

## 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.<sup>1</sup> 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.<sup>2</sup> 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.<sup>3</sup> 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.<sup>4</sup>

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.<sup>5</sup>

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<sup>1</sup> TNC Narrative Response dated April 15, 2004, *see* Appendix D.

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

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

<sup>4</sup> TNC Answer to Question 6., March 3, 2004, Committee Letter to TNC.

<sup>5</sup> 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.<sup>6</sup>

## 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.<sup>7</sup>

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

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<sup>6</sup> Id.

<sup>7</sup> 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.<sup>8</sup>

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.<sup>9</sup>

The Committee asked TNC to provide specific monitoring information regarding certain States, as a test of its overall monitoring practices.<sup>10</sup> 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.

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<sup>8</sup> The North Carolina document is revised as of March 19, 2004.

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

<sup>10</sup> 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"<sup>11</sup> 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.<sup>12</sup>

### **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

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<sup>11</sup> 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.

<sup>12</sup> 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.<sup>13</sup> 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.<sup>14</sup>

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,

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

<sup>14</sup> 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.<sup>15</sup>

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.<sup>16</sup>

## **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.<sup>17</sup> 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.<sup>18</sup> 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."<sup>19</sup> 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."<sup>20</sup>

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.<sup>21</sup>

## **6. Land Trust Alliance— The Standards and Practices Guidebook**

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<sup>15</sup> TNC Narrative Response dated December 22, 2004, *see* Appendix D.

<sup>16</sup> TNC Narrative Response dated December 22, 2004, *see* Appendix D.

<sup>17</sup> TNC Narrative Response dated December 22, 2004, *see* Appendix D.

<sup>18</sup> TNC Narrative Response dated December 22, 2004, *see* Appendix D.

<sup>19</sup> TNC Narrative Response dated December 22, 2004, *see* Appendix D.

<sup>20</sup> TNC Narrative Response dated December 22, 2004, *see* Appendix D.

<sup>21</sup> 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.<sup>22</sup> 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."<sup>23</sup> 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

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<sup>22</sup> 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.

<sup>23</sup> 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.<sup>24</sup> 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.<sup>25</sup>

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.<sup>26</sup> 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.<sup>27</sup>

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.<sup>28</sup> 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.

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<sup>24</sup> TNC Narrative Response dated July 25, 2003, *see* Appendix E.

<sup>25</sup> TNC Narrative Response dated July 25, 2003, *see* Appendix E.

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

<sup>27</sup> *Id.*

<sup>28</sup> [https://nature.org/forms/secure/support\\_us.asp?support=AHOBA200401700](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).<sup>29</sup> 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."<sup>30</sup> 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."<sup>31</sup>

## **2. Tax Analysis regarding CBP Transactions<sup>32</sup>**

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

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<sup>29</sup> 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.

<sup>30</sup> TNC Narrative Response dated July 25, 2003, *see* Appendix E.

<sup>31</sup> 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.

<sup>32</sup> 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.”<sup>33</sup>

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.<sup>34</sup> 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

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

<sup>34</sup> 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.<sup>35</sup> 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

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<sup>35</sup> 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.<sup>36</sup> 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

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<sup>36</sup> 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.<sup>37</sup> 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

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<sup>37</sup> 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.”<sup>38</sup>

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,

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<sup>38</sup> 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 to 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.<sup>39</sup> 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.

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<sup>39</sup> 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.<sup>40</sup> "TNC completed approximately 20 like-kind exchanges as part of a transfer-out of property during fiscal years 2002 through 2004."<sup>41</sup> 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.<sup>42</sup>

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.<sup>43</sup>

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.<sup>44</sup>

#### **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 (SO<sub>2</sub>) 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 SO<sub>2</sub> 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.

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<sup>40</sup> Committee Letter to TNC dated April 21, 2005, *see* Appendix B.

<sup>41</sup> TNC Narrative Response dated May 12, 2005, *see* Appendix E.

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> *Id.*

“Allowance trading is the centerpiece of EPA's Acid Rain Program, and allowances are the currency with which compliance with the SO<sub>2</sub> 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.”<sup>45</sup>

The overall goal of the Acid Rain Program is to achieve significant environmental and public health benefits through reductions in emissions of sulfur dioxide (SO<sub>2</sub>) and nitrogen oxides (NO<sub>x</sub>), 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.<sup>46</sup>

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 SO<sub>2</sub> and NO<sub>x</sub> 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.<sup>47</sup>

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 SO<sub>2</sub>
- the opt-in program allows nonaffected industrial and small utility units to participate in allowance trading
- the NO<sub>x</sub> emissions reduction rule sets new NO<sub>x</sub> emissions standards for existing coal-fired utility boilers and allows emissions averaging to reduce costs

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

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

<sup>47</sup> <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 disagree<sup>48</sup>

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.<sup>49</sup>

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 SO<sub>2</sub> during or after a specified year. For each ton of SO<sub>2</sub> emitted in a given year, one allowance is retired, that is, it can no longer be used.<sup>50</sup>

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.<sup>51</sup>

The allowance trading system contains an inherent incentive for utilities to prevent pollution, since for each ton of SO<sub>2</sub> 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.<sup>52</sup>

In the SO<sub>2</sub> 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

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

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

<sup>50</sup> Id.

