

REPORT OF STAFF INVESTIGATION OF
THE NATURE CONSERVANCY

(VOLUME I)

Prepared by the Staff of the

COMMITTEE ON FINANCE
UNITED STATES SENATE

CHARLES E. GRASSLEY, *Chairman*
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INTRODUCTION

On July 16, 2003, Senator Charles Grassley (R-IA) and Senator Max Baucus (D-MT), Chairman and Ranking Member of the Senate Committee on Finance (“Committee”) wrote to The Nature Conservancy (“TNC”) beginning an investigation by the Staff of the Senate Finance Committee (“Staff”) of TNC.

On April 9, 2003, the Senate passed the CARE Act by a vote of 95-5. The CARE Act was intended to encourage charitable giving and included specific provisions strongly supported by Senators Grassley and Baucus to encourage the donation or sale of partial and entire interests in property dedicated for conservation. In May of 2003, *The Washington Post* published a series of stories on TNC and raised serious questions about the policies and practices of TNC, including issues of corporate governance, charitable contributions (especially regarding certain conservation easement arrangements), commercial activity and unrelated business income, and arrangements with insiders.

The Committee undertook an investigation of TNC to better understand the questions raised by *The Washington Post* articles and their significance regarding the administration and enforcement of Federal tax laws governing exempt organizations and charitable donations.

Because the Committee continues to consider legislation to encourage charitable giving, the Chairman and Ranking Member take a particular interest in ensuring that the tax laws affecting donors and charitable organizations – as well as the changes in law being considered – operate in a manner that would provide the intended benefits. The investigation has been conducted to not only inform the Finance Committee and the public about The Nature Conservancy, but also to provide a broader picture of issues to be considered by Congress and the public with regard to tax-exempt organizations and charitable donations.

The Committee’s investigation confirms that TNC’s reputation as a leading and innovative conservation organization is well deserved. TNC 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. TNC is proud of its innovation, especially of its use of public-private partnerships to attempt to achieve its conservation goals and objectives. Given the ongoing IRS audit of TNC, the Staff has made no specific determination whether any particular TNC activity did or did not comply with the relevant technical requirements of the Internal Revenue Code (“Code”). However, the Staff questions whether some of the activities TNC conducted in the past, and continues to pursue in limited cases, are potentially inconsistent with the tax policy considerations behind the rules governing tax-exempt status under section 501(c)(3) and charitable contribution deduction rules of the Code.

This report includes the Staff’s observations and issues for consideration as well as detailed discussions of certain programs and activities. Appendices to the report include the following: correspondence between the Committee and TNC, newspaper articles and memos, transactional documents and legal opinions regarding certain TNC programs and activities. The Table of Contents contains a list of documents in the Appendices.

EXECUTIVE SUMMARY

A. General Overview of Investigation

1. Scope

The Staff began its investigation of TNC in July 2003. The investigation comprised a detailed review of certain TNC programs, activities, practices, and transactions in light of section 501(c)(3)¹ governing tax-exempt status, unrelated business income tax, the excess benefit excise taxes, and Federal tax and information reporting requirements. In addition, the Committee reviewed TNC's practices regarding the solicitation, valuation, documentation, substantiation, and reporting of charitable contributions of property other than cash. *The Washington Post* reported on some of these areas that the Staff reviewed in a series of articles first published in May 2003.²

The Staff's investigation did not constitute an examination or audit of TNC, which is the responsibility of the Internal Revenue Service ("IRS"). In December 2003, the IRS commenced an examination of TNC which is independent and separate from this Staff's investigation. The Staff took every precaution to ensure that information obtained by the Committee from TNC during this investigation was not shared with IRS personnel conducting the examination. In this report, the Staff refrains from making specific factual determinations and legal conclusions that could possibly influence the IRS examination.

The representatives of TNC and the Committee executed a disclosure agreement. Under the terms of this agreement, TNC agreed to the disclosure of its return information that is not otherwise subject to disclosure under section 6104. The Committee agreed that any disclosure of information collected during the investigation would only be disclosed through official reports, meetings, or hearings of the Committee.³

2. Methodology

TNC agreed to cooperate with the Committee investigation. TNC complied with the Committee's requests for information through the voluntary production of documents.⁴

¹ Except as otherwise indicated, all references to "section" in this Report refer to the Internal Revenue Code of 1986, as amended.

² See Appendix A.

³ Committee Letter to TNC dated November 4, 2003, see Appendix B.

⁴ In November 2003, TNC and the Committee corresponded about the potential application of certain privileges that might attach to portions of the requested information (see Appendices B and C for copies of that correspondence). Because TNC took action to satisfy its disclosure concerns, the Committee was not forced to issue subpoenas or otherwise compel TNC to provide any requested information.

In conducting its investigation, the Committee:

- Reviewed IRS Form 990, *Return of Organization Exempt From Income Tax*, for fiscal years ending June 30, 1993, through June 30, 2003
- Reviewed IRS Form 990-T, *Exempt Organization Business Income Tax Return*, for fiscal years ending June 30, 1999, through June 30, 2003
- Reviewed IRS Forms 8282, *Donee Information Return* and 8283, *Noncash Charitable Contributions*, relating to various charitable contributions of noncash property made to TNC during the past decade
- Reviewed IRS Forms 990, 1065, *U.S. Return of Partnership Income*, and 1120, *U.S. Corporation Income Tax Return*, and related financial statements for tax-exempt and taxable entities affiliated with TNC
- Reviewed documents received from TNC which included narrative responses, transactional documents relating to hundreds of transactions, and internal TNC policies and operating procedures
- Reviewed various internal audits, reports, and studies pertaining to TNC
- Conducted meetings with TNC personnel during the course of the investigation and periodically updated TNC personnel about the status of the investigation
- Reviewed publicly available information relating to TNC, including annual reports and financial statements, press releases, and other information available on its website, www.nature.org
- Reviewed the series of articles published by *The Washington Post* during the period May 2003 through December 2003
- Reviewed tax opinions that TNC's outside counsel provided to TNC with respect to various transactions or activities
- Reviewed documents, policies, and procedures relating to reforms implemented by TNC after commencement of the Committee's investigation
- Obtained the assistance of the staff of the Joint Committee on Taxation as well as staff of the IRS Exempt Organization's 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 TNC
- Provided TNC the opportunity to review Parts One, Two, Three and Four of the report prior to publication.

The Committee commends TNC for its cooperation during this investigation. The volume and complexity of TNC's activities required the Committee to compile several information requests. TNC responded to these requests in a very detailed, organized and timely manner which greatly assisted the Committee staff in sorting, reviewing and understanding the documentation provided.

3. Investigation Highlights

The following summarizes the highlights of the Staff's investigation:

- Conservation easements present issues in valuation as well as monitoring and enforcement in perpetuity.
- Proper valuation of easements and non-cash contributions in general is critical to ensuring the accuracy of the resulting charitable contribution deduction and the Staff review highlighted the difficulty in obtaining and enforcing proper valuations.
- TNC's Conservation Buyer Program raises potential concerns regarding donative intent, inurement, private benefit, valuation, and 170(h) circumvention.
- The IRS should generally review emissions credits arrangements to determine tax consequences to exempt organizations and other participants.
- TNC's participation in Conservation Beef, LLC and Forest Bank, LLC is indicative of the types of ventures increasingly being used by exempt organizations to achieve fundraising and exempt purpose goals.
- TNC's withdrawal from the Forest Bank venture, which was structured to comply with existing IRS administrative guidelines pertaining to joint ventures involving for-profit and exempt organizations, might have been the result of multiple factors, but illustrates the difficulties exempt organizations face when attempting to achieve commercial and charitable objectives in a manner that satisfies existing tax laws.
- Existing unrelated business income tax reporting requirements and TNC's reporting practices and tax planning strategies make it difficult for the IRS and the public to identify unrelated business income activities.
- TNC repeatedly entered into transactions with insiders, which often allowed these parties to employ "side deals" or verbal agreements that were not documented.
- Since the commencement of the investigation, TNC has made significant changes to its internal practices and procedures and now requires approvals to conduct certain transactions and activities that may pose financial, legal or reputational risk to TNC.
- Existing IRS reporting requirements and exempt organization practices do not require organizations to provide meaningful disclosure regarding activities such as monitoring and enforcement of easements, TNC's conservation buyer program, joint ventures and emissions credits arrangements.
- TNC often obtained tax opinions that addressed tax consequences to other parties (rather than to TNC) and used these opinions when marketing certain transactions to provide comfort to participants and their advisors.

B. Overview of TNC

1. Mission

TNC's 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."⁵ TNC operates throughout the United States, Canada, Mexico, South America,

⁵ The Nature Conservancy website, "About Us," available at <http://nature.org/aboutus/>.

Central America, the Caribbean, and the Asia-Pacific region. As of January 17, 2005, TNC reported that it has protected 14.3 million cumulative acres in the United States, 18.4 million cumulative acres in the Asia-Pacific region, and 83.5 million cumulative acres in Central America, South America, Mexico and the Caribbean, for a total of 117 million acres around the world.⁶ TNC reports that it has approximately 1,400 preserves worldwide.⁷

Presently, TNC has five priority conservation initiatives to address the principal threats to conservation at the sites where it works, focusing on climate change, fire management, freshwater conservation, invasive species, and marine conservation.⁸

2. History⁹

TNC is the outgrowth of the Ecologists Union, an organization formed by a small group of scientists in 1946 to take action to save threatened natural areas. The Ecologists Union changed its name to The Nature Conservancy in 1950. On November 29, 1950, the organization was granted exempt status.¹⁰ In 1951, TNC was incorporated as a nonprofit organization in the District of Columbia for scientific and educational purposes.

In 1954, TNC granted its first official chapter charter in eastern New York. In 1955, TNC completed its first land acquisition, a 60-acre purchase along the Mianus River Gorge on the New York and Connecticut border. TNC established a loan fund for the acquisition, which ultimately became the Land Preservation Fund, the revolving loan fund that is used by TNC for its land acquisition programs. By 1958, TNC had 3,000 members and had saved more than 2,500 acres.

In 1961, TNC formed its first “partnership” with a public agency, the Bureau of Land Management, to manage an old growth forest in California. In the same year, TNC also received its first donated conservation easement, relating to six acres of Bantam River salt marsh in Connecticut. In 1967, TNC purchased its first real property (located in Mason Neck, Virginia) as part of a plan to later sell it to the Federal government.

During the 1970s, TNC conducted a biological inventory of the United States covering all 50 states. This effort led to TNC’s Natural Heritage Network, a database containing information about the existence and location of species and natural

⁶ Id.

⁷ Id.

⁸ The Nature Conservancy website, “Initiatives,” available at <http://nature.org/aboutus/>.

⁹ This description largely is based on excerpts from materials available on TNC’s website, “Answers to Frequently Asked Questions,” available at <http://nature.org/contactus/faqs/art2441.html>, and “Milestones: A Quick Take on Conservancy History,” available at <http://nature.org/aboutus/history/index.html>.

¹⁰ “Milestones: A Quick Take on Conservancy History,” available at <http://nature.org/aboutus/history/index.html>.

communities in the United States. In 1980, TNC launched its International Conservation Program, its first international program, designed to identify natural areas and conservation organizations in Latin America in need of technical and financial assistance.

In 1991, TNC established its “Last Great Places: An Alliance for People and the Environment” initiative, a multinational effort to protect large-scale ecosystems. The science-driven initiative emphasized core reserve areas surrounded by buffer zones. In 1995, TNC adopted “Conservation by Design,” its approach for setting conservation priorities and taking action. In 1997, TNC introduced the ecoregional approach to its conservation planning. In 2000, TNC placed Natural Heritage Network into a separate and independent organization, the Association for Biodiversity Information (later renamed NatureServe). Also in that year, the “Campaign for Conservation,” an effort to raise one billion dollars to help fulfill the organization’s goals, was officially launched.

In December 2003, TNC’s Board of Governors approved a resolution to adopt a new organizational goal, referred to by TNC as the 2015 Goal: “By 2015, The Nature Conservancy will work with others to ensure the effective conservation of places that represent at least 10% of every Major Habitat Type on Earth.”¹¹ The purpose of the 2015 Goal is to help TNC define and guide conservation priorities; drive increased conservation investment outside the United States; establish fundraising priorities; and galvanize other institutions and donors and the general public to join with TNC to protect important areas for biodiversity.¹²

3. Financial Information (fiscal years 2002 through 2004)

TNC reported total revenues of \$972.4 million for its fiscal year ended June 30, 2002, and total expenses of \$632.5 million for the same fiscal year. Its net assets as of June 30, 2002, were reported as \$2.93 billion. TNC’s total assets and total liabilities as of June 30, 2002, were \$3.28 billion and \$0.35 billion, respectively.

TNC’s total revenues declined for fiscal year ended June 30, 2003, to \$761.6 million. Total expenses declined to \$569.5 million for the year. Its net assets as of June 30, 2003, were reported as \$3.2 billion. TNC’s total assets and total liabilities as of June 30, 2003, were \$3.7 billion and \$0.56 billion, respectively.

TNC reported 2,271 and 2,955 employees for fiscal years 2002 and 2003, respectively. Selected revenue information of TNC for its fiscal years 1993 through 2003 is contained in Table 10, in Part Four of this report.

On its 2003 Form 990 for the fiscal year ended June 30, 2004, TNC reported gross receipts of \$2.5 billion, and total revenue of \$732 million. Of this total revenue,

¹¹ The Nature Conservancy website, “How We Work,” available at <http://nature.org/aboutus/>. Specific information regarding the 2015 Goal is available at <http://sites-conserveonline.org/gpg/projects/tnc2015goal.html>.

¹² Id.

TNC reported \$436 million from contributions, grants, and similar amounts received, and \$228 million from program service revenue. (Noncash contributions were reported as \$90.1 million.) TNC reported investment income of approximately \$65 million, and other sources of income of approximately \$3 million. TNC reported total expenses for the year of \$516 million, including \$54 million for fundraising expenses. TNC reported total assets of \$4.1 billion, total liabilities of \$547 million, and net assets or a net fund balance of \$3.5 billion. On Part VII of the 2003 Form 990, TNC listed unrelated business income of \$292,052.¹³

a. Revenues

TNC reported \$3.7 billion of contributions and grants, and total revenues of \$6.1 billion for fiscal years 1993 through 2003.¹⁴ Contributions and grants represented 61 percent of aggregate total revenues during this period. TNC's program service revenue comprised 27 percent of total revenues during this period, and its investment income (interest, dividends, and gain from sales of investments) totaled 11 percent of total revenues.¹⁵

TNC reported that it raised \$2.5 billion of cash contributions, and \$1.1 billion of non-cash contributions, during the 11-year period ending on June 30, 2003. In-kind contributions (consisting of all property other than cash, including land and conservation easements) represented approximately 29 percent of the aggregate contributions during this period, and comprised as little as 16 percent, and as much as 42 percent, of total contributions in a single year. Both cash and in-kind contributions decreased from 2002 to 2003.

TNC reported program service revenue of over \$1.6 billion for fiscal years 1993 through 2003. Of this amount, approximately 58 percent was from sales of property to governments, and 28 percent was from fees and contracts from government agencies, for a total of 86 percent of program service revenue derived from activities involving Federal, State and local governments. Activity fees accounted for approximately 12 percent of total program service revenue for this period. A breakdown of TNC's types of program service revenue for its fiscal years 1993 through 2003 is contained in Table 1 below.

b. Expenses

¹³ TNC 2003 Form 990 available at http://nature.org/aboutus/annualreport/files/irs_form990_2004.pdf.

¹⁴ TNC's fiscal year begins on July 1. Fiscal years 1993 through 2003 include years ended June 30, 1993 through June 30, 2003. A fiscal year is referenced by the year in which it ends, e.g., FY03 references the year beginning July 1, 2002 and ending June 30, 2003. However, the fiscal year does not correspond with the Form 990 year, e.g. FY03 is reported on Form 990 for 2002.

¹⁵ Program service revenue, or exempt function income, is income from program and activities that form the basis for an organization's tax exemption.

TNC's total expenses for fiscal years 1993 through 2003 totaled \$3.8 billion. TNC's total fundraising expenses for the period were \$420 million, which represents approximately 11 percent of TNC's total revenues from contributions and grants during the same period. TNC's program services expenses and management and general expenses increased at a faster rate than its fundraising expenses. A breakdown of TNC's expenses for its fiscal years 1993 through 2003 is contained in Table 11 Part Four of this report.

c. Unrelated business income activities

TNC provided the Committee its Forms 990-T, *Exempt Organization Business Income Tax Return*, for fiscal years 1999 through 2003. Although the Committee did not review any Form 990-T filings made by TNC prior to this period, the Committee did review TNC's unrelated business taxable income information as reported on TNC's Forms 990 for earlier periods. Based on these reports, TNC paid no unrelated business income tax for fiscal years 1993 through 2001, and paid unrelated business income tax ("UBIT") of approximately \$214,000 for fiscal years 2002 and 2003.¹⁶ TNC's unrelated business income tax liability for fiscal years 2002 and 2003 resulted from unrelated debt financed income. TNC reported total unrelated business taxable income of approximately \$664,000 for its fiscal years 1993 through 2003. TNC reported no unrelated business taxable income within the following categories during this 11-year period: (1) capital gain or loss (except for 2002); (2) rent income; (3) other income; or (4) interest, annuities, royalties, and rents from controlled organizations.

The Staff's review of TNC's internal e-mail correspondence regarding unrelated business income activities suggests that TNC adopted a strategy to minimize UBIT reporting with respect to its self-designated Conservation by Design Programs. TNC regularly took the position that income derived from its Trade Lands program (described below) and the performance of management and other services for other exempt organizations and governments was not unrelated.

A comparison of TNC's program service revenues and its unrelated business income, as reported for its fiscal years 1999 through 2003, is contained in Table 14 in Part Four of this report.

C. Summary of Observations and Issues regarding Conservation Programs

TNC is a non-profit organization recognized as a tax-exempt organization under section 501(c)(3) of the Internal Revenue Code. It is classified as a charitable organization because it is organized and operates to promote conservation purposes or environmental conservancy.

As of June 30, 2003, TNC had net assets of \$3.1 billion (\$3.7 billion of assets less \$ 0.6 million in liabilities). As of December 31, 2003, TNC held over 1,600 conservation

¹⁶ The Committee was unable to determine whether TNC paid unrelated business income tax for 1992, because it did not obtain a copy of a Form 990-T for that year.

easements. These easements, valued by TNC at \$800 million, constituted over 22% of TNC's total assets as of June 30, 2004. TNC estimates that approximately \$200 million of stewardship funds are available to enforce its conservation easements.

Although TNC uses many vehicles to accomplish its mission, the Committee focused primarily on the following programs and activities:

1. Conservation Easements
2. Conservation Buyers Program
3. Trade Lands
4. Government Land Sales
5. Emissions Credit Arrangements
6. Joint Ventures

Because TNC reports revenues from some of these activities as contributions and grants on Form 990, Part I, Line 1, Staff was unable to discern dollar amounts associated with each of these above listed activities from review of Forms 990. The following table summarizes the categories of program service revenue TNC reported on its Forms 990, Part VII for the periods indicated.

Table 1
Summary of Program Service Revenue¹⁷
Fiscal Years Ending June 30, 1993 through 2003
(millions of dollars)

Form 990 Year	Activity fees (line 93a)	Contract fees (line 93b)	Government sales (line 93c)	Sale of trade lands	Fees and contracts from govt. agencies (line 93g)	Total program service revenues¹⁸
2002	22.3	4.7	172.6	0	72.8	272.4
2001	23.3	2.5	181.9	2.8	104.6	315.1
2000	35.8	2.0	83.0	0	63.1	183.9
1999	18.2	3.6	81.9	0	60.1	163.8
1998	25.4	1.4	78.6	0	48.5	153.9
1997	14.1	2.3	57.7	0	33.5	107.6
1996	17.8	1.7	44.5	0	40.5	104.5
1995	12.7	2.4	37.9	0	33.3	86.3
1994	7.9	1.7	45.9	0	Data NA	55.5
1993	8.7	1.4	70.0	0	Data NA	83.9

¹⁷ Table 1 includes a summary of Form 990, Part VII for all years listed.

¹⁸ Includes "other revenue" not summarized in this table.

1. Conservation Easements

Observations

A conservation easement is a restriction on the use of property by a landowner who has held and continues to hold the underlying real property. Subjecting suitable properties to conservation easements and enforcing the resulting restrictions is a recognized conservation activity. Conservation organizations further their exempt purpose by creating and accepting contributions of conservation easements. TNC currently holds 1,600 easements.

Enforcement of easements, limiting modifications to appropriate cases, and providing adequate funding to ensure enforcement and proper valuation are important concerns with respect to conservation easements. Organizations are required to enforce, in perpetuity, the terms and conditions of these 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.

During this time, TNC commenced litigation five times to enforce conservation easements during this period. The Staff notes that in at least one case involving a small easement, TNC was reluctant to bear the cost of litigation to enforce to resolve easement disputes.¹⁹ TNC and conservation organizations often must weigh the cost of litigation against the benefit achieved from enforcement. This makes easements, particularly those small in value, difficult to enforce in perpetuity because easement holders may not believe there is a credible threat of litigation.

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.²⁰ During the period 1994 through 2003, TNC agreed to 75 easement modifications.

The Staff's review indicates that TNC's monitoring and enforcement practices were not always consistent with respect to site visits and documentation of these visits. TNC's historical monitoring efforts, based on a relatively small survey (including the additional information volunteered by TNC to the Committee) indicate a level of monitoring that may be considered inadequate for the small conservation easements and minimally adequate for the larger easements. In the cases reviewed by the Staff, TNC's monitoring efforts did not reach the level that is now the standard requirement of TNC

¹⁹ Memo dated April 15, 2004, see Appendix D.

²⁰ Modifications made to correct ministerial or administrative errors are permitted under present law Federal tax law.

for annual monitoring of conservation easements (i.e., current procedures require annual property visits in which the TNC employee prepares a written report, takes photos, and sends a copy of the report to the land owner). Thus, the results, as to the historical monitoring effort by TNC, are mixed and fail to comply with TNC's current standards. In addition, TNC's conservation easement compliance efforts failed to meet the tests established in the Alliance Land Trust Standards and Practices set forth in the LTA Guidebook.

TNC generally does not establish a specific stewardship fund with respect to a specific easement, but instead relies on an aggregate endowment fund for this purpose. The Staff notes that, although an aggregate fund might be preferable to individual stewardship funds in certain circumstances, this practice makes it difficult to determine whether TNC has adequately funded its obligations to enforce the aggregate of the conservation easements in perpetuity. The Staff also notes that it may be more beneficial for conservation organizations to maintain an aggregate fund in order to consolidate resources and hedge risks.

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. A taxpayer may claim a deduction for a qualified conservation contribution of an easement or restriction under section 170(h). Valuation of land generally involves a straightforward process, i.e. willing buyer, willing seller or through comparing 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 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 the benefit that inures to the public.²¹ The difficulty in completing these valuations of conservation easements also poses significant challenges and costs to the IRS in assessing whether the appraisal that formed the basis for a qualified conservation contribution is reasonable.

Issues for Consideration

The Staff recommends that the IRS consider revoking the tax-exempt status of a conservation organization that regularly and continuously fails to monitor and enforce conservation easements. Alternatively, the IRS should suspend tax-deductible contributions to such an organization and require the organization to notify potential donors of such suspension. In addition, the law should permit the IRS to impose excise taxes on officers and directors for failure to adopt and enforce policies to assure the organization satisfies its monitoring and enforcement obligations.

The Staff recommends that the IRS consider modifying Form 990 to require conservation organizations to provide information regarding its ongoing monitoring and

²¹ Treas. Reg. §1.170A-14(h)(3).

enforcement policies and practices. Increased public oversight may provide a greater incentive to watch dog groups and the press to scrutinize the activities of conservation organizations holding conservation easements.

The Staff recommends the implementation of an accreditation system for conservation organizations. This may be a particularly effective means to assure best practices with respect to monitoring and enforcement of easements (as well as compliance with section 170(h) requirements).

The Staff recommends that the Committee consider limiting charitable contribution deductions for certain small easement donations and consider providing the IRS with authority to require pre-approval of tax deductions for such donations.

The Staff recommends that the IRS issue guidance regarding what factors may be necessary to establish minimum levels of compliance regarding monitoring of easements. For example, such regulations may list a number of factors necessary for an adequate monitoring program. These factors may include, by way of example, a stewardship fund dedicated to each easement, periodic written monitoring reports, maintenance of a centralized directory of conservation easements with names and addresses of the owners, and mandatory notification (required by conservation deed) of any sale or other transfer or property subject to a conservation easement.

2. Conservation Buyer Program (CBP)

Observations

The acquisition of land and interests in land, which will be held permanently as conservation lands, is a key activity of many conservation organizations. The Conservation Buyers Program (CBP) is a program by which TNC, or its related organizations, sells interests in land or water rights that are or become subject to a conservation easement or option of conservation easement to persons other than governments or other conservation organizations.²² The CBP allows TNC to promote conservation while minimizing expenditure of its own funds. TNC's CBP program raises concerns regarding valuation of easements, circumvention of partial interest and section 170(h) limitations, donative intent, inurement, private benefit, and excess benefits.

Although TNC used multiple arrangements to complete CBP transactions, all CBP transactions involved the placement of a conservation easement on the property conveyed to the buyer. TNC structured many transactions with buyers to consist of two parts – the purchase of property at restricted value price, and a cash contribution for the additional consideration paid by the buyer to TNC.

TNC conducted approximately 275 CBP program transactions during the period from 1990 to 2005. As of May, 2005, TNC lists 57 properties on its website as CBP

²² TNC Narrative Response dated July 25, 2003, *see* Appendix E.

properties. TNC states that CBP projects are only a small part of its habitat preservation activities.²³ Regardless of size, the program's complexity and innovative nature suggest that the IRS should consider requiring reporting on such activities.

CBP transactions raise the same valuation issues associated with the acquisition of conservation easements by a conservation organization. However, valuation is further complicated when a conservation organization purchases land for resale and that organization's purchase is actually financed by the ultimate buyer of the conservation property by the CBP buyer. Such transactions might be characterized by the conservation organization and the ultimate buyer as a part-gift, part-sale transaction involving a cash contribution and a purchase of property, as was done by TNC and many of its CBP buyers. In many of these transactions, the purported value of the conservation restriction was used by the parties to determine the portion of the aggregate cash payment that the parties will treat as a charitable contribution of cash rather than as purchase price consideration for the acquired property. Thus, even though the parties characterize CBP contributions as cash contributions (rather than as an easement contribution), an accurate valuation of the conservation restrictions imposed on a CBP property is critical to determining the correct amount of any charitable contribution deduction associated with the transaction.²⁴

In addition to the opportunity for abusive valuations and overstated charitable contribution deductions, the Staff is concerned that CBP transactions may provide a means to circumvent the policies and requirements of section 170(h). Transactions that have as a component a cash contribution equal in amount to the value of the conservation restriction placed on the property pursuant to the sale transaction might, in substance, be a contribution of a partial interest, i.e., the conservation easement. However, by classifying the contribution as a cash contribution, rather than a contribution of a qualified conservation easement, the donor may be able to avoid the requirements of section 170(h).²⁵ Such efforts could lead to widespread use of structured transactions designed to provide significant tax benefits to the donor without satisfying the Code's partial interest and section 170(h) limitations. TNC stated in discussions with the Staff on May 31, 2005, that all easements obtained through CBP transactions are subject to 170(h) restrictions.

²³ TNC's Response to *The Washington Post Series*, see Appendix A.

²⁴ The Staff notes that this valuation concern also exists if the transaction is instead treated as involving a conveyance of a conservation easement.

²⁵ For example, a conservation organization might use a CBP transaction to structure a conservation easement for a term of years rather than in perpetuity. It might also structure a contribution of a restriction that does not have a conservation purpose under section 170(h) and take the position that section 170(h) does not apply to prohibit the deduction because the charitable contribution was of cash and not the easement. In other words, the staff is concerned that CBP transactions might be used to generate charitable deductions of cash for the imposition of conservation restrictions that fail to satisfy the conservation purpose, perpetuity, and public benefit requirements applicable to contributions subject to conservation requirements.

CBP transactions also raise donative intent issues. They test the limits of present-law charitable contribution deduction rules because cash amounts paid by the buyers to TNC in the transactions appear to have been a condition of the completion of transactions. In many, if not all, of these cases, it appears that TNC would not have conveyed the property to the buyer without the receipt of cash from that buyer.²⁶ In most cases reviewed by the staff, TNC attempted to be “made whole” with respect to its acquisition and transaction costs by receiving full reimbursement from its CBP buyer. In such cases, the Committee questions whether the cash payment portion of the consideration treated by TNC and the buyer as a donation should be regarded as additional purchase price rather than as a gift or contribution. Absent the requisite donative intent, the portion of the cash consideration treated by the parties as a charitable contribution of cash instead should be characterized as additional purchase price for the acquired property, includible in the buyer’s basis in the property.

Parties to CBP transactions often involved related parties or insiders and, as a result, these transactions might have excess benefit transactions tax consequences to the insiders and TNC’s organization managers. For example, if the portion of consideration paid by the CBP buyer that is allocated to the purchase price (as opposed to the charitable contribution component) is less than the value of the easement-restricted property, an excess benefit (as defined under section 4958) subject to intermediate sanctions excise taxes could accrue to the CBP purchaser.

At least until recently, TNC generally did not make the CBP properties available for purchase by the general public. Moreover, TNC routinely identified specific CBP buyers for particular properties while it was still negotiating the acquisition of the properties. In many instances, TNC and the buyer specifically identified by TNC worked together to structure the parameters of the acquisition and disposition of the property by TNC, taking into account the CBP buyer’s objectives and interests with respect to the property. A practice that generally excludes the general public from being available to acquire the CBP program properties from TNC, and involves the potential CBP buyer in the process of TNC’s acquisition of the property for disposition to that particular buyer, raises potential private benefit issues. The Committee questions whether this practice allowed TNC to receive the optimal sales price for easement-restricted properties (i.e., a member of the public might have paid more than an insider to acquire a property). In addition, conservation restrictions in certain situations permitted CBP buyers to construct large new homes, swimming pools and tennis courts on the restricted property.

Documentation TNC provided to the Committee indicates that TNC did not exercise adequate due diligence to ascertain the consequences that regularly conducting such extensive activities might have on TNC’s exempt status. TNC sought outside counsel’s advice with respect to the general tax consequences to the donor of CBP transactions from Steptoe & Johnson in 1992 (updated in 1997), and, in effect, conducted

²⁶ For example, Letter from Kaledin to Shelter Island Town Counsel, *see* Appendix O.

hundreds of CBP transactions on the basis of that advice.²⁷ TNC also obtained written advice regarding CBP transactions from Jerry McCoy, Attorney-At-Law, but not until January 2003. These opinions did not analyze donative intent, potential circumvention of section 170(h), or private benefit and, in most cases, did not analyze substance of the arrangements. Further, these opinions did not focus on conservation purposes or the consequences to TNC, but rather focused on charitable deduction issues for the CBP buyer.

Prior to completing some CBP transactions, TNC discussed tax planning strategies with CBP buyers, sometimes at great length. In some cases, TNC considered using variants of the traditional CBP approach to assist CBP buyers in their tax planning strategies to ensure CBP buyers received maximum tax benefits.²⁸ In at least one case, TNC represented that a conservation easement would greatly lower the value of property and that reductions of up to 70% were not uncommon.²⁹

Issues for Consideration

The Staff recommends that TNC and other conservation organizations that conduct programs of this nature exercise due diligence with respect to compliance with Federal income tax laws. They should take steps to reasonably conclude that they are not (a) jeopardizing their exempt status, or (b) assisting, aiding or abetting others in the avoidance or evasion of taxes through improper charitable contribution deductions. If they do not have adequate internal resources to assist them in these efforts, they should obtain tax advice from independent and competent outside counsel with respect to the conduct of such activities, and when appropriate, seek determinations or rulings from the IRS regarding the tax consequences of such activities.

Programs such as the CBP that are regularly and systematically conducted by a conservation organization, and that affect significant assets of an organization, should be subject to a formal analysis and review that takes into account actual rather than hypothetical facts, and rigorously applies all relevant law to the material facts. Tax opinions used to promote charitable deductions should be subject to sanctions to be imposed on the provider of an inadequate opinion, the organization that solicited and obtained the opinion, and any donors who relied on such opinion to support the claimed charitable deduction.

²⁷ See Appendix F for tax opinions and advice TNC provided regarding conservation easement and conservation buyer transactions.

²⁸ See Appendix F for Ernst & Young LLP opinion dated August 23, 1999 (regarding combined use of §1031 like-kind exchange with §170(h) qualified conservation contribution; Steptoe & Johnson opinion dated June 7, 2001 (regarding formation of a limited liability company with CBP buyer as a member to effect transfer of land and easement to the LLC); Holland & Hart opinion dated October 26, 2001 (regarding TNC's use of §1031 "parking arrangements" involving CBP properties).

²⁹ Letter dated October 3, 2000 from TNC to Chi-Mac partnership, see Appendix P.

The Staff recommends that conservation organizations that conduct programs similar to TNC's CBP adopt governance practices that require the organization to make properties available for sale to the general public to assure the organization received the optimal sales price taking into account conservation objectives. The Committee commends TNC for including this practice in its revised CBP policies.

The Staff recommends, as a follow-up to IRS Notice 2004-41, that the IRS (a) continue to review the law applicable to programs of this nature, and (b) conduct a comprehensive review of any similar programs conducted by other conservation organizations in order to determine the extent of potential noncompliance with respect to section 170 and exempt organization laws relating to such types of alleged charitable contributions. Specifically, the Committee invites the IRS to revisit the guidance it issued in Revenue Rulings 67-246 and 76-185 (and related pronouncements) to determine whether such rulings should be revised to emphasize the requirement of donative intent, and to eliminate any implication that a taxpayer is entitled to deduct the excess of the amount he or she paid to a charity over the fair market value of the acquired item, without regard to the purchaser's intent (donative or otherwise) with respect to the excess payment.

The Staff recommends that Congress amend section 170(h) to insure that it applies to all conservation easements obtained through conservation buyer transactions. This would ensure that donors do not avoid the conservation requirements of 170(h) or the partial interest rules by structuring a portion of the transaction as a contribution of cash.

3. Emissions Credit Arrangements

Observations

TNC participated in eight (8) emissions credit or allowance arrangements from 1995 through 2004, involving \$34 million of cash payments made by financial participants to TNC under the various agreement. TNC is currently involved in promoting two additional emissions credit projects. TNC reports payments under these agreements as contribution revenues.

Under a typical "cap and trade" program for certain emissions allowances, "[a] government establishes a target for the amount of emissions during a compliance period. Based on the targeted emissions, the government allocates emissions allowances that give a participant in the plan the right to emit a specified amount of gases (for example, a ton of carbon dioxide). Participation in the program may be voluntary or compulsory. Participants may be allocated allowances free of charge, or they may be required to purchase allowances from the government (for example, through government auctions). Programs operate over a compliance period, and allowances are allocated (or auctioned) to the participants at the beginning of the compliance period. During the period,

participants may buy or sell allowances directly with other participants or, depending on market sophistication, through a broker or on an exchange.”³⁰

“At the end of a compliance period, the participant must deliver emissions allowances equal to its actual emissions. If a participant fails to deliver the required allowances, it may be required to pay fines (or receive a smaller financial incentive) and it may receive a smaller allocation of emissions allowances in the future. In some cases, unused (or excess) allowances may be carried forward to future compliance periods.”³¹

“For a compliance period, a participant has three options:

- It may emit gases to the level of its allocated allowances.
- It may emit gases to a lower level than is represented by the allocated allowances and it may sell or bank the excess allowances.
- It may emit gases to a higher level than is represented by the allocated allowances and either buy additional allowances or pay a penalty.”³²

“In the extreme, a participant may sell all of its allowances at the beginning of the compliance period with the expectation of either (a) buying allowances to cover emissions at a later date or (b) ceasing gas emissions. Brokers and other nonparticipants typically may buy and sell emissions allowances. The participation of these other parties may increase the liquidity of the market for the allowances.”³³

TNC’s emissions credit arrangements provide financial participants with the right to receive potential emissions credits or allowances in exchange for cash provided to TNC for a conservation project. In each of TNC’s arrangements, 100% of the emissions credits or allowances accrue to the for-profit entities so that TNC does not receive or retain any of these potential benefits. As a result, the Staff questions: (a) whether the for-profit participants obtained an impermissible private benefit as a result of the arrangements; (b) whether TNC owned the emissions credits or allowances and thus was required to receive fair market value for their current or future transfer to and use by the for-profit participants; (c) whether excess benefit rules should apply to these arrangements if disqualified persons were involved; (d) whether income from such arrangements should be classified as income from a joint venture or as a management fee (for managing a conservation or emissions reduction project) rather than as a

³⁰ Emerging Issues Task Force (EITF), Issue 03-14, *Participant’s Accounting for Emissions Allowances under a “Cap and Trade” Program*. (In addition to members of the Financial Accounting Standards Board (FASB), the EITF consists of auditors, preparers and users of financial statements. Its mission is to assist the FASB in improving financial reporting through the timely identification, discussion, and resolution of financial accounting issues within the framework of existing authoritative literature. See http://www.fasb.org/eitf/about_eitf.shtml.)

³¹ Id.

³² Id.

³³ Id.

contribution; (e) whether the arrangements should be regarded as the conduct by TNC of an unrelated trade or business; (f) what the tax consequences are to the participants with respect to amounts paid by the for-profit participants to fund the projects; and (g) what the tax consequences are to the for-profit participants if and when they (rather than TNC) receive the emissions credits or allowances.

Emissions credit and allowance arrangements are innovative and unusual, even for for-profit participants. These arrangements raise new issues with respect to financial accounting, tax, and commodities exchange regulations. The IRS, Securities and Exchange Commission and the Environmental Protection Agency do not have regulations or guidelines for accounting, monitoring or regulating such arrangements. TNC did not seek the advice of outside counsel or obtain a ruling from the IRS for any of these eight transactions. As a result, the Staff questions whether TNC exercised due diligence in considering its tax consequences before participating in these arrangements.

TNC “actively markets” these projects to potential participants.³⁴ The Staff did not determine whether TNC approached, or was approached by, more than one participant with respect to any individual emissions arrangement, or whether TNC negotiated the best deal it could pursuant to these arrangements.

The Staff questions whether these transactions are consistent with TNC’s exempt purpose. Emissions credits essentially increase the amount by which the for-profit participant can emit pollutants. While furthering one exempt purpose, i.e. the preservation of land, TNC’s assignment to the for-profit participant of potential credits (as opposed to TNC’s retaining and retiring them), would appear to frustrate an environmental purpose – the reduction of greenhouse gases. TNC’s transferring of potential credits to the for-profit participant presumably permits such participants to maintain their current emissions levels, or in the worst case, actually increase their emissions levels. In other words, the Staff questions whether TNC is furthering one exempt purpose, i.e., land conservation while frustrating another, i.e., the reduction of greenhouse gases.

At present, certain emissions credits are nearly impossible to value as there appears to be no regulated market for them. This also makes it difficult to determine whether TNC received adequate consideration for contractually assigning such rights to the for-profit entity. The Staff did not investigate or otherwise determine how the for-profit participants account for or report for tax purposes their financial commitments in these arrangements.

Issues for Consideration

The Staff recommends that, at a minimum, TNC and other organizations participating in emissions credits arrangements obtain tax advice from independent and competent outside counsel with respect to the conduct of such activities. They should

³⁴ TNC Narrative Response dated April 21, 2005, *see* Appendix H.

also seek determinations or rulings from the IRS regarding the tax consequences of such activities. The number of emissions credit transactions conducted by TNC, combined with the complex and innovative nature of the arrangements and the tax issues pertaining to such arrangements, impose a duty on TNC to seek and obtain a formal analysis and review of the tax consequences of the arrangements that takes into account the particular facts of each arrangement, and rigorously applies all relevant law to the material facts.

The Staff recommends that Federal and State securities or commodities regulators determine whether the development and promotion of such transactions are subject to, or should be made subject to, Federal and State securities or commodities laws.

The Staff recommends that the IRS commence a review of emissions credit arrangements to determine the extent to which they are being conducted by exempt organizations, and to provide guidance to exempt organizations with respect to the tax consequences of such arrangements. The Staff notes that by reporting these payments as contribution revenue on Form 990, Line 1, TNC avoided having to fully describe these transactions elsewhere on its Form 990.

The Staff recommends the IRS consider making Schedule B information more easily available for public inspection. Because TNC reported payments from financial participants under these arrangements as contributions, they may have been subject to Schedule B requirements. Large transactions such as this should not escape the scrutiny of the public.

4. Joint Ventures³⁵

Observations

Tax-exempt organizations are increasingly participating in joint ventures to fund their exempt activities. Because Congress has only enacted legislation governing certain types of joint ventures and investments (e.g., low-income housing credits), the IRS and the courts have attempted to establish and interpret law generally applicable to such arrangements, including the application of the exempt status and unrelated business income tax rules to such arrangements.

The Staff reviewed two joint ventures that TNC established. With respect to the first venture, Conservation Beef, LLC, the material TNC provided to the Committee did not indicate that TNC exercised due diligence with respect to determining the tax consequences of its participation in such a venture. In contrast, for the second venture,

³⁵ Although the Staff refrains from characterizing the TNC emissions credit and allowance arrangements as joint ventures for purposes of this Report, in order not to prejudge the characterization of those arrangements for Federal income tax purposes, the Staff notes that many of the issues pertaining to those arrangements are similar to arrangements involving joint ventures between exempt organizations and for-profit investors.

Forest Bank, LLC, TNC obtained the opinion of independent tax counsel, and obtained a private letter ruling from the IRS, that were included in the securities offering materials relating to this project. This process helped TNC identify and resolve material Federal tax issues pertaining to the project.

TNC's involvement in both ventures was unsuccessful. TNC withdrew from Conservation Beef, LLC for reasons not disclosed to the Committee. TNC abandoned Forest Bank, LLC because it was unable to secure private funding.

The Form 990 does not require an organization to provide meaningful information regarding its participation in joint ventures. In many cases, the most important concerns regarding joint ventures among exempt organizations and for-profit investors involve arrangements in which the exempt organization possesses a minority interest and lacks control of the venture's activities and governance. Yet, Part IX of the Form 990 presently only requires the reporting organization to list investments or entities (corporations, partnerships, or limited liability companies) in which the organization owns at least 50%.

Issues for Consideration

The Staff recommends that TNC and other exempt organizations exercise due diligence with respect to analyzing tax consequences of joint ventures regardless of whether the venture will be subject to securities laws.

The Staff recommends that the IRS consider modifying Form 990 to require more detail on joint ventures involving capital contributions, funding commitments, or assets of the exempt organization that exceed a certain amount. Descriptions should clearly state the nature of the joint venture activity, whether it is an unrelated trade or business or an exempt activity (and if applicable, how the venture furthers the organization's exempt purposes), the exempt organization's capital contributions and funding obligations with respect to the joint venture, the type of State law entity or other arrangement, and the identities and respective ownership interests of the parties participating in the joint venture.

The Staff recommends that the IRS consider modifying Form 990 to require reporting on joint ventures in which exempt organizations own a 50% or less interest.

5. Tax Planning regarding Conservation Easements & Conservation Buyer Program

Observations

The Staff reviewed 26 written opinions providing advice to TNC regarding conservation easements and CBP transactions. While the Staff does not believe exempt organizations should always obtain the advice of outside tax advisors, it also believes it is prudent for an organization such as TNC to do so with respect to many of its activities. Given TNC's size and innovative approaches as well as the complexity of many of its programs and activities, the Staff expected TNC to have much more documentation

regarding the tax impact of participating in and conducting its various programs and activities. TNC obtained 26 written opinions by outside tax counsel over a period of 12 years – an average of slightly over two opinions per year.

Further, the Staff notes that when TNC did in fact obtain written opinions or other tax advice from outside advisors, such opinions often addressed the tax implications to other parties to a transaction rather than the impact to TNC's tax-exempt status or UBIT liability. The Staff questions whether present tax laws provide adequate incentives for exempt organizations to exercise due diligence in satisfying its own reporting and UBIT payment obligations. Also, the propriety of using TNC funds to pay for tax advice that directly benefits other parties to the transactions should be considered.³⁶

Issues for Consideration

The Staff recommends that TNC consider whether programs and activities might negatively affect its tax exempt status when seeking the advice from outside advisors.

The Staff recommends that the cost of tax advice obtained by an exempt organization for the benefit of a specific individual be borne by those who benefit, rather than by the exempt organization.

D. Observations and Issues regarding Fundraising & Charitable Contributions

Observations

TNC raised \$3.7 billion of contributions during fiscal years 1993 through 2003. This accounted for 61% of TNC's total revenues during this period. Of this amount, \$2.6 billion was from cash contributions, and \$1.1 billion was from contributions of property other than cash.

TNC accepts a variety of non-cash gifts, including goods and services.³⁷ On its website, TNC explains that there are three types of contributed goods and services: (1) tangible personal property gifts that TNC intends to sell (e.g., a piece of jewelry from an estate, artwork, or rare stamps and coins); (2) in-kind goods (goods TNC intends to use, such as equipment, computer software, or a truck that is used to build a shelter); and (3) in-kind services (such as pro bono legal or other professional services donated to TNC).

³⁶ For a discussion of some of the issues relating to tax planning consulting made available by charitable organizations to prospective donors, see Bruce R. Hopkins, *The Law of Tax-Exempt Organizations*, 8th ed. pp. 813-14 (noting that the provision of tax planning information and services by charitable organizations to prospective contributors is considered, at least by some courts, to be the provision of impermissible private benefit; Hopkins states that while it "would seem nearly inconceivable to seriously contend that, when a charitable organization works with a prospective donor to effect a sizable gift that will generate significant tax and other advantages for the donor, by reason of a charitable contribution deduction and other benefits, the organization is imperiling its tax exemption because it is conferring a private benefit, this is the import of three court opinions").

³⁷ A charitable deduction is not allowed for the donation of services to a charitable organization.

TNC explains that it accepts two types of land as donations: natural areas that become preserves, and trade lands that are not ecologically significant but that are sold to acquire additional land. Trade land properties include condominiums, vacation homes, personal residences, commercial properties, and farms.³⁸ TNC also encourages and accepts gifts of long-term appreciated stock or mutual funds, describing such gifts as a “quick, easy, and tax-efficient” way to support TNC, avoid capital gains tax, and receive an income tax deduction.

On its website, TNC describes various gift options for its donors as: (1) bequests; (2) life-income gifts (e.g., exchanging securities or real estate for the right to receive income for life or a term of years); (3) naming TNC as a beneficiary of a retirement plan, insurance policy, or financial account; (4) gifts of outright securities or real estate; (5) retained life estate gifts that allow the donor to use the property for his or her life; (6) donor advised funds; and (7) charitable lead trusts that provide annual income to TNC for a period of years, with the principal transferring to the donor’s beneficiaries after the period ends. As of March 31, 2005, the value of assets held in TNC’s donor advised funds was \$4,318,144.³⁹

For the period 1991 to 2002, TNC reported fundraising expenses of \$420 million, or approximately 11% of the total contributions reported for this period. TNC’s fundraising expenses as a percentage of annual contributions ranged from a low of 9% to a high of 15% during this period.

1. Fundraising

a. Trade Lands

Observations

Through its Trade Lands program, TNC regularly solicited and received contributions of land that did not have a conservation purpose. TNC sold the donated Trade Lands properties to raise cash to fund charitable and other activities. On average, from 1981 through 2003, TNC received \$8 to \$10 million per year from trade land sales. TNC engaged in 287 trade lands program transactions during the period July 1, 1997 through June 30, 2002 (approximately 58 transactions per year).

A donee’s cost basis in donated property is generally carryover, i.e. the donor’s basis, unless the donation comprises loss property in which case the donee’s basis is limited to fair market value at the time of the gift.⁴⁰ Under section 170, taxpayers have

³⁸ On its website, TNC notes that trade land gifts allow the donor to avoid capital gains taxation and receive an income tax deduction, and explains that the donor makes the gift with the explicit understanding it will be sold.

³⁹ TNC Narrative Response dated May 4, 2005, *see* Appendix I.

⁴⁰ Treas. Reg. §1.1015-1.

an incentive to donate appreciated property and avoid recognition of the realized gain because the charitable contribution deduction would equal fair market value. In contrast, taxpayers have an incentive to sell depreciated property and recognize the loss because the charitable contribution deduction is limited to fair market value when basis exceeds fair market value. At the margin, these rules may encourage taxpayers to inflate the claimed value of certain properties without any concomitant cost to the donee.

TNC received promissory notes for all or a portion of the sales price in a number of trade lands program sales. In some cases, TNC charged no interest or below market interest rates with respect to such loans. The Staff questions whether TNC's extension of credit at zero or below market interest rates resulted in private benefit to certain trade lands program buyers.

TNC provided various e-mail communications which indicate that TNC was aware that the Trade Lands program could result in UBIT liability, but did not report Trade Lands income as unrelated business income.⁴¹ The Staff notes the systematic solicitation, acquisition, and sale of non-exempt use property, e.g. trade lands, is a fundraising technique used by many organizations.

Issues for Consideration

The Staff recommends that Congress and the IRS consider whether current UBIT rules adequately address the regular and continuous solicitation, acquisition and sale of non-charitable use property.

The Staff recommends that IRS consider reviewing the extent to which charitable organizations raise funds through the systematic solicitation, acquisition, and sale of non-exempt use property and provide guidance on the applicability of the unrelated trade or business income tax and other laws to such fundraising activities.

b. Donor Advised Funds

The Staff reviewed the following with respect to TNC's donor advised funds: DAF Procedures (for internal staff), Protocol for Distributions (for internal staff and donors) and Memorandum of Understanding (for potential donors). The Committee notes that these documents indicate that TNC has instituted significant policies and procedures to ensure the assets are used for charitable purposes rather than to benefit the original donors. The Committee commends TNC for its leadership in this area.

2. Reporting of Non-Cash Charitable Contributions

Taxpayers must submit a Form 8283 to the donee organization for acknowledgement of receipt of noncash contributions greater than \$500. The donee organization must return the signed form to the donor before the donor can claim a

⁴¹ See Appendix L.

deduction for the contribution. Prior to submitting to the donee for signature, the taxpayer must provide the taxpayer's name and identifying number along with a description of the donated property.

The Staff reviewed Forms 8283 and 8282 provided by TNC with respect to various transactions and notes that many of these forms were inaccurate or incomplete. The Staff notes, however, that the IRS imposes minimal requirements on donee organizations. The Staff commends TNC for adopting revised policies regarding reporting of these forms.

Issues for Consideration

The Staff recommends that the IRS consider imposing reporting requirements on donee organizations consistent with TNC's reforms.

The Staff notes that the IRS has not updated this Form since 1998 and recommends that the IRS update this Form to insure that donors complete these accurately.

The Staff recommends that the Committee and IRS consider imposing penalties on donee organizations that sign these Forms when they are incomplete.

3. Valuation

Observations

TNC receives more than sixty trade lands and conservation easements each year and engages in approximately 25 CBP transactions, each year. In addition, TNC receives contributions of other real and personal property, including automobiles, artwork, jewelry, and securities. With the exception of publicly traded securities, an estimate of value must be made for each such contribution. An appraisal is required for each contribution claimed of at least \$5,000. The need for accurate appraisals in order to assure that donors claim the appropriate amounts for their charitable deductions is evident.

The Staff is concerned about valuation abuses and difficulties as it relates to noncash contributions in general. The Staff is concerned about the potential abuse of the appraisal method utilizing the "subdivision development" analysis for contributions of conservation easements. This method calculates the value of the property before and after conservation restrictions based on the premise that the property would have been more valuable had it been subdivided and sold, without regard to the likelihood that the property would have been subdivided.

Issues for Consideration

The Staff recommends that Congress, the IRS, and the Treasury Department review the *McLennan* decision⁴² and consider whether use of the “subdivision development analysis” method of valuation should be restricted or barred for valuations of certain conservation easements subject to section 170(h).⁴³

The Staff recommends that the IRS, Treasury and Congress continue to explore other means to improve the accuracy of appraisals used to determine Federal income tax consequences.

E. Observations and Issues regarding IRS Reporting & Public Disclosure Requirements

Observations

1. Form 990

TNC’s corporate structure changed significantly from fiscal years 1993 through 2003. On its 1992 Form 990, TNC reported no taxable subsidiaries (corporate or partnership).⁴⁴ On its 2001 Form 990, TNC reported nine taxable subsidiaries or disregarded entities. On its 1992 Form 990, TNC reported that it was related through common membership, governing bodies, trustees, officers, or otherwise with only one organization - The Nature Conservancy Action Fund. On its 2001 Form 990, TNC reported 16 organizations with which it had relationships of common control. These

⁴² An appropriate starting point may be *McLennan v. U.S.*, 24 Cl. Ct. 102 (1991), where the Court of Claims found that the “highest and best use” referred not only to the potential use of the property but also to the property’s likely use. In other words, the court looked at whether or not the taxpayer had any actual intent to develop the property in considering the value of the conservation restriction. The potential strengths of such a method include addressing situations where taxpayers may be claiming a diminution in value for restrictions that have the potential to actually increase the value for the taxpayer. The weaknesses of such an approach include the fact that the method does not take into account the permanent nature of such easement restrictions and their affect of future holders of the land. The Court decided that the highest and best use refers to “the most profitable and probable use” of the property. Although the property could be subdivided into eight parcels, the taxpayer’s “strong aversion to development” meant that a valuation based on an assumption of subdividing the entire property was “untenable” and “directly contradicts [taxpayers’] clear intention to preserve their land from development”. The court also found that the reasonable and probable use of the property was as an undivided country estate, not as a subdivision, and that the easement did not affect the highest and best use of the land.

⁴³ See Nancy A. McLaughlin, *Increasing the Tax Incentives for Conservation Easement Donations – A Responsible Approach*, 31 Ecology L.Q. 1, 78-81 (2004) (discussing the growing use of the “subdivision development analysis,” which generally bases the value of the property by reference to acquiring the property for subdivision and development as commercial or residential uses, to inflate the before-easement value in a conservation easement appraisal).

⁴⁴ TNC included 20 controlled nonprofit entities on its Form 990 for 1992 on the basis that they were controlled title holding corporations. TNC continues to own and control most of these entities, although TNC has ceased reporting the entities in its Form 990 on a consolidated basis.

figures do not include ownership interests in any for-profit corporations, partnerships, or limited liability companies in which TNC owns less than a majority interest.⁴⁵

TNC took the position that the reporting requirements relating to activities, relationships, or the accomplishment of exempt purposes did not require TNC to disclose and describe to the IRS certain of its activities, e.g., its Conservation Beef, LLC joint venture activities, its Virginia Eastern Shore development activities, its tradable emissions credit arrangements with various for-profit entities regarding its South American conservation projects, or its oil drilling activities in Texas.

TNC's reporting of its program service accomplishments, and the relationship of its activities to the accomplishment of its exempt purposes, appears to be deficient. Its disclosure with respect to transactions with TNC board members (or affiliates of TNC board members) was oftentimes ambiguous or incomplete, and in a few instances, misleading. TNC's reporting with respect to its relationships with affiliated organizations, taxable subsidiaries, and disregarded entities, can be described as inconsistent from year to year.

At least one of TNC's possible reporting deficiencies perhaps can be attributed to a combination of a lack of clear guidance and TNC's reporting attitudes. TNC's reporting with respect to noncontrolling interests it held in limited liability companies and limited partnerships could have been improved by identifying each of the investment entities in which TNC held interests, listing the percentage interests held by TNC in such entities, and reporting the amount of TNC's investment in each such entity, rather than combining them all as a single line item called "investments in limited liability companies" or "investments in limited partnerships." In many respects, the disclosure of information regarding investments or joint ventures in which an exempt organization lacks a controlling interest is even more critical than in those instances where it possesses the controlling interest. In such cases, the exempt organization's lack of control may enhance the risk of loss of exempt status or implicate other exempt organization tax law concerns.

TNC's reporting for the fiscal year ended June 30, 2003, its first Form 990 filed after commencement of this investigation, was not materially different from its earlier reporting.

The Staff notes existing reporting requirements and practices do not require organizations to provide meaningful disclosure regarding activities such as monitoring

⁴⁵ The Form 990 reporting requirements do not obligate exempt organizations to disclose such ownership interests, other than to describe the activity if it constitutes a significant or material change in an activity and such change has not previously been reported to the IRS, or to include them as investments for purposes of the Form 990 balance sheet reporting. For example, in TNC's Form 990 balance sheet for 2001, TNC reported as investments its holdings in real estate trusts (endowments), life income trusts, limited liability companies, a life insurance policy, and limited partnerships. TNC reported that its investments in limited liability companies and limited partnerships totaled \$448,180 as of June 30, 2002. TNC did not provide detail regarding such investments.

and enforcement of easements, TNC's conservation buyer program, joint ventures and emissions credits arrangements.

Issues for Consideration

The Staff believes that present reporting requirements with respect to reporting of material changes in structure and operations must be revised to provide bright line rules that an organization may use to determine when and whether it must report such changes. Such reporting enhancements should address changes to existing activities and operations, as well as the establishment of new activities and programs.

The Staff recommends that the ongoing IRS review of the Form 990 consider improved reporting requirements with respect to program services revenues of the organization. Consideration should be given to requiring large organizations such as TNC to provide more detail than is presently required with respect to the organization's largest programs, and to provide summary detail regarding programs that are not considered to be its largest programs but that are innovative in nature or substantial in size.

The Staff recommends that reporting requirements with respect to insider deals be strengthened to require a more complete picture of the transaction or arrangement, including a description of compliance with the organization's applicable conflict of interest procedures.

The Staff recommends that reporting requirements with regard to related organizations, whether exempt or nonexempt, be improved to require information regarding ownership and control, nature of the activities conducted by the related organization, capitalization, and a description of material contractual, or financial arrangements between the exempt organization and its related organization.

2. Form 990-T

Observations

The Staff provides its observations and issues for consideration regarding TNC's trade lands program above.

TNC's unrelated business income tax planning strategy categorically treated income from other 501(c)(3) organizations as related income without conducting a formal legal analysis of the facts of each arrangement. TNC directed its employees to be aggressive when considering whether income from "Conservation by Design" activities was related income. It 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.

TNC's e-mails and memos regarding UBIT suggest that TNC closely analyzed certain activities (e.g., travel tours and merchandising), conducted no analysis for others

(e.g., emissions credits, Conservation Beef, LLC) and conducted incomplete analysis for others (e.g., trade lands, timber sales, consulting fees).

TNC's e-mails suggest that TNC's strategy may be to concede UBIT on activities that do not generate significant revenue in order to provide credibility and leverage with the IRS on activities that generate more significant revenue.

TNC's e-mails suggest that, in some instances, it did not report revenues from certain activities as unrelated income because it was not material in amount. The Staff notes that the Code requires all income to be reported regardless of dollar amount.⁴⁶

The Staff believes that current UBIT reporting requirements and practices do not enable the IRS to adequately assess an exempt organization's UBIT liability. This may cause exempt organizations to play the audit lottery. As with for-profit corporations, inadequate reporting and enforcement often leads to less compliance and contributes to the tax gap.

TNC's UBIT analysis and e-mails reviewed by Staff did not address the general rule that income from services provided by an exempt organization to an unrelated exempt organization is unrelated business income.

Issues for Consideration

The Staff recommends that TNC conduct comprehensive legal analysis similar to that conducted for the four travel tour programs for all activities that may potentially generate unrelated business income.

The Staff recommends that the IRS review UBIT reporting requirements and current enforcement practices to strengthen compliance with current UBIT laws.

The Staff recommends the Committee consider adoption of the Joint Committee on Taxation's recommendations for UBIT certification for certain large organizations. Form 990-T reporting rules must be revamped to assure that all material activities of an organization are disclosed to the IRS and the public. This is especially important as many exempt organizations increasingly may resemble for-profit businesses in their activities and the manner in which they conduct them.

F. Observations and Issues regarding TNC Reforms

Observations

TNC undertook a significant review of its conflict of interest policy and other operating policies and procedures to determine how to improve its governance, transparency, and accountability. In addition, TNC made specific changes to its

⁴⁶ Organizations must file Form 990-T when gross revenues from unrelated activities exceeds \$1,000.

procedures that are designed to improve TNC's compliance with Federal tax reporting and substantiation requirements, including with respect to contributions of noncash property (e.g., land, interests in land, conservation easements).

TNC's efforts and reforms should significantly improve the scrutiny of insider transactions, and prohibit certain types of transactions that came to light in May 2003. While the Staff commends TNC for its quick and comprehensive actions, the Staff remains concerned that TNC's involvement in emissions credit arrangements, joint ventures, and similar arrangements, may escape review under TNC's revised policies.

The Staff notes that TNC's preference to deal with insiders to acquire CBP properties likely made it easier for the parties to structure and document the transactions as separate sale and contribution components, to support the CBP buyer's charitable deduction claim.⁴⁷

The aggregate of the revised or newly implemented policies do not require Board of Governors approval with respect to joint ventures or corporate investments in which TNC does not have a 50-percent or more controlling interest.⁴⁸ Although possessing a controlling interest often is an important consideration for financial reporting purposes, and generally triggers enhanced or special reporting with respect to organizations controlled by the reporting organization, the *absence* of control by an exempt organization (such as TNC) over a joint venture or related organization often causes the greatest concern for Federal tax purposes. A partnership, joint venture, or corporation in which TNC owns less than a controlling interest, is more likely to require additional safeguards, such as through contractual arrangements with TNC's co-venturers, than an investment in which TNC may dictate overall management and day-to-day operations, thereby providing TNC the ability to ensure that its charitable mission is furthered and other exempt organization laws are satisfied.

TNC's revised or newly implemented policies do not specifically address emissions credit arrangements in cases where the arrangement is between TNC and a company that has a relationship with a member of TNC's Board. An emissions or similar arrangement does not seem to be described within TNC's Related Organizations Policy,

⁴⁷ For example, in the Shelter Island transaction discussed in Part Three of this report, neither the Pledge Agreement nor the Purchase Agreement involving the related party referred to the other agreement. Given TNC's insistence that it recover its full acquisition and transaction costs from the buyer in this and similar transactions, it is difficult to imagine that TNC would document such components separately without legally conditioning one on the other, unless it had sufficient comfort that the buyer would honor the pledge even though the purchase and pledge agreements did not refer to each other. TNC's longstanding relationship with the related party provided such comfort to TNC. A breach of the pledge agreement by this party would have jeopardized his stature with TNC and the conservation community. Such comfort likely would not have existed if the buyer had been a member of the general public with whom TNC had no relationship.

⁴⁸ TNC's Related Organizations Policy requires approval for more than 50 percent partnership or joint venture arrangements, and other organizations in which TNC controls the organization.

because it is not structured (at least in form) as an entity or joint venture in which TNC and others have equity investments or membership interests.

