

RECENT JUDICIAL GUIDANCE ON VALUING CONSERVATION EASEMENTS

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According to recent comments by IRS officials, the most common problems noted during audits of conservation easement donations involve valuation.¹ Reg. 1.170A-14(h), which governs the valuation of conservation easements, requires that the value be determined from the sales price of comparable easements or, if no substantial record of comparable sales is available, then from the difference between the total property's fair market value (FMV) before and after the easement donation.

Because established markets for easements rarely exist, the standard approach is to appraise the property before and after the imposition of the conservation restrictions using the three commonly recognized valuation methods (income, cost, and comparable sales). Peculiarities of the property are taken into account by modifying either the method or its relative weight in the valuation. Factors affecting the valuation, such as laws or local restrictions governing future development, also are considered. The difference between these "before" and "after" values represents the value of the easement donation.

While the conceptual framework for before-and-after easement valuations is straightforward, the practical application of this framework is problematic.

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Absent market data, an easement valuation is often based on estimates regarding the effects of such things as local zoning laws, easement covenants, market demand, and possible future property development. In light of the current IRS position regarding easement valuations,² it is imperative that appraisers document the basis for their estimates and that they carefully consider all of the relevant facts surrounding easement donations.

Tax benefits

For tax purposes, a qualified conservation contribution is one that conveys a perpetual real property interest to a qualified organization or political subdivision exclusively for conservation purposes. Conservation purposes are defined broadly to include the preservation of land areas, natural habitats, open spaces, and historic structures. While easements protecting significant historic properties, facades, landscapes, or archeological sites from future change or development are often referred to as preservation easements, they are classified together with conservation easements for tax purposes and their valuation follows the same guidelines.

Significant tax benefits often arise from contributions of qualified conservation easements. Section 170(h) allows the donor to claim a federal income tax deduction in an amount equal to the FMV of the

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easement at the time of the contribution. In addition, such a contribution generally reduces the donor's estate or gift taxes, state income tax, and local property taxes. Non-tax benefits also may accrue in that the donor can continue to use the encumbered property in its current condition, without fear of unwanted development.

Because the amount of a donor's tax benefit is directly affected by the value assigned to the easement, the IRS requires that valuations greater than \$5,000 be based on qualified appraisals by independent, qualified appraisers who regularly perform appraisals on the type of property being valued. It further requires that the appraiser sign an attachment (Form 8283) to the donor's return. In addition, if the value of a donation exceeds \$500,000, a copy of the appraisal must be submitted with the tax return.³

Before-and-after approach

Absent an established market, the accepted valuation method for easement donations is the before-and-after approach. Under this approach, the "before" value of the property encumbered by the easement is determined on the basis of its highest and best use, without regard to any restrictions imposed by the easement. In determining the best use, the suitability of the property's current use under existing zoning, conservation, or historic preservation laws is examined. Any suggested use higher than the current use must be realistic under current market conditions ---and likely to occur within a reasonable period of time. After making a determination as to the property's best use, the property is valued using one or more of the recognized valuation methods (income, cost, and comparable sales), as applicable. These methods are modified for any unusual or distinct features of the property that might affect their reliability.

The "after" value of the property is its highest and best use as encumbered by the easement. In determining this value, the easement's terms and covenants are examined, individually and collectively, and compared to existing zoning regulations and other restrictions, such as local historic preservation ordinances, to estimate whether, and the extent to which, the easement will affect current and alternate future uses of the property. Consideration also is given to the effect of restrictions that,

while preventing the property from its highest and best use, still permit uses that increase its FMV above that of the current use. Based on a complete understanding of the easement, the above-mentioned three valuation approaches then are again used to determine the value of the property as burdened by the easement.

Kiva Dunes Conservation

The Tax Court's recent decision in *Kiva Dunes Conservation*, TCM 2009-145, provides an excellent illustration of the before-and-after approach of valuing easement donations. The taxpayer in this case was an LLC taxed as a partnership. After completing development of the Kiva Dunes Golf Course on 141 acres located between two segments of the Bon Secour National Wildlife Refuge in Alabama, the taxpayer donated a perpetual conservation easement on the property to the North American Land Trust. The easement declarations restricted the use of the property to protect the natural habitats for fish, wildlife, and plants, and to preserve open space for the scenic and recreational enjoyment of the general public. The taxpayer claimed a charitable contribution deduction for the easement donation in the amount of \$30.6 million. Upon audit, the IRS reduced the value to \$10 million and asserted an accuracy-related penalty for overvaluation.

The expert appraiser for the taxpayer (the same expert who had conducted the original appraisal on which the taxpayer based its claimed deduction amount) and the appraiser for the IRS agreed that the property's highest and best use before the easement donation was residential subdivision and that after the donation the best use was as a golf course. They also both determined the property's "before" value using a discounted cash-flow analysis of estimated revenues and costs associated with the development and sale of lots in a hypothetical subdivision. In this respect, their assumptions regarding lot appreciation, developer's profit, sales commissions, closing costs, marketing expenses, property taxes, and the appropriate discount rate were largely offsetting. Their assumptions differed markedly, however, with respect to the number of lots available for sale, the average sale price of the lots, and the rate at which the lots would sell.

¹ Elmore, "IRS Official Defends Audit Strategy On Conservation Easements," 93 TNT 61-2, 10/5/09. This article reports on comments by Alexandra Nicholaides, senior counsel, IRS Small-Business/Self-Employed Division, at the Fall 2009 Individual and Family Taxation session of the ABA Section of Taxation meeting in Chicago.

² See IR 2009-41, 4/13/09 (specifically mentioning overvaluation of easement donations in its "Dirty Dozen 2009" list) and IRS Notice 2004-41, 2004-1 CB 31 (providing notice that the IRS may disallow deductions for easement donations and even challenge the tax-exempt status of charitable organizations that participate in improper easement deduction transactions).

³ Section 170(f)(11).

The taxpayer's expert developed a conceptual plan for subdivision of the property that proposed the enlargement of several lakes and the creation of several pool and recreation areas. This allowed approximately 70% of the lots on the property to front the lakes and gave some beautiful views of Mobile Bay. When evaluated in light of the limited supply of lots with similar characteristics and the area's growing population, his plan increased the selling price and selling rate of the proposed lots.

In contrast, the expert for the IRS misinterpreted a local zoning regulation in determining the number of lots that could be developed in a subdivision of the property. He also estimated the average lot price on the basis of just two previous sales of inferior lots at a nearby residential subdivision. And because he envisioned a subdivision of lower quality lots, his estimated absorption period was substantially longer than that of the taxpayer's expert. Together, these factors led to a significantly lower value for the property at its highest and best use prior to the easement donation.

In determining the value of the property after being burdened by the easement, the taxpayer's expert averaged the sales price of five comparable properties after adjusting the price per acre for market conditions, location, access, visibility, size, utