

NOTE

The Façade of Valuation: Why the *Whitehouse Hotel Ltd. Partnership v. Commissioner* Façade Easement Valuation Method Is Not Working

I. Introduction

In *Whitehouse Hotel Ltd. Partnership v. Commissioner*, the Tax Court determined the taxpayer was entitled to a deduction for a qualified conservation contribution for its donation of a façade easement under section 170(h) of the Code.¹ The court concluded the fair market value of the façade easement was \$1,792,301, drastically lower than the \$7,445,000 claimed by the taxpayer on its 1997 return.² The Fifth Circuit vacated the Tax Court's decision and remanded the case to the Tax Court to revalue the façade easement.³ On remand, the Tax Court maintained the fair market value as previously assessed.⁴

The Code and regulations currently give little valuation guidance for façade easements, which results in the Service challenging the taxpayer's valuation and the taxpayer bringing the Service to court to litigate over the value of the easement. Courts commonly employ three "before and after" valuation approaches: replacement cost, capitalization of income, and comparable sales.⁵ A value is calculated under each approach, if applicable, and then the court reviews each of these approaches and determines the overall value of the easement based on all available evidence; accordingly, the value arrived at by the court may not be the exact figure determined by any one approach.⁶ Due to the subjective nature of the current valuation method, the taxpayer often claims a very large deduction, which the Service is forced to litigate case by case, a time-consuming method of enforcement. Because the current valuation method is too cumbersome to apply to easements and can often yield varying results depending upon the appraisers, this Note proposes the current

¹*Whitehouse Hotel Ltd. P'ship v. Commissioner (Whitehouse I)*, 131 T.C. 112 (2008), *vacated*, 615 F.3d 321 (5th Cir. 2010). All section references are to the Code and the Treasury regulations promulgated thereunder unless otherwise specified.

²*Id.* at 172.

³*Whitehouse Hotel Ltd. P'ship v. Commissioner (Whitehouse II)*, 615 F.3d 321, 343 (5th Cir. 2010).

⁴*Whitehouse Hotel Ltd. P'ship v. Commissioner (Whitehouse III)*, No.12104-03, 2012 WL 5231823, at *19, *26 (Oct. 30, 2012).

⁵See *Whitehouse I*, 131 T.C. at 129.

⁶See *id.* at 146.

valuation method be abandoned in favor of a new, more objective method based on a fixed percentage.

Part II provides an overview of the qualified conservation contribution and current valuation method used to determine the value of façade easements. Part III discusses the facts and initial decision in the *Whitehouse* case, the Fifth Circuit appellate decision, and the Tax Court's decision on remand. Part IV analyzes the Tax Court's reasoning and acknowledges the potential tax abuse problems. Part V proposes a possible solution to the current difficulties with the valuation methods.

II. Relevant Area of Law

Part II.A discusses qualified conservation contributions. Part II.B explains the three “before and after” approaches: replacement cost approach, capitalization of income approach, and comparable sales approach, which comprise the current valuation method for façade easements.

A. Qualified Conservation Contribution Defined

Normally, charitable deductions are not allowed for the donations of partial interests in property, but one exception to the rule is a qualified conservation contribution.⁷ A qualified conservation contribution is the donation to a charitable organization of a partial interest in real property exclusively for conservation purposes, which is protected into perpetuity.⁸ A façade easement is a partial interest in property that is either donated or sold to another party, which is allowed to restrict changes to the building façade in accordance with the agreement.⁹

The deduction for a qualified conservation contribution has been a permanent part of the Code since 1980.¹⁰ The purpose of the Act of January 3, 1980, was to use the Code to encourage historic preservation.¹¹ In 2008, 1,180 taxpayers claimed a deduction for a qualified conservation contribution in the form of a façade easement on their individual tax returns.¹² As of 2006, façade easements were in force on more than 13,400 properties in the United States.¹³

⁷Reg. § 1.170A-14(a).

⁸*Id.*

⁹See I.R.C. § 170(h)(4)(B)(i).

¹⁰Act of Dec. 17, 1980, Pub. L. No. 96-541, § 6(a), 94 Stat. 3204, 3206.

¹¹See Scott D. McClure, Steven E. Hollingworth & Nicole D. Brown, *Courts to IRS: Ease Up on Conservation Easement Valuations*, 124 TAX NOTES (TA) 551, 551 (Aug. 10, 2009).

¹²Pearson Liddell & Janette Wilson, *Individual Noncash Contributions 2008*, STATS. OF INCOME BULL., Winter 2011, at 76–77.

¹³Brief for the National Trust for Historic Preservation in the United States as Amicus Curiae Supporting Petitioners–Appellants at 2 n.4, *Whitehouse II*, 615 F.3d 321 (5th Cir. 2010) (No. 09-60085), 2009 WL 6636039.

B. *Determining the Value of the Easement*

Despite the Service continuously litigating overvaluations of the façade easements, Congress has not made changes to the valuation method.¹⁴ The current valuation method of façade easements is dependent on many estimates, and consequently, is not a “precise science.”¹⁵ The first step in valuing an easement is to determine that no other similar easements have been sold. If a similar easement has been sold, then the price paid for the easement will be deemed to be the fair market value of the easement; no further valuation method is necessary.¹⁶ Because façade easements are not regularly bought and sold, this step is not typically available.¹⁷ Instead, façade easements are generally valued by determining the difference in the fair market value of the property before and after the easement.¹⁸ The first step is to calculate the value of the property before it is encumbered by the easement, which is no different than determining the property value for any other purpose. The second step is to calculate the value of the property after it is encumbered by the easement. The difficulty with this method is determining how to calculate the after value.

