Tax Valuation

By Lance S. Hall

The Valuation of Conservation Easements

In 2004 when The Washington Post published articles on the abuses of conservation easement donations, the IRS swung into action.[1] Soon thereafter, the IRS issued Notice 2004-41 saying, "The purpose of this notice is to advise participants in [conservation easement] transactions that, in appropriate cases, the Service intends to disallow such deductions and may impose penalties and excise taxes." In 2005, the IRS "established a team dedicated to tracking down abusive tax breaks claimed through conservation easements."[2] And, in 2009, we are now witnessing the results of the IRS crackdown with six new court decisions issued in just nine months, involving conservation easements.[3]

What Is a Conservation Easement?

"A conservation easement is a legally binding agreement between the owner of the land encumbered by the easement and the holder of the easement that restricts the development and use of the land to achieve certain conservation goals, such as the preservation of wildlife habitat, open space, or agricultural land. Conservation easements are generally sold or donated by a landowner to a government agency or charitable conservation organization … that agrees to enforce the development and use restrictions in the easement for the benefit of the public."[4]

Generally, partial interest gifts to charity are not deductible as charitable contributions. However, Code Sec. 170(f)(3)(B)(ii) provides an exception for partial interest donations provided such donations meet the detailed requirements of the code. These requirements include the following:

- The recipient of the donation must be a "qualified organization."
- The "qualified organization" must not only accept the donated property, but must also demonstrate a

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commitment to protect the purpose(s) of the donation and have the means to enforce the restrictions.

- The donated property must be a "qualified real property interest."
- The "qualified real property interest" must be a restriction on the use of the property that is granted "in perpetuity."
- The "qualified real property interest" must be "exclusively for certain conservation purposes."

Valid conservation purposes include outdoor recreation, "the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem." Also, a valid conservation purpose can be the "preservation of open space…for the scenic enjoyment of the general public" or "the preservation of a historically important land area or a certified historic structure."

In *Herman v. Commissioner*, the taxpayer owned the "unused development rights" attached to an apartment building in Manhattan that was a "certified historic structure" as defined by Code Sec. 170(h)(4)(B). The building was approximately three stories shorter than the two buildings on either side. Accordingly, the taxpayer, Mr. Herman, assumed he could add another three stories to the building which would add 22,000 square feet to the building. In 2003, the taxpayer donated 10,000 of the 22,000 square feet of airspace to a qualified charitable organization and took a $21,850,000 charitable deduction. The question before the Court was "(i) whether the conservation easement preserves a 'historically important land area' or a 'certified historic structure' within the meaning of section 170(h)(4)(A)(iv), and (ii) whether the conservation purpose of the conservation easement, if any, is protected in perpetuity in accordance with section 170(h)(5)(A)."

The *Herman* Court noted that "Mr. Herman did not own, and did not contribute, any interest in either the existing structure … or the land on which it was built. The 'air rights' easement that he did contribute did not oblige him to preserve—and he did not have the power to preserve—the structure of the existing building or the underlying land." Accordingly, the "air rights" easement did not "'preserve … an historically important land area or a certified historic structure' within the meaning of section 170(h)(4)(A)(iv)."

Substantiation Requirements

Code Sec. 170A-13 states that " … No deduction under section 170 shall be allowed with respect to a charitable contribution … unless the substantiation requirements … are met." Code Sec. 170(f)(8)(A) requires that "for any contribution of $250 or more…the taxpayer [must obtain] … a contemporaneous written acknowledgement of the contribution by the donee organization … ." Moreover, the written acknowledgement must include "(1) the amount of cash and a description of any property other than cash contributed, (2) whether the donee organization provided any goods or services in consideration for any such property and (3) if goods or services were provided in exchange, a description and good faith estimate of the value of such goods or services."[5] Also, in order to meet the "contemporaneous written acknowledgement" requirement, the acknowledgement "must be obtained on or before the date on which the taxpayer files a tax return containing the charitable deduction … ."[6]

"The obligation to substantiate a claimed charitable contribution is clear and unambiguous."[7] In *Bruzewicz v. U.S.*, the taxpayer, however, failed to obtain a written acknowledgement from the donee organization that (a) described the easement donated, (b) indicated a value of the donated easement that matched the deduction claimed by the donor, and (c) stated whether "any goods or services [were received] in consideration for the preservation easement donation." In light of these deficiencies, as well as others, the *Bruzewicz* Court concluded, the taxpayer's "total failure to comply with the … [substantiation] statutory requirement is alone fatal to their claimed deduction of the preservation façade easement."