Issues for Consideration

The Staff recommends that TNC amend its related organizations policy, or establish a separate noncontrolling interest policy, to address those situations in which TNC may own less than a controlling interest in a partnership, joint venture or corporation.

The Staff recommends that TNC adopt a policy that requires Board of Governors approval for emissions credit arrangements and other similar arrangements in which no formal equity interest in an entity is acquired or issued.

The Staff recommends that the IRS and the Committee consider overall changes to the reporting of insider deals by exempt organizations. Such changes might include:

1) Certain transactions with Board members or affiliates of Board members be accompanied by a determination that the transaction is fair and reasonable to the exempt organization. This determination should be supported by an appraisal or fairness opinion provided by an independent expert, unless the determination is obvious on its face. A copy of such determination and supporting documentation should be posted on the organization's website and noted in the organization's Form 990 filings;

2) Certain transactions with a Board member or affiliate of a Board member be accompanied by an opinion of independent legal counsel (1) concluding that the exempt organization's internal conflicts of interest policy has been satisfied; and (2) describing the material tax consequences to the exempt organization under Federal income tax laws;

3) Agreements between an exempt organization and its Board members or affiliates of Board members, as well as copies of the agreements should be made public on the organization's website. A complete and accurate description of the agreement should also be disclosed in the Form 990, and a notation that a copy of the agreement is available on the organization's website should also be disclosed on the Form 990; and,

4) An organization's press releases pertaining to a transaction or arrangement with a Board member or affiliate of a Board member should include a statement describing the relationship between the exempt organization and the contracting party.



PART ONE - OVERVIEW OF APPLICABLE EXEMPT ORGANIZATIONS LAW

The Staff compiled the following discussion of present law governing charitable organizations primarily from documents or publications prepared by the Staff of the Joint Committee on Taxation.¹

a. Exemption requirements

1. Exempt purposes and dedication of assets for charitable purposes

In general

Organizations described in section 501(c)(3) (generally “charitable organizations” or “charities”) generally are exempt from Federal income tax and are eligible to receive tax-deductible contributions. A charitable organization must be organized and operate exclusively to further one or more tax-exempt purposes constituting the basis of its tax exemption. Section 501(c)(3) organizations are classified either as “public charities” or “private foundations.”² A charitable organization may lose its exemption for various reasons, including failure to operate exclusively for exempt purposes, impermissible private inurement or private benefit, political campaign activities, and substantial nonexempt business or lobbying activities.

Conservation and environmental protection as a charitable purpose

An organization that is organized and operates to promote conservation purposes or environmental conservancy may qualify for exempt status as a charitable organization. The IRS has issued several revenue rulings in this area.³

In Revenue Ruling 76-204, the IRS ruled that efforts to preserve and protect the natural environment for the benefit of the public serve a charitable purpose.⁴ The organization in that

¹ See *Description Of Present Law Relating To Charitable And Other Exempt Organizations And Statistical Information Regarding Growth And Oversight Of The Tax-Exempt Sector*, June 22, 2004 available at <http://www.house.gov/jct/x-44-04.pdf>, *Historical Development And Present Law Of The Federal Tax Exemption For Charities And Other Tax-Exempt Organizations*, April 19, 2005 available at <http://www.house.gov/jct/x-29-05.pdf>, and *Options To Improve Tax Compliance And Reform Tax Expenditures*, January 27, 2005 (Part VII) available at <http://www.house.gov/jct/s-2-05.pdf>.

² Sec. 509(a). The phrase “public charity” is not defined in the Code, but generally refers to a charitable organization described in section 501(c)(3) that is not a private foundation. In general, private foundations are subject to special rules (such as reporting requirements, excise tax rules, and charitable deduction limitations) that do not apply to public charities.

³ *E.g.*, Rev. Rul. 67-292, 1967-1 C.B. 184 (ruling that an organization formed for the purpose of purchasing and maintaining a sanctuary for wild birds and animals for the benefit of the public may qualify as a charitable organization); Rev. Rul. 70-186, 1970-1 C.B. 128 (ruling that an organization formed to preserve a lake as a public recreational facility and to improve the condition of the water in the lake to enhance its recreational features qualifies for exemption as a charitable organization).

⁴ Rev. Rul. 76-204, 1976-1 C.B. 152. The facts of this ruling resemble certain aspects of TNC’s mission and activities.

ruling was formed by scientists, educators, conservationists, and community representatives for the purpose of preserving the environment. It accomplished this purpose by acquiring and maintaining ecologically significant undeveloped land such as swamps, marshes, forests, wilderness tracts, and other natural areas. The organization worked closely with Federal, State, and local government agencies, and private organizations concerned with environmental conservation. It acquired the lands by various means, including by charitable gift, bequest, or purchase. Some of its lands were preserved in their natural state, and others were held and preserved by the organization until arrangements could be made to transfer title to the land to a government conservation agency. In such cases, depending upon the circumstances involving the organization's initial acquisition of the land (gift, bequest, or purchase), and the restrictions on the government acquirer, the organization either made an outright gift of the land to the government agency, or was reimbursed for its cost of the land. The organization received most of its funding from the general public. Under these circumstances, the IRS determined that the organization was organized and operated exclusively for charitable purposes.

Dedication of assets to charitable purposes

An organization is not organized exclusively for exempt purposes (and thus may be denied or lose exempt status) unless its assets are dedicated to an exempt purpose.⁵ A charitable organization's assets will be considered dedicated to an exempt purpose if, upon dissolution, such assets would, by reason of a provision in the organization's articles or by operation of law, be distributed for one or more exempt purposes, or to the Federal government, or to a State or local government, for a public purpose, or would be distributed by a court to another organization to be used in such manner as in the judgment of the court will best accomplish the general purposes for which the dissolved organization was organized.⁶ The IRS takes the position that a charitable organization's articles of organization must contain a dissolution clause that satisfies these requirements, unless the organization is organized under a State law that satisfies the dissolution provisions of Treasury Regulations section 1.501(c)(3)-1(b)(4).⁷

Organized and operated for a non-exempt purpose

An exempt organization must be operated exclusively for exempt purposes. This requirement may be violated if the organization conducts activities that are similar to those of a commercial enterprise. This applies to activities that are conducted directly by the exempt organization, and to activities of certain affiliates of the organization (e.g., joint ventures in which the exempt organization is a co-venturer). The presence of profit-making activities is not

⁵ Treas. Reg. sec. 1.501(c)(3)-1(b)(4).

⁶ *Id.*

⁷ Rev. Proc. 82-2, 1982-1 C.B. 367 (providing which State nonprofit corporation statutes satisfy the dissolution provision, and explaining the application of the provision to inter vivos charitable trusts, testamentary charitable trusts, and unincorporated nonprofit associations). See also Rev. Proc. 2003-12, 2003-1 C.B. 316. The IRS provided a sample dissolution provision that may be used by charitable organizations to satisfy this provision. It reads: "[u]pon dissolution of [this organization], assets shall be distributed for one or more exempt purposes within the meaning of section 501(c)(3) of the Internal Revenue Code, or corresponding section of any future Federal tax code, or shall be distributed to the Federal government, or to a state or local government, for a public purpose." Rev. Proc. 82-2, 1982-1 C.B. 367.

a per se bar to qualification as an exempt organization. For example, exempt organizations are permitted to conduct activities that are not related to their exempt purposes. However, they must pay unrelated business income tax on income derived from such unrelated activities. The IRS and the courts look to the nature of the activity that gives rise to commercial profits, and, in general, to the time and resources expended on the unrelated activity. Generally, however, unrelated trade or business activities may not comprise a substantial portion of the organization's total activities without jeopardizing the exempt status of the organization. An organization may qualify as an exempt entity if it operates a trade or business that is substantially related to the charitable, educational, or other purposes that constitute the basis for its exemption, and is not subject to unrelated business income tax on income from such an activity.

2. Private inurement and private benefit

Section 501(c)(3) provides that no part of a charitable organization's net earnings may inure to the benefit of any private shareholder or individual.⁸ For this purpose, "private shareholder or individual" means persons having a personal and private interest in the activities of the organization.⁹ This generally includes founders, trustees, directors, officers, key employees, and related family and organizations of these persons. There is no de minimis or incidental exception to the private inurement prohibition. Violation of the private inurement prohibition means that an organization does not qualify for exemption from Federal income tax as a charitable organization, and the IRS may seek revocation of the organization's exemption.¹⁰

An organization cannot qualify as an exempt charitable organization if it violates the private benefit doctrine. This doctrine generally provides that the exempt organization cannot operate to confer a benefit on private parties. The private benefit doctrine differs from the private inurement prohibition in that it is not limited in its application to providing benefits to insiders. In addition, the private benefit doctrine does not prohibit all private benefit. Incidental private benefit will not cause an otherwise exempt organization to fail to qualify or to lose its exempt status. The IRS and the courts generally look to whether the private benefit is incidental in both a quantitative and a qualitative sense.

b. Intermediate sanctions (excess benefit transaction tax)

1. In general

The Code imposes excise taxes on excess benefit transactions between disqualified persons and charitable organizations (other than private foundations) or social welfare organizations (as described in section 501(c)(4)).¹¹ An excess benefit transaction generally is a

⁸ The private inurement prohibition also applies to organizations described in sections 501(c)(4), 501(c)(5), and 501(c)(6).

⁹ Treas. Reg. sec. 1.501(a)-1(c).

¹⁰ As an alternative to revocation of tax exemption, the IRS may assert intermediate sanctions to the extent that the inurement results in an "excess benefit transaction," as described below.

¹¹ Sec. 4958. The excess benefit transaction tax is commonly referred to as "intermediate sanctions," because it imposes penalties generally considered to be less punitive than revocation of the organization's exempt status.

transaction in which an economic benefit is provided by a charitable or social welfare organization directly or indirectly to or for the use of a disqualified person, if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit. The tax does not apply to fixed payments made by an organization to a disqualified person pursuant to a binding written contract between the organization and a person who was not a disqualified person immediately before entering into the contract (the “initial contract exception”).¹² For example, the tax does not apply to a fixed payment compensation agreement between an exempt organization and an individual who is hired by the organization as its chief executive officer, if the individual was not a disqualified person with respect to the organization immediately before the parties executed the agreement.

The excess benefit tax is imposed on the disqualified person and, in certain cases, on the organization’s organization managers, but is not imposed on the exempt organization. An initial tax of 25 percent of the excess benefit amount is imposed on the disqualified person that receives the excess benefit. An additional tax on the disqualified person of 200 percent of the excess benefit applies if the violation is not corrected. A tax of 10 percent of the excess benefit (not to exceed \$10,000 with respect to any excess benefit transaction) is imposed on an organization manager that knowingly participated in the excess benefit transaction, if the manager’s participation was willful and not due to reasonable cause, and if the initial tax was imposed on the disqualified person.¹³ If more than one person is liable for the tax on disqualified persons or on management, all such persons are jointly and severally liable for the tax.¹⁴

2. Disqualified person

A disqualified person is any person in a position to exercise substantial influence over the affairs of the organization at any time in the five-year period before the excess benefit transaction occurred.¹⁵ A disqualified person also includes certain family members of such a person, and certain entities that satisfy a control test with respect to such persons. Disqualified person is defined separately for purposes of the self-dealing rules applicable to private foundations.

Persons holding certain powers, responsibilities, or interests are considered to be in a position to exercise substantial influence over the affairs of the organization. These include: (1) any individual serving on the governing body of the organization who is entitled to vote on any matter over which the governing body has authority; (2) any person who, regardless of title, has ultimate responsibility for implementing the decisions of the governing body or for supervising the management, administration, or operation of the organization (generally includes a president, chief executive officer, or chief operating officer unless the person demonstrates otherwise); and (3) any person who, regardless of title, has ultimate responsibility for managing the finances of

¹² Treas. Reg. sec. 53.4958-4(a)(3).

¹³ Sec. 4958(d)(2). Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

¹⁴ Sec. 4958(d)(1).

¹⁵ Sec. 4958(f)(1)(A); Treas. Reg. sec. 53.4958-3(a).

the organization (generally includes a treasurer or chief financial officer unless the person demonstrates otherwise).¹⁶

Certain persons are deemed not to have substantial influence over the affairs of the organization. These include employees receiving economic benefits of less than a specified amount in a taxable year and who are not family members of other disqualified persons or a substantial contributor to the organization.¹⁷

In all other cases, whether a person is a disqualified person depends upon all relevant facts and circumstances. Facts and circumstances tending to show substantial influence over the affairs of the organization include, but are not limited to, whether: (1) the person founded the organization; (2) the person is a substantial contributor to the organization; (3) the person's compensation is primarily based on revenues derived from activities of the organization, or of a particular department or function of the organization, that the person controls; (4) the person has or shares authority to control or determine a substantial portion of the organization's capital expenditures, operating budget, or compensation of employees; (5) the person manages a discrete segment or activity of the organization that represents a substantial portion of the organization's activities, assets, income, or expenses, as compared to the organization as a whole; and (6) the person owns a controlling interest in an entity that is a disqualified person.¹⁸

Facts and circumstances tending to show that the person does not have substantial influence over the affairs of the organization include, but are not limited to: (1) the person is a contractor whose sole relationship to the organization is providing professional advice (without having decision-making authority) with respect to transactions from which the contractor will not economically benefit either directly or indirectly (aside from customary fees received for the advice rendered); (2) the direct supervisor of the individual is not a disqualified person; (3) the person does not participate in any management decisions affecting the organization as a whole or a discrete segment of activity of the organization that represents a substantial portion of the organization's activities, assets, income or expenses, as compared to the organization as a whole; and (4) any preferential treatment based on the size of the person's contribution is also offered to all other donors making a comparable contribution as part of a solicitation intended to attract a substantial number of contributions.¹⁹

3. Rebuttable presumption for certain arrangements

In certain cases, an exempt organization may avail itself of a rebuttable presumption procedure with respect to compensation arrangements and property transfers. Payments under a compensation arrangement are presumed to be reasonable, and a transfer of property, or the right to use property, is presumed to be at fair market value, if: (1) the arrangement or terms of

¹⁶ Treas. Reg. sec. 53.4958-3(c).

¹⁷ Treas. Reg. sec. 53.4958-3(d).

¹⁸ Treas. Reg. sec. 53.4958-3(e)(2).

¹⁹ Treas. Reg. sec. 53.4958-3(e)(2).

transfer are approved in advance by an authorized body of the organization composed entirely of individuals who do not have a conflict of interest with respect to the arrangement or transfer; (2) the authorized body obtained and relied upon appropriate data as to comparability prior to making its determination; and (3) the authorized body adequately documented the basis for its determination concurrently with making that determination.²⁰ If these requirements are satisfied, the IRS may overcome the presumption if it develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body.²¹

c. Unrelated business income tax

1. Types of unrelated business taxable income

Section 501(c)(3) organizations generally are not subject to Federal income tax on contributions received, on income from activities that are substantially related to the purpose of the organization's tax exemption, or on investment income.²² Section 501(c)(3) organizations are subject to the unrelated business income tax on income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization's tax-exempt functions.²³ Certain types of income, however, are specifically exempt from the unrelated business income tax, such as dividends, interest, royalties, and certain rents, unless derived from debt-financed property or from certain 50-percent controlled subsidiaries. Other exemptions from the unrelated business income tax are provided for activities in which substantially all the work is performed by volunteers, for income from the sale of donated goods, and for certain activities carried on for the convenience of members, students, patients, officers, or employees of a charitable organization. In addition, special unrelated business income tax provisions exempt from tax certain activities of trade shows and State fairs, income from bingo games, and income from the distribution of certain low-cost items incidental to the solicitation of charitable contributions.

Income constitutes unrelated business income if it is derived from a trade or business that is regularly carried on by the organization and if the activity is not substantially related to the organization's exempt purposes. The statutory definition of trade or business used for unrelated business income purposes includes any activity which is carried on for the production of income from the sale of goods or the performance of services.²⁴ Specific business activities of an organization will ordinarily be deemed to be regularly carried on if they manifest a frequency

²⁰ Treas. Reg. sec. 53.4958-6(a).

²¹ Treas. Reg. sec. 53.4958-6(b).

²² Private foundations, however, are subject to an excise tax on their net investment income. Sec. 4940.

²³ Secs. 511 through 514. Tax-exempt corporations are taxed on their unrelated business taxable income at the regular corporate tax rates (sec. 511(a)). Charitable trusts and other tax-exempt trusts generally are subject to tax on their unrelated business taxable income under the rates generally applicable to taxable trusts (sec. 511(b)). Organizations liable for tax on unrelated business taxable income may be liable for alternative minimum tax determined after taking into account adjustments and tax preference items.

²⁴ Sec. 513(c); Treas. Reg. sec. 1.513-1(b).

and continuity, and are pursued in manner, generally similar to comparable commercial activities of nonexempt organizations.²⁵ To determine whether the trade or business activity is substantially related to the organization's exempt purposes necessitates an examination of the relationship between the business activities which generate the particular income in question (i.e., producing or distributing the goods or performing the services) and the accomplishment of the organization's exempt purposes. A characterization of the income as exempt income, rather than as unrelated business income, generally requires that the conduct of the business activity that gives rise to the income have a causal relationship to the achievement of the organization's exempt purposes, and that the activity contribute importantly to the accomplishment of such exempt purposes.²⁶

Gains or losses from the sale, exchange, or other disposition of property, other than stock in trade, inventory, or property held primarily for sale to customers in the ordinary course of a trade or business, generally are excluded from unrelated business taxable income. Gains or losses are treated as unrelated business taxable income, however, if derived from debt-financed property. A special exception from unrelated business taxable income applies to certain gains or losses from the qualified sale, exchange, or other disposition of qualifying brownfield properties that are remediated and disposed of by an exempt organization, or by a qualifying partnership of which an exempt organization is a partner.²⁷

In Malat v. Riddell, 383 U.S. 569, 86 S. Ct. 1030 (1966), the Supreme Court decided the standard to be applied in determining whether property is held "primarily" for sale to customers in the ordinary course of business. The Court interpreted "primarily" to mean "of first importance" or "principally".

IRS letter rulings detail factors to consider in determining whether the sale of property has been carried out in the regular course of business. These factors are: 1) purpose for which the property was acquired; 2) frequency, continuity, and size of sales, 3) extent of improvements to the property; 4) activities of owner in improving and disposing of property; 5) purposes for which the property is held; 6) proximity of purchase and land; 7) other, including local ordinances, land use laws, market factors, or master land use plans.²⁸

If a trade or business regularly carried on by a partnership of which an exempt organization is a partner is an unrelated trade or business with respect to such organization, such organization must treat as unrelated business taxable income its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such income.²⁹

²⁵ Treas. Reg. sec. 1.513-1(c)(1).

²⁶ Treas. Reg. sec. 1.513-1(d).

²⁷ Sec. 512(b)(18) [sic19] (as added by section 702(a) of The American Jobs Creation Act of 2004, P.L. No. 108-357).

²⁸ See PLRS 200510029, 200243056, 200242041, and 200237027

²⁹ Sec. 512(c).

2. Determination of unrelated business taxable income

In general, unrelated business taxable income is the gross income derived by an exempt organization from an unrelated trade or business regularly carried on by it, less the deductions allowed that are directly connected with the carrying on of such trade or business.³⁰ An unrelated trade or business generally means any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption.³¹

In general, an expense is directly connected with the conduct of an unrelated business only if the expense has a proximate and primary relationship to the carrying on of that business.³² If an organization derives gross income from the regular conduct of two or more unrelated business activities, unrelated business taxable income is the aggregate of gross income from all such activities less the aggregate of the deductions allowed with respect to all such activities. Expenses, depreciation, and similar items attributable solely to the conduct of unrelated business activities are proximately and primarily related to that business activity, and qualify for deduction to the extent they satisfy the requirements of section 162, section 167, or other relevant provisions of the Code. For example, depreciation of a building used entirely in the conduct of unrelated business activities is an allowable deduction to the extent otherwise permitted by section 167.

If facilities or personnel are used both to carry on exempt activities and to conduct unrelated trade or business activities (i.e., dual use facilities or personnel), the expenses attributable to such facilities (e.g., depreciation and overhead expenses) or such personnel (e.g., salaries) must be allocated between the two on a reasonable basis.³³ The portion of any such item allocated to the unrelated trade or business must bear a proximate and primary relationship to that business activity in order to be deductible in computing unrelated business taxable income.

3. Income from debt-financed property

Certain types of income that otherwise are not treated as unrelated trade or business income (e.g., interest, dividends, rents, royalties, and gains from the sale or exchange of property) are treated as unrelated trade or business income if they are derived from debt-financed property.³⁴ Debt-financed property generally means any property that is held to produce income

³⁰ Sec. 512. Treasury Regulations section 1.512(a)-1(a) provides that “[t]o be deductible in computing unrelated business taxable income, therefore, expenses, depreciation, and similar items not only must qualify as deductions allowed by Chapter 1 of the Code, but also must be directly connected with the carrying on of unrelated trade or business.”

³¹ Sec. 513.

³² Treas. Reg. sec. 1.512(a)-1(a).

³³ Treas. Reg. sec. 1.512(a)-1(c).

³⁴ Sec. 512(b)(4).

and with respect to which there is acquisition indebtedness at any time during the taxable year. In general, income of a tax-exempt organization that is produced by debt-financed property is treated as unrelated business income in proportion to the acquisition indebtedness on the income-producing property. Acquisition indebtedness generally means the amount of unpaid indebtedness incurred by an organization to acquire or improve the property and indebtedness that would not have been incurred but for the acquisition or improvement of the property. Acquisition indebtedness generally does not include indebtedness incurred in the performance or exercise of a purpose or function constituting the basis of the organization's exemption.³⁵

Special rules apply in the case of an exempt organization that owns a partnership interest in a partnership that holds debt-financed property. An exempt organization's share of partnership income that is derived from debt-financed property generally is taxed as debt-financed income unless an exception provides otherwise.

4. Income from controlled entities

Section 512(b)(13) provides special rules regarding income derived by an exempt organization from a controlled subsidiary, and generally treats otherwise excluded rents, royalties, annuities, and interest as unrelated business income if such income is received from a taxable or tax-exempt subsidiary that is 50 percent controlled by the parent tax-exempt organization. In the case of a stock subsidiary, control means ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, control means ownership of more than 50 percent of the profits, capital or beneficial interests. In addition, the constructive ownership rules of section 318 apply for purposes of section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary). Interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization are includible in the latter organization's unrelated business income and are subject to the unrelated business income tax to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity (determined as if the entity were exempt from tax).

5. Income from Transactions with other Exempt Organizations

In general, net income derived by an exempt organization from providing services to another exempt organization constitutes unrelated business income.³⁶ There is no categorical or automatic exemption from unrelated business income for providing services to another, even if the service-provider and service-recipient organizations have similar exempt purposes. Providing managerial and consulting services on a regular basis for a fee is a trade or business

³⁵ Other exceptions to acquisition indebtedness include obligations to pay certain types of annuities; an obligation, to the extent it is insured by the Federal Housing Administration, to finance the purchase, rehabilitation, or construction of housing for low and moderate income persons; indebtedness incurred by certain qualified organizations to acquire or improve real property; and indebtedness incurred by certain small business investment companies. Sec. 514(c).

³⁶ Bruce R. Hopkins, *The Law of Tax-Exempt Organizations*, John Wiley & Sons, Inc. (8th ed.), 26.5(i)

regularly carried on for profit.³⁷ Where an organization provides commercial-type services to charitable organizations that control it, these services must be of an essential function for the charitable organizations and must be performed at substantially below cost to qualify as an exempt activity under section 501(c)(3).ⁱ Where the charitable organizations are unrelated, providing services even at cost lacks the donative element necessary to distinguish the services (consulting and management) from a regular trade or business ordinarily carried on for profit.³⁸ The Service has ruled that the provision of management services by an exempt organization to an affiliated organization was unrelated business income³⁹ and that providing management services to unaffiliated charitable organizations is inconsistent with exemption and may justify revocation of the service provider's exempt status as a charitable organization⁴⁰. Exceptions to these general rules may apply in the case of certain services provided by an exempt organization to an affiliated or related exempt organization.

d. Deductibility of contributions made to section 501(c)(3) organizations

1. In general

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3) or to a Federal, State, or local governmental entity.⁴¹ The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced or limited depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.⁴² In general, more generous charitable contribution deduction rules apply to gifts made to public charities than to gifts made to private foundations. Within certain limitations, donors also are entitled to deduct their contributions to section 501(c)(3) organizations for Federal estate and gift tax purposes. By contrast, contributions to nongovernmental, non-charitable tax-exempt organizations generally are not deductible by the donor,⁴³ though such organizations are eligible for the exemption from Federal income tax with respect to such donations.

³⁷ Rev. Rul. 72-369, 1972-2 C.B. 245.

³⁸ Rev. Rul. 72-369, 1972-2 C.B. 245. See also Rev. Rul. 69-528, 1969-2 C.B. 127 (an organization regularly carrying on an investment services business that would be an unrelated trade or business if carried on by any of the exempt organizations on whose behalf it operates is not exempt).

³⁹ Technical Advice Memorandum 9811001

⁴⁰ Technical Advice Memorandum 9822004

⁴¹ The deduction also is allowed for purposes of calculating alternative minimum taxable income.

⁴² Secs. 170(b) and (e).

⁴³ Exceptions to the general rule of non-deductibility include certain gifts made to a veterans' organization or to a domestic fraternal society. In addition, contributions to certain nonprofit cemetery companies are deductible for Federal income tax purposes, but generally are not deductible for Federal estate and gift tax purposes. Secs. 170(c)(3), 170(c)(4), 170(c)(5), 2055(a)(3), 2055(a)(4), 2106(a)(2)(A)(iii), 2522(a)(3), and 2522(a)(4).

In general, if a donor receives a benefit or quid pro quo in return for a contribution, any charitable contribution deduction is reduced by the amount of the benefit received. For contributions of \$250 or more, no charitable contribution deduction is allowed unless the donee organization provides a contemporaneous written acknowledgement of the contribution that describes and provides a good faith estimate of the value of any goods or services provided by the donee organization in exchange for the contribution.⁴⁴

2. Donative intent, dual character transfers, and significant public benefit

Donative intent requirement and dual character gifts

A charitable deduction for a transfer to a charitable organization is allowable only if it is a “contribution or gift.”⁴⁵ The “sine qua non” of a charitable contribution is a transfer of money or property without adequate consideration.⁴⁶ The burden of proof is on the taxpayer to show that all or a portion of the payment is a contribution or gift.

No part of a payment to a charitable organization that is in consideration for goods or services is a contribution or gift within the meaning of section 170(c), unless (1) the taxpayer intends to make a payment in an amount that exceeds the fair market value of the goods or services, and (2) actually makes a payment in an amount that exceeds the fair market value of the goods or services.⁴⁷ The charitable deduction for a payment a taxpayer makes partly in consideration for goods or services may not exceed the excess of the amount of any cash paid and the fair market value of any property (other than cash) transferred by the taxpayer, over the fair market value of the goods or services the organization provides in return.⁴⁸

Courts and the IRS have provided guidance on the deductibility of “dual character” gifts or contributions such as this. Revenue Ruling 67-246 sets forth guidance for instances involving the sale by a charitable organization of a privilege or benefit (such as admission to events), combined with the solicitation by such organization of a gift or donation in addition to the sale. The ruling states that as a general rule, if a transaction involving a payment is in the form of a purchase of an item of value, the presumption arises that no gift has been made for charitable contribution purposes, the presumption being that the payment in such case is the purchase price. The ruling further states that the burden is on the taxpayer to establish that the amount paid is not the purchase price of the privileges or benefits and that part of the payment, in fact, does qualify as a gift. In showing that a gift has been made, an essential element of proof is that the portion of the payment claimed as a gift represents the excess of the total amount paid over the value of the consideration. Another element that is important to establish that a gift was made is evidence

⁴⁴ Sec. 170(f)(8).

⁴⁵ Sec. 170(c).

⁴⁶ *U.S. v. American Bar Endowment*, 477 U.S. 105, 118 (1986).

⁴⁷ Treas. Reg. sec. 1.170A-1(h).

⁴⁸ *Id.*

that the payment in excess of the value received was made with the intention of making a gift. The ruling states that “[w]hile proof of such intention may not be an essential requirement under all circumstances and may sometimes be inferred from surrounding circumstances, the intention to make a gift is, nevertheless, highly relevant in overcoming doubt in those cases in which there is a question whether an amount was in fact paid as a purchase price or as a gift.”⁴⁹ In *American Bar Endowment*, the United States Supreme Court upheld the the two-part “dual payment” test established by the IRS in Revenue Ruling 67-246.⁵⁰

The IRS applies the section 170 and Revenue Ruling 67-246 to conservation easements in Notice 2004-41. The IRS advises taxpayers “who (1) transfer an easement on real property to a charitable organization, or (2) make payments to a charitable organization in connection with a purchase of real property from the charitable organization” that “the Service intends to disallow such deductions and may impose penalties and excise taxes. Furthermore, the Service may, in appropriate cases, challenge the tax-exempt status of a charitable organization that participates in these transactions. In addition, this notice advises promoter and appraisers that the Service intends to review promotions of transactions involving these improper deductions, and the promoters and appraisers may be subject to penalties.”⁵¹

Significant public benefit doctrine

If the donor receives, or can reasonably expect to receive, sufficiently substantial financial or economic benefits in excess of those that would inure to the general public, no deduction under section 170 is allowable. For example, a taxpayer that pledged and paid an amount of money to a county government on the condition that the county hard-surface the roads in the vicinity of the taxpayer’s property was not entitled to a charitable deduction, because the taxpayer could reasonably expect to receive benefits substantially greater than those that would

⁴⁹ The IRS went on to state that “the organization conducting the activity should employ procedures which make clear not only that a gift is being solicited in connection with the sale of the admissions or other privileges related to the fund-raising event, but also, the amount of the gift being solicited.” See also Rev. Rul. 68-432, 1968-2 C.B. 104 (stating that in cases involving payments in the form of membership dues to a charitable organization, the IRS will give due consideration to the possible separation on a uniform basis of that portion of the total payment that may properly be treated as a charitable contribution whenever the discrepancy between the size of the membership contribution and the potential monetary benefit is so great as to make it reasonably clear that the payment is of a “dual character”).

⁵⁰ See Rev. Rul. 76-185, 1976-1 C.B. 60, involving payments made by a taxpayer to contractors to finance the restoration and maintenance of a state-owned historic mansion and its surrounding grounds in exchange for a right to reside on the premises for 15 years. The IRS ruled that the taxpayer was entitled to a charitable contribution deduction to the extent the payments exceeded the monetary value of all benefits received or expected to be received by the taxpayer. The IRS stated that if the transferor receives, or can reasonably expect to receive, a financial or economic benefit that is substantial but less than the amount of the transfer, then the transaction may involve both a purchase and a gift, and may entitle the taxpayer to a contribution deduction for the gift portion if the other requirements of section 170 are satisfied. See also Rev. Rul. 76-232, 1976-1 C.B. 62, ruling that taxpayers who donated amounts to a charitable organization and participated in a weekend marriage seminar were entitled to deduct as a charitable contribution the excess of the amount donated over the monetary value of the benefits and privileges received; taxpayers were under no obligation to donate any amount in order to participate in the seminar.

⁵¹ Notice 2004-41

inure to the general public.⁵² Under this doctrine, no deduction is permitted unless there is a significant public benefit resulting from the contribution. A similar requirement applies with respect to perpetual conservation restrictions. The Treasury Regulations provide that if, as a result of the donation of such a restriction, the donor or a related person 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, then no charitable deduction is allowable.⁵³ This requirement focuses on the relationship between the benefits received or expected to be received by the taxpayer as compared to those to be provided to the general public, rather than on the comparison between the amount of the payment made by the taxpayer and the value of any benefit to be received by the taxpayer, which is the focus of dual character gifts.

3. Contributions of noncash property

The amount of the deduction for charitable contributions of capital gain property generally equals the fair market value of the contributed property on the date of the contribution. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations than other contributions of property.

For certain contributions of property, the deductible amount is reduced from the fair market value of the contributed property by the amount of any gain, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) ordinary income property, e.g., property that, at the time of contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date;⁵⁴ (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

In general, a charitable contribution deduction is allowed only for contributions of the donor's entire interest in the contributed property, and not for contributions of a partial interest.⁵⁵ (An exception to the partial interest rule applies for qualified conservation contributions, described below.)⁵⁶ If a taxpayer sells property to a charitable organization for less than the property's fair market value, the amount of any charitable contribution deduction is determined

⁵² Rev. Rul. 76-257, 1976-2 C.B. 52.

⁵³ Treas. Reg. sec. 1.170A-14(h)(3)(i).

⁵⁴ For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciated value (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis. Sec. 170(e)(3) (property for the care of the ill, the needy, or infants). Similar deductions are provided by sections 170(e)(4) (contributions of scientific property and equipment) and 170(e)(6) (contributions of computer technology used for educational purposes).

⁵⁵ Sec. 170(f)(3).

⁵⁶ Sec. 170(h).

in accordance with the bargain sale rules.⁵⁷ If a taxpayer pays more than fair market value for property acquired from a charitable organization, the excess above fair market value may be deductible assuming that the donor intended to make a gift of such excess.

Taxpayers are required to obtain a qualified appraisal for donated property with a value of \$5,000 or more, and to attach an appraisal summary to the tax return.⁵⁸ In the case of contributions of art valued at \$20,000 or more, taxpayers are required to attach the appraisal to the tax return. Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things: (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170;⁵⁹ (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.⁶⁰

In general, if the total charitable deduction claimed for non-cash property exceeds \$500, the taxpayer must file IRS Form 8283 (Noncash Charitable Contributions) with the IRS. C corporations (other than personal service corporations and closely-held corporations) are required to file Form 8283 only if the deduction claimed exceeds \$5,000. Information required on the Form 8283 includes, among other things, a description of the property, the appraised fair market value (if an appraisal is required), the donor's basis in the property, how the donor acquired the property, a declaration by the appraiser regarding the appraiser's general qualifications, an acknowledgement by the donee that it is eligible to receive deductible contributions, and an indication by the donee whether the property is intended for an unrelated use. If a donee organization sells, exchanges, or otherwise disposes of contributed property with a claimed value over \$5,000 (other than publicly traded securities) within two years of the property's receipt, the donee is required to file a return (Form 8282), and furnish a copy of the return to the donor, showing the name, address, and taxpayer identification number of the donor, a description of the property, the date of the contribution, the amount received on the disposition, and the date of the disposition.⁶¹

⁵⁷ Sec. 1011(b) and Treas. Reg. sec. 1.1011-2.

⁵⁸ Pub. L. No. 98-369, sec. 155(a)(1) through (6) (1984) (providing that not later than December 31, 1984, the Secretary shall prescribe regulations requiring an individual, a closely held corporation, or a personal service corporation claiming a charitable deduction for property (other than publicly traded securities) to obtain a qualified appraisal of the property contributed and attach an appraisal summary to the taxpayer's return if the claimed value of such property (plus the claimed value of all similar items of property donated to one or more donees) exceeds \$5,000).

⁵⁹ In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

⁶⁰ Treas. Reg. sec. 1.170A-13(c)(3).

⁶¹ Sec. 6050L(a)(1).

4. Contributions of conservation easements

Qualified conservation contributions

Section 170(h) provides special rules that apply to charitable contributions of qualified conservation contributions, which include conservation easements and façade easements. Qualified conservation contributions are not subject to the “partial interest” rule, which generally bars deductions for charitable contributions of partial interests in property. Accordingly, qualified conservation contributions are contributions of partial interests that are eligible for a fair market value deduction.

A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property.⁶² Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

In general, no deduction is available if the property may be put to a use that is inconsistent with the conservation purpose of the gift.⁶³ A contribution is not deductible if it accomplishes a permitted conservation purpose while also destroying other significant conservation interests.⁶⁴

Conservation purposes

Public recreation or education

Under Treasury Regulations, a donation satisfies the conservation purpose of preservation of land areas for recreation or education if there is substantial and regular use of the property by the general public.⁶⁵ There is no requirement that the preservation of the land area

⁶² Charitable contributions of interests that constitute the taxpayer’s entire interest in the property are not regarded as qualified real property interests within the meaning of section 170(h), but instead are subject to the general rules applicable to charitable contributions of entire interests of the taxpayer. Priv. Ltr. Rul. 8626029 (March 25, 1986).

⁶³ Treas. Reg. sec. 1.170A-14(e)(2).

⁶⁴ Treas. Reg. sec. 1.170A-14(e)(2).

⁶⁵ Treas. Reg. sec. 1.170A-14(d)(2)(i).

be made pursuant to a governmental policy or that the area be certified by a governmental unit as worthy of conservation efforts.

Protection of a significant habitat or ecosystem

Treasury Regulations provide that the donation of a qualified real property interest to protect a significant natural habitat in which a fish, wildlife, or plant community, or similar ecosystem normally lives will satisfy the conservation purpose requirement.⁶⁶ Whether a donation satisfies the conservation purpose requirement generally depends on the type of animal or plant life that exists on the property being protected. If a property is a habitat for any endangered species of plant or animal life, a restriction protecting that habitat likely satisfies the conservation purpose requirement. Administrative rulings provide that if a particular species has been identified as unique to a particular place or is approaching an endangered or other protected status, protection of the habitat will suffice.

Preservation of open space

A conservation purpose includes the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is (1) for the scenic enjoyment of the general public; or (2) pursuant to a clearly delineated Federal, State, or local government conservation policy.⁶⁷ Scenic enjoyment is evaluated by considering all pertinent facts and circumstances germane to the contribution. The factors identified in the regulations include the compatibility of the land use with other land in the vicinity, the degree of contrast and variety provided by the visual scene, the harmonious variety of shapes and textures, and the consistency of the proposed scenic view with a methodical state scenic identification program. Some examples of donations that have satisfied the scenic enjoyment requirements in private letter rulings include conservation easements on a ranch that provided views of a natural vista from adjacent roads; rolling farmland interspersed by wooded areas and steep slopes that could be seen from an adjacent road; land that provided views of a pond and the ocean from the highway; and property that provided a view of a pond in a heavily developed area.

Treasury Regulations provide that the purpose of preserving open space pursuant to a clearly delineated government policy is satisfied by donations that further a specific conservation purpose identified by public representatives.⁶⁸ A general declaration of conservation goals by a single official or legislative body is not sufficient, although the government policy need not be a certification program that identifies particular lots or small parcels of individually owned property.⁶⁹ For example, a governmental program according preferential tax assessment or preferential zoning for certain property deemed worthy of protection for conservation purposes

⁶⁶ Treas. Reg. sec. 1.170A-14(d)(3)(i).

⁶⁷ Treas. Reg. sec. 1.170A-14(d)(4)(i).

⁶⁸ Treas. Reg. sec. 1.170A-14(d)(4)(iii).

⁶⁹ *Id.*

constitutes a significant commitment by a government, and accordingly satisfies the requisite standard.⁷⁰

Preservation of historic property

Section 170(h) defines conservation purpose to include the preservation of an historically important land area or a certified historic structure.⁷¹ For this purpose, a structure means any structure, whether or not it is depreciable, and, accordingly, easements on private residences may qualify under this provision.⁷² If restrictions to preserve a building or land area within a registered historic district permit future development on the site, a deduction will be allowed only if the terms of the restrictions require that such development conform with appropriate local, State, or Federal standards for construction or rehabilitation within the district.⁷³

5. Valuation of conservation easements

Valuation standards

The value of a conservation restriction granted in perpetuity generally is determined under the “before and after approach.” Such approach provides that the fair market value of the restriction is equal to the difference (if any) between the fair market value of the property the restriction encumbers before the restriction is granted and the fair market value of the encumbered property after the restriction is granted.⁷⁴ Courts generally apply this standard by looking at the objective uses of the property. At least one court, however, has examined the subjective intentions of the contributing taxpayer to apply this standard.⁷⁵

⁷⁰ *Id.*

⁷¹ The conservation purpose standard for historically important land is that the area be: (1) an independently significant land area including any related historic resources that meets the National Register Criteria for Evaluation; (2) an area within a registered historic district including any buildings on the land areas that can reasonably be considered as contributing to the significance of the district; and (3) an area (including related historic resources) adjacent to a property listed individually in the National Register of Historic Places (but not within a registered historic district) in a case where the physical or environmental features of the land area contribute to the historic or cultural integrity of the property. Treas. Reg. sec. 1.170A-14(d)(5)(ii). The IRS and the courts have held that a facade easement may constitute a qualifying conservation contribution. *Hillborn v. Commissioner*, 85 T.C. 677 (1985) (holding the fair market value of a facade donation generally is determined by applying the “before and after” valuation approach); *Richmond v. U.S.*, 699 F. Supp. 578 (E.D. La. 1988); Priv. Ltr. Rul. 199933029 (May 24, 1999) (ruling that a preservation and conservation easement relating to the facade and certain interior portions of a fraternity house was a qualified conservation contribution).

⁷² Treas. Reg. sec. 1.170A-14(d)(5)(iii).

⁷³ Treas. Reg. sec. 1.170A-14(d)(5)(i).

⁷⁴ Treas. Reg. sec. 1.170A-14(h)(3).

⁷⁵ *McLennan v. U.S.*, 24 Cl. Ct. 102 (1991) (highest and best use refers to “the most profitable and probable use” of the property; although the property could be subdivided into eight parcels, the taxpayer’s “strong aversion to development” meant that a valuation based on an assumption of subdividing the entire property was “untenable” and “directly contradicts [taxpayers’] clear intention to preserve their land from development;” found that the reasonable

If the granting of a perpetual restriction has the effect of increasing the value of any other property owned by the donor or a related person, the amount of the charitable deduction for the conservation contribution is to be reduced by the amount of the increase in the value of the other property.⁷⁶ In addition, the donor is to reduce the amount of the charitable deduction by the amount of financial or economic benefits that the donor or a related person receives or can reasonably be expected to receive as a result of the contribution.⁷⁷ If such benefits are greater than those that will inure to the general public from the transfer, no deduction is allowed.⁷⁸ In those instances where the grant of a conservation restriction has no material effect on the value of the property, or serves to enhance, rather than reduce, the value of the property, no deduction is allowed.⁷⁹

Valuation-related penalties

Present law imposes accuracy-related penalties on a taxpayer in cases involving a substantial valuation misstatement or gross valuation misstatement relating to an underpayment of income tax.⁸⁰ For this purpose, a substantial valuation misstatement generally means a value claimed that is at least twice the amount determined to be the correct value, and a gross valuation misstatement generally means a value claimed that is at least four times the amount determined to be the correct value.⁸¹ Present law does not impose substantial or gross valuation misstatement penalties on an appraiser that conducted an appraisal that was used by a taxpayer to support the value claimed on the taxpayer's return. However, the Secretary may disqualify an appraiser from practicing before the IRS under certain circumstances.⁸²

6. Donor Advised Funds

The IRS has described a donor advised fund as separate accounts established by a charity for a donor whereby the donor may exercise a right to make a recommendation on either uses of the account, such as providing advice about how to invest, or distributions from the account,

and probable use of the property was as an undivided country estate, not as a subdivision, and that the easement did not affect the highest and best use of the land).

⁷⁶ Treas. Reg. sec. 1.170A-14(h)(3)(i).

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ Treas. Reg. sec. 1.170A-14(h)(3)(ii).

⁸⁰ Sec. 6662(b)(3) and (h).

⁸¹ Sec. 6662(e) and (h).

⁸² 31 U.S.C. sec. 330(c) (after notice and opportunity for a hearing to any appraiser with respect to whom a penalty for aiding and abetting understatement of tax liability has been assessed, the Secretary may provide that appraisals by such appraiser shall not have any probative effect in any administrative proceeding before the Treasury or the IRS, and bar such appraiser from presenting evidence or testimony in any such proceeding).

such as providing advice about how to make expenditures.⁸³ In recent years, the use of donor advised funds maintained by charities has grown dramatically. These funds general permit a donor to claim a current charitable deduction for amounts contributed to the charity, whether cash or noncash property, and to provide ongoing advice regarding the investment or distribution of such amounts, which are maintained by the charity in a separate fund or account. Several financial institutions have formed organizations for the purpose of offering donor advised funds, and many existing charities now operate donor advised funds as a means to raise funds through contributions.

There presently is no clear definition of donor advised fund. However, in its private letter rulings, the IRS has stated that a donor advised fund must have appropriate control and ownership over the donated assets, and that the IRS applies the material restriction or condition provisions (relating to the termination of private foundation status) in Treasury Regulations section 1.507-2(a)(8) to measure the level of such control. The IRS has used this control standard to determine whether the donor advised fund has sufficient dominion and control over the funds contributed such that the organization that operates the fund may be treated, for tax purposes, as the owner of the assets.⁸⁴ If a donor retains too much control over the donated asset, there has not been a completed gift for purposes of the charitable contribution deduction. Donor advised funds also raise issues regarding the retention of control by a donor in a manner that circumvents the private foundation rules, by establishing the fund with a public charity.

e. Tax-exempt financing

State and local governments may act as conduits to provide tax-exempt financing for limited activities conducted and paid for by nongovernmental entities or individuals, including for the exempt activities of section 501(c)(3) organizations.⁸⁵ Accordingly, section 501(c)(3) organizations have access to tax-exempt financing through State and local governments. This generally does not include financing for unrelated business activities of such organizations.⁸⁶ Tax-exempt organizations other than section 501(c)(3) organizations generally must satisfy requirements generally applicable to nongovernmental entities or individuals in order to obtain tax-exempt financing.

f. Joint Ventures

1. Overview

An exempt organization may be affiliated with other organizations or entities, some exempt and some taxable. Thus, as is the case with taxable for-profit corporations, an exempt organization might be a parent of one or more incorporated organizations, a subsidiary of another

⁸³ Instructions to Form 1023 (Rev. Oct. 2004), p. 10

⁸⁴ E.g., Priv. Ltr. Rul. 200150039

⁸⁵ Sec. 145.

⁸⁶ Sec. 145(a).

exempt organization, or an organization that is under the common control of another exempt organization. In general, an exempt organization will be treated as separate from its related corporations as long as the purposes for which the related entity was formed are carried out in its activities.⁸⁷ An exempt organization also may participate in joint ventures involving partnerships or limited liability companies.

A leading commentator has defined a joint venture as “an association of persons or entities jointly undertaking a particular transaction for mutual profit,”⁸⁸ and divided joint ventures involving exempt organizations into four categories: those involving only exempt organizations (exempt-only joint ventures), those entered as passive investments (investment-type joint ventures), those that represent a small proportion of the assets of the exempt organization (ancillary joint ventures), and those to which the exempt organization devotes all or substantially all of its assets (disposition-type joint ventures).⁸⁹ The fourth category includes what has been described as the “whole-hospital” joint venture, a structure in which an exempt hospital system transfers all of its assets, including a hospital facility, to a partnership or limited liability company in exchange for an ownership interest in the joint venture entity.

The Federal income tax consequences to an exempt organization and to the other participants in a joint venture generally depend upon a variety of circumstances, including the type of State law entity (if any) used for the joint venture, the activities to be conducted, the extent to which the exempt organization maintains control over the activities of the joint venture, the size of the joint venture’s activities compared to the exempt organization’s other activities, the terms of the organizational documents and related agreements, and whether the exempt organization receives fair market value in exchange for its financial and other contributions to the venture. In addition, because charitable organizations generally are subject to special rules that do not apply to many other types of exempt organizations (e.g., the private inurement prohibition, excess benefit transaction tax rules, and impermissible private benefit), a charity’s involvement in a joint venture must consider its unique status as a charitable organization.⁹⁰ In certain cases, an exempt organization may jeopardize its exempt status by participating in a joint venture.⁹¹

The Federal income tax law regarding joint ventures involving exempt organizations has changed slowly but significantly over the past 30 years. During this period the IRS position regarding participation by charitable organizations in such ventures has changed from one that prohibited certain types of participation by the organization (e.g., the IRS took the position a

⁸⁷ *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943).

⁸⁸ Michael I. Sanders, *Joint Ventures Involving Tax-Exempt Organizations*, John Wiley & Sons, 2d. ed., 2.

⁸⁹ *Id.*, 2004 Cumulative Supplement, 44-46; Michael I. Sanders, *How to Structure Joint Ventures Involving Charities in Today’s Climate*, 14 *Taxation of Exempts* 3 (July/August 2002), 3.

⁹⁰ Social welfare organizations described in section 501(c)(4) also are subject to certain of these special rules, such as the private inurement prohibition and the excess benefit transaction tax rules.

⁹¹ In addition, special considerations apply if the exempt organization is a private foundation. Such an organization is subject to the self-dealing, net investment income, excess business holdings, jeopardized investments, and taxable expenditure provisions of sections 4941 through 4945.

charity could not participate as a limited partner in a partnership managed by a for-profit general partner) to one that acknowledges that charities may participate in joint ventures if they satisfy certain requirements. Under present law, a joint venture must be examined to determine whether (1) the charity's income derived from the venture is taxed as unrelated business taxable income; (2) the charity receives fair market value in connection with all aspects of the venture; (3) the joint venture furthers a charitable purpose; and (4) the arrangement does not provide an impermissible private benefit to any private persons, including others who participate in the joint venture. The IRS and the courts recently have emphasized the extent to which the charity may and does control the activities of the joint venture, particularly with respect to the charitable aspects and day-to-day operations of the venture, when examining whether the joint venture jeopardizes the exempt status of the participating charity, or causes the charity's share of the income from the venture to be taxed as unrelated business taxable income.

2. Partnership or Limited Liability Company Joint Ventures

A partnership (including a limited liability company treated as such for Federal tax purposes) is a pass-through entity, with its income, gains, losses, deductions, and credits allocated to its partners in accordance with the partnership agreement. The partners then report their respective distributive shares of the partnership's tax items on their Federal income tax returns. An exempt organization's distributive share of a partnership's income or loss is treated as if the partnership directly conducted the activity that generated the income or loss. If a trade or business regularly carried on by a partnership of which an exempt organization is a partner is an unrelated trade or business with respect to the exempt organization, then the exempt organization must treat its share (whether or not distributed) of the income from the unrelated trade or business as unrelated business taxable income.⁹² In addition, the controlled-entity rules of section 512(b)(13) apply to a partnership that is more than 50-percent owned (directly or indirectly) by an exempt organization.⁹³

3. Evolution of law regarding joint ventures involving exempt organizations and for-profit partners

Pre-1982 law. The IRS once took the position that a charitable organization could not participate as a general partner in a limited partnership that involved for-profit limited partners because the exempt organization would have a fiduciary duty to further the private economic interests of the for-profit limited partners. The IRS was concerned that this duty would conflict with the exempt organization's mission to operate exclusively for charitable purposes.⁹⁴

⁹² Sec. 512(c)(1).

⁹³ Sec. 512(b)(13)(D)(ii).

⁹⁴ See, General Counsel Memorandum 36293 (May 30, 1975) (joint profit motive of partnership made it incompatible with charitable purpose of the exempt entity), and Priv. Ltr. Rul. 7820058 (participation by a charitable organization as a general partner in a partnership with private investors as limited partners conveyed impermissible private benefit, even though venture was formed to provide low-income housing).

Plumstead Theatre. In *Plumstead Theatre Society v. Commissioner*,⁹⁵ the court held that a charitable organization could serve as a general partner in a limited partnership that included for-profit limited partners without losing its exempt status. In that case, the court employed a two-part test to determine that the exempt organization could remain exempt: (1) did the partnership's activities further the charitable purposes of the exempt organization, and (2) did the structure of the partnership protect the exempt organization against potential conflicts between its fiduciary duties to its for-profit partners and its charitable mission. Based on an examination of the facts and circumstances of the case, the court determined that the exempt organization could protect against impermissible private benefit and private inurement, and operate exclusively to further its charitable purposes, even if it participated in a joint venture with for-profit limited partners. This decision rejected the IRS position of a per se prohibition against such arrangements.

Housing Pioneers. In *Housing Pioneers v. Commissioner*,⁹⁶ the court held that a low-income housing exempt organization's activities as a co-general partner in a limited partnership substantially furthered non-exempt purposes when the exempt organization's authority as a co-general partner was limited and the other co-general partner (a taxable organization) was in a position of control. Accordingly, the court denied the exempt organization exempt status on the basis that it substantially furthered non-exempt purposes and private interests. In a different low-income housing joint venture, however, the IRS ruled that a charitable organization's participation as a co-general partner in a limited partnership did not adversely affect its exempt status.⁹⁷ In that private ruling, the IRS upheld the general partner's exempt status because the organization was the managing general partner with responsibility for day-to-day operations and with authority to cause the project to be managed in a manner that furthered its exempt purposes.

Revenue Ruling 98-15. In 1998, the IRS issued guidance regarding its position on a particular type of transaction, a "whole-hospital" joint venture. Revenue Ruling 98-15⁹⁸ used two examples with significantly different facts and circumstances to illustrate the IRS's position regarding the effect a whole-hospital joint venture had on the exempt status of the participating charitable organization. Both examples involved a public charity that contributed all of its assets to a limited liability company in exchange for a membership interest in the limited liability company. Thus, after the contribution, the charity's sole asset was its membership interest in the limited liability company. In both examples, a for-profit corporation contributed assets to the limited liability company in exchange for a membership interest that was proportionate to its financial contribution. However, the two examples differed importantly with respect to the respective rights of the charity and the for-profit relating to board governance, approval of major decisions, and the provision of charity care by the joint venture. Also, the terms of the management agreement employed in each of the two examples differed materially. In one example, the charity had 60 percent of the board membership, controlled approval of major

⁹⁵ *Plumstead Theatre Society, Inc. v. Commissioner*, 74 T.C. 1324 (1980), 675 F.2d 244 (9th Cir. 1982).

⁹⁶ *Housing Pioneers v. Commissioner*, TCM 1993-120, *aff'd* 49 F.3d 1395 (9th Cir. 1995).

⁹⁷ Priv. Ltr. Rul 9736039.

⁹⁸ Rev. Rul. 98-15, 1998-1 C.B. 718.

decisions, and could terminate the management agreement between the joint venture and an unrelated management company. The joint venture agreement also required that the hospital operate in a manner that furthered charitable purposes. The IRS held that the exempt organization in this example did not jeopardize its exempt status by participating in the joint venture. In the other example, the charity possessed only 50 percent of the board control, held only a veto right with respect to approval of major decisions, and could not terminate the management agreement between the joint venture and a service provider that was related to the for-profit participant. In addition, in this example, there was no express requirement that the hospital operate to further charitable purposes, and the officers responsible for oversight of day-to-day operations of the joint venture were individuals who previously were employed by the for-profit member. The IRS ruled that the activities of the joint venture in the latter example did not further the exempt purposes of the charity, and that the organization would not remain tax-exempt.

Redlands and St. David's. The control standard established in *Plumstead Theatre* and developed further in Revenue Ruling 98-15 and subsequent private letter rulings was the focal point of two recently litigated cases involving exempt organizations and for-profit investors in health care joint ventures. In *Redlands*,⁹⁹ the United States Tax Court and the Ninth Circuit Court of Appeals determined that a nonprofit subsidiary of a tax-exempt hospital system failed to retain control of a joint venture ambulatory surgery center, and thus was not entitled to exempt status as a charitable organization because the joint venture did not operate to further the subsidiary's exempt purposes. In *St. David's*,¹⁰⁰ an exempt organization contributed all of its health care facilities to a partnership joint venture with a for-profit health care system. The for-profit system contributed assets to the joint venture, and a subsidiary of the for-profit partner provided management services to the joint venture. In the litigation, the IRS agreed that the joint venture provided substantial charity care, but contended that the exempt organization did not retain sufficient control over the venture to ensure that charity care would continue to be provided in the future. Ultimately, a jury determined that the exempt organization did retain sufficient effective control of the venture to ensure that the joint venture's operations would substantially further charitable purposes. *Redlands* and *St. David's*, like Revenue Ruling 98-15, focused on the extent of the exempt organization's control over the venture's activities in determining whether exempt status of the tax-exempt partner was retained or denied.

Revenue Ruling 2004-51. Following the judicial decisions in *Redlands* and *St. Davids*, the IRS issued Revenue Ruling 2004-51¹⁰¹ to provide guidance regarding ancillary joint ventures (i.e., joint ventures in which the participating exempt organization did not contribute all or substantially all of its assets). In the ruling, a university described in section 501(c)(3) formed a limited liability company and transferred a small portion of its assets to the limited liability company in exchange for a 50-percent membership interest. A for-profit corporation contributed interactive video assets to the limited liability company in exchange for a 50-percent

⁹⁹ *Redlands Surgical Services, Inc. v. Commissioner*, 113 T.C. 47 (1999), *aff'd* 242 F.3d 904 (9th Cir. 2001).

¹⁰⁰ *St. David's Health Care System v. U.S.* No. A-01-CA-046 JN (W.D. Texas) (June 7, 2002); 349 F.3d 232 (5th Cir. 2003); remanded _____.

¹⁰¹ Rev. Rul. 2004-51, 2004-22 I.R.B. 974.

membership interest. The limited liability company's exclusive purpose was to provide teacher training programs to various locations using interactive video technology provided by the for-profit member. Both the exempt university and the for-profit member held equal ownership interests and representation on the limited liability company's board of directors, and all financial rights were shared equally. The training programs to be conducted by the joint venture contained the same substantive material that was provided at the university's on-campus seminars. The university possessed the right to determine and approve the curriculum, training materials, instructors, and educational standards of the programs. The for-profit possessed the right to select the technical employees and the locations at which the programs would be conducted. Other decisions were to be made by both members. The limited liability company's activities were limited to those connected with the training programs, and the company could not engage in an activity that jeopardized the exempt status of the university. On these facts, the IRS determined that the educational organization's participation in the ancillary joint venture did not jeopardize the exempt status of the university. Further, the IRS determined that the university's share of income derived by the joint venture from the training programs did not constitute unrelated business taxable income to the university.¹⁰²

4. Joint ventures among exempt organizations

Exempt organizations may come together to form corporate or partnership joint ventures. Exempt organizations might enter into joint operating agreements or other types of contractual arrangements with other exempt organizations, pursuant to which each exempt organization agrees to make certain of its assets (e.g., intellectual property or physical facilities) available for use by the parties to the agreement under the specified terms of the arrangement. Exempt organizations also might use corporate or partnership entities to conduct the venture. If a corporation is used, the generally applicable corporate tax rules apply to the arrangement. If the organizations form a limited liability company or State law partnership to hold the investment or to conduct the activity, the general principles of partnership taxation apply to the arrangement.

In general, joint ventures among exempt organizations of a similar type do not raise the same concerns that exist if for-profit entities or individuals also are parties to the arrangement. For example, a partnership joint venture consisting of two charitable organizations that come together to conduct an exempt activity generally are free to do so without regard to the private benefit and private inurement doctrines that apply when an individual or entity other than a charity is a party to the arrangement. This might provide the charitable organizations some increased flexibility in structuring their respective financial and governance rights, because only charities are involved in the joint venture and thus will necessarily control the venture. However, a charity generally is required to treat non-charitable exempt organizations (e.g., a social welfare organization described in section 501(c)(4)) in the same manner as a for-profit

¹⁰² For an analysis of the revenue ruling, see Michael I. Sanders, *The Impact of Rev. Rul. 2004-51 on Ancillary Joint Ventures*, Taxation of Exempts (November/December 2004), 99. See also, Paul Streckfus, *Ancillary Joint Ventures May Involve Exemption Risk*, Tax Notes Today (February 1, 2005); *Practitioners Pleased With Revenue Ruling on Ancillary Joint Ventures*, Tax Notes Today (May 7, 2004).

organization for these purposes, in order to ensure that charitable purposes are served and that charitable assets remain dedicated to charitable purposes.¹⁰³

5. Private inurement and excess benefit transaction taxes in joint ventures

Organizations described in section 501(c)(3) and (c)(4) are subject to the private inurement prohibition and the excess benefit transaction tax rules. These rules apply to such an organization's participation in a joint venture, whether the joint venture is taxed as a partnership or a corporation, and in other related organization structures in which the organization participates. Under these requirements, a charitable, educational, or social welfare organization must receive fair market value upon the transfer of property to a joint venture, during the term of the joint venture, and upon liquidation of the joint venture, if the joint venture or another participant in the joint venture is a disqualified person with respect to the charitable, educational, or social welfare organization. For example, if a charitable organization enters into a partnership arrangement with one or more members of its board of directors, then the charitable organization must receive a partnership interest that has a fair market value that equals or exceeds the value of the property the organization transferred to the partnership in exchange for the partnership interest. If the fair market value of the interest received is less than the value of the property transferred by the charitable organization, the transaction constitutes an excess benefit transaction subject to the excise taxes imposed by section 4958. Similarly, if the organization participates in a joint venture that forms a corporation or a limited liability company, the arrangement must be examined for compliance with the private inurement and excess benefit transaction rules.

The section 4958 excess benefit transaction taxes apply whether the excess benefit is provided directly or indirectly by the exempt organization. The legislative history to section 4958 states that the organization managers and disqualified persons will be subject to the tax even if the excess benefit is provided indirectly through an entity controlled by the exempt organization (e.g., a taxable for-profit subsidiary). For example, the excess benefit transaction tax rules apply to compensation paid to a disqualified person of a public charity whether the compensation is paid directly by the charity or indirectly by a subsidiary controlled by the charity.

g. Annual reporting requirements

1. Form 990

Section 501(c)(3) organizations (as well as other organizations exempt from taxation under section 501(a)) are required to file an annual return, stating specifically the items of gross income, receipts, disbursements, and such other information as the Secretary may prescribe.¹⁰⁴

¹⁰³ Treas. Reg. sec. 1.501(c)(3)-1(b)(4) (a charity's assets must be distributed to another charity or to a governmental unit for charitable or public purposes upon the dissolution of the charity).

¹⁰⁴ Sec. 6033(a).

The requirement that an exempt organization file an annual information return does not apply to certain exempt organizations, including organizations (other than private foundations) the gross receipts of which in each taxable year normally are not more than \$25,000. Also exempt from the requirement are churches, their integrated auxiliaries, and conventions or associations of churches; the exclusively religious activities of any religious order; certain state institutions whose income is excluded from gross income under section 115; an interchurch organization of local units of a church; certain mission societies; certain church-affiliated elementary and high schools; and certain other organizations, including some that the IRS has relieved from the filing requirement pursuant to its statutory discretionary authority.¹⁰⁵

Section 501(c)(3) organizations that are classified as public charities must file Form 990, *Return of Organization Exempt From Income Tax* if it has gross receipts in excess of \$100,000 and net assets in excess of \$250,000.¹⁰⁶ Public charities must also complete and attach, Schedules A and to its annual Form 990. Schedule A requests information on payments to employees and independent contractors as well as payments for lobbying and political activities among other things. An organization “must list on Part I [Schedule B] every contributor who, during the year, gave the organization directly or indirectly, money, securities, or any other type of property aggregating \$5,000 or more for the year”.¹⁰⁷

On the applicable annual information return, organizations are required to report their gross income, information on their finances, functional expenses, compensation, activities, and other information required by the IRS in order to review the organization’s activities and operations during the previous taxable year and to review whether the organization continues to meet the statutory requirements for exemption. Examples of the information required by Form 990 include: (1) a statement of program accomplishments; (2) a description of the relationship of the organization’s activities to the accomplishment of the organization’s exempt purposes; (3) a description of payments to individuals, including compensation to officers and directors, highly paid employees and contractors, grants, and certain insider transactions and loans; and (4) disclosure of certain activities, such as expenses of conferences and conventions, political expenditures, compliance with public inspection requirements, and lobbying activities. The IRS is currently revising Form 990.