Both the before value and after value of the property are based on its highest and best use, not simply its current use.¹⁹ The highest and best use of the property is the use that yields the highest present value.²⁰ For the after value, any rights given up as a result of the easement are considered when determining the highest and best use.²¹ The courts have recognized three “before and after” valuation approaches: replacement cost, capitalization of income, and comparable sales.²² The value of the easement can be based on a combination of the approaches.²³ The calculation of value under each approach is described below, along with the possible difficulties associated with each.

1. *Replacement Cost Approach*

The origin of the replacement cost approach is the substitution principle, which assumes that a buyer would not pay more for the property than it costs

¹⁴ See Shea B. Airey, *Conservation Easements in Private Practice*, 44 REAL PROP. TR. & EST. L.J. 745, 814 (2010).

¹⁵ *Whitehouse I*, 131 T.C. 112, 146 (2008), *vacated*, 615 F.3d 321 (5th Cir. 2010).

¹⁶ Reg. § 1.170A-14(h)(3).

¹⁷ *Dorsey v. Commissioner*, 59 T.C.M. (CCH) 592, 598–99, T.C.M. (P-H) ¶ 90,242, at 1097 (1990).

¹⁸ Reg. § 1.170A-14(h)(3).

¹⁹ *Id.*; see also *Dorsey*, 59 T.C.M. (CCH) at 599, T.C.M. (P-H) ¶ 90,242, at 1098 (1990).

²⁰ Craig J. Langstraat & Akela Young, *Where is the Ease in Valuing a Façade Easement?*, 87 PRAC. TAX STRATEGIES 21, 23 (2011).

²¹ *Losch v. Commissioner*, 55 T.C.M. (CCH) 909, 914–15, T.C.M. (P-H) ¶ 88,230, at 1156 (1988).

²² See *Whitehouse I*, 131 T.C. 112, 129 (2008), *vacated*, 615 F.3d 321 (5th Cir. 2010).

²³ See *id.*

to recreate it.²⁴ Courts are skeptical of using the cost approach for historic buildings because a historic building is unlikely to be rebuilt after a demolition.²⁵ Even if the building was demolished and rebuilt, it is highly unlikely the same construction methods and materials used originally to create the building would be used today.²⁶ Because the value derived from the approach is not likely to be meaningful for historic buildings, the court typically only adopts this approach when the capitalization of income and comparable sales approaches are not applicable.²⁷

2. Capitalization of Income Approach

Under the income approach, the fair market value of the property is determined by discounting the expected cash flows to present value.²⁸ This approach assumes a buyer would not be willing to pay more for the property than the present value of the anticipated income from the property.²⁹ The key estimates in determining the value under this approach are net operating income, expenses, building sale price, and the discount rate.³⁰ Because there is little data addressing the typical effect of the façade easements on these key estimates, it is difficult to determine the after value of the property.³¹

Although past earnings are not directly used in the calculation, they are used as a basis for potential future earnings.³² For this reason, the income approach is less reliable when the property has no past earnings track record.³³ Additionally, the approach cannot be applied if the property is not used to produce income.

3. Comparable Sales Approach

The comparable sales approach relies on the market to determine the fair market value of the property both before and after the easement. Information on the selling price of similar properties is obtained and then adjusted to reflect the differences between that property and the property being valued.³⁴ For example, adjustments might be made because one property is in a more desirable location or is subject to more rigorous zoning requirements. In order to value a façade easement using this approach, the buildings used as compa-

²⁴Talkington v. Commissioner, 76 T.C.M. (CCH) 868, 874, 1998 T.C.M. (RIA) ¶ 98,412, at 2431 (1998).

²⁵Dorsey v. Commissioner, 59 T.C.M. (CCH) 592, 600, T.C.M. (P-H) ¶ 90,242, at 1099 (1990).

²⁶Losch, 55 T.C.M. (CCH) at 915, T.C.M. (P-H) ¶ 88,230, at 1157 (1988).

²⁷See *Whitehouse I*, 131 T.C. at 147–48.

²⁸*Id.* at 138–39.

²⁹*Id.* at 139.

³⁰*Id.* at 154.

³¹See *id.* at 153–56.

³²Willis W. Hagen II, *The Tax Court's Capricious Nature in Ascertaining the Value of Donated Property*, 114 J. TAX'N 301, 305 (2011).

³³*Whitehouse I*, 131 T.C. at 153.

³⁴*Id.* at 142.

rable properties for the before value are not burdened by an easement while those used for the after value are burdened by a similar façade easement.³⁵

Of the three valuation methods discussed, the courts consider the comparable sales method to be the most reliable as long as there is information on sales of property similar to the property being valued.³⁶ However, calculating the after value can be problematic due to a lack of comparable buildings encumbered by comparable façade easements.

III. The *Whitehouse* Case

Part III.A describes the property purchased by the taxpayer, while Part III.B describes the façade easement. Part III.C analyzes the Tax Court's decision, while Part III.D discusses the Fifth Circuit's decision and the Tax Court's decision on remand.