The "Qualified Appraisal" Requirement

As part of the substantiation requirements, the donor must (a) obtain a "qualified appraisal" from a "qualified appraiser," (b) attach a signed appraisal summary, and (c) maintain adequate information regarding the conservation easement transfer.

A "qualified appraisal" is defined, in part, as an appraisal "conducted by a qualified appraiser in accordance with generally accepted appraisal standards … ."[8] Unfortunately, the term "generally accepted appraisal standards" is an undefined term. It is generally understood that if a qualified appraiser follows the guidelines of the Uniform Standards of Professional Appraisal Practice, then the qualified appraiser has complied with the "generally accepted appraisal standards" requirement.

A "qualified appraiser" is defined as one who "(1) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements … , (2) regularly performs appraisals for which the individual receives compensation, and (3) meets such other requirements as may be prescribed by the Secretary in regulations or other guidance."[9]

Reg. §170.A-13(c)(3)(ii) requires that a "qualified appraisal" contain the following information:

(A) A description of the property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was (or will be) contributed;

(B) In the case of tangible property, the physical condition of the property;

(C) The date (or expected date) of contribution to the donee;

(D) The terms of any agreement or understanding entered into (or expected to be entered into) by or on behalf of the donor or donee that relates to the use, sale, or other disposition of the property contributed, including, for example, the terms of any agreement or understanding that –

(1) Restricts temporarily or permanently a donee's right to use or dispose of the donated property,

(2) Reserves to, or confers upon, anyone (other than a donee organization or an organization participating with a donee organization in cooperative fundraising) any right to the income from the contributed property or to the possession of the property, including the right to vote donated securities, to acquire the property by purchase or otherwise, or to designate the person having such income, possession, or right to acquire, or

(3) Earmarks donated property for a particular use;

(E) The name, address and (if a taxpayer identification number is otherwise required by Code Sec. 6109 and the regulations thereunder) the identifying number of the qualified appraiser; and, if the qualified appraiser is acting in his or her capacity as a partner in a partnership, an employee of any person (whether an individual, corporation, or partnerships), or an independent contractor engaged by a person other than the donor, the name, address, and taxpayer identification number (if a number is otherwise required by Code Sec. 6109 and the regulations thereunder) of the partnership or the person who employs or engages the qualified appraiser;

(F) The qualifications of the qualified appraiser who signs the appraisal, including the appraiser's background, experience, education, and membership, if any, in professional appraisal associations;

(G) A statement that the appraisal was prepared for income tax purposes;

(H) The date (or dates) on which the property was appraised:

(1) The appraised fair market value (within the meaning of Reg. §1.170A-1(c)(2)) of the property on the date (or expected date) of contribution;

(J) The method of valuation used to determine the fair market value, such as the income approach, the market-data approach, and the replacement-cost-less-depreciation approach; and

(K) The specific basis for the valuation, such as specific comparable sales transactions or statistical sampling, including a justification for using sampling and an explanation of the sampling procedure employed.

In *Bruzewicz v. U.S.,* the Court had a particularly difficult time with the information included in the appraiser's report. *Bruzewicz* involved the donation of three facades of a home located in the Frank Lloyd Wright-Prairie School of Architecture Historic District. The many criticisms of the qualified appraisal included:

- A lack of adequate descriptions of the appraiser's qualifications. Merely listing the appraiser's state license number was insufficient. The regulation specifically requires a description of "the appraiser's background, experience, education and membership in professional appraisal associations."
- While the appraisal included a detailed description of the house, it lacked a description of what easement was donated. While a "Supplemental Addendum" agreement was attached, this agreement was in draft form, was incomplete, and was unsigned. According to the Court: "Absent a description of the facade easement, the appraisal and its valuation of the donated property are meaningless."
- The appraisal summary submitted by the taxpayers was not signed by the appraiser.
- The Court further stated, "it must be said that the appraisal's superficial impressiveness in size, which emulates conventional real estate

appraisals in many respects, does not fully mask its obviously problematic treatment" of the conservation easement determination of value.