2. Form 990-T & Form 4720

A section 501(c)(3) organization that is subject to the unrelated business income tax and that has \$1,000 or more of gross unrelated business taxable income must file Form 990-T. Public charities that make an election under section 501(h) regarding permitted lobbying expenditures and that incur tax for excess lobbying expenditures must file Form 4720. Form 4720 also is required to be filed (by public charities or private foundations, as the case may be)

¹⁰⁵ Sec. 6033(a)(2)(A); Treas. Reg. sec. 1.6033-2(a)(2)(i) and (g)(1).

¹⁰⁶ An organization that is required to file an information return, but that has gross receipts of less than \$100,000 during its taxable year, and total assets of less than \$250,000 at the end of its taxable year, may file Form 990-EZ. Private foundations are required to file Form 990-PF rather than Form 990.

¹⁰⁷ Instructions, Form 990 Schedule B, *Schedule of Contributors*

with respect to any taxes owed for self-dealing (sec. 4941), undistributed income (sec. 4942), excess business holdings (sec. 4943), investments that jeopardize charitable purposes (sec. 4944), taxable expenditures (sec. 4945), political expenditures (sec. 4955) and excess benefit transactions (sec. 4958).

3. Penalties for Late Filing or Incomplete Information Returns

If an exempt organization does not timely and completely file the information return (e.g., Form 990 for a public charity) or does not furnish the correct information, it must pay \$20 for each day the failure continues (\$100 a day for large organizations, i.e., ones with gross receipts exceeding one million dollars for the taxable year).¹⁰⁸ The maximum penalty for each return will not exceed the lesser of \$10,000 (\$50,000 for a large organization) or five percent of the gross receipts of the organization for the year. The penalty will not be imposed if the organization can show the failure was due to reasonable cause. There also are penalties for willful failures and for filing fraudulent returns and statements.¹⁰⁹

4. Penalties for Late Filing or Incomplete Tax Returns

In general, exempt organizations that have gross unrelated business taxable income of at least \$1,000 for the taxable year are required to file Form 990-T.¹¹⁰ Such organizations may be subject to penalties for filing late returns or failing to pay tax when due. The penalty for late filing of a Form 990-T is five percent of the unpaid tax for each month or part of a month the return is late, up to a maximum of 25 percent of the unpaid tax.¹¹¹ The minimum penalty for a return that is more than 60 days late is the smaller of the tax due or \$100. The penalty for late payment of taxes is usually one-half of one percent of the unpaid tax for each month the tax is unpaid, not to exceed 25 percent of the unpaid tax. Failure to file and failure to pay penalties will not be imposed if the organization can show the failure was due to reasonable cause. Penalties can be imposed for negligence, substantial understatement of tax, and fraud.¹¹² There also are penalties for willful failure to file and for filing fraudulent returns and statements.¹¹³

Organizations required to file Form 4720, Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code, may be liable for

¹⁰⁸ Sec. 6652(c)(1)(A).

¹⁰⁹ Secs. 7203, 7206, and 7207.

¹¹⁰ Sec. 6012; Treas. Reg. sec. 1.6012-2(e). Organizations liable for the proxy tax on lobbying and political expenditures also are required to file Form 990-T. The proxy tax is treated as an income tax for purposes of applicable filing and payment requirements and penalties. Sec. 6033(e)(2)(C).

¹¹¹ Sec. 6651(a).

¹¹² Secs. 6662 and 6663.

¹¹³ Secs. 7203, 7206, and 7207.

penalties for failure to file or to pay tax.¹¹⁴ There also are penalties for willful failure to file returns, supply information, or pay tax,¹¹⁵ and for filing fraudulent returns and statements.¹¹⁶

4. Penalties for failure to satisfy inspection and disclosure requirements

Organizations must make Form 990, along with Schedules A and B available for public inspection.¹¹⁷ However, section 6104(d) prohibits the disclosure of names or addresses of contributors to the organization; thus, an organization must redact such information before making Schedule B available for public inspection.

A penalty may be imposed on any person who does not make an organization's annual returns or exemption application materials available for public inspection. The penalty amount is \$20 for each day during which a failure occurs. If more than one person fails to comply, each person is jointly and severally liable for the full amount of the penalty. The maximum penalty that may be imposed on all persons for any one annual return is \$10,000. There is no maximum penalty amount for failing to make the exemption application available for public inspection. Any person who willfully fails to comply with the public inspection requirements is subject to an additional penalty of \$5,000.¹¹⁸

5. Form 8283

Taxpayers must submit a Form 8283 to the donee organization for acknowledgement of receipt of noncash contributions greater than \$500. The donee organization must return the signed form to the donor before the donor can claim a deduction for the contribution. Prior to submitting to the donee for signature, the taxpayer must provide the taxpayer's name and identifying number along with a description of the donated property.

6. Form 8282

Donee organizations use Form 8282 to report information to the IRS about dispositions of certain charitable deduction property made within 2 years after the donor contributed the

¹¹⁴ Sec. 6651.

¹¹⁵ Sec. 7203.

¹¹⁶ Secs. 7206 and 7207.

¹¹⁷ Sec 6104(d)

¹¹⁸ Sec. 6685.

property.¹¹⁹ An organization is penalized \$50 for each occurrence of non-filing or incomplete filing.¹²⁰

¹ Rev. Rul. 71-529, 1971-1 C.B. 234.

¹¹⁹ Instructions, Form 8282, *Donee Information Report*

¹²⁰ Sec. 6721.



PART TWO – GENERAL OBSERVATIONS

I. Conservation Programs

a. Conservation Easements

1. Overview

A conservation easement on land is a legal agreement by the landowner to place legally enforceable restrictions on the use of the land that serve environmental and conservation goals such as protection of natural habitat (fish, wildlife, or plants), and preservation of open space, including farmland for scenic enjoyment or pursuant to clearly defined government policy. Conservation easements often are structured in such a manner as to entitle the landowner to claim a charitable deduction under section 170(h).

TNC's computer database tracks interests in land subject to conservation easements on a parcel by parcel basis. As of December 31, 2003, TNC held 1,608 parcels subject to conservation easements granted in the favor of TNC.¹ Additionally, TNC has broken down the conservation easements it holds in different ways. TNC provided information that indicated that under the CBP program, TNC acquired conservation easements in 150 transactions in the ten year period preceding July 16, 2003.² In a separate compilation, TNC recorded 78 conservation easement purchases and donations in excess of \$1,000,000 during the period beginning with fiscal year 1998 and ending with fiscal year 2002.³ TNC listed 441 easements with a value above \$25,000. Finally, at the Committee's request, TNC identified 50 individuals who contributed conservation easements to it for each of the years 1999, 2001, and 2003.⁴

For the fiscal year ended June 30, 2004, TNC's financial statements reported a line item in the balance sheet for "conservation easements" in the amount of \$795,812,000. As of the same date, TNC reported total assets as \$3.7 billion. Thus, based on TNC's valuations and reporting, the value of TNC's conservation easements represented approximately 22 percent of its total assets.

TNC received approximately 165 conservation easements during fiscal years 2003 and 2004. The aggregate value of the conservation easements acquired during this period totaled approximately \$150 million dollars. TNC acquired these easements at a cost of approximately \$25 million; some easements were acquired as outright gifts and some easements were acquired by purchase at a price below the appraised fair market value. These figures do not include the value of or number of easement transactions in which TNC purchased a conservation easement for its full market value.⁵

¹ TNC Narrative Response dated April 15, 2004, *see* Appendix D.

² TNC Summary, provided in response to Question 1, of Committee Letter to TNC dated July 16, 2003.

³ TNC Answer to Question 6, July 16, 2003, Committee Letter to TNC, *see* Appendix D.

⁴ TNC Answer to Question 6., March 3, 2004, Committee Letter to TNC.

⁵ TNC Narrative response dated May 12, 2005.

TNC reported that in virtually every case, the predominant conservation easement purpose served by the conservation easement is for the 'protection of a relatively natural habitat' and that the properties over which TNC has accepted such easements are in furtherance of a systematic, ecoregional assessment identifying the conservation significance of such properties. TNC's assumes that the majority, if not all, of these transactions involved a claim for a charitable contribution deduction.⁶

2. Monitoring Conservation Easements

TNC adopted a broad range of policies and operating procedures governing the use of conservation easements to carry out its mission. Since 1996, it has had written policies or standard operating procedures that govern certain aspect of the easements at the time of acceptance. Two items may be relevant to TNC's enforcement and monitoring of the conservation easements it receives. First, TNC prepares a detailed "baseline" report at the time of acquisition of the conservation easement. The baseline report is helpful in the future monitoring of the easement to determine if the property is appropriately maintained. Second, at the time of acceptance of the easement, a stewardship fund is set up to fund the costs of monitoring and enforcement.⁷

TNC keeps a central file for key legal documents such as conservation easements. TNC states that the legal documents of transfer are kept in secure files in TNC's central office in Arlington, Virginia. After three years, the copies of the legal documents are recorded on microfiche and all the original legal documents are transferred to a third party storage facility for safekeeping. The legal documents are also entered into TNC's computer database. As to whether there are files where conservation easement deeds are missing, TNC stated as follows:

The Conservancy's staff believes that the central files are complete, but recognizes that there may be cases where this is not the case.

TNC periodically reviews its files for missing documents and if documents are determined to be missing, duplicates are sought from other TNC offices or from repositories of land records.

TNC provided copies of certain forms which are used to monitor the compliance of a property with the terms of the easement. One is a checklist used by the Maryland Chapter of TNC, and another is a checklist used by the Maine Chapter. In addition, TNC provided a document titled "Procedures for the establishment and management of CONSERVATION EASEMENTS for the North Carolina Chapter of The Nature Conservancy." The document provides for monitoring of conservation easements on an annual basis. The procedure calls for the completion of a checklist form for purposes of the monitoring of the property. The procedure also instructs the TNC monitor to first check the baseline report and any prior monitoring reports before proceeding with the monitoring of the property. The TNC monitor is instructed to take a camera and record

⁶ Id.

⁷ TNC's stewardship fund practice is described more fully below.

all violations. Finally, the procedure instructs the TNC monitor to send a copy of the monitoring report to the easement landowner.⁸

Information submitted as to easement monitoring for prior years, during time periods that may extend as early as 1998 and end as late as 2004, show that TNC is inconsistent in its monitoring efforts. Easement summaries voluntarily submitted by TNC (without request by the Committee), based on Ecoregion, showed easement monitoring for varying intervals. These summaries show that the monitoring is often occurring every third year, but sometimes as infrequently as every fourth or fifth year. A second list provided by TNC, entitled "Conservation Easement Monitoring Schedule," indicates an intended schedule with a monitoring interval of every two years, yet the actual monitoring occurred less frequently than 2 year intervals. Again, the monitoring appeared to be every third year, but on occasion every 4 or 5 years.⁹

The Committee asked TNC to provide specific monitoring information regarding certain States, as a test of its overall monitoring practices.¹⁰ The Committee requested information regarding the ten smallest and the ten largest easements in certain States. In its response regarding easements in Ohio, TNC indicates that it has only nine (9) conservation easements in that state. Since TNC did not attach copies of the reports to monitor these easements, the Staff assumes that there were no formal written monitoring reports. For a few properties, TNC responded that a TNC staff person walks the property annually. Other responses include that TNC staff or volunteer drive by the property frequently.

The Committee requested information regarding the ten smallest easements in California. The following is a summary of TNC's monitoring efforts with respect these easements.

- TNC prepared written reports for only two properties it had before March, 2004.
- TNC prepared a written report for a three acre easement identified as Boggs Lake-Melen on March 21, 2004, but it did not prepare any reports on this property from 1998 through 2003. TNC states that one of its ecologists made "a number" of informal monitoring visits.
- TNC did not prepare written reports on three small easements associated with McGinty Mountain since 1998. TNC states that its staff from the San Diego office visits the site from time to time in order to determine if there are violations of the easement terms.
- TNC did not prepare written reports for another easement of 3.5 acres. TNC states that staff from its San Luis Obispo office visits the site from time to time.
- TNC lists four small easements associated with Tenaja Corridor. TNC has two staff members working in relatively close proximity to the easements. The staff frequently visits the easements to observe the compliance of the property owners with the terms of the easement.

⁸ The North Carolina document is revised as of March 19, 2004.

⁹ It is noted that the summaries provided were for a relatively small number of properties. Approximately 20 properties were involved in these lists.

¹⁰ TNC Narrative Response to Question 6, of Committee Letter to TNC dated March 3, 2004.

With respect to the ten largest conservation easement properties in California, all of which were cattle ranches, TNC provided the following information:

- TNC prepared written reports on the Lassan Foothills easement, a cattle ranch, in 2000, 2001 and 2002.
- TNC prepared a written report on the easement on #2 Mt. Hamilton, having 28,043 acres, in 2002. The report disclosed that the property was being significantly overgrazed and the owner must be brought into compliance with the conservation easement.
- TNC had a third party consultant prepare monitoring reports on two large properties subject to easement.
- As of the date of TNC's response, TNC had not monitored another which was donated in 2002.

3. Enforcement of Conservation Easements Through Litigation

One of the greatest concerns regarding the maintenance of the conservation easement by an organization exempt under section 501(c)(3) is whether the organization is willing to enforce compliance of the easement through litigation or other means. Enforcement through litigation may be viewed by many environmental and conservation groups as having many downsides and few benefits. To such organizations, litigation may be viewed as expensive, as possibly alienating donors to the organization, as possibly resulting in bad press, and for organizations that have not been scrupulous in adhering to state law or IRS requirements, risking exposure of the organization's practices and procedures to regulatory authority.

TNC states in its letter to the Committee dated April 15, 2004, that while it does try to avoid litigation through negotiation, it will pursue litigation to enforce the conservation easement pursuant to its standard operating procedure adopted in 1996. TNC lists five cases in the "Annex A"¹¹ which it litigated to enforce the conservation easement. The examples provided in Annex A include one case which did not involve a conservation easement held by TNC. In two other cases, TNC settled for less than its full rights. In "Annex B", TNC failed to enforce the conservation easements on Roanoke Island Marshes (Guthrie), North Carolina.¹²

4. Conservation Easement Modifications or Amendments

Landowners have requested a number of modifications to, or amendments of, conservation easements, most of which TNC approved. TNC defends such easement

¹¹ TNC joined a Motion to Intervene in a suit brought by the Attorney General of the state of Maryland to enforce a conservation easement that had been created in 1975 and was held by The National Trust for Historic Preservation at the time of the Motion. TNC Memo dated April 15, 2004, *see* Appendix D.

¹² TNC owned an easement covering 28 acres of marsh and 6 acres of upland loblolly pine/myrtle hammock. TNC "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 because she cleaned out a few acres of diseased loblolly pine trees on the advice of a state forester ... TNC also felt that the main reason for the easement was to protect the marshes and that was being accomplished". *Id.* at 29.

amendments or modifications in part based on a formal written procedure adopted in 2001, which procedure was reviewed in proposed form by independent counsel.¹³ The procedure applies to all conservation easements held by TNC except where the proposed changes only impose additional conservation restrictions, are clearly *de minimis*, or merely clarify, rather than change, the substantive terms of the easement. TNC stated that the procedure was adopted after TNC sought and obtained informal opinions and advice from a wide variety of sources including, but not limited to, independent attorneys, conservation practitioners, other conservation organizations, and officials at the IRS.¹⁴

In cases where the procedure is applicable, a four part analysis must be undertaken by TNC upon a receipt of a request for an easement modification: 1) The TNC staff must determine that the proposed changes will not diminish the overall conservation goals and objectives of the original easement in any way; 2) TNC's legal staff must determine that the proposed changes will not result in a violation of the private benefit rule set forth in section 501(c)(3) and TNC stated to Staff that an appraisal is performed to support this determination; 3) Other than for the conservation buyer program, the donor must be contacted to confirm that he or she has no objection to the modification; and, 4) TNC's legal staff must determine that the proposed change complies with all applicable state law requirements.

In addition to the four part analysis, TNC's policy, starting in 2003, is to request approval of conservation easement modifications from a State authority that has oversight of charitable organizations, and when appropriate, TNC seeks court approval.

The Staff questions whether the four-part procedure adopted by TNC offers additional meaningful protection of the easements in a manner that may be assessed and administered by TNC and the IRS. Regarding the first item, many modifications will diminish the conservation goals and objectives of the original easement, and thus require a determination that such diminutions are offset by other equal or enhanced conservation benefits. For example, the modification may permit an owner to construct a larger home on the property in exchange for a more limited use of the property for agricultural purposes, a trade off that may be difficult to measure from a conservation perspective. This weighing of increases and decreases is difficult to perform by TNC and to assess by the IRS. Secondly, the private benefit prohibition aspect of the procedure can be a subjective inquiry, with no bright lines available to make the determination. Third, the requirement that the donor must be contacted to determine if he or she has an objection to the modification as a practical matter is somewhat limited in utility (e.g., it will not apply if the donor is deceased or otherwise unavailable), and does not provide what the policy is in the event a donor is found but objects to the proposed modification. Finally,

¹³ Letter dated March 15, 2001, from McCutchen, Doyle, Brown & Enersen, LLP, to Michael Dennis and Laurel Mayer, Re: Amending Conservation Easements, *see* Appendix D.

¹⁴ TNC Narrative Response dated December 22, 2004, *see* Appendix D. TNC stated that it had informal discussions with the IRS, which consisted of occasional meetings with attorneys at the IRS where technical issues were discussed and where TNC was simply seeking informal guidance as to best practices that TNC might adopt in this area, "where no official rules or regulations exist."

compliance with state law, the fourth requirement of the procedure, is required in any case, and does not add any meaningful protections to the procedure. In summary, the procedure contains aspects that remain subjective and difficult to assess.

TNC submitted to the Committee a chart of 75 conservation easement modifications completed during the ten year period July 1, 1994, through June 30, 2003. Some of the modifications are described as correcting legal description of the property or adding acreage subject to the easement restriction. Of the 75 items, at least 34 items appeared to be items that were requested by the owner of the land or benefited the owner based on the brief description provided in the chart. TNC's response to the Committee's March 3, 2004 letter provides a narrative of many of these transactions in somewhat more detail. TNC also provided copies of deeds of easements including the deeds of modification of the easements as to some of these properties. Some examples of where the owner may have been benefited by the easement modification include the following:

1. Item 13 allows the owner to expand the home site for the personal residence from 5 to 10 acres and, additionally, the owners are allowed to harvest timber on the property. The modification also limited the owner's hunting and trapping rights and eliminated two additional standing structures.
2. Items 28 and 29 allow the owners to construct five residences on property that is shore land in Maine. The modification also strengthened protection of area abutting the TNC preserve.
3. Item 56 allows development of barrier island shore property in South Carolina by increasing the number of residences permitted in the development by 4, increasing the size of the residences, allowing for the construction of two new docks and construction of a lodge. The modification also decreased the size of each dwelling lot from 5 acres to 1.25 acres and reduced the size of each dwelling from 4,000 square feet to 3,000 square feet.
4. Item 65 permits the harvesting of timber when cutting of timber was specifically prohibited in the original deed of easement. TNC states that the original easement did not reflect the intention of parties and that timber harvesting was to be permitted under a management plan.

TNC states that each of the conservation easement modifications is either insignificant in terms of the environmental or conservation impact or that the owner of the property, while receiving a benefit by virtue of the release of a restriction imposed by the conservation easement, made a corresponding new easement restriction or limitation that provided TNC with an easement benefit that outweighed the easement restriction released by TNC. The Staff notes that it is difficult to evaluate all the factors that would make up such a determination and that there is currently no requirement to notify the IRS of modifications under current law.

TNC maintains that approximately 50% of the 75 easement modifications relating to the period 1994 through 2003 were initiated either by TNC or the landowner to add

additional land for conservation protection under the easement, and another 18% were initiated by mutual agreement to correct a mutual mistake. TNC maintains that less than 4% of the modifications were initiated at the request of a third party, such as a State agency or local government, and approximately 28% were initiated by the landowner or a subsequent landowner.¹⁵

TNC stated to Staff that since the 2003 modification procedure became effective, TNC has sought and received approval for modifications of conservation easements from State authorities in 2004 and 2005. TNC did not seek such approval from the relevant State authority for any of the easement modifications covered by the time period 1997 through 2002.¹⁶

5. Maintenance of a Stewardship Fund

TNC's written policy since 1989 has been to set funds aside for the perpetual management, or stewardship, of any legal interest (fee and less than fee) that TNC acquires in conservation land.¹⁷ TNC maintains specific stewardship funds for specific properties and also maintains over 400 endowments totaling over \$700 million in the aggregate that are expected to continue in perpetuity to be used for monitoring and enforcement of easements.¹⁸ According to TNC, "these endowments provide the principal source of funding for the enforcement of conservation easements, and thus obviate the need for a separate endowment limited to enforcement activities with respect to any specific conservation easement. In [TNC's] view, this approach is more compatible with the broad interpretation of the term 'stewardship' applied by [TNC] with respect to the conservation easements it holds."¹⁹ TNC stated that although "it is not feasible to identify a specific portion of the \$700 million that is allocable to the enforcement of easements," "funds with assets totaling in excess of \$200 million are identifiable as stewardship funds." TNC stated that "[o]n balance, [it] is thus satisfied that its endowments are adequate to fund enforcement activities for the easements it now holds."²⁰

TNC stated that its longstanding policy is to require that a stewardship fund be created or an existing fund increased whenever a new conservation easement is created. This policy does not specify the dollar amount of the fund required because the level of expense that may reasonably be anticipated will vary from property to property, but provides an amount equal to 20 percent of the value of the property be set aside where the circumstances are such that a more precise estimate of needed funding is impractical.²¹

6. Land Trust Alliance— The Standards and Practices Guidebook

¹⁵ TNC Narrative Response dated December 22, 2004, *see* Appendix D.

¹⁶ TNC Narrative Response dated December 22, 2004, *see* Appendix D.

¹⁷ TNC Narrative Response dated December 22, 2004, *see* Appendix D.

¹⁸ TNC Narrative Response dated December 22, 2004, *see* Appendix D.

¹⁹ TNC Narrative Response dated December 22, 2004, *see* Appendix D.

²⁰ TNC Narrative Response dated December 22, 2004, *see* Appendix D.

²¹ TNC Narrative Response dated December 22, 2004, *see* Appendix D.

The Land Trust Alliance is a trade group that represents the community of more than 1300 land trusts across the country. In 1993 The Land Trust Alliance published "The Standards and Practices Guidebook" ("LTA Guidebook"), a detailed operating manual for land trusts consisting of 533 pages of information. The LTA Guidebook devotes chapter 14 to conservation easement stewardship. The preamble to chapter 14 states as follows:

A land trust that holds conservation easements commits itself to their perpetual stewardship. A trust must regularly monitor its easements, maintain contact with easement property owners, and enforce easement terms when they are violated. A trust that fails to do so will eventually lose its credibility, could cause its easement program to be invalidated, and may erode public confidence in easements as a protection tool. A trust should also try to make contingency provisions for its easements in the event it can no longer fulfill its stewardship obligations.

The LTA Guidebook emphasizes the importance of good stewardship. It gives an example of a timber cutting violation unchecked by the land trust and concludes that "even one mishandled stewardship issue can haunt a land trust for years in the future." The LTA Guidebook summarizes the components of effective stewardship as including "thoughtful easement drafting, good landowner and community relations, regular and documented monitoring, a commitment to enforce the easement, contingency planning and strong financial planning."

The LTA Guidebook recommends the establishment of a separate stewardship fund for the purpose of supporting the costs of baseline documentation, routine monitoring, and enforcement to correct violations. The LTA Guidebook provides specific and detailed requirements for monitoring the conservation easement. The LTA Guidebook recommends annual monitoring of conservation easements or more frequent monitoring for easements with greater potential for violations. The LTA Guidebook recommends that the monitoring be recorded in a detailed written report including photos.

TNC states that it maintains a stewardship fund for its conservation easements. However, the cases studied by the Committee regarding TNC conservation easement monitoring indicate that such monitoring was not completed on an annual basis. The cases studied also indicate that TNC did not complete detailed written reports for many of the easements, primarily the small easements.

The LTA Guidebook emphasizes the importance of the need to contact the new owner when there has been a change in ownership of the property. It suggests that notification of a new owner be a requirement of the easement deed.

The LTA Guidebook provides that a land trust must enforce the terms of an easement and provides detailed guidelines on how the easements may be enforced. The LTA Guidebook considers litigation as a last resort but indicates that a land trust must go to court where a violator persists in a restricted activity or damages a protected resource.

The LTA Guidebook does not provide guidance regarding voluntary modifications of conservation easements. The Guidebook does note (Chapter 14D) that a land trust's section 501(c)(3) status could be in jeopardy if it were shown that the trust relinquished enforcement rights to benefit private individuals. The LTA Guidebook does discuss mediation as one alternative when there is a dispute between the landowner and the land trust as to the terms of a conservation easement. However, the Guidebook warns against mediation as leaving the land trust vulnerable to compromises that may encroach on the easement purposes. It suggests that a court ruling on the violation may be preferable.

TNC's voluntary modifications of conservation easements appear to be inconsistent with the LTA Guidebook.

7. Recent Changes in TNC Policies and Procedures

TNC's senior management commissioned a comprehensive internal review of the processes by which the Conservancy acquires, uses, monitors, and enforces conservation easements; this review resulted in TNC adopting three new policies.²² One policy that TNC adopted provides that while monitoring and enforcement will continue to be completed by on-site personnel at the state and local level, TNC will provide increased central oversight and guidance.

The Executive Committee of the Board of Governors also approved the revisions to its policy on land management to explicitly state that "in the case of conservation easements or other interests in land held by the Conservancy, [the Conservancy] will monitor and enforce those easements and interests in land to achieve their conservation objectives."²³ Also, as mentioned above, TNC's policy is to obtain a baseline report as to each easement property which will enable it to monitor future changes in the condition or use of the land. TNC also elaborated on the policy, mentioned earlier, to establish stewardship funds for each easement property. TNC states that, under this policy, funds may be raised from donors or from others to provide for the perpetual management of the property. Funds may be borrowed for this purpose from TNC's own Land Preservation Fund. Under TNC procedures, TNC is to establish a plan for monitoring the property when the property is accepted. Procedures for monitoring a particular easement do not and have not varied "with respect to the size of the property or the importance of the easement for conservation purposes." In prior years, TNC relied upon its field offices to develop and implement their own monitoring plans. All state chapters have employees responsible for monitoring easements and staffs to assist them. TNC states that it is developing a recommendation for new centralized procedures to supplement the

²² TNC Narrative Response dated April 15, 2004, *see* Appendices D, E. One policy states that all conservation buyer transaction easements must include a monitoring plan that will ensure that the conservation goals will be met and the easement terms will be enforced. However, this policy appears to be limited to CBP transactions.

²³ TNC Narrative Response dated April 15, 2004, *see* Appendix D.

necessarily decentralized local monitoring process. These procedures will include a new centralized easement management electronic database. When fully operational, the protocol will include entering all monitoring activities in a database.

b. Conservation Buyers Program

1. Overview

TNC considers one of its most important and largest programs to be the acquisition of land and interests in land to be held permanently as conservation lands.²⁴ In many instances these lands are owned and managed by TNC. Sometimes TNC will transfer these lands by gift or sale to other non-governmental organizations or governmental agencies for management purposes. In other cases, TNC will transfer these lands to private individuals or entities other than government agencies or nonprofit conservation organizations, subject to conservation restrictions imposed on the property. TNC's conservation buyers program is the sole program by which TNC or its related organizations have sold to persons, other than governments or other conservation organizations, land, interests in land, or water rights that are subject to a conservation easement or option of conservation easement.²⁵

TNC describes CBP as "a small part of [its] habitat preservation activities." Since 1990, TNC has sold over approximately 270 parcels of land pursuant to the CBP program out of more than 12,000 other conservation land transactions during the same period.²⁶ TNC states that for all CBP projects, TNC obtains independent documentation of land values and the impact of those values on the permanent restrictions on development imposed by the easements.²⁷

An important element in the analysis of TNC's CBP transactions is TNC's marketing of the respective properties. Prior to TNC's reforms, in some cases, TNC did not widely market the properties. TNC currently markets these properties on its website, which provides a listing of CBP properties and a description of the program and also markets them through its state chapters. As of March 24, 2005, TNC's website listing of CBP properties contained 53 properties with an asking price of as low as \$35,000 and as high as \$16 million. TNC also solicits cash donations to support the conservation buyer fund.²⁸ TNC's website contains materials promoting the CBP program by various TNC State chapters, including Alaska, Arizona, Arkansas, California, Connecticut, Idaho, Illinois, Kentucky, Louisiana, Massachusetts, Michigan, Missouri, South Carolina, South Dakota, Tennessee, Vermont, and Wyoming, as well as in Mexico.

According to TNC, CBP encompasses four different types of transactions, each of which uses a conservation easement to impose certain conservation restrictions on the involved land.

²⁴ TNC Narrative Response dated July 25, 2003, *see* Appendix E.

²⁵ TNC Narrative Response dated July 25, 2003, *see* Appendix E.

²⁶ TNC's Response to *The Washington Post* Series, *see* Appendix A.

²⁷ *Id.*

²⁸ https://nature.org/forms/secure/support_us.asp?support=AHOBA200401700.

Type I

TNC acquires property with its own funds.

TNC places conservation easement on the property

TNC sells easement-restricted property. Sales price is TNC's original acquisition price.

Type II

TNC acquires property with its own funds.

TNC places conservation easement on the property.

TNC sells easement-restricted property. Sales price is TNC's original acquisition price *reduced* for easement restriction. TNC recoups remainder of original acquisition costs by raising funds from other sources.

Type III

TNC acquires property with its own funds.

TNC places conservation easement on the property.

TNC sells easement-restricted property. Sales price is TNC's original acquisition price *reduced* for easement restriction. TNC recoups remainder of original acquisition costs by raising funds from the *buyer*, as opposed to other sources as in Type II transactions.

Type IV

TNC acquires property with its own funds.

TNC sells property before placing a conservation easement on it. As a condition of the sale, buyer must grant TNC a "nominal (but legally enforceable) option to buy back a conservation easement over the property".

TNC, at a later time, exercises the option to acquire the easement at the nominal purchase price OR it receives the conservation easement as donation from the buyer.

The first type involves the purchase by TNC of a property, followed by TNC's placement of a conservation easement on the property and a sale of the restricted property to a third party (typically for the price paid for the property by TNC before the easement was imposed). This form or type assumes a sale transaction probably documented as a sale at a premium price, maybe even without reference to a contribution for the premium component of the price in the sale documents. The parties would rely on the IRS revenue rulings, presumably, that state that a charitable deduction is available if you pay more than FMV to buy property from a charity.

The second type is the same as the first except that TNC sells the property to a third party for the restricted value of the property, with TNC raising private funds from other sources to cover the remainder of the initial cost of the property. In this case the CBP buyer has basis in the restricted property equal to the purchase price, but no charitable deduction because the CBP buyer paid FMV. Any charitable deduction belongs to the other providers of the cash or property that made TNC whole with respect to its acquisition price and transaction costs.

According to TNC, the third type of CBP transaction is the same as the second except that TNC raises the remainder of the initial cost of the property from the buyer

(rather than from other sources). This is essentially the same as Type 1, except the parties probably structure this as a part-sale, part-charitable contribution by pledge transaction. In either Type 1 or Type 3, the buyer pays unrestricted value to get the restricted property, with the expectation that the excess of the amount paid over the restricted value is a charitable deduction.

The fourth type of CBP transaction differs from the first three in that TNC does not place a conservation easement on the property before it sells the property to a third party. Rather, TNC sells the acquired property to a third party, and as a condition of the sale, the buyer grants TNC a "nominal (but legally enforceable) option to buy back a conservation easement over the property." At a later time, the buyer either donates the conservation easement to TNC or TNC exercises its option to acquire the easement at the nominal purchase price. Under general tax principles, this option should probably be viewed as exercised by TNC at the time TNC acquired the option, because TNC holds at that time the ability to compel the grant of the easement for nominal consideration.

TNC considers the tax consequences of the CBP program to be the same regardless of the type of transaction effected - a charitable contribution deduction equal to the permanent reduction of the land's value resulting from the placement of the conservation easement on the property. These transactions are structured by TNC such that the contribution of the conservation restriction is not treated as a qualified conservation contribution subject to section 170(h).²⁹ TNC stated to Staff that while they recognize that there is not a legal requirement for such easements to conform with section 170(h), that in practice TNC does require the easements in these transactions to comply with section 170(h).

On June 13, 2003, the TNC Board of Governors approved a policy that "all charitable gifts associated with a conservation buyer transaction must be legally documented as part of the transaction."³⁰ According to TNC, this action was taken by the Board of Governors to ensure that the charitable gift "be a legally enforceable element of the conservation buyer transaction and explicitly documented," so that "there is an explicit link between the sale of the property and the gift."³¹

2. Tax Analysis regarding CBP Transactions³²

TNC describes CBP as involving only properties that are "important wildlife habitat or [that] buffer critical protected areas and are often targeted for intense commercial or residential development." TNC maintains the conservation easements placed on the involved lands permit "only modest, if any, changes in land use." TNC

²⁹ Although unstated by TNC, the person claiming the charitable deduction in Types 1, 3, and 4 is the CBP buyer. In Type 2, it is the contributor of the cash funds.

³⁰ TNC Narrative Response dated July 25, 2003, *see* Appendix E.

³¹ TNC did not provide any analysis regarding whether this change in policy affected the ability of a buyer of a CBP property to claim a charitable deduction for the amount of the diminution in value resulting from the restrictions.

³² Copies of legal opinion discussed are provided in Appendix F.

states that it has been advised by independent legal counsel that “the buyer in these cases is entitled to a federal income tax deduction.”³³

The Committee requested that TNC provide copies of tax opinions or written advice regarding conservation easements and conservation buyer transactions. While copies of all 26 documents provided by TNC are included in Appendix F, the Staff summarizes below the opinions provided by Steptoe & Johnson, LLP, Ernst & Young LLP, Holland & Hart LLP, and Jerry A. McCoy, Attorney-at-Law.

Series of Steptoe & Johnson LLP opinions, including that for Davis Mountain (1992-2002)

January 31, 1992: On January 31, 1992 Steptoe & Johnson provided a written opinion to Michael Dennis, General Counsel of TNC, regarding two “alternative ways in which a combined purchase/donation” to TNC could be implemented.³⁴ The factual description of the transaction stated that the buyer of the property was “willing to make a \$15 million commitment” to TNC “in exchange for [a] 75 percent interest in the property” owned by TNC. “As a condition of the conveyance,” TNC was to place conservation restrictions on the land. TNC had paid approximately \$20 million for the entire property. The parties were to obtain an appraisal to determine the fair market value of the 75 percent interest subject to the conservation restrictions. The opinion stated that “[t]o the extent that the \$15 million commitment exceeds the value of the land subject to the conservation restrictions, the donor/purchaser is willing to make a charitable contribution to [TNC] of the difference between \$15 million and the appraised value of the land.”

The Steptoe opinion stated “[w]e think there are two forms that achieve these results and come within these guidelines.” The first involved two simultaneous agreements, one a purchase agreement for the appraised value of the 75 percent interest subject to the conservation restriction, and the other a separate charitable subscription for the remainder of the \$15 million. The second form was a single agreement for \$15 million, with the appraised value of the 75 percent interest subject to the conservation easement expressly allocated to the land purchase, and the remainder of the \$15 million expressly designated as a charitable subscription. In either form, the entire \$15 million commitment could be secured by assets acceptable to TNC.

The opinion stated that as “a preliminary matter, it appears to us that the payment of an amount in excess of the value of the land does not create an automatic problem under the charitable gift rules. Donors commonly engage in ‘bargain sales,’ selling property to a charity for an amount less than fair market value. The ‘bargain’ is recognized as a charitable donation, and is deductible by the donor. Our situation is simply the reverse of the bargain sale,” observing that in this case “our donor will give money in excess of the property’s value.” Steptoe went on to say that “it appears that there is little risk that the Service will refuse to acknowledge the gift portion of a

³³ TNC’s Response to *The Washington Post* Series, see Appendix A.

³⁴ The opinion referred to a particular transaction involving the transfer by TNC of the Gray Ranch in New Mexico.

transaction that appears to combine both purchase and gift elements,” and that “the Service is unlikely to deny that a gift has occurred.” Likening the transaction to one previously approved by the IRS recognizing a charitable donation for amounts paid to charities for annuity contracts in excess of their fair market value, the opinion concluded that “[w]hile Form 1 is our preferred form, we are not opposed to either of the formats described.” The opinion noted that: (1) there may be no advantage to structuring the transaction as two separate agreements because there “is always a risk that the Service will ignore the form selected, and will recharacterize the transaction in a manner it considers more consistent with the substance of the transaction;” and (2) where parties contend that the value is less than the amount being paid, “the Service has some room to challenge the allocation of the price between the sale and the gift.”

March 10, 1997. Five years after their first CBP opinion, Steptoe provided another tax opinion, this time with respect to the Davis Mountain, Texas transaction.³⁵ In this transaction, TNC held the rights to acquire ranch lands, and desired to sell at a premium six ranch tracts subject to a conservation easement in order to fund the acquisition price. Relying on the annuity gift analogy, as well as other rulings and case law recognizing the “dual character” of other gifts of property, the opinion concluded that the excess of the price paid by a buyer to acquire a ranch tract from TNC over the fair market value of the tract “should be deductible under Section 170(a) of the Code so long as the transaction makes clear that the purchaser intends to make a gift to TNC of the premium amount.”

The opinion also analyzed the tax consequences if the purchaser-donor used appreciated stock, instead of cash, to pay the premium. Steptoe opined that in such a case, the donor would be entitled to deduct the fair market value of the appreciated stock, and recommended that such a donation be structured as a separate transaction from the purchase of the property, which “should insure that the appreciated stock is treated as the gift element and the cash is treated as the purchase element, thereby avoiding the recognition of gain” that would result if appreciated property were treated as used to purchase the tract.

June 7, 2001. On June 7, 2001, Steptoe issued an opinion to TNC regarding the formation of a limited liability company (LLC) by TNC and a buyer of conservation property in order to effect a charitable contribution deduction for the buyer through a contribution of a conservation easement by the LLC to TNC. In this transaction, TNC and the buyer would form the LLC of which they would be the only members. The buyer would contribute to the LLC cash equal to the fair market value of the land to be acquired from TNC in exchange for a majority interest in the LLC. TNC would contribute nominal cash to acquire a small interest in the LLC. Sometime thereafter, the LLC would purchase the land from TNC at the appraised fair market value, using the cash provided by the buyer. Although there would not be an explicit requirement that a conservation

³⁵ Steptoe provided the opinion at the written request of TNC, which stated that the “memo would essentially be an update of the January 31, 1992 opinion” and should contain a message in bold print that it is not intended as advice for the purchasers and that purchasers should seek their own counsel. TNC indicated that it was advising the purchasers to seek their own tax advice, but viewed the Steptoe opinion as helpful because it could be shared with potential purchasers and their advisers.

easement be placed on the property within a certain period of time, it was contemplated (though “not a foregone conclusion”) that both parties would subsequently agree to the grant of a conservation easement by the LLC to TNC, with most of the charitable deduction relating to the easement flowing through to the buyer who held most of the interest in the LLC. To assure that TNC could control the grant of the easement, or that the property would not be distributed to the buyer without the grant of the easement, TNC would have equal governance rights with the buyer. After granting the conservation easement to TNC, the LLC would be dissolved and the land, encumbered by the easement, would be distributed to the buyer in satisfaction of his interest in the LLC. Steptoe opined that on these facts, there was a risk that the transaction lacked economic substance and would be viewed as the sale of encumbered property (land subject to the conservation easement) by TNC to the LLC at a premium price, thereby putting at risk the ability of the buyer to obtain a charitable deduction that included any appreciation in the fair market value of the property after it was acquired by the LLC. The opinion also stated that the control rights held by TNC likely would reduce the value of the land held by the LLC, and could depress the amount of the charitable deduction available to the buyer.

September 26, 2002. On this date, Steptoe provided an update of the March 10, 1997, opinion rendered in connection with the Davis Mountain, Texas transaction. The 2002 opinion did not refer to a specific transaction. Based on the same analysis applied in the 1997 opinion, Steptoe opined that “if TNC sells any property at a price in excess of the property’s fair market value, the premium payment will be deductible to the purchaser under section 170(a) of the Code so long as the transaction makes clear that the purchaser intends to make a gift to TNC of the premium amount.”

Ernst & Young opinions regarding section 1031 exchanges and conservation buyer transactions.

TNC received other opinions regarding the application of Federal income tax law to conservation buyer transactions. For example, on August 23, 1999, TNC received an opinion from Ernst & Young LLP that a charitable deduction would be available for the contribution of a conservation easement that was made as part of a like-kind exchange of properties between the buyer and TNC.³⁶ Ernst & Young opined that a buyer of conservation property that exchanged like-kind property worth more than the acquired property (including because the acquired property’s value was diminished because it was subject to a conservation easement) could claim a charitable deduction for the excess if the exchange was with a charitable organization.

Holland & Hart opinion regarding parking arrangements and conservation buyer transactions

On October 26, 2001, Holland & Hart LLP provided an opinion to TNC regarding “parking arrangements” in which TNC acquired conservation properties from a seller

³⁶ Tax deferral of gain is available in an exchange of like kind properties that satisfies the requirements of section 1031 of the Code.

with an agreement to sell them back to the seller or to a conservation buyer. In one of the transactions, the seller had the option to buy, and TNC held the concurrent option to sell, the subject property at the original sales price plus the cost of funds. In two other transactions, an option contract was not signed to document the parties' understanding regarding the concurrent options. In a fourth transaction, TNC would acquire the property as an intermediary between a seller and a buyer related to the seller. Holland & Hart analyzed various risks to other parties to the transactions in the event that TNC was not viewed as the owner of the properties for Federal income tax purposes.

Jerry J. McCoy tax advice letter

In a January 21, 2003, letter to the General Counsel of TNC, Mr. Jerry J. McCoy, Attorney at Law, responded to TNC's "request for [his] comments" on two alternative forms of the CBP transactions.³⁷ Mr. McCoy described Alternative A (Type 3) and Alternative B (Type 1). In his letter, Mr. McCoy described these alternative forms of the CBP transaction as "a typical land trust technique for acquiring, protecting and reselling tracts of land with significant conservation values." Mr. McCoy's letter did not address Types 2 and 4 referred to above, which involved raising funds from sources other than the buyer when TNC placed the conservation easement on the property, or the use of an option held by TNC to acquire a conservation easement from the buyer for a nominal consideration.

Mr. McCoy stated that in either of Alternatives A or B, "the result is the same. The total outlay of the donor/buyer is equal to the full unencumbered value of the property, and the excess over the actual value (reflecting the restrictions imposed by the conservation easement) is deductible for income tax purposes." His letter contained an example in which TNC acquired for \$1 million forest land that could be developed into a series of 5-acre homesites. In the example, TNC then conveys the property to [donor], subject to a conservation easement "precluding such development of the land and any other activity (e.g., logging, strip mining, operation of a business, etc.) that would be deleterious to the pristine forest nature of the property." TNC receives \$700,000 (the asserted value of the restricted land) from [donor] for the conveyed property. Mr. McCoy's example then describes two alternatives, one in which "[a]t the closing or soon thereafter, [donor] voluntarily contributes \$300,000 in cash to TNC, so that it breaks even on the transaction." (This is Alternative A, or Type 3.) Alternatively, "[donor] may buy the property from TNC for \$1,000,000, the same amount TNC paid for it." (This is Alternative B, or Type 1.)

With respect to these examples, Mr. McCoy states "[the donor] will be entitled to a charitable contribution deduction in the amount of \$300,000 for income tax purposes under either approach." Mr. McCoy further stated "I believe I can say with certainty that the buyer ([donor] in our example) is clearly entitled to the deductions described, subject to the normal conditions (e.g., a qualified donee, substantiation by means of a timely receipt, qualified appraisals, percentage limitations based upon the donor's adjusted gross

³⁷ Letter of Mr. Jerry J. McCoy to Michael Dennis, General Counsel, The Nature Conservancy, dated January 21, 2003, see Appendix F.

income, etc.).” Mr. McCoy concluded by stating that “the critical question is one of respective values - the amount paid by the donor/buyer versus the value of the property received,” and that “[t]he donee organization is not involved in the valuation process, and the determination of value (including defense of any attack by IRS) is entirely the donor’s obligation.”³⁸

The Staff notes that Mr. McCoy’s letter of advice does not address or refer to (1) the donative intent requirement, (2) the fact that the excess payment treated by the donor as a charitable deduction generally is a condition of the arrangement between TNC and the CBP buyer, (3) raise the possibility that a court may refer to the subjective intentions of the donor to determine the value of the conservation restrictions obtained by TNC, or (4) discuss the possibility that the IRS may look to the substance rather than the form of the transaction to determine whether the transaction must comply with section 170(h).

Tax analysis and tax reporting with respect to charitable contribution component

In nine of the 19 CBP transactions described in TNC’s first submission of CBP materials to the Committee, TNC’s files contained records regarding the tax analysis of the transaction to the purchaser. These included, among others, the Mackinac County, Michigan property transaction and two of the three Garrard County transactions referred to in *The Washington Post* series. TNC stated there were no file records providing a tax analysis of the Shelter Island/Suffolk County, New York transaction. TNC provided documentation of Forms 8283 with respect to two of the property acquisitions, and stated that a form was not required in 12 cases because no gift was involved. In four cases, TNC failed to obtain the forms.

TNC provided documentation of Forms 8283 with respect to two of the property dispositions by TNC. TNC reported that it was not required to file Forms 8283 in 16 disposition instances. TNC failed to file a Form 8283 with respect to one of the sale transactions.

TNC provided Forms 8282 with respect to two of the property dispositions by TNC. TNC reported that it was not required to file Forms 8282 in 13 instances because no gift was involved, in two instances because the property was disposed of more than two years after donation, and that it failed to find file copies in two instances.

Summary of CBP transactions (first submission)

In its first submission dated July 2003 (which only involved insider transactions at the request of Staff), TNC provided information and documentation regarding 19 conservation buyers program transactions, including the Shelter Island, Garrard County,

³⁸ Mr. McCoy states that with respect to Alternative A, or Type 3, “there is no room for argument, since the values have been confirmed by a reliable independent professional appraiser.” He supports his conclusion with respect to Alternative B, or Type 1, by citing Treasury Regulations section 1.170A-1(d)(1), Rev. Rul. 70-15, 1970-1 C.B. 20, and *United States v. American Bar Endowment*, 477 U.S. 105 (1986). See Appendix F.

and Lake Huron transactions described below. This submission did not include any documentation regarding the Martha's Vineyard transaction. Three of the 19 properties were acquired by donation to TNC. TNC's purchase prices for these other properties ranged from \$7,935 to \$7.4 million. The appraised values of the properties (with easements imposed) were in the range of \$11,500 to \$5.4 million per transaction.

Of the 19 properties, four were described as primarily agricultural, two were described as primarily forests or timber land, one was described as marsh and wetlands, two were described as waterfront and lake shoreline, and eight were described as having multiple uses, such as a mixture of agricultural or grazing and forest lands.

TNC received a "sales price" that was less than the purchase price it paid to acquire the properties in 10 of these transactions. TNC received a "sales price" that was greater than its acquisition price in six transactions (including the three donated properties). The Staff was unable to determine the relationship between TNC's purchase price and sales price in the remaining three instances.

The length of time TNC held a property varied from one day (three properties, Cochise County, Arizona, and two Jeff Davis County, Texas properties, were sold on the same day they were acquired) to 19 years (one of the Keya Paha County, Nebraska properties). Eight of the other properties were disposed of within one year of the acquisition by TNC. Another six properties were disposed of within two to three years of acquisition by TNC. One property was held by TNC for six years.

Relationships between TNC and seller

Of the 19 transactions, two were acquired by donation by TNC from persons with whom TNC had a relationship. The Pendleton County, West Virginia property (number 15) was donated to TNC by one of its members. The Santa Fe County, New Mexico property was donated by the Public Service Company of New Mexico, of which a Vice President also was a state trustee of TNC within New Mexico. TNC did not purchase any of the 19 properties from a related person.

Relationships between TNC and purchaser

TNC's responses indicate that all of the 19 transactions involved a sale by TNC to a purchaser who had some sort of relationship with TNC. Two of the transactions involved sales to corporations of which a TNC state trustee was an officer (Cochise County, Arizona; Kootenai County, Idaho). Seven of the transactions involved sales to staff or employees (or to relatives or business entities of staff or employees) of TNC (Crawford County, Indiana; one of the Garrard County, Kentucky transactions; the two Keya Paha, Nebraska transactions; Grant County, New Mexico; Suffolk County, New York; one of the Jeff Davis County, Texas transactions). Eight involved sales to then current or former state chapter trustees (or relatives of state chapter trustees) of TNC (two of the Garrard County, Kentucky transactions; Mackinac County, Michigan; Union County, Ohio; two of the Jeff Davis County, Texas transactions; Grand County, Utah; Pendleton County, West Virginia). Two transactions involved sales to a TNC Board of

Governor (or to a relative of a Board of Governor) (Santa Fe County, New Mexico; Charleston County, South Carolina).

Appraisal information regarding the properties

All 19 of the properties acquired by TNC involved some sort of appraisal process to establish fair market value at or about the time of acquisition by TNC, although TNC did not provide a copy of the appraisal for two of the properties. Twelve of the properties also involved a separate appraisal of the entire parcel at the time it was disposed of by TNC. In the case of six properties, TNC used the purchase appraisal to allocate value to the property disposed of by TNC. In one case, TNC did not provide any information regarding whether an appraisal was obtained for the disposition of the property, because the transaction was subject to a confidentiality agreement that prevented TNC from making such information available (Cochise County, Arizona). Separate appraisals for the conservation easement or the conservation restriction were obtained in 13 of the 19 instances.

Summary of CBP transactions (second submission)

In its second submission dated August 23, 2003, TNC provided documentation and information regarding 150 conservation buyer program transactions. This submission included information pertaining to the Wallace family Martha's Vineyard transactions involving the Herring Creek farm. Because the first submission only included insider transactions, Staff did not consider this aspect in reviewing transactions provided in the second submission.

Part Three of this report provides a detailed discussion of the following CBP transactions: Herring Creek Farm, Martha's Vineyard (the Wallace family); Mackinac County, Michigan (Jerrold Jung); Shelter Island, New York (James Dougherty); and Davis Mountain, Texas.

3. Summary of CBP Transactions (third submission)

The Committee requested information regarding TNC's CBP transactions from the time TNC revised its policies in June 2003 through May 2005.³⁹ TNC provided a list of 47 transactions.

TNC now requires completion of an Approval of Conservation Buyer Transaction form and a Real Estate Disclosure form. The Approval form requires TNC to classify each transaction as one of the following types: gift option, sale and separate gift of easement, premium sale (type a or b), straight conservation sale with private fundraising, or straight conservation sale with public funding. The Staff notes that, for at least twelve of these transactions, TNC did not identify the type. TNC stated to Staff that identification was not made because the transaction is still in progress.

³⁹ Committee Letter to TNC dated April 21, 2005, *see* Appendix B.

The Real Estate Disclosure form requires TNC to indicate whether the parties to the transaction are related to TNC. In at least 19 of the 47 transactions, the Staff was not able to determine whether the transactions involved related parties either because the form was not available or because TNC did not complete the information. In at least 23 of the transactions, TNC indicated that the parties to the transaction were not related to TNC.

4. Application of section 1031 exchanges in CBP transactions

The Committee requested information regarding TNC's participation in section 1031 exchanges with respect to CBP transactions.⁴⁰ "TNC completed approximately 20 like-kind exchanges as part of a transfer-out of property during fiscal years 2002 through 2004."⁴¹ In each of these transactions, the property owned by TNC was transferred to the conservation buyer in exchange for: a) a conservation easement over the other land owned by the individual conservation buyer (typically a neighboring landowner) that TNC sought to protect based on its conservation priorities, or b) non-conservation land owned by the individual conservation buyer that TNC would later sell for cash.⁴²

TNC participated in approximately five like-kind exchanges in which TNC acquired property. In these cases, TNC acquired land by trading other land to the seller. The land TNC acquired in the exchange was subsequently sold to a conservation buyer.⁴³

In all cases, TNC structured exchanges on a value for value basis and where values were not equal, cash was included as part of the transaction so that equal values could be obtained.⁴⁴

c. Emissions Credits

1. Nature of emissions credits, certified offsets, and emissions reductions

TNC entered into its first emissions credit arrangement in 1995. TNC's involvement in these projects has generally involved the reforestation projects related to carbon sequestration. All eight of the agreements reviewed by the Staff involved the accrual of potential emissions credits or allowances to the financial participants. While allowances for carbon dioxide emissions do not currently exist in the United States, the U.S. Environmental Protection Agency ("EPA") has administered a sulfur dioxide (SO₂) emissions allowance cap and trade program since the mid-1990's.

Overview of EPA Program for Sulfur Dioxide

Title IV of the Clean Air Act set a goal of reducing annual SO₂ emissions by 10 million tons below 1980 levels. To achieve these reductions, the law required a two-phase tightening of the restrictions placed on fossil fuel-fired power plants.

⁴⁰ Committee Letter to TNC dated April 21, 2005, *see* Appendix B.

⁴¹ TNC Narrative Response dated May 12, 2005, *see* Appendix E.

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.*

"Allowance trading is the centerpiece of EPA's Acid Rain Program, and allowances are the currency with which compliance with the SO₂ emissions requirements is achieved. Through the market-based allowance trading system, utilities regulated under the program, rather than a governing agency, decide the most cost-effective way to use available resources to comply with the acid rain requirements of the Clean Air Act. Utilities can reduce emissions by employing energy conservation measures, increasing reliance on renewable energy, reducing usage, employing pollution control technologies, switching to lower sulfur fuel, or developing other alternate strategies. Units that reduce their emissions below the number of allowances they hold may trade allowances with other units in their system, sell them to other utilities on the open market or through EPA auctions, or bank them to cover emissions in future years. Allowance trading provides incentives for energy conservation and technology innovation that can both lower the cost of compliance and yield pollution prevention benefits. The Acid Rain Program established a precedent for solving other environmental problems in a way that minimizes the costs to society and promotes new technologies."⁴⁵

The overall goal of the Acid Rain Program is to achieve significant environmental and public health benefits through reductions in emissions of sulfur dioxide (SO₂) and nitrogen oxides (NO_x), the primary causes of acid rain. To achieve this goal at the lowest cost to society, the program employs both traditional and innovative, market-based approaches for controlling air pollution. In addition, the program encourages energy efficiency and pollution prevention.⁴⁶

Acid Rain Program is implemented through an integrated set of rules and guidance designed to accomplish three primary objectives:

1. Achieve environmental benefits through reductions in SO₂ and NO_x emissions.
2. Facilitate active trading of allowances and use of other compliance options to minimize compliance costs, maximize economic efficiency, and permit strong economic growth.
3. Promote pollution prevention and energy efficient strategies and technologies.⁴⁷

Each individual component fulfills a vital function in the larger program:

- the allowance trading system creates low-cost rules of exchange that minimize government intrusion and make allowance trading a viable compliance strategy for reducing SO₂
- the opt-in program allows nonaffected industrial and small utility units to participate in allowance trading
- the NO_x emissions reduction rule sets new NO_x emissions standards for existing coal-fired utility boilers and allows emissions averaging to reduce costs

⁴⁵ <http://www.epa.gov/airmarkets/arp/allfact.html>.

⁴⁶ <http://www.epa.gov/airmarkets/arp/index.html>.

⁴⁷ <http://www.epa.gov/airmarkets/arp/overview.html>.

- the permitting process affords sources maximum flexibility in selecting the most cost-effective approach to reducing emissions
- the continuous emission monitoring (CEM) requirements provide credible accounting of emissions to ensure the integrity of the market-based allowance system and to verify the achievement of the reduction goals
- the excess emissions provision provides incentives to ensure self-enforcement, greatly reducing the need for government intervention
- the appeals procedures allow the regulated community to appeal decisions with which it may disagree⁴⁸

The Acid Rain Program represents a dramatic departure from traditional command and control regulatory methods which establish specific, inflexible emissions limitations with which all affected sources must comply. Instead, the Acid Rain Program introduces an allowance trading system that harnesses the incentives of the free market to reduce pollution.⁴⁹

Under this system, affected utility units are allocated allowances based on their historic fuel consumption and a specific emissions rate. Each allowance permits a unit to emit 1 ton of SO₂ during or after a specified year. For each ton of SO₂ emitted in a given year, one allowance is retired, that is, it can no longer be used.⁵⁰

Allowances may be bought, sold, or banked. Anyone may acquire allowances and participate in the trading system. However, regardless of the number of allowances a source holds, it may not emit at levels that would violate federal or state limits set under Title I of the Clean Air Act to protect public health.⁵¹

The allowance trading system contains an inherent incentive for utilities to prevent pollution, since for each ton of SO₂ that a utility avoids emitting, one fewer allowance must be retired. Utilities that reduce emissions through energy efficiency and renewable energy are able to sell, use, or bank their surplus allowances. As also provided in the Act, EPA has set aside a reserve of 300,000 allowances to stimulate energy efficiency and renewable energy generation. Those utilities that either implement demand-side energy conservation programs to curtail emissions or install renewable energy generation facilities may be eligible to receive bonus allowances from this reserve.⁵²

In the SO₂ Allowance Trading Program, the legislation specifies that allowances are not property rights. This provision was inserted to obviate a challenge of an unconstitutional “taking” should the government decide to alter the emissions cap (i.e., to reduce the number of available allowances). Functionally, however, the ownership rights

⁴⁸ <http://www.epa.gov/airmarkets/arp/allfact.html>.

⁴⁹ <http://www.epa.gov/airmarkets/arp/overview.html>.

⁵⁰ Id.

⁵¹ Id.

⁵² Id.

and responsibilities of allowances are similar to property rights (Ellerman,1999).⁵³ This raises the question of whether Congress intended exempt from tax revenues from the sale of such allowances.

An allowance trading program, also known as a “cap and trade” program is different from a “project-based trading” program.

“Project-based trading, otherwise known as credit trading or offset trading, is generally not used as a stand-alone program. It can be used to offer emission sources the flexibility to seek lower cost emission offsets from sectors outside a regulatory program. Historically in the United States, these types of credits or offsets have been used to meet rate-based emissions limits for conventional pollutants. More recently, there has been considerable international interest in using project-based trading as a complement to cap and trade to meet voluntary or mandatory greenhouse gas emission targets. Emission offsets, or credits, are typically calculated by comparing actual emissions against a baseline. The baseline is an estimate of what emissions would be in a hypothetical situation (e.g., if the project had not been created). Determining the baseline is often the biggest challenge with project-based trading. Designing effective protocols to verify offsets is difficult because it requires making a determination about whether the emission reductions from an offset project would have occurred anyway. This type of test is known as “additionality.” If emission reductions from a project are not “additional,” there is a risk that these reductions could dilute an emissions goal and lead to increased emissions compared to a case in which no offsets are allowed.”⁵⁴

“A similar concern in some situations is ‘paper credits.’ These are created when a source uses its legal allowable level of emissions (e.g., its maximum potential to emit) as its baseline rather than what emissions would have been in the absence of the project. These paper credits are the difference between what a source is allowed to emit and what a source actually emits. These credits increase allowable emissions without generating any real emission reductions.”⁵⁵

“Two issues must be addressed for project-based trading –the effect on total emissions from ‘non-additional’ offsets and ‘leakage,’ which is an increase in emissions or decrease in sequestration caused by the project but not accounted for in the emission baseline for that project activity.”⁵⁶ The underlying concept is

⁵³ *Tools of the Trade: A Guide to Designing and Operating a Cap and Trade Program for Pollution Control*, U.S. Environmental Protection Agency, June 2003, p. 43 available at <http://www.epa.gov/airmarkets/international/tools.pdf>

⁵⁴ *Tools of the Trade: A Guide to Designing and Operating a Cap and Trade Program for Pollution Control*, U.S. Environmental Protection Agency, June 2003, p. 15-16 available at <http://www.epa.gov/airmarkets/international/tools.pdf>

⁵⁵ Id.

⁵⁶ Leakage can also occur in cap and trade programs that do not include all sources contributing to the environmental problem. Sources in the program may shift production to other sources not participating in the program, thereby negating some of the emission reductions. Id.

that a particular project can produce offsetting effects that fully or partially negate the benefits of the project. For example, a project that protects a forest tract slated for deforestation may simply accelerate logging of the next most suitable location. Projects that temporarily sequester emissions (e.g., forestry projects that sequester carbon dioxide) also raise issues of 'permanence.' If the emission reductions from the project are used to offset other emissions, and the project subsequently releases the sequestered emissions, not only is the environmental benefit lost, but the credits may allow emissions to increase."⁵⁷

Kyoto Protocol

The Kyoto Protocol set targets for each of 38 developed countries, which would have to reduce greenhouse gas emissions by a certain percentage below their 1990 emissions baseline.⁵⁸ The Kyoto Protocol would regulate emissions of carbon dioxide (CO₂), methane (CH₄), nitrous oxide (N₂O), perfluorocarbons (PFCs), hydrofluorocarbons (HFCs) and sulphur hexafluoride (SF₆). The United States is currently not a signatory to this treaty and there is much debate in the Congress about the regulation of CO₂.

Participants in the European Union and various other countries will begin actively trading emissions credit allowances beginning in 2005. There are a number of initiatives to establish GHG emissions trading programs or GHG emission registries in the U.S., most of which are in various stages of development, e.g. the Chicago Climate Exchange.⁵⁹

2. Summary of TNC's Participation in Emissions Credits Arrangements⁶⁰

The Staff first became aware of TNC's participation in emissions credit arrangements as a result of reviewing TNC's 1999 Form 990. In this return, TNC disclosed a transaction with a board member.⁶¹

Because TNC's description of the arrangement on its Forms 990 was unclear, the Committee asked TNC to provide additional information regarding the General Motors arrangement. After receiving this information, the Committee discovered that TNC had entered into a similar arrangement with American Electric Power (AEP), the President and Chief Executive Officer of which subsequently became a member of the TNC Board of Governors. The Committee asked TNC to provide additional information regarding

⁵⁷ Id.

⁵⁸ AICPA Statement of Position 03-2, *Attest Engagements on Greenhouse Gas Emissions Information*, September 22, 2003, p. 6.

