that the Conservancy does comply with the rebuttal presumption standard with respect to executive compensation.

5. ***Has TNC attempted to comply with the rebuttable presumption standard with respect to its executive compensation arrangements? Has TNC engaged compensation consultants to provide independent comparability data, and if so, what steps has TNC taken to assure the comparability data used is based on similarly situated offices and organization?***

See response above.

6. ***Confirm that TNC no longer provides loans to officers or employees.***

As described more fully in its prior submissions to the Committee, the Conservancy in 2003 adopted a policy prohibiting loans to officers or employees and it continues to adhere to that policy.

FORM 990 AND RELATED REPORTING REQUIREMENTS

1. ***Describe how TNC has materially modified its Form 990 reporting since the Committee staff commenced its investigation of TNC. In particular, explain how TNC has addressed transparency with respect to its insider deals, largest program service accomplishments, and other arrangements, such as emissions credit arrangements, that are highly unusual and have not been disclosed to the IRS through prior reporting.***

The Conservancy continues to work to improve its Form 990 disclosures, as it always has, in compliance with the statutory regulations. The Conservancy has taken important steps to improve the transparency and public understanding of its Form 990 filings. Guided by recommendations from the Governance Advisory Panel created by the Conservancy in 2003, the Conservancy's Form 990 for its fiscal years ended June 30, 2004 and June 30, 2005 included more information about the Conservancy's governance and its direct charitable programs and accomplishments.

Key examples of increased transparency include: a complete list of every grant the Conservancy awarded; expanded reporting of executive compensation; extensive information about the Conservancy's performance including its approach to projects, the work performed, and conservation results; and information about the Conservancy's governance structure and new policies and procedures that were put in place over the last year.

Much of the information reported on the Form 990 is derived from the contents of the Conservancy's annual report and public website. The annual report is posted on www.nature.org and both are frequently updated. The Form 990 for the fiscal year ended June 30, 2005 and two previously filed Forms 990 are available on the Conservancy's website. On an ongoing basis, the Conservancy will continue to seek additional ways to improve the quality if its

Form 990 filings. The Conservancy regards its Form 990 as an essential document demonstrating its commitment to enhanced public accountability.

The Conservancy has instituted a thorough tax return preparation and review process that is designed to ensure transparency and full compliance with its Form 990 tax reporting requirements. This process begins with the production of the underlying financial information by the Conservancy's Finance Department and the collection of necessary non-financial information from various other departments. This information is reviewed for completeness and accuracy by the Director of Tax Services with regard to applicable reporting requirements. Upon completion of the draft of the return, the Conservancy's Internal Audit Department independently verifies appropriate portions of the return. An updated draft is circulated to Senior Management to ensure that the return properly reflects the Conservancy's activities in all material respects. Next, the Conservancy's outside tax return preparers perform a detailed review of the return and sign the return as paid preparers. Finally, the Audit Committee of the Board reviews the return in accordance with its charter.

All of these steps and certain of the recommendations of the Governance Advisory Panel (created by the Board in 2003) have led to significant revisions to the Conservancy's Form 990 that are intended to place the Conservancy in the vanguard of transparency and compliance when it comes to public disclosure by tax-exempt organizations. Specifically, the Conservancy has enhanced its reporting, increased the amount of disclosure, or increased the level of internal review and scrutiny related to Grants and Allocations on Part II, Program Service Accomplishments on Part III, Changes in Activities and Relation to Other Organizations on Part VI, Reporting Information Regarding Taxable Subsidiaries and Disregarded Entities in Part IX, and Statements About Activities on Part III of Schedule A.

2. *Has TNC reported any material changes in operations, structure, or activities, since June 1, 2005? If so, provide a copy of such reports.*

The Conservancy has not reported any material changes in operations, structure or activities since June 1, 2005.

3. *Has TNC amended its articles or bylaws since June 1, 2005? If so, provide a copy of such amendments.*

The Conservancy has not amended its articles or bylaws since June 1, 2005. The Conservancy's bylaws were last amended in April, 2005. A copy of the revised by-laws were attached to the Conservancy's Form 990 for the year ended June 30, 2005.

4. ***Congress recently enacted Code Section 4965, which addresses participation by exempt organizations as accommodation parties in certain abusive tax shelter transactions. Describe whether TNC is a party to any transactions described within new Section 4965, and if so, the nature and TNC's role in such transactions. Also provide the names of all other parties to such transactions and state the basis for the transaction's status as a prohibited tax shelter transaction (listed, confidential, contractual protection). Provide any documentation that shows the Board or relevant committee reviewed TNC's role in any such transaction.***

The Conservancy is not a party to any Listed Transactions, as defined by section 6707A(c)(2) of the Code, or to any prohibited Reportable Transactions, as defined by section 6707A(c)(1) of the Code and thus is not subject to the provisions of IRC §4965.

Consistent with the practices of many tax-exempt organizations, the Conservancy provides general information to third parties with respect to the potential tax consequences of contributions to and conservation transactions with the Conservancy, but it has long had a written procedure prohibiting the providing of legal and tax advice to third parties.