In *Simmons*, a case also involving a façade conservation easement, the appraiser failed to state within the body of the report that the appraisal was "prepared for income tax purposes." Technically, this is a violation of the substantiation requirements. However, the *Simmons* court ruled that nonetheless, the appraisal "substantially complied" with the requirements.

Conservation Easement Valuation Methodology

As in any valuation, the ideal methodology to employ is an actual arm's-length transaction involving the interest being valued, which occurred near the valuation date. If no actual arm's-length transaction involving the subject interest occurred near the valuation date, the next best approach is to make a comparison with actual arm's-length transactions involving unrelated interests that are very similar to the subject interest and have also occurred near the valuation date. As can be imagined, the above instances are extremely rare as it relates to conservation easement donations. Accordingly, valuations must be performed utilizing a different methodology.

In a letter dated June 11, 2009, addressed to the late Senator Edward Kennedy, the IRS laid out its interpretation of the preferred valuation methodology for conservation easements called the "before and after" method. In this letter the IRS states that in a "before and after" appraisal:

> The fair market value of the property "before" contribution of an historic easement must take into account not only the current use of the property but also an objective assessment of how immediate or remote the likelihood is that the property, absent the restriction, would in fact be developed, as well as any effect from zoning, conservation, or historic preservation laws that already restrict the properties highest and best use. [The] "after" valuation must take into account the amount of access permitted by the terms of the easement and the effect that the particular restrictions in the easement will have on the value of the property subject to the easement.

In *Brucewicz*, the appraiser did not perform a "before and after" appraisal. Rather, the appraiser "applies an arbitrary percentage to the established 'before' value of the property to arrive at the asserted 'after' value, rather than independently determining the real 'after' value."[10] Unlike the taxpayer's appraiser in *Brucewicz*, the taxpayer's expert in *Simmons* (also involving a façade donation) utilized a "before and after" appraisal methodology and was successful in defending much of the donation.[11]

In *Hughes v. Commissioner*, the primary issue before the court was the highest and best use of two ranches that were purchased within 14 months of the conservation easement donation.[12] The taxpayer's expert concluded that the highest and best use "was residential development in lots ranging in size from 35 to 350 acres." This assumption increased the value of the ranches from \$2.2M to \$4.1M. The *Hughes* Court noted that a "property's highest and best use is the highest and most profitable use for which it is adaptable and needed or likely to be needed in the reasonably near future." However, the ranches were located in Gunnison County, Colorado, where the population was less than one person per square mile. With such a low population density, the Court believed there would be insufficient demand to support the taxpayer's expert's highest and best use assumption. Accordingly, the Court found that the highest and best use of the ranches was for "continued agricultural and recreational use."

Interestingly, the *Hughes* Court also concluded that the "after" value must also be reduced by the fact that the donation "precluded any future purchasers from granting a conservation easement and thus from receiving the benefit of the tax credits. This should have been at least considered in determining the parcels' diminution in fair market value."

In *Drummond v. Commissioner*, the two appraisers concluded at dramatically different values.[13] The issue before the Court was the value of a conservation easement on a 141-acre "award-winning" golf course. The amount of the charitable conservation easement donation was valued by the taxpayer's expert at \$31,938,985. The IRS challenged the donation and valued the conservation easement at \$10,018,000. The decision in *Drummond* hinged on the quality of the appraisal and the expert's appraisal testimony. The Court noted that the IRS's expert's "testimony at trial is inconsistent with his appraisal in several respects" and, as a result, the taxpayer's expert largely prevailed.

The Matrix

If your conservation easement property is in the state of Colorado, there is a good chance the IRS will decide whether or not to challenge your donation on a comparison with the "matrix." "The matrix is a compilation of valuation data on thirty-five (35) sales of real property subject to conservation easements located throughout the State of Colorado. The matrix is largely a body of factual information with certain assumptions, analysis, and conclusions reached by the [IRS] concerning the effect of a conservation easement on value."[14] In developing the matrix, the IRS screened through approximately 235 Colorado conservation easement donations and selected only 35 to use in the matrix. The 35-property matrix "took five IRS employees more than one year to compile, organize, review, and analyze all of the documents that went into creating the matrix … ." The matrix was used in the *Hughes* case to challenge and value the conservation easement donation.