⁵⁹ Id.

⁶⁰ TNC Narrative Response dated December 22, 2004, *see* Appendix H. TNC described the project and also provided certain information regarding the General Motors arrangement in its April 2004 narrative responses.

⁶¹ TNC's Form 990 (1999), Statement 24 (statement regarding Mr. Jack Smith, Jr., "General Motors signed an agreement with TNC to undertake a climate change project under which TNC received \$10 million and General Motors may potentially receive greenhouse gas mitigation offsets.")

the AEP arrangement, and requested that TNC also provide information regarding any other similar emissions arrangements in which TNC was a participant.

The Staff then learned that TNC entered into eight different emissions credit arrangements during the period from 1995 to 2004.⁶²

Each of these arrangements involved financial participation by private companies, generally energy companies, manufacturers, or utilities. TNC did not contribute funds in six of these arrangements, provided loan financing of \$1.08 million in one arrangement, and contributed \$2.6 million of funds in one arrangement. Private parties contributed or have committed to contribute a total of \$33.8 million to the eight projects.

Each of the eight project agreements provides for the allocation of certified offsets or emissions reductions to the financial participants (in the case of the Noel Kempff Mercado Climate Action Project, to the financial participants and the Government of Bolivia). TNC does not participate in the certified offsets or emissions reductions for any of the projects. It appears that the financial interests of the financial participants consist entirely of their respective shares of certified offsets or emissions reductions. Each project has a project agreement that sets forth the rights and obligations of TNC, the financial participants, and any other parties, for the term of the agreement.⁶³

Although the terms of each arrangement differ, there are some material similarities regarding the various emissions arrangements between TNC and the financial participants.⁶⁴ Each of the arrangements involves financial contributions by private parties, usually one or more utilities or energy companies. The projects located outside the United States also involve a government or nonprofit in addition to TNC. Each of the arrangements assigns *all* emissions credits, offsets, or reductions to financial participants generally based on the relative financial contributions of the financial participants.⁶⁵ TNC retains no rights with respect to any potential credits, offsets or reductions. The following chart summarizes certain information regarding the ten different emissions arrangements reported by TNC.⁶⁶

⁶² TNC Narrative Response dated December 28, 2004, *see* Appendix H.

⁶³ At the Committee's request, TNC provided copies of the transactional and project documents relating to the eight projects.

⁶⁴ The General Motors Agreement served as a form of agreement for the Texaco and CSW/AEP agreements.

⁶⁵ For example, Sec. 5.4 and 5.5 of the Rio Bravo agreements, Sec 9.4 of Texaco and General Motors agreements, Art IV of Bayou Pierre Floodplain Agreement.

⁶⁶ TNC provided information about two projects in current negotiations - Cat Island and the Dominican Republic. TNC Narrative Response dated May 12, 2005, *see* Appendix H.

Table 2, Summary of Emissions Credits Arrangements

Project	Project description	Other entities involved	Date of Agreement	TNC's financial obligation in project	Private parties' financial position in project
General Motors Atlantic Rainforest Restoration Project	Restore and protect 30,000 acres of Atlantic Rainforest in southeastern Brazil	General Motors; General Motors do Brasil Ltda.; Sociedade de Pesquisa e Vida Selvagen	6-9-2000	None	\$10 million (General Motors) (sec. 7.1 of agreement)
Noel Kempff Mercado Climate Action Project	Retirement of timber concession on 1.6 million acres and incorporation of land into national park in northeastern Bolivia	American Electric Power (AEP); Pacificorp; British Petroleum; The Government of Bolivia; Fundacion Amigos de la Naturaleza	3-9-1998	\$2.6 million (including Fundacion Amigos de la Naturaleza's portion)	\$8.75 million (AEP - \$6.2 million; Pacificorp - \$1.75 million; BP - \$0.8 million) (Art VII of agreement states \$7 million total)
Rio Bravo Carbon Sequestration Pilot Project	Purchase of 14,880 acre tract of endangered tropical forest land for incorporation into the Rio Bravo Conservation and Management Area in northwestern Belize, and implementation	Wisconsin Electric Power Company (now WE Energies); Cinergy Services, Inc.; Detroit Edison Corporation (now DTE Energy); Pacificorp; Utilitree Carbon	11-1-1995	Loan to private parties and project of \$1.08 million (sec 3.5 of agreement)	\$2.6 million (sec. 3.1 of agreement)

	of sustainable forest management	Company (consortium of 40 utilities); Programme for Belize			
Rio Bravo Carbon Sequestration Pilot Project Expansion	Purchase of 21,000 acre tract of endangered forest land for expansion of project in northwestern Belize	Wisconsin Electric Power Company (now WE Energies); Suncor Energy, Inc.; Canadian Occidental Petroleum, Ltd. (now Nexen, Inc.); Programme for Belize	8-31-1999 (assignment to Canadian Occidental Petroleum 8-3-2000)	Initial funding of \$452,600 was recouped from transfer of TNC's financial participation in project to Canadian Occidental Petroleum, Ltd.	\$3.1 million (Programme for Belize - \$1.2 million; Wisconsin Electric Power - \$1.0 million; Suncor - \$0.4 million; Canadian Occidental Petroleum - \$0.5 million) (Art III of agreement)
Texaco Antonina Pilot Reforestation Project	Restore and protect 2,500 acres of Atlantic Rainforest in southeastern Brazil	Texaco; Sociedade de Pesquisa e Vida Selvagen	12-12-2000	None	\$3 million (Texaco) (sec. 5.1.2 of agreement)
Central and South West Services Guaraquecaba Climate Action Project	Restore and protect 17,000 acres of Atlantic Rainforest in southeastern Brazil	Central and South West Services (now part of American Electric Power); Sociedade de Pesquisa e Vida Selvagen	3-18-2000	None	\$5.4 million (CSW/AEP) (sec. 7.1 of agreement)
Reforestation and	Reforestation of 925 acres in	Cinergy Services,	1-5-1999	None	\$500,000 (page 3 of

Biodiversity Projects Agreement between TNC and Cinergy Services	Ohio and Indiana	Inc.			agreement)
Bayou Pierre Floodplain Climate Action Project	Purchase of 400 acres and reforestation of 500 acres of cropland in northwest Louisiana	Powertree Carbon Company, LLC (consortium of 25 utilities)	4-19-2004	None	\$424,520 (Art. 4 of agreement)
Cat Island Climate Change Project	Land protection/ reforestation – Cat Island, Louisiana	Detroit Edison	4-15-2005 Letter of Intent	None	Not provided
Rio Blanco Climate Action Project	Protection of forested and reforested areas within and around Juan B. Perez Rancier/Valley Nuevo National Park – Dominican Republic	World Bank BioCarbon Fund	3-30-2005 Tentative Approval	None	Not provided

3. TNC's description of its tax position with respect to the arrangements

TNC did not seek the advice of outside counsel with respect to the tax consequences to TNC of the emissions transactions.⁶⁷ In the case of arrangements involving a conflict of interest, relevant tax law issues were to be analyzed and reviewed by TNC's legal department.⁶⁸ Under written guidance⁶⁹ received from TNC's outside accountants in 1998, TNC reported the majority of payments under the Climate Change Projects as contribution revenue (Form 990, line 1). In a few cases where the financial obligations of the participating contributors to make payments to a project over time were secured by a note receivable, such obligations were reported on Form 990 as Notes Receivable.

⁶⁷ TNC Narrative Response dated December 28, 2004, *see* Appendix H.

⁶⁸ TNC Narrative Response dated December 28, 2004, *see* Appendix H.

⁶⁹ TNC did not provide the Committee with a copy of this written advice.

At the Committee's request, TNC provided a description of TNC's position regarding the tax consequences to TNC of the General Motors emissions arrangement. TNC responded that the \$10 million funding from General Motors was used by TNC for land acquisition and habitat restoration relating to the project, and that the primary purposes of the agreement are to "promote the protection of plants and animals, sequester carbon from the atmosphere, otherwise reduce so-called greenhouse gases in the atmosphere and achieve sustainable development through community conservation...." Under the agreement, General Motors retained the right to seek approval from the appropriate international institutions to obtain carbon offset credits for climate mitigation that may be generated from the project. TNC stated that at the time of the agreement, no legal or commercial framework existed to secure such credits, and that no such framework exists today. TNC further stated that "[c]learly, implementation of the agreement is in furtherance of the mission of TNC" and "is without a doubt, directly and substantially related to the exempt purpose of TNC." TNC stated that the tax and legal aspects of the transaction were reviewed by the TNC legal department when the transaction was approved, and "that review indicated that there were no tax consequences to [TNC]. The review concluded that this project taken as a whole was consistent with TNC's 501(c)(3) exempt and charitable purposes."⁷⁰

4. Development of Emissions Credits Programs

TNC provided the following description in response to the Committee's April 13, 2005 request for information on TNC's involvement in these arrangements:

"It is important to note that the projects described herein provide rights to prospective carbon benefits (also known as carbon dioxide (CO₂) offsets); it is incorrect to say at this time that any of the projects have generated 'emissions credits or allowances'. None of these projects or reductions and emissions have yet been certified or used to help participating companies comply with current regulatory programs that limit CO₂ emissions. At this point, participating companies have voluntarily supported these conservation projects for a number of reasons including for the purposes obtaining rights to CO₂ benefits to meet a company's own internal emissions reduction goals, possible use in future regulatory regimes, experimentation and learning about carbon sequestration methods and verification, and achieving conservation results. Some of the companies involved in this work have registered reductions in voluntary registry programs (e.g. the Department of Energy 1605(b) program and the Chicago Climate Exchange). However, the projects reported herein have not resulted in officially recognized allowances to emit pollution elsewhere."⁷¹

TNC's initial experience with these projects grew slowly out of an experimental project undertaken with Wisconsin Electric Power in 1995. Subsequent to that project, TNC's work in this area became more formalized and TNC began seeking participants for similar projects. TNC's full description of the development of its involvement in

⁷⁰ TNC Narrative Response dated December 28, 2004, *see* Appendix H.

⁷¹ TNC Narrative Response dated May 12, 2005, *see* Appendix H.

these projects is provided in its Narrative Response dated May 12, 2005 (see Appendix H).

5. Tax Considerations of Participation in Emissions Credits Programs

The Committee notes that the tax consequences of these transactions may not be as straightforward as TNC suggests. An organization's analysis of the tax consequences of such transactions should not end merely by concluding that the project and funding furthers conservation purposes. "Under written guidance received from its outside accountants in 1998, TNC has treated the majority of payments under Climate Change Projects on its Form 990 as contribution revenue, line 1".⁷² Reporting revenues from these arrangements on Form 990, Line 1 does not appear to reflect the expectations, rights, and obligations of the financial participants in these arrangements. This classification may be more accurate if TNC simply solicited charitable contributions and use these contributions to conduct the reforestation projects rather than use funds provided by a financial participant to acquire the land and carry out the conservation effort.

A number of pertinent questions must be asked to analyze these transactions for tax consequences to TNC and the other participants. Some of these include:

1) Is TNC acting as a) project manager for another entity's carbon sequestration efforts, b) a broker or seller of emissions credits, or c) a partner in a dual purpose joint venture that further TNC's exempt purpose while also providing a return on investment to the participants?

2) How did the financial participants discover these deals? Did TNC solicit their participation, or did the financial participants (or some third party broker or promoter) bring the deal to TNC?

3) How might financial participants characterize their payments to TNC under these agreements? For example, a for-profit participant may characterize its payments as an equity investment in a joint venture, a fee for management services rendered by TNC with respect to the project, a payment of purchase price for the underlying land or assets of the project, a purchase of the emissions credits or offsets relating to the project, or a contribution or gift.

4) Is TNC furthering one exempt purpose, i.e., land conservation while frustrating another, i.e., the reduction of greenhouse gases?

If revenues from these agreements are classified as anything other than charitable contributions, then the arrangements also raise Federal tax issues relating to private benefit and unrelated business income taxes. The unrelated business income tax consequences to TNC might depend upon the frequency with which TNC continues to enter into similar deals (e.g., the regular conduct of such an activity might constitute a

⁷² TNC Narrative Response dated May 12, 2005, *see* Appendix H.

trade or business, and found by the IRS or a court to be subject to the unrelated business income tax). The analysis also should consider how the funding commitments of the financial participants are treated by them for the Federal income tax purposes.

In addition, TNC should consider whether it received fair market value in exchange for its role in the arrangement, i.e. that compensation was reasonable to insure that a participant does not receive substantial private benefit. TNC should then examine whether the private benefit derived by financial participants is incidental, both in qualitative and quantitative terms, or whether a benefit is substantial such that the arrangement impermissibly serves the private interests of the financial participants rather than those of TNC. It is clear that financial participants expect something in exchange for their funding commitments.⁷³ Moreover, the executed agreements not only set forth the respective rights and obligations of TNC and the financial participants but also place restrictions on TNC's ability to extricate itself from the agreement.

TNC did not seek or obtain a valuation of the emissions credits or of the financial participant's financial interests in the arrangements. Given that the projects have not resulted in officially recognized allowances and there is not fully developed market even if the allowances were recognized, valuation of these credits or rights to these credits is difficult. An IRS revenue agent, if faced with this arrangement, has insufficient facts to determine whether General Motors' \$10 million funding was overly generous to TNC, and perhaps should be viewed at least in part as a contribution, or wholly inadequate because it constitutes a purchase of an asset for only cents on the dollar. These transactions demonstrate that exempt organization reporting makes it difficult for the IRS to learn of significant transactions with material tax issues, analyze the nature and consequences of these types of transactions, and ultimately determine the reasonableness of consideration flowing back and forth pursuant to the parties' bargain.

On June 1, 2005, TNC provided the Staff an additional written statement regarding its emissions credit programs. A copy of the statement, entitled "Carbon Investments not Charitable Contributions," is included in the Appendix H. The statement supplements and clarifies TNC's earlier submissions by saying that "carbon sequestration revenues (included in this category of revenues [reported on line 1 of page 1 of Form 990]) are considered temporarily restricted contributions or grants" that TNC must spend on carbon sequestration projects that further its mission in a specified way. TNC reiterated its earlier statements that it did not know the characterization of the payments by the for-profit participants, and stated that to the best of TNC's knowledge, none of the "project investments" made in the carbon sequestration projects had been reported as a charitable contribution. TNC stated it orally told the participants to consult with their

⁷³ General Motors Agreement, page 3 ("Whereas GM, GMB, The Conservancy and SPVS wish to convey to GM any credits or benefits which may result from this endeavor); page 20 ("The Parties to this Agreement understand and agree that this Project is being developed as a pilot project to demonstrate the viability and effectiveness of reforestation and forest protection greenhouse gas mitigation strategies and to generate certified offsets that may be used at a later date."); Texaco Antonina Pilot Reforestation Project Comprehension Agreement, page 2 ("Whereas, the Parties desire that the Project generate the maximum number of certified offsets or as rapid and regular basis as feasible, ... and that Texaco obtain a proprietary interest in any offsets which may be generated from the Project.").

own lawyers as to the proper characterization of the payments, and orally represented to such participants that, "because of the retained rights to the carbon benefits, such payments would not be able to be reported as charitable contributions." TNC stated that the acknowledgement letters provided to the participants differed from the acknowledgement letters it provides to donors who make charitable contributions. TNC stated it never sent letters or other reports representing or acknowledging that "such contributions were to be characterized as a charitable contribution." TNC noted that it was TNC's understanding that the funds for the General Motors project came from GM's North American operations budget rather than from GM's charitable foundation.

Also, the additional documentation TNC provided to the Staff on June 1, 2005, included copies of two letters from TNC to Jack Smith at General Motors, both thanking him "for all your help," and the second stating "thank you again, now, for your role in making it happen." As stated elsewhere in this Report, TNC's Form 990 reporting of this transaction stated that "Mr. Smith did not participate or vote on" the transaction.

d. Joint Ventures

Exempt organizations are increasingly partnering with for-profit entities or engage in dual purpose ventures as a means to raise funds for exempt activities. Many of these arrangements have a dual purpose – they allow exempt organizations to further their exempt purpose through a commercial enterprise that can further a for-profit entity's interest. TNC stated to Staff that it was the intent of their ventures to further their exempt purposes. Forest Bank, Conservation Beef, Virginia Eastern Shore Development Company ("VES") and the emissions credit arrangements are examples of the innovative strategies that TNC used to simultaneously raise funds and further its exempt purpose. The Staff believes that such arrangements raise material issues regarding the propriety, under present law or as a matter of tax policy, of joint venture arrangements between exempt organizations and for-profit persons pursuant to which the exempt organization owes conflicting duties to itself and to its for-profit partners.

The Washington Post series included a story on Conservation Beef, a joint venture project that involved an attempt by TNC and others to market high-brand beef products from cattle raised on conservation lands. The Staff reviewed the Conservation Beef joint venture as part of the investigation. In addition, the Staff reviewed Forest Bank, LLC, an attempted joint venture involving a conservation forest bank, which would have set aside forest lands for conservation purposes while at the same time permitting the forests to operate as working forests, and provided economic returns to the landowners in exchange for conservation easements placed on their lands. The Staff requested information from TNC regarding its use of joint ventures and related organizations to conduct commercial activities. Based on the Staff's review of TNC's Forms 990, information provided by TNC pertaining to related organizations, and other materials provided by TNC during the investigation, and putting aside the possible characterization of the emissions credit arrangements as joint ventures, there appear to have been no other joint ventures (partnerships or limited liability companies) entered into between TNC and for-profit investors or individuals during the periods reviewed by the Staff.

Conservation Beef was a limited liability company formed by TNC and another exempt organization, which entered into numerous agreements with cattle ranchers, beef processors, and others to conduct its operations. Forest Bank was a limited liability company formed by TNC that attempted to attract individual forest land owners as investors through a public offering of membership interests in the limited liability company. The Staff reviewed the annual information tax returns, financial statements, narrative summaries, and transactional documents provided by TNC with respect to the Conservation Beef and Forest Bank projects. The Staff also reviewed the securities offering documents provided by TNC with respect to Forest Bank, LLC. Neither Conservation Beef nor Forest Bank involved a material investment of TNC's assets or required a significant expenditure of TNC's resources. Although TNC does not appear to have regularly and significantly used joint ventures to conduct nonexempt activities, Conservation Beef and Forest Bank provide important insights into the pressures faced by exempt organizations to raise money through unconventional means, and the difficulties of teaming up with for-profit parties to carry out activities that generate profits as a return to investors or other participants in the arrangements while at the same time furthering charitable goals. These ventures also point out the inadequacy of existing reporting requirements and practices with respect to such arrangements. The Staff notes that TNC's Form 990s did not provide any meaningful information regarding the formation, conduct, or termination of either of these joint ventures. Although annual partnership returns were filed for each of the joint ventures, these ventures were practically invisible to the public (because those returns are not available for public inspection).

The Washington Post series also included a report on Virginia Eastern Shore Corporation, an attempt by TNC to conduct commercial operations to generate profits ultimately for use in TNC's exempt activities. The staff requested information from TNC regarding this arrangement and the use by TNC of other for-profit subsidiaries. Most of TNC's related organization structures involved nonprofit corporation affiliates used by TNC to hold real property or conduct exempt activities in various states. The staff reviewed TNC's for-profit corporation subsidiary arrangements, including the Virginia Eastern Shore project. The staff did not identify any material tax issues relating to that operation that were not reported on the income tax returns filed by the corporation. The Staff notes the difficulty the public and the IRS have in obtaining information regarding these arrangements, given the inadequacy of existing Form 990 reporting requirements and practices.

1. Forest Bank LLC

Forest Bank LLC was one example of a joint venture dual purpose project for which TNC exercised due diligence with respect to the tax consequence of participating in such a venture. TNC obtained the opinion of independent tax counsel as well as private letter ruling from the IRS.⁷⁴ TNC dissolved this entity because it was unable to secure private funding. The failure of Forest Bank to attract any investors may be the result of many factors such as a bad business model, the unique and unprecedented nature of the venture or poor timing of the public offering in the equities market. The

⁷⁴ These were included in the securities offerings materials for Forest Bank, see Appendix T.

Committee questions whether there is an overall unwillingness of investors to participate in a venture that cedes virtually all control to the charitable manager, and subordinates the maximization of profits to the charitable objectives of the exempt organization participant.

2. Conservation Beef, LLC

Conservation Beef, LLC is another example of a dual purpose arrangement. The joint venture was not profitable for any year in which TNC participated in the joint venture. TNC withdrew from this venture as well presumably due to the lack of profit. Although the joint venture agreement for Conservation Beef, LLC is between TNC and Artemis Wildlife Foundation, it appears that the actual agreement created a joint venture among TNC, AWF, and a for-profit organization – PM Holdings, at least with respect to certain of the conservation beef activities for a period of time. “CBL had a verbal agreement with PM Holdings, LLC on terms similar to those described in the form of Joint Venture Agreement previously provided in response to your March 3, 2004 request. Due to changed circumstances and the performance of PM Holdings, LLC, the two parties never formalized a joint venture agreement. Instead, CBL elected to hire a salaried president to direct and implement much of the work which CBL had originally intended PM to perform.”⁷⁵

Further, TNC did not exercise the same due diligence it exercised with Forest Bank. TNC did not provide the Committee with evidence of internal legal analysis or an opinion of outside counsel. TNC did not enter into a written agreement with the AWF and PM Holdings to formalize the arrangement and make clear the respective rights and obligations of the parties. It did not obtain an IRS private letter ruling or an opinion from independent tax counsel regarding the tax consequences to TNC of participating in the joint venture with AWF and PM Holdings, LLC.

The Staff was unable to determine from reviewing TNC’s Form 990s, whether TNC is engaged in any material joint venture activities other than those described above.

Part Three of this report contains detailed descriptions of the Forest Bank LLC and Conservation Beef LLC activities.

⁷⁵ TNC Narrative Response dated January 14, 2005, *see* Appendix S.

II. Fundraising & Charitable Contributions

a. Summary of revenues

TNC reported that it raised \$2.5 billion of cash contributions, and \$1.1 billion of non-cash contributions, during the 11-year period ending on June 30, 2003.⁷⁶ In-kind contributions (consisting of all property other than cash, including land and conservation easements) represented approximately 29 percent of the aggregate contributions during this period, and comprised as little as 16 percent and as much as 42 percent, of total contributions in a single year. Both cash and in-kind contributions decreased from 2001 to 2002. The breakdown of cash and in-kind contributions for TNC's fiscal years 1993 through 2002 is contained in the following table.

**Table 3, Breakdown of Cash and Non-Cash Contributions,
Fiscal Years 1993 through 2003⁷⁷
(millions of dollars)**

Form 990 Year	Cash contributions	Cash contributions as % of total contributions	In-kind contributions	In-kind contributions as % of total contributions	Total Contributions
2002	332.3	69.2%	147.9	30.8%	480.2
2001	362.6	57.6%	265.7	42.4%	628.3
2000	381.6	82.8%	79.3	17.2%	460.9
1999	351.8	79.0%	93.5	21.0%	445.3
1998	257.6	63.8%	145.9	36.2%	403.5
1997	242.7	83.7%	47.1	16.3%	289.8
1996	169.7	72.1%	65.4	27.8%	235.1
1995	148.6	72.9%	55.3	27.1%	203.9
1994	154.2	64.9%	83.3	35.1%	237.5
1993	128.0	63.9%	72.3	36.1%	200.3
Totals (1993 to 2002)	2529.1	70.6%	1055.7	29.4%	3584.8

⁷⁶ The breakdown between cash and in-kind contributions was not required to be reported on the Form 990 for 1992, and was not available.

⁷⁷ Per Forms 990 for fiscal years 1993 through 2003.

Table 4, Estimated Non-Cash Contributions Breakdown⁷⁸
Fiscal Years 2000 through 2004
(millions of dollars)

Fiscal Year	Conservation Land	Conservation Easement	Trade Lands	Securities	Other In-Kind	Totals
2000	44.3	41.8	4.9	40.9	1.8	133.7
2001	36.0	36.3	7.1	88.2	4.5	172.1
2002	57.5	201.5	4.9	36.3	1.7	301.9
2003	41.3	93.0	5.1	24.5	1.5	165.4
2004	26.0	55.3	5.1	28.1	10.7	125.2
Totals	205.1	427.9	27.1	218.0	20.2	898.3

b. Trade Lands Program

1. Overview

TNC commenced its Trade Lands program in 1981. In this program TNC solicits donations of land without a significant conservation purpose from individuals, and in some cases corporations, for resale by TNC. Such donated properties include, but are not limited to, single-family homes, apartment buildings, farms, office buildings, and building lots. TNC calls the properties “trade lands” because they are donated with the understanding that they will be sold and the proceeds invested in TNC’s conservation activities. Trade land donations are “critically important to TNC’s mission” and are handled through its State offices.⁷⁹

Between July 1, 1997, and June 30, 2002, TNC completed 287 sales of trade land properties. Between 1981 and 2003, TNC raised over \$180 million from trade lands sales.

Due to costs involved in evaluating a potential gift and maintaining a property until it is sold, TNC has established a minimum gift of \$50,000 for a donation of a trade land property. TNC stated that “[f]ollowing the valuation of the property by real estate agents, standard practices for marketing trade land properties include real estate listings and/or marketing properties to adjacent landowners.”⁸⁰ TNC sometimes finances all or a portion of the trade land sales price by taking a promissory note from the trade land buyer. In some cases, TNC provides the financing to the buyer at zero or below-market interest rates.

For financial reporting purposes, TNC books a contribution of trade land property at the appraised fair market value as of the date of donation, and reports a gain or loss on the disposition of such property measured by the difference between the booked fair market value and the sales price, net of transaction and any development costs. TNC

⁷⁸ TNC Narrative Response dated May 4, 2005, *see* Appendix I.

⁷⁹ <http://nature.org/contactus/faqs/art2444.html>.

⁸⁰ TNC’s Narrative Response dated July 25, 2003, *see* Appendix I.

makes periodic adjustments to its book values for trade land properties that have been held for at least three years, and with respect to retained life estate trade lands.⁸¹

The following table summarizes aggregate trade lands property acquisitions and dispositions by TNC for fiscal years 1999 through 2003.⁸²

**Table 5, Summary of Trade Lands Activity
Fiscal Years 1999 through 2003.**

Fiscal year	Beginning book value	Land in	Land out	Land reclaimed	Valuation adjustment up or (down)	Ending book value	Subtotal (gains) or losses on Form 990
1998	26,916,859	7,928,816	(5,950,877)	765,376	(245,582)	29,417,592	651,944
1999	29,417,592	8,081,822	(8,283,276)	628,144	197,732	30,042,014	(221,949)
2000	30,042,014	5,814,402	(11,562,765)	1,994,651	(528,534)	25,759,767	1,054,187
2001	25,759,767	7,057,796	(9,357,870)	2,063,898	851,523	26,375,113	(1,291,710)
2002	26,375,113	6,544,924	(18,199,784)	1,581,820	161,667	16,463,740	(2,756,338)

A donee's cost basis in donated property is generally carryover, i.e. the donor's basis.⁸³ Under section 170, taxpayers have an incentive to donate appreciated property and avoid recognition of the realized gain because the charitable contribution deduction would equal fair market value. In contrast, taxpayers have an incentive to sell depreciated property and recognize the loss because the charitable contribution deduction is limited to fair market value when basis exceeds fair market value.

Donors of trade land properties that are long-term capital gain property may claim a charitable deduction for the fair market value of the donated property, if greater than the donor's basis in the property. Thus, donors of trade land properties that have a value greater than their basis may claim a fair market value charitable deduction without having to recognize and pay income tax on the unrealized long-term capital gain in the property.⁸⁴

The amount of a donor's charitable contribution deduction with respect to a trade land property would be reduced if the fair market value of the donated property is ultimately determined to be less than the amount claimed by the donor. To the best of TNC's knowledge, TNC never entered into a tax indemnification agreement pursuant to

⁸¹ Retained life estate trade lands are properties that are gifted to TNC with the donor retaining a life estate in the property for the donor's life. Upon the death of the donor, TNC becomes the owner in fee simple of the trade land property. Changes in IRS valuation tables in 2000 for retained life estates caused TNC to writedown its retained life estate trade land properties held by TNC at that time.

⁸² TNC Summary provide January 14, 2005.

⁸³ Treas. Reg. §1.1015 -1.

⁸⁴ TNC makes potential donors aware of this treatment on its website. See <http://nature.org/joinanddonate/giftandlegacy/faqs/art12361.html> ("Trade land gifts allow you to avoid capital gains and receive an income tax deduction, while making a significant gift to conservation.")

which it indemnified a trade land donor against reduced tax benefits resulting from a downward adjustment to the fair market value of the donated property.

TNC reports donations to TNC of trade land properties as contributions of property other than cash on its Form 990. TNC did not solicit tax advice from outside counsel on the Federal income tax treatment of trade land sales. TNC does not report income, gain, or loss from trade land sales as unrelated trade or business income.

TNC publicizes its trade lands program on its website, including on TNC's Maine, Massachusetts, North Carolina, and Wisconsin state chapter sites. On the Wisconsin site, for example, TNC states that "[i]dentical tax treatment is accorded to gifts of trade land and ecologically important land."⁸⁵

During fiscal years 1999 through 2003, TNC acquired trade land properties valued at approximately \$35 million, and disposed of trade land properties valued at approximately \$53 million. As of June 30, 2003, TNC reported trade land properties valued at \$16.5 million as an asset on its financial statements.

2. Solicitation & Sale of Trade Lands Properties

TNC defines trade lands as properties that have little or no ecological significance. When TNC disposes of these properties, an ecological evaluation is performed to determine whether the property warrants protection for conservation purposes.⁸⁶

TNC expends minimal effort to solicit trade lands gifts, and such efforts are largely confined to TNC's membership. TNC uses three solicitation methods: 1) occasional advertisements in TNC's quarterly magazine; 2) personal discussions between TNC staff and potential donors; and 3) as a funding option in general planned giving materials, including information on the internet. TNC does not use agents to solicit or develop trade lands gifts, and does not actively pursue the purchase of trade lands.⁸⁷

Once clear title is obtained for a given trade land gift, staff arrange for its sale, which is usually handled by third-party real estate agents in the area where the trade land is located. TNC takes no steps to develop or enhance the value of the property prior to sale, although general maintenance of the property (payment of taxes, arranging for upkeep, etc) is allowed.⁸⁸

The vast majority of trade lands received and sold by TNC are unimproved or improved residential real estate. TNC provided a list of trade lands it currently holds

⁸⁵ <http://nature.org/wherewework/northamerica/states/wisconsin/contact/art10846.html>.

⁸⁶ TNC Narrative Response dated May 12, 2005 *see* Appendix I.

⁸⁷ *Id.*

⁸⁸ *Id.*

with an appraised value in excess of \$100,000. Many of these gifts are subject to retained life estates and cannot be sold until the resident with the right to occupy vacates.⁸⁹

c. Donor Advised Funds

TNC established The Nature Conservancy Donor Advised Fund in 2000. The parameters of the fund and the procedures developed for administering the Fund were set up in accordance with regulations proposed at that time by the Internal Revenue Service.⁹⁰ Eight participants created funds with contributions of stock and cash since April 1, 2002. The total value of these eight funds as of March 31, 2005 was over \$4.3 million. Of the eight participants, one was a trustee of a state organization and while another was an employee of TNC. None of the individual fund balances have been used for expenditures relating to donor review of the grants from the fund or investment of the fund balances.

d. Conservation Buyer Fund

TNC reports that, beginning in 1998, three state programs raised \$13 million for such purposes while TNC's national conservation fund has raised \$870 since implementation in 2002. These funds are invested in conservation buyer properties; when properties are sold the proceeds are returned to the fund for use in other conservation buyer projects. Expenditures from these funds are governed by TNC's corporate policies and procedures.⁹¹

e. CBP Transactions & Donative Intent

CBP transactions raise the question whether the requisite donative intent exists to support a charitable deduction with respect to any portion of these transactions. TNC and certain of its advisors suggest that donative intent will be presumed if the transactional documents express the CBP buyer's intent to "donate" that amount equal to reduction in value of the property resulting from the grant of the conservation easement by the buyer to TNC. The Staff notes that the IRS has questioned this practice in Notice 2004-41.

f. Valuations & Appraisals

The success of TNC's conservation programs hinges on its ability to receive tax deductible contributions. Conservation easements are deductible under section 170(h) while section 170(c) governs the deductibility of contributions under the trade lands and emissions credits arrangements. The values of conservation easements, including those TNC obtains through the CBP, are generally determined by independent appraisers. Overvaluation of property is generally recognized as a common abuse.

⁸⁹ Id.

⁹⁰ TNC Narrative response dated May 12, 2005, see Appendix I. TNC attached the following to this response: *Donor Advised Fund Procedures, Protocol for Distributions, Distribution to Charity Cover Letter, and Memorandum of Understanding (with Exhibit A)*.

⁹¹ TNC Narrative Response dated May 12, 2005, see Appendix I.

TNC states that it does not provide tax advice to donors on the potential charitable contribution deduction available to the donor.⁹² However, legal opinions obtained by TNC contain calculations of potential tax deductions available to donors.⁹³ Other documents the Staff reviewed indicate that, although TNC may not provide specific tax advice, it sometimes may be aware in CBP transactions that the values of easements are overstated.⁹⁴

The use of the “subdivision development analysis” method used by appraisers to value conservation easements is perceived by some to be abused by appraisers.⁹⁵ TNC notes that this appraisal method was used to value the easement that resulted from the Shelter Island CBP transaction.⁹⁶ Staff notes that this property may actually be more valuable undivided and subject to an easement than subdivided and questions whether the subdivision development analysis may be inappropriate for some transactions.

⁹² Governance Advisory Panel Final Report, *see* Appendix J.

⁹³ Copies of legal opinions are provided in Appendix F.

⁹⁴ See documents related to Shelter Island transaction in Appendix O.

⁹⁵ See Nancy A. McLaughlin, *Increasing the Tax Incentives for Conservation Easement Donations – A Responsible Approach*, 31 Ecology L.Q.1, 78-81 (2004) (discussing the growing use of the “subdivision development analysis,” which generally bases the value of the property by reference to acquiring the property for subdivision and development as commercial or residential uses, to inflate the before-easement value in a conservation easement appraisal). See also, *Local, State, and Federal Tax Aspects of Conservation Easements*, 2nd Edition, South Carolina Department of Revenue, March 2005, p. 96.

⁹⁶ See Real Estate Report prepared by TNC for Shelter Island Transaction in Part Four of this report.

III. Related Party Transactions & TNC Reforms

a. Overview

TNC has in place a formal conflict of interest policy.⁹⁷ According to TNC, it “has long had a conflict of interest policy intended to ensure proper advance review of transactions involving employees, directors, State trustees, and other related parties.”⁹⁸ TNC has stated that its conflict of interest policy serves “to assure and ensure that the Nature Conservancy will live up to its high fiduciary obligations and operate in compliance with [its] highest corporate value: ‘Integrity Beyond Reproach.’” Although it appears that TNC’s stated purpose has remained the same despite various amendments to the conflict of interest policy, the material aspects of such policy have been modified and expanded recently. Part Three of this report includes a detailed description of transactions conducted with various TNC insiders.

Based on the documentation submitted by TNC to the Committee, it is difficult to ascertain how long this stated purpose (or a formal conflicts policy) has been in place. The documentation suggests that this purpose (and perhaps the initial formal policy) was originally approved by the Board of Governors in June 1995, and later revised in March 1996 and October 2002. The present conflict of interest policy, approved in March 2004, incorporates this stated purpose.

In May 2003, following *The Washington Post* series, TNC announced the suspension of certain activities until its next regularly scheduled Board meeting that was held on June 13, 2003.⁹⁹ The Board of Governors took various actions at the board meeting regarding certain of the transactions reported by the *Washington Post*, including: (1) prohibiting buying or selling land in transactions with board members, trustees and employees and their immediate families; (2) requiring that all charitable gifts associated with a conservation buyer transaction be legally documented as part of the transaction; (3) determining that TNC would make no new loans to employees; and (4) determining that TNC would not initiate new oil and gas drilling or mining of hard rock minerals on its preserves unless required by existing contracts.

In June 2003, TNC’s Board of Governors formally announced a number of substantive changes with respect to its programs structure. The changes centered on: (1) conservation buyer transactions; (2) cause-related marketing partnerships; (3) resource extraction activities on TNC-owned lands; (4) loans made to TNC employees; and (5) related-party transactions. In a statement released by TNC, the Board of Governors summarized the following with respect to each of the changes listed, respectively: (1)

⁹⁷ TNC maintains “that the Board of Governors as well as all staff are subject to the Conservancy’s Conflict of Interest Policy.” TNC Memo: The Board of Governors and the Role of Trustees, *see* Appendix K. Furthermore, the Nature Conservancy maintains that subsidiaries (an undefined term) of TNC are also subject to the conflict of interest policy. *Id.*

⁹⁸ The Nature Conservancy Interim Report on Governance, Policies and Procedures dated March 2, 2004, *see* Appendix J.

⁹⁹ <http://nature.org/pressroom/links/art10309.html>.

TNC is prohibited from buying or selling land in transactions with Board members, trustees and employees and their immediate families; (2) all charitable gifts associated with a conservation buyer transaction must be legally documented as part of the transaction; (3) TNC will make no new loans to employees; (4) TNC will not initiate new oil and gas drilling or mining of hard rock minerals on its preserves unless required by existing contracts; and (5) the Board of Governors will enlist independent, outside advisors to assist it in achieving its aspiration of making TNC a recognized leader in governance and oversight.¹⁰⁰

As a means of developing and implementing these changes, the Board of Governors solicited the work and perspective of outside experts to help the organization continue to strengthen its “governance, transparency and accountability.”¹⁰¹ For this purpose, the Board of Governors announced the formation of the Governance Advisory Panel in September 2003.¹⁰²

b. The Governance Advisory Panel Interim Report

The Governance Advisory Panel assembled in September 2003, and deliberated for several months before providing its interim report (“Interim Report”) to TNC’s Board of Governors in January 2004.¹⁰³ At the request of the Board of Governors, the Governance Advisory Panel focused its efforts on providing recommendations with respect to the three areas of governance, transparency and accountability.

The Interim Report contained various governance changes to restructure TNC’s Board of Governors. In response to the changes outlined in the Interim Report, in January 2004, the Board of Governors adopted a number of the recommended changes.¹⁰⁴ For example, the Board of Governors delegated oversight and guidance responsibilities to the Executive Committee and restructured the Board of Governors Committees.¹⁰⁵ Under these changes, the Executive Committee is comprised of the Chair, two Vice Chairs, President, Secretary/Treasurer, and the Chairs of six committees, for a total of 11 members. The Board delegated oversight and guidance responsibilities to the Executive Committee in order to promote transparency in all facets of TNC’s governance, businesses, programs, and performance, including the oversight of all mandatory and discretionary spending.¹⁰⁶ The Board of Governors established six new committees: (1) the Strategy Committee; (2) the Governance Committee; (3) the Conservation Project Review Committee; (4) the Audit Committee; (5) the Finance Committee; and (6) the Marketing and Philanthropy Committee. The purpose of establishing these new

¹⁰⁰ <http://nature.org/pressroom/links/art10309.html>.

¹⁰¹ <http://nature.org/pressroom/links/art11508.html>.

¹⁰² <http://nature.org/aboutus/leadership/bogstatement.html>.

¹⁰³ Governance Advisory Panel Interim Report, *see* Appendix J. This report includes a list of persons who participated on the panel.

¹⁰⁴ <http://nature.org/aboutus/leadership/art12214.html>.

¹⁰⁵ <http://nature.org/aboutus/leadership/art12214.html>.

¹⁰⁶ Governance Advisory Panel Final Report, *see* Appendix J.

committees was to ensure that the Board of Governors serve as an active and objective body for monitoring management activities.¹⁰⁷

Significant reforms identified and proposed in the Interim Report included: (1) a new conflict of interest policy prohibiting land sales or purchases, easements or any other interests in land involving board members, trustees, employees and immediate family members; (2) extension of the conflict of interest policy to cover major donors, identified as anyone who donated cash or assets worth \$100,000 or more in aggregate during five years prior to the transaction; and (3) a new conflict of interest policy allowing for the refusal by TNC to sign a Form 8283 (Noncash Charitable Contributions) under certain circumstances.

c. The Governance Advisory Panel Final Report

On March 19, 2004, the Governance Advisory Panel formally submitted a 28-page final report ("Final Report") prepared over six months to the Executive Committee and the Board of Governors of TNC addressing various areas of reform.¹⁰⁸ Part I of the Final Report discussed the board structure and attendant board duties and the structure of various committees. Part II of the Final Report discussed governance standards for chapter boards, decision-making roles and responsibilities, and transparency and communication. Part III of the Final Report discussed reforms in programs, transparency and accountability. The panel recommended that TNC "put in place careful, systemic and strict procedures that will ensure compliance with all aspects of the spirit and letter of the rules for charitable contributions of conservation donations, with particular emphasis on appraisals."

The Final Report supplemented the earlier recommendations made in the Interim Report, and also made specific recommendations regarding easements, conflicts, annual reporting, and other matters. Several of these recommendations are described below.

1. Valuations and appraisals in land donation and conservation easements

In the Final Report, the panel offered a number of recommendations on valuations and appraisals in land donations and conservation easements. For example, it recommended that TNC refuse to sign a Form 8283 (Noncash Charitable Contributions), unless the donor's appraiser is state-certified, has not been barred from practicing before the Internal Revenue Service, and is experienced at appraising conservation lands and easements.¹⁰⁹ The panel also recommended that potential donors be informed that TNC will closely examine the qualifications of the appraiser, the methods used, and the appraisal itself. Furthermore, the panel recommended that TNC review all aspects of the proposed conservation transaction, including review of the donor's appraisal to determine whether such transaction is appropriate. Lastly, the panel recommended employee

¹⁰⁷ Governance Advisory Panel Final Report, *see* Appendix J.

¹⁰⁸ *Id.*

¹⁰⁹ This recommendation was also made in the Interim Report.

training in TNC's compliance policies to cover tax issues relevant to both TNC and its donors.

2. Monitoring and enforcement of easements

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 terms of the easement. To promote compliance, the panel recommended that TNC's General Counsel and Compliance Director¹¹⁰ implement programs to enforce the easement amendment policy and take aggressive action against landowners who infringe upon TNC's easement rights.

3. Conflicts of interest

The panel recommended that TNC's conflict of interest policy be modified to prohibit a member of the Board of Governors or Executive Committee of the Board (or his or her company) from taking an income tax deduction for any gift of land to TNC; purchase land from, or sell easements to, TNC; or have a cause-related marketing agreement with TNC.¹¹¹ The panel further recommended that major donors be considered "covered persons" and subject to the policy. A major donor includes anyone who donated cash or assets worth \$100,000 or more in the aggregate during the five years prior to the transaction. It also recommended that the Audit Committee remain actively involved in overseeing and monitoring policies and procedures with respect to conflicts of interest to promote transparency.

4. Transactions with governmental entities

The panel recommended that TNC's "no net profit" policy with respect to transfers of land or interests in land to governmental agencies be fully disclosed on TNC's Form 990. The "no net profit" policy is intended to ensure that TNC only recovers its costs upon such transfers.¹¹²

5. Compatible human use

The panel agreed with the TNC Board's June 2003 articulation of compatible human use on TNC property (i.e., that TNC would not initiate new oil and gas drilling or mining of hard rock minerals on designated TNC preserves, unless previously required by existing contracts). The panel affirmed the Board's direction that human use on TNC

¹¹⁰ See the discussion regarding establishing the office of Compliance Director in Compliance, below.

¹¹¹ The Final Report did not define the term "Cause-Related Marketing Agreement." In general, "cause-related marketing" generally is regarded as the sale by a charitable organization of products or services to generate proceeds to benefit the charity. See e.g., Better Business Bureau Wise Giving Alliance, Standards for Charity Accountability, Standard 19 (addressing such types of fundraising by providing for clear disclosure of how the charity benefits from such activities at the point of solicitation, including disclosure of the actual or anticipated portion that will benefit the charity, the duration of the campaign, and any maximum or guaranteed minimum contribution amount), available at www.give.org/standards/newcbbbstds/asp.

¹¹² Governance Advisory Panel Interim Report, see Appendix J.

preserves remains permitted in four circumstances: (1) the activity has limited predicated impact and poses no identified threat to TNC's conservation targets; (2) the activity has limited predicated impact but has educational or other value that outweighs the predicated impact; (3) the activity is part of a strategy to reduce or eliminate threats to conservation targets or is designed to mimic or restore essential ecological processes; or (4) the activity contributes significantly to learning and demonstration opportunities for compatible use and biological diversity preservation when weighed against potential impacts. The panel suggested that any proposed transactions be presented to the newly formed Conservation Project Review Committee of the Board for final approval. Further, the panel recommended that TNC include an explanation of its compatible human use policy, with examples, in its Form 990.

6. Executive compensation

The panel recommended that compensation of TNC executives be comparable with that of other similar not-for-profit organizations. According to the Final Report, the Governance Committee should play an active and independent role in reviewing performance and establishing the compensation of the President, and in reviewing and approving the compensation of senior staff positions. The Final Report also recommended that compensation of the President and senior staff be disclosed in great detail on the Form 990.

7. Lobbying

The panel agreed with the Board of Governors' approval of an expenditure of up to two percent of the charitable budget on lobbying activities.

8. Compliance

The panel recommended that TNC hire a permanent Compliance Director to implement programs to ensure that TNC operates in accordance with the law and its policies.¹¹³ The Compliance Director would be charged with reviewing specific transactions and events on an on-going basis.¹¹⁴ The panel recommended that the Compliance Director be someone not previously affiliated with TNC and report directly to the Executive Committee as well as to the President of TNC.

9. Reputation and transparency

The panel observed that generic questions of reputation and transparency are important in establishing mechanisms as a means of reviewing conservation projects to ensure conservation objectives and policies, and suggested using TNC's Form 990 as a voluntary disclosure device to promote transparency.

10. Conservation project and activity review

¹¹³ In January 2004, TNC's Board of Governors adopted the panel's recommendation to hire a permanent Compliance Director.

¹¹⁴ By contrast, the Internal Auditor's role would be to review completed transactions and events.

Similar to the Conservation Project Review Committee created by the new Board of Governors, the panel agreed with TNC's approach to augment the work of the Conservation Project Committee of the Executive Committee. This Conservation Project Committee would be charged with ensuring adequate oversight and risk management of TNC's conservation programs, with a particular focus on large or novel conservation projects.

TNC, with the assistance of the Board of Governors, created a Risk Assessment Committee comprised of its senior staff, including the General Counsel and the Chief Ethics and Compliance Officer. The Chief Conservation Officer of the Conservation Project Committee appointed a ten-member risk assessment committee. By memorandum dated June 2, 2004, TNC outlined the specific duties of the Risk Assessment Committee such that the committee would be charged with evaluating "the risks of exceptionally complex or precedent-setting land acquisition, partnership and policy projects undertaken by field and headquarters units."¹¹⁵ The organizational documents of the Risk Assessment Committee contemplate that it will conduct advance reviews of all projects and transactions that (1) fall outside of existing TNC policies; (2) represent a high profile "first instance" for the organization or operating unit; and (3) otherwise involve substantial financial, legal, ethical or other "reputational risk"¹¹⁶ to the organization.

The Risk Assessment Committee is required to regularly report its decisions to the Project Review Committee of the Board of Governors, and in cases where broad-decision-making is required, the Risk Assessment Committee will refer such cases through the Chief Conservation Officer to the Project Review Committee for final decision.

11. Form 990

The panel suggested TNC use its Form 990 to disclose information similar to that required of public companies under the Sarbanes-Oxley legislation and regulations. The stated purpose for TNC voluntarily disclosing information on its mission, policies, programs and goals is to "keep donors, the public, and interested governmental entities well informed about its activities."¹¹⁷

d. TNC Actions in Response to Panel's Recommendations

TNC has adopted many of the Governance Advisory Panel recommendations outlined above. Material changes were made to the preceding conflict of interest policy. Entirely new procedures and policies were added affecting: (1) the reporting and substantiation requirements relating to Forms 8282 and 8283; (2) sales of land or interests in land to or from related parties; and (3) tax deductions for contributions of land by members of the Board of Governors. These policies, taken in the aggregate, were

¹¹⁵ TNC Memorandum re: Operation of Risk Assessment Committee, dated June 2, 2004, *see* Appendix K.

¹¹⁶ Reputational risk in this context includes actions that in some manner may be or seem to be inconsistent with TNC's stated values.

¹¹⁷ Governance Advisory Panel Final Report, *see* Appendix J. .

intended to specify whether and under what circumstances certain transactions are permitted or prohibited.

By letter dated October 27, 2004,¹¹⁸ to the Committee, TNC stated that its formal conflicts of interest policy had been strengthened with the addition of key provisions affecting: (1) purchases and sales of land (including interests in land, such as easements) involving related parties to be expressly prohibited; (2) other transactions with related parties to be subject to advance review; (3) purchases and sales of conservation lands involving major donors to be subject to advance scrutiny; (4) gifts of lands (including easements) by related parties and major donors to be subject to special rules; and (5) financial supporters of TNC to be elected to the Board of Governors on the condition that if a member of such board (or a company related to the member) intends to claim an income tax deduction for a gift of land made to TNC, the transaction will be subject to strict scrutiny by TNC and must be approved by disinterested members of the board.

1. Revisions to conflict of interest policy

The conflict of interest policy was modified substantially in that the revised policy specifically defines how a conflict of interest arises, and outlines a procedure for reviewing and managing conflicts. The modified policy states, “[a] conflict exists when a covered person... proposes to act on any issue, matter, or transaction in which the Conservancy has an interest, and the covered person may have an interest separate from the Conservancy.” This policy further states that “[a] conflict of interest also exists in situations in which there is an appearance that a covered person is utilizing inside information that is proprietary to the Conservancy for his or her benefit, is acting in his or her interests rather than the best interests of the Conservancy, has the ability to exercise undue influence over the Conservancy’s decisions, or is receiving favorable treatment by the Conservancy because of his or her status as a covered person.”

Certain guidelines for evaluating typical categories of conflicts and potential conflicts were added to the revised conflict of interest policy. The guidelines list five areas to consider in evaluating a potential conflict: (1) hiring individuals who are close relatives of covered persons; (2) contracting for products or services with covered persons; (3) purchases or gifts of interests in land from or sales of interests in land to covered persons; (4) a covered person serving on public and/or private boards, commissions, or councils transacting business with TNC or with which TNC may have a potential adverse interest; and (5) use of inside information by a covered person.

The revised conflict of interest policy also expanded the definition of what constitutes a covered person to include “major donors” and “other insiders”. Major donors are defined as an individual, corporation, or foundation that makes a gift or pledge of \$100,000 or more at any one time or cumulatively within a five year period prior to the occurrence of the conflict either in cash, appreciated securities, other assets or in land, easement, or bargain-sale value. Other insiders are defined as individuals, such as former board of director members, former Chapter Trustees, members of TNC advisory boards

¹¹⁸ TNC response to Committee Letter dated November 23, 2004.

or committees, members of the President's Conservation Council, volunteers or former employees who, by virtue of their continued involvement with TNC, either have access to inside information that could place them within a conflict situation or give the appearance of such persons having the ability to unduly influence TNC. Depending on the facts and circumstances, an independent contractor may be an "other insider" if that person or entity has access to inside information.

The revised conflict of interest policy also expanded the definition of "organization" to include public boards and commissions and not-for-profit organizations.¹¹⁹

2. New policy regarding Forms 8282 and 8283

On March 12, 2004, TNC adopted a policy specifically outlining a standard operating procedure to ensure compliance with Internal Revenue Service Forms 8282 (Donee Information Return) and 8283 (Noncash Charitable Contributions). Prior to accepting a donation of land or a conservation easement that is reasonably expected to have a value that exceeds \$5,000, the TNC project staff is required to provide a copy of the standard operating procedure and a copy of the current Internal Revenue Service regulations governing non-cash gift value substantiation to the donor.

According to these new requirements, TNC must adhere to the following conditions prior to signing a donor's Form 8283: (1) all relevant information is to be completed on the form including the identification of the property donated, the physical description of the condition of the property donated, the appraised fair market value, and the declaration of the appraiser and the taxpayer's identification number; (2) the donor is to provide a complete copy of the signed qualified appraisal commissioned by the donor that is the basis for the appraisal summary stated in the form to be used for TNC's accounting purposes; (3) the donor is to provide TNC with a statement from the appraiser who completed the qualified appraisal attesting among other things that such appraiser is a State general certified and qualified appraiser; and (4) Form 8283 is to be reviewed to ascertain that there are no factual errors, and in the case of a qualified conservation contribution, such form is to include a supplemental statement showing the fair market value of the underlying property (both before and after the gift), and that the conservation purposes are furthered by the gift.

If it has been determined that all the appropriate requirements have been met and the transaction has been determined not to be suspect or unreasonable (i.e., that both the new policy regarding Forms 8282 and 8283, and the revised conflict of interest policy, have been satisfied), the appropriate TNC project attorney is required to sign Form 8283, if requested by the donor, for all donations of real estate and non-cash contributions. Under the new policy, in the event that TNC has signed Form 8283, TNC is then required to complete and submit Form 8282 for all property, including real estate or interests in real estate, transferred or sold within two years of the contribution. The policy provides

¹¹⁹ The preceding conflict of interest policy defined an organization as including a corporation, partnership, trust, estate, joint venture, and unincorporated affiliation of any kind.

an exception to the requirement for submitting Form 8282 to the Internal Revenue Service if the real estate is transferred solely for conservation use and without financial consideration.¹²⁰

Under these requirements, TNC is required to provide a copy of Form 8282 to the donor. Further, all gift acknowledgement letters provided by TNC to donors where Form 8283 has been signed must clearly state that TNC does not take a position on either the value or the tax deductibility of the gift.

3. New policy affecting sales of land or interests in land to or from related parties

On June 13, 2003, TNC adopted a policy governing sales to or from related parties. This policy was intended to be a “complementary addition” to the revised conflict of interest policy. All potential conflicts of interest, other than purchases and sales of land, are to be governed by the organization’s general conflict of interest policy. The complementary related parties policy is to specifically prohibit the purchase of real estate (or any interest therein) to any “related party”. Under the related parties policy, a related party is defined as 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 Governors, a Trustee, or an employee of TNC; any individual who is a close relative of such individual; or an entity¹²¹ in which the individual owns and/or his close relatives own directly or indirectly more than five percent of the equity interest therein. The related parties policy specifically addresses transactions involving the potential sale or purchase of real estate to or from the Board of Governors member, a Trustee, or a TNC employee (or their close relatives).¹²² This policy also applies to interests in real estate, including sales and purchases of conservation easements.

On September 30, 2004, the Nature Conservancy revised its policy governing sales to or from related parties. The revised policy retained the stated purpose as described in the June 13, 2003, version and added a list of activities not prohibited by the policy.

4. New policy affecting tax deductions for contributions of land by Board members

¹²⁰ An exception to Form 8282 reporting is provided for items consumed or distributed, without consideration, in fulfilling the organization’s exempt purpose or function. *See* Instructions to Form 8282.

¹²¹ For purposes of this policy, an entity is defined as 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. Related organizations are not included unless the party owns more than a five percent equity interest in the organization.

¹²² For purposes of this policy, a close relative has the same definition as in the conflict of interest policy: spouse, child (natural or adoptive), parent and step-parent, in-laws, grandchild, grandparent or brother or sister. The definition has since been expanded to include “any person with whom a related party shares living quarters under circumstances that closely resemble a marital relationship or is financially dependent upon the employee, Governor, or Trustee.”

On September 30, 2004, TNC adopted a policy that prohibits a member of the Board of Governors (and a “Governors-related entity”) from claiming an income tax deduction for any gift of land or an easement to TNC unless the transaction has been subjected to strict scrutiny by TNC. It is unclear how TNC intends to enforce this requirement, given that TNC (or any other organization) generally could not prevent a person from taking a tax deduction otherwise permitted by law. The policy is silent on whether a certified copy tax return or other evidence is required to be given to TNC to determine whether a deduction has been claimed by a Board member.¹²³ Elements of the strict scrutiny standard involve conservation standards, valuation substantiation, conflict of interest considerations, and public relations. Conservation standards are described in the context of gifts of land or easements from Board members, or from their companies, and such gifts are to be accepted only by TNC when they serve legitimate conservation purposes.

The policy states that gifts of land must meet specific economic standards beyond those that have been adopted in TNC’s policies and standard operating procedures pertaining to Forms 8282 and 8283. Gifts are to be accepted on the condition that an independent review of the market value has been conducted, the value is judged to be within a reasonable range of the value claimed by the donor, and the Board’s Project Activity Review Committee has reviewed the economic terms of the land donation. Transactions are to be reviewed to ensure that no special arrangements are associated with the gift transaction. Additionally, contributions are to be accepted only after: the disclosure of all transaction terms and parties; review of compliance with the conflict of interest policies (including member recusal); review to ensure the use of standard TNC conservation easement terms; and express approval by the Board of Governors. Finally, the policy provides that a gift is to be reviewed to anticipate likely public or community relations’ reactions to ensure that a plan is in place to address any adverse consequences.

e. Other Policies

TNC provided the Committee with copies of two other policies that were not referenced in the Governance Advisory Panel’s Initial Report or Final Report. One is its related organizations policy, and the other pertains to its policy on significant business interests in separate legal entities.¹²⁴

1. Related organizations policy

On January 30, 2004, the Board of Governors adopted a policy on the acquisition and creation of related entities as a means of approving new business relationships, in order to ensure all activities are consistent with TNC’s strategy and that related risks are

¹²³ TNC may intend this policy to serve as a means to disqualify individuals from serving on the Board of Governors if TNC becomes aware that a deduction was claimed, or to prevent completion of the transaction if the person who is on the Board fails to certify that he or she will not claim a deduction with respect to the transaction.

identified and managed.¹²⁵ The policy lists types of related entities as: (1) wholly-owned not-for-profit corporations;¹²⁶ (2) controlled not-for-profit organizations;¹²⁷ (3) owned or controlled for-profit entities;¹²⁸ (4) partnerships/joint ventures;¹²⁹ (5) trusts;¹³⁰ and (6) arrangements where TNC acts as a financial fiduciary or agent for other organizations and coalitions who use TNC's tax identification number or otherwise conduct their activities under the duly authorized auspices of TNC. Relationships with any of these listed entities that result from TNC's receipt of a gift, the purchase of an interest in an entity by TNC, or the creation of a new entity by TNC, must be approved by TNC's Board of Governors (on a case-by-case basis) prior to such acceptance, purchase, or creation of the entity.

Under the related organizations policy, the Board of Governors may grant approval¹³¹ based on the following factors: (1) consistency with TNC's mission, strategy and values; (2) need for a separate legal entity; (3) additional risks or costs; and (4) tax or reporting implications. Exceptions to the approval process may be made by the President or Chief Financial Officer when interests in entities are contributed by gift solely to enable TNC to acquire and sell the underlying assets for fundraising purposes.

Once an organizational relationship is established, the policy requires organizational responsibility for governance, oversight, filing of required reports (e.g., audited financial statements and tax returns), and other administrative actions necessary to fulfill TNC's responsibilities in the relationship.

2. Policy regarding significant business interests in separate legal entities

On January 30, 2004, the Audit Committee of the Board of Governors adopted a policy on the acquisition by TNC of any significant business interest in a separate legal

¹²⁵ The documentation submitted to the Committee does not mention the existence of a prior policy addressing related organizations.

¹²⁶ Wholly-owned not-for-profit corporations are incorporated as legal entities, but conduct no substantive operations; they generally hold title to property, or do business, in a given State or country.

¹²⁷ Controlled not-for-profit organizations are created through majority board membership or another form of controlling financial interest.

¹²⁸ Owned or controlled for-profit entities are created through majority stock ownership or majority LLC ownership.

¹²⁹ Partnerships or joint ventures are relationships established by formal legal agreements with others where TNC is a named partner in an ongoing conservation or business operation and TNC has a greater than 50 percent interest in the venture.

¹³⁰ Trusts are defined as separately created entities where TNC is a trustee or acts in a similar management capacity, but is not merely a beneficiary. For example, planned giving trust arrangements are excluded from the definition.

¹³¹ Actions taken by TNC to acquire or create any new related entity must be reported to the Worldwide Office Legal Function and Worldwide Office Finance Function at the time of the acquisition or creation to ensure proper inclusion in the Nature Conservancy's corporate records and financial reports.

entity as a means of ensuring that all activities are consistent with TNC's strategy and that related risks are identified and managed.¹³²

This policy applies to any transaction involving TNC's acquisition of a significant business interest¹³³ in a separate legal entity¹³⁴ that is not merely a passive investment. Any transaction involving TNC's acquisition of a significant business interest in a separate legal entity must be approved¹³⁵ by the President prior to such acquisition. TNC asserted that "the President's discretion is not unfettered" as the approval process takes into account all relevant factors. TNC explained the absence of a requirement for advance Board approval of non-controlling interests because (1) TNC does not have the right to exercise control over the activities of the entity involved and is rather, primarily concerned in determining whether TNC's investment is consistent with its exempt purposes and to oversee the financial investment; (2) experience has demonstrated that the volume and time-sensitivity of such investments may be impracticable as well as unnecessary; and (3) the acquisition of such non-controlling interests may trigger special review by TNC's Risk Assessment Committee and, consequently, by the Board.

The following table summarizes the policies adopted by TNC, describes their purpose and to whom they apply.

¹³² This policy is intended to supplement the related organizations policy. According to TNC, the reporting of financial information in a timely manner helps to ensure proper recording in the Nature Conservancy's financial records. See The Nature Conservancy's policy on *Significant Business Interests in Separate Legal Entities*. All approvals that are granted by the President must be reported to the Worldwide Finance Department. Copies of relevant documents also must be provided to the Worldwide Finance Department.

¹³³ A significant business interest is any ownership interest in a separate legal entity that: (1) has a fair market value in excess of \$100,000 and (2) is more than a purely passive investment in the separate legal entity but is not a controlling interest in the separate legal entity. The fair market value of TNC's ownership interest shall be determined at the time the ownership interest is acquired, whether by purchase or by gift. If ownership interests in the same separate legal entity are acquired over time, then the fair market value of the entire ownership interest that will be owned by TNC as the result of each acquisition will be determined. If such cumulative value exceeds \$100,000, the ownership interest is then considered a "significant business interest". A significant business interest can also include any management, voting or other decision-making right or interest in a separate legal entity which involves an investment on the part of TNC in excess of \$100,000 (or an equivalent value), whether initially or cumulatively over time.

¹³⁴ A separate legal entity includes any for-profit corporation, nonprofit corporation or nonprofit organization, general partnership or limited partnership, limited liability company, joint venture, or other comparable organization or entity.