As described more fully in the Conservancy's prior submissions to the Committee, on April 7, 2005, the Conservancy adopted a more comprehensive Standard Operating Procedure (Tax SOP) to promote tax compliance by both the Conservancy and those who participate in transactions with the Conservancy. Among other things, this new procedure places explicit limits on the types of conservation transactions in which the Conservancy will participate. Specifically, the Conservancy will not enter into any conservation land transaction that provides tax benefits to a third party unless (1) the transaction enhances, directly or indirectly, the ability of the Conservancy to carry out its conservation mission; and (2) the Conservancy determines that the transaction:

(a) is not a "reportable transaction" within the meaning of section 6111 or 6707 of the U.S. Internal Revenue Code, relating to tax shelters;

(b) has not been structured to enhance the ability of any person to avoid a tax reporting or substantiation obligation under any federal, state or local tax law; and

(c) is substantially similar to the types of transactions previously approved by the Conservancy.

In general, a type of transaction will be approved by the Conservancy only if an independent and qualified tax counsel could reasonably render an opinion that, upon audit by the IRS or other appropriate tax authority, the anticipated tax benefits "should" be upheld by the tax authority or a court, as opposed to opinions that merely say it is "more likely than not" that the tax benefits claimed would be allowed, or that there is a "reasonable basis" for such a claim.

5. ***Explain the steps TNC will take to assure compliance with new Section 4965.***

Section 4965 was enacted in 2006 and imposes penalty taxes on tax-exempt organizations that participate in "listed transactions" or "prohibited reportable transactions". The Conservancy's 2005 Tax SOP effectively prohibits participation by the Conservancy in any of the transactions encompassed by section 4965. Responsibility for ensuring compliance with the Tax SOP adopted by the Conservancy rests with the Legal Department, which reviews all transactions undertaken by the Conservancy for compliance with the Conservancy's policies and procedures and applicable laws and regulations. Any unusual transactions are brought to the attention of the General Counsel, as appropriate, are subject to additional levels of review.

The Conservancy has several additional policies and procedures in place to assure compliance with all tax laws, including section 4965. First, the Conservancy's Policy on Compliance with Tax Laws and Donations of Land and Interests in Land requires conformity both with the letter and the spirit of the law. Second, the Conservancy's adherence to this policy and to the Tax SOP is monitored by its Legal Department as part of their standard review of contractual arrangements. When questions arise regarding the tax aspects of a proposed transaction, the Conservancy's Director of Tax Services is consulted for consultation regarding the potential tax aspects of the proposed transaction. Third, the Conservancy's Director of Tax Services monitors changes in tax law that may impact the Conservancy's operations. This includes tracking revisions to the IRS' list of abusive tax shelters and transaction to ensure that the Conservancy has not or does not enter into any such transactions. Finally, the Conservancy's CFO is required to annually certify annually to its outside tax preparer through the completion of a detailed Reportable Transactions Compliance Checklist whether it has been a party to any such transactions.

TAX OPINIONS AND OTHER TAX ADVICE

1. ***Has TNC sought or obtained tax opinions or other outside advice regarding the federal income tax consequences to TNC, a TNC official or employee, or a party to a transaction with TNC, since June 1, 2005? If so, provide a copy of such requests, opinions, and advice.***

No.

2. ***Has TNC been a party to a tax indemnity agreement or similar arrangement sine June 1, 2005? If so, describe the arrangement and TNC's rights and obligations there under.***

No.

LOCAL CHAPTERS

1. ***Describe the steps TNC has taken to improve oversight of its state and local chapters and the officials responsible for managing and operating such chapters.***

On September 30, 2004, the Board of Directors approved a policy entitled Roles and Minimum Standards for Governing The Nature Conservancy. This policy document makes explicit:

- the role of the Board of Directors as ultimate holder of legal and fiduciary responsibility for Conservancy operations

- the roles of chapter Boards of Trustees as advisory boards that help local management implement the mission of the Conservancy and help the Board of Directors oversee the functioning of local programs

- the required minimum performance standards for each chapter Board of Trustees, and

- the description of the Trustee Council, a mechanism to facilitate two-way communication between the Board of Directors and the chapter Boards of Trustees.

The Conservancy has made substantial progress in ensuring implementation across all state and local chapters of the 19 minimum standards enumerated in the Roles and Minimum Standards document. These minimum standards were adopted to help the Board of Directors and senior management improve oversight of state and local chapters. For example, as of June 15, 2006:

- 45 of 53 domestic chapters have adopted the uniform "Chapter Operating Principles" created to ensure uniform chapter structure and operations across the Conservancy. The remaining chapters are scheduled to adopt the new operating principles within the next two months.

- 46 of 53 domestic chapter Boards of Trustees have completed compliance training to ensure that all chapter Trustees are in compliance with relevant Conservancy policies and procedures. Following training, each Trustee is asked to sign a compliance pledge to confirm adherence to these policies and procedures. Each of the remaining chapters has training scheduled in the next two months.