A. *Property Description*

On December 21, 1995, Whitehouse Hotel Limited Partnership purchased real estate located near the French Quarter in New Orleans, Louisiana.³⁷ The property consisted of the historic Maison Blanche Building and two annexes bordered by Canal, Burgundy, Iberville, and Dauphine Streets.³⁸ The Maison Blanche Building is composed of a base of five floors, a mezzanine level and basement, and a "U-shaped tower" of eight floors.³⁹ One annex has five floors and the other has six floors.⁴⁰ At the time of purchase, the Maison Blanche Building's first, second, and third floors were leased to a department store, which had prepaid rent through 2004.⁴¹ Whitehouse paid \$6.625 million for the property and later paid an additional \$3.376 million for the right to use the Maison Blanche name and to buy out the remaining term of the lease.⁴² In October of 1997, Whitehouse purchased a building located adjacent to the Maison Blanche Building, known as the Kress Building, and the Kress parking garage, located across the street, for \$3.4 million.⁴³

The Maison Blanche Building exterior façades are almost exclusively made of glazed terra cotta.⁴⁴ The Maison Blanche Building was designated as a "Category B" building by the Central Business District Historic Landmark Commission, meaning the building is of major architectural significance.⁴⁵

³⁵ *Id.* at 145.

³⁶ *Estate of Spruill v. Commissioner*, 88 T.C. 1197, 1229 n.24 (1987); *see also Whitehouse I*, 131 T.C. at 171 (determining both the before and after value by using the comparable sales method).

³⁷ *Whitehouse I*, 131 T.C. at 115–16.

³⁸ *Id.* at 115.

³⁹ *Id.* at 116.

⁴⁰ *Id.*

⁴¹ *Id.* at 115.

⁴² *Id.* at 115–16.

⁴³ *Id.* at 116.

⁴⁴ *Id.*

⁴⁵ *Id.*

No alterations could be made to the exterior of the building unless approved by the commission.⁴⁶ The property has also been designated a certified historical structure by the U.S. National Park Service.⁴⁷

On February 19, 1997, Whitehouse entered into a contract with the Ritz-Carlton under which the partnership would renovate the Maison Blanche and Kress Buildings and the Ritz-Carlton would operate a hotel in the renovated buildings.⁴⁸ In October of 2000, the Ritz-Carlton commenced operations of a hotel, a spa, and a garage.⁴⁹

B. *Easement Description*

On December 29, 1997, Whitehouse conveyed a façade easement in perpetuity for the Maison Blanche Building to the Preservation Resource Center of New Orleans (PRC), a nonprofit corporation.⁵⁰ This conveyance provided in part that Whitehouse would maintain the façade; Whitehouse would not alter the façade without permission; and PRC could require Whitehouse to maintain the façade.⁵¹ As a result of the conveyance, the partnership claimed a \$7.445 million conservation contribution on its 1997 tax return.⁵²

The Service agreed that the partnership was entitled to a qualified conservation contribution but disputed the amount of the deduction.⁵³ The Service believed the deduction should have been \$1.15 million.⁵⁴

C. *Tax Court Analysis*

Because there is no market for conservation easements, section 1.170A-14(h)(3)(i) requires the value of the easement be determined by the impact on the market value of the property affected by the easement.⁵⁵ When determining both the before value and the after value of the property, the first step is to determine the highest and best use of the property.⁵⁶ For the after value, the taxpayer argued the highest and best use of the Kress Building was decreased by the conveyance of the easement because it could no longer add rooms to the top of the Kress Building.⁵⁷ These new rooms would block the Maison Blanche façade and violate the terms of the easement.⁵⁸ The Tax Court determined that the highest and best use was not altered because the promise to maintain a view of the Maison Blanche Building was a personal servitude;

⁴⁶ *Id.*

⁴⁷ *Id.* at 116–17.

⁴⁸ *Id.* at 117.

⁴⁹ *Id.*

⁵⁰ *See id.*

⁵¹ *Id.*

⁵² *Id.* at 118.

⁵³ *Id.* at 128.

⁵⁴ *Id.* at 129.

⁵⁵ *Id.*

⁵⁶ *Id.* at 130.

⁵⁷ *Id.* at 131.

⁵⁸ *See id.* at 131–32.

therefore, subsequent owners of the Kress Building would not be subject to the restriction.⁵⁹ Whitehouse contended that the highest and best use of the property, both before and after the conveyance, was as a luxury hotel, while the Service determined that a non-luxury hotel was the highest and best use of the property.⁶⁰ The Tax Court did not explicitly rule on the taxpayer's contention⁶¹ but implicitly accepted the Service's findings by agreeing with its approach for comparable sales.⁶²

The Tax Court next examined the three possible valuation approaches: cost approach, income approach, and comparable sales approach.⁶³ Whitehouse's expert had relied primarily on the cost and income approaches while the Service's expert relied solely on the comparable sales approach.⁶⁴ The Tax Court ultimately rejected the cost approach and the income approach.

