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Best Use of Land Must be Reasonable

Cross References

- *Watson Lake Investments, LLC, and Meadow Lake Investments, LLC,* T.C. Memo. 2026-106

A conservation easement involves transferring a permanent legal restriction on the use of land to a qualified organization. The purpose of the easement is to protect natural habitats. The taxpayer retains ownership, use, and living rights, but gives up any future development or harmful use of the land.

Regulation section 1.170A-1(a) provides that a charitable contribution deduction is allowed if the taxpayer makes a gift of property other than money. The amount of the contribution deduction is generally equal to the fair market value (FMV) of the property at the time of the gift. The FMV of property is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. Valuation of property is not a precise science, and the FMV of property on a given date is a question of fact to be resolved on the basis of all the evidence.

Courts have ruled that the FMV of real property should reflect its highest and best use (HBU). Thus, for example, the FMV of land used for farming may be much lower than the FMV of that same land used for residential development. A property's HBU is the most profitable, legally permissible use for which the property is adaptable and needed, or likely to be needed in the reasonably near future. If different from the current use, a proposed HBU thus requires both closeness in time and reasonable probability.

Donating a conservation easement to a qualified organization is considered a donation of property for federal income tax purposes. The FMV of the easement is generally less than the FMV of the property, since the taxpayer retains ownership of the land. The appraiser must determine the land's HBU FMV before the conservation easement, and the FMV of the property after the conservation easement is placed on the property. The difference between these two amounts will generally be the FMV of the easement (and thus the amount of the charitable contribution).

A recent court case illustrates the fact that the HBU of the land must be reasonable when determining the value of a conservation easement. The court case combined two taxpayers, Watson Lake Investments, LLC (Watson Lake) and Meadow Lake Investments, LLC (Meadow Lake) into one case because they have a similar fact pattern. Both partnerships have the same tax matters partner.

In December 2015, Watson Lake acquired 144 acres of undeveloped land in rural Georgia for $325,000, or $2,257 per acre. In April of 2016, Meadow Lake acquired 189 acres of undeveloped land, just two miles away, for $320,000, or $1,693 per acre.

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After donating conservation easements on the property to a qualified organization in 2016 and 2017, Watson Lake and Meadow Lake claimed charitable contribution deductions on their federal income tax returns based on the theory that the before HBU values of the two parcels (that is their values before being encumbered by the easements) were $8,371,000 (or $58,132 per acre) and $11,456,000 (or $60,614 per acre), respectively. They thus took the position that the land had appreciated by more than 2,000% from the time they acquired it.

The taxpayers' appraiser calculated these values on the assumption that the HBU of each tract was mixed-use development, supposedly including 66 to 69 single-family lots, 35 to 45 acres of multifamily and senior housing, and numerous commercial and office sites.

The court stated these assumptions were wholly unrealistic in a rural county with a total population of roughly 22,000. The court ruled that the HBU of each tract was its current use for low-density, single-family residences, with agriculture, recreation, and timber harvesting as complementary uses.

Employing the comparable sales method, backstopped by the actual prices paid to acquire the tracts 12 to 21 months before the easements were granted, the court held that the before values of the two tracts were $331,000 and $435,000, respectively. Subtracting from those figures the after values determined by the court, Watson Lake and Meadow Lake were entitled to charitable contribution deductions of $115,300 and $208,500, respectively. The court also imposed the 40% penalty for a gross valuation misstatement under IRC section 6662.

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