In conjunction with the distribution of the "Roles and Minimum Standards for Governing The Nature Conservancy", the Conservancy produced and distributed a comprehensive Trustee Handbook to assist chapters in developing the leadership and oversight responsibilities of their Boards of Trustees. The Conservancy currently employs a small group of staff members to assist

chapters with training in this area. As the Conservancy developed additional materials in subsequent years, the Trustee Handbook has been enlarged and improved. Currently, the Trustee Handbook contains:

- Roles and Minimum Standards for Governing The Nature Conservancy.
- Trustee Advisory Council materials.
- Best Practices for Excellence in Board Performance, a collection of model performance standards in eleven areas of board operations, including planning, oversight, financial management and conservation activities.
- Board Evaluation Tool, for use in evaluating performance against both minimum standards and best practices.
- Trustee Ethics and Compliance information.
- Information on implementing the standard Chapter Operating Principles.
- Materials for standard Trustee orientation, including a video overview of the Conservancy, suggested meeting agenda, orientation presentation template and suggested handbook materials.

2. ***Has TNC terminated any state or local chapter since June 1, 2005, or terminated a state or local chapter official's status or relationship with TNC since that date?***

The Conservancy has not terminated a state or a chapter officials' status or relationship with the Conservancy during the time period covered by this letter.

MISCELLANEOUS

1. ***TNC reported to the staff that the value of assets held in TNC's donor advised funds as of March 31, 2005, was $4.3 million. Provide the value of assets held in TNC's donor advised funds as of May 31, 2006. Describe how TNC has assured compliance with its recently enacted policy regarding donor advised funds.***

As of April 30, 2006, the Conservancy had 11 funds within the Donor Advised Fund; the total amount of the Fund was $8,238,745 million. The Conservancy continues to operate within the Guidelines that are established in the TNC Donor Advised Fund Procedures, Distribution Guidelines, and the Memo of Understanding. Donors must and do distribute at least five percent of the value of their fund every year and over time, at least 20 percent of the fund's principal and

income must be distributed to the Conservancy. Donors are informed of these requirements through quarterly reports that state the value of the fund, the amount distributed and where, and the amount that remains to be distributed for that year. Prior to making any advised distribution to an organization, the Conservancy contacts that organization and requests a copy of its 501(c)(3) determination letter. Furthermore, the distribution letter that accompanies the disbursement to the charity states that by endorsing the check, the organization acknowledges the payment does not represent the payment of any personal pledge or other financial obligation of the donor and that no benefits will be offered in connection with the distribution.

2. ***Explain how TNC assures compliance with employment tax reporting with respect to all of its employees.***

The Conservancy contracts with an outside payroll service with substantial expertise in employment tax reporting to complete its bi-weekly payroll. With appropriate oversight by the Conservancy, this provider also completes and files all federal and state employment tax reporting with respect to the Conservancy's employees.

The Conservancy also maintains standard operating procedures in this area (Definition of Employees, Employee/Independent Contractor Designations, Standard Work Hours) and provides tools such as a questionnaire entitled "Is Your New Worker an Employee vs. Independent Contractor Questionnaire" to ensure compliance with employment tax reporting and to make correct determinations on worker classification. These SOPs, along with others, are part of the Conservancy's ongoing comprehensive compliance training program for all TNC staff.

IRS AUDIT

1. ***Provide the following items with respect to the completed IRS examination:***

a. ***A copy of the IRS letter concluding the examinations;***

b. ***A copy of the IRS proposed adjustments and notice of deficiency, if any, with respect to TNC's Form 990-T;***

c. ***A copy of all information documentation requests (IDRs) pertaining to the examination and TNC's written responses to the IDRs;***

Issues with respect to the disclosure of the materials requested in the preceding subparagraphs (a) through (c) are under consideration by the Committee staff in response to the Conservancy's letter to the staff dated June 14, 2006.

d. ***A copy of any materials submitted to the Board of Trustees or Board committees relating to the IRS audit of TNC.***

All information related to the IRS audit of the Conservancy was communicated orally to the Board of Directors or Board committees.

2. ***Has TNC been notified by the IRS that the IRS intends to audit any other TNC taxable years?***

The Conservancy has not been notified that the IRS intends to audit any other taxable years of the Conservancy.

3. ***Describe any steps taken by TNC as a result of the IRS audit that TNC expects will help TNC improve its compliance with federal tax laws.***

As discussed elsewhere in this letter, the Conservancy has revised its tax return preparation and review process to ensure transparency and full compliance with its Form 990 tax reporting requirements; revised its internal process for ensuring that it properly reports all unrelated business income on its Form 990-T and confirmed that its previously adopted Tax SOP will ensure compliance with section 4965 of the Code.

The Conservancy has also created a new senior level position of Director of Tax Services. The Director of Tax Services, who has responsibility for overall tax compliance, reports directly to the Chief Financial Officer and consults regularly with the Legal Department on tax matters. In addition to the processes outlined above, the Conservancy conducts an ongoing tax review in order to ensure compliance with federal tax laws.