¹³⁵ Approval may be granted based on the following factors: (1) consistency with TNC's mission, strategy and values; (2) financial, legal, and other risks and costs; (3) tax and other legal and financial reporting implications; and (4) public perception. An exception to the requirement for Presidential approval may be made by the Chief Financial Officer when TNC acquires a significant business interest in a separate legal entity as a gift with the sole intention of promptly reselling such interest for fundraising purposes. The President and Chief Financial Officer are required in any event to apprise the Board of Governors of any acquisition that poses significant financial, legal, or other risks to TNC. Once approved, TNC's acquisition and subsequent handling of a significant business interest in a separate legal entity should be reviewed and approved by the relevant TNC attorney.

Table 6, Summary of Various TNC Policies

TNC Policy	General Description	Purpose	Board Members; State Trustees	Major Donors	Other Employees
Conflict of Interest (March 2004)	Policy specifically defining how a conflict of interest arises	To outline a procedure for reviewing and managing conflicts	Considered as other insiders	An individual, corporation, or foundation that makes a gift or pledge of \$100,000 or more	Considered as other insiders
Forms 8282 and 8283 (March 2004)	Forms provided to a donor prior to TNC's acceptance of a donation of land or a conservation easement that exceeds \$5,000	To ensure compliance with the Internal Revenue Service form requirements			
Related Party Land Transactions (June 2003; revised September 2004)	Policy governing purchases and sales of land; interests in real estate, including sales and purchases of conservation easements	To prohibit the purchase of real estate (or any interest therein) to a "related party."	A member of the Board of Governors or a Trustee is a related party if during the 12-month period ending on the date of purchase or sale owns more directly or indirectly than five percent of the equity interest		An employee of TNC or any close relative of a member of the Board of Governors, a Trustee, or an employee of TNC is a related party if during the 12-month period ending on the date of purchase or sale

					owns more directly or indirectly than five percent of the equity interest
Related Organizations (January 2004)	Policy governing the acquisition and creation of related entities defined as wholly-owned not-for-profit entities; controlled not-for-profit organizations; owned and controlled for-profit entities; partnerships/joint ventures; trusts; and arrangements where TNC acts as a financial fiduciary or agent for other organizations and coalitions	To ensure that all TNC activities are consistent with its strategy and that related risks are identified and managed			
Significant Business Interests (February 2004)	Policy governing any transaction involving TNC's acquisition of a significant business interest in a separate legal entity that is not merely a passive investment	To ensure that all TNC activities are consistent its strategy and that related risks are identified and managed			

f. Transactions or Arrangements Reviewed pursuant to Governance, Practice and Policy Reforms

The Committee requested the following from TNC on April 21, 2005:

“Please provide a list of transactions or arrangements which have been brought before or reviewed by the relevant governing body (board or committee) pursuant to the governance, practice and policy reforms since they were implemented by TNC in 2003 and 2004. Also, please provide copies of all documentation regarding the review of such matters, and state whether the transaction or arrangement was approved, approved with conditions, deferred for further consideration or disapproved.”¹³⁶

In response to this request, TNC provided the agenda and minutes of the following Conservation Practice Committee (also known as Conservation Projects Committee and Projects and Activities Review Committee) meetings: June 13, 2003, October 1, 2003, January 29, 2004, June 10, 2004, September 28, 2004 and February 11, 2005. All materials provided related to conservation activities so the Staff was not able to assess the implementation of all policies listed in the table above. The Staff notes that this particular committee’s agenda regularly consists of the following: discussion and approval of specific conservation projects, real estate reports and reports from the Risk Assessment Committee and Conservation Easement Working Group.

In response to another question from the Committee’s letter dated April 21, 2005, TNC provided documentation regarding 47 CBP transactions conducted after TNC’s reforms of this program announced on June 13, 2003. TNC now requires completion of an Approval of Conservation Buyer Transaction form and a Real Estate Disclosure form. The Staff notes that, with respect to the Approval form, TNC did not provide copies of this form for at least nine of the 47 transactions and that the form was incomplete for at least four of the transactions. With respect to the Real Estate Disclosure form, the Staff notes that TNC did not provide this form for at least nine of the 47 transactions and that the form was incomplete for at least five of the transactions.

¹³⁶ Committee Letter to TNC dated April 21, 2005, *see* Appendix B.

PART THREE - DETAILED DISCUSSION OF CERTAIN TNC PROGRAMS & ACTIVITIES

I. Related Party Transactions

a. Overview

TNC entered into a number of arrangements with “insiders” or persons who had some sort of affiliation or relationship with TNC. These transactions included arrangements with TNC Board members, affiliates of TNC Board members, trustees or officials of TNC state or local chapters, officers and employees, and in limited cases, persons considered by TNC to be independent contractors.

The Committee’s focus with respect to these arrangements was on the process undertaken by TNC, including any relevant internal policies or procedures, to ensure that the arrangement was fair and reasonable to TNC, and consistent with TNC’s status as a tax-exempt public charity. There is no explicit Federal tax law requirement regarding an exempt organization’s conflicts of interest policies. As described below, however, the existence or absence of a conflict of interest is relevant to determining whether the organization may rely on the rebuttable presumption that a transaction is not an excess benefit transaction if certain procedural requirements are satisfied. In addition, conflicts of interest procedures help promote transparency with respect to transactions with insiders.

The Staff did not attempt to determine whether the actual consideration given or received by TNC and the relevant parties in these arrangements was fair and reasonable under the circumstances, or whether any of these arrangements constituted an excess benefit transaction subject to intermediate sanctions,¹ violated the prohibition against private inurement,² or conferred upon private persons an impermissible private benefit.³ In certain instances, the Staff does make some observations about the potential application of such provisions to TNC’s transactions.

The transactions described below between TNC and its board members, or between TNC and affiliates of its board members, are all reported on TNC’s Forms 990 for its fiscal years 1992 through 2002. In response to a question from the Staff, TNC stated that “[t]o the best of our knowledge, all transactions involving a corporation with an executive serving on The Nature Conservancy’s Board of Governors at the time of the transaction are set forth in the Conservancy’s 990s, previously supplied to the Committee.”⁴ The Committee did not separately attempt to identify whether there were other insider transactions that TNC should have reported on the Form 990.

¹ Sec. 4958.

² Sec. 501(c)(3).

³ Treas. Reg. sec. 1.501(c)(3)-1(d).

⁴ TNC Narrative Response dated April 23, 2004, *see* Appendix K.

The Committee asked TNC to “[p]lease provide a list of lawyers, accountants, and other outside counsel who have provided tax opinions or other tax advice (including opinions or advice regarding compliance with relevant conflicts of interest requirements) to TNC with respect to the consequences to TNC or other parties regarding transactions between TNC and its board members, trustees, officers, executives or local chapter officials.” TNC responded that “[t]o the best of our knowledge, there are none.”⁵

TNC reported 53 transactions or arrangements between TNC and its Board members (or affiliates of its Board members) on its Forms 990 for 1992 through 2002. The following table lists the number of items reported by TNC for such years.⁶

**Table 7, Summary of Transactions with Board Members
Fiscal years 1993 through 2003**

Form 990 Year	Number of Transactions with Board Members	Number of Transactions with Affiliates of Board Members	Total items reported on Form 990 for the year
1992	1	2	3
1993	1	5	6
1994	0	1	1
1995	0	3	3
1996	0	6	6
1997	1	2	3
1998	0	8	8
1999	0	6	6
2000	1	7	8
2001	0	6	6
2002	0	3	3
Totals	4	49	53

Several of these items are described below.

b. Transactions with TNC Board members

The Appendix K contains copies of the relevant schedules from TNC’s Forms 990 for its fiscal years 1993 through 2003. During these periods, TNC reported four transactions with its Board members.

Two of these items involved free office space or services provided to TNC during the 1993 reporting period. A third item involved a land transaction in which TNC acquired property

⁵ TNC Narrative Response dated April 23, 2004, *see* Appendix K.

⁶ The Staff listed certain of these items that relate to multiple years (e.g., General Motors Corporation contribution agreement reported in each of 1993 through 2001), so the actual number of transactions involved in these reported items is less than 53.

from one of its Board members during the 1997 reporting period. TNC described that transaction as follows: "Ms. Janss entered into an option agreement with The Nature Conservancy to sell property to the Conservancy for the original purchase price. On March 13, 1998, The Nature Conservancy exercised the option and purchased the property. Janss recused herself from participating in and voting upon said transactions." The fourth item involved a consulting fee provided to a Board member during the 2000 reporting period for attendance at a conservation seminar.

The description of the March 13, 1998, land transaction between Janss and TNC does not provide the terms of the option agreement or purchase agreement, describe the property to be acquired (real or personal, tangible or intangible), explain what is meant by "the original purchase price," or state whether the transaction was consummated on terms that were fair and reasonable to TNC.

c. Transactions with affiliates of TNC Board members

Appendix K contains a copy of the relevant schedules from TNC's Forms 990 for its fiscal years 1993 through 2003. During these periods, TNC reported 49 items with affiliates of its Board members.

Appendix K also contains a copy of information provided by TNC to the Committee in response to a request regarding TNC transactions with three companies of which company officers were members of TNC's Board of Governors or Leadership Council: Georgia Pacific Corporation, International Paper Company, and Orvis Services Company. It appears that one of the transactions included in the supplemental information should also have been disclosed in the Form 990 (1999).⁷

The following is a discussion of certain of these transactions that the Staff reviewed.

1. General Motors Corporation support agreements

In its Forms 990 for 1992 through 2002, TNC reported that it had entered into transactions with General Motors Corporation (GM) pursuant to which GM agreed to support TNC with contributions of various items, including cash, vehicles, potential gifts of land, data systems equipment, and other assets of value. In each case, TNC reported that the GM officer who was also a TNC Board member (i.e., Mr. Smale from 1993 through 1997, Mr. Smith from 1998 through 2002) recused himself from participating in and voting upon the transactions.

TNC's Form 990 disclosures of these transactions did not report the terms of these arrangements, such as value of property contributed by GM to TNC during the reporting period or over the life of the arrangement, or whether any consideration flowed from TNC to GM under these arrangements.

2. General Motors Corporation emissions arrangement

⁷ TNC Narrative Response dated April 23, 2004, *see* Appendix K (acquisition of 1807.70 acres from Georgia Pacific Company for \$406,732 on September 27, 1999).

In its Forms 990 for 1999 through 2002, TNC reported the following with respect to this arrangement: “General Motors signed an agreement with TNC to undertake a climate change project under which TNC received \$10 million and General Motors may potentially receive greenhouse gas mitigation offsets. Mr. Smith did not participate or vote on said transactions.”

The materials provided by TNC to the Committee in April 2004 contain an April 28, 2000 document that lists the names of TNC Executive Committee, Conservation Committee, and International Committee members that approved the project. The document states that the project was “approved on 4/25/00 through a fax ballot to the Executive Committee and the Conservation Committee ...”⁸ The document lists John F. Smith, Jr., as approving the project on April 26, 2000, as a member of TNC’s Conservation Committee. Mr. Smith signed the Comprehensive Agreement for General Motors Corporation and for General Motors do Brasil. Mr. W. William Weeks signed the agreement for TNC.⁹

TNC did not seek a review of this transaction by outside counsel. TNC did not obtain an independent determination that this transaction was fair and reasonable to TNC or an appraisal of the potential value of the emissions credits that could inure to the benefit of TNC.

In its submission to the Committee dated December 22, 2004, TNC provided an additional narrative response (provided in Appendix H) and additional transactional materials relating to this particular arrangement, as well as two other similar emissions credit arrangements with other investors.

3. Trademark, mailing list, name, and logo arrangements

S.C. Johnson Company transactions

In its 1995 Form 990, TNC reported that it had entered into a one-year contract with S.C. Johnson Wax which permitted it to use TNC’s trademark in a national product promotion in exchange for \$100,000. In its 1996 return, TNC reported that the contract was extended for one year, and two additional royalty streams were added (royalties paid on behalf of participating retailers, and royalties generated by customers buying a self-liquidating premium). The reports stated that Mr. Johnson recused himself from participating in and voting upon the transactions.

Procter & Gamble/Millstone Coffee transactions

In its 1996 and 1997 Forms 990, TNC reported that Millstone Coffee, Incorporated, a company owned and controlled by Procter & Gamble, entered into a five-year agreement with TNC on January 10, 1997, granting Millstone the rights to use TNC trademarks on licensed product packaging, advertisements, point-of-purchase displays, and other material. The license was “exclusive for whole bean coffee.” Under the agreement, Millstone “will pay the

⁸ FAX BALLOT FOR BRAZIL ATLANTIC RAINFOREST REFORESTATION PROJECT, BRAZIL from Mike Dennis to Jonathon Rotter, Steve Cox, and Joe Keenan, dated April 28, 2000, *see* Appendix Q.

⁹ TNC stated in discussions with Staff on June 1, 2005, that the Conservation Board did not have the responsibility for approval of the said transaction. TNC stated the Conservation Board had an advisory role.

Conservancy royalties of a minimum of \$400,000 over five years plus two percent of net sales of licensed product.” The licensed product consisted of Organic, Estate, and Limited Edition coffees. In its 1998, 1999, and 2000 Forms 990, TNC modified the definition of licensed product to refer to “Millstone Exotics brand Organic Mayan/Black Onyx and Organic Aztec Star & Sky coffees.”

Discovery Communications transaction

TNC reported in its 1997 and 1998 Forms 990 that Discovery Communications had entered into a licensing transaction with TNC. The description stated that “[e]ffective September 17, 1997, in cooperation with the National Audubon Society, The Nature Conservancy licensed its name and logo to Discovery Communications for use in connection with the “All Bird Television” series. The non-profits also provided funding for the series and performed editorial consulting services. In return, they received royalty rights, rights to use the original footage from the series, rights to purchase home video copies of the series at cost, and credits at the opening and end titles of every broadcast.” The descriptions did not state the terms of the agreement.

TNC reported in its 1997 and 1998 Forms 990 that TNC “granted Discovery Communications permission to use its name to promote the Discovery Channel credit card. In return, the Conservancy receives revenues generated from the card.” The description did not state the terms of the agreement.

The reports stated that Mr. Hendricks, the Discovery Communications officer, did not participate in said transactions.

GM mailing list agreement

In its 1993 reporting period Form 990, TNC reported that GM entered into an agreement to rent membership mailing lists from TNC at “full fair market value.” No terms of the agreement were disclosed.

4. Cisco Systems and Morgridge transactions

In its 1998, 1999, 2000 and 2002 Forms 990, TNC reported that TNC “acquires computer upgrades and purchases from Cisco Systems, Inc., at a substantial discount. Before any orders are placed Mr. Morgridge [the TNC board member and chairman of Cisco Systems, Inc.] reviews the order and approves the discounts.” In its 2001 Form 990, TNC stated that it paid a total of \$145,477 to Cisco Systems, Inc. for the following transactions: “From July 2001 to around March/April 2002 the arrangement was: 1) CISCO gives TNC an automatic 30% off their list price[;] 2) TNC purchases its equipment DIRECTLY from CISCO[;and] 3) TNC submits to Mr. Morgridge the amount paid to CISCO[.] This resulted in an effective 76% discount from list to TNC.”

In TNC’s supplemental response to the Committee’s request for information regarding the 2001 description, TNC stated: “From July 2001 to around March/April 2002 the process to execute this arrangement was: 1) TNC submits list of desired Hardware/Software to CISCO Systems for a quote. 2) CISCO provides a quote to TNC, which includes 30% discount off list price. 3) TNC submits for approval 2/3 of the quote (Hardware/Software) to the Morgridge

Foundation for payment approval. 4) If approved: Morgridge Foundation pays 2/3 of total Hardware/Software equipment cost. TNC pays remaining 1/3 cost in Hardware/Software DIRECTLY to CISCO. 5) This resulted in an effective 76% discount from list to TNC.”

The TNC supplemental response contained an example to demonstrate the amount of the discount, and described its dealings with the Morgridge Foundation as “ask[ing] for [a] donation.”

The TNC description in the 2001 Form 990 did not refer to the Morgridge Foundation. Neither TNC’s Form 990 nor TNC’s supplemental submission provided any details regarding the Morgridge Foundation, or whether the Morgridge Foundation had any affiliation or relationship with Mr. Morgridge or Cisco Systems, Inc.

In its submission to the Committee dated December 22, 2004, TNC provided additional information regarding this arrangement.

5. Land or Easement Deals

Mitchell ranch transaction

In its 1993 Form 990, TNC reported that a member of TNC’s Board sold a majority of his ranch to his ranch manager, who in turn sold 1,000 acres to TNC, and gave TNC a conservation easement on 1,800 acres. No other terms of the transaction were described.

FM Properties transaction

In its 1993 Form 990, TNC reported that it sold 4,282 acres to a partnership that was related to a corporation of which one of TNC’s Board members was also a board member. The TNC sale was reported to be “[s]ubject to the legal condition that 4,070 acres were donated back to [TNC] for conservation.” The Board member recused himself from any involvement in this project. No other terms of the transaction, or explanation for the sale-contribution form of the transaction, were provided in the description.

Georgia Pacific transactions

TNC entered into several land transactions with Georgia Pacific or affiliates of the company. The Chairman of the Board and Chief Executive Officer of Georgia Pacific Corporation was a TNC Board member. In its 1996 Form 990, TNC reported that it acquired 1,000 acres of land in Wisconsin from a Georgia Pacific subsidiary for the fair market value price of \$575,000. In its 1998 Form 990, TNC reported that it acquired 1,108 acres in Maine from another affiliate for consideration of \$380,000. In its 1999 and 2000 Forms 990, TNC reported that it purchased 9,477 acres of land in Louisiana from another subsidiary of the company for \$7.5 million, with the closings taking place over two years. Also in the 1999 Form 990, TNC reported that it bought 5,482 acres known as Van Swamp in North Carolina from a subsidiary of Georgia Pacific. No purchase price was reported for the acquisition of the North Carolina property.

TNC noted that in each case, the Board member recused himself from participating in and voting upon the transaction.

Quentin transaction

In its 1996 Form 990, TNC reported that in a partial sale, TNC acquired property on September 23, 1996, and February 19, 1997, in the amounts of \$279,851 and \$359,350, respectively. An unsecured promissory note dated February 19, 1997, was entered into and was payable September 12, 1997. No other terms of the transactions were disclosed. The owner of the corporation that sold the properties to TNC was also a TNC Board member. The Board member recused himself from participating in and voting upon the transactions.

Orvis transaction

In its 1998 Form 990, TNC reported that it acquired a conservation easement covering approximately 1,622.48 acres in Florida from Orvis Services, Inc., for consideration of \$648,992. The President and Chief Executive Officer of Orvis Company, Inc., an affiliate of the easement grantor, was a TNC Board member. TNC noted that the Board member recused himself from participating in and voting upon the transaction.

SMI easement deal

In its 2000 Form 990, TNC reported that Silver Mountain Industries (SMI), a subsidiary of Leucadia National Corporation, donated a conservation easement (439.22 acres) valued at \$3,950,000 to TNC, which included a public train easement. In addition, SMI made a cash endowment of \$25,000 that was received by TNC in July 2000. A TNC Board member was chairman of Leucadia Corporation. He recused himself from participating in and voting upon the transaction.

At the request of the Committee, TNC provided supplemental information regarding this transaction. In the supplemental response, TNC described the property subject to the easement and the surrounding area.

6. Other arrangements

AOL content provider arrangement

In its 1995 Form 990, TNC stated that TNC “is a content provider on America Online, and maintains a forum that provides information on the Conservancy’s work both domestically and abroad.” The President of AOL Enterprises was a TNC Board member. TNC noted that he recused himself from participating in and voting upon said transactions. No terms of the agreement were provided in the description.

S.C. Johnson Company arrangement

In its 1998 Form 990, TNC reported that “[d]uring the fiscal year commencing on July 1, 1998, and terminating on June 20, 1999, S.C. Johnson & Son, Inc., paid \$100,000 to The Nature Conservancy in a promotion.” There was no indication that this was a renewal or

continuation of earlier arrangements between the two organizations involving trademark licensing. The report stated that Mr. Johnson recused himself from participating in and voting upon said transaction.

Orvis arrangement

In its 1996 Form 990, TNC reported that it entered into the following transactions with Orvis Company: “General activities on Mays Pond; and sale of fly fishing tackle to the Belize Program.” The President and Chief Executive Officer of the company was a TNC Board member. He recused himself from participating in and voting upon said transactions. No terms of the arrangement were provided in the description.

d. Transactions with TNC International Leadership Council members

TNC engaged in certain transactions with members of its International Leadership Council (“ILC”). The ILC serves as an advisory committee that makes recommendations to the board of governors and is therefore not a governing body with decision making authority. Because TNC did not report any of these transactions on its Form 990, the Committee requested information regarding the council and certain of these transactions.

TNC describes the council as a corporate “giving club” created in 1995, with each company on the council contributing \$25,000 per year to TNC.¹⁰ TNC facilitates a meeting for the council supporters approximately every nine months, with attendees responsible for covering their own travel and hotel expenses. There are no formal committees or subcommittees. TNC stated the council has no governance function within TNC.

The submitted materials list nine separate land acquisition transactions with reported values of approximately \$119 million with International Paper Company, or its affiliates, one of the companies with representation on TNC’s Leadership Council. In these transactions, International Paper Company transferred approximately 496,500 acres to TNC or other grantees. TNC has transferred many of these properties to others in conservation transactions. In a tenth transaction, the company acquired from TNC certain timber rights on 140 acres for \$44,104.

e. Transactions with individuals or affiliates who subsequently became TNC Board members

TNC engaged in at least one transaction with individuals, or companies associated or affiliated with individuals, who became a TNC Board member after the transaction was completed. Presumably because the Board relationship did not exist at the time the agreement was completed, TNC did not report this transaction on the Form 990. This transaction was an emissions credit arrangement with AEP, which is discussed in Part Two of the report.

f. Transactions with TNC State or Local Chapter Trustees

¹⁰ According to TNC’s submission, contributions from the council members totaled approximately \$700,000 per year for each of fiscal years 2001 through 2003.

TNC entered into numerous CBP, trade lands, and easement transactions with trustees or officials of its State and local chapters. TNC did not report any of these transactions on its Form 990, presumably because these trustees do not perform governance functions.

g. Employee Loans

TNC entered into several employee loan transactions that were reported on the Form 990. Two of these transactions are described below.

1. Loan to Steve McCormick

By resolution of the Board of Governors of TNC on December 20, 2000, Steven J. McCormick was elected as President and CEO of TNC, effective February 1, 2001, and was also elected to TNC's Board of Governors as of the same date.

TNC made a loan to Steve McCormick, the President and CEO and a member of the Board of Governors of TNC, on May 22, 2002, in the amount of \$1,550,000.¹¹ The loan was for a term of ten years and interest was charged at the rate of 4.59 percent per annum. The note converted to a demand note should Steven McCormick no longer be employed by TNC. The interest rate is adjustable each year on May 1. The interest rate was indexed to the weekly yield on United States Securities adjusted to a constant maturity of one year, as made available by the Federal Reserve. The rate was further adjusted by the addition of 200 basis points to the indexed rate. The interest rate was capped at 8 percent over the life of the loan. The floor for the interest rate was 4.59 percent. The loan provided an interest -- only payment which was payable monthly. The loan was payable by both Steven J. McCormick and his wife named in the Note. The loan was secured by a deed of trust on the property. The property serving as security for payment of the loan was stated to have a value of \$1,725,000.

The Staff notes it is difficult to compare the interest rate charged on the loan and the other terms of the loan to the going rate (and terms) for mortgages in the Washington, D.C. area for the same time period, May 2002. A report provided by HSH Associates, Financial Publishers of Pompton Plains, New Jersey provides a chart of "average" interest rates for "jumbo" loans. The HSH chart for the date May 24, 2002, for Washington, D.C. for a jumbo loan indicates that the average rate is 4.91 and the average points are 0.92. Since the payment of points tends to lower the interest rate, a loan with no points (as was the case for the McCormick loan) suggests that the rate for such a loan should be greater than 4.91 percent.¹²

A Freddie Mac Survey indicated that the average rates for a one-year adjustable rate mortgage for May 23, 2002, was 4.85 percent and the average points was 0.7. There is no indication that this rate applied to a conforming or jumbo loan. It is unclear whether this rate

¹¹ TNC Narrative Response dated July 25, 2003, *see* Appendix D.

¹² TNC stated to Staff on June 1, 2005 that they used rates available on May 3, 2002, *see* Appendix K for TNC's memo regarding the loan to McCormick.

applied to loans with a 10-year repayment period. Interest rates for jumbo loans tend to be higher than rates for conforming loans.

McCormick paid off the loan to TNC by a certificate of satisfaction filed with the local court on May 8, 2003 shortly after *The Washington Post* published its series on TNC.

If the TNC – McCormick loan offered significantly better terms (interest only payments, better lifetime cap, favorable index for adjustment of interest rate and a better interest rate than the commercial or arms length mortgages offered at the time), the loan had value and may have provided an economic benefit to Mr. McCormick within the meaning of section 4958. An excess benefit transaction under section 4958(c)(1)(A) of the Code provides that an economic benefit shall not be treated as consideration for the performance of services unless the organization clearly indicated its intent to so treat such benefit.

The Committee requested that TNC provide additional information regarding the McCormick loan. In response to this request, TNC stated that treasury regulation section 53.4958-4T(c) did not apply to the loan transaction between TNC and Mr. McCormick because the loan was not intended to compensate him for his services and TNC charged Mr. McCormick an arm's length interest rate.¹³

Section 53.4958-4T(c)(3)(iii) of the regulations provides that if an applicable tax-exempt organization's failure to report an economic benefit as required is due to reasonable cause (within the meaning of section 301.6724-1), then the organization will be treated as having clearly indicated its intent to provide an economic benefit as compensation for services. See also Example (2) of section 53.4958-4T(c)(4) of the regulations. TNC, in its response of April 5, 2004, did not state that a reasonable cause exception pursuant to section 53.4958-4T(c)(3)(iii) was applicable to the loan TNC made to Mr. McCormick.

TNC also stated that it met the "approved in advance" requirement of section 53.4958-6T(a)(1) of the regulations regarding the rebuttal presumption for the overall compensation of Mr. McCormick.¹⁴ TNC states that:

Each year, the Conservancy's Board of Governors sets compensation for President/CEO at its January meeting. Their decision is effective retrospectively to the first day of the month. Under this process, the President/CEO is paid based on the prior year's salary for the first pay period in January. However, if the Board of Governors votes a pay increase for the President/CEO, the Conservancy includes a retroactive adjustment in his paycheck for the second half of January that corrects the underpayment for the first pay period. In this way, the President/CEO receives compensation at a single rate for the entire calendar year.

¹³ TNC Narrative Response dated April 5, 2004, see Appendix J.

¹⁴ Id.

TNC's Board of Governors held a meeting on January 29, 2002 which included setting Mr. McCormick's compensation for 2002. His salary was increased by \$25,000 to \$300,000. He received immediately a payment of \$25,000 as incentive compensation for services provided in year 2001.

2. Shared Appreciation Note with Dr. Graham Chisolm

During January, 2001, a shared appreciation note was negotiated between TNC and Dr. Graham Chisolm to compensate him for the differences in the housing costs between Reno and San Francisco, when he agreed to accept the position of Executive Director of TNC of California and relocate to San Francisco. The note was intended to offer Dr. Chisolm limited financial assistance to find a residence in San Francisco that was reasonably comparable to the residence he left in Nevada.

TNC states that Dr. Chisolm was not a disqualified person with respect to TNC at the time he negotiated the note with TNC pursuant to the authority provided under section 53.4958-4T(a)(3) or the regulations.¹⁵ Section 53.4958-4T(a)(3) of the regulations provides that section 4958 does not apply to any fixed payment made to a person pursuant to an initial contract. A fixed payment is defined in section 53.4958-4T(a)(3)(ii) as an amount of cash or other property specified in the contract, or determined by a fixed formula specified in the contract, which is to be paid or transferred in exchange for the provision of specified services or property. Section 53.4958-4T(a)(3)(iii) defines the term initial contract as a binding written contract between an applicable tax exempt organization and a person who was not a disqualified person within the meaning of section 4958(f)(1) immediately prior to entering into the contract.

Section 53.4958-4T(a)(3)(vii), example 10, provides an example of a person who entered into an initial employment contract which included the right to borrow funds from the section 501(c)(3) employing organization. The example concludes that section 4958 does not apply to the loan because of the initial contract exception.

TNC states that this regulation is directly applicable to the shared appreciation note held by TNC in which Dr. Chisolm is the obligor. TNC states that Dr. Chisolm was not a disqualified person as to TNC prior to the new position as Executive Director of TNC of California based on either of two grounds. First, Dr. Chisolm met the requirements of section 53.4958-3T(d)(3) in that his salary was less than a specified amount. Additionally, Dr Chisolm, in his prior position as State Director of the Nevada Program, was not a disqualified person under the facts and circumstances analysis of section 53.4958-3T(e) of the Regulations. TNC indicated that the note was not signed until July 9, 2001, which is approximately six months after he assumed the new position. TNC also states that the letter confirming Dr. Chisolm's appointment sets out the terms of the Note.

TNC states that in response to the controversy prompted by the articles by *The Washington Post*, TNC's Board of Governors decided it had to terminate loan situations with employees. Dr. Chisolm agreed, and paid off the loan on November 18, 2003.

¹⁵ TNC Narrative Response dated April 5, 2004, see Appendix J.

h. Use of Independent Contractors

The Committee requested information regarding TNC's payments to a particular individual. TNC provided various information including copies of the contracts, invoices, etc. regarding the services provided by this individual to TNC in a capacity as an independent contractor. These documents support TNC's assertion that the individual is an independent contractor and not an employee. However, TNC does not appear to have considered the individual's status as a disqualified person for purposes of testing whether payments to her constitute an excess benefits transaction. Section 53.4958-3T(d)(3) of the regulations list facts and circumstances that tend to show a person does not have substantial influence over the affairs of the organization. One of the factors of such regulation is found under subsection (3)(ii); that is section 53.4958-3T(d)(3)(ii). The regulation provides as follows:

The person is an independent contractor (such as an attorney, accountant, or investment manager or advisor) whose sole relationship to the organization is providing professional advice (without decision-making authority) with respect to transactions from which the independent contractor will not economically benefit either directly or indirectly (aside from customary fees received from the professional advice rendered).

Observations

1. **Lack of transparency.** TNC generally did not completely and clearly disclose and report many of these related party or insider transactions. In many cases, it is impossible to determine the nature and material terms of the transaction without looking beyond TNC's descriptions contained in its Forms 990.
2. **Recusals.** TNC's descriptions of its insider transactions on the Form 990 suggests that the relevant insider routinely recused himself or herself from participating in or voting on the transaction.
3. **Legal or tax opinions regarding conflicts of interest or tax consequences.** TNC did not seek the advice of outside counsel to determine whether such transactions were compatible with tax law or internal conflicts of interest requirements and state nonprofit laws, or to obtain a tax opinion with respect to the consequences of any of such transactions. Staff recognizes that TNC is under no obligation to seek outside guidance on the legal consequences of any transaction, but notes that in the case of highly complex, novel, or insider transactions, this may be advisable.
4. **Fairness to TNC.** Except in the case of certain of TNC's land transactions with insiders, it appears that TNC did not confirm that the transactions were done at terms that were fair and reasonable to TNC. TNC apparently did not regularly seek or obtain appraisals or fairness opinions with respect to these transactions.
5. **International Leadership Council.** TNC's Conflicts of Interest Policy extends to trustees of state and local chapters of the organization, but does not apply to members of the International Leadership Council.
6. **Morgridge / Cisco.** TNC's description of the Morgridge/Cisco transaction was incomplete and vague, and did not describe the role of the Morgridge Foundation in the transaction. TNC

did not refer to the Morgridge Foundation in the Form 990 disclosure of the transaction, or provide details regarding the relationship of the foundation to Mr. Morgridge or to Cisco Systems, Inc. in its supplemental response. The Staff did not determine the extent to which the foundation might be using its funds to benefit Cisco Systems, Inc.

7. GM Emissions Deal. The GM emissions arrangement is an unusual transaction that should have been more thoroughly and accurately disclosed by TNC in its Form 990 reports. Mr. Smith's role in the transaction should have been more accurately described by TNC.

8. TNC Reforms. In 2003, TNC revised its policies regarding land transactions, easements, and conservation buyer program transactions, with respect to insiders.

II. CBP Transaction – Martha's Vineyard

One of the Conservation Buyer Program transactions reported in *The Washington Post* series involved a property located on Martha's Vineyard. TNC prepared the following summary of this transaction for its June 13, 2003 Board of Governors meeting.

CONSERVATION BUYER TRANSACTION SUMMARY—E

Site or Project Name: Herring Creek Farm, Martha's Vineyard, MA

Purchaser Name:

Land: approximately 220 acres located on the southeast quadrant of the Island

Date of Sale: July 2001

1. **Consistency with Conservation by Design:** The site that contains the Herring Creek Farm tract is a portfolio site within the North Atlantic Coast Eco-region plan. The Herring Creek Farm property has been of long-standing interest to the Conservancy because of its close proximity to Katama Plains, which is currently managed by the Conservancy. Katama is an excellent example of existing sandplain grasslands. The coastal sandplain grasslands natural community found on Martha's Vineyard is one of the most threatened natural systems on Earth, with less than one percent of its original global acreage remaining. By restoring the Herring Creek farm property to the original native sandplain grasslands, the Conservancy has been working to expand this rare habitat to create a better functioning, less fragmented ecosystem. This is especially beneficial to animals that require large spaces to forage and reproduce, like the northern harrier, a species of hawk. Once restored, the grassland and beachfront habitats at Herring Creek Farm will support rare local bird species like the grasshopper sparrow and short-eared owl as well as rare native plants such as the Nantucket shadbush and bushy rockrose. The restoration of the 102 acres permanently protected from development at Herring Creek Farm will be one of the largest such projects ever undertaken in this ecosystem, will take many years to complete and is scheduled to begin in earnest within two years.
 - **Threat:** Originally proposed for 58 lots, The Herring Creek Farm property had been officially approved for a 33 lot subdivision by both the Martha's Vineyard Commission and the Town Planning Board.
 - **Conservation Easement:** The conservation transaction undertaken by TNC will further limit the property to six additional houses and assure that 102 acres of the property are in permanent conservation status. The conservation easement prohibits any Atlantic beachfront development, requires that any new homes may only be constructed on former farm pasture and/or previously cleared land and includes prohibitions on such things as outdoor lighting, and use of pesticides, herbicides and synthetic fertilizers. None of the new home development may occur on actual or potential sandplain grasslands. The Conservation Commission of Edgartown will co-hold the conservation restrictions with the Conservancy.
2. **Valuation Substantiation:** TNC obtained an independent, professional appraisal, dated as of July 17, 2001, indicating a total value of the land that was purchased at \$64M, as confirmed in meetings with TNC staff (Note: Sellers appraisal was for \$78M for the same land.)
3. **Marketing Efforts:** None
4. **Buyer's Relationship to TNC:** No party in this transaction held any official position or had any prior connection to TNC.
5. **Structure of the Deal:**
 - The Nature Conservancy purchased the entire property from its then current owners, Neil and Monte Wallace and the Wallace Family Trust for the Conservancy's appraised fair market value of \$64M.

- TNC then placed a Conservation Restriction on the entire property limiting the number, size and location of any buildings and protecting the East Fields (62 acres) and Central Fields (40 acres) and Moore Beach Parcel (20 acres.)
 - TNC retained ownership of the East and Central Fields
 - TNC then sold or exchanged:
 - 1) 15.85 acres to Fairview MV Property, LLC (Roger Bamford and Denise Lahey) for \$7.250M. and 9.62 acres remaining to be sold for \$4.750M (for a total of \$12M.), based on confirmed appraised values as of July 9, 2001.
 - 2) approximately 46 acres to the Farming Agriculture and Resource Management (F.A.R.M.) Institute, a non-profit, educational institution, for \$28M.
 - F.A.R.M. then sold approximately 39 acres of their acreage to the MV Regency Group (David Letterman) for \$27M. This sale was made subject to restrictions limiting the property to being subdivided and sold in up to three lots to private buyers. MV Regency Group retained a portion of the property, and sold one lot to James B. Deaman, Trustee of Butler's Cove Realty Trust (Daniel Stanton) and one lot to Petergro Acquisition Company (David Peters.)
 - 3) Transferred certain lots to the Wallace family's predecessor in title, the Cohan family, to the land who held a right of first refusal over the property, in exchange for and in order to extinguish those rights.
 - F.A.R.M. also leased approximately 40 acres of the Conservancy's owned land for a demonstration farm and for education and research. The cost to F.A.R.M. of the lease was \$1.
 - TNC received charitable contributions of:
 - \$18.5M, in cash, from the Wallace Foundation
 - \$ a pledge of an amount in excess of \$10M from Roger Bamford to be satisfied by July, 2003.
 - **Transaction Category:** (multiple parts, exceptional case)
6. **Other Conservation Purposes Served:** to keep the Central Field in a compatible use such as agriculture, to limit the number, location and size of houses to protect the water quality at Edgartown Great Pond and to protect the nesting bird population and dune community on the Moore Beach Parcel
7. **How would possible changes in TNC conservation buyer policy have changed the transaction?** Possible restrictions to achieve community standards for residential structures; possibly a wider marketing effort.

Observations

1. In general. The transaction first described in *The Washington Post* series involving the Herring Creek Farm on Martha's Vineyard involved numerous parties, substantial transactional complexity, unusual payments by TNC (such as tax indemnity payments to cover tax obligations of another party to the transaction), and what appear to have been circular flows of millions of dollars between the Wallace family members and TNC. Although TNC ultimately obtained and held over 100 acres of said property on which conservation restrictions were placed, several components of the overall transaction warrant scrutiny to determine the appropriate tax treatment to the parties, and to assess whether TNC's participation in the overall transaction substantially furthered conservation purposes that outweighed any private benefits derived by other parties to the transaction.

2. Charitable Contribution Deductions. Based on Form 8283 filings provided to the Committee, it appears that charitable contribution deductions were claimed with respect to the transaction by various taxpayers, including the following:¹⁶

- \$2.068 million for bargain sale of real estate and certain preemptive rights to TNC by Herring Creek Acquisition Company, LLC ("HCAC")
- \$1.125 million aggregate deduction claimed by Wallace family members pertaining to the transfer of undivided interests in a Slough Cove Road parcel to TNC
- \$50,000 claimed by Wallace family members pertaining to a transfer of undivided interests in another Slough Cove Road parcel to TNC
- \$760,000 claimed by Wallace family members pertaining to a transfer of undivided interests in ocean front property to TNC
- \$12.115 million claimed by Windsor Capital Corporation with respect to the bargain sale of Herring Creek Farm by the corporation to TNC¹⁷

3. No charitable contribution deduction attributable to 170(h) conservation restrictions. In its review of the Forms 8283 related to this transaction, the Staff did not find that any party to this transaction sought a charitable contribution deduction for the grant of a conservation easement. The filings suggest, as noted above, the contribution deductions appear to have been related to the donation of undivided interests, preemptive rights and bargain sales.¹⁸ The Staff notes that

¹⁶ Each of the Forms 8283 report the date of the donation as July 20, 2001.

¹⁷ The Staff notes that this list contains certain contributions not described in TNC's above summary provided to the Board of Governors.

¹⁸ See Summary of Form 8283 and Form 8282 Filings, pp 32-34 below. For example, each 10% undivided interest of a certain property valued on the Form 8283 at \$110,000 appears to have been sold by TNC for \$62,500. The property acquired by TNC on July 20, 2001, from Windsor Capital Corporation for \$64 million, and which was appraised at \$76.115 million, was reported as sold by TNC for \$35.350 million on July 24, 2001. The Staff assumes the decrease in values reported for these properties results in part from TNC retaining certain portions of the

this is the type of transaction that may lead to the circumvention of 170(h) requirements discussed in Part Two of this report.

4. Indemnification of HCAC's Federal and state tax liabilities. In the June 29, 2001, agreement between TNC and HCAC (under which TNC transferred certain property to HCAC and TNC acquired certain preemptive rights from HCAC), TNC agreed to make a \$1.484 million tax indemnity payment to HCAC to cover certain of HCAC's taxes attributable to the transaction. Under this agreement, the amount of TNC's tax indemnity payment was to be adjusted in the event of a Federal or State income tax audit of HCAC. The documentation states that TNC also paid \$402,755 of HCAC's legal expenses, and executed a "tax-make whole" agreement with HCAC. The Staff notes that such agreements and payments raise private benefit issues.¹⁹

5. Tax treatment to HCAC and others with respect to preemptive rights. In the June 29, 2001, agreement between TNC and HCAC, the parties agreed that HCAC would claim a charitable deduction of up to \$2.066 million attributable to the bargain sale of the preemptive rights to TNC. This represented the excess of the appraised value of \$14 million for the rights over the \$11.9 million purchase price allocated by TNC to these rights. The preemptive rights acquired by TNC from HCAC in June 2001 had been transferred by the Wallaces to HCAC only a few months before in December 2000. It was not clear to the Staff why the December 2000 transfer of the rights occurred, or who owned HCAC. Further, it was not clear to the Staff why TNC was required to purchase the preemptive rights previously held by the Wallaces from HCAC, given that TNC was acquiring the property to which the rights pertained from the Wallaces or a an entity affiliated with the Wallaces. The Staff reviewed documentation that stated that preemptive rights possessed by the Cohans were to be released as part of the overall transaction, but the Staff could not determine whether the Cohans were paid, directly or indirectly (e.g., through the Wallaces), by TNC for the release of such rights. During the investigation, the Committee asked TNC to provide information regarding the ownership of HCAC and other entities involved in the transaction, as well an explanation of TNC's payments with respect to the preemptive rights, to help the Staff understand the various components of the overall transaction. TNC stated to the Committee that it did not know who owned HCAC, and provided cursory information regarding the transfer of the preemptive rights. In discussions between the Staff and TNC on June 1, 2005, regarding this transaction, TNC informed the Staff that HCAC was owned by the Aldeborghs and the Cohans, and stated that TNC was required to negotiate with HCAC in order to obtain the required consent of the Cohans to proceed with completion of the transaction. One of the Staff's substantive concerns regarding the payment by TNC of amounts designated as made for preemptive rights is that the payments be characterized by the Wallaces, HCAC, the Cohans, and any other involved parties, in accordance with applicable Federal income tax laws, and that the parties responsible for recognizing income with respect to such payments properly report such

property (the property acquired from Windsor Capital Corporation), and TNC imposing conservation restrictions on some portions of the property.

¹⁹ In discussions between TNC and the Staff on June 1, 2005, TNC stated that the TNC-HCAC indemnification agreement was part of a mutual indemnification arrangement, pursuant to which Roger Bamford agreed to indemnify TNC for amounts it paid to HCAC pursuant to TNC's indemnification obligation to HCAC. The Staff notes that private benefit issues remain regardless of whether the any Bamford indemnification rights and obligations are taken into account.

income. For example, the Staff questions whether the payment by TNC to HCAC for preemptive rights should be properly treated by the parties as a payment by TNC to the seller of the underlying real estate, and a separate payment of that same amount by the seller of the property to HCAC in exchange for the release of HCAC's rights, or instead should be treated for Federal tax purposes (as is suggested by the parties) as a direct payment by TNC to HCAC (without any intervening payment to the seller with respect to that amount). The Staff notes that the structuring and transferring of the preemptive rights immediately prior to and as part of the transaction may have been done for non-tax purposes, including with respect to disputes between various parties to the transaction, but is concerned that it may have been accomplished to achieve tax minimization objectives for the involved parties.

6. Wallace and TNC purchase agreement. The purchase price terms of the purchase agreement between the Wallace family and TNC provided considerable flexibility to the Wallaces to determine the ultimate purchase price for the property, and how much was to be treated as a contribution by the Wallaces. The Staff notes that this flexibility may have allowed the Wallaces to achieve optimal tax benefits with respect to the transaction. For example, they may have been able to structure the purchase price to optimize their capital gains and charitable contribution deduction tax planning objectives. It was also unclear to the Staff why Real Estate Equities Limited Partnership paid \$18.5 million to TNC to help fund the purchase price when the partnership appeared to be obligated to contribute only \$9.5 million under the pledge agreement.

7. TNC's involvement in tax planning. The Committee asked TNC to explain the structuring of the agreement.²⁰ TNC's response stated that it did not assist the Wallace family members or any other parties to the transactions with respect to planning their tax consequences and that, because Wallaces had the right to specify the purchase price of the land, TNC was not in a position to speculate why the particular contribution structure was selected.²¹

8. Ownership of entities and other parties to transaction. TNC stated to the Staff at various times that it had no knowledge as to the identity of owners or members of Windsor Capital Corporation, HCAC and the Real Estate Equity Limited Partnership.²² TNC also stated that Windsor Capital Corporation is the parent company of Windsor Investment Co., Inc., which, in turn, is the holder of the beneficial interest of Herring Creek Farm Trust, a nominee trust.²³ The Staff observes that a full understanding of the legal rights and obligations, and tax consequences, of the Martha's Vineyard transaction and its components may not be realized without knowledge of the owners of the various entities that participated in the transaction. On June 2, 2005, TNC informed the Staff that it had knowledge of the identity of the owners of HCAC early on in the negotiations regarding the transaction.

²⁰ Committee Letter to TNC dated October 27, 2004, *see* Appendix B.

²¹ TNC Narrative Response dated November 23, 2004, *see* Appendix M.

²² For example, TNC Narrative Response dated May 12, 2005, Appendix M.

²³ *Id.*

Overview

After the completion of a series of transactions, a property consisting of approximately 215 acres of land known as Herring Creek Farm (the “Farm”) was acquired by TNC, subdivided into various parcels, and ultimately split up to be owned in part by TNC and in part by others. A portion of the acquired property became subject to conservation restrictions enforceable by TNC and the Town of Edgartown, Massachusetts.

At the start of the transaction, TNC acquired and became the sole owner in fee simple of the Farm, which was located in the Town of Edgartown, Dukes County, Massachusetts. Following this acquisition and various related transfers of parcels by TNC to others, TNC held approximately 102 acres (comprised of 62 acres of property known as the “East Field” and 40 acres of property known as the “Central Field”). The remaining 113 acres of the Farm were transferred by TNC to other parties: (1) 40 to 50 acres were acquired by the F.A.R.M. Institute, portions of which ultimately were acquired by MV Regency Group, LLC and a private individual named Daniel Stanton; (2) 26 acres were acquired by a private individual named Roger Bamford; (3) Herring Creek Acquisition Company acquired: (a) two unnamed lots; (b) a property named Sanderling; (c) a property named Blue Heron; and (d) certain beach rights and other property enhancements;²⁴ and (4) Herring Creek Farm Landowner’s Association acquired from TNC a beach parcel, roadways, and a horse barn.²⁵

By grant of deed of conservation restrictions made by TNC, in favor of the Conservation Commission of the Town of Edgartown (“Conservation Commission”), the Conservation Commission acquired joint ownership of the conservation restrictions over Herring Creek Farm. Thus, after these various transactions were completed, portions of the 215 acres were held by TNC, the F.A.R.M. Institute, Roger Bamford, HCAC, and Herring Creek Farm Landowner’s Association, with the Conservation Commission holding as a joint owner with TNC conservation restrictions over a portion of the property.

A charitable contribution deduction was claimed by HCAC with respect to a bargain sale of property and certain preemptive rights pertaining to the initial acquisition of the property by TNC. Charitable deductions were also claimed by various members of the Wallace family with respect to undivided land interests and cash amounts paid to TNC as part of the transaction.²⁶

Description of Herring Creek Farm

Herring Creek Farm (“Farm”) is located in Edgartown, Massachusetts, on the island of Martha’s Vineyard. The Farm has bucolic vistas along Slough Cove Road, out over approximately 105 acres of open farmland, down to Edgartown Great Pond and the Atlantic

²⁴ As part of the transaction, TNC also acquired from HCAC certain preemptive rights that HCAC had acquired from the Wallaces in late 2000 and that pertained to the 1969 Agreement.

²⁵ TNC Response Letter to Committee dated April 15, 2004, *see* Appendix C.

²⁶ For a breakdown of the charitable contributions reported on the Forms 8283 pertaining to the preemptive rights and certain other in kind contributions, *see* Summary of Form 8283 and Form 8282 Filings, pp 32-34 below.

Ocean. The Farm is a waterfront farm located along the easterly shoreline of Edgartown Great Pond and is located on the shoreline of South Beach.

According to the documentation provided to the Committee, the most prominent features of the property were parcels of land such as the Moore Beach parcel (20 acres), the East Field (62 acres), described as the most ecologically important section slated for native grassland restoration, and the Central Field (40 acres). Two of the most significant structures on the property were the Monte Wallace and Neil Wallace homes located on the shoreline of Edgartown Great Pond. Rounding out the property were 10 numbered building lots and two homes, a parcel known as Blue Heron,²⁷ and a caretakers' cottage.²⁸ It appears that certain of these properties described by TNC as the most prominent and ecologically significant properties were retained by TNC and became subject to the conservation restrictions.

The 1969 Agreement Establishing Preemptive Rights

On December 30, 1969, four owners²⁹ of adjoining land in Edgartown, Massachusetts that included the Farm entered into an agreement (the "1969 Agreement") that provided certain rights and easements for access to public ways and for access to and use of certain beach property in exchange for mutual rights of first refusal to purchase their respective lands. The material provisions of the 1969 Agreement stated that: (1) the Wallaces granted to the Cohans specified rights of way across the Wallaces' land for access to the beach and to other bodies of water; (2) the Wallaces and the Cohans agreed that until January 1, 2010, as long as members of each family continued to own their property, "no use shall be made of" their land "other than for detached single family residences ... which residences shall not be designed intended for use, or used primarily for the production of rental income to the owner thereof"; and (3) the Wallaces and Cohans agreed that until January 1, 2010, they would not transfer any part of their land, other than within their own family, without first offering it for sale to those members of the other family who continued to own abutting property with houses. The agreement provided that in the event that the Wallaces wished to sell property between January 1, 2000, and December 31, 2009, the Cohans and Aldeborghs³⁰ had a right of first refusal to purchase Herring Creek Farm

²⁷ Blue Heron is a parcel of land located at 7 Butler's Cove Road. The property is located on the northeast corner of Herring Creek Farm and is non-waterfront property with private beach rights to South Beach. The Blue Heron house is 1,068 square feet and is located on the outskirts of Herring Creek Farm, adjacent to certain farm buildings. It was determined that the highest and best use of the property was either demolition and new construction or substantial remodeling with additions.

²⁸ The caretakers' cottage is part of the farm complex of buildings. The farm buildings have an average effective age of 50 years and are described as in average condition. Other structures on the property include two structures called the Sanderling house and the Movius cottage. The Movius cottage is located on lot 10, is in poor condition and is considered a "tear down."

²⁹ The four owners were Neil Wallace, Monte Wallace, Benjamin Harrison Cohan, and Hildegard Cohan. In 1969, Neil and Monte Wallace (through a trust) purchased 151 acres of property from Benjamin Harrison Cohan and his wife, Hildegard Cohan. The Wallaces purchased the property to establish summer vacation homes for their respective families.

³⁰ It is unclear who the Aldeborghs were or what relationship they had with the various parties to the 1969 Agreement.

for \$10,000 per acre plus the fair market value of the then existing residences and other structures on the land.

Thus, the 1969 Agreement created certain mutual rights and obligations among certain of the landowners with respect to property that included the Farm. These rights and obligations appear to have existed over 30 years later when TNC expressed interest in acquiring the Farm. These provisions appear to have granted the owners of certain land adjacent to the Farm the right to acquire the Farm at a specified price established in 1969, if the owners of the Farm attempted to sell the Farm to another party at any time before 2010.

Acquisition of Herring Creek Farm by TNC

During 2000, TNC expressed its desire to acquire and restrict the development and use of a portion of the Herring Creek Farm. In October 2000, TNC made an offer to the Wallaces, the owners of the Farm, to purchase the entire 215 acres for approximately \$35 million.³¹ The offer was ultimately rejected by the Wallaces, who at the time had pending with the local government authorities a request for approval of the 33-lot subdivision of the Farm.³² The Wallace's request for approval of the 33-lot subdivision on Herring Creek Farm was granted, with certain conditions, in November 2000. On November 21, 2000, the Board of Governors authorized the acquisition of the Farm for a purchase price not to exceed \$40 million.

On April 24, 2001, Stuart R. Johnson, the trustee of Herring Creek Farm Trust, signed a definitive agreement with TNC for the sale of the Farm. Pursuant to the April 24, 2001, definitive agreement, TNC agreed to purchase the Farm from the Wallaces for a price of \$64 million.³³ Under the terms of the agreement, the Wallaces had the right to specify the final purchase price based on a final appraisal, but TNC was not obligated to pay more than \$45.5 million from its own resources. The payment of the purchase price under the agreement contemplated that cash would be raised by TNC through some combination of gifts, loans, and re-sales of various portions of Herring Creek Farm.³⁴ In the event that the final purchase price designated by the Wallaces as a result of the appraisal exceeded \$64 million, TNC was under no obligation to complete the purchase unless it received additional contributions in an amount

³¹ TNC Response Letter to Committee dated April 15, 2004, *see* Appendix C. On October 23, 2000, the Board of Governors permitted TNC to enter into negotiations with the Wallace family for the purchase of the Wallace family tract. Phase 1 allowed for the transfer of 15 acres plus \$1.6 million in cash to the Cohan/Aldeborgh families, the holders of the right of first refusal.

³² TNC Response Letter to Committee dated April 15, 2004, *see* Appendix C.

³³ The \$64 million figure was comprised of the following: (1) \$27 million (cash) received from the F.A.R.M. Institute, Inc.; (2) \$7,250,000 received from Roger Bamford for the purchase of an existing residence; (3) \$9,250,000 representing a portion of the proceeds of a Bank of America loan obtained, guaranteed, and collateralized by Roger Bamford and which was non-recourse to TNC; (4) \$1 million credit for TNC's initial deposit for which TNC was later reimbursed by the Bank of America loan; (5) \$1 million promissory note secured by a mortgage on the Herring Creek Farm lot; and (6) \$18.5 million gift contributed by the Wallace Foundation.

³⁴ Letter dated April 24, 2001, from TNC (signed by Wayne A. Klockner) to Stuart R. Johnson, *see* Appendix M.

equal to the excess.³⁵ In short, TNC was not responsible for the portion of the purchase price (as finally determined) that exceeded \$45.5 million. The excess purchase price over \$45.5 million was to be funded by others, with any shortfall to be provided for by members of the Wallace family.

Also, on April 24, 2001, TNC signed a definitive agreement with the F.A.R.M. Institute, Inc., for a sale of a portion of Herring Creek Farm.

In a separate transaction, F.A.R.M. Institute, Inc., signed a definitive agreement with MV Regency Group, LLC³⁶ for the sale of another portion³⁷ of Herring Creek Farm.

Several months later, on July 17, 2001, MV Regency Group, LLC signed a purchase and sale agreement with a private individual, Daniel W. Stanton, for the sale of another portion of Herring Creek Farm.

Certain Herring Creek Farm closing documents stated that upon completion of all the conveyances and payments, and upon TNC securing the agreement of the Wallaces also to sign the document, the Cohan descendants were to: (1) execute and file a stipulation of dismissal with prejudice, without costs, and waiving all rights of appeal of all claims and counterclaims in the litigation currently pending between the Wallaces and Cohan descendants and (2) execute a general release of all claims against the Wallaces, in return for a mirror image release from the Wallaces of all claims against the Cohan descendants.³⁸

Funding for the Acquisition of Herring Creek Farm

Charitable gifts made by Herring Creek Farm Trust to TNC

³⁵ Letter dated January 8, 2001, from Frank Giso III, (Choate, Hall & Stewart) to Stuart R. Johnson, David A. Peters, Christopher H. Milton and Thomas P. Bloch, *see* Appendix M. Documentation provided to the Committee staff suggests that if the final purchase price determined by the Wallaces exceeded the initial \$64 million purchase price and the gifts made from Wallace family members were not adequate to cover the difference between \$45.5 million and the final purchase price, then the Wallaces were nevertheless required to sell the property to TNC for an amount equal to the total of \$45.5 million, plus the current value of gifts made (calculated as of the day before closing). Any remaining unpaid portion of the final purchase price would generate a bargain sale gift from Herring Creek Farm Trust to TNC. A letter concluded that TNC should have the right to obtain specific performance of a sale of the property on these terms. *See* On June 5, 2001, Coleman & Sons Appraisal Group appraised the fair market value of Herring Creek Farm for \$78 million. On July 17, 2001, TNC obtained an independent professional appraisal from Meredith & Grew Inc., who appraised the fair market value of Herring Creek Farm for the same amount.

³⁶ TNC Response Letter to Committee dated April 15, 2004, *see* Appendix C. MV Regency Group, LLC was a development company managed by David Peters and owned by the David M. Letterman Trust.

³⁷ Letter dated June 3, 2003, from Hans P. Birlle to Philip Tabas regarding Herring Creek Farm, *see* Appendix M. The documentation provided by TNC states that F.A.R.M. Institute, Inc., sold approximately 39 acres to MV Regency Group, LLC.

³⁸ Executed agreements between TNC, HCAC, and F.A.R.M. Institute, Inc.

On April 24, 2001, as part of the definitive agreement between TNC and the Herring Creek Farm Trust, TNC and the trust expressed their intentions with respect to gifts to be made by certain persons and entities affiliated with the trust.³⁹ The parties acknowledged that if the purchase price under that agreement exceeded \$45.5 million, TNC would request the trust and related parties to consider making gifts as described in the letter. The trust agreed to encourage the owners of the Blue Heron Parcel, the Moore Beach Parcel, and the Sliver Parcel to gift those parcels to TNC, and to encourage certain members of the Wallace family to make, on or before June 15, 2001, gifts of cash or other assets having a value of at least \$9.5 million. The purpose of the contemplated gifts was to aid TNC in achieving its goal of preserving large areas of farmland on Martha's Vineyard.

The agreement also provided that any Wallace family gifts were to be evidenced by a charitable pledge agreement and interest free promissory note, enforceable against the Wallace family donors unless a bargain sale gift was made by the trust pursuant to the parties' agreement. In the event that the purchase price exceeded \$55 million and TNC was unable to raise the additional funds from the Wallace family, or the Wallace family failed to honor a \$9.5 million pledge, the trust would make a bargain sale gift of any "shortfall"⁴⁰ to TNC. The letter of intent provided TNC a break up fee of \$3 million if certain circumstances occurred. A confidentiality agreement executed by the parties on December 11, 2000, was incorporated by reference.

Cash pledge of Real Estate Equities Limited Partnership and Wallace Foundation

On June 21, 2001, the Real Estate Equities Limited Partnership, a Delaware limited partnership ("the Partnership") executed a "Charitable Pledge Agreement," with TNC as pledgee, pursuant to which the Partnership pledged to pay \$9.5 million to TNC. The pledge contemplated that large areas of farmland on Martha's Vineyard would be preserved. The parties executed a non-negotiable promissory note to evidence the commitment to complete the gift contemplated in the pledge agreement.⁴¹ The promissory note in the amount of \$9.5 million was executed by the Partnership on June 21, 2001. Under the note, the Partnership was obligated to pay TNC up to \$9.5 million when TNC acquired farmland on Martha's Vineyard as part of its program to preserve the same, provided that TNC gave the Partnership at least seven days written notice.⁴²

³⁹ Letter dated April 24, 2001, from TNC (signed by Wayne A. Klockner) to Stuart R. Johnson, *see* Appendix M.

⁴⁰ For these purposes, shortfall means the amount equal to the purchase price under the agreement minus the total of \$45.5 million, plus the total of cash gifts actually funded by the Wallace family donors, plus any credit against the purchase price received by TNC for promissory notes delivered by the Wallace family donors but not funded with cash by the closing under the purchase agreement.

⁴¹ Letter dated June 21, 2001, from Herring Creek Farm Trust to TNC (formal submission of charitable pledge agreement and non-negotiable promissory note), *see* Appendix M.

⁴² Interest did not accrue under the note until the maturity date, an undefined term which appeared to mean the date (including the up to seven day notice period) on which TNC requested payment under the note.

On July 18, 2001, the Wallace Foundation⁴³ remitted to TNC (by wire transfer) \$18.5 million to fully satisfy the promissory note and charitable pledge agreement obligations of the Partnership. The letter specifically stated that the \$18.5 million satisfied in full a certain non-negotiable note dated June 21, 2001, of the Partnership in the original principal amount of \$9.5 million as well as a charitable pledge agreement also dated June 21, 2001, of the Partnership in favor of TNC.⁴⁴

On July 20, 2001, TNC closed on the purchase of the Farm by paying cash consideration of \$45.5 million and executing a promissory note in the amount of \$1 million, payable to Stuart R. Johnson, Trustee of Herring Creek Farm Trust, payable in full on July 19, 2004. By prior agreement, TNC and Stuart R. Johnson agreed that TNC could pay up to \$1 million of the purchase price by delivering at closing a promissory note in such amount.⁴⁵

Transfer of Preemptive Rights, Bargain Sale by HCAC to TNC, and Tax Indemnity Payments

In late 2000, certain preemptive rights held by the Wallaces were transferred to HCAC.⁴⁶ TNC took affirmative steps to obtain the approval from HCAC to waive these rights of first refusal when TNC acquired the Farm. HCAC expressed a willingness to make a bargain sale gift to TNC of the appraised fair market value of the preemptive rights under the 1969 Agreement in excess of the value of the cash and real estate conveyances expressly described in the agreement.

Bargain sale gift and TNC's tax indemnity obligations

On June 29, 2001, TNC and HCAC executed an agreement regarding a bargain sale gift of the preemptive rights⁴⁷ and certain tax payments. The agreement acknowledged that HCAC had conveyed to TNC certain preemptive rights which had been held by HCAC pursuant to the 1969 Agreement, and that such rights had been appraised prior to the conveyance at \$14

⁴³ Forms 990-PF from 2000, 2001 and 2002, show that the Wallace foundation is an entity by the name of the "Monte J. Wallace Foundation" with Monte J. and Anne H. Wallace as trustees and with a principal address of 600 Atlantic Avenue Suite 2000 Boston, Massachusetts 02210, *see* Appendix L.

⁴⁴ Letter dated July 18, 2001, from the Wallace Foundation to TNC, *see* Appendix M.

⁴⁵ Letter dated April 24, 2001, from TNC (signed by Wayne A. Klockner) to Stuart R. Johnson, *see* Appendix.

⁴⁶ TNC Response Letter to Committee dated April 15, 2004, *see* Appendix C.