<sup>51</sup> Id.

<sup>52</sup> Id.

and responsibilities of allowances are similar to property rights (Ellerman,1999).<sup>53</sup> 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.”<sup>54</sup>

“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.”<sup>55</sup>

“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.”<sup>56</sup> The underlying concept is

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<sup>53</sup> *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>

<sup>54</sup> *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>

<sup>55</sup> Id.

<sup>56</sup> 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.”<sup>57</sup>

### 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.<sup>58</sup> The Kyoto Protocol would regulate emissions of carbon dioxide (CO<sub>2</sub>), methane (CH<sub>4</sub>), nitrous oxide (N<sub>2</sub>O), perfluorocarbons (PFCs), hydrofluorocarbons (HFCs) and sulphur hexafluoride (SF<sub>6</sub>). The United States is currently not a signatory to this treaty and there is much debate in the Congress about the regulation of CO<sub>2</sub>.

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.<sup>59</sup>

## **2. Summary of TNC’s Participation in Emissions Credits Arrangements<sup>60</sup>**

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.<sup>61</sup>

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

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<sup>57</sup> Id.

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

<sup>59</sup> Id.

<sup>60</sup> 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.

<sup>61</sup> 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.<sup>62</sup>

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.<sup>63</sup>

Although the terms of each arrangement differ, there are some material similarities regarding the various emissions arrangements between TNC and the financial participants.<sup>64</sup> 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.<sup>65</sup> 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.<sup>66</sup>

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<sup>62</sup> TNC Narrative Response dated December 28, 2004, *see* Appendix H.

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

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

<sup>65</sup> 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.

<sup>66</sup> 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**

<b>Project</b>	<b>Project description</b>	<b>Other entities involved</b>	<b>Date of Agreement</b>	<b>TNC's financial obligation in project</b>	<b>Private parties' financial position in project</b>
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.<sup>67</sup> 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.<sup>68</sup> Under written guidance<sup>69</sup> 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.

<sup>67</sup> TNC Narrative Response dated December 28, 2004, *see* Appendix H.

<sup>68</sup> TNC Narrative Response dated December 28, 2004, *see* Appendix H.

<sup>69</sup> 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."<sup>70</sup>

#### **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 (CO<sub>2</sub>) 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 CO<sub>2</sub> emissions. At this point, participating companies have voluntarily supported these conservation projects for a number of reasons including for the purposes obtaining rights to CO<sub>2</sub> 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."<sup>71</sup>

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

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<sup>70</sup> TNC Narrative Response dated December 28, 2004, *see* Appendix H.

<sup>71</sup> 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".<sup>72</sup> 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) 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

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<sup>72</sup> 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.<sup>73</sup> 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

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<sup>73</sup> 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.<sup>74</sup> 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

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<sup>74</sup> 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.”<sup>75</sup>

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.

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<sup>75</sup> 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.<sup>76</sup> 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 2003<sup>77</sup>  
(millions of dollars)**

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

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

<sup>77</sup> Per Forms 990 for fiscal years 1993 through 2003.

**Table 4, Estimated Non-Cash Contributions Breakdown<sup>78</sup>**  
**Fiscal Years 2000 through 2004**  
**(millions of dollars)**

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

**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.<sup>79</sup>

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.”<sup>80</sup> 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

<sup>78</sup> TNC Narrative Response dated May 4, 2005, *see* Appendix I.

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

<sup>80</sup> 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.<sup>81</sup>

The following table summarizes aggregate trade lands property acquisitions and dispositions by TNC for fiscal years 1999 through 2003.<sup>82</sup>

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

<b>Fiscal year</b>	<b>Beginning book value</b>	<b>Land in</b>	<b>Land out</b>	<b>Land reclaimed</b>	<b>Valuation adjustment up or (down)</b>	<b>Ending book value</b>	<b>Subtotal (gains) or losses on Form 990</b>
<b>1998</b>	26,916,859	7,928,816	(5,950,877)	765,376	(245,582)	29,417,592	651,944
<b>1999</b>	29,417,592	8,081,822	(8,283,276)	628,144	197,732	30,042,014	(221,949)
<b>2000</b>	30,042,014	5,814,402	(11,562,765)	1,994,651	(528,534)	25,759,767	1,054,187
<b>2001</b>	25,759,767	7,057,796	(9,357,870)	2,063,898	851,523	26,375,113	(1,291,710)
<b>2002</b>	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.<sup>83</sup> 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.<sup>84</sup>

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

<sup>81</sup> 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.

<sup>82</sup> TNC Summary provide January 14, 2005.

<sup>83</sup> Treas. Reg. §1.1015 -1.