As discussed more fully in its prior submissions to the Committee and highlighted in this letter, the Conservancy has also updated or created numerous standard operating procedures to ensure that the Conservancy meets or exceeds the requirements of federal tax law.

FINAL FINDINGS

1. ***Provide a list of all the recommendations of TNC's Governance Advisory Panel and the current status of TNC's compliance with those recommendations.***

Please see material included in the attached chart, included as Exhibit 1.

2. ***Provide copies of all internal audits (including drafts) from June 1, 2005.***

Issues with respect to the disclosure of internal audits (and drafts) are under consideration by the Committee staff in response to the Conservancy's letter to the staff dated June 14, 2006.

3. ***Reports of the Risk Assessment Committee to the Board of TNC (and any subcommittee).***

Please see material included in the attached chart, included as Exhibit 2.

4. ***A description of all land and other transactions involving major donors and Board members that were subject to advance review and approval by the Board under the conflicts procedure.***

Please see material included in the attached chart, included as Exhibit 3.

5. ***A description of all requests for substantive modifications of easements that were approved or disapproved by TNC.***

Please see material included in the attached chart, included as Exhibit 4.

* * * * * *

While many of the documents referred to in this letter are available on the Conservancy's website, we will be happy to provide copies of those documents directly to you. My colleagues at the Conservancy and I stand ready to respond to any questions you or your staff may have.

Respectfully submitted,

Steven J. McCormick
President and Chief Executive Officer

COMMISSIONER
TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

SEP 21 2006

The Honorable Charles E. Grassley
Chairman, Committee on Finance
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

I am responding further to your June 7, 2006 letter about our actions on conservation easements. On June 23, 2006, I provided you an interim response that addressed requests 1 through 4 relating to The Nature Conservancy (TNC). We also provided all documents that you requested that were available at that time.

Today, I am supplementing my June 23 response to your first request by providing those Forms 8283 that have become available since June 23. We will provide the remaining Forms 8283 when we receive them. The information and documents we are providing on The Nature Conservancy and its donors are protected from disclosure under section 6103(a), and are provided to you under the authority of section 6103(f)(4).

I am also addressing your fifth request, which asks how we are responding to the recommendations the Committee staff made in its 2005 report on the TNC investigation. I appreciate the many thoughtful recommendations of Committee staff in this area, and we will refer to them as we pursue our guidance and compliance activities. I also appreciate the opportunity to outline the steps we are taking to improve our enforcement in the conservation easement area.

With respect to information reporting, we are modifying our tax forms to gather more and better information about organizations with conservation easement programs and their donors. In late 2004, in connection with the overall revision of the Form 1023, Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code, we added questions to identify organizations with conservation easement donation programs in order to ensure that they meet the requirements for exemption, including the ability to meet conservation responsibilities. Another modification requests information about joint venture arrangements.

We have created a team that is redesigning Form 990, Return of Organization Exempt From Income Tax. Starting with 2005 returns, we added a question to Schedule A of the Form 990, to identify organizations that receive qualified real property interests under section 170(h) of the Code during the year. In addition, we are considering questions on Form 990 for tax year 2006 to facilitate conservation organization compliance and enforcement.

One area our Form 990 redesign team is focusing on is to address easements with greater specificity. Our current plan is that in May 2007 we will release a version of the form for public comment that will include, among other improvements, a more comprehensive sequence of questions, rewritten instructions, and a new glossary of terms. The subject matter areas that we address in future stages of the revision process and the timing of specific changes will depend on resource availability. As a result of this comprehensive overhaul, we will have a superior information return that will increase transparency and improve its usefulness as a compliance tool.

We have also amended the instructions to Form 8283, Noncash Charitable Contributions, to improve our discussion of standards in the area, and we have changed Form 8283 to better identify easement donors. These changes will enable us to better identify the universe of organizations and donors involved in conservation easement transactions, and will allow us to better target our future enforcement efforts.

In addition, we will issue guidance and take other steps necessary to implement the provisions of the recently enacted Pension Protection Act of 2006, Pub. L.109-280, that pertain to the federal income tax consequences of easements.

The TEGE Exempt Organizations 2006 Implementing Guidelines list easements as a critical initiative. Cross-functional issue management teams (IMT) focus on specific abuses to ensure the law is enforced, to educate the public, and to prepare guidance where appropriate. Our IMT in the conservation easement area permits a joint effort among various IRS functions for developing a strategic approach to conservation easement issues and enforcement. The conservation easement IMT has been instrumental in helping to identify abuses, including valuation abuse. The IMT is also instrumental in coordinating examinations of easement donors with examinations of charities that receive conservation easements.