⁴⁷ A letter from TNC to Stuart R. Johnson dated April 24, 2001, outlined the effect of bargain sale gift on TNC's requirements regarding approval of an appraisal under the purchase agreement. The letter stated that in the event that Herring Creek Trust does elect to make a bargain sale gift of some portion of the Herring Creek Farm, TNC will review and approve the appraisals for Herring Creek Farm based on the figure that represents the actual net price to TNC rather than based upon the full fair market value stated in HCAC's appraisal. An example was provided in the letter stating that if Herring Creek Trust's appraisal indicated a fair market value of \$70 million and Herring Creek Trust elected to make a bargain sale gift in the amount of \$15 million, then TNC would evaluate the appraisal to ensure that TNC and its Board were satisfied that the fair market value of Herring Creek Farm was at least \$55 million (rather than the higher \$70 million figure) and would grant or withhold their approval of the appraisal on that basis. Letter dated April 24, 2001, from TNC (signed by Wayne A. Klockner) to Stuart R. Johnson, *see* Appendix M.

million.⁴⁸ The agreement provided that HCAC was to report a bargain sale gift amount with respect to the conveyance not to exceed \$2,066,000, based on the excess of the value of the rights over the value and amount of certain items transferred by TNC to or on behalf of HCAC. The agreement provided that the transfer of the rights would be treated as a long-term capital transaction for tax purposes. The agreement further acknowledged that TNC and HCAC had executed a separate agreement regarding the transfer that, among other things, obligated TNC to make certain tax indemnification payments to HCAC.⁴⁹ TNC and HCAC agreed that the payment owed by TNC to HCAC under that agreement was \$1,484,000, subject to further adjustments, as the indemnification provisions were to remain in effect in the event of any State or Federal tax audit.

Valuation of the pre-emptive rights

On August 15, 2001, Meredith & Grew, Inc., submitted an appraisal report to Daniel J. Gleason (attorney for HCAC) for the right of first refusal and valued such right for \$14 million. The analysis submitted indicated a value ranging from \$12.9 million to \$17 million for the right, but it was ultimately concluded that the right was worth \$14 million. Meredith & Grew, Inc., stated that the \$14 million figure represented a 21.9 percent discount when applied against the \$64 million deeded price. Furthermore, it was estimated that the property that was subject to the right of first refusal comprised an estimated 186 acres of the 220-acre Herring Creek Farm.

On August 25, 2001, Appraisal/Economics, Inc., determined that the rights of first refusal represented an impairment to the marketability on the sale of 175 acres and that the rights were worth \$14 million.⁵⁰

Transfers made by TNC in exchange for waiver of preemptive rights

In exchange for the waivers of the preemptive rights, TNC made transfers valued at \$11,931,755⁵¹ representing the following: (1) \$1.7 million as a reimbursement of the legal expenses with respect to the litigation concerning the validity of the 1969 agreement and attempts to secure a 50-lot and 33-lot subdivision approval with respect to Herring Creek Farm; (2) \$402,755 representing a payment of HCAC's legal expenses; (3) \$1,484,000 representing a gross up payment representing the anticipated taxes on the consideration received for the waiver of the preemptive rights; (4) \$4,750,000 representing the conveyance of two buildable lots to HCAC for no consideration; (5) \$1 million representing the conveyance of the Sanderling lot to

⁴⁸ In a summary appraisal report dated July 15, 2001, Meredith & Grew Inc., determined that the right of first refusal had a fair market value of \$14 million, *see* Appendix M.

⁴⁹ TNC stated that HCAC insisted on the indemnity as the only acceptable alternative to payment by TNC of the value of pre-emptive rights. TNC concluded that providing the tax indemnity was the least costly alternative and that the sum of the value of the indemnity and \$11,931,755 paid in consideration was less than the appraised value of the pre-emptive rights. TNC Response Letter to Committee dated April 15, 2004, *see* Appendix C.

⁵⁰ Letter entitled, "Determination of the FMV of a right of first refusal on certain real estate in Edgartown, Massachusetts," *see* Appendix M.

⁵¹ TNC Response Letter to Committee dated April 15, 2004, *see* Appendix C.

HCAC for no consideration; (6) \$625,000 representing the conveyance of the Blue Heron lot to one of the family members for no consideration; (7) \$750,000 representing the conveyance of beach rights and other property enhancements to HCAC for no consideration; and (8) \$1,222,000 representing the release by TNC of the preemptive rights under the 1969 agreement.

Tax Payments

A letter dated October 18, 2001, outlined the concept of “tax-make whole payment” (“TMW”).⁵² TNC and HCAC agreed that TNC would cover any tax liability incurred by HCAC as a result of TNC’s conveyance of lots 2 and 3, Blue Heron, and Sanderling⁵³ to HCAC for no consideration. The letter further stated that TNC would receive a credit against the TMW payment to reflect the charitable deductions that HCAC would be able to pass through to its members based upon HCAC having made a bargain sale gift to TNC of some portion of the preemptive rights under the 1969 Agreement.

The letter calculated the TMW payments prior to giving any effect to the bargain sale gift by multiplying the fair market value of \$6,375,000 by an agreed upon Federal⁵⁴ and State⁵⁵ formula. Further, the letter calculated the bargain sale gift component by using the fair market value of the pre-emptive rights as the base. Having previously determined through various appraisals that the value of the preemptive rights was worth at least \$14 million, the bargain sale gift⁵⁶ was calculated by subtracting \$14 million from the total consideration received by HCAC from TNC in connection with TNC’s acquisition of the preemptive rights. It was ultimately determined that HCAC was to report a bargain sale gift not to exceed \$2,068,245 based on the excess of the value of the rights over the value of certain transfers by TNC (i.e., \$14 million minus \$11,931,755).

⁵² Letter from Frank Giso III, PC to Hans P. Birle, Esq., Regarding the Status of Negotiations with Herring Creek Acquisition Company Regarding “Tax Make-Whole Payment” dated October 18, 2001, *see* Appendix M.

⁵³ The fair market value of lots 2 and 3, Blue Heron, and Sanderling were collectively valued at \$6,375,000. A summary report provided by Meredith & Grew Inc., appraised lots 2 and 3, Blue Heron, and Sanderling as follows, \$2,250,000, \$2.5 million, \$625,000, and \$1 million, respectively. Summary appraisal report by Meredith & Grew Inc., for Blue Heron, Sanderling and Lots 2 and 3 dated July 15, 2001, *see* Appendix M.

⁵⁴ The Federal component was calculated as follows: \$6,375,000 multiplied by .2 and then divided by .8 for a value of \$1,593,750. Letter from Frank Giso III, PC to Hans P. Birle, Esq., Regarding the Status of Negotiations with Herring Creek Acquisition Company Regarding “Tax Make-Whole Payment” dated October 18, 2001, *see* Appendix M.

⁵⁵ The State component was calculated as follows: \$6,375,000 multiplied by .05 and then divided by .95 for a value of \$355,526. Letter from Frank Giso III, PC to Hans P. Birle, Esq., Regarding the Status of Negotiations with Herring Creek Acquisition Company Regarding “Tax Make-Whole Payment” dated October 18, 2001, *see* Appendix M.

⁵⁶ The TMW payment was reflected as one of the line items in calculating the bargain sale component. The letter stated in relevant part that, the bargain sale gift would increase as the TMW payment is decreased to reflect the credit for the bargain sale gift. Letter from Frank Giso III, PC to Hans P. Birle, Esq., Regarding the Status of Negotiations with Herring Creek Acquisition Company Regarding “Tax Make-Whole Payment” dated October 18, 2001, *see* Appendix M.

Charitable Letter of Acknowledgment

On March 8, 2002, TNC sent HCAC a letter acknowledging a charitable gift from HCAC.⁵⁷ In that letter, TNC treated the total value of consideration from TNC to HCAC in return for the conveyance of HCAC's interest under a 1969 agreement which encumbered the Herring Creek Farm to be \$11,931,755. This consisted of: (1) \$6,375,000 relating to the conveyance of Lots 2 and 3, Sanderling and Blue Heron; (2) \$3,586,755 for cash payments to or on behalf of HCAC; (3) \$750,000 for beach rights and enhancements; and (4) \$1,220,000 for the release of preemptive rights encumbering the Cohan and Aldeborgh properties. TNC stated that the value of HCAC's interest in the 1969 agreement in excess of \$11,931,755 "represents a bargain sale gift to TNC and the amount of any charitable contribution deduction taken by HCAC or its members is limited to such excess."⁵⁸ In the Form 8283 provided by HCAC to TNC on March 8, 2002, HCAC reported the appraised value of the real estate and preemptive rights conveyed to TNC to be \$14 million and the amount claimed by HCAC as a charitable deduction to be \$2,068,245.

Transfer of Portions Herring Creek Farm by TNC to Various Parties

After TNC acquired Herring Creek Farm, a series of transfers of parcels to other parties took place. The initial purchase of the Farm and subsequent property transfers of parcels of the Farm were broken down into three separate agreements⁵⁹: (1) the Sellers/TNC agreement that covered everything currently owned by Herring Creek Farm Trust as well as all the adjacent properties owned by various Wallace family members (for a fixed stated price); (2) the TNC/F.A.R.M. Institute, Inc., agreement that covered portions of the property conveyed from TNC to the F.A.R.M. Institute, Inc. (for \$28 million); and (3) the F.A.R.M. Institute, Inc./MV Regency Group, LLC agreement that covered four building lots that were transferred from F.A.R.M. Institute, Inc. to MV Regency Group LLC.

Transfer to the F.A.R.M. Institute

On April 24, 2001, TNC signed a definitive agreement with the F.A.R.M. Institute, Inc.,⁶⁰ for a sale of the portion of Herring Creek Farm.⁶¹ The overall purchase price was \$28 million.⁶²

⁵⁸ Letter dated March 8, 2002, from Dennis B. Wolkoff, Vice President, TNC, to Herring Creek Acquisition Company, LLC, c/o Robert Hughes, *see* Appendix M.

⁵⁹ Letter dated January 8, 2001, from Frank Giso III, (Choate, Hall & Stewart) to Stuart R. Johnson, David A. Peters, Christopher H. Milton and Thomas P. Bloch, *see* Appendix M. A TNC press release stated that "[t]hough portions of Herring Creek Farm will change ownership multiple times throughout the course of the transaction, the conservation restrictions set by TNC must be adhered to by all buyers."

⁶⁰ F.A.R.M. Institute, Inc., is a local non-profit organization whose mission includes the preservation of farms and the promotion of agricultural education. TNC Response Letter to Committee dated April 15, 2004, *see* Appendix C.

⁶¹ Letter dated April 24, 2001, Purchase and Sale Agreement between TNC, as Seller and the F.A.R.M. Institute, Inc., as Purchaser, Regarding a Portion of Herring Creek Farm Edgartown, Dukes County, Massachusetts, *see* Appendix M. All of the consideration received by TNC from F.A.R.M. Institute, Inc., was used by TNC to finance

Subject to certain adjustments and apportionments, F.A.R.M. Institute, Inc., was required to remit \$27 million. With respect to the remaining \$1 million of the purchase price, TNC (seller) assigned and F.A.R.M. Institute, Inc. (purchaser) assumed all of the seller's obligations under the promissory note secured by a mortgage on the Herring Creek Farm lot. TNC made the following transfers to the F.A.R.M. Institute, Inc: (1) title to Herring Creek Farm lot; (2) a 99-year ground lease on a piece of property named the Central Field; and (3) title to four building lots, one of which was the site of one of the existing Wallaces residences.⁶³

By prior agreement, F.A.R.M. Institute, Inc., signed a definitive agreement with MV Regency Group, LLC for the sale of a portion of Herring Creek Farm. Pursuant to the definitive agreement, F.A.R.M. Institute, Inc., transferred four building lots to MV Regency Group, LLC.⁶⁴

Transfer to Bamford

The documentation indicates that at some point, Roger Bamford held the titles of President, Treasurer, and Director of Herring Creek Farm, but ultimately resigned from those positions. An agreement dated October 18, 2000, indicated that Roger Bamford would lend TNC up to \$40 million to finance the acquisition of the Wallace properties and would provide TNC an indemnity in the amount of \$1 million.⁶⁵ TNC stated that the purpose of the agreement with Roger Bamford was to enable TNC to complete the transaction without out-of-pocket costs either for the acquisition of Herring Creek Farm or for securing waiver of the pre-emptive rights held by HCAC.⁶⁶

The agreement specifically stated that if TNC was successful in signing an agreement with the Wallaces for the purchase of the Wallace land, Roger Bamford would make a loan to TNC in the amount of the purchase price owed by the Wallaces and TNC would execute and deliver to Roger Bamford as evidence of, and security for, the acquisition loan, a non-recourse promissory note from the Bank of America bearing a seven percent per annum interest rate. The

the purchase of Herring Creek Farm from the Wallaces. TNC Response Letter to Committee dated April 15, 2004, *see* Appendix C.

⁶² A deposit in the amount of \$100,000 was placed in escrow with respect to this transaction. Letter dated April 24, 2001, Purchase and Sale Agreement between TNC, as Seller and the F.A.R.M. Institute, Inc., as Purchaser, Regarding a Portion of Herring Creek Farm Edgartown, Dukes County, Massachusetts, *see* Appendix M.

⁶³ It appears the total amount of acreage transferred to F.A.R.M. Institute, Inc., was 40 to 50 acres.

⁶⁴ Subsequently, on July 17, 2001, MV Regency Group, LLC signed a purchase and sale agreement with another party for the sale of a portion of Herring Creek Farm. TNC was neither a party to the F.A.R.M. Institute Inc. agreement with MV Regency Group, LLC nor to the subsequent transfer of certain lots by MV Regency Group, LLC to another party.

⁶⁵ Letter dated October 18, 2000, outlining the terms of the acquisition loan, *see* Appendix M. Documentation provided by TNC indicated that Bamford pledged to make a sizable donation to cover the balance of the purchase price and the costs of the transaction. Letter dated June 3, 2003, from Hans P. Birle to Philip Tabas regarding Herring Creek Farm, *see* Appendix M.

⁶⁶ TNC Response Letter to Committee dated April 15, 2004, *see* Appendix C.

loan was intended to provide TNC with the funds needed to fully fund the \$45.5 million purchase price, make cash payments to HCAC, and recover its other transactional costs, including legal fees and transfer taxes.⁶⁷

The agreement further granted Roger Bamford an option to purchase for fair market value all or any portion of the Wallace land covered by the purchase mortgage.⁶⁸ Under the arrangement, Roger Bamford would purchase two lots for their final appraised values.⁶⁹ Pursuant to such arrangement, TNC transferred to Roger Bamford a lot (lot 6⁷⁰) on which an existing Wallace residence was situated for \$7,250,000.⁷¹ A second lot (lot 5⁷²) was sold in December 2003, at fair market value, for \$4,750,000.⁷³

Transfer to Herring Creek Farm Landowners Association, Inc.

The Herring Creek Farm Landowners Association, Inc. is a non-profit Massachusetts corporation, organized under the provisions of Chapter 180 of the Massachusetts General Laws, charged with the duties and invested with the power prescribed by law and set forth in its Articles of Organization, By-Laws and the Declaration. The Conservancy had the right to retain ownership of the roadways at the farm and the beach lot, subject to certain travel and use easements in favor of other landowners at Herring Creek Farm. TNC conveyed the so-called "Beach Parcel," and all roadways on Herring Creek Farm and the so-called "Horse Barn" structure in the "Central Field" to Herring Creek Farm Landowner's Association, Inc. As a means of avoiding the risk of liability as owner in the event of personal injury or death, TNC transferred these portions for no consideration to the Association.

Conservation Restrictions Applicable to the Acquired Property

⁶⁷ TNC Response Letter to Committee dated April 15, 2004, *see* Appendix C.

⁶⁸ TNC agreed that if it received any net sales proceeds from the sales to Bamford or the F.A.R.M. Institute, Inc., in excess of the total costs of the transaction, the excess would be used to reduce the Bank of America loan. Bamford agreed to make a contribution to TNC in an amount sufficient to enable TNC to pay off the loan. TNC Response Letter to Committee dated April 15, 2004, *see* Appendix C.

⁶⁹ TNC Response Letter to Committee dated April 15, 2004, *see* Appendix C.

⁷⁰ Lot 6 is comprised of 15.86 acres and includes the existing "Neil Wallace residence" and an abandoned cottage known as Movius Camp. Meredith & Grew Inc., estimated the fair market value of lot 5 in the amount of \$7,250,000 million. Letter dated July 9, 2001, from Meredith & Grew Inc., to Hans P. Birle, Counsel for TNC, *see* Appendix M.

⁷¹ TNC Response Letter to Committee dated April 15, 2004, *see* Appendix C.

⁷² Lot 5 is comprised of 9.62 acres that fronts Edgartown Great Pond. Meredith & Grew Inc., estimated the fair market value of lot 5 in the amount of \$4.7 million. Letter dated July 9, 2001, from Meredith & Grew Inc., to Hans P. Birle, Counsel for TNC, *see* Appendix M.

⁷³ The proceeds from the sale were used to reduce a loan taken out with the Bank of America. TNC Response Letter to Committee dated April 15, 2004, *see* Appendix C.

On July 13, 2001, TNC and the Town of Edgartown entered into a Memorandum of Understanding concerning the deed of conservation restrictions⁷⁴ relating to the Farm.⁷⁵ TNC stated that it desired to convey conservation restrictions and the Conservation Commission of the Town of Edgartown determined that it would be desirable and beneficial to enforce the conservation restrictions in order to protect the property's conservation values, while permitting uses of the property that did not impair the property's conservation values and that were not inconsistent with the purpose of the conservation restriction. The conservation restrictions were intended to maintain the property such that it remain predominantly in or be restored to its natural, open, agricultural and scenic state in perpetuity, except for limited portions of the property to be developed with selected improvements and related structures as permitted in such a manner as to protect the "conservation values."⁷⁶

The conservation restriction agreement resulted in a portion of property that consisted of a subdivision of 33 lots,⁷⁷ a separate parcel containing 56 acres (lot 70, the East Field) and two beach parcels containing approximately 20 acres (lots 104 and 104A or the Beach).

TNC described the conservation restriction pertaining to Herring Creek Farm as follows⁷⁸:

⁷⁴ The deed of conservation restrictions dated July 2001, specifically stated that TNC and the Conservation Commission of the Town of Edgartown intended to: (1) enhance the conservation values of the property by limiting the number of developable lots and the size and number of permitted structures thereon; (2) manage and restore the native grassland on portions of the property; (3) designate other portions of the property for agricultural activities; (4) manage the beach to protect the fragile nature of this landform and its species of plant and animal; (5) prohibit the introduction of and providing for the removal of certain invasive plant species; and (6) prohibit the use of synthetic fertilizer and the application of biocides, herbicides or pesticides without TNC's prior approval in consultation with the Conservation Commission of the Town of Edgartown and the Association and encouraging the use of native landscaping and restoration. Deed of Conservation Restrictions, Herring Creek Farm, Edgartown, MA dated July 2001, *see* Appendix M.

⁷⁵ TNC Response Letter to Committee dated April 15, 2004, *see* Appendix C.

⁷⁶ TNC and the Conservation Commission of the Town of Edgartown jointly expressed the desire to preserve the natural, scenic, agricultural and open space values of the property; to protect the shoreline and water quality of Edgartown Great Pond and Crackatuxet Cove; to protect globally rare sandplain grasslands, savannas, oak woodlands, heathlands and other natural communities; to preserve agricultural and farming uses on portions of the property; to promote the restoration of native habitats; to increase the populations of native animals, birds, insects and other species; and to prevent habitat fragmentation and to promote restoration of native grassland. TNC and the Conservation Commission of the Town of Edgartown recognized the conservation values of the property and shared the common goal of protecting these conservation values. Deed of Conservation Restrictions, Herring Creek Farm, Edgartown, MA dated July 2001, *see* Appendix M.

⁷⁷ Originally approved for a 33-lot subdivision by both the Planning Board and the Martha's Vineyard Commission, the agreement reached by the parties provides for six additional houses, all to be located within the numbered lots subject to restrictions and conservation easements. *See* TNC response letter to Senate Finance Committee dated April 15, 2004, at 22. To this effect, a TNC press released stated that "[a]s a result of the conservation restrictions, the number of new houses to be built on the land is limited to six, none of which are sited in the sensitive restoration area." <http://nature.org/pressroom/links/art10072.html>.

⁷⁸ TNC Response Letter to Committee dated April 15, 2004, *see* Appendix C.

a conservation restriction is a permanent encumbrance on the entire Farm and, in pertinent part: (a) establishes pristine areas of Farm with exceptional wildlife and plant species habitat where no development will ever be permitted; (b) establishes on those lots within the Farm where limited residential development will be permitted, so-called “development envelopes” outside of which no improvements will be permissible, and joins together the resulting open space on each lot into meaningful tracts of contiguous habitat; (c) imposes key restrictions on the Farm, including limiting public access to sensitive grasslands and beach areas, limitations on the types and numbers of domesticated pets that may be kept on the Farm, on the planting of non-native grasses and plant species outside the development envelopes; (d) incorporates the Conservancy’s science-based habitat management techniques, such as prescribed burning of grassland areas and beach management activities; and (e) prohibits development of shore-hugging mansions that would irreparably alter the character of the Farm and its unique vistas and “viewsheds.”

TNC reserved the right to enforce the terms of the conservation restriction. The Town of Edgartown and TNC agreed to meet at least annually at an open space management meeting to review and discuss ongoing monitoring and enforcement activities.⁷⁹ The parties also agreed to cooperate in implementing aggressive conservation strategies, including soil and water conservation, restoration of native grasslands, active management of the beach area and open spaces, and selective cutting and clearing of vegetation for habitat protection.⁸⁰ TNC prepared a baseline report to document the condition of Herring Creek Farm upon acquisition as a means of measuring future enforcement efforts as well as the success of the program.

⁷⁹ TNC Response Letter to Committee dated April 15, 2004, *see* Appendix C.

⁸⁰ TNC Response Letter to Committee dated April 15, 2004, *see* Appendix C.

The following table shows certain information reported on the Forms 8283 provided to TNC and filed with the IRS by donors with respect to the Martha's Vineyard properties.

Table 8, Summary of Form 8283 filings

Name of donor	Date of Form 8283	Date of Donation	Description of Donation	Appraised FMV reported on Form 8283	Date property was acquired	How acquired	Other comments
Herring Creek Acquisition Company, LLC	3/8/02	7/20/01	Real estate/preemptive rights	\$14,000,000	1/96	Exchange	Amount claimed as a deduction was \$2,068,245; bargain sale amount received reported as \$11,931,755
Jonathan R. Wallace & Lisa S. McGovern	9/9/02	7/20/01	10% undivided interest Slough Cove Road (SCR) parcel	110,000	11/86	Purchase	See Form 8282 info. below
Anthony G. & Elizabeth W. Trase	9/9/02	7/20/01	10% undivided interest SCR parcel	110,000	11/86	Purchase	See Form 8282 info. below
William Gardner & Page C. Wallace	9/9/02	7/20/01	10% undivided interest SCR parcel	110,000	11/86	Purchase	See Form 8282 info. below
John H. Wallace	9/9/02	7/20/01	10% undivided interest SCR parcel	110,000	11/86	Purchase	See Form 8282 info. below
Robert E. & Julia W. Bennett	9/9/02	7/20/01	10% undivided interest SCR parcel	110,000	11/86	Purchase	See Form 8282 info. below
Bradford S. & Ann F. Wallace	9/9/02	7/20/01	10% undivided interest	110,000	11/86	Purchase	See Form 8282 info. below

			SCR parcel				
Neil W. & Elise R. Wallace	9/9/02	7/20/01	20% undivided interest SCR parcel	220,000	11/86	Purchase	See Form 8282 info. below
Monte J. & Anne H. Wallace	9/9/02	7/20/01	20% undivided interest SCR parcel	220,000	11/86	Purchase	See Form 8282 info. below
Neil W. & Elise R. Wallace	9/9/02	7/20/01	50% undivided interest in other SCR parcel	12,500	----	Purchase	
Monte J. & Anne H. Wallace	9/9/02	7/20/01	50% undivided interest in other SCR parcel	12,500	----	Purchase	
Neil W. & Elise R. Wallace	9/9/02	7/20/01	50% undivided interest SCR ocean front	380,000	1984-1989	Purchase	
Monte J. & Anne H. Wallace	9/9/02	7/20/01	50% undivided interest SCR ocean front	380,000	1984-1989	Purchase	
Windsor Capital Corporation	9/9/02	7/20/01	Herring Creek Farm; 34 building lots, beach front and wood lot on approx. 205 acres	76,115,000	1969-1980s	Purchase	Amount received for bargain sale was \$64.0 million; donor's basis was \$11.9 million; see Form 8282 info. below

The following table summarizes certain information reported by TNC on Forms 8282 filed by TNC with respect to the Martha's Vineyard properties.

Table 9, Summary of Form 8282 Filings

Name of donor	Description of property	Date of donation	Date of sale by TNC	Amount received by TNC	Value reported on Form 8283
Windsor Capital Corporation	Herring Creek Farm	7/20/01	7/24/01	\$35,250,000	\$76,115,000
Monte J. & Anne H. Wallace	20% undivided interest	7/20/01	2/15/02	125,000	220,000
John H. Wallace	10% undivided interest	7/20/01	2/15/02	62,500	110,000
Neil W. & Elise R. Wallace	20% undivided interest	7/20/01	2/15/02	125,000	220,000
Jonathan R. Wallace & Lisa S. McGovern	10% undivided interest	7/20/01	2/15/02	62,500	110,000
William Gardner & Page C. Wallace	10% undivided interest	7/20/01	2/15/02	62,500	110,000
Anthony G. & Elizabeth W. Trase	10% undivided interest	7/20/01	2/15/02	62,500	110,000
Bradford S. & Ann F. Wallace	10% undivided interest	7/20/01	2/15/02	62,500	110,000
Robert E. & Julia W. Bennett	10% undivided interest	7/20/01	2/15/02	62,500	110,000

III. CBP Transaction – Lake Huron

TNC prepared the following summary of this transaction, also described in *The Washington Post*, for its June 13, 2003 Board of Governors meeting.

CONSERVATION BUYER TRANSACTION SUMMARY—C

Site or Project Name: Northern Lake Huron, MI

Purchaser Name: Jerrold Jung, as Trustee for Jerrold M. Jung Trust

Land: 184.5 acres of land located on the shoreline of northern Lake Huron.

Date of Sale: 12/9/2002

1. **Consistency with Conservation by Design:** The Northern Lake Huron shoreline is a portfolio site identified within the Great Lakes eco-regional plan. This shoreline was identified as one of the richest and most productive biological areas in the country by TNC science and protection staff and as a critical Biodiversity Investment Area by the U.S. Environmental Protection Agency. The shoreline where this project is located features nine globally rare communities and at least 13 federally endangered, threatened or listed species. The site also contains at least 21 globally rare species of plants and animals, and 60 species rare in the state of Michigan. More than 250 species of migratory songbirds and waterfowl fly through this shoreline and use this habitat as a critical resting and feeding stopover site.
 - **Threat:** The property was threatened with development into a golf course and 27 residential housing units. The primary conservation goal is to prevent further habitat fragmentation.
 - **Conservation Easement:** The permanent conservation easement prevented any further development of the property and limited development to the existing buildings (one residence, one log cabin, one pole barn, one boat dock); all except the log cabin may be replaced in the same location as the existing building. The log cabin can not be replaced if it is removed or destroyed. The easement also prohibits any commercial use of the property, disturbance of native vegetation, agriculture, forestry, and other changes to and economic uses of the land.
2. **Valuation Substantiation:** TNC obtained an independent, professional appraisal of the property. The appraisal, as of January 1, 2002, indicated a value for the property without use restrictions to be \$2,298,500. The appraisal of the property with the restrictions imposed indicated a value of \$1,062,000. This creates a value of the easement of \$1,236,500. The appraisal was obtained prior to price being established in the purchase agreement.
3. **Marketing Efforts:** TNC sought potential buyers by word of mouth in conversations with Michigan Chapter Trustees. One of the current Trustees suggested to the MI State director, among other names, that Mr. Jung might be a prospect for this property. TNC established a written outline of the proposed conservation terms and conditions prior to sale. The only person to emerge as a possible conservation buyer was Jerry Jung. No other marketing efforts were undertaken.
4. **Buyer's Relationship to TNC:** Buyer is a former MI Chapter Trustee, having served on the Chapter Board from 1995 to 1998.
5. **Structure of the Deal:** TNC purchased the property by buying two parcels of land without restrictions for total consideration of \$2,574,500 (an independent appraisal indicated a fair market value of \$2,632,000) in October of 2000 and April of 2001. TNC sold the larger portion of the property, subject to the conservation easement, for \$1,062,000 to the conservation buyer. No charitable pledge was made by the buyer. The buyer made a \$650,000 gift, in cash, to TNC within two weeks after closing. Project costs were also covered by additional private fundraising, although fundraising is not complete and there is still an outstanding project debt of \$417,000.
 - **Transaction Category:** I with a gift of cash

6. **Other Conservation Purposes Served:** A smaller portion (24.8 acres) of the two parcels originally acquired (the balance of the land not sold to the conservation buyer) was sold to an independent not-for profit Christian camp for \$200,000, its appraised FMV, in December of 2002, subject to conservation restrictions.

7. **How would possible changes in TNC conservation buyer policy have changed the transaction?**
Possible restrictions on sales to former Trustees.

Lake Huron, Mackinac County, Michigan (Jerrold Jung trust)

Observations

1. **Jung cash contribution of \$650,000 and donative intent.** Jung was quoted as saying that “[s]ince it was never my intent to develop the property anyway, it’s a real ‘no-brainer’ for me.”⁸¹ TNC’s internal e-mails and May 6, 2003, memorandum to the file (Gail Lewellan, TNC attorney) question donative intent.⁸² The Staff notes that this may be a transaction where donative intent is not present. The Staff also notes that it did not find a charitable pledge agreement similar to those TNC executed for other CBP transactions that might detail what portion of payments should be classified as purchase versus a charitable contribution. However, TNC did provide Jung with a letter of acknowledgement of receipt.

2. **Chi-Mac charitable contribution.** Chi-Mac provided TNC with a Form 8283 reporting that it was claiming a charitable contribution deduction of \$98,700 with respect to a bargain sale of the property to TNC (\$1,091,200 appraised value less \$992,500 received by the partnership from TNC). TNC accepted these even though it had stated internally that Chi-Mac had no donative intent.

3. **Harmon charitable contribution.** Harmon was paid \$100,000 for each property to assign his rights to the purchase agreements to TNC. Harmon took title to the Shillingburg tract and then deeded that property to TNC. Harmon apparently was never in the chain of title with respect to the Chi-Mac tract, which might affect his ability to claim a charitable contribution deduction for the “bargain sale” element of the transaction. Because TNC did not provide Forms 8283 or 8282 with respect to Harmon for either the Shillingburg or Chi-Mac tracts, the Staff could not determine whether Harmon claimed a charitable contribution deduction with respect to either of these properties. The assignment documents relating to Chi-Mac and Shillingburg between Harmon and TNC acknowledged Harmon’s intentions with respect to the excess of FMV over consideration to be a charitable contribution, and TNC’s agreement to treat such excess as a gift.⁸³

4. **Shillingburg charitable contribution.** 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.

5. **Charitable organization’s obligations with respect to donative intent.** 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.

⁸¹ “You can save the land, money too,” Observer & Eccentric of Real Estate, by Melissa Soule, Special Writer; “Wanted: Conservation Buyers,” The Nature Conservancy, Michigan Chapter.

⁸² See Appendix P for copy of memo.

⁸³ See *infra* footnote.

(a) Background

During August 2000, the Michigan chapter of TNC began to work on the acquisition of two adjacent tracts, one the Shillingburg tract (approximately 131 acres) and the other the Chi-Mac tract (approximately 81 acres), located on the northern shoreline of Lake Huron. These tracts were under purchase agreements between their respective owners and a real estate developer named Larry Harmon. Harmon indicated that he planned a development of 27 condominiums and a golf course with respect to the two tracts.⁸⁴ TNC identified these properties as having conservation value because they contained significant undeveloped shoreline for migratory and breeding birds and populations of the federally-threatened Houghton's goldenrod.⁸⁵ TNC ultimately acquired both of the tracts for disposition of a substantial portion of the property (approximately 185 acres) to a conservation buyer, Jerrold Jung. Mr. Jung was a former trustee of the TNC Michigan chapter.⁸⁶

TNC incurred acquisition and transaction costs of \$2,584,500 with respect to the Shillingburg and Chi-Mac tracts.⁸⁷ TNC financed the acquisitions by selling a substantial portion of the acquired properties to Jung, and obtaining cash contributions from Jung and others.⁸⁸ TNC acquired the Shillingburg tract in October 2000, and the Chi-Mac tract in April 2001.

In December 2002, TNC transferred to the Jerrold M. Jung Trust approximately 185 acres and received approximately \$1.7 million from the trust. The transferred land included almost all of the Shillingburg tract, and a significant portion of the Chi-Mac tract.⁸⁹ As part of

⁸⁴ Northern Lake Huron Bush Bay Shoreline Project Financial Summary, June 3, 2003, *see* Appendix P. The developer (Harmon) provided TNC with copies of his development plan for the condominiums and golf course, which was scheduled to go before the local planning commission on September 12, 2000, to secure local support. Planning commission approval was not required for the developer's plan. Action Item description for TNC Michigan Chapter Board of Trustees, October 6, 2000, p. 51; Memorandum dated May 15, 2003, from Diane Ray to file regarding Purchase of Chi-Mac and Shillingburg/Sale to Jung.

⁸⁵ TNC Project Approval Package Report for Huron (Chi-Mac Associates Limited Partnership), January 19, 2001; Action Item description for TNC Michigan Chapter Board of Trustees, October 6, 2000, p. 51.

⁸⁶ An April 2, 2001, email from Pat Bray to Jeffrey Knoop [both of TNC] describes Jung as "[a] friend and former trustee."

⁸⁷ This consisted of \$1,109,500 for Chi-Mac and \$1,475,000 for Shillingburg. Email dated April 9, 2001, from Bill McCort to Jeff Knoop, *see* Appendix O. This email suggested the amount paid for Shillingburg might be \$100,000 greater because of the assignment fee paid to Harmon, but this proved to be incorrect. A May 6, 2003, email from Diane Ray to Gail Lewellan states that the total cost to TNC was \$2,574,500 (\$1,099,500 for Chi-Mac and \$1,475,000 for Shillingburg), including the consideration paid to Harmon for assignment of the purchase agreements. The May 2003 amount does not include an additional \$450 paid by TNC to the seller for an appraisal update, or an additional \$9,550 paid by TNC to the seller's realtor to resolve a commission dispute between the realtor and the seller. Email dated May 6, 2003, from Diane Ray to Gail Lewellan, *see* Appendix P.

⁸⁸ Northern Lake Huron Bush Bay Shoreline Project Financial Summary, June 3, 2003.

⁸⁹ A memorandum dated July 29, 2003, from Diane Ray to Mike Dennis described that survey adjustments were made following the sales and that the 24.8 acres sold to Cedar Campus was about two-thirds from Shillingburg and one-third from Chi-Mac, and that the remaining 184.5 acres were sold to Jung.

the transfer, the trust conveyed a conservation easement to TNC. The conservation easement permitted Jung to construct a residence of up to 8,000 square feet on the property, to replace the existing 2,320 square feet home that was situated on the property. The transaction documentation referred to the transfer as part sale (consideration of \$1,062,000) and part contribution. TNC reported its purchase price for the portion of the property transferred to Jung as \$2,277,730.⁹⁰ An appraisal of 184.5 acres sold to Jung valued the acreage at \$2,298,000 (unrestricted) and the value of the property as restricted at \$1,062,000.⁹¹ TNC sold the remaining acreage (24.8 acres) to Inter-Varsity Ministries, a nonprofit known locally as Cedar Campus, in December 2002 for \$200,000.⁹²

TNC obtained its own appraisals that supported the purchase prices ultimately paid by TNC. TNC's appraisals were substantially less than those obtained by the developer, Mr. Harmon, but greater than the estimate of TNC's review appraiser and the appraisal ultimately obtained for the Jung transaction.⁹³ The combination of the \$2.3 million value of the property acquired by Jung and the \$0.2 million paid by Cedar Campus equaled \$2.5 million, slightly less than the \$2.6 million appraised amount of the Shillingburg and Chi-Mac tracts combined.⁹⁴ TNC's acquisition of each of the Shillingburg tract and the Chi-Mac tract was approved by TNC's state, division, and home office personnel.⁹⁵ The TNC Board of Governors approved the sale to Jung by resolution dated November 27, 2002.⁹⁶

According to TNC document submissions, the only Form 8283 filed with respect to these property transactions pertained to Chi-Mac Associates Limited Partnership, as more fully described below.

⁹⁰ Question 1 Response.

⁹¹ Memorandum dated May 6, 2002, from Densie Copen to file.

⁹² Memorandum dated November 5, 2001, from Jeff Knoop to Diane Ray; Northern Lake Huron Bush Bay Shoreline Project Financial Summary, June 3, 2003; Memorandum to file dated May 6, 2003, from Densie Copen regarding purchase of Chi-Mac and Shillingburg/sale to Jung, *see* Appendix P.

⁹³ TNC obtained appraisals of the properties from Steigerwaldt Land Services, Inc., for an appraisal fee of \$9,200. Invoice of Steigerwaldt Land Services, Inc. dated January 5, 2001. TNC paid the firm an additional fee of \$450 to update the appraisal in [May] 2001. The combined appraisals came in at \$2.5 million. Lloyd Kirby, TNC's review appraiser, estimated the combined values to be in the \$1.9 to \$2 million range. Memorandum to File from Diane B. Ray dated September 29, 2000, *see* Appendix P.

⁹⁴ TNC's appraiser appraised the Chi-Mac tract at \$1,054,500 and the Shillingburg tract at \$1,578,000, as of August 30, 2000.

⁹⁵ Real Estate Project Division/Home Office/BOG Approval, Midwest and Great Plains Divisions, Home Office Approval dated September 25, 2000. The project was approved by Bill Weeks in his capacity as acting president on September 25, 2000. Email from George Spicer to various TNC personnel dated September 25, 2000. The Executive Committee of the Michigan chapter approved the acquisitions of the two tracts on September 6, 2000. Action Item description for TNC Michigan Chapter Board of Trustees, October 6, 2000, p. 51.

⁹⁶ Certificate of Dianne Masters, Assistant Secretary, dated November 27, 2002, regarding Northern Lake Huron Chi-Mac and Shillingburg Tracts Mackinac County, Michigan.

(b) Description of the parcels

The Shillingburg and Chi-Mac parcels were adjacent to each other and were located on the Lake Huron northern shoreline. The Shillingburg tract consisted of 131.5 acres and approximately 2,200 feet of shoreline.⁹⁷ The Shillingburg tract had a small cabin on the property.⁹⁸ The Chi-Mac property consisted of 81.39 acres and approximately 1,600 feet of frontage along Lake Huron.⁹⁹ The Chi-Mac tract also included a house, garage, pole barn, and crib dock.¹⁰⁰

To the west of the Shillingburg and Chi-Mac parcels were 330 acres of shoreline property owned by a private business. To the east of the properties were 360 acres of shoreline owned by a nonprofit organization, Cedar Campus.¹⁰¹ TNC described the area as one of the “richest and most productive biological areas in the country,” and identified the site as a priority area for biodiversity in its report, “Conservation of Biological Diversity.”¹⁰²

(c) Harmon’s development plan and role in the transactions

Larry Harmon, a local real estate developer, had executed purchase agreements in August 2000 to acquire the Shillingburg and Chi-Mac tracts from their respective owners. Harmon executed the Chi-Mac tract purchase agreement on August 19, 2000. This agreement obligated Harmon to purchase the Chi-Mac tract for \$992,500, and was accepted by the Chi-Mac partnership on August 21, 2000.¹⁰³ Harmon executed the Shillingburg purchase agreement on August 29, 2000. This agreement obligated Harmon to purchase the Shillingburg tract for \$1,375,000.¹⁰⁴ Thus, Harmon had the right to acquire both tracts for a combined purchase price of \$2,367,500.¹⁰⁵

Harmon intended to develop the Shillingburg and Chi-Mac tracts as condominiums (27 condominiums with an average lot size of 2.85 acres, plus 24 additional condominiums of much smaller lot sizes) and a golf course. Harmon obtained an appraisal of the Shillingburg and Chi-

⁹⁷ Action Item description for TNC Michigan Chapter Board of Trustees, October 6, 2000, p. 51.

⁹⁸ Action Item description for TNC Michigan Chapter Board of Trustees, October 6, 2000, p. 51.

⁹⁹ Action Item description for TNC Michigan Chapter Board of Trustees, October 6, 2000, p. 51.

¹⁰⁰ TNC Closing Memorandum dated April 30, 2001, from Rose Anne Roznowski to Helen Taylor.

¹⁰¹ Action Item description for TNC Michigan Chapter Board of Trustees, October 6, 2000, p. 51.

¹⁰² Northern Lake Huron (Chi-Mac Associates Limited Partnership) Project Approval Package Report, January 19, 2001.

¹⁰³ TNC ultimately acquired this property for total costs of \$1,109,500.

¹⁰⁴ TNC ultimately acquired this property for total costs of \$1,475,000.

¹⁰⁵ Appraisal of Carol Peterson dated September 24, 2000.

Mac tracts on September 24, 2000, which determined the “as is” fair market value of the two tracts as of August 31, 2000, to be \$3.852 million.¹⁰⁶

Throughout August and September 2000, TNC discussed the properties and his development plans with Harmon, and by late September 2000, TNC reached a tentative deal with Harmon to acquire the properties from him for \$200,000 more than his combined purchase price of \$2,367,500.¹⁰⁷

On September 27, 2000, Chi-Mac partnership notified Harmon that it did not wish to proceed with the sale to Harmon, primarily because Harmon was not proceeding satisfactorily with respect to the partnership’s wishes that the property be preserved in its natural state by TNC.¹⁰⁸ Shortly thereafter Harmon and Chi-Mac Partnership became involved in litigation regarding the Chi-Mac purchase agreement. Harmon filed a summons and complaint in Mackinac County court of October 14, 2000, seeking damages and specific performance of the purchase agreement. A settlement agreement between the parties resulted in dismissal of Harmon’s lawsuit against the partnership in exchange for the partnership’s consent to the assignment of Harmon’s rights under the purchase agreement to TNC.¹⁰⁹ The settlement agreement obligated TNC to protect the property for conservation purposes through a transfer to a conservation buyer, and the conveyance of a conservation easement with respect to the tract to TNC.

The documentation provided by TNC does not indicate whether Harmon claimed a charitable contribution deduction with respect to either of the Chi-Mac or Shillingburg properties.

(d) TNC’s acquisition of Shillingburg tract

TNC acquired the 131.50 acre Shillingburg tract on October 30, 2000, for \$1,475,000.¹¹⁰ There were improvements on the property - a cabin and a shack.¹¹¹ The acquisition was effected

¹⁰⁶ Summary Appraisal of Real Property as of August 31, 2000, by Carol A. Peterson. Peterson projected the value of the properties under Harmon’s proposed development to be \$6 million, with roads and site improvements. Peterson previously had appraised the properties separately, determining the value of the Chi-Mac tract to be \$1,210,000 (report dated September 13, 2000), and the value of the Shillingburg tract to be \$1,700,000 (report dated September 13, 2000). TNC’s review appraiser later determined that Harmon’s appraiser, though licensed, was not certified, and thus could not do appraisals of that magnitude, and that the methodology used by the appraiser was suspect. Memorandum to File from Diane B. Ray dated September 29, 2000.

¹⁰⁷ Email dated September 29, 2000, from Bill McCort to Diane Ray, *see* Appendix P.

¹⁰⁸ Letter dated September 27, 2000, from Mark K. Wilson to Sally J. Brumleve of Brumleve Properties.

¹⁰⁹ This apparently had the effect of terminating the earlier assignment and acceptance executed by TNC and Harmon in September 2000.

¹¹⁰ This included a payment of \$100,000 to Larry Harmon for his assignment of the purchase agreement to TNC. Harmon also was reimbursed his \$50,000 earnest money.

¹¹¹ Memorandum dated October 19, 2000, from Bill McCort to Helen Taylor, State Director, MIFO. “MIFO” stands for Michigan Field Organization.

through an assignment by Harmon of his rights, interests, and obligations with respect to the purchase agreement to TNC, and deeds of the property from the Shillingburgs to Harmon, and then from Harmon to TNC.

TNC had been aware that Harmon was attempting to acquire the Shillingburg tract. On August 22, 2000, William McCort of TNC sent Brumleve Properties, the listing agent, a letter stating that TNC was interested in buying the Shillingburg property.¹¹²

On August 28, 2000, TNC engaged the services of Steigerwaldt Land Services, Inc. to conduct an appraisal of the Shillingburg tract. The firm completed the appraisal as of August 30, 2000, and in an undated appraisal report, determined the value of the property to be \$1,578,000, based on its highest and best use as a development of seasonal residential lots.¹¹³

The Michigan chapter obtained state, division, and home office approvals by September 25, 2000, with respect to the Shillingburg acquisition for a purchase price not to exceed \$1,679,500.

Harmon had executed the Shillingburg purchase agreement on August 29, 2000, to purchase the Shillingburg tract for \$1,375,000. An Assignment of Real Property Interest, Agreement to Quit Claim, and Acceptance of Assignment was executed by Harmon on October 6, 2000, and by TNC on October 10, 2000, pursuant to which Harmon assigned his rights and interests in the purchase agreement to TNC in exchange for \$100,000.¹¹⁴ The parties acknowledged that the fair market value of the property may substantially exceed the purchase price established by the purchase agreement and the additional consideration paid for the assignment, and that any excess "is intended by Harmon as a charitable contribution to the Conservancy and will be treated by the Conservancy as such a gift."¹¹⁵

A warranty deed dated October 18, 2000, with Larry Harmon as the grantor and TNC as the grantee, granted the right to make all divisions under section 108 of the land division act in exchange for the sum of \$100,000.¹¹⁶

In a letter from TNC to Harmon dated March 7, 2001, TNC described the acquisition as a bargain sale purchase for consideration of \$1.475 million from the Harmons that closed on

¹¹² Letter dated August 22, 2000, from William D. McCort to Ms. Sally Brumleve of Brumleve Properties.

¹¹³ A Real Estate Appraisal 131.5 Acres of the Shillingburg Property with 2,200 Feet of Frontage on Lake Huron Mackinac County, Michigan, August 30, 2000.

¹¹⁴ TNC files show an earlier assignment dated September 12, 2000, was null and void for failure by one of the parties to remove a contingency. An October 2, 2000, email from Bill McCort to Diane Ray, states that Harmon planned to treat the \$200,000 (\$100,000 for each of the two properties) assignment fees as if it all related to Shillingburg, not equally between the two tracts. See Appendix P.

¹¹⁵ Assignment of Real Property Interest, Agreement to Quit Claim, and Acceptance of Assignment, between Harmon and TNC.

¹¹⁶ Warranty deed dated October 18, 2000. It is unclear why the warranty deed recites a consideration of \$100,000, the amount of the assignment consideration, rather than for the entire purchase price.

October 13, 2000.¹¹⁷ In that letter, TNC advised the Harmons that they needed to complete and return to TNC a Form 8283 if the Harmons intended to take a charitable contribution deduction with respect to a gift of the land in excess of \$500, and enclosed a copy of Form 8283 for completion by the Harmons. The documentation provided by TNC does not indicate that the Harmons provided a Form 8283 with respect to the Shillingburg tract, or that they claimed a charitable contribution deduction with respect to that tract.

(e) TNC's acquisition of Chi-Mac tract

TNC had been aware that Harmon was attempting to acquire the Chi-Mac tract. On August 22, 2000, William McCort of TNC sent Brumleve Properties, the listing agent, a letter with a draft of a right of first refusal regarding the Chi-Mac tract.¹¹⁸ The right of first refusal would have given TNC a right to acquire the Chi-Mac tract from the partnership for \$992,500 for a one-year period if the partnership received a bona fide offer with respect to the property.

On August 28, 2000, TNC engaged the services of Steigerwaldt Land Services, Inc. to conduct an appraisal of the Chi-Mac tract. The firm completed the appraisal as of August 30, 2000, and in an undated appraisal report, determined the value of the property to be \$1,054,500, based on its highest and best use as a development of seasonal residential lots.¹¹⁹

TNC negotiated with Harmon to attempt to purchase the Chi-Mac tract from Harmon. Harmon and TNC executed an Assignment of Real Estate Sales Contract and Acceptance of Assignment with respect to Harmon's purchase agreement for the Chi-Mac tract on September 11, 2000, and September 12, 2000, respectively. The assignment provided that TNC would pay Harmon \$147,000 as consideration for the assignment and reimburse Harmon the earnest money consideration Harmon had paid. The parties acknowledged that the fair market value of the property may substantially exceed the purchase price established by the purchase agreement and the additional consideration paid for the assignment, and that any excess "is intended by Harmon as a charitable contribution to the Conservancy and will be treated by the Conservancy as such a gift."¹²⁰

The Michigan chapter obtained state, division, and home office approvals by September 25, 2000, with respect to the Chi-Mac acquisition for a purchase price not to exceed \$1,213,000.

¹¹⁷ TNC letter dated March 7, 2001, to Larry D. and Sandra Harmon. This letter was intended to serve as TNC's written substantiation of the gift from the Harmons to TNC. The letter made no statement about the value of the gift, and stated that TNC does not play a role in determining the value of the gift.

¹¹⁸ Letter dated August 22, 2000, from William D. McCort to Ms. Sally Brumleve of Brumleve Properties.

¹¹⁹ A Real Estate Appraisal 81.39 Acres of the Connolly Property with 1,800 Feet of Frontage on Lake Huron Mackinac County, Michigan, August 30, 2000. The Chi-Mac property was also referred to as the Connolly property because one of the partnership's partners was a Connolly and the property had been held by the Paul Connolly Estate.

¹²⁰ Assignment of Real Estate Sales Contract and Acceptance of Assignment, between Harmon and TNC.

On September 27, 2000, Chi-Mac partnership notified Harmon that it did not wish to proceed with the sale to Harmon, primarily because Harmon was not proceeding satisfactorily with respect to the partnership's wishes that the property be preserved in its natural state by TNC.¹²¹ Shortly thereafter Harmon and Chi-Mac Partnership became involved in litigation regarding the Chi-Mac purchase agreement. Harmon filed a summons and complaint in Mackinac County Court on October 14, 2000, seeking damages and specific performance of the purchase agreement.

Internal TNC file documents indicate that TNC had identified its conservation buyer with respect to the Chi-Mac tract at least by October 3, 2000.¹²² A TNC letter of the same date from Helen Taylor to Mark Wilson of the Chi-Mac partnership informs Wilson of this fact and states that TNC will place a conservation easement on the property upon acquisition of the property from Chi-Mac. TNC's letter to Wilson states that although conservation easements "greatly lower the value of the property (up to 70 percent lower is not uncommon)," TNC's "conservation buyer is willing to give [TNC] \$1,000,000 for the property with the conservation easement in place." TNC stated that it would hold the conservation easement and monitor it to make sure it is upheld.

A November 20, 2000, internal TNC email indicates that TNC was having conservation easement charitable contribution discussions with the seller of the Chi-Mac tract.¹²³

On January 23, 2001, TNC mailed Harmon a draft purchase agreement pursuant to which TNC would acquire from Harmon for a purchase price of \$1,092,500 the Chi-Mac tract after he acquired it from the current owner.¹²⁴ Notes to TNC's files indicate that Harmon requested that TNC pay Harmon's legal fees with respect to the Chi-Mac litigation, but that TNC stated that TNC could "not pay his legal fees directly (nor can another non-profit)."¹²⁵

After extensive settlement negotiations pertaining to the Chi-Mac Partnership/Harmon litigation, a settlement agreement between the Chi-Mac partnership, Harmon, and TNC resulted in dismissal of Harmon's lawsuit against the partnership in exchange for the partnership's consent to the assignment of Harmon's rights under the purchase agreement to TNC.¹²⁶ The settlement agreement obligated TNC to protect the property for conservation purposes through a

¹²¹ Letter dated September 27, 2000, from Mark K. Wilson to Sally J. Brumleve of Brumleve Properties.

¹²² Email dated October 3, 2000, from Diane Ray to Bill McCort (describing that a conservation buyer is not "paying" unrestricted fair market value for the restricted property, but rather is "buying the property for its (reduced) fair market value, then making a donation of the rest."). See Appendix P.

¹²³ Email from Diane Ray to Bill McCort dated November 20, 2000, acknowledging Wilson's questions regarding how deductions may be taken for value decreases attributable to conservation restrictions. See Appendix P.

¹²⁴ Letter dated January 23, 2001, from William D. McCort to Larry Harmon.

¹²⁵ Notes to TNC's files dated February 22, 2001.

¹²⁶ This apparently had the effect of terminating the earlier assignment and acceptance executed by TNC and Harmon in September 2000.

transfer to a conservation buyer, and the conveyance of a conservation easement with respect to the tract to TNC. As a part of the settlement, Chi-Mac Associates Limited Partnership executed a Consent of Seller to Assignment of Sales Contract on March 21, 2001.¹²⁷ This consent recited that TNC intended to ensure preservation of the property's natural features by placement of a conservation easement on the property that will bind future landowners, restrict uses of the property, and prohibit development on the property beyond its present state. On March 22, 2001, Harmon sent a letter to the real estate listing agent stating that TNC had assumed his contract to purchase the Chi-Mac tract from the Chi-Mac Partnership, and that TNC would be reimbursing Harmon \$50,000 for his earnest money being held by the agent.¹²⁸ Harmon and TNC executed the Assignment of Real Estate Sales Contract and Acceptance of Assignment on March 23, 2001.¹²⁹ Under the agreement, Harmon would receive \$107,000 as consideration to assign the purchase agreement rights to TNC.

A March 23, 2001, internal TNC email discusses the possibility of Chi-Mac taking a charitable contribution deduction with respect to the partnership's sale of the property to TNC, and states "[a]s I told [Chi-Mac] when we spoke (before the letter was drafted), we can provide them with a copy of our appraisal but they'll need their own (and need to pay for it) if they plan to take a charitable deduction. Also, I told him I didn't think there was any donative intent and that they would be asking for trouble if they do try to take this as a deduction."¹³⁰

TNC acquired the Chi-Mac tract from the Chi-Mac Associates Ltd. Partnership on April 6, 2001, for \$1,099,500.¹³¹ In addition, TNC paid \$9,550 to the seller's listing agent to resolve a dispute between the seller and the agent regarding her commission.¹³² The warranty deed dated April 5, 2001, from Chi-Mac Associates Limited Partnership directly to TNC reported the consideration as \$992,500 for real estate transfer tax purposes.

Chi-Mac Associates Limited Partnership provided TNC with a page 2 of Form 8283, on October 11, 2002. This form reported the appraised fair market value of the Chi-Mac property as \$1,091,200; the donor's cost or adjusted basis as \$208,486; the amount received by the partnership pursuant to a bargain sale as \$992,500; and the amount claimed as a deduction as \$98,700. The form also reported that TNC received the donated property on April 6, 2001. TNC

¹²⁷ Consent of Seller to Assignment of Sales Contract by Chi-Mac Associates Limited Partnership dated March 21, 2001.

¹²⁸ Letter from Larry Harmon to Sally Brumleve dated March 22, 2001.

¹²⁹ Assignment of Real Estate Sales Contract and Acceptance of Assignment between Larry Harmon and TNC dated March 23, 2001.

¹³⁰ Email dated March 23, 2001, from Diane Ray to Bill McCort regarding Chi-Mac, *see* Appendix O. Ray repeated her belief there was no donative intent in an April 4, 2001, email to Bill McCort ("I just don't see why we should pay for an updated appraisal when we don't even think there's donative intent."). *See* Appendix P.

¹³¹ Settlement Statement dated April 6, 2001. This included a payment of \$107,000 to Larry Harmon for the assignment of the purchase agreement to TNC, and \$992,500 to the partnership as purchase price.

¹³² Letter dated April 6, 2001, from Diane B. Ray to Sally Brumleve of ERA Brumleve Properties, Inc., agreed to by Brumleve on the same date, *see* Appendix P.

files indicate approval of the form as provided by Chi-Mac, and that TNC signed the form.¹³³ TNC subsequently provided the partnership with a Form 8282 notifying the partnership that TNC had acquired the property from the partnership in a bargain sale transaction, and disposed of the donated property on December 13, 2002. Thus, TNC signed these forms even though its earlier internal correspondence documented that TNC believed there was no donative intent on the part of Chi-Mac, and Chi-Mac “would be asking for trouble if they do try to take this as a deduction.”

(f) TNC negotiations with Jung, the conservation buyer

During the summer of 2000, Helen Taylor of the Michigan chapter “made several phone calls to current trustees to determine if they or anyone they knew would be interested in being a conservation buyer for the [Shillingburg and Chi-Mac] parcels.”¹³⁴ Jung, a former Michigan chapter trustee, emerged from this inquiry as the only person as a potential conservation buyer.¹³⁵ In an August 23, 2000, memorandum from Bill McCort to Jerry Jung, TNC informed Jung that the Shillingburg property, 120 acres with 2,150 feet of frontage on Lake Huron, was up for sale and suggested that Jung “might be interested in making an offer” for the property.¹³⁶

TNC records state that TNC made no other attempts to market the property.¹³⁷ On January 17, 2001, Mr. Shillingburg contacted TNC asking whether TNC would be willing to sell the Shillingburg property back to him with deed restrictions, but there is no indication that TNC ever contacted Shillingburg regarding this possibility.¹³⁸

Internal TNC correspondence dated September 25, 2000, indicates that Jung had committed to providing \$1 million to TNC for the Lake Huron properties, and that TNC would “secure the properties, carve off the Chi-Mac property, place development restrictions on it, modify the boundaries a bit, and transfer it to Jung.”¹³⁹

An October 3, 2000, email from Bill McCort to Diane Ray evidences that TNC had conversations with Jung by this time about which property, the Chi-Mac or Shillingburg tract,

¹³³ TNC copy of Mark Wilson fax dated October 11, 2002, to Diane Ray of TNC regarding page 2 of Form 8283 regarding bargain sale of the Chi-Mac tract (“OK-fax back to Mark Wilson”). There is no indication that TNC notified Chi-Mac that TNC’s appraised value of the Chi-Mac tract was approximately \$50,000 less than that reported as the appraised fair market value by Chi-Mac on the Form 8283.

¹³⁴ Memorandum dated May 15, 2003, from Diane Ray to file.

¹³⁵ Memorandum dated May 15, 2003, from Diane Ray to file.

¹³⁶ Memorandum dated August 23, 2000, from Bill McCort to Jerry Jung.

¹³⁷ Conservation Buyer Transaction Summary (“No further marketing was done on the tracts.”); Email dated May 8, 2003 from Jeff Knoop to Diane B. Ray (“the property was never listed for sale to the general public after it was acquired by TNC.”).

¹³⁸ Email from Bill McCort to “jknoop” and “dray” of TNC dated February 15, 2002.

¹³⁹ Email dated September 25, 2000, from Helen Taylor to Diane Ray.

would better suit Jung's needs with respect to a residence, and that the Chi-Mac tract was better suited for Jung because the Shillingburg property had the smaller residence on it and would require more development and improvement.

In an October 5, 2000 fax from McCort to Brumleve, McCort states that TNC intends to "place a conservation easement on the property and then sell it to a conservation buyer who we have already identified."

An April 2, 2001, email from Bray to Knoop describes the potential sale to Jung. The email states that Jung is willing to buy "whatever property he can" of the two pieces for a "total commitment of \$1.7 million." Bray states that it is TNC's "goal to get out of the project without having to do anymore fund raising while covering our costs. If the value is equal to or lower than \$1.7 million we would want to sell it all to Jerry. If it's lower we hope Jerry will donate the difference."

On May 17, 2001, TNC notified Chi-Mac that the conservation buyer with respect to the Chi-Mac tract is Jerry Jung.¹⁴⁰

The negotiations between Jung and TNC included discussions regarding the conservation easement (e.g., pond and ditch restoration, ATV and snowmobile use, garden use and flower beds, preventing motorized access to the property, timber cutting, and the size of the residence that could be built on the property).¹⁴¹ Jung suggested that the square footage of the residence not exceed 8,000 square feet.¹⁴² Jung also advised TNC that he had "reserved \$1,700,000 to purchase the property with easement. I'd prefer to purchase the property for as little as possible and make a charitable contribution of the balance. We will see what the appraisal says."¹⁴³

TNC and Jung had further discussions regarding Jung's charitable contribution deduction. TNC records indicate that on or about October 25, 2001, Jung had asked TNC the following question: "Would there be any advantage having TNC buy the easement with a donation that I made to the Conservancy? For instance, what if I write two checks to the Conservancy -- one for \$1,500,000 to purchase the property and one for \$1,200,000 as a donation. TNC would then purchase the easement for \$1,000,000. This provides the same net proceeds of \$1,700,000 to TNC. It would also better document the transaction for tax purposes."¹⁴⁴ On December 21, 2001, TNC wrote Jung that "the best, and cleanest, way to

¹⁴⁰ Email from Bill McCort to "crufone" dated May 17, 2001, *see* Appendix P.

¹⁴¹ Emails between Jung and Jeff Knoop, September 2001, *see* Appendix P.

¹⁴² Email from Jerry Jung to Jeff Knoop dated September 21, 2001, *see* Appendix P.

¹⁴³ Emails between Jung and Jeff Knoop dated September 2001, *see* Appendix P.

¹⁴⁴ Email dated October 25, 2001, from Jeff Knoop to [Diane Ray], *see* Appendix P.

structure this deal is for you to acquire the property at full market value subject to the easement. The difference up to the \$1.7M can be made as a cash contribution for income tax purposes.”¹⁴⁵

In a letter dated February 7, 2002, Jung’s counsel advised Jung that the [draft] purchase agreement prevented Jung from ever being able to “split the land” and that “the imposition of the conservation easement may well have a major negative impact on the value of the land should you decide to sell it at some point in the future.”¹⁴⁶

The purchase agreement between the Jerrold M. Jung Trust UTA as buyer, and TNC as seller, was executed by the parties on February 28, 2002, and March 1, 2002, respectively. The agreement provided for the acquisition by the Jung trust of 185.459 acres for a purchase price of \$1,062,000. As a condition of closing, the Jung trust was to execute and deliver to TNC at closing a conservation easement in the form attached to the agreement. The conservation easement was to be recorded prior to any mortgage or other security interest that secured the buyer’s repayment of any loan obtained in relation to the buyer’s purchase of the property. The agreement conveyed to the buyer the right to make zero division splits under the Michigan Land Division Act. The form of the conservation easement granted TNC a conservation easement in perpetuity over the property, including, among other things, the following terms: (1) a restriction against industrial, commercial, agricultural, or commercial recreational activity; (2) no construction or placing of any house, garage, barn or other building, and other listed structures, except that existing structures may be maintained, improved, replaced or removed as specified elsewhere in the easement; (3) the property may not be divided, partitioned, subdivided, or conveyed except in its current configuration as an entity; and (4) no mining, drilling, exploring for, or removal of minerals from the property was permitted. The buyer reserved the right to convey the property subject to the easement, and to use the personal residences, accessory buildings, and other improvements on the property at the time of the grant of the easement, consisting of the single story house, pole building, log cabin, and a cribbage boat deck. The buyer also retained the right to reconstruct or replace the house, so long as any replacement or expansion is located in substantially the same location as the main house at the time of the grant of the easement, and the footprint of the main house or replacement thereof does not exceed 8,000 square feet.¹⁴⁷ The log cabin could not be replaced, renovated, or restored.

In a May 21, 2002, letter from TNC to the seller of the Chi-Mac property, McCort (as TNC’s Director of Protection) notified Connolly that he could not remove some saplings from the property because it was not allowing any cutting until it completed its conservation easement and identified the stewardship needs of the property.

¹⁴⁵ Email dated December 21, 2001, from Jeff Knoop to Jerry Jung. This is consistent with an email from Diane Ray to Jeff Knoop dated November 14, 2001 (“I agree with you that the ‘cleanest’ way for the donation to be handled is to have him pay FMV for the property (with the easement in place), then have him give a cash donation of the remainder.”).

¹⁴⁶ Letter from D. Douglas Alexander to Jerrold M. Jung dated February 7, 2002.

¹⁴⁷ The footprint square footage of the existing single story house was 2,320 square feet. Exhibit C to Conservation Easement dated December 9, 2002.

TNC kept Jung apprised of difficulties it was experiencing regarding the land acquisitions. On August 6, 2002, Jung told TNC that he would “be happy to make a similar commitment (\$1,700,000) on another parcel if this one falls through.”¹⁴⁸

Certain TNC records indicate that Jung “never made any kind of formal pledge, written or unwritten, in conjunction with the transaction.”¹⁴⁹ These records are inconsistent with other TNC records, however, that acknowledge that TNC and Jung discussed structuring the transaction to split Jung’s \$1.7 million commitment as purchase price (to the extent of the property’s restricted value) and a cash contribution for the remainder.¹⁵⁰

(g) TNC’s transfer of real property to Jung for cash and conservation easement

The sale to Jung closed on December 13, 2002.¹⁵¹ According to the settlement statement, Jung paid \$1,062,000 to TNC for the property. The warranty deed, dated November 18, 2002, conveyed the property from TNC to the Jerrold M. Jung Trust UTA and reported full consideration as \$1,057,000. The conservation easement, dated December 9, 2002, was consistent with the form of easement attached to the executed purchase agreement.¹⁵²

Internal TNC accounting documents dated December 16, 2002, report the acquisition of the conservation easement with respect to the 188.09 acres as having a fair market value of \$1,312,500.¹⁵³ Internal TNC documents of the same date report the transfer out of 56.59 acres of the Chi-Mac tract and all 131.50 acres of the Shillingburg tract for \$1,062,000.

TNC obtained an appraisal of the conservation easement granted by Jung to TNC on the 184.5 acres. The appraisal report, dated January 22, 2002, valued the easement at \$1,236,500 as of January 1, 2002.¹⁵⁴ The appraiser concluded that under the easement “the grantor gives up numerous rights including all potential income from forest management, the opportunity to

¹⁴⁸ Email dated August 6, 2002, from Jerry Jung to Helen Taylor.

¹⁴⁹ Memorandum dated May 15, 2003, from Diane Ray to file; Conservation Buyer Transaction Summary. See also TNC summary provided above regarding lack of pledge agreement.

¹⁵⁰ Email dated October 25, 2001, from Jeff Knoop to [Diane Ray]. Email dated December 21, 2001, from Jeff Knoop to Jerry Jung. This is consistent with an email from Diane Ray to Jeff Knoop dated November 14, 2001 (“I agree with you that the ‘cleanest’ way for the donation to be handled is to have him pay FMV for the property (with the easement in place), then have him give a cash donation of the remainder.”).

¹⁵¹ Closing Memorandum dated December 20, 2002, from Sue Corbin to Helen Taylor.

¹⁵² The conservation easement was accepted by TNC on November 18, 2002, although it was not executed by Jung on behalf of the Jung trust until December 9, 2002.

¹⁵³ Other internal TNC documents report the easement value as \$1,236,500, with the unrestricted property value being \$2,298,500 for the 184.5 acres acquired by Jung. Northern Lake Huron Bush Bay Shoreline Project Financial Summary, June 3, 2003.

¹⁵⁴ Complete Appraisal Summary Report, 184.5 Acres of The Nature Conservancy Property with 3,800 Feet of Frontage on Lake Huron Mackinac County, Michigan. The appraisal noted that the property field work and inspection occurred in August 2000.

divide the land into smaller parcels for future development (and income), and the right to hunt. It is our opinion that the easement substantially lowers the property value, not only for the current landowners, but in perpetuity, by restricting development, eliminating potential income from the sale of timber, and the prohibition of hunting which, in itself, is a significant ownership factor, or reason for buying and holding recreational land in the regional market.”¹⁵⁵ The appraiser concluded that the highest and best use of the property, but for the conservation restrictions, was as development property with resale of the property into smaller seasonal residential and recreational properties.¹⁵⁶ The highest and best unit of the property as restricted was as one large parcel of residential and recreational land. The conservation easement value was the difference between a “before” condition value of \$2,298,500, and an “after” condition value of \$1,062,000.¹⁵⁷

TNC provided a letter dated January 22, 2003, to Jung, acknowledging his gift of \$650,000 on December 30, 2000. A copy of Jung’s check in the amount of \$650,000, dated December 17, 2002, was included in TNC’s files. According to TNC records, Jung’s total contribution was the sum of the \$650,000 cash contribution and the \$1,236,500 value of the conservation easement.¹⁵⁸ TNC records indicate that it was Jung’s understanding that the funds were to be used “as the Michigan chapter saw fit.”¹⁵⁹ TNC reported that it did not obtain a Form 8283 with respect to the disposition of the property to the Jung trust.¹⁶⁰

IV. CBP Transaction – Shelter Island

TNC prepared the following summary of this transaction, also described in *The Washington Post*, for its June 13, 2003 Board of Governors meeting.

¹⁵⁵ Complete Appraisal Summary Report, at p. 19.

¹⁵⁶ Complete Appraisal Summary Report, at p. 20.

¹⁵⁷ Complete Appraisal Summary Report, at p. 34.

¹⁵⁸ Northern Lake Huron Bush Bay Shoreline Project Financial Summary, June 3, 2003. This would appear to suggest a contribution by Jung of approximately \$1.9 million, although no other documentation suggests a contribution of this magnitude.

¹⁵⁹ Email dated May 8, 2003, from Jeff Knoop to Diane B. Ray regarding Jung Sale - ChiMac.

¹⁶⁰ Question 1 Response (not applicable (no gift involved) on the TNC disposition).

CONSERVATION BUYER TRANSACTION SUMMARY—D

Site or Project Name: Thompson Hill Property, Mashomack Preserve, NY

Purchaser Name: James and Nancy Dougherty

Land: 9.38-acre parcel located immediately adjacent to and surrounded on two sides by TNC's Mashomack Preserve, on Shelter Island, NY. Another side of the property is bounded by Peconic Bay, one side is bounded by a road, and one side is bounded by another private landowner.

Date of Sale: 10/28/99

1. **Consistency with Conservation by Design:** Mashomack Preserve is long-standing (20 years) Conservancy Preserve and one which is included in the North Atlantic Coast Eco-regional plan as portfolio site. At the time of the original acquisition of the Mashomack property, the sellers, three brothers engaged in various real estate development activities withheld from the sale this parcel of land for possible resale or development. For many years thereafter, this parcel was sought after by TNC to complete the lands needed for protection and as a buffer for the Preserve.
 - **Threat:** The property could be easily subdivided into three residential development lots. Threats to be addressed include habitat fragmentation through further subdivision and habitat (sensitive coastal dunes and bluffs) destruction and water quality (adjacent tidal salt marsh and creek) degradation through sedimentation and erosion from inappropriately sited residential development.
 - **Conservation Easement:** Conservation easement terms provide for the property being permanently restricted to one residential dwelling and ancillary structures and require all but a small writer's cabin to be located within a surveyed development envelope placed well away from the bluffs and nearby creek.
2. **Valuation Substantiation:** TNC obtained independent appraisal of property setting FMV at \$2.0 Million based on highest and best use of a three lot residential subdivision as of 1/20/99 prior to TNC purchase of property. TNC obtained independent appraisal (from yet other appraiser) appraising conservation easement at \$1.594 Million and value of encumbered land at \$506,000.
3. **Marketing Efforts:** During negotiations for purchase of property, TNC sought potential buyers by word of mouth. Three Mashomack Trustees expressed interest in property. TNC established a written outline of the proposed conservation terms and conditions. The Doughertys expressed most willingness to abide by conservation terms and conditions. Considering the most likely way to avoid future problems with owners about the proposed conservation terms and conditions, TNC decided to sell the land to the Doughertys as people known to have a sincere conservation ethic. No other marketing efforts were undertaken.
4. **Buyer's Relationship to TNC:** Buyers are husband and wife; husband was a former trustee of the TNC's South Fork-Shelter Island Chapter (term of service from 1982 to 1994) and wife is current Trustee of Mashomack Preserve Advisory Board, having served since 1997 and was a Trustee when the transaction occurred.
5. **Structure of the Deal:** TNC purchased the property unrestricted from the original owners on 9/2/99 for \$2.1 Million. On 10/28/99, TNC signed the contract and transferred title to the land to new buyer for \$506,000, subject to conservation restrictions. At the closing on 10/28/99, the new buyer made a separate charitable pledge to donate \$1.652 Million over 15 months. The pledged amount was received by TNC from buyers in a series of stock donations within the required timeframe. No other private fundraising was sought or needed for this project.

- **Transaction Category:** I with a gift of stock
- 6. **Other Conservation Purposes Served:** aesthetic considerations to keep development away from the Preserve, native vegetation protected.
- 7. **How would possible changes in TNC conservation buyer policy have changed the transaction?**
Greater restrictions on sales involving Trustees and possible wider marketing efforts.

Observations

1. Purchase and pledge agreements. The Staff notes the purchase agreement and the pledge agreement do not describe the entirety of the agreement of the parties. They do not indicate that both TNC and the Doughertys understood and agreed that the Doughertys were to pay \$2,152,000 to TNC, consisting of \$500,000 allocated to purchase price, and the remainder allocated to the charitable pledge. The Staff notes that the documentation indicates that TNC agreed to exclude from the legal documents certain critical terms at the request of the Doughertys to accommodate the Doughertys tax position in the event of IRS audit.

2. Tax planning for charitable contribution deduction. The Staff notes that that TNC engaged in substantial discussions with the Doughertys and their counsel regarding the ability of the Doughertys to claim a charitable deduction for the \$1.652 million amount paid pursuant to the Pledge Agreement, and regarding the structuring and documentation of the transactions for the Doughertys tax purposes.

Overview

The Shelter Island, New York CBP transaction involved the purchase and sale by TNC of unimproved real property at 21 Thompson Hill Road ("Thompson Hill") on Shelter Island, New York, and the placement of conservation restrictions on the subject property. The property was acquired by TNC in September 1999 from the Gerard family ("Gerards")¹⁶¹ and shortly thereafter sold by TNC to James and Nancy Dougherty ("Doughertys"). The 9.38 acre property, mostly wooded, abuts, on both its northerly and easterly side, the Mashomack Preserve, protected land owned by TNC.¹⁶² The property was vacant and unimproved when acquired and transferred by TNC. Shelter Island is primarily a summer community accessible only by ferry, private boats, or small planes.¹⁶³ There are no bridges providing road access to the island.

TNC purchased the property from the Gerards on September 2, 1999, for \$2.1 million. There were no conservation restrictions on the property when it was acquired by TNC, and TNC acquired the property with certain subdivision rights. TNC sold the entire 9.38 acres of unimproved land to Dougherty on October 28, 1999, for a purchase price of \$500,000.

Negotiations with Gerards and Dougherty

On March 8, 1999, and at the request of TNC, Marchitelli Barnes & Company, Inc. ("MB&C") appraised the Thompson Hill property at \$2.0 million as of January 20, 1999. The appraisal described the property as a 9.38 acre parcel of residentially zoned land on Thompson Road in Shelter Island. The appraisal noted the site consisted of a peninsula extending toward Mashomack Preserve into the waters of Clark's Cove at Nicoll's Creek, with topography

¹⁶¹ The Thompson Hill property was owned by C.H. Coster Gerard, the Estate of James Gerard, and Sumner Gerard, Jr., as tenants in common.

¹⁶² Appraisal dated October 22, 1999, of the conservation easement, *see* Appendix O.

¹⁶³ Appraisal dated October 22, 1999, of the conservation easement, *see* Appendix O.

reaching elevations of up to 70 feet above sea level. Based on MB&C's highest and best use analysis, it appeared that the site was capable of being subdivided into three waterfront building plots and a small wetland preserve. The appraisal letter acknowledged that TNC intended to use the appraisal in negotiating its purchase of the property.

On March 25, 1999, TNC sent a letter to Dougherty regarding the potential availability of property to be acquired by TNC for sale to Dougherty. TNC stated it expected to be made whole and receive from the buyer a conservation easement. In that letter, TNC indicated that it had been working with Gerard since 1980 to structure a scenario that would allow for a single home development on the Thompson Hill property while protecting its important ecological features. The letter set forth several proposed easement restrictions to be placed on the property, including those to protect the watershed and biological integrity of Miss Annie's creek, and others to insure that the natural sediment transport that influences the Mashomack Preserve shoreline was not impeded. The letter referred to an upcoming meeting with Dougherty on the following Saturday to discuss the potential purchase of the property by Dougherty.

On April 2, 1999, TNC made a formal offer to acquire the property from the Gerards for \$2.1 million. On April 7, 1999, the Gerards make a counteroffer to TNC, which was rejected by TNC on April 12, 1999. On April 15, 1999, TNC amended its offer to extend the closing date to accommodate certain section 1031 like-kind closing date issues for one of the Gerards with respect to a one-third interest of the property. The amendment to the offer did not modify the \$2.1 million purchase price offer by TNC. On April 23, 1999, the Gerards accepted TNC's offer.

On June 8, 1999, TNC sent the Gerards a letter with execution copies of a purchase agreement to acquire the property from the Gerards. On June 11, 1999, the TNC Board approved the acquisition of Thompson Hill from the Gerards for sale by TNC to a conservation buyer. The documents supporting the request for Board approval noted that the proposed purchase price of \$2.1 million was within 10 percent of the appraised fair market value of the property of \$2.0 million.

On June 29, 1999, TNC sent \$105,000 as a down payment on the property. On or about June 30, 1999, TNC and the representatives of the Gerard family executed the purchase agreement to acquire Thompson Hill from the Gerards for \$2.1 million.

On August 6, 1999, Jonathan Kaledin, State Counsel for TNC, prepared a memorandum addressed to the Doughertys and others regarding the documents and structure of the TNC transaction with the Doughertys. The memorandum summarized a meeting among Dougherty, Kaledin, and Dougherty's counsel (Rich Upton) the previous day. The memorandum acknowledged that they first discussed "the tax/charitable deduction aspects of the transaction," and stated that "[i]n order to create as clean a paper trail as possible for Jim and Nancy, so as to minimize whatever IRS risks might exist from having a sale/donation occur, we have agreed to sign the contract and the pledge (the pledge will not have contingency language in it) and convey the [Thompson Hill] property to Jim and Nancy simultaneously on the same day that the Conservancy acquires the [Thompson Hill] property – after TNC's acquisition" (underlining in original). The memorandum acknowledged that the parties discussed the possibility of interest

costs in the event Dougherty did not satisfy the charitable pledge by September 30th. The memorandum also stated that the parties needed to get together to finish work on permitted areas, viewshed areas, cut restriction lines, and the dock area, regarding the easement and survey.

On August 30, 1999, Jonathan Kaledin sent a memorandum to Michael Dennis of TNC regarding a potential conflict of interest with respect to the Dougherty purchase, because of the Doughertys being “long time supporters” of TNC and Nancy currently sitting on the Mashomack Preserve’s Board of Trustees. In the memorandum, Kaledin noted that the Doughertys had agreed to make TNC whole with respect to TNC’s acquisition costs of the property through the acquisition and pledge structure, and that the Doughertys would pledge a charitable contribution “above and beyond the outsale’s purchase price.”

The memorandum notes that although it is true that TNC “gave an ‘insider’ [the Doughertys] the first crack at acquiring the Property from [TNC],” TNC “minimized its transactional financial risk by lining up a conservation buyer prior to acquiring the Property.”¹⁶⁴ Handwritten notes on the copy of the memorandum provided to the Committee evidence the consent of John Sawhill and Dennis, with Dennis stating he was “ok with this” because TNC had “solid appraisals” and the Doughertys “stayed out of the decision making process.”

Agreement to sell property to Doughertys and the accompanying pledge agreement

On October 28, 1999, TNC and the Doughertys executed and closed on a purchase agreement pursuant to which TNC transferred to the Doughertys the unimproved Thompson Hill property, and TNC retained and reserved a conservation easement on the transferred property. The delivery of the deeds pertaining to the transfer of the real property and the grant of the conservation easement was accompanied by the execution by the Doughertys of a Pledge Agreement. The property conveyed to the Doughertys was the entire property acquired by TNC from Gerard. The deed reserved and retained a conservation easement, whose terms and conditions were set forth in a separate easement document.

Under the terms of the purchase agreement, the Doughertys paid TNC \$500,000 at closing. Under the terms of the Pledge Agreement, the Doughertys agreed to pay TNC an additional \$1,652,000, as follows: \$650,000 on October 29, 1999 (the day after closing on the property); \$372,000 on November 30, 1999; \$300,000 on January 28, 2000; and \$330,000 on January 29, 2001. Thus, the Doughertys made total payments of \$2,152,000 for the property. The Pledge Agreement did not refer to the Thompson Hill property or to the purchase of the property by the Doughertys from TNC. The Pledge Agreement was to provide TNC the funds to reimburse it for its acquisition costs of acquiring the property, as well as direct costs incurred in acquiring and selling the property. The Pledge Agreement stated that the pledge “may be enforced by [TNC] by an action for specific performance or by any other appropriate remedy by any court having jurisdiction. It is further understood that this Pledge is a binding obligation on Pledgor, their

¹⁶⁴ A February 14, 2000, letter from Kaledin to Shelter Island Town Counsel, explaining TNC’s role in the transaction, *see* Appendix O. The letter stated that there had been several other persons interested in acquiring the property from TNC.

estate, successors, administrators, and assigns.” The Pledge Agreement was governed by the laws of the State of New York.

On the real property transfer report dated October 28, 1999, both James and Nancy Dougherty were listed as buyers, and Nancy Dougherty signed as the buyer. The consideration reported on the report was \$500,000.

An October 29, 1999, TNC memorandum from Melanie Woullard (Legal) to Bethany Seeback (Accounting) regarding accounting for the transaction requested information from Seeback regarding how to account for the purchase and charitable components of the transaction.

Summary of conservation easement

The conservation easement was effected by delivery of a deed from the Doughertys to TNC on October 28, 1999, the date the Doughertys acquired the property from TNC. The conservation easement granted by the Doughertys to TNC permitted the Doughertys to use the property for “single family residential purposes, including a professional office or customary home occupation engaged in by the residents,” and certain other structures within a permitted use area (sec. 2 and 2.1(a)). The easement prohibited certain types of structures (sec. 2.1), and subdivision of the property (sec. 2.9), and imposed certain conservation restrictions on the property. Under the terms of the easement, the Doughertys or their successors were permitted to construct one single family residential structure (with no square footage limitation referred to in the easement), and “accessory structures incidental and ancillary thereto, such as garages, a swimming pool, tennis court, home office space, a guest cottage, a writer’s cabin, etc.” The easement provided that none of its terms shall give or grant to the public a right to enter upon or to use the property (i.e., no public access rights) (sec. 5). The permitted use area was approximately 2.75 acres.

Appraisal and valuation letter

TNC and the Doughertys obtained a separate appraisal of the value of the conservation easement.¹⁶⁵ The appraisal, dated October 22, 1999, indicated that the easement will be made with the intention that it qualify as a conservation easement under section 170(h). The appraised value of the conservation easement was \$1,594,000, which was approximately the \$1.6 million amount that TNC and the Doughertys used to establish the purchase price as \$500,000. The appraisal valued the land before the grant of the easement at \$2.1 million,¹⁶⁶ and after the grant of the easement at \$506,000. The appraisal assumed single family use for the 2.75 acre permitted use area of the property, with the remaining 6.6 acres encumbered with a conservation easement and remaining in a natural state. The appraisal valued the 2.75 acre plot at \$460,000,

¹⁶⁵ Appraisal dated October 22, 1999, of the conservation easement, *see* Appendix O.

¹⁶⁶ The appraisal stated that the “recent sale of the subject for \$2,100,000 will establish its value before the granting of the conservation easement and we have not prepared an appraisal of the subject’s value before granting of the conservation easement.” Appraisal dated October 22, 1999, of the conservation easement, *see* Appendix O.

and the 6.6 conservation area at \$46,000.¹⁶⁷ The appraisal stated it was a qualified appraisal for Federal income tax purposes, and was not intended for any other use.

The appraisal noted that the property lies in the AA Residential zone of the Town of Shelter Island, which permits primarily a single family residential usage on lots having a minimum size of 80,000 square footage. The zone does not permit commercial or industrial uses, and a zone change to other than a residential use "is not deemed likely."¹⁶⁸

It appears that the \$500,000 stated purchase price for the property also was the consideration used to determine the local transfer tax payable by the Doughertys on the acquisition.¹⁶⁹

Included in Appendix O is a copy of a letter from Robert J. Lanahan, Chairman, Board of Assessors, to the Shelter Island Town Board Members. The subject of the letter was the valuation of the Shelter Island property transferred by TNC to the Doughertys for purposes of Community Preservation Fund taxes due the Town of Shelter Island with respect to the property. The letter states that Lanahan, in his capacity with the Board of Assessors, did not consider TNC's purchase from the Gerards to be an arms-length sale, and that the \$2.1 million purchase price paid by TNC was "somewhat lower than could have been obtained in an open market sale." In the letter, Lanahan also states that "the cash payment [paid by the Doughertys] for the property was reported as \$500,000.00. A more realistic value for the property is probably about \$1,500,000.00." Lanahan noted that the "payment structure" involved in the transaction had the effect of "considerably reducing" the transfer tax due.

Tax advice and discussions

August 5, 1999, James Dougherty and TNC met to discuss the structure of the transaction and certain tax risks associated with the "tax/charitable deduction aspects of the transaction." This meeting was memorialized in the August 6, 1999, memorandum from Jonathan Kaledin, State Counsel for TNC, to Dougherty and others. The memorandum acknowledged that at the meeting they first discussed "the tax/charitable deduction aspects of the transaction," and stated that "[i]n order to create as clean a paper trail as possible for Jim and Nancy, so as to minimize whatever IRS risks might exist from having a sale/donation occur, we have agreed to sign the contract and the pledge (the pledge will not have contingency language in it) and convey the [Thompson Hill] property to Jim and Nancy simultaneously on the same day that the Conservancy acquires the [Thompson Hill] property – after TNC's acquisition" (underlining in original).

A September 22, 1999, memorandum from Stephen J. Schreiber to Kaledin notes that Dougherty's counsel wanted assurances that TNC could make a representation that the South

¹⁶⁷ Appraisal dated October 22, 1999, of the conservation easement, *see* Appendix O.

¹⁶⁸ Appraisal dated October 22, 1999, of the conservation easement, *see* Appendix O.

¹⁶⁹ Letter dated October 21, 1999, from Stephen Schreiber of Patterson, Belknap, Webb & Tyler to Peter J. Matheis of Philip O'Hara Associates, Inc., regarding closing instructions for the transfer from TNC to Dougherty. Peconic Bay Region Community Preservation Fund form regarding computation of transfer tax due *see* Appendix O.

Fork-Shelter Island Chapter is exempt under section 501(c)(3) for purposes of the Dougherty gift to be made pursuant to the charitable pledge.

In a February 14, 2000, letter from Kaledin to Shelter Island Town Counsel, Kaledin stated “[o]f course, the transaction between the Conservancy and the Doughertys was structured with both conservation and tax consequences in mind. Yet, as explained above, the structure of the transaction, as conceived and consummated, was built around independent appraisals of the property before and after the conservation easement. It is also important to remember that the transaction accomplished important conservation easements for the community.”

It appears that TNC did not solicit or obtain any tax advice pertaining to this specific transaction. None of the written tax opinions provided by TNC to the Committee relate to this transaction.

Form 8283 reporting

The parties treated this as a contribution of cash, rather than of a conservation easement, by the Doughertys to TNC. Accordingly, no Form 8283 was filed by the parties with respect to the claimed charitable deduction.

V. CBP Transaction – Davis Mountain

Observations

1. Related party. Caroline Alexander (Forgason) was a member of Board of Governors for TNC, Texas for a number of years preceding and following the transaction, which may have made it easier for TNC to structure the pledge and sale transactions.
2. Valuation. The Staff notes that TNC may not have performed adequate due diligence with respect to the valuation of this property.
3. Donative Intent. The documentation makes clear that TNC required the buyers to pay a premium to obtain the properties, which the Staff considers to be relevant to a determination regarding the existence or absence of donative intent on the part of the buyers.

Overview

TNC acquired approximately 32,529 acres of ranch land in the Davis Mountains area of West Texas. TNC’s purchase price for the ranch land was \$10.7 million. TNC had obtained an appraisal of the property which indicated a fair market value of \$11.4 million. TNC acquired the ranch land with the objective of selling ranch tracts to conservation buyers in order to fund most of the purchase price of the project. TNC intended to retain 9,475 acres as a preserve.

TNC subsequently sold most of the property to Caroline R. Alexander Forgason (“Forgason”), an individual who was affiliated with TNC through her service as a Texas State

chapter trustee for TNC for several years.¹⁷⁰ Alexander acquired the properties from TNC in two separate transactions, one in which she was the acquiring party, and the second in which a company she owned was the acquiring party.

By Special Warranty Deed dated December 22, 1997, TNC transferred to Forgason approximately 5,854 acres of the property. The warranty deed provides that the reservation of a conservation easement is attached as Exhibit B and is made part of this deed. The Conservation Buyer Transactions (Related Parties) Summary ("Summary") indicates that 5,854.17 acres were sold to Caroline Alexander. One appraisal in the file is an appraisal of 5,854.17 acres of the McIvor Ranch. The property was appraised for \$1,900,000. The Summary lists the TNC purchase price as \$1,901,876 and the TNC sales price as \$1,160,834. The Summary states that the appraisal of the property on disposition was \$1,170,000. The transfer of 5,854.17 acres was the first Davis Mountains transaction between Caroline Alexander (Forgason) and TNC.

On October 12, 1998, James J. Jeffries, MAI,¹⁷¹ provided a letter to TNC regarding the value of 27,518.78 acres in the Davis Mountains, the Glass-Glen Burnie property also known as the Caldwell Ranch. TNC had requested that Jeffries provide "some preliminary valuation" of the property, which TNC had estimated to be worth approximately \$250 per acre. Jeffries specifically stated in the letter that, as he and TNC had agreed, "this writing is not an appraisal" of the subject property, but rather, a "confidential value consultation document between [them], with both of [them] fully recognizing the limitations of the work effort. It is specifically disclosed that I have not made a field inspection of the Caldwell Ranch nor have I completed any type of specific comparative analysis to directly relate any comparable sales to the Glass-Glen Burnie Foundation Tract." Jeffries provided a "preliminary and grossly limited conclusion" that the subject property's assignment price of \$220-\$250 per acre would fall within a normal range of prices for the subject's region, given its subdivision potential, desirable recreational amenities, size and location.

Forgason made a charitable pledge for the benefit of TNC by a written pledge agreement dated August 12, 1999. Forgason is identified as the sole owner of Davis Mountains Land and Cattle Company. The Pledge recites that Davis Mountains Land and Cattle Company and the Pledgor have entered into a contract with TNC of Texas to purchase 27,133 acres of land in Jeff Davis County, of which this pledge is an exhibit. Such purchase is to be effected at a price equal to the full fair market value of the property, as determined by independent appraisal. This pledge is equal to the value of a conservation easement retained by TNC. The Pledge continues with the recitals that TNC, in pursuit of its conservation purposes, caused the property to be subject to a perpetual conservation easement. Further, the Pledgor desires to make a substantial charitable contribution to TNC to support its conservation efforts, in an amount sufficient to offset the monetary detriment attributable to TNC's creation and imposition of the Conservation Easement

¹⁷⁰ The Summary referred to in this narrative description indicates that Caroline Alexander (also called Caroline Forgason) served as a trustee on the Texas Board of Trustees of TNC from 1993 to 2003. She was also the president and majority owner of Davis Mountain Land & Cattle Company, the company which acquired property from TNC in the 1999 transaction described herein.

¹⁷¹ Member of Appraisal Institute.

over and upon the Property. The Pledgor promises to contribute to TNC real property, cash and securities of not less than \$2,839,717, subject to adjustment at closing.

By a special warranty deed dated August 23, 1999, TNC transferred the 27,133 acre property to Davis Mountains Land and Cattle Company (owned by Forgason). The deed contained the reservation by the Grantor of a conservation easement over the property as set forth in the Caldwell Ranch Deed of Conservation Easement attached as Exhibit B and made a part of the deed.

The file contains an appraisal of the property as of February 4, 1999. The fair market value is listed at \$7,570,000. The Summary lists the estimation of the value of the property with the easement imposed of \$5,426,632. The Summary also lists this amount as TNC's sale price. The Conservation Buyer Transaction Summary contains the information that no separate appraisal with the easement imposed was obtained by TNC. However, the value estimation (not an appraisal) of the property is based on a hypothetical conservation easement. The value attached to the property was \$200 an acre. At the rate of \$200 an acre for 27,133 acres, the value is \$5,426,600, the number derived in the Summary.

On October 5, 1999, Forgason transferred 3,696.43 acres of property to TNC, in a transaction characterized as a charitable contribution for which a Form 8283 was filed. Forgason reported that she had acquired the property in December 1997 by purchase for a cost of \$729,224, and that the property had a fair market value of \$739,286 at the time of the donation. It appears that the contribution amount approximates the excess of the \$1.9 million appraised amount for the property acquired by Forgason from TNC in 1997, over the stated purchase price of \$1.17 million. Thus, it appears that Forgason claimed a charitable deduction of \$729,224 for the 1999 donative transfer of property she had acquired in 1997, and a cash contribution deduction of \$2.8 million for the pledged amount pertaining to the 1999 acquisition by Davis Mountains Land and Cattle Company.¹⁷²

The file contains the letter of TNC dated January 29, 1997, to Steptoe & Johnson in Washington, D.C., requesting tax advice on the structure of purchase of conservation land "at a premium." The question is how the transaction should be structured for federal income tax purposes. The letter first starts by describing the overall transaction. To finance most of the project, TNC intends to sell most of the ranch tract to conservation buyers. The letter states as follows:

To meet our conservation goals the Conservancy must retain a substantial portion of the economic value of the property. . . thus, we, are requiring the various tract buyers to pay a premium to cover our costs, and provide for start-up expenses and a stewardship endowment. The Board of Governors has made it clear that the Texas chapter must have

¹⁷² The staff did not confirm whether the company is a corporation, in which case Forgason is making a charitable contribution individually for property acquired by her corporation. A recharacterization of the pledge might be in order in such a case, with the result that Forgason is viewed as making a capital contribution to the corporation, and any charitable deduction would be that of the corporation, not Forgason individually.

\$8 million in income from the sale of tracts closed simultaneously with the purchase of the property. (Emphasis added).

Stephoe & Johnson replies to TNC with a letter dated March 10, 1997, giving TNC the go ahead with respect to structuring the sale with a “premium” attached.

The charitable pledge of Forgason is revealing in that it precedes the land transfer by a few days and it refers directly to the contract for the sale of land by TNC to the Pledgor as if the Pledge was a part of the larger land transaction. Further, the Pledge recites that the Pledge is equal to the value of a conservation easement retained by TNC.

VI. Emissions Credits – General Motors Atlantic Rainforest Restoration Project¹⁷³

On June 9, 2000, General Motors Corporation (GM), General Motors do Brasil Ltda. (GMB), Sociedade de Pesquisa e Vida Selvagem e Educacao Ambiental (SPVS), and TNC executed the Comprehensive Agreement For The General Motors Atlantic Rainforest Restoration Project (Project).¹⁷⁴ The Project is a forty year climate action mitigation project in the municipality of Guaratuba on the coastal plain of Parana State in southeastern Brazil. The objective of the agreement was: (1) the implementation of a climate action mitigation project to protect plants and animals; (2) to protect biodiversity on the project site; (3) to mitigate greenhouse gases in the earth's atmosphere, principally through reforestation and the prevention of deforestation; (4) to sequester carbon from the earth's atmosphere as rapidly as possible without compromising the biodiversity of the Project; (5) to promote sustainable development; and (6) to generate certified credit offsets for GM.¹⁷⁵ The agreement provided that it was not intended to be, and shall not be construed to have created, a partnership, joint venture, or other business arrangement, nor was it a principal purpose of the parties to enter into a commercial undertaking. The agreement prohibited any of the parties from filing or making any form or return that took a position inconsistent with the stated intention.

The agreement was signed on behalf of GM and GMB by John F. Smith, Jr., then-Chairman of the Board and Chief Executive Officer of General Motors Corp., and a member of TNC's Conservation Committee and 2000-2001 Board of Governors. Mr. Smith voted, as a member of TNC's Conservation Committee, to approve TNC's participation in the agreement on April 26, 2000.¹⁷⁶ TNC's states on its Forms 990, Statement 24 for 2000, 2001 and 2002, that "Mr. Smith did not participate or vote on said transactions." Mr. Smith is no longer Chairman of General Motors Corporation, but serves as Special Advisor to the Company, and was a member of TNC's Board of Governors for 1999-2003.

The Project's aim was to create an approximately 30,000 acre private nature reserve in Brazil through land acquisition, active restoration, and long-term management for forest and biodiversity protection. In the materials provided to the TNC Board of Governors, TNC

¹⁷³ See Appendix Q for documents related to this transaction.

¹⁷⁴ GMB is a Brazilian limited liability company affiliated with GM. SPVS is a Brazilian non-profit conservation organization.

¹⁷⁵ For this purpose, a credit offset means one metric ton of Carbon equivalent demonstrated by the project site manager to be mitigated, reduced, avoided, sequestered or fixed in any calendar year. According to one source, greenhouse gas air credit trading has emerged as a mechanism to reduce greenhouse gas (GHG) emissions such as carbon dioxide and methane. www.emissionstrading.com/defined.htm ("While the global mandate for reducing GHG emissions is not yet in place, it may yet emerge out of the December 1997 Kyoto Conference. Participating countries agreed to specified GHG emissions budgets that are tied to 1990 emission levels. Participating sources within each country may then be allocated a proportional share of the budget and/or allowed to participate in an auction to acquire such GHG allocations. GHG allocations can be used to mitigate the impact of defined GHG producing activities, sold to GHG emitting sources without a sufficient supply to meet anticipated needs, or stored for later use or sale.")

¹⁷⁶ Fax Ballot for Brazil Atlantic Rainforest Restoration Project, Brazil dated April 28, 2000, from Mike Dennis to various persons.

estimated that 1.5 to 2.0 million tons of carbon would be sequestered on the project area over the 40-year life of the Project. Those materials state that the Project “may allow General Motors Corporation to receive recognition and greenhouse gas emission offsets. Without compromising biodiversity objectives, [TNC] will design the project plan to place General Motors in a position to be eligible for carbon offsets.” The TNC Executive Committee of its Board of Governors, and the TNC Conservation Committee, approved TNC’s participation in the agreement on April 25, 2000.¹⁷⁷

The April 10, 2000, Preliminary Project Plan stated that with a \$10.0 million investment from GM, the project will promote assisted natural forest regeneration on pastures and degraded forests on the acquired lands, and that the project aims to “produce significant net carbon benefits” that “will be quantified and validated in such a way as to maximize the probability that they will be accepted under any future international carbon trading regime.” The April plan document stated that TNC will carry out its financial management and technical assistance responsibilities as to improve the possibility that the net carbon benefits generated by the Project will be recognized and credited under a future international greenhouse gas carbon trading regime, and to achieve the Project’s biodiversity goals. The plan document went on to say that “[a] primary goal of the project is to generate as much as 2 million tons of carbon benefits that are scientifically quantifiable and long-lasting and that will be recognized as certified carbon offsets eligible for credit under a prospective international carbon trading regime,” and that the project partners “will make every effort to maximize the possibility that the carbon benefits generated by the project will ultimately be accepted, credited, and available to GM to meet its emission-reductions targets.” In the plan’s description of the “strategy to obtain credits for the greenhouse gas emissions reductions generated by the Project,” the plan acknowledged the Brazilian government’s reluctance to accept forest conservation projects to receive credits, and stated that the parties’ actions prior to November 2000 “will focus especially on participation in the debate concerning the crediting of forest conservation projects.”¹⁷⁸

Authority and responsibility for the Project are allocated among the Project Executive Committee, Project Site Manager, and Project Funds Manager. The Project’s Executive Committee is responsible for making certain advisory recommendations and binding decisions. The Executive Committee consists of four members, one representing each of GM, GMB, SPVS, and TNC. Advisory recommendations require the approval of three of four members. Binding decisions require the agreement of all four members. Thus, GM and GMB possess 50 percent control of the Executive Committee, and each member (including TNC) possesses veto power over binding decisions. Binding decisions include, among other things, approval of annual work

¹⁷⁷ It appears that the agreement also was approved by TNC’s International Committee before April 25, 2000. It is unclear whether the transaction was submitted for approval by the Executive Committee to the full Board of Governors.

¹⁷⁸ According to the plan document, two of the four elements of the project partners’ core strategy were to “inform key decision-makers in the climate change arena about the benefits of forest conservation projects” (noting that “all three project partners have pre-established channels of communication with key actors within the Brazilian Government on the climate change debate. The partners will thus coordinate to engage Brazilian officials and keep them apprised of the Project.”), and to “position the project as a CDM [Clean Development Mechanism] pilot project for the Brazilian Government” (noting that “project partners will engage and inform U.S. officials to promote the project’s acceptance under guidelines established by this government”).

plans and budgets, approval of any sale, lease, or other disposition of the project site, and the determination of when to submit any filing, submission, or registration of any credit offsets generated by the Project.

SPVS, as the Project Site Manager, was principally responsible for managing and implementing the Project. TNC, as the Project Funds Manager, was responsible, in consultation with the Executive Committee, for providing financial management services as set forth in the agreement. TNC's duties included establishing and maintaining project funds accounts within TNC to fund the Project's expenditures, disburse funds to the Project Site Manager in accordance with annual work plans and budgets, sending financial reports to GM and GMB, and establishing and maintaining the Project's endowment fund. GM's duties were to provide financing for the Project (\$500,000 at the start of the Project and \$9.5 million within 30 days of the agreement), and, with GMB, to consult with TNC and SPVS regarding the financing and implementation of the Project. Under the agreement, TNC could not assign any of its duties or obligations under the agreement without GM's consent. GM was permitted to assign all or any portion of its interest [in the agreement] to any third party subject to approval of the other Parties "which approval may not be reasonably withheld.

The agreement recitals state that the parties wished to convey to GM any credits or benefits which may result from this endeavor to the extent related to efforts by any country to achieve sustainable development and to meet any net greenhouse gas emissions reduction goals either through the UNFCCC¹⁷⁹ (including any protocols related thereto, including but not limited to the Kyoto Protocol) or otherwise. GM was the sole recipient of the credit offsets under the agreement. The agreement required all parties to perform their duties in a professional and efficient manner using due diligence to prevent unnecessary injury or damage to the credit offsets produced on the project site. The parties agreed to cooperate to submit the necessary documentation for obtaining certification of credit offsets as was consistent with "the Project objective of generating [credit offsets] on as rapid and regular a basis as is feasible." The agreement provided that each credit offset constituted an "unconditional marketable private right" for GM, or GM's successor in interest or permitted assignees, to register the offset and to count such offset toward compliance by GM, or its successor in interest or assignee, with its current or potential future greenhouse gas limitation obligation or commitments, voluntary or otherwise. No credits were guaranteed or warranted under the agreement, and there was no cap or limitation on the value of emission credits GM could realize from the arrangement.¹⁸⁰

Under the agreement, TNC made the following covenants: (1) not to sell, assign, convey, lease or otherwise dispose of all or a substantial part of TNC's assets or real properties to the

¹⁷⁹ United Nations Framework Convention for Climate Change.

¹⁸⁰ Although the Kyoto Protocol has not been ratified, a market emissions credit trading has emerged. According to one source, the right to emit a ton of carbon dioxide traded for between \$3 and \$6.50 as of January 2004, and that experts predict prices will rise if the Kyoto Protocol is implemented. The Asahi Shimbun, January 17, 2004. According to that source, credits for about 70 million tons of emissions were traded during 2003. Another source stated that demand for the credits more than doubled during 2003, with credits beginning the year at EUR6 (approximately \$7 (US)) and ending the year at EUR12.50 (approximately \$15 (US)). www.bellona.no/en/energy/32069.html (citing Politiken).

extent such action would have an effect on the Project, whether such assets or real properties are now owned or hereafter acquired, except for the replacement of capital assets with assets of equal or greater value; (2) not to voluntarily dissolve, liquidate or otherwise cease to do business during the term of the Project; (3) not to change the nature or scope of the Project without the written consent of the other parties; (4) not to change TNC's articles of association or other organizing documents in a manner that would be inconsistent with the provisions of any Project Document; (5) not to enter into any partnership, profit-sharing or royalty agreement or other similar arrangement whereby Project Disbursement are or might be shared with any person, except as specifically authorized in a Project Document; (6) to maintain its corporate existence and its right and authorities to carry on the Project; (7) to assist GM in defending the conveyance of credit offsets transferred under the agreement, against the claims of any person including by providing any documentation in its possession; (8) to ensure observance of confidentiality with regard to any restricted information or confidential information or data disclosed to it; and (9) not to sell, assign, convey, lease or otherwise dispose of any of the real estate or assets which comprise the Project without the written approval of the Executive Committee. Under the agreement, the fund accounts maintained by TNC for the Project were only to be used for the purposes of supporting the Project. Any income from any use of the project site during the project term must be used solely for the benefit of the Project unless otherwise decided by the Executive Committee. Under the agreement, if TNC ceased to exist or substantially restructured to the point where its activities in Brazil cease to be a priority, such cessation or restructuring constituted an event of default. TNC could not amend or terminate the agreement without the written consent of all of the other parties to the agreement.

VII. Joint Ventures

a. Conservation Beef

Observations

1. Joint Venture Participants. TNC describes CBL as a joint venture with another charitable organization, AWF. In its March 3, 2004, response TNC provided a form of Joint Venture Agreement with respect to PM Holdings, LLC, a for-profit entity.¹⁸¹ The Staff notes that the form of Joint Venture suggests that PM Holdings, LLC would be a member of the venture. TNC later states that “CBL had a verbal agreement with PM Holdings, LLC on terms similar to those described in the form of Joint Venture.”¹⁸² “Due to changed circumstances and the performance of PM Holdings, LLC, the two parties never formalized a joint venture agreement. Instead, CBL elected to hire a salaried president to direct and implement much of the work CBL had originally intended PM to perform.”¹⁸³ In verbal conversations with the Staff, TNC stated that it never executed the form of Joint Venture with PM Holdings, LLC and that PM Holdings, LLC only provided services in a contracting capacity.
2. Profitability. The joint venture turned out to be very unprofitable from TNC’s perspective. Conservation Beef, LLC did not have an operating profit for any year in which TNC participated in the joint venture.
3. Tax Analysis. TNC apparently did not conduct any tax analysis to determine the tax consequences to TNC of participating in the joint venture with AWF, or the effect the relationship with PM Holdings, LLC would have on TNC’s tax consequences.
4. Potential Tax Issues. The joint venture arrangement is an example of a dual purpose arrangement, in which TNC attempted to further conservation purposes at the same time it provided substantial financial benefits to third parties (including non-exempt parties) with whom the joint venture conducted business. Such arrangements may implicate exempt purpose, private benefit, and unrelated business income tax issues.

Overview¹⁸⁴

The concept of the conservation beef program originated with William Weeks and Brian Kahn, both senior staff employees of TNC, in 1995. Kahn subsequently moved to Artemis

¹⁸¹ See Appendix S.

¹⁸² TNC Narrative Response dated January 14, 2005.

¹⁸³ Id.

Wildlife Foundation (“AWF”)¹⁸⁵ where he remained interested in the conservation beef program idea. TNC, through its operating unit Center for Compatible Economic Development (“CCED”), formed Conservation Beef, LLC (“CBL”), a Montana limited liability company, in partnership with AWF in 1999. TNC and AWF approached and received support from the W. Alton Jones Foundation for initial support for the project.

On January 1, 2003, TNC was formally substituted for CCED in CBL’s operating agreement. TNC and AWF each had a fifty percent (50%) ownership interest in CBL until TNC withdrew from CBL on February 19, 2004.

CBL reported that the net income or loss of CBL furthered the exempt purpose of its members, “to wit: in the case of Artemis Wildlife Foundation, to conserve biologically significant lands in the Western United States by developing market forces that will support economically sustainable and ecologically sound livestock ranching; and in the case of The Nature Conservancy, to be operated, exclusively for educational, scientific and charitable purposes.”¹⁸⁶

Description of operations¹⁸⁷

CBL is a sales and direct-marketing organization that markets fully mature, range-fed, additive-free, healthful beef (“Conservation Beef”) to the consumer and corporate gift markets, and to a small number of highly visible, food-source conscious restaurants.

CBL’s mission is to conserve biologically significant lands in the western United States by developing market forces that will support economically sustainable and ecologically sound cattle ranching. CBL’s means to accomplish that mission is to create a niche market for Conservation Beef that will return a premium price to ranchers who commit to long-term land conservation strategies.

Conservation Beef is produced only on western landscapes of the highest ecological value by ranchers who commit, through strategic alliances with CBL, to long-term conservation of their open lands through ecologically sound land stewardship practices, land-use planning, and conservation easements. CBL works with its rancher-suppliers to develop those stewardship standards and coordinates the work of an independent panel of scientists and ecologists who monitor and certify adherence to the standards and evaluate their beneficial impacts on ecosystem health and wildlife habitat. TNC maintains that the financial rewards to be provided to the rancher suppliers help economically sustain responsible operators and thus encourage

¹⁸⁵ AWF reportedly is a California nonprofit corporation and charitable organization described in section 501(c)(3).

¹⁸⁶ Attachment to Statement 3, Federal Supplemental Information, Form 1065 for CBL for 2003; see also, section 3.1 of the Operating Agreement dated October 20, 1999, *see* Appendix S.

¹⁸⁷ This description of the Conservation Beef joint venture is based on narrative descriptions provided by TNC to the Committee, as well as on the organization’s organizational documents, transactional documents, Federal tax information returns, and financial statements.

further sound land stewardship for large blocks of both publicly and privately owned land in critical areas of the western United States.

CBL had three employees in 2000, one of whom was full time. In 2002, CBL had four employees, three of whom were full time. All employees of CBL were eligible to participate in the TNC retirement plan.¹⁸⁸

For 1999 through 2003, CBL had a negative gross profit from its activities, i.e., gross receipts from sales were less than its inventory costs associated with those sales, before taking into account other administrative and operating costs. For example, for the calendar year 2003, CBL reported gross sales of \$304,836, and cost of goods sold relating to its inventory of \$435,888.¹⁸⁹ CBL's net losses were allocated 50-50 to each of TNC and AWF for 1999 through 2003.

CBL reported on its Form 1065 that its principal product was organic beef, and its principal business activity was sales.

Agreement with Artemis Wildlife Foundation and ownership of the joint venture

TNC (through CCED) and AWF executed an operating agreement as of October 20, 1999. At the outset, TNC contributed \$135,000 of cash and AWF contributed \$252,500 of cash to CBL (sec. 8.1), in exchange for equal 50% interests in the LLC.¹⁹⁰ Neither member was obligated to make additional capital contributions (sec. 8.2).

The operating agreement provided that management of the LLC was vested in the managers rather than in the members (i.e., was vested in the LLC's officers rather than in TNC and AWF as members). The managers were Brian Kahn, representing AWF, and William Weeks, representing TNC (secs. 1.22 and 5.2). CBL was not to take any action that did not further the exempt purposes of its members (sec. 3.1). Each member was permitted to withdraw from CBL at any time, and receive a payment in exchange for its membership interest under the terms and conditions agreed to by CBL and the withdrawing member (sec. 8.4). AWF was the tax matters partner for CBL (sec. 9.12).

Under the operating agreement, Kahn's powers as manager included acquiring property and miscellaneous administrative duties. Weeks' powers included determining which landscapes or watersheds met the company's ecological criteria for participation in the company's programs. Certain actions could not be taken without the consent of both managers, and a number of major

¹⁸⁸ The withdrawal agreement executed by TNC in 2004, described below, did not address whether CBL employees ceased to be eligible for benefits under TNC's retirement and other programs.

¹⁸⁹ CBL apparently reported its financial statements on a fiscal year basis (ending June 30), but reported its partnership return information on a calendar year basis.

¹⁹⁰ TNC stated that AWF also contributed its connections and relationships with cattle ranchers and the time and expertise of its staff, which the parties felt justified the equal ownership interests despite TNC's disproportionately larger cash contributions made over the course of the joint venture.

decisions (including establishing conservation standards to be used in conservation agreements) required the consent of both TNC and AWF as members (Article V).

TNC and AWF amended and restated the operating agreement effective as of January 1, 2003. The amended and restated operating agreement retained the respective interests of TNC and AWF at 50%, and acknowledged that TNC had contributed cash of \$1,150,864, and AWF had contributed cash of \$499,021, by that time. Under the amended and restated agreement, neither member was obligated to make additional capital contributions.

As more fully described below, TNC executed an agreement to withdraw from CBL effective as of February 19, 2004.

CBL's separate joint venture agreement with PM Holdings and related agreements

CBL entered into various agreements with other parties. CBL negotiated a Form of Joint Venture Agreement with PM Holdings, LLC ("PMH") in which CBL and PMH agreed to "pursue a joint venture to develop and expand marketing of Conservation Beef."¹⁹¹ PMH is a holding company that generated average sales of \$250 million annually and employed more than 700 employees, with subsidiaries including PM Beef Group.¹⁹² TNC reported that CBL and PMH had a verbal agreement on terms similar to those described in the Form of Joint Venture Agreement, but that due to changed circumstances and the performance of PMH, the two parties never formalized a joint venture agreement. This verbal agreement with terms similar to the form of joint venture agreement, combined with the agreement between TNC and AWF, may have had the effect of creating a joint venture among, TNC, AWF, and PMH, with respect to certain of CBL's activities for some period of time.

CBL entered into: (1) a PM-Conservation Beef Protocol for Live Animal Handling, Harvest, Beef Fabrication, Portioning and Shipping; (2) a Conservation Beef Option/Purchase Agreement with John Crumley; (3) a Conservation Beef Option/Purchase Agreement with Karl Ohs, dated May, 2000; (4) a Conservation Beef Option/Purchase Agreement with Sun Ranch, LLC, dated September 18, 2000; (5) a Conservation Beef Option/Purchase Agreement with John Crumley, dated September 10, 2001; and (6) a Conservation Beef Purchase Agreement with Sun Ranch, LLC, dated October 15, 2001. Under the cattle option/purchase agreements, sellers to CBL agreed to an introductory stewardship plan, and if they participated beyond one year, a full stewardship plan. All such stewardship plans were required to be approved by CBL in accordance with CBL's stewardship guidelines. Under these arrangements, ranchers are able to choose among a variety of acceptable strategies to achieve the stewardship goals, and may retain specific, limited development rights provided they are consistent with CBL's goals of conservation of landscape, watershed, and habitat integrity.

A copy of the Stewardship Guidelines is included in the Appendices. TNC reported that individual stewardship plans are subject to a confidentiality agreement between the rancher and

¹⁹¹ Form of Joint Venture Agreement with PM Holdings, LLC, *see* Appendix S.

¹⁹² PM Beef Group, LLC News Release, *available at* <http://www.pmholdings.com/heinenspressrelease.html>.

CBL, and that TNC does not have copies of these plans because it is no longer a member of CBL.

TNC's withdrawal from the joint venture in February 2004

As a part of a review by TNC of its related organizations, TNC identified CBL as 'a candidate for termination' in terms of participation by TNC. TNC withdrew from CBL effective February 19, 2004. The withdrawal was effected pursuant to an Agreement to Withdraw By and Between TNC and CBL of that date.

Pursuant to the withdrawal agreement, TNC relinquished its membership rights in CBL in exchange for \$225,000, including cash of \$100,000 and a promissory note from CBL in the amount of \$125,000 with interest payable at 3.02%. The withdrawal agreement provided that: (1) TNC retained all rights and interests in conservation agreements granted to TNC through the joint efforts of CBL and TNC, including the Sun Ranch easement valued on TNC's books at \$5.84 million; (2) CBL retained all rights and interests in the trademark Conservation Beef (CB Mark); and (3) the licensing agreement made on August 16, 2001, between TNC and CBL concerning use by CBL of the TNC marks was terminated.

Tax advice and analysis by TNC

TNC provided no information to the Committee staff regarding the tax analysis TNC conducted with respect to the treatment of its joint venture with AWF, or indirectly with PM Holdings and perhaps various ranchers, for Federal income tax purposes. The conservation beef program was not a subject of any of the tax opinions provided by TNC to the Committee. Apparently no tax analysis was conducted by TNC to determine the effect, if any, that the joint venture between TNC and AWF, or the relationship between CBL and PMH, would have on the Federal tax consequences to TNC or CBL.

Reporting on Form 990

For its fiscal years ended June 30, 1999, through June 30, 2001, TNC reported its contributions to CBL as grants and allocations (Part II, line 22). Effective for the Form 990 for the year ended June 30, 2002, TNC reclassified prior contributions to CBL as investments, and the losses allocable to TNC were reported as a component of gain or loss from sales of assets other than inventory (Part I, line 8). TNC noted that based on consultation with its auditors, it would report any income or loss from the 2003 Form K-1 consistent with the characterization of the amount on CBL's Form 1065.

b. Forest Bank

On January 17, 2001, TNC formed the Forest Bank, LLC ("FBLLC"), a Delaware limited liability company, to conduct a forestry conservation project. Upon the formation of FBLLC, TNC was its sole member. TNC acquired its membership interest in exchange for \$500,000 cash and an obligation to provide an additional \$250,000 cash on an as needed basis. TNC and

FBLLC sought private investors in the LLC to provide funding and working capital for the LLC's activities.

FBLLC sought to acquire from owners of forest land the rights to maintain, conserve, selectively cut, manage, sell, retain the proceeds from and regenerate the trees located on each owner's property in exchange for units of membership interests in FBLLC. The membership interests offered to investors would have entitled the holder to preferred annual distributions based on the value of the timber rights contributed to the LLC, and the limited right to withdraw the initial value of the timber rights contributed to the LLC for cash, subject to certain restrictions.

FBLLC was formed because TNC believed that small, non-industrial owners of forest land often sell the rights to harvest the timber to raise funds to meet pressing cash flow needs, without a long-term forest management plan. TNC believed this random harvesting jeopardizes the long term conservation of forests, threatens the environment, and may damage the long-term economic productivity of the landowner's forest. TNC and FBLLC sought to eliminate as much as possible the random cutting of forests that occurs because of such circumstances by acquiring permanent rights to manage standing timber, developing sustainable forest management plans for each contribution of timber rights, providing the landowner with a regular source of income in the form of preferred annual distributions from the LLC, and providing the landowner with the right to withdraw the initial value of the timber rights contributed to the LLC in cash without having to harvest that particular timber.

TNC and FBLLC conducted an initial public offering of three classes of the FBLLC membership interests in an attempt to sell FBLLC membership interests. In the offering materials, FBLLC stated its two primary objectives were to conserve forests, lands and watersheds of the regions in which it acquired timber rights, and to maximize the sustainable financial return to its members who contributed timber rights to FBLLC. The FBLLC agreement expressly required that in the case of a conflict between FBLLC's conservation objectives and economic objectives, the conservation objectives would take priority. Pursuant to a management agreement, TNC was to control the day-to-day management of the FBLLC operations. The initial offering materials stated that FBLLC was authorized to purchase timber rights for up to 10,000 acres of land.

FBLLC offered three different membership interests. Class A-1 interests provided for annual distributions equal to 4% per year of the initial value of the contributed timber rights. Class A-2 and A-3 interests provided for preferred annual distributions of 4.5% of the initial value of the contributed timber rights. Each of the classes provided for different withdrawal rights for investors who wanted to withdraw from FBLLC. Persons generally were eligible to become members if they owned at least twenty (20) acres of forest land in a project area designated by TNC.

FBLLC members were to convey timber rights to FBLLC by means of a forest conservation and management easement, which gave FBLLC the right to manage the member's timber, including the right to maintain, conserve, selectively cut, sell, retain the proceeds from and regenerate the trees located on the member's property. The easements were to permanently

prohibit any development of the land on which the contributed timber rights resided for commercial purposes or in any manner inconsistent with FBLLC's conservation objectives. Members exchanged rights to cut and manage their timber for rights to receive economic returns in the form of cash distributions. Members would continue to own the underlying land, and were able to use the land for recreational purposes. The contribution of the easement was permanent and irrevocable.

The governance provisions of FBLLC provided that members had little or no ability to control the operations of the affairs of the company, and could not vote on any matter concerning the LLC, other than the sale, merger, or consolidation of the LLC (which required the approval of 2/3 of the members and of TNC). TNC, as manager, had control over FBLLC's forest management and timber sale decisions. TNC was to work with each member to develop a management plan for the member's property, but TNC and FBLLC was not bound by that plan. In addition, TNC had the right to appoint, remove and replace all the members of TNC's board of managers, which were expected to always be employees of TNC. The management agreement provided that TNC was to provide management services to FBLLC free of charge for five (5) years.¹⁹³

On July 20, 2000, TNC received a private letter ruling from the IRS with respect to its participation in FBLLC that contained the following rulings: (1) TNC's participation as manager of FBLLC pursuant to the terms of the management agreement, and its obligations and activities with respect to FBLLC, would not impair TNC's status as an organization described in section 501(c)(3); (2) cutting and selling timber based solely on long-term conservation objectives does not constitute an unrelated trade or business; (3) cutting and selling timber based solely on revenue objectives, or where conservation objectives are merely incidental to revenue or other objectives, constitutes an unrelated trade or business, assuming that such activities are regularly carried on; (4) if sales of timber constitute an unrelated trade or business, gains from section 631(a) dispositions are not excluded under section 512(b)(5), although transactions coming within section 631(b) may result in gains therefrom being excluded under section 512(b)(5); and (5) membership interests in FBLLC do not constitute acquisition indebtedness as defined in section 514(c)(1).

FBLLC received opinions from an outside law firm, Hunton & Williams, that: (1) FBLLC would be taxed as a partnership for federal income tax purposes, and each member would be treated as a partner for such purposes; (2) a member would not recognize gain or loss upon the contribution of timber rights in exchange for LLC membership interests; (3) any gain recognized for federal income tax purposes from the LLC's harvesting activities would be treated as long-term capital gain; (4) the allocations of income, gain, loss, deductions, and credits in the LLC agreements should have substantial economic effect for purposes of the partnership allocation rules; and (5) the descriptions of tax law contained in the offering materials were correct in all material respects, and the discussions thereunder fairly summarized the federal income tax considerations that were likely to be material to an investing member. The offering materials

¹⁹³ The parties valued this five-year commitment of free management services at \$750,000, placing the value of TNC's initial membership interest at \$1,250,000 (including the \$500,000 cash).

disclosed the risk that the LLC might be treated as a publicly traded partnership, taxable as a corporation.

Despite a public offering of the membership interests, FBLLC was unable to attract any investors, and was dissolved on November 6, 2002.

PART FOUR – DISCUSSION OF IRS REPORTING REQUIREMENTS

The Staff reviewed TNC's Forms 990 for fiscal years 1993 through 2003 (form years 1992 through 2002).¹ This part of the report summarizes the general reporting requirements for each part of the 990 and then describes TNC's reporting with respect to such requirements. Any changes in reporting made by TNC with respect to its Form 990 for the fiscal year ended June 30, 2003 are described separately, to show any reporting changes made after commencement of the investigation.

The Staff also reviewed Forms 990-T for fiscal years 1999 through 2003 (form years 1998 through 2002). A summary of the Staff's review of these forms also follows.

I. Form 990

a. Part I – Revenue, Expenses, and Changes in Net Assets

In Part I, organizations are required to list their sources of revenues, provide a summary of their expenses listed in Part II and report and explain any other changes in net assets.

1. Revenues

TNC reported \$3.7 billion of contributions and grants, and total revenues of \$6.1 billion for fiscal years 1993 through 2003. Contributions and grants represented 61 percent of aggregate total revenues during this period. TNC's program service revenue comprised 27 percent of total revenues during this period, and its investment income (interest, dividends, and gain from sales of investments) totaled 11 percent of total revenues. Annual revenues by category are listed in the following table.

¹ TNC's fiscal year begins on July 1. Fiscal years 1993 through 2003 include years ended June 30, 1993 through June 30, 2003. A fiscal year is referenced by the year in which it ends, e.g. FY03 references the year beginning July 1, 2002 and ending June 30, 2003. However, the fiscal year does not correspond with the Form 990 year, e.g. FY03 is reported on Form 990 for 1992.

**Table 10, Summary of Revenues
TNC Fiscal Years 1993 through 2003
(in millions of dollars)**

Form 990 Year	Contributions and grants (Form 990, Line 1d)	Program service revenue (Form 990, Line 2)	Interest and dividend income (Form 990, Line 4)	Net gain or loss from sale of investments (Form 990, Line 8d)	Gross profit from sales of inventory (Form 990, Line 10c)	Other sources of revenue	Total revenues
2002	480.3	272.3	3.7	0.7	1.0	3.7	761.7
2001	628.3	315.1	1.8	19.0	-0.4	8.6	972.4
2000	461.0	183.9	2.3	75.2	-0.9	10.4	731.9
1999	445.3	163.9	13.1	151.6	-1.5	11.9	784.3
1998	403.5	153.9	9.2	130.7	-0.9	7.6	704.0
1997	289.8	107.6	10.4	78.5	-0.1	7.6	493.8
1996	235.1	104.5	15.5	58.7	-0.4	8.0	421.4
1995	203.9	86.3	13.3	26.9	0.0	7.1	337.5
1994	237.5	55.6	9.8	12.1	-0.4	7.0	321.6
1993	200.3	83.9	9.2	12.9	0.0	0.4	306.7
1992	164.0	91.6	10.5	12.1	0.0	0.3	278.5
Totals	3749.0	1618.6	98.8	578.4	-3.6	72.6	6113.8
Totals as % of cumulative total revenues	61.3%	26.5%	1.6%	9.5%	0.0%	1.1%	100.0%

b. Part II – Statement of Functional Expenses

In Part II, organizations are required to list all of their expenses and provide an allocation of these expenses among Program Service (related to exempt purpose), Management and General, and Fundraising.