<sup>84</sup> 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]dential tax treatment is accorded to gifts of trade land and ecologically important land."<sup>85</sup>

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.<sup>86</sup>

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.<sup>87</sup>

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.<sup>88</sup>

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

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<sup>85</sup> <http://nature.org/wherewe work/northamerica/states/wisconsin/contact/art10846.html>.

<sup>86</sup> TNC Narrative Response dated May 12, 2005 *see* Appendix I.

<sup>87</sup> *Id.*

<sup>88</sup> *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.<sup>89</sup>

### **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.<sup>90</sup> 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.<sup>91</sup>

### **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.

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<sup>89</sup> Id.

<sup>90</sup> 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)*.

<sup>91</sup> 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.<sup>92</sup> However, legal opinions obtained by TNC contain calculations of potential tax deductions available to donors.<sup>93</sup> 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.<sup>94</sup>

The use of the “subdivision development analysis” method used by appraisers to value conservation easements is perceived by some to be abused by appraisers.<sup>95</sup> TNC notes that this appraisal method was used to value the easement that resulted from the Shelter Island CBP transaction.<sup>96</sup> 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.

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<sup>92</sup> Governance Advisory Panel Final Report, *see* Appendix J.

<sup>93</sup> Copies of legal opinions are provided in Appendix F.

<sup>94</sup> See documents related to Shelter Island transaction in Appendix O.

<sup>95</sup> 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*, 2<sup>nd</sup> Edition, South Carolina Department of Revenue, March 2005, p. 96.

<sup>96</sup> 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.<sup>97</sup> 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.”<sup>98</sup> 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.<sup>99</sup> 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)

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<sup>97</sup> 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.*

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

<sup>99</sup> <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.<sup>100</sup>

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.”<sup>101</sup> For this purpose, the Board of Governors announced the formation of the Governance Advisory Panel in September 2003.<sup>102</sup>

### **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.<sup>103</sup> 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.<sup>104</sup> For example, the Board of Governors delegated oversight and guidance responsibilities to the Executive Committee and restructured the Board of Governors Committees.<sup>105</sup> 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.<sup>106</sup> 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

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

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

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

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

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

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

<sup>106</sup> 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.<sup>107</sup>

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.<sup>108</sup> 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.<sup>109</sup> 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

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<sup>107</sup> Governance Advisory Panel Final Report, *see* Appendix J.

<sup>108</sup> *Id.*

<sup>109</sup> 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 Director<sup>110</sup> 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.<sup>111</sup> 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.<sup>112</sup>

## **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

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<sup>110</sup> See the discussion regarding establishing the office of Compliance Director in Compliance, below.

<sup>111</sup> 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](http://www.give.org/standards/newcbbbstds/asp).

<sup>112</sup> 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.<sup>113</sup> The Compliance Director would be charged with reviewing specific transactions and events on an on-going basis.<sup>114</sup> 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**

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

<sup>114</sup> 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."<sup>115</sup> 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"<sup>116</sup> 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."<sup>117</sup>

### **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

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

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

<sup>117</sup> 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,<sup>118</sup> 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

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<sup>118</sup> 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.<sup>119</sup>

## **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

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<sup>119</sup> 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.<sup>120</sup>

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 entity<sup>121</sup> 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).<sup>122</sup> 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**

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<sup>120</sup> 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.

<sup>121</sup> 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.

<sup>122</sup> 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.<sup>123</sup> 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.<sup>124</sup>

##### **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

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<sup>123</sup> 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.<sup>125</sup> The policy lists types of related entities as: (1) wholly-owned not-for-profit corporations;<sup>126</sup> (2) controlled not-for-profit organizations;<sup>127</sup> (3) owned or controlled for-profit entities;<sup>128</sup> (4) partnerships/joint ventures;<sup>129</sup> (5) trusts;<sup>130</sup> 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 approval<sup>131</sup> 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

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

<sup>126</sup> 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.

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

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

<sup>129</sup> 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.

<sup>130</sup> 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.

<sup>131</sup> 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.<sup>132</sup>

This policy applies to any transaction involving TNC’s acquisition of a significant business interest<sup>133</sup> in a separate legal entity<sup>134</sup> 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 approved<sup>135</sup> 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.

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<sup>132</sup> 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.

<sup>133</sup> 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.

<sup>134</sup> 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.

<sup>135</sup> 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**

<b>TNC Policy</b>	<b>General Description</b>	<b>Purpose</b>	<b>Board Members; State Trustees</b>	<b>Major Donors</b>	<b>Other Employees</b>
<b>Conflict of Interest (March 2004)</b>	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
<b>Forms 8282 and 8283 (March 2004)</b>	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			
<b>Related Party Land Transactions (June 2003; revised September 2004)</b>	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
<b>Related Organizations (January 2004)</b>	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			
<b>Significant Business Interests (February 2004)</b>	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.”<sup>136</sup>

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.

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<sup>136</sup> Committee Letter to TNC dated April 21, 2005, *see* Appendix B.