The extent to which a conservation organization monitors and enforces its easements or has allowed property owners to modify an easement or develop the land in a manner inconsistent with an easement's restrictions, is a central issue we raise on examination of a land conservancy organization or other organization accepting conservation easements. We also look at whether the organization is accepting and holding easements that exclusively further a purpose listed in section 170(h). Additionally, we closely scrutinize conservation buyer programs, an area that the IMT has identified as potentially abusive, during an examination. Other issues explored during an examination include implications of unrelated business taxable income from the solicitation, acquisition and sale of property by the organization, and the extent to which conservation organizations are involved in emissions credit arrangements (normally only seen in larger conservation organizations that operate overseas).

We have been pursuing compliance in the conservation easement area through litigation. The results to date have been mixed, with a favorable result in *James D. and Beverly H. Turner v. Commissioner,* 126 TC No. 16 (2006); and an unfavorable outcome in *Charles F. Glass v. Commissioner,* 124 TC 258 (2005), notice of appeal filed (6th Cir. Mar. 27, 2006).

Moreover, as part of its revenue proposals for the Fiscal Year 2007 Budget, the Treasury Department included a legislative proposal that would impose significant penalties on any charity that removes or fails to enforce a conservation restriction for which a charitable contribution deduction was claimed, or transfers such an easement without ensuring that the conservation purposes will be protected in perpetuity. The amount of the penalty would be determined based on the value of the conservation restriction shown on the appraisal summary provided to the charity by the donor.

We will continue to evaluate the data obtained from the examinations to determine the need for guidance and more focused enforcement projects and guidance. We also will continue to work with Counsel and the Treasury Department in issuing new guidance on issues that further IRS and TEGE strategic goals and that concern the tax-exempt community.

We appreciate your interest in tax exempt organizations and the leadership you have shown in this area. The Administration shares the goal of rewarding the millions of Americans who generously support our Nation's charities, while deterring the relatively small number of taxpayers who seek to misuse charities for their personal gain.

If you have additional questions, please call me at (202) 283-2500, or Lois G. Lerner, Director, Exempt Organizations at (202) 283-2300.

Sincerely,

Steven T. Miller

Enclosure

EDISTO ISLAND
OPEN LAND TRUST

June 6, 2005

The Honorable Charles A. Grassley, Chairman
Committee on Finance
United States Senate
Washington, District of Columbia 20510-1501

Dear Chairman Grassley:

Edisto Island, South Carolina, lies within the ACE Basin, an expanse of 350,000 acres of pristine land in the deltas of three rivers. On Edisto more than 8,000 acres of land have been preserved and in the entire ACE Basin more than 160,000 have been preserved. Without the tool of conservation easements, there is little doubt that this land would not be the natural paradise it is today.

The Edisto Island Open Land Trust is a small 501(c) (3) non-profit that focuses exclusively on Edisto Island, where we have worked for more than 10 years to protect this barrier island's open spaces, scenic views and rural way of life. The inventory of protected properties that we steward includes the *Steamboat Creek Easement*. This 30-acre property, which lies along the road to the historic Steamboat Ferry landing, offers many benefits for the public good, with scenic, low-density, and water-quality values. It encompasses highland, wetland and marshland habitat for many botanical and wildlife species, including active oyster beds along the creek banks. The Edisto Island Open Land Trust has committed to the stewardship costs of maintaining in perpetuity the natural state of this property and others – none of the costs are borne by American tax payers.

The proposed restrictions to the tax benefits for conservation easements would drastically reduce, if not eliminate, most future donations of easements or land -- and critical open space and natural habitat would be lost. The development explosion that has destroyed the natural beauty of surrounding islands on SC's coast threatens Edisto Island, as well, with all the problems that unchecked growth brings. It's not that landowners are motivated to donate easements and land because of the tax benefits only – in every case the prime motivation is to keep their land from changing long after they are gone. Unfortunately the cost for setting aside land for conservation simply prohibits most landowners from doing it without some financial assistance, relief or tax incentive.

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The Honorable Charles A. Grassley, Chairman
Committee on Finance
June 6, 2005
Page Two

Like all legitimate and properly managed land trusts, we abhor the rogue/straw land trusts (so called) that have abused the tools we need to successfully preserve threatened lands. As a supporting member of the national Land Trust Alliance, we have adopted and adhere to *LTA Standards and Practices* for our day-to-day operations. We strongly support holding donors and donees (such as land trusts) to high ethical standards, as well as to strict compliance with the current State and Federal laws on conservation values for easement and land donations. The Edisto Island Open Land Trust and, I am confident, the majority of land trusts in South Carolina endeavor to follow these laws to the letter.

We trust that members of the Senate Finance Committee will consider the adverse impact of any decision to legislatively enact the Joint Committee on Taxation's proposals that seek to diminish the benefits of conservation easement and land donations. Our position is completely consistent with that taken by SC Governor Mark Sanford in his letter to your committee dated March 7, 2005. A copy of that insightful letter is attached to, and made a part of, this letter. Also attached is a copy of a resolution passed by the Board of Trustees of the Edisto Island Open Land Trust. Together with this letter, we ask that these two attachments be made a part of the Committee record. Thank you.