The court regarded the cost approach as a poor measure for the value of older properties due to the subjective estimate of obsolescence.⁶⁵ The cost approach requires "probative correlation between [reproduction] cost and the fair market value of the property."⁶⁶ Here, there was no "probative correlation" because the estimated reproduction cost was \$43 million, but the partnership only paid approximately \$11 million for the property.⁶⁷ This difference would mean the property appreciated by 291% in two years.⁶⁸ The court was not persuaded by the taxpayer's explanation of the large appreciation and disregarded the cost approach for determining the value of the easement.⁶⁹

The court rejected the income approach because the property was not yet operating as a hotel and therefore had no track record of earnings.⁷⁰ The lack of earnings track record meant the expenses and revenues necessary for applying the approach would be based entirely on speculation; accordingly, the income approach was not appropriate for the Maison Blanche property.⁷¹

The court relied solely on the comparable sales approach to value the easement.⁷² In utilizing this approach, the court refused to give any weight to nonlocal properties that also had been converted into luxury hotels; instead, it opted to use only other French Quarter properties, regardless of use.⁷³ The court ignored the nonlocal properties because the adjustments to the sales

⁵⁹ *Id.* at 135.

⁶⁰ *See id.* at 130–31.

⁶¹ *Whitehouse II*, 615 F.3d 321, 335–36 (5th Cir. 2010).

⁶² *Whitehouse I*, 131 T.C. at 158.

⁶³ *Id.* at 147–61.

⁶⁴ *Id.* at 129–30.

⁶⁵ *Id.* at 147–48.

⁶⁶ *Id.* at 148.

⁶⁷ *Id.* at 149.

⁶⁸ *Id.*

⁶⁹ *Id.* at 152.

⁷⁰ *Id.* at 154–55.

⁷¹ *Id.* at 155–56.

⁷² *Id.* at 171–72.

⁷³ *Id.* at 157–58.

price were more subjective than that of the local properties, resulting in a valuation that was more prone to error.⁷⁴ The Tax Court's approach resulted in an easement value of \$1,792,301.⁷⁵ This easement value was greater than the value determined by the Service of \$1.15 million,⁷⁶ but substantially less than Whitehouse's value of \$7.445 million.⁷⁷ The court's easement value was derived from a before value of \$12,092,301 and an after value of \$10.3 million.⁷⁸ In its calculation, the court accepted the after value as determined by the Service, but rejected the Service's before value.⁷⁹ The court rejected both the before value and after value used by the taxpayer.⁸⁰

D. *The Fifth Circuit and Tax Court on Remand*

On appeal, the Fifth Circuit determined that the Tax Court made errors in its determination of the highest and best use of the property.⁸¹ The Tax Court did not explicitly rule on whether the highest and best use of the property was as a luxury or non-luxury hotel.⁸² The Tax Court decision was ambiguous and could be interpreted in two ways: "even if the highest and best use was as a [luxury hotel], that had no effect on the property's value; or, a non-luxury hotel was the highest and best use" of the property.⁸³ The Fifth Circuit instructed the Tax Court to reconsider this distinction on remand and to determine explicitly its effect on the highest and best use.⁸⁴ The Fifth Circuit also determined it was irrelevant that the servitude on the Kress Building was personal because the easement still affected the value of the Kress Building as part of the entire property owned by Whitehouse.⁸⁵ On remand, the Fifth Circuit required the Tax Court to take into account the effect of the easement on the Kress Building as part of the highest and best use analysis.⁸⁶

On remand, the Tax Court addressed the impact of the distinction between luxury and non-luxury hotels on the highest and best use of the property.⁸⁷ Because "the highest and best use of property does not itself identify the fair market value of the property" it was not necessary to determine whether the highest and best use of the Maison Blanche Building was as a luxury or non-luxury hotel.⁸⁸ As long as the comparable properties had as similar potential

⁷⁴ *See id.*

⁷⁵ *Id.* at 171.

⁷⁶ *Id.* at 129.

⁷⁷ *Id.* at 118.

⁷⁸ *Id.* at 168–69.

⁷⁹ *See id.* at 130, 161–72.

⁸⁰ *See id.* at 161–72.

⁸¹ *Whitehouse II*, 615 F.3d 321, 340 (5th Cir. 2010).

⁸² *Id.* at 335.

⁸³ *Id.* at 335–36.

⁸⁴ *Id.* at 336.

⁸⁵ *Id.* at 337–39.

⁸⁶ *Id.* at 340.

⁸⁷ *Whitehouse III*, No. 12104-03, 2012 WL 5231823, at *16–19 (Oct. 30, 2012).

⁸⁸ *Id.* at *16.

for hotel development as the Maison Blanche Building, their actual development as hotels—non-luxury or luxury—was irrelevant.⁸⁹

The Tax Court also addressed the effect of the easement on the Kress Building, stating, “[W]hile the partnership may have obligated itself personally to maintain a view of the Maison Blanche Building, petitioner has failed to show how that promise binds anyone who does not undertake it.”⁹⁰ The court held the easement did not burden the Kress Building and the easement itself imposed no obligation on Whitehouse that would forbid it from building on top of the Kress Building and subsequently blocking the view of the Maison Blanche Building.⁹¹ Whitehouse may have been personally obligated not to build on the Kress Building,⁹² “but unless the obligation is, or constitutes part of, a perpetual conservation restriction, that reduction in value cannot be counted as part of qualified conservation contribution.”⁹³ In case the Fifth Circuit felt the Tax Court had overstepped its authority by not including the Kress Building,⁹⁴ the Tax Court, in the alternative, recalculated the easement’s value including the Kress Building at \$1,857,716.⁹⁵