TNC's total expenses for fiscal years 1993 through 2003 totaled \$3.8 billion (see Table 2, below). TNC's total fundraising expenses for the period were \$420 million, which represents approximately 11 percent of TNC's total revenues from contributions and grants during the same period. TNC's program services expenses and management and general expenses increased at a faster rate than its fundraising expenses. The following table provides a breakdown of TNC's expenses for its fiscal years 1993 through 2003.

**Table 11, Summary of Functional Expenses – Form 990, Part II
TNC Fiscal Years 1993 through 2003
(millions of dollars)**

Form 990 Year	Program services expenses	Management and general expenses	Fundraising expenses	Total expenses	Fundraising as % of contributions and grants²
2002	453.0	63.6	52.9	569.5	11.0%
2001	520.7	57.7	54.1	632.5	8.6%
2000	334.6	50.5	48.7	433.8	10.6%
1999	306.9	40.2	45.7	392.8	10.3%
1998	285.0	33.5	40.9	359.4	10.1%
1997	211.0	29.8	33.5	274.3	11.6%
1996	181.0	25.7	34.2	240.9	14.5%
1995	180.3	24.9	30.8	236.0	15.1%
1994	169.1	21.7	28.6	219.4	12.0%
1993	185.5	18.3	25.8	229.6	12.9%
1992	177.7	16.9	24.8	219.4	15.1%
Totals	3004.8	382.8	420.0	3807.6	11.2%

c. Part III - Statement of program services accomplishments

Part III requires the organization to state its primary exempt purpose, and, with respect to its four largest program services (as measured by total expenses incurred), to “describe [its] exempt purpose achievements in a clear and concise manner. State the number of clients served, publications issued, etc. Discuss achievements that are not measurable.” The instructions direct the organization to (a) describe program services accomplishments through measurements, (b) describe the activity’s objective, for both this time period and the longer-term goal, if the output is intangible, (c) give reasonable estimates for any statistical information if exact figures are not readily available and indicate this information is estimated, and (d) be clear, concise, and complete in your description, and avoid adding an attachment. Section 501(c)(3) organizations are also required to provide the amount of grants and allocations to others, and the amount of program services expenses, for each listed program services accomplishment. Part III also requires the organization to attach a schedule that lists the organization’s other program services, without most of the detailed information required for the organization’s four largest program services.

Observations

TNC reported the following in its Form 990 (2001), Statement 10, as its response to the required statement of program services accomplishments:

² Contributions used for the denominator are derived from Table 10 above.

“Conservation Activities and Actions. Expenditures related to the broad spectrum of activities and actions critical to advancing The Conservancy’s ecoregion-based approach to conservation. Expenditures related to understanding, monitoring, maintaining, restoring and managing natural areas owned by the Conservancy and others are included, as are expenditures for developing and enhancing The Conservancy’s ability to gather and share ecological information and to assess and evaluate threats to the elements of natural diversity within ecoregions in which The Conservancy works. In addition, this area includes expenditures necessary for developing and implementing ecoregion-based plans and strategies to mitigate, prevent, or slow the effects of threats to the elements of biodiversity, including investments in the institutional development of domestic and international conservation organizations. Also [this section] includes expenditures related to introducing, educating, and informing members and the public at large about the mission of the Conservancy and the issues, progress and performance it has made in reaching its strategic objectives.”³

TNC reported program expenses for this category of \$486,212,309, and program grants of \$34,472,290, for a total of program grants and expenses of \$520,684,599 for the 2001 fiscal year. The total of grants and expenses equaled the total program services expense reported on line 13, page 1, of TNC’s Form 990.

Earlier TNC’s Form 990 filings had contained more categories regarding this reporting requirement. TNC’s Forms 990 for its 1992 and 1993 fiscal years contained information regarding six categories: biological information management; conservation planning and implementation; stewardship, conservation, science and biological management; communications and outreach; training and support conservation partners; and government and multilateral programs. The number of categories was reduced to four for the 1994 through 1995 Forms 990 (stewardship, conservation science and biological information management; conservation planning and implementation; communications and outreach; and government/multilateral programs), and to three for the 1996 Form 990 (conservation activities and actions; communication and outreach; and government/multilateral programs). As stated above, TNC reduced the number of categories to two in 1997, and to one in 2001.

TNC took the position that TNC had only one program service - conservation activities and actions - to which all of TNC’s program service expenses related. By 2001, TNC made no distinctions among expenses incurred for any of its numerous and various conservation programs conducted throughout the world.

When TNC reported multiple categories of program services, it did not provide any detail regarding its accomplishments. No actual or estimated statistics regarding the number of persons benefited or served, habitat protected, or acres preserved, were provided in any of the Forms 990 filed by TNC with respect to 1992 through 2001. TNC’s reporting described general categories of expenses that generally would not assist a reader in understanding what TNC had accomplished through its program service activities.

³ An identical description was included in TNC’s Forms 990 for 1997 through 2000, except that TNC described the activities contained in the last sentence as “Communication and Outreach,” and separately listed program expenses and program grants for that category. Statements 10, TNC’s Form 990 (1997 through 2000) *see* Appendix L.

Part III of the current Form 990 asks the organization to be “clear, concise, and complete in your description. Avoid adding an attachment.” The Staff recognizes that this instruction may place organizations in the position of discerning whether to be expansive and complete in the description of their activities, and at the same time avoid lengthy descriptions and attachments that would give the IRS and public a complete picture of an organization’s activities. Staff encourages the IRS to consider the implications of the restriction on attachments and make appropriate changes to the form that will give organizations clear guidance consistent with the principal that the Form 990 serve as a valuable source of information for the public, state and local governments, and the IRS.

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TNC’s description of its program service accomplishments for that period was 18 pages in length, and included a narrative on mission, strategy, values and highlights of 2003 accomplishments (including a description of 16 specific projects), and a message from the organization’s President. TNC did not provide the required information regarding its four largest program services, however.

d. Part VI – Other Information

Part VI requires an organization to answer questions on various topics including whether it had any material changes to its activities.

1. Reporting changes in activities

Item 76 of Part VI of the Form 990 asks the organization “Did the organization engage in any activity not previously reported to the Internal Revenue Service? If ‘Yes,’ attach a detailed description of each activity.” The instructions require the organization to attach a statement to explain any significant changes in the kind of activities the organization conducts to further its exempt purpose, and to include new or modified activities not listed as current or planned in the organization’s application for recognition of exemption, or not yet reported to the IRS by a letter or by an attachment to the organization’s return for any earlier year.⁴

The IRS may revoke an organization’s 501(c)(3) status if there are substantial changes in the organization’s character, purposes, or methods of operation.⁵ In addition, an IRS ruling or determination letter recognizing exemption may not be relied upon if there is a material change inconsistent with exemption in the character, the purpose, or the method of operation of the organization.⁶

Observations

⁴ Instructions to IRS Form 990 (2003), p. 28.

⁵ Treasury Regulation section 1.501(a)-1(a)(2).

⁶ Treasury Regulation section 601.201(n)(3)(ii).

For its Forms 990 filed for fiscal years 1992 through 2000, TNC responded that it did not engage in any activity not previously reported to the IRS. TNC did not respond to the question in its Form 990 for its fiscal year 2001. TNC did not submit to the IRS any letters reporting a material change in its activities, or describing an activity not previously reported to the IRS, during the period 1992 through 2001.⁷

During fiscal years 1993 through 2002, TNC commenced several new activities that it had not previously reported to the IRS, and that were significant in terms of level of expenditure, investment, resources to be committed to the activity, innovative methods and strategies, or reputational risk to TNC. Some examples include the Virginia Eastern Shore Development project, the emissions arrangements, and the Conservation Beef program. Each of these activities involved new or innovative strategies or methods that were unlike TNC's activities that TNC previously had reported to the IRS.

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For its Form 990 filed for the fiscal year ended June 30, 2003, TNC responded "No" to the questions asking whether it had engaged in any activity not previously reported to the IRS, or made changes to its organizing or governing documents that were not reported to the IRS.

2. Reporting its relation to other organizations

Part VI, line 80, requires that the organization provide certain information regarding its relation to other organizations. The exempt organization is required to state whether it is related (other than by association with a statewide or nationwide organization) through common membership, governing bodies, trustees, officers, etc., to any other exempt or non-exempt organization, and if so, provide the name of the related organization and state whether it is exempt or non-exempt. The instructions state the organization is to answer "Yes" if "most (more than 50 %) of the organization's governing body, officers, directors, trustees, or membership are also officers, directors, trustees, or members of any other organization." The organization is to disregard any coincidental overlap of membership with another organization; that is, when membership in one organization is not a condition of membership in another organization.

Observations

TNC responded "Yes" to this question for each of its Forms 990 for fiscal years 1992 through 2001, and identified the following organizations as related for this purpose:

Nature Conservancy Action Fund (exempt)⁸ - 1992 through 2001

Sumner T. McKnight Foundation (exempt) - 1993

STM/TNC LLC (non-exempt) - 1994 through 2001⁹

⁷ TNC Narrative Response, dated November 23, 2004, *see* Appendix L.

⁸ The Nature Conservancy Action Fund is TNC's lobbying affiliate that is exempt under section 501(c)(4).

Adirondack Land Trust (exempt)¹⁰ - 1994 through 2001

VES¹¹ Sustainable Development Co. (non-exempt) - 1995 through 1999 (ceased operations in 1999)

Northway Corp. (non-exempt) - 1995 through 2001 (dissolved on January 16, 2003)

Dog Island Co. (non-exempt) - 1995 through 1996

Yayasan Pusaka Alam Nusantara (exempt)¹² - 1995 through 1997 (TNC withdrew in 1997)

Sustainable Forest Resources of PNG (non-exempt) - 1997 through 2001¹³

Montark, Inc. (non-exempt) - 1997 through 2001

Lake George Basin Land Trust¹⁴ (exempt) - 1997 through 2001

Lost Island Club Corp. (non-exempt) - 1998 through 1999, 2001 (dissolved in 2001)¹⁵

TNC San Rafael Ranch Inc. (non-exempt)¹⁶ - 1998 through 2001

TNC do Brasil (non-exempt) - 1998 through 2001

Clear Lake Club Corp. (exempt) - 1998 through 1999, 2001 (dissolved in 2001)¹⁷

PK Ranch Co. (renamed Soldier Creek Preserve, Inc.) (non-exempt) - 1999 through 2001

Delta Island Reclamation District (exempt)¹⁸ - 1999 through 2001

⁹ TNC did not state whether this organization was exempt or non-exempt in its 1994 Form 990.

¹⁰ Adirondack Land Trust is exempt under section 501(c)(3). TNC did not state whether this organization was exempt or nonexempt in its 1994 Form 990.

¹¹ "VES" stands for Virginia Eastern Shore.

¹² This organization was an Indonesian nonprofit entity.

¹³ This is a limited liability company of which TNC is the sole member (i.e., is a disregarded entity of TNC); TNC reports that it has never operated and has no assets, liability, or equity.

¹⁴ Legal name is Lake George Land Conservancy, Inc. It is exempt under section 501(c)(3).

¹⁵ Lost Island Club Corp. was not listed in the Form 990 for 2000.

¹⁶ Reported as a section 501(c)(2) organization beginning in 2000.

¹⁷ Clear Lake Club Corp. was not listed in the Form 990 for 2000. TNC filed no returns for it for 1998 or 1999, due to no activity, and a corporate tax return for it for 2000.

Albany Pine Bush Commission (exempt)¹⁹ - 1999 through 2001

Eastern Shore Enterprises LLC (non-exempt) - 2000 through 2001 (ceased operations in 2002)

Forest Bank LLC (non-exempt) - 2000 (dissolved November 2002)

Conservation Beef LLC (non-exempt) - 2000 (TNC withdrew from the LLC on February 19, 2004)

R & P Anderson Enterprises Ltd Partnership (non-exempt) - 2000²⁰

Association for Biodiversity Information (NatureServe) (exempt)²¹ - 2000 through 2001

Wilton Wildlife Preserve & Park (exempt)²² - 2000

Fundacion The Nature Conservancy of Panama (exempt) - 2000

TNC did include Lost Island Club Corp. and Clear Lake Club Corp. in its Form 990 for fiscal year 2000, and Forest Bank LLC, Conservation Beef LLC, Fundacion The Nature Conservancy of Panama, and Wilton Wildlife Preserve & Park, in its Form 990 for fiscal year 2001. One organization, Sustainable Forest Resources of PNG, should have been reported as a disregarded entity on Part IX of Form 990, because TNC was the sole member of this limited liability company. Clear Lake Club Corp. should not have been listed as exempt because, although it was a nonprofit, it was regarded by TNC as a taxable corporation and filed corporate tax returns. TNC Yayasan Pusaka Alam Nusantara should not have been reported as exempt for 1995 through 1997, because it was not exempt for United States Federal tax purposes.

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In its Form 990 for the fiscal year ended June 30, 2003, TNC reported eight new related organizations: Bear Mountain Lodge, Inc. (non-exempt), Conservation Farms & Ranches - Merced (non-exempt); P T Putri Naga Komodo, LLC (non-exempt); Conservation Farms & Ranches (Staten Island, CA) (501(c)(3)); Invasive Plant Council of NY State (501(c)(3)); The Nature Conservancy Limited (Australia) (exempt); The Nature Conservancy of Japan (exempt); and The Nature Conservancy of Venezuela (exempt). TNC continued to report the following as non-exempt related organizations: Conservation Beef, LLC; Eastern Shore Enterprises, LLC;

¹⁸ This is a California Special District.

¹⁹ This is a New York State public benefit corporation.

²⁰ TNC owns less than 2 percent of this financial investment limited partnership, an interest it received as a gift. TNC no longer reports this as a related organization.

²¹ This is a section 501(c)(3) organization.

²² Described as section 501(c)(3), recognized as exempt in 2001.

Forest Bank LLC; Montark, Inc.; Northway Corporation; Soldier Creek Preserve, Inc.; and Sustainable Forest Resources of PNG. TNC continued to report the following organizations as related and exempt: Adirondack Land Trust (501(c)(3)); Albany Pine Bush Commission; Fundacion The Nature Conservancy of Panama; Lake George Basin Land Conservancy, Inc. (501(c)(3)); The Nature Conservancy Action Fund (501(c)(4)); The Nature Conservancy San Rafael Ranch Inc. (501(c)(2)); and Wilton Wildlife Preserve & Park (501(c)(3)). TNC also reported The Nature Conservancy do Brasil as exempt in 2002 (rather than as non-exempt, as reported in earlier years).

In addition, TNC reinstated its reporting practice of including 19 separate title holding corporations in TNC's Form 990 on a consolidated basis, and listed each of the 19 organizations as a related exempt organization.

e. Part VII - Analysis of income-producing activities

Part VII of Form 990 requires the exempt organization to provide an analysis of its income-producing activities. The analysis requires the organization to list its different types of revenue, and then identify whether the revenue constitutes unrelated business income, income excluded from unrelated business income by sections 512 through 514, or related or exempt function income. For this purpose, related or exempt function income means "any revenue from activities related to the organization's exempt purpose; (i.e., income received from activities that form the basis of the organization's exemption from taxation)."

Observations

TNC reported program service revenue of over \$1.6 billion for fiscal years 1993 through 2003. Of this amount, approximately 58 percent was from sales of property to governments, and 28 percent was from fees and contracts from government agencies, for a total of 86 percent of program service revenue derived from activities involving Federal, State and local governments. Activity fees accounted for approximately 12 percent of total program service revenue for this period. A breakdown of TNC's types of program service revenue for its fiscal years 1993 through 2003 is contained in the following table.

**Table 12, Types of Program Service Revenue,
TNC Fiscal Years 1993 through 2003
(millions of dollars)**

Form 990 Year	Activity fees	Contract fees²³	Government sales	Sale of trade lands²⁴	Fees and contracts from govt. agencies	Royalty income²⁵	Total program service revenues
2002	22.3	4.7	172.6	0	72.8	0	272.4
2001	23.3	2.5	181.9	2.8	104.6	0	315.1
2000	35.8	2.0	83.0	0	63.1	0	183.9
1999	18.2	3.6	81.9	0	60.1	0	163.8
1998	25.4	1.4	78.6	0	48.5	0	153.9
1997	14.1	2.3	57.7	0	33.5	0	107.6
1996	17.8	1.7	44.5	0	40.5	0	104.5
1995	12.7	2.4	37.9	0	33.3	0	86.3
1994	7.9	1.7	45.9	0	Data NA	0	55.5
1993	8.7	1.4	70.0	0	Data NA	3.8 ²⁶	83.9
1992	12.0	0.9	76.3	0	Data NA	2.4	91.6
Total amounts for 1992 to 2002	198.2	24.6	930.3	2.8	456.4	6.2	1618.5
Totals as % of total program service revenue	12.2%	1.5%	57.5%	0.2%	28.2%	0.4%	100.0%

TNC's Form 990 reporting did not describe the nature of the activities from which these revenues were derived. TNC provided an "Analysis of Income-Producing Activities" schedule, and the following descriptions of these activities.²⁷ Activity fees consist of mitigation, multi-

²³ For certain years, also includes "preserve fees."

²⁴ TNC did not report trade land sales as program service revenue in years other than 2001. TNC averaged \$8 to \$10 million of gross sales from trade lands during this period. For years other than 2001, TNC reported trade lands revenue as "gains and losses from the sales of assets other than inventory" (Form 990, Part I, line 8a).

²⁵ After 1993, TNC reported royalties as income excludable from unrelated business income rather than as program service revenue.

²⁶ Includes both lease fees (e.g., grazing rights) and royalty fees.

²⁷ TNC Narrative Response, dated April 5, 2004, see Appendix L.

lateral development bank grant, fee-option assignment, hotel and lodging (excluding UBIT lodging), speaking/lecture fees, fee-meeting/field trip, data base user fee, and rent (excluding UBIT rent). Fees and contracts from government agencies included Federal government grants and overhead, and State and local grants and overhead. TNC provided no further information regarding contract fees.

In the December 2004 response, TNC stated that its “Analysis of Income-Producing Activities” schedule (previously provided in April 2004) includes the total amounts derived from a list of specific accounts in TNC’s general ledger financial system.²⁸ TNC attached an excerpt from its Chart of Accounts to more fully describe the nature of the revenue items included in each category. The full description is provided in Appendix L. The excerpt generally describes the items as follows:

Federal government grants and contracts: Grants, cooperative agreements, or contracts from Federal or Federal pass-through agency. Includes Federal funding of Heritage programs. Excludes sale of land to government.

Federal government indirect cost recovery on grants: Indirect cost recovery on a Federal or Federal pass-through agency grant, cooperative agreement, or contract. Includes Federal funding of Heritage programs. Excludes sales of land to government.

State/local government grants and contracts: State or local government grants, cooperative agreements, or contracts, for which the source of funding is truly at the State or local level and does not involve the pass-through of Federal funds. Excludes sales of land to government.

State/local government grants indirect cost recovery: Indirect cost recovery on a State or local government grant, cooperative agreement, or contract, for which the source of funding is truly at the State or local level and does not involve the pass-through of Federal funds. Excludes sales of land to government.

Foreign government/multilateral development bank grants: Grants, contracts, or contributions from foreign governments or multilateral development banks for international programs.

Mitigation fees: Receipts of mitigation monies, e.g., a corporation is ordered by law to give money to a conservation entity such as TNC to make up for environmental damages caused by that corporation. Includes revenue received from contracts signed under the Joint Implementation Treaty for carbon mitigation.²⁹ Also includes mitigation bank revenue.

²⁸ TNC Narrative Response dated December 22, 2004, *see* Appendix L.

²⁹ The Staff notes that TNC states that it reports payments under emissions agreements as contributions.

Fee-contract: Fee for service provided by TNC under contract or memorandum of understanding to a private entity or person. Also includes private matching donation part of NFWF³⁰ or other government payments to TNC where donor on receipt is unknown.

Fee-contract overhead recovery: Overhead recovery portion of fee for service by TNC under contract to a private entity or person.

Fee-option assignments/assists: Reimbursement to TNC for transfer of option to purchase real estate and any associated fees charged by TNC for handling the option. Includes fees for assists (land projects in which TNC is not in the chain of title).

Hotel and lodging: Income received for the use of TNC lodging facilities (guest ranch, conference center, etc).

Speaking/lecture fees: Receipt of fees or reimbursement paid by outside organization to TNC for staff to give lecture, attend seminar, participate in panel or committee, etc., including reimbursement for reports and other products and travel, not covered under formal grants and contracts. Also includes miscellaneous fees, e.g., photo contest. Also includes jury duty recovery payments.

Lease and rent: Receipts from property leases or rents. Includes leases for real estate, grazing, hunting, gas, oil, water, timber, and easements.

Fee-meetings: Receipts from TNC-sponsored meetings, such as board meetings. Does not include receipts from special fund raising events such as dances, raffles, craft fairs, or sporting events.

Fee-field trips: Receipts from TNC-sponsored field trips. Does not include receipts from special fund raising events such as dances, raffles, craft fairs, or sporting events.

Data base user fee: Fees for the use of TNC data base, such as Biological and Conservation Data System.

Related or exempt function income

TNC listed various types of related or exempt function income on its Form 990 for 1992 through 2001. The most common categories included: activity fees, contract fees, government sales, fees and contracts from government agencies, and miscellaneous income. At various times, TNC also reported as program service revenue the gain or loss on the sale of tradelands (2001 Form 990 only), and preserve fees.

Income excluded from unrelated business income

On its Form 990, Part VII for 1992 through 2001, TNC reported various categories of revenues as excluded from unrelated trade or business income by sections 512 through 514,

³⁰ The Staff presumes "NFWF" refers to the U.S. National Fish & Wildlife Service.

including lease or royalty fees; interest and dividend income; rental income from real estate; gain or loss from sales of assets other than inventory; and net income from special fundraising events.

Unrelated trade or business income

TNC reported lease or royalty fee income as unrelated business income in its 1992 Part VII. TNC reported no unrelated business income on its Form 990, Part VII, for 1993 through 1997. On its Form 990, Part VII for 1998 through 2001, TNC reported unrelated business income or loss from lease or royalty fees, dividends and interest from securities, debt-financed rental income from real estate, rental income from real estate, inn income or loss, and income or loss from special events.³¹

Unrelated business income is also reported on Form 990-T.³² For 1998, TNC reported unrelated business income of \$452,679 on Part VII, and a loss of \$166,303 on Form 990-T.³³ For 1999, TNC reported unrelated business income of -\$74,611 on Part VII, and -\$78,902 on Form 990-T. TNC's unrelated business income reported on Part VII of Form 990 equaled the net unrelated business income amount it reported on Form 990-T for each of 2000 and 2001.

The Staff did not examine whether TNC accurately reported the amounts or types of its income-producing activities for these reporting periods. The Staff also did not attempt to reconcile the difference between TNC's reporting of unrelated business income for purposes of Part VII and the Form 990-T for 1999.

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There was no material change in TNC's reporting of this item for this period.

f. Part VIII - Relationship of Activities to the Accomplishment of Exempt Purposes

Part VIII of Form 990 requires that the organization give a brief description of how an activity reported as generating related or exempt function income specifically contributed to the accomplishment of the organization's exempt purposes. For example, an organization that operates a school for the performing arts and that charges admission at student performances might report admission income as related or exempt function income and explain in Part VIII that performances before an audience were an essential part of the students' training and related to the exempt purpose of the organization.

³¹ The classification of revenues as unrelated business income for Form 990, Part VII, differ from that as reported for purposes of Form 990-T filings. Part VII of Form 990 generally classifies revenues by type of activity, whereas Form 990-T sometimes classifies revenues by source (e.g., income or loss from partnerships and S corporations).

³² Unrelated business income tax is calculated and paid with the filing of a Form 990-T.

³³ Part VII reported unrelated trade or business revenues before any reduction for expenses. Form 990-T reported income of \$452,679 and expenses of \$618,982, for a net loss from unrelated trade or business activity of \$166,303. TNC changed its Part VII reporting in 1999 to report revenues on a net (rather than gross) basis, after a reduction for allocable expenses, making it more consistent with its Form 990-T reporting.

Observations

On its Forms 990 for 1992 through 2001, TNC provided a statement describing the accomplishment of exempt purposes for Part VIII.

In its Form 990 for fiscal year 1992, TNC stated the following:

“Activities Fees - This includes revenues from seven [sic] separate types of activity: mitigation fees, lodging operations, speaking/lecture fees, fees from meetings and field trips, conservation science data base user fees, and leases and rents associated with the management of protected areas. All these activities are directly related to the Conservancy’s programs which contribute to the protection of biodiversity.

Royalty Fees - The Conservancy receives royalty fees from the sale of published items and other merchandise, which bears the Conservancy’s logo or name. The publications and other items are all related to the communication of conservation issues and the Conservancy’s programs.

Contract Fees - The Conservancy receives fees for the management of protected areas on behalf of private and public organizations. Contract fees are also received for managing and collecting scientific information for the Conservancy’s science heritage programs.

Preserve Fees - The Conservancy derives fees, usually paid on a voluntary basis, from public visitation and use of certain of its nature preserves.

Sale of Land to Government and Other Conservation Agencies - The Conservancy undertakes conservation projects involving land acquisition with government agencies and other non-profit organizations. The Conservancy sells and donates conservation land to the government and other conservation agencies for future management subject to restrictions and agreements to insure the on-going protection of these areas.

Sale of inventory - The Conservancy derives revenues from the sale of low cost merchandise, which is intended to communicate information on conservation.

Miscellaneous Income - The Conservancy derives revenues from various sources in conducting the normal business operations to support its fundamental exempt purpose of preserving, protecting, conserving, and managing natural habitat, and educating the public about these matters.

Loss on tradelands - The Conservancy sells certain real property, which has little ecological value, and uses the proceeds to support the acquisition of sites which contribute to the protection of biodiversity.

Gain and Losses - Represents gains and losses from the sale of equipment and stock used in maintaining and cultivating conservation property.”

TNC subsequently modified its descriptions of these activities for purposes of reporting for Part VIII. TNC no longer separately reported royalty fees in Part VIII beginning in 1994 (it

combined this with sales of inventory), gains and losses on equipment or stock in 1993, or preserve fees beginning in 1999.³⁴ TNC's descriptions of activity fees, contract fees, and government sales revenue, were revised in 1993 and 1994 to the identical formats that have been used through 2001. TNC added a description for fees and contracts from government agencies in its Form 990 for fiscal year 1995.³⁵

In its Form 990 for fiscal year 2001, TNC stated the following with respect to accomplishment of exempt purposes:

“ACTIVITY FEES - The Conservancy derives revenues from fees paid by a variety of activities associated with meetings and educational conferences on Conservancy property, which are related to the Conservancy's purpose to promote conservation and proper use of natural resources.

CONTRACT FEES - The Conservancy provides information, data, and consulting related to biological conservation science, and protected areas design and management to private organizations. This information assists these organizations in planning, implementing, and managing Conservancy programs which furthers the exempt purpose goals of the Conservancy.

GOVERNMENT SALES REVENUE - The Conservancy derives revenues from the sale of land to federal and local governments for use by these as parklands and other recreational and natural preserves in the interest of preservation, protection, and conservation of natural habitat.

FEES AND CONTRACTS FROM GOVERNMENT AGENCIES - The Conservancy provided information, data, and consulting related to biological conservation science and protected areas design and management to various government agencies.

SALE OF INVENTORY - The Conservancy derives revenues from the sale of low cost merchandise and memorabilia containing the Conservancy's logo which further promotes the educational goals of the Conservancy.

MISCELLANEOUS INCOME - During the course of operations, the Conservancy derives revenues from various sources which support its fundamental exempt purpose of preserving, protecting, conserving, and managing natural habitat, and educating the public about these matters.”

Although TNC reported income of \$2.8 million from the sale of tradelands for 2001, TNC did not describe this activity in its statement relating to Part VIII.

³⁴ In its Form 990 for fiscal year 1998, TNC's statement regarding accomplishment of exempt purposes also contained the following: “PRESERVE FEES - The Conservancy derives fees paid, usually voluntarily, for entry to certain of its preserves. Providing access to preserves increases public awareness and support for the Conservancy's conservation mission.”

³⁵ Prior to 1995, TNC reported fees and contracts from government agencies as government contributions and grants, rather than as program service revenue, and did not describe the activity on its return. TNC's description of fees and contracts from government agencies has been identical since 1995.

TNC's earlier Statements of Accomplishments were more specific, for example, its description of activity fees used to include references to hotel and lodging fees. Later statements combined several of the earlier categories in a way that does not clearly describe the accomplishments. In one case, TNC did not describe one category for which it provided a description in its 2001 Form 990 (i.e., sale of tradelands).

TNC's statements tend to be conclusory, rather than descriptive, in terms of explaining how these activities help TNC accomplish its exempt purposes. The instructions require TNC to explain how the activity "significantly contributed to accomplishing the exempt purpose." However, TNC's recent descriptions of activity fees³⁶ and contract fees³⁷ make these activities seem commercial in nature. TNC's description of government sales revenue does not describe how selling land to governments for use as parklands or preserves actually furthers TNC's exempt purposes. TNC's description of fees and contracts from government agencies raises the question of whether TNC is deriving consulting services income that should be taxed as unrelated business income. The TNC also does not explain how miscellaneous income furthers TNC's exempt purposes.

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TNC's reporting of exempt purpose accomplishments was identical to that for the prior period, with two additional items reported. The fiscal year 2002 description of activity fees referred to mitigation fees (as had been the case in 1992). In addition, the fiscal year 2002 description of contract fees included a paragraph referring to sales of conservation real estate to a government agency.

g. Part IX - Reporting Information Regarding Taxable Subsidiaries and Disregarded Entities

Part IX of Form 990 requires the organization to provide certain information regarding taxable subsidiaries and disregarded entities.³⁸ Specifically, the organization is to provide the name, address, and employer identification number (EIN) of each taxable corporation or partnership and each disregarded entity in which the organization held a 50% or greater interest at any time during the year. If a disregarded entity does not have its own EIN, the organization

³⁶ The mere fact that TNC receives "activity fees" for "activities associated with meetings and educational conferences on Conservancy property" does not mean those activities further TNC's exempt purposes.

³⁷ TNC's description of contract fees does not make clear how providing "information, data, and consulting related to biological conservation science, and protected areas design and management to private organizations" to assist private organizations "in planning, implementing, and managing Conservancy programs" actually furthers TNC's exempt purposes.

³⁸ A business entity that has a single owner and that is not a corporation may be disregarded as an entity separate from its owner for Federal tax purposes under the "check-the-box" entity classification regulations. Treasury Regulation sections 301.7701-1 through -4. Such an entity is a "disregarded entity." Part IX of Form 990 was revised in 1999 to require reporting of disregarded entities, in addition to taxable subsidiaries.

is to state that it uses the organization's EIN. The organization also is to report the total income and end-of-year total assets of the corporation, partnership, or disregarded entity in Part IX.

On its Form 990 for 1993 through 1995, TNC reported no taxable subsidiaries on Part IX of Form 990. TNC reported the following taxable subsidiaries or disregarded entities in its Part IX during 1996 through 2002:

Northway Corporation - 1995 through 2001 (dissolved on January 16, 2003)

Dog Island Company - 1995 through 1996

Montark, Inc. - 1997 through 2001

San Rafael Cattle Co. - 1998 through 2000³⁹

PK Ranch (renamed Soldier Creek Preserve, Inc.) - 1999 through 2001

Clear Lake Club, Inc. - 2000 through 2001

Lost Island Club Corporation - 2000 through 2001

Forest Bank LLC - 2001⁴⁰

Conservation Beef LLC - 2001

STM/TNC LLC - 2001

Eastern Shore Enterprises, LLC - 2001⁴¹

TNC did not include Virginia Eastern Shore Sustainable Development Corporation (VESC) as a taxable subsidiary at any time prior to the corporation's dissolution in 1999. TNC obtained control of the board of directors of VESC on July 17, 1996, and attained majority ownership of all of the shares of the corporation's stock on March 11, 1998. Based on records provided by TNC to the Committee, TNC was a majority shareholder of this corporation for taxable subsidiary reporting purposes no later than March 1998. It appears that TNC should

³⁹ TNC reported as an exempt title holding corporation for 2001.

⁴⁰ TNC reported its ownership interest in Forest Bank LLC as 10 percent of Class M and A shares. At this time, however, TNC was the only owner of membership interests in Forest Bank LLC. TNC was listed as the owner of 100 percent of the profits, losses, and capital on Schedule K-1 (Form 1065) for the LLC's 2001 taxable year.

⁴¹ TNC reported its ownership interest in Eastern Shore Enterprises LLC as 100 percent, making TNC the sole owner of the entity at this time. This LLC was formed in 1999, and had owners other than TNC from its inception. TNC's stated percentage interest under the LLC's initial operating agreement was 91 percent. TNC's Schedule K-1 (Form 1065) for 2000, 2001, and 2002, showed TNC's ownership interest ranging from 91 percent to 100 percent. Eastern Shore Enterprises LLC filed partnership tax returns for 2000 through 2002. It dissolved in October 2002. It is unclear whether TNC regarded Eastern Shore Enterprises LLC as a disregarded entity, or as an association taxable as a corporation, once the LLC ceased to be a tax partnership upon TNC's becoming the sole member. TNC reported to the Committee that the LLC was terminated with the Commonwealth of Virginia in 2002.

have reported VESC as a taxable subsidiary for its 1997 Form 990, once it acquired majority ownership of the VESC stock in March 1998, and should have continued to report VESC as a taxable subsidiary until VESC dissolved and liquidated in October 1999 (i.e., for TNC's 1998 and 1999 Forms 990).⁴²

TNC did not include Eastern Shore Enterprises, LLC as a taxable subsidiary or disregarded entity for 1999 or 2000. TNC was a majority owner of this LLC from its formation on October 15, 1999, until the LLC dissolved in October 2002.

TNC did not report Sustainable Forest Resources of PNG-US, LLC, as a disregarded entity on this schedule for any of the years it has been in existence (1997 and thereafter).⁴³

Based on records provided by TNC to the Committee, TNC acquired all of the membership interests of Clear Lake Club, Inc., a taxable nonprofit hunting club, from its former members in 1998. TNC did not report this organization as a taxable subsidiary for 1998 and 1999. The organization was dissolved in 2001. TNC was reported as the 100 percent owner of the club on the Form 1120 filed by the corporation for the period beginning January 1, 2000, and ending July 31, 2001. The club included 18 months of activity in its final corporate income tax return.

Based on records provided by TNC to the Committee, TNC acquired all of the membership interests of Lost Island Club, Inc., a for-profit hunting club, in 1998. TNC did not report this organization as a taxable subsidiary for 1998 and 1999. The organization was dissolved in 2001.⁴⁴

TNC did not report Conservation Beef, LLC as a taxable subsidiary for 1999 or 2000, despite its ownership of a 50 percent membership interest in the LLC from its inception in October 1999 until it withdrew from the LLC in February 2004.

TNC did not report Forest Bank, LLC as a taxable subsidiary or disregarded entity for its 2000 fiscal year. The LLC was formed in January 2001, and TNC owned the entire interest of the LLC from its inception until it was dissolved in November 2002.

TNC did not report TNC do Brasil, a non profit Brazilian corporation that conducts TNC activities in Brazil, as a taxable subsidiary. Based on records provided by TNC to the Committee, TNC controls 100 percent of this entity through 100 percent control of its board. TNC do Brasil is not recognized as tax exempt by the IRS, and is reported as non-exempt by TNC on TNC's schedule of related organizations.

⁴² TNC was not listed as an owner of 50 percent or more of the corporation's stock on the corporate tax returns filed by VESC for 1996 through 1999.

⁴³ TNC reported this organization as a related organization, however, on its schedule for related organizations.

⁴⁴ TNC was reported as the 100 percent owner of the club on each of the corporate tax returns filed by the corporation for 1998 through 2001.

It is unclear why TNC reported STM/TNC LLC as a taxable subsidiary in 2001. TNC had owned a 35 percent ownership in the LLC during the period 1993 through 2001, and did not report the organization as a taxable subsidiary prior to 2001.

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TNC reported 10 organizations as taxable subsidiary corporations, partnerships or disregarded entities on its Form 990 for the fiscal year ended June 30, 2003. These included four newly reported organizations: Sustainable Forest Resources of PNG-US, LLC (100%); Conservation Farms and Ranches-Merced (100%); Bear Mountain Lodge, Inc. (100%, but to be dissolved in 2004); and Putri Naga Komodo JV (100%). TNC also reported Montark, Inc. (100%); Soldier Creek Preserve, Inc. (100%); Northway Corporation (100%, but dissolved in 2003); Forest Bank LLC (100%, but dissolved in 2003); Conservation Beef (50%); and Eastern Shore Enterprises, LLC (91%, but dissolved in 2003).

II. Form 990 – Schedule A

In their annual returns on Schedule A of Form 990 or 990-EZ, section 501(c)(3) organizations must disclose information regarding their direct or indirect transfers to, and other direct or indirect relationships with, other section 501(c) organizations (except other section 501(c)(3) organizations). This requirement helps prevent the diversion or expenditure of a section 501(c)(3) organization's funds for purposes not intended by section 501(c)(3). All such organizations must maintain records regarding all such transfers, transactions, and relationships.

a. Statements of Activities with Related Parties

Part III, Question 2 of Form 990, Schedule A, requests whether during the year, the organization, either directly or indirectly, engaged in any of the following acts with any substantial contributors, trustees, directors, officers, creators, key employees, or members of their families, or with any taxable organization with which any such person is affiliated as an officer, director, trustee, majority owner, or principal beneficiary: (1) sale, exchange, or leasing of property; (2) lending of money or other extension of credit; (3) furnishing of goods, services, or facilities; (4) payment of compensation (or payment or reimbursement of expenses if more than \$1,000); or (5) transfer of any part of its income or assets. If the organization entered into any of such transactions, then the organization is required to attach a detailed statement explaining the transactions.

Observations

TNC reported numerous transactions involving a TNC board member, or a company which was affiliated with a TNC board member.

Sale, exchange, or leasing of property

TNC reported "Yes" to this question for each fiscal year from 1992 through 2001. TNC generally reported in the Form 990 schedules whether the board member recused himself or herself from participating in or voting on the transaction.

TNC reported various arrangements with companies of which TNC board members were officers, directors, or principals. These included: (1) rental of membership mailing lists by General Motors Corporation from TNC reportedly at fair market value (1993); (2) agreements by General Motors Corporation to provide cash, vehicles, potential gifts of land, data systems equipment, and other miscellaneous assets to TNC (1993 through 2001); (3) an arrangement with AOL Enterprises pursuant to which TNC was a content provider on AOL and maintained a forum that provided information regarding TNC's work (1995); (4) a contract with S.C. Johnson Wax which permitted the company to use TNC's trademark in a national product promotion in exchange for \$100,000 (1995);⁴⁵ (5) the acquisition by TNC of 1,000 acres of land from an affiliate of Georgia Pacific reportedly at fair market value (1996); (6) the acquisition by TNC of property from Quentin Corporation (1996); (7) an arrangement with the Orvis Company pursuant to which the company conducted general activities on TNC property (Mays Pond) and sold fly fishing tackle to one of TNC's programs (Belize Program) (1996); (8) an arrangement with Discovery Communications, Inc. pursuant to which TNC, in cooperation with the National Audubon Society, licensed TNC's name and logo to Discovery Communications for use in connection with a television series, and TNC and National Audubon Society received royalty rights, credits, and certain other programming rights with respect to the series in exchange for providing funding and editorial consulting services to the series (1997);⁴⁶ (9) an acquisition by TNC of 1,108 acres from a Georgia Pacific affiliate; (10) the acquisition by TNC of computer upgrades and purchases from Cisco Systems, Inc. at a substantial discount (1998-2001);⁴⁷ (11) the acquisition by TNC of a conservation easement covering approximately 1,622 acres from an affiliate of The Orvis Company, Inc. (1998); (12) the acquisition by TNC of approximately 14,959 acres of land from two separate affiliates of Georgia Pacific (1999);⁴⁸ (13) an agreement with General Motors Corporation "to undertake a climate change project under which TNC received \$10 million and General Motors may potentially receive greenhouse gas mitigation offsets" (1999);⁴⁹ (14) the retention of a law firm of which a board member is a partner for

⁴⁵ This agreement was extended in 1996 for an additional year and added two royalty streams paid by the company to TNC. Also, in its 1998 Form 990, TNC reported that S.C. Johnson & Son, Inc. "paid \$100,000 to The Nature Conservancy in a promotion."

⁴⁶ This agreement was modified in 1998 to grant Discovery Communications permission to use TNC's name to promote the Discovery Channel credit card, in exchange for revenues generated from the card. The terms of credit card deal were not disclosed.

⁴⁷ TNC reported that "[b]efore any orders are placed Mr. Morgridge [the TNC board member and chairman of Cisco Systems, Inc.] reviews the order and approves the discounts." In its 2001 Form 990, TNC stated that it paid a total of \$145,477 to Cisco Systems, Inc. for the following transactions: "From July 2001 to around March/April 2002 the arrangement was: 1) CISCO gives TNC an automatic 30% off their list price[;] 2) TNC purchases its equipment DIRECTLY from CISCO[; and] 3) TNC submits to Mr. Morgridge the amount paid to CISCO[.] This resulted in an effective 76% discount from list to TNC."

⁴⁸ One of the purchases was for \$7.5 million. The price of the other purchase was not disclosed.

⁴⁹ TNC reported that Mr. Smith, the Chief Executive Officer and Chairman of General Motors as well as a TNC board member, did not participate or vote on said transactions. This is inconsistent with records provided by TNC to the Committee, including a Conservation Committee vote record which showed Mr. Smith approved the transaction, and a copy of the agreement which showed Mr. Smith signed the agreement on behalf of General Motors Corporation and GM's Brazilian affiliate.

certain legal services (2000);⁵⁰ (15) payment of a \$1,200 consulting fee to a board member for his attendance at a two-day sustainable conservation seminar (2000); (16) the acquisition by TNC of an integrated forestry management system from a subsidiary of Georgia Pacific for \$65,000 plus a user fee that was half the current market price for the fee (2001); and (17) the acquisition by TNC of numerous personal property items from The Orvis Company, Inc. at a 40% discount (2001).

TNC also reported on its 1996 Form 990 a transaction with a Procter and Gamble affiliate, Millstone Coffee. Mr. John Sawhill, TNC's President and Chief Executive Officer at the time, was also a board member of Procter and Gamble. Under the agreement, TNC granted Millstone the rights to use TNC trademarks on licensed product packaging, advertisements, point-of-purchase displays, and other material. The license was exclusive for whole bean coffee for a five-year term. Millstone was to pay TNC royalties of a minimum of \$400,000 over five years plus two percent of net sales of licensed product. The agreement was not reported in the 1997 Form 990. TNC reported this transaction on the Forms 990 for each of 1998 through 2000, though the description of the licensed product changed somewhat in the 1998 report.⁵¹

TNC reported acquisitions of real estate and conservation easements in transactions involving TNC board members in various years. A 1993 transaction involved a sale by a board member of his ranch to a third party, who in turn sold a portion of the ranch to TNC and gave TNC a conservation easement on a portion of the acreage retained by the third party. Another 1993 transaction involved the sale by TNC of land to an affiliate of one of TNC's board members, subject to the legal condition that most of the acreage be donated back to TNC for conservation purposes. A 1997 transaction involved the purchase of property by TNC from a board member for the property's original purchase price. In 2000, an affiliate of one of TNC's board members donated a conservation easement to TNC reportedly valued at \$3.95 million.

Lending of money or other extension of credit

None reported prior to 2001.

In 2001, TNC reported loan receivables from Stephen McCormick (President and Chief Executive Officer of TNC), Graham Chisholm, John Wiens and Beatrice Van Horne (TNC managers), all relating to the financing of acquisitions of principal residences.

Furnishing of goods, services, or facilities

TNC reported arrangements during 1992 and 1993 with companies of which TNC board members were officers. Some of these arrangements included free office space use by TNC, reductions in consulting expenses provided to TNC, or free use of various real or personal property by TNC. Others involved arrangements awarded through competitive bidding, or other arrangements reportedly made at fair market value.

⁵⁰ TNC reported that it also negotiated with a client of this firm for the acquisition by TNC of certain real estate.

⁵¹ TNC reported the same transaction twice on the 1998 report because it had two P&G officers on the TNC Board at that time (Messrs. Sawhill and Jager).

Payment of compensation (or payment or reimbursement of expenses if more than \$1,000)

TNC reported compensation, fringe benefit, and expense account and other allowances information regarding its officers and regional directors, for all fiscal years from 1992 through 2001.

For each of the years 1992 through 2001, TNC reported that no compensation, contributions, expense accounts, or other benefits were received by any members of the TNC Board of Governors.

Transfer of any part of its income or assets

None reported.

TNC reported numerous transactions involving board members, or companies with which TNC board members were affiliated. The Committee did not attempt to determine whether TNC regularly disclosed all transactions involving board members or officers, and limited its review to those transactions that were disclosed by TNC on the Forms 990.⁵² Often TNC's description of the disclosed transaction provided sufficient detail to disclose the material aspects of the transaction. In several instances, however, TNC's description did not provide a clear and complete picture of the nature of the transaction. Examples include TNC's description of the agreement with General Motors Corporation regarding emission credit offsets, and the arrangement with Cisco Systems, Inc. pursuant to which TNC received discounts on purchases.⁵³ The description of the Cisco Systems, Inc./Morgridge transaction in the 2001 Form 990 did not mention the involvement of the Morgridge Foundation. Another example is that of the S.C. Johnson, Inc. transaction in the 1998 Form 990, which states that the company paid TNC \$100,000 "in a promotion."

TNC's description of the General Motors Corporation emissions arrangement fell short of even the most minimal standard of reporting and disclosure. TNC's disclosure regarding this arrangement consisted of the following: "General Motors signed an agreement with TNC to undertake a climate change project under which TNC received \$10 million and General Motors may potentially receive greenhouse gas mitigation offsets. Mr. Smith did not participate or vote on said transactions." The General Motors Corporation emissions arrangement is a complex 35-

⁵² In response to a question from the Committee, TNC stated that "[t]o the best of our knowledge, all transactions involving a corporation with an executive serving on The Nature Conservancy's Board of Governors at the time of the transaction are set forth in the Conservancy's 990s, previously supplied to the Committee." TNC SFC II Response, XIV. Transactions With Board Members, April 2004, Question 2. Appendix K contains a copy of the relevant schedules from TNC's Forms 990 for its fiscal years 1992 through 2001. In addition, Appendix K contains a copy of information provided by TNC to the Committee in response to a request regarding TNC transactions with three companies of which company officers were members of TNC's Board of Governors or Leadership Council: Georgia Pacific Corporation, International Paper Company, and Orvis Services Company. It appears that one of the transactions included in the supplemental information should have been disclosed in the Form 990 (1999). TNC Narrative Response, Transactions With Board Members, questions 1b and 1c (acquisition of 1807.70 acres from Georgia Pacific Company for \$406,732 on September 27, 1999), dated April 23, 2004, see Appendix K.

⁵³ The Cisco Systems and General Motors transactions are discussed in Part Three of this Report.

page agreement involving a 40-year relationship among four parties, and is difficult to describe easily.⁵⁴ In particular, TNC failed to characterize the nature of the arrangement among General Motors, TNC, and their respective Brazilian affiliates (e.g., as a management services agreement, joint venture, charitable contribution, or other arrangement) or the nature of the activity (e.g., a description of what is meant by a climate change project and whether it was a conservation project consistent with TNC's exempt purposes), and to disclose that TNC ceded certain of its operational control unrelated to the project, as well as the value of all emissions credits to be generated by the project, to General Motors Corporation. Further, TNC's statement that Mr. Smith "did not participate or vote on" the General Motors Corporation emissions offset agreement is misleading and inaccurate. TNC records provided to the Committee show that Mr. Smith voted on the transaction as a member of TNC's Conservation Committee, and executed the agreement on behalf of General Motors Corporation and GM's Brazilian affiliate. Perhaps TNC only meant to say that Mr. Smith did not participate or vote on the transaction as a member of the TNC Board of Governors. Regardless of TNC's intentions, TNC should have disclosed that Mr. Smith voted on the transaction as a member of TNC's Conservation Committee, recused himself from voting on the transaction as a TNC Board member, and executed the agreement on behalf of General Motors Corporation and GM's Brazilian affiliate.

In other instances, TNC failed to disclose the amount of consideration received or paid by TNC in the transaction, or whether the amount paid or received reflected fair market value. For example, TNC did not disclose the value of the items provided by General Motors Corporation to TNC pursuant to the ongoing agreement for cash, vehicles, and other assets.

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Sale, exchange, or leasing of property

TNC reported three separate items in this category for the fiscal year ended June 30, 2003: (1) receipt of \$59,000 from Orvis for licenses to conduct two experimental ecotourist fishing trips to TNC's Paylmyra Atoll property; (2) the purchase by TNC of computer equipment directly from Cisco Systems, Inc. for \$8,366; and (3) the five year cash, vehicle and miscellaneous asset agreement with General Motors, and the \$10 million greenhouse gas mitigation offset arrangement with General Motors.⁵⁵

Lending of money or other extension of credit

TNC reported that a note receivable from the President and CEO in the amount of \$1,550,000 was repaid in full on April 25, 2003.

Furnishing of goods, services, or facilities

⁵⁴ The explanation provided to the TNC Board of Governors was a three page summary and a one page budget plan. The preliminary project plan was 26 pages in length. The forms of agreement between TNC and TNC's Brazilian nonprofit affiliate were 8 pages in length.

⁵⁵ TNC again reported that Mr. Smith did not participate in or vote on said transactions.

None reported.

Payment of compensation (or payment or reimbursement of expenses if more than \$1,000)

TNC reported compensation, fringe benefit, and expense account and other allowances information regarding its officers and regional directors, for fiscal year 2002.

Transfer of any part of its income or assets

None reported.

b. Transactions and Relationships with Noncharitable Exempt Organizations

Part VII of Form 990, Schedule A, requires the organization to provide certain information regarding transfers to, and transactions and relationships, with noncharitable exempt organizations, including the following: (1) transfers from the organization to a noncharity of cash or other assets; (2) sales or exchanges of assets with a noncharity; (3) purchases of assets from a noncharity; (4) rental of facilities, equipment, or other assets; (5) reimbursement arrangements; (6) loans or loan guarantees; (7) performance of services or membership or fundraising solicitations; or (8) sharing of facilities, equipment, mailing lists, other assets, or paid employees. If the organization engaged in any of such transactions, it is required to complete a schedule providing the amount involved, the name of the noncharity, and a description of transfers, transactions, and sharing arrangements. Part VII also requires the organization to describe any relationship it has pursuant to which it is directly or indirectly affiliated with, or related to, one or more exempt organizations that are not charities.

Transfer of cash or other assets to a noncharity

TNC reported that it transferred cash (but not other assets) to its exempt lobbying organization, The Nature Conservancy Action Fund, for fiscal years 1993 through 2003, and to certain other lobbying organizations in 2002 and 2003.

TNC did not report any of the following activities for during this time:

- Sales or exchanges of assets with a noncharity
- Purchases of assets from a noncharity
- Rental of facilities, equipment, or other assets
- Reimbursement arrangements
- Loans or loan guarantees
- Performance of services or membership or fundraising solicitations

Direct or indirect relationships with exempt organizations that are not charities

TNC reported its relationship with The Nature Conservancy Action Fund, its lobbying organization exempt under section 501(c)(4), for fiscal years from 1993 through 2003. TNC did

not report relationships with any other noncharitable exempt organizations with respect to these periods.

Sharing of facilities, equipment, mailing lists, other assets, or paid employees

TNC reported that it paid for administrative support services of, and provided administrative support services to, its exempt lobbying organization, for fiscal years 1993 through 2003.

c. Reporting of certain corporate subsidiaries on a consolidated basis

Explanation of reporting requirement

Section 1504(e) provides that two or more organizations exempt from taxation under section 501, one or more of which is described as a title holding corporation within section 501(c)(2), and the others of which derive income from such corporation, shall be considered as includible corporations for the purpose of the application of the consolidated return filing rules.

A parent organization and one or more of its subsidiaries may file a group return on a Form 990 if certain conditions are satisfied. In order to file a group return, the subsidiary must, among other things, be exempt from tax under a group exemption letter that is still in effect.⁵⁶

Observations

TNC included a number of controlled corporate entities in its Form 990 on a “consolidated basis” for several of its reporting years.⁵⁷ Initially, TNC reported that these controlled entities were formed for the sole purpose of passively holding title to land (and engaging in no other activity), apparently as title holding corporations within section 501(c)(2). In its 1999 Form 990, TNC stated that these entities were established for business and legal reasons which assist TNC in accomplishing its corporate goals in various states, with goals and objectives identical or quite similar to those of TNC.

The Staff did not review whether these entities properly were included in TNC’s Forms 990 as title holding corporations that could be reported on a consolidated basis under section 1504(e). The Committee did request that TNC provide an explanation regarding why it changed its reporting of such entities beginning in its 2000 Form 990.⁵⁸ TNC responded:

“As disclosed on Statement 22 of the Forms 990’s for the years ended June 30, 1993 through June 30, 2000, TNC reported between 19 and 21 corporate subsidiaries on a

⁵⁶ Treasury Regulations section 1.6033-2(d); Instructions to IRS Form 990, pp. 13-14.

⁵⁷ TNC listed between 19 and 21 separate wholly-owned corporate subsidiaries as being included in its Form 990 for fiscal years 1992 through 1999. TNC discontinued the practice of reporting these corporations in a consolidated Form 990 for its 2000 Form 990.

⁵⁸ The Committee requested TNC provide information regarding TNC’s reporting changes with respect to these organizations. SFC Letter to TNC, Question 22, dated October 27, 2004, *see* Appendix B.

consolidated basis. On Form 990 for the year ended June 30, 2001, the corporate subsidiaries were again reported on a consolidated basis. However, the Statement 22 disclosure inadvertently omitted the language relating to the consolidated reporting for this year. These corporate subsidiaries represent the state corporations covered by TNC's group exemption ruling and are not corporations described within IRC section 501(c)(2) that are includible corporations within the meaning of IRC section 1504(e)."⁵⁹

⁵⁹ TNC Narrative Response, dated January 14, 2005, *see* Appendix L.

III. Form 990-T

1. Summary of UBIT Reporting

TNC provided the Committee its Forms 990-T, *Exempt Organization Business Income Tax Return*, for fiscal years 1999 through 2003. Although the Staff did not review any Form 990-T filings made by TNC prior to this period, the Staff did review TNC's unrelated business taxable income information as reported on TNC's Forms 990 for earlier periods. Based on these reports, TNC paid no unrelated business income tax for fiscal years from 1993 through 2001, and paid unrelated business income tax of approximately \$214,000 for fiscal years 2001 and 2002.⁶⁰ All of TNC's unrelated business income tax liability for fiscal years 2002 and 2003 resulted from unrelated debt financed income. TNC reported total unrelated business taxable income of approximately \$664,000 for its fiscal years 1993 through 2003. TNC reported no unrelated business taxable income within the following categories during this 11-year period: (1) capital gain or loss (except for 2002); (2) rent income; (3) other income; or (4) interest, annuities, royalties, and rents from controlled organizations.

The following table provides certain unrelated business income information for TNC for its fiscal years 1993 through 2003.

**Table 13, Unrelated Business Income Information,
TNC Fiscal Years 1993-2003⁶¹**
(in thousands of dollars) (incorporate expense info)

Form 990-T year	Gross profit from sales	Income from partnerships or S corporations	Unrelated debt financed income	Other income	Net operating loss deduction	Total unrelated business income	Total unrelated business income tax
2002	0	-60,937	272,547	-11,429 ⁶²	0	199,981	55,972
2001	26,217	-52,375	504,310	-2,392 ⁶³	-11,460	464,300	157,862
2000	- 101,822	-32,058	367,625	0	-233,745	0	0
1999	- 183,089	0	104,187	0	0	-78,902	0

⁶⁰ The Committee was unable to determine whether TNC paid unrelated business income tax for 1992, because it did not obtain a copy of a Form 990-T for that year.

⁶¹ As noted above, the information for fiscal years 1999 through 2003 is derived from TNC's Forms 990-T for such years. The information for 1992 through 1997 is derived from TNC's Forms 990, Part VII, Analysis of Income-Producing Activities, for such years. See Appendix L.

⁶² Includes \$1,285 of capital gain and net expenses of \$12,714.

⁶³ Advertising income.

1998	0	0	-166,603	0	0	-166,603	0
1997	0	0	0	0	0	0	0
1996	0	0	0	0	0	0	0
1995	0	0	0	0	0	0	0
1994	0	0	0	0	0	0	0
1993	0	0	0	0	0	0	0
1992	0	0	0	80,317 ⁶⁴	0	80,317	NA

During TNC's most recent five-year period, TNC's reported unrelated business income tax liability represented less than 0.1 percent of its total revenues from all sources (and of total revenues other than from contributions and grants). During this same five-year period, TNC reported investment income of \$410.0 million. Its excess of revenues over expenses totaled \$1.56 billion, which approximated TNC's aggregate of revenues (other than from contributions and grants) for the period of \$1.54 billion. Put another way, TNC's total contributions and grants of \$2.42 billion during this five-year period (see Table 1, above) exceeded TNC's total expenses during this period of \$2.39 billion (see Table 4, above), and TNC was able to retain the entire \$1.5 billion of revenues it derived from sources other than contributions and grants.

A comparison of TNC's program service revenues and its unrelated business income, as reported for its fiscal years 1999 through 2003, is contained in the following table.

Table 14, Unrelated Business Income as a Percentage of Revenues (Other than Contributions and Grants) or Excess of Revenues over Expenses, TNC Fiscal Years 1999 through 2003 (dollars in millions)

Form 990 Year	Program service revenue	Investment income	Unrelated trade or business income (before NOL deduction)	Other income (other than contributions and grants)	Total revenues (other than contributions and grants)	Excess of revenues over expenses (including contributions and grants)	UBI as % of revenues (other than contributions and grants)	UBI as % of excess of all revenues over expenses
2002	272.4	7.1	0.3	1.6	281.4	192.1	0.1%	0.2%
2001	315.0	20.8	0.5	-0.4	344.1	339.8	0.1%	0.1%
2000	183.9	77.5	0.2	-0.9	270.9	298.0	0.0%	0.0%
1999	163.9	164.7	-0.1	-1.5	339.0	391.5	0.0%	0.0%
1998	153.9	139.9	-0.2	-0.9	300.5	344.6	-0.1%	0.0%
Totals	1089.1	410.0	0.7	-2.1	1535.9	1566.0	0.0%	0.0%

In its notes to its financial statements contained in TNC's Annual Report for the fiscal year ended June 30, 2004, TNC reported it "pays a nominal amount of tax relating to several unrelated business income activities, primarily rental income from debt-financed property. At

⁶⁴ Royalty income.

June 30, 2004 and 2003, [TNC] had a cumulative unrelated business income net operating loss of \$0.”⁶⁵

TNC Analysis of UBIT

In response to the Committee’s request for information regarding TNC’s process for characterizing UBIT, TNC provided a volume internal e-mail correspondences in which UBIT is raised for the years 2000 through 2005.⁶⁶ Because the Committee did not request e-mail correspondence, it did not determine whether the volume contained *all* e-mails regarding UBIT for this time period. Further, in one e-mail, TNC refers to an internal audit of UBIT activities apparently conducted in or prior to 2000 that TNC did not provide to the Committee.

In addition to these e-mails, TNC provided its Standard Operating Procedure (SOP) on UBIT, four memos providing legal analysis of four separate travel tour programs, and an internal newsletter article submitted by TNC’s controller’s office which provides UBIT guidance for field offices.⁶⁷ TNC’s SOP requires consultation with TNC’s General Counsel prior to commencing any activity with UBIT implications and immediate reporting to the Finance Function after the activity is commenced.

The Staff reviewed all e-mails provided by TNC regarding potential UBIT liability. Various activities and projects were discussed in these e-mails including: rental income from leased properties, corporate sponsorships, affinity cards, consulting services, timber sales, merchandise sales, travel tours, sale of water rights, an airplane lease, and advertising.

Although review of the e-mail correspondence suggests that TNC does discuss whether certain activities are related to its exempt purpose, it appears that activities that the Staff believes may be unrelated were not discussed or analyzed. For example, the Staff did not find any discussion or legal analysis of potential UBIT liability arising from TNC’s participation in Conservation Beef, LLC or the emissions credits projects.

The Staff notes that a few of the e-mails discuss whether income from the Trade Lands program is related income. However, none of the e-mails contain a legal analysis. Some state that TNC does not regard Trade Lands revenue as unrelated and that using real estate brokers to market the Trade Lands properties can “shelter the Trade Lands program from UBIT”.⁶⁸ TNC does not generally market Trade Lands properties but rather lists the properties with brokers to keep TNC’s role “sufficiently passive”.⁶⁹

⁶⁵ The Nature Conservancy, Consolidated Financial Statements as of June 30, 2004 and 2003, Together With Report of Independent Auditors, note 14 at p. 20.

⁶⁶ Certain of these e-mails are included in Appendix L.

⁶⁷ See Appendix L.

⁶⁸ See Appendix L.

⁶⁹ See Appendix L.

TNC also provided e-mails that mention the UBIT implications of conducting timber sales and providing consulting services. However, similar to the e-mails regarding the Trade Lands program, the Staff did not find any analysis involving the application of UBIT law to the pertinent facts.

The e-mails provide insights into TNC's UBIT tax planning strategies. TNC repeatedly states that revenues from transactions with other 501(c)(3) organizations are not UBIT because the activities are connected with TNC's exempt purposes. Another e-mail states that "as a rule, TNC treats all merchandising as mission-related, on the theory that any revenues are 'insubstantial' ... To do otherwise ... would be a significant departure from prior practice."⁷⁰

An e-mail from TNC in-house counsel states that:

"We do not want to be particularly aggressive on the UBIT front when dealing with revenues that are not directly related to conservation projects. We are not interested in picking fights with the IRS on these topics. Thus, we will declare some revenues from certain travel tours, overnight accommodations of the bed-and-breakfast variety, and merchandise sales, depending on circumstances. We do, however, want to be aggressive when the revenues in questions are directly connected to TNC's core conservation mission and are prepared to defend this position vigorously to IRS if necessary. (So far it has not been necessary.) Thus to date we have not declared revenues from timbering and other forest management activities as far as I know."⁷¹

In another e-mail, TNC states: "[w]e should also consider how aggressive a position TNC wants to take. As a practical matter, there are perhaps not too many \$\$\$ at issue here. We might be well-advised not to push the envelope and save our bargaining strength with something bigger and more important from a Conservation by Design standpoint."⁷²

⁷⁰ See Appendix L.

⁷¹ See Appendix L.

⁷² See Appendix L.