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(VOLUME I)

INTRODUCTION

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

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

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

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

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

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

EXECUTIVE SUMMARY

A. General Overview of Investigation

1. Scope

The Staff began its investigation of TNC in July 2003. The investigation comprised a detailed review of certain TNC programs, activities, practices, and transactions in light of section 501(c)(3) [1] governing tax-exempt status, unrelated business income tax, the excess benefit excise taxes, and Federal tax and information reporting requirements. In addition, the Committee reviewed TNC's practices regarding the solicitation, valuation, documentation, substantiation, and reporting of charitable contributions of property other than cash. *The Washington Post* reported on some of these areas that the Staff reviewed in a series of articles first published in May 2003.[2]

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

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

2. Methodology

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

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

[2] *See* Appendix A.

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

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

In conducting its investigation, the Committee:

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

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

3. Investigation Highlights

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

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

B. Overview of TNC

1. Mission

TNC's mission is "to preserve the plants, animals and natural communities that represent the diversity of life on Earth by protecting the lands and waters they need to survive."[5] TNC operates throughout the United States, Canada, Mexico, South America,

[5] The Nature Conservancy website, "About Us," *available at* http://nature.org/aboutus/.

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

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

2. History[9]

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

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

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

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

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[6] Id.

[7] Id.

[8] The Nature Conservancy website, "Initiatives," *available at* http://nature.org/aboutus/.

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

[10] "Milestones: A Quick Take on Conservancy History," available at http://nature.org/aboutus/history/index.html.

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

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

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

3. Financial Information (fiscal years 2002 through 2004)

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

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

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

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

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

[12] Id.

TNC reported $436 million from contributions, grants, and similar amounts received, and $228 million from program service revenue. (Noncash contributions were reported as $90.1 million.) TNC reported investment income of approximately $65 million, and other sources of income of approximately $3 million. TNC reported total expenses for the year of $516 million, including $54 million for fundraising expenses. TNC reported total assets of $4.1 billion, total liabilities of $547 million, and net assets or a net fund balance of $3.5 billion. On Part VII of the 2003 Form 990, TNC listed unrelated business income of $292,052.[13]

a. Revenues

TNC reported $3.7 billion of contributions and grants, and total revenues of $6.1 billion for fiscal years 1993 through 2003.[14] Contributions and grants represented 61 percent of aggregate total revenues during this period. TNC's program service revenue comprised 27 percent of total revenues during this period, and its investment income (interest, dividends, and gain from sales of investments) totaled 11 percent of total revenues.[15]

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

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

b. Expenses

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

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

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

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

c. Unrelated business income activities

TNC provided the Committee its Forms 990-T, *Exempt Organization Business Income Tax Return*, for fiscal years 1999 through 2003. Although the Committee did not review any Form 990-T filings made by TNC prior to this period, the Committee did review TNC's unrelated business taxable income information as reported on TNC's Forms 990 for earlier periods. Based on these reports, TNC paid no unrelated business income tax for fiscal years 1993 through 2001, and paid unrelated business income tax ("UBIT") of approximately $214,000 for fiscal years 2002 and 2003.[16] TNC's unrelated business income tax liability for fiscal years 2002 and 2003 resulted from unrelated debt financed income. TNC reported total unrelated business taxable income of approximately $664,000 for its fiscal years 1993 through 2003. TNC reported no unrelated business taxable income within the following categories during this 11-year period: (1) capital gain or loss (except for 2002); (2) rent income; (3) other income; or (4) interest, annuities, royalties, and rents from controlled organizations.

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

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

C. Summary of Observations and Issues regarding Conservation Programs

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

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

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

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

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

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

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

Table 1
Summary of Program Service Revenue[17]
Fiscal Years Ending June 30, 1993 through 2003
(millions of dollars)

Form 990 Year	Activity fees (line 93a)	Contract fees (line 93b)	Government sales (line 93c)	Sale of trade lands	Fees and contracts from govt. agencies (line 93g)	Total program service revenues[18]
2002	22.3	4.7	172.6	0	72.8	272.4
2001	23.3	2.5	181.9	2.8	104.6	315.1
2000	35.8	2.0	83.0	0	63.1	183.9
1999	18.2	3.6	81.9	0	60.1	163.8
1998	25.4	1.4	78.6	0	48.5	153.9
1997	14.1	2.3	57.7	0	33.5	107.6
1996	17.8	1.7	44.5	0	40.5	104.5
1995	12.7	2.4	37.9	0	33.3	86.3
1994	7.9	1.7	45.9	0	Data NA	55.5
1993	8.7	1.4	70.0	0	Data NA	83.9

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

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

1. Conservation Easements

Observations

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

Enforcement of easements, limiting modifications to appropriate cases, and providing adequate funding to ensure enforcement and proper valuation are important concerns with respect to conservation easements. Organizations are required to enforce, in perpetuity, the terms and conditions of these easements to ensure that conservation goals are not compromised. Failure to enforce these restrictions increases the risk that easement-restricted property will not be conserved in perpetuity or that the actual conservation benefits will be less than what was claimed when the amount of the resulting charitable contribution was calculated.

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

Modifications to an easement held by a conservation organization may diminish or negate the intended conservation benefits, and violate the present law requirements that a conservation restriction remain in perpetuity.[20] During the period 1994 through 2003, TNC agreed to 75 easement modifications.

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

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

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

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

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

The determination of the value of the conservation easement or restriction is critical to determining the amount of any charitable deduction claimed as a result of the donation of the easement or the restriction. A taxpayer may claim a deduction for a qualified conservation contribution of an easement or restriction under section 170(h). Valuation of land generally involves a straightforward process, i.e. willing buyer, willing seller or through comparing sales of similar property. In contrast, valuation of conservation easements is more difficult because of the absence of a market for their trade and the variety of restrictions that may be imposed on a particular property. In addition, valuations of easements must reflect any increase in value of other properties owned by the taxpayer contributing the easement and must consider whether the tax benefits accruing to the taxpayer as a result of the contribution exceed the benefit that inures to the public.[21] The difficulty in completing these valuations of conservation easements also poses significant challenges and costs to the IRS in assessing whether the appraisal that formed the basis for a qualified conservation contribution is reasonable.

Issues for Consideration

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

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

[21] Treas. Reg. §1.170A-14(h)(3).

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

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

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

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

2. Conservation Buyer Program (CBP)

<u>*Observations*</u>

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Issues for Consideration

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

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

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

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

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

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

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

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

3. Emissions Credit Arrangements

Observations

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

Under a typical "cap and trade" program for certain emissions allowances, "[a] government establishes a target for the amount of emissions during a compliance period. Based on the targeted emissions, the government allocates emissions allowances that give a participant in the plan the right to emit a specified amount of gases (for example, a ton of carbon dioxide). Participation in the program may be voluntary or compulsory. Participants may be allocated allowances free of charge, or they may be required to purchase allowances from the government (for example, through government auctions). Programs operate over a compliance period, and allowances are allocated (or auctioned) to the participants at the beginning of the compliance period. During the period, participants may buy or sell allowances directly with other participants or, depending on market sophistication, through a broker or on an exchange."[30]

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

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

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

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

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

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

[31] Id.

[32] Id.

[33] Id.

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

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

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

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

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

Issues for Consideration

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

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

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

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

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

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

4. Joint Ventures[35]

Observations

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

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

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

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

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

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

Issues for Consideration

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

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

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

5. Tax Planning regarding Conservation Easements & Conservation Buyer Program

Observations

The Staff reviewed 26 written opinions providing advice to TNC regarding conservation easements and CBP transactions. While the Staff does not believe exempt organizations should always obtain the advice of outside tax advisors, it also believes it is prudent for an organization such as TNC to do so with respect to many of its activities. Given TNC's size and innovative approaches as well as the complexity of many of its programs and activities, the Staff expected TNC to have much more documentation regarding the tax impact of participating in and conducting its various programs and activities. TNC obtained 26 written opinions by outside tax counsel over a period of 12 years – an average of slightly over two opinions per year.

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

Issues for Consideration

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

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

D. Observations and Issues regarding Fundraising & Charitable Contributions

Observations

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

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

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

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

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

On its website, TNC describes various gift options for its donors as: (1) bequests; (2) life-income gifts (e.g., exchanging securities or real estate for the right to receive income for life or a term of years); (3) naming TNC as a beneficiary of a retirement plan, insurance policy, or financial account; (4) gifts of outright securities or real estate; (5) retained life estate gifts that allow the donor to use the property for his or her life; (6) donor advised funds; and (7) charitable lead trusts that provide annual income to TNC for a period of years, with the principal transferring to the donor's beneficiaries after the period ends. As of March 31, 2005, the value of assets held in TNC's donor advised funds was $4,318,144.[39]

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

1. Fundraising

a. Trade Lands

Observations

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

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

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

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

[40] Treas. Reg. §1.1015-1.

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

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

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

Issues for Consideration

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

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

b. Donor Advised Funds

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

2. Reporting of Non-Cash Charitable Contributions

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

[41] *See* Appendix L.

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

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

Issues for Consideration

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

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

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

3. Valuation

Observations

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

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

Issues for Consideration

The Staff recommends that Congress, the IRS, and the Treasury Department review the *McLennan* decision[42] and consider whether use of the "subdivision development analysis" method of valuation should be restricted or barred for valuations of certain conservation easements subject to section 170(h).[43]

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

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

Observations

1. Form 990

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

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

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

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

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

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

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

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

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

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

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

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

Issues for Consideration

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

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

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

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

2. Form 990-T

Observations

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

TNC's unrelated business income tax planning strategy categorically treated income from other 501(c)(3) organizations as related income without conducting a formal legal analysis of the facts of each arrangement. TNC directed its employees to be aggressive when considering whether income from "Conservation by Design" activities was related income. It classified income from non-conservation activities that generated small amounts of income as unrelated so that TNC would have bargaining power in an IRS audit.

TNC's e-mails and memos regarding UBIT suggest that TNC closely analyzed certain activities (e.g., travel tours and merchandising), conducted no analysis for others (e.g., emissions credits, Conservation Beef, LLC) and conducted incomplete analysis for others (e.g., trade lands, timber sales, consulting fees).

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

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

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

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

Issues for Consideration

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

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

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

F. Observations and Issues regarding TNC Reforms

Observations

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

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

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

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

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

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

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

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

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

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

Issues for Consideration

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

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

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

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

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

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

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