IV. Analysis

In determining the value of the easement in *Whitehouse I*, the Tax Court did not give much weight to the taxpayer’s assertion that the highest and best use of the property was as a luxury hotel and it ignored the impact of the easement on the Kress Building.⁹⁶ On remand, the Tax Court determined the use of the property as luxury or non-luxury hotel did not affect the fair market value of the easement.⁹⁷ It also determined that the Kress Building could not be counted towards the value of the contribution.⁹⁸

The court’s struggle to determine the easement’s value is indicative of the façade easement cases and illustrates a systemic problem with the current valuation method. A more objective valuation method would serve to reduce the amount of litigation and would promote Congress’s historical preservation goal. Part IV.A explains the Tax Court’s errors in determining the highest and best use of the property. Part IV.B illustrates the problems with the Tax Court’s current valuation method.

⁸⁹ *Id.* at *18.

⁹⁰ *Id.* at *20.

⁹¹ *Id.*

⁹² *Id.*

⁹³ *Id.* at *21.

⁹⁴ *Id.*

⁹⁵ *Id.* at *27.

⁹⁶ *Whitehouse I*, 131 T.C. 112, 131–35 (2008), *vacated*, 615 F.3d 321 (5th Cir. 2010).

⁹⁷ *Whitehouse III*, 2012 WL 5231823, at *16.

⁹⁸ *Id.* at *20–21.

A. *Highest and Best Use*

The Fifth Circuit determined that the Tax Court erred in failing to determine if the highest and best use of the property was as a luxury or non-luxury hotel.⁹⁹ Section 1.170A-14(h)(3)(ii) explains that, when applying the before and after valuation method, the appraiser

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 property's potential highest and best use.¹⁰⁰

The Service's expert contended that the highest and best use of the property was as a non-luxury hotel; however, the agreement for Ritz-Carlton Hotel to operate in the Maison Blanche Building was entered into before the Whitehouse partnership conveyed the easement.¹⁰¹ Thus, there was an "immediate," and not remote, likelihood that the Maison Blanche would be developed into a Ritz-Carlton luxury hotel. Because a luxury hotel is the most probable use of the property, the highest and best use of the property is as a luxury hotel as long as it is the most profitable use.¹⁰² The Tax Court did not explicitly rule on the highest and best use determination but implicitly accepted the Service's findings by agreeing with its approach for comparable sales.¹⁰³ On appeal, the Fifth Circuit expressed an assumption against the Service's view of a non-luxury hotel as the highest and best use and instructed the Tax Court to review its findings on this point.¹⁰⁴

The Tax Court on remand asserted it was not necessary to determine whether the highest and best use of the Maison Blanche Building was as a luxury or non-luxury hotel.¹⁰⁵ While distinguishing luxury from non-luxury hotels might be relevant for valuing renovated properties, it is not relevant when applying the comparable sales approach to valuing shell buildings.¹⁰⁶ Whitehouse failed to show the shell of the Maison Blanche Building had a "luxury hotel market orientation," or that such a difference exists.¹⁰⁷

⁹⁹ *Whitehouse II*, 615 F.3d 321, 335–36 (5th Cir. 2010). The Fifth Circuit also found that the court erred in determining the easement had no effect on the highest and best use of the property with regard to the Kress Building. On remand this was also considered. *Id.* at 340.

¹⁰⁰ Reg. § 1.170A-14(h)(3)(ii).

¹⁰¹ See *Whitehouse I*, 131 T.C. at 117, 131 (The Ritz-Carlton contract was dated February 19, 1997, and the easement was conveyed December 29, 1997).

¹⁰² See *Symington v. Commissioner*, 87 T.C. 892, 896–97 (1986).

¹⁰³ *Whitehouse I*, 131 T.C. at 158.

¹⁰⁴ See *Whitehouse II*, 615 F.3d at 336–37.

¹⁰⁵ *Whitehouse III*, No.12104-03, 2012 WL 5231823, at *16 (Oct. 30, 2012).

¹⁰⁶ *Id.* at *18.

¹⁰⁷ *Id.*

B. *Current Valuation Method Is Not Working*

The Service has been aggressively pursuing taxpayers who are taking a deduction for qualified conservation contribution because overvaluation is viewed as tax abuse.¹⁰⁸ The Service often asserts the easement is valueless.¹⁰⁹ Due to the heavy reliance on estimates of all three approaches, the taxpayer and the Service can arrive at drastically different before and after values. Accordingly, these cases devolve into an appraisal battle in which the taxpayer argues for a higher before value and lower after value and the Service argues for a lower before value and a higher after value.¹¹⁰ Ultimately, the court is forced to determine its own estimate of the façade easement value, which typically falls in between the value proposed by the taxpayer and the value proposed by the Service.¹¹¹

None of the current before and after valuation approaches work well for determining the after value. Courts have deemed the replacement cost approach unsuitable for historic properties, basically eliminating this approach for façade easements because the property in question will always be historic.¹¹² The after value is difficult to determine under the capitalization of income approach due to a lack of data on the effect of façade easements on the key estimates used in the approach.¹¹³ The comparable sales approach, which is typically favored by the courts, begins with an objective fair market value of a comparable property encumbered by a similar easement, which is then subjectively adjusted for differences in size, location, use, and zoning restrictions.¹¹⁴ The problem with these adjustments is that unlike the similar adjustments made in the before value, there is a lack of data available for the after value.¹¹⁵ Because all of the approaches rely so heavily on estimates, the valuation is too difficult to determine with much accuracy. In a majority of cases, the court, the taxpayer, and the Service all calculate different values.¹¹⁶

¹⁰⁸ See Letter from Steven T. Miller, Deputy Commissioner, Service and Enforcement, to Paul W. Edmondson, Vice President and General Counsel, National Trust for Historic Preservation (Mar. 13, 2008), available at http://www.architecturaltrust.org/images/documents/4c_-_2008_0313_Miller_Letter_Re_Valuation.pdf.

¹⁰⁹ See Scott D. McClure, Steven E. Hollingworth & Nicole D. Brown, *Courts to IRS: Ease Up on Conservation Easement Valuations*, 124 TAX NOTES (TA) 551, 555 (Aug. 10, 2009).

¹¹⁰ See Mark A. Turner & Ramon Fernandez, *Conservation Contributions: When Saving Face is a Charitable Event*, 84 PRAC. TAX STRATEGIES 269, 275 (2010); David M. Wooldridge, Ronald A. Levitt, & Gregory P. Rhodes, *Kiva Dunes—Making and Substantiating the Value of Conservation Easements*, 111 J. TAX'N 300, 304 (2009).

¹¹¹ While the court's value typically falls between the taxpayer's and Service's value, the court's value is not simply splitting the difference between the two values and is not skewed toward either the taxpayer's or the Service's value. See McClure, *supra* note 109, at 555.

¹¹² See *Whitehouse I*, 131 T.C. 112, 147–48 (2008), *vacated*, 615 F.3d 321 (5th Cir. 2010).

¹¹³ See *id.* at 153–56.

¹¹⁴ See I.R.S. Publication 561, 6 (Apr. 2007).

¹¹⁵ See *Nicoladis v. Commissioner*, 55 T.C.M. (CCH) 624, 627, 629, T.C.M. (P-H) ¶ 88,163, at 852–53 (1988).

¹¹⁶ See McClure, *supra* note 109, at 555.

Some of the difficulty with the valuation of the easement is due to the nature of the transaction. Easements are almost always donated and rarely sold, so there is no ascertainable market value.¹¹⁷ In a typical two-party transaction, the buyer and the seller have divergent interests and the price that they reach reflects the fact that the buyer wants to pay as little as possible and the seller wants to receive as much as possible. Because charities do not pay income taxes, there is no downward pressure on the fair market value of the easement being donated.

Although all three valuation approaches are based on the before and after method, where the easement value is derived by subtracting the after value from the before value, the Tax Court in past cases has applied a diminution percentage to the before value to calculate the value of the easement instead of determining an after value.¹¹⁸ This percentage approach to determining the value of the easement is evidence that the Tax Court feels the current valuation method is too cumbersome to apply to façade easements. While courts are able to apply a diminution percentage to ascertain the fair market value, the Service refuses to accept an appraisal that merely applies a percentage to the before value of the property as substantiation of the façade easement value.¹¹⁹

V. Proposal to Change the Valuation Method

While the courts are struggling to apply the before and after method, they are for the most part unwilling to agree with the Service's assertion that the easements have no value.¹²⁰ Congress passed the law providing for deductions for qualified conservation contributions to encourage historic preservation, and in the more than 20 years since the law was passed, Congress has not seen fit to remove it.¹²¹ The specific valuation approaches currently in use are derived from the approaches taken to value total interests in real property and are not specific to the qualified conservation contribution.¹²² Due to the difficulty in using valuation methods created to value real property as a whole, a new tailored valuation method specifically for façade easement contributions

¹¹⁷ See, e.g., *Symington v. Commissioner*, 87 T.C. 892, 895 (1986).

¹¹⁸ See, e.g., *Simmons v. Commissioner*, 98 T.C.M. (CCH) 211, 217, 2009 T.C.M. (RIA) ¶ 2009-208, *aff'd*, 646 F.3d 6 (D.C. Cir. 2011) (five percent); *Dorsey v. Commissioner*, 59 T.C.M. (CCH) 592, 602, T.C.M. (P-H) ¶ 90,242, at 1101 (1990) (ten percent); *Griffin v. Commissioner*, 56 T.C.M. (CCH) 1560, 1564, T.C.M. (P-H) ¶ 89,130, at 613 (1989), *aff'd*, 911 F.2d 1124 (5th Cir. 1990) (20%); *Nicoladis*, 55 T.C.M. (CCH) at 629, T.C.M. (P-H) ¶ 88,163, at 853-54 (ten percent); *Hilborn v. Commissioner*, 85 T.C. 677, 700 (1985) (ten percent).

¹¹⁹ C.C.A. 2007-38-013 (Sept. 21, 2007).

¹²⁰ McClure, *supra* note 109, at 552.

¹²¹ See Airey, *supra* note 14, at 814. *But cf.* STAFF OF THE JOINT COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, 277-87 (Comm. Print 2005) (discussing recommendations for possible changes to the treatment of façade easements).

¹²² See I.R.S. Publication 561, 6 (Apr. 2007).

should be created either in the form of a regulation or an amendment to the Code.¹²³

Part V.A explains the purpose behind the deduction, while Part V.B proposes a solution to the valuation problems inherent in the current method.