Sincerely,

William F. Thompson, Jr.
President of the Board of Trustees
Edisto Island Open Land Trust

Enclosures

cc: Ms. Blair Goodrich, Washington Office of SC Governor Mark Sanford
The Honorable Lindsey Graham
The Honorable Jim Demint
The Honorable Henry E. Brown
The Honorable Joe Wilson
The Honorable J. Gresham Barrett
The Honorable Bob Inglis
The Honorable John Spratt
The Honorable James E. Clyburn
Members of the Board of Trustees for the Edisto Island Open Land Trust

State of South Carolina

Office of the Governor

MARK SANFORD
GOVERNOR

POST OFFICE BOX 12267
COLUMBIA 29211

March 7, 2005

The Honorable Charles A. Grassley
Chairman
Committee on Finance
United States Senate
Washington, District of Columbia 20510-1501

Dear Mr. Chairman,

I would like to express my concern about the proposal to reduce or eliminate the federal income tax deduction for conservation easements. While there have been some abuses of the tax benefits of easements, conservation easements have been successful and are essential to the protection of land in South Carolina and many other states. Over the past decade, easements have facilitated protection for more than 100,000 acres of land in South Carolina that are important historically, recreationally and environmentally. We are confident that a significant portion of this land would not have been protected in the absence of easements.

Perhaps a better solution to curb abuse would be to establish a system of review to ensure that easement appraisals are accurate rather than simply eliminating this effective mechanism for achieving voluntary and private conservation. South Carolina has initiated its own Department of Revenue audit to review these incentives in the interest of protecting them from abuse – because we believe in the tremendous success of engaging private landowners in permanent land protection.

In South Carolina, we promote conservation easements as an essential tool to protect our landscape. Over the past decade, our state has lost more than 200 acres of land to development every day. To address this trend and respect private property rights, we must have a cost-efficient, non-intrusive means of securing important land in the face of this growth pressure. I would like to note six reasons that we believe easements serve this purpose well.

1. **Using easements to protect land accomplishes land conservation at a fraction of the price of purchasing the land in fee.** I would make a conservative estimate that if the total cost of our state's easements to the public had been translated into direct fee purchases of land funded from federal and state sources, we would have only protected one fifth or less of the land that we've been able to conserve over the past decade.

2. **Easements allow land to remain on county tax roles.** There is some misunderstanding around this point, but in South Carolina, private land under easement remains on the property tax roles. In most cases, the easement results in no additional reduction in tax revenues. That is, easements have little or no impact on county property tax receipts because the land remains on the tax roles and easements rarely, if ever, diminish assessments below the agricultural valuation.
3. **Land protected by easements remains in private hands and does not require public funds for maintenance or ownership liability.** South Carolina, like many states, has had a difficult time funding the maintenance of its parks, public forests, game management areas and other public lands. Land under easement produces extensive public benefits – water quality, aesthetics, wildlife habitat and more – but does not cost the public in ongoing maintenance.
4. **Easements provide an outlet for conservation that does not require regulatory intervention.** Like many citizens around the country, South Carolinians demand protection of their natural landscapes. Often this takes the form of campaigns for stricter zoning or for other forms of government intervention on the use of land. Successful easement campaigns can persuade the public that protection is being accomplished without government regulation, which we believe is to everyone's benefit.
5. **Easements are capable of much greater levels of protection than government regulation.** Many Southeastern states struggle with zoning in rural areas. More and more, counties that pass restrictive zoning codes only succeed in increasing the rate of land conversion with flawed strategies like establishing minimum lot sizes. Most of our easements limit land to uses and densities that are truly rural, supporting traditional activities like farming, forestry and hunting.
6. **Easements can bring landowners together around a common vision for the future of important areas.** The process of obtaining easements entails an assessment of the value of natural resources and the threats they face. In areas where we have been most successful, such as the Ashepoo-Combahee-Edisto (ACE) basin between Charleston and Beaufort, the civic debate and discussion has produced a positive, science-based assessment of the value of conservation. Landowners have come together to voluntarily limit their own uses of land for the greater good. This happens much less often when the tool at hand is government regulation.

I would be glad to further elaborate on the importance of easements and the continued deductibility of easements to South Carolina. Eliminating or reducing the utility of easements, and thus pushing regulatory tools and public ownership of land to the forefront of land conservation tools, strikes me as contrary to the philosophy of limited government that we are promoting as Republicans. Thank you for your consideration.

Sincerely,

Mark Sanford

MS/as

cc: The Honorable Lindsey Graham
The Honorable Jim DeMint
The Honorable Henry E. Brown
The Honorable Joe Wilson
The Honorable J. Gresham Barrett
The Honorable Bob Inglis
The Honorable John Spratt
The Honorable James E. Clyburn

Resolution by the Board of Trustees of The Edisto Island Open Land Trust

Approved: March 28, 2005

We are resolute in our opposition to the recommendations of the Joint Committee on Taxation to reduce landowners' tax deductions when land or conservation easements are donated to preserve the conservation values of that land. Specifically we oppose those recommendations to be made to Congress which:

- Do not allow ANY deductions for a conservation easement on a property used as a personal residence by the landowner
- Slash the deductions allowed for donating a conservation easement by 2/3 -- from 100% of the value of the easement, to no more than 33% of its value
- Limit deductions to the landowner's basis in the land, rather than its market value, for gifts of land or bargain sales

These recommendations would drastically reduce, if not eliminate most donations of conservation easements or land, and critical open space and natural habitat would be lost to development. We support holding such donations and donees, like the Edisto Island Open Land Trust, to high standards, and we have adopted and adhere to the Land Trust Standards and Practices promulgated by the National Land Trust Alliance. These Standards and Practices prohibit the abuses that concern the JCT and every ethical organization involved in the land trust initiative.

The
Northern Virginia
Conservation Trust

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June 15, 2005

Senate Committee on Finance
Attn.: Editorial and Document Section
Room SD-203
Dirksen Senate Office Building
Washington, DC 20510-6200

Re: Hearing Entitled: "Tax Code and Land Conservation: Report on Investigations and Proposals For Reform," June 8, 2005

Dear Senators:

The Northern Virginia Conservation Trust ("NVCT") hereby submits this written testimony regarding the hearing held on June 8, 2005 entitled "Tax Code and Land Conservation: Report on Investigations and Proposals For Reform" ("Hearing"). While NVCT supports many of the specific reforms suggested at the Hearing, *infra,* for the reasons set forth below, NVCT urges the Committee not to set a double standard for conservation that would adversely affect urban and suburban land trusts, by setting a different standard of public purpose for smaller conservation easements.

NVCT Preserves The Natural and Historic Resources of Northern Virginia

Since 1994, The Northern Virginia Conservation Trust has permanently protected over 1,300 acres of environmentally sensitive and historically significant property in rapidly developing Northern Virginia. With a staff of five, NVCT has recorded numerous successes:

- Over 5 miles of local stream and river banks conserved;
- Over 800 acres of land buffering public parks conserved;
- Over 600 acres of land with wetlands, streams or rivers conserved;
- Over 340 acres of land with historic features preserved;
- 3,000 volunteer hours working on environmental enhancement projects; and
- Over 2,500 native trees planted.

NVCT holds 52 conservation easements and owns 13 properties in fee. To protect the conservation value of these lands in the future, NVCT has over $200,000 in its growing Stewardship Fund to monitor and enforce properties under easement. Moreover, at its

annual Board Retreat in March, 2005, NVCT adopted the recently revised Standards and Practices of the Land Trust Alliance (LTA), becoming one of the first land trusts in the country to do so.[1]

A key component of NVCT's success story has been public-private partnerships between NVCT and three local jurisdictions: Arlington County, Fairfax County and the City of Alexandria. The three local jurisdictions provide financial support for NVCT in return for NVCT's assistance in helping those localities implement their open space master plans. These three jurisdictions have a combined population of 1.3 million, greater than the population of twelve states.

While the open space master plans differ by jurisdiction, they all share the common characteristic of trying to preserve even small parcels of open space for their rapidly growing populations to enjoy. As stated by one jurisdiction:

> "A comprehensive network of safe, high quality open spaces is a critical component of Arlington County's future. Open space benefits the County through the conservation of natural, cultural and historic resources, the protection of environmental quality, the provision of public facilities, the enhancement of neighborhoods and the provision of visual and aesthetical relief in high density urban areas. Open space is an important element in Arlington's identity as a desirable community in which to live and work."

Arlington County, Open Space Master Plan (Adopted September 10, 1994).

NVCT Protects Small Parcels With Significant Conservation Values

Given the urban/suburban nature of NVCT's service area, it is not surprising that 44 of NVCT's protected properties are less than ten acres in size. Working closely with local jurisdictions and their appointed citizen boards and commissions, NVCT has preserved numerous small parcels under ten acres that both match the goals of the local open space master plans as well as fit within the terms of section 170(h) and implementing regulations. A listing of some representative examples of these small parcels reveals the significant conservation values permanently protected by NVCT:

- the habitat of the Small Whorled Pogonia, a federally listed threatened orchid;
- the viewshed of a heavily traveled hiking trail in Potomac Overlook Regional Park;
- a 200+ year old plantation house that is listed on the National Register of Historic Places;
- lands connecting trails between existing public parks;
- the shoreline of the Potomac River, Belmont Bay and other area waterways;
- numerous properties buffering federal, state, regional and local parks;

[1] For more information on NVCT, please see our most recent Newsletter and Annual Report (copies attached). NVCT can also be found on the Web at www.nvct.org.

- several properties with Revolutionary and Civil War historic features.

NVCT Supports Many of the Suggested Reforms

NVCT has reviewed the Hearing video and all the written testimony. NVCT fully supports many of the suggested reforms discussed by Committee Members and the witnesses on June 8th.[2] These suggested changes from existing law include the following: a strong private accreditation program; a high standard for legal and ethical practices within all land trusts; monitoring and enforcement of all easement restrictions; stricter rules for minimum qualifications for appraisers and appraisals; a high bar for the modification of existing easements; and the prohibition of deductions for the donation of a conservation restriction on a golf course or similar property. NVCT notes that these reforms were suggested by the Land Trust Alliance, the umbrella organization of which NVCT is a member in good standing.