In *RCL Properties v. U.S.,* also a Colorado conservation easement challenge by the IRS, the taxpayers argue that, "because [the matrix] reflects information gathered and used by the IRS, in part, to value the charitable contributions for conservation easement deductions that [the taxpayers] are entitled to take on property they own" the information is relevant to them.[15] Moreover, the taxpayers "argue that the matrix and identity of the additional properties would reveal the analysis and methodology used by the IRS to determine the value of [the taxpayers'] easements and enable [the taxpayers] to bear their burden of rebutting the valuation made by the IRS and putting forth the appropriate valuation." Accordingly, the Court ruled that the IRS must provide the taxpayers with the matrix information and the additional 200 properties not utilized in the matrix provided that the information "shall only be used for purposes of this litigation." Moreover, the Court ordered a "protective order detailing the agreed-upon treatment of the material produced as a result of this discovery."

Summary and Conclusions

The IRS has identified conservation easement donations as an area fraught with abuse and has increased its audit and challenges of conservation easements. Unlike non-charitable gift transfers, the substantiation requirements are more complex and rigid. Religiously following the substantiation requirements are not enough, however. Correctly utilizing the "before and after" valuation methodology, provided the taxpayer has substantially complied with the substantiation requirements, is necessary. This entails correctly diagnosing the highest and best use of the property and utilizing relevant data in the traditional market, income and cost/asset valuation approaches. Moreover, the taxpayer's valuation expert should also reduce the "after" value to reflect the fact that future owners of the property no longer have the ability to grant a conservation easement on the property. The option to donate a conservation easement has value and when that option is no longer within the property's bundle of rights the "after" value must be reduced, accordingly.

Over the next few years, as the IRS challenges wind their way through the courts, we can look forward to a more clear picture as to what to do and what to avoid in successfully navigating the conservation easement complexities.

Endnotes

1 Joe Stephens, *Loophole Pays off on Upscale Buildings,* The Washington Post, December 12, 2004; *The Uses and Abuses of Conservation Easements*, The Washington Post, January 3, 2004.

2 Joe Stephens, *IRS Starts Team on Easement Abuses*, The Washington Post, June 9, 2005.

3 *Simmons v. Commissioner,* Dec. 57,934(M), 98 TCM 211, T.C. Memo. 2009-208; *Herman v. Commissioner,* Dec. 57,931(M), 98 TCM 197, T.C. Memo. 2009-205; *Kiva Dunes Conservation, Drummond v. Commissioner,* Dec. 57,863(M), 97 TCM 1818, T.C. Memo. 2009-145; *Hughes v. Commissioner*, Dec. 57,808(M), 97 TCM 1488, T.C. Memo. 2009-94; *Bruzewicz v. U.S.,* No. 1:07-cv-04074, Northern District of Illinois – Eastern Division (March 25, 2009); *RCL Properties v. U.S., 2009-1* USTC ¶50,114, No. 08-cv-00055-LTB-KLM (December 11, 2008).

4 Nancy A. McLaughlin, Conservation Easements—A Troubled Adolescence, 2005.

5 Code Sec. 170(f)(8)(B).

6 *Bruzewicz v. U.S.,* No. 1:07-cv-04074, Northern District of Illinois – Eastern Division (March 25, 2009) and Code Sec. 170(f)(8)(c).

7 *Simmons v. Commissioner*, Dec. 57,934(M), 98 TCM 211, T.C. 2009-208.

8 Code Sec. 170(h)(11)(E).

9 Ibid.

10 No. 1:07-cv-04074, Northern District of Illinois – Eastern Division (March 25, 2009).

11 Dec. 57,934(M), 98 TCM 211,T.C. Memo. 2009-208.

12 Dec. 57,808(M), 97 TCM 1488,T.C. Memo. 2009-94.

13 Dec. 57,863(M), 97 TCM 1818,T.C. Memo. 2009-145.

14 *RCL Properties v. U.S.,* 2009-1 USTC ¶50,114, No. 08-cv-00055-LTB-KLM (December 11, 2008) quoting from an IRS reply to the Court; the matrix was also used in *Hughes v. Commissioner*, Dec. 57,808(M), 97 TCM 1488, T.C. Memo. 2009-94.

15 Ibid.