A. *The Deduction Promotes Historic Preservation*

Congress created the deduction in order to promote historic preservation.¹²⁴ The central goal of historic preservation can be seen through the requirements imposed by section 170(h). The property must be a certified historic structure,¹²⁵ which is defined as any building listed in the National Register, or any building located in a registered historic district and is certified by the Secretary of the Interior to the Secretary as being of historic significance to the district.¹²⁶ Additionally, section 170(h)(4)(B) imposes special rules with regard to buildings in registered historic districts. These requirements include the restriction must preserve the entire exterior of the building and the restriction must prohibit any change to the exterior if it is inconsistent with historical character.¹²⁷

The National Trust for Historic Preservation¹²⁸ maintains that façade easements are effective means of using private, voluntary agreements to preserve historic buildings.¹²⁹ Because local zoning laws are often inadequately enforced, façade easements are considered to be a superior preservation tool.¹³⁰ Congress's goal of historic preservation might be undermined because the difficulties with the current valuation method may discourage taxpayers from donating easements.¹³¹

B. *New Method*

After recognizing that the current valuation method was problematic, in 2005, the Joint Committee on Taxation made a proposal to limit the façade easement to the lesser of five percent of fair market value of the property or 33% of the value of the easement.¹³² While this proposal did not result in an amendment to the Code, it supports the assertion that the way to address the

¹²³As a practical matter it is unlikely the Treasury would change the regulation; therefore, implementing the new valuation method would require congressional action.

¹²⁴See Airey, *supra* note 14, at 814.

¹²⁵I.R.C. § 170(h)(4)(A)(iv).

¹²⁶I.R.C. § 170(h)(4)(C).

¹²⁷I.R.C. § 170(h)(4)(B)(i).

¹²⁸The National Trust for the Historic Preservation was created in 1949 and is a private nonprofit membership organization tasked with revitalizing and preserving historical places. NATIONAL TRUST FOR HISTORIC PRESERVATION, <http://www.preservationnation.org/who-we-are> (last visited October 31, 2012).

¹²⁹Brief for the National Trust for Historic Preservation, *supra* note 13, at 1.

¹³⁰*Id.* at 2.

¹³¹*Id.* at 3–4.

¹³²STAFF OF THE JOINT COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES, 277–87 (Comm. Print 2005).

problem with the current method is to use an objective valuation method, specifically a fixed percentage. The Tax Court also has gravitated toward determining the value based on a percentage of fair market value, and changing the valuation would just codify past court practices.¹³³ An objective evaluation approach would reduce the necessity for litigation to determine the easement value.

Ownership of property can be thought of as a package of “distinct entitlements” comprising a bundle of rights.¹³⁴ A façade easement can be viewed as a conveyance of two rights: the right to control the exterior and the right to further develop the property.¹³⁵ The diminution in the value of the property based on the loss of these two rights should be separately calculated. The value of the easement will equal the sum of these two losses of value. Part V.B.1 describes the right to control the exterior, while Part V.B.2 describes the right to develop. Finally, in Part V.B.3, the new method is applied to the facts in *Whitehouse*.

1. *The Right to Control the Exterior*

The first step in determining the value associated with the right to control the exterior is to determine whether the taxpayer possessed this right prior to conveying the easement. The taxpayer must have the right in the first place in order to donate it.¹³⁶ If the easement is no different than historical preservation restrictions already enforced on the property, then no deduction for this right should be allowed.¹³⁷

Once it is determined that the easement is more onerous in at least some respects than the existing historical preservation restrictions, the next step is to determine the fair market value of the building before the easement was conveyed.¹³⁸ The before value can be determined under any of the appropriate appraisal methods. Due to the nature of the properties typically at issue in façade easement cases, the comparable sales approach is likely to be the

¹³³ See cases cited *supra* note 103.

¹³⁴ JOSEPH SINGER, *PROPERTY 2* (3d ed. 2010).

¹³⁵ *Dorsey v. Commissioner*, 59 T.C.M. (CCH) 592, 601, T.C.M. (P-H) ¶ 90,242, at 1099–100 (1990).

¹³⁶ See Joe Stephens, *Loophole Pays Off on Upscale Buildings*, WASH. POST (Dec. 12, 2004), <http://www.washingtonpost.com/wp-dyn/articles/A57445-2004Dec11.html>.

¹³⁷ See Reg. § 1.170A-14(h)(3)(ii) (“[T]here may be instances where the grant of a conservation restriction may have no material effect on the value of the property or may in fact serve to enhance, rather than reduce, the value of property. In such instances no deduction would be allowable.”).

¹³⁸ The land value is not included because the right to change the exterior does not implicate land value. See *Dorsey*, 59 T.C.M. (CCH) at 602, T.C.M. (P-H) ¶ 90,242, at 1101.

most reliable approach. Next, the fair market value of the building should be multiplied by a flat percentage rate.¹³⁹

2. *The Right to Develop*

To determine whether the conveyance includes a right to develop, one must compare the highest and best use of the property before and after the easement. Only when the highest and best use is less after the conveyance has the taxpayer conveyed a right to develop the property. The right to develop will likely only be applicable to properties being used for commercial purposes because an easement does not typically affect the highest and best use of personal residences.