NVCT Urges One Uniform Standard Of Public Benefit
For All Easements Regardless Of Size

In sharp contrast, nothing in the Hearing video or the written testimony supports the view that conservation easements on smaller parcels may be more prone to abuse than easements of greater size. The few references to the issue actually support the important conservation values of such small parcels.[3] In addition, the 216 page report entitled "Finance Committee Report on The Nature Conservancy" (TNC Report) is devoid of any factual references to any purported abuses on such small easements.[4] Accordingly, the Record lacks any documentation remotely suggesting that conservation easements on parcels less than a certain size present any unique problems warranting a higher standard of public purpose than larger easements.[5]

In fact, just the opposite is often true. The abuses concerning golf courses, for example, all occurred on large parcels. Moreover, because easements on small parcels are more likely to be found in areas of greater population density, such as Northern Virginia, the benefits provided by their conservation --- such as scenic enjoyment, clean air and clean water --- are enjoyed by far more people than the preservation of much larger

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[2] For example, the testimony of Burnet R. Maybank III, the Director of the South Carolina Department of Revenue, included a copy of recent legislation in Virginia that was championed by the Northern Virginia Conservation Trust.

[3] See, e.g., Testimony of Timothy Lindstrom at 12 (citing small parcels inside the Grand Teton National Park and along the seacoasts).

[4] The only factual references to small easements are not to the appropriate standard of public benefit but rather to The Nature Conservancy's alleged failure to monitor and enforce small conservation easements. TNC Report at 12.

[5] The LTA testimony is not to the contrary. LTA noted that the concerns of Committee Staff about small easements were met by "current law and regulations." Testimony of Rand Wentworth at 7. LTA recounted that "[t]here are hundreds of land trusts across the country operating in jurisdictions in which most if not all land ownerships are less than 10 acres, and where the landscape is changing in front of people's eyes." Id., at 7-8. Yet, LTA put forward an additional public benefits test for small properties "very reluctantly" in the hopes of "discussing specific conditions" with Committee Staff. Id.

landscapes in more isolated areas of the country. In short, there is no factual support showing any need for a higher standard of public benefit for smaller parcels.

Despite this lack of evidence that small easements pose any real problem, the June 7th Staff report from the Senate Finance Committee made reference to considering limits on the donation of smaller easements, and the Land Trust Alliance has proposed a double standard for public benefit and conservation value, with one standard for larger properties and a more restrictive standard for properties under 10 acres.

NVCT Opposes Any Two-Tiered Standard That Would Adversely Affect Urban And Suburban Land Trusts

Such a two-tiered standard would adversely affect conservation efforts in the areas where land is under the greatest threat of being lost to development. There is simply no rational reason for such unequal treatment.

In fact, an argument can be made that these urban and suburban land trusts play an even more critical role in land preservation than do their more rural counterparts. Given the enormous development pressure in the nation's urban and suburban centers, without the timely action of land trusts many environmentally important and historically significant properties will be lost in the next few years. On the other hand, the preservation of many larger properties in rural America affect land that is under relatively little development pressure, and has less direct and immediate public benefit.

In addition, a two-tiered test for public benefit simply does not make sense. Either preservation of a property has a public benefit or it does not. It is the quality of the property that is important, not its size. Preservationists trying to conserve a five acre parcel containing a globally rare orchid surrounded by subdivisions should not be forced to prove a higher standard of public benefit than advocates for a 100+ acre ranch located in the middle of dozens of similar ranches solely because the size of the parcel fails to reach some arbitrary threshold. All land, wherever located and of whatever size, should be evaluated based on merit on a level playing field.

Moreover, the practical result of a two-tiered standard of public benefit would be devastating to the operations of urban and suburban land trusts. Regardless of whatever test the Committee crafts for small parcels with the best of intentions, the word will quickly spread through communities across the country that parcels less than 10 acres in size do not qualify for any tax benefits. This misperception will be amplified by lawyers, accountants and realtors who will use the opportunity to steer landowners interested in preservation away from talking with their local land trust by mischaracterizing any higher standard for small easements into an absolute prohibition.

Finally, the dedicated professional Staff and volunteer Board Members of the Northern Virginia Conservation Trust believe that creation of a different standard for urban and suburban land trusts will brand these organizations as "second class citizens" in the perception of the general public. By any objective standard, NVCT's work has

been as significant as any similarly sized local land trust in the country. The Committee should not denigrate that important work by adoption of a special standard for small parcels.

Conclusion

For the foregoing reasons, the Northern Virginia Conservation Trust NVCT urges the Committee to maintain one uniform standard of public benefit for all easements regardless of size.

Sincerely,

Paul Gilbert
President

Attachments: (1) Summer 2005 Newsletter
(2) 2004 Annual Report

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