In general, the diminution of value from the loss of developmental rights should be based on the percentage change in the square footage multiplied by the fair market value of the property before the easement.¹⁴⁰ If the property prior to the conveyance is an income-producing property, such as a hotel or rental property, then the capitalization of income approach can be used to determine the loss in developmental rights.¹⁴¹

3. *Applying the Formula to Whitehouse*

In order to apply the formula to the property described in *Whitehouse*, assume the fair market value of the building for which the right to control the exterior was donated¹⁴² is \$6,625,000.¹⁴³

$$\text{Right to change the exterior (RCE}_w) = FR^{144} (\text{flat rate}) \times FMV (\text{fair market value})$$

$$RCE_w = .10 \times 6,625,000$$

$$RCE_w = \$625,000$$

Even though the Kress Building is not burdened by the easement, it is affected by the easement, and this effect is considered when determining the loss on the right to develop the contiguous parcel that is imposed by the ease-

¹³⁹The cases cited *supra* note 103, applying a flat rate in order to determine the easement's value, do not provide reasoning for valuing a façade easement at the given flat rates. Accordingly, this Note proposes the benefits of using a flat rate in general and declines to advocate for any particular rate.

¹⁴⁰The entire property value, not just the building, is included because the loss of development rights affects the entire property and not just the building. See *Dorsey*, 59 T.C.M. (CCH) at 602, T.C.M. (P-H) ¶ 90,242, at 1101.

¹⁴¹This insures that there is a track record as a basis for the capitalization of income valuation approach.

¹⁴²The fair market value of the Kress Building is not considered in this calculation because the easement only burdened the Maison Blanche Building. See *Whitehouse I*, 131 T.C. 112, 115–17 (2008), *vacated*, 615 F.3d 321 (5th Cir. 2010).

¹⁴³This is the price the Whitehouse Partnership paid for the property in December 1995. *Id.* at 115–16. For the purposes of illustration this is assumed to be the fair market value of the property on December 1997 when the easement was conveyed.

¹⁴⁴This example sets the flat rate at ten percent because it was the most prevalent in the case law. See cases cited *supra* note 103; see also discussion *supra* note 123.

ment.¹⁴⁵ The general formula for the loss of developmental rights would be used for the property in *Whitehouse* because, even though it is currently used as income-producing property, it was not a hotel prior to the conveyance. Because there is no information in the record regarding the square footage of the parcel at its highest and best use before the easement, the number of hotel rooms before and after the easement will be used as a proxy for square footage. Before the conveyance, the highest and best use of the property is 780 rooms, but after, it is only 720 rooms.¹⁴⁶ For the purposes of illustration, \$11,000,938 is assumed to be the fair market value of the property when the easement was conveyed.¹⁴⁷

$$\text{Right to Develop } (RD_w) = (\text{Before-After/Before}) \times \text{FMV}$$

$$RD_w = ((780-720)/780) \times 11,000,938$$

$$RD_w = .0769 \times 11,000,938$$

$$RD_w = \$846,226$$

$$\text{Qualified Conservation Contribution } (QCC) = RCE_w + RD_w$$

$$QCC_w = 625,000 + 846,226$$

$$QCC_w = \$1,471,226$$

Under the new method, the easement would be valued at \$1,471,226. While this valuation method results in a value substantially lower than that argued by the taxpayer, it is more objective and the results can be consistently verified.¹⁴⁸ The new method results in a verifiable value; accordingly, the Service will not need to pursue as many façade easement cases in court.

This method places a premium on administrability, and in doing so it sacrifices accuracy and arguably produces an arbitrary value. The calculated value may or may not be reflective of the easement's "actual" value, which is perhaps undeterminable. The value of the right to change the exterior is determined by multiplying the fair market value of the property by a flat rate, which serves as an approximation for the value of this right. As a result, this method does not take into account the fact that some façade easements may be much more restrictive than others and instead it treats them all equally.

¹⁴⁵ "[B]ecause of the easement, Whitehouse could not build on top of the Kress building." *Whitehouse II*, 615 F.3d 321, 337 (5th Cir. 2010). On remand the Tax Court may have overstepped its authority in refusing to include the effect on the Kress Building in the value of the easement. See *Whitehouse III*, No. 12104-03, 2012 WL 5231823, at *21 (Oct. 30, 2012).

¹⁴⁶ See *Whitehouse I*, 131 T.C. at 137.

¹⁴⁷ This fair market value equals the price Whitehouse Partnership paid for the Maison Blanche Building and the Kress Building plus the buyout of the retail lease. *Id.* at 148–49.

¹⁴⁸ The proposed method still involves estimations and assumptions, but this is inherent for any fair market value calculation when there is no true market for the asset.

VI. Conclusion

While historic preservation is a worthy goal, the current before and after method for valuing the façade easement is cumbersome and results in litigation over the appropriate value of the easement. The difficulty with the approach is illustrated by the court's misapplication of the method in *Whitehouse*.¹⁴⁹ In order to further the historic preservation goal of Congress, this valuation method needs to be replaced with a more objective method. An approach that objectively values the easement based on the rights being conveyed in the easement will provide a more easily ascertainable value of the easement. Congress should take the opportunity to act to curb potential valuation abuses and to reduce the amount of litigation for façade easements.

Stephanie S. Jeane

¹⁴⁹ See *Whitehouse II*, 615 F.3d at 340 (directing the Tax Court to revalue the easement due to errors in the approach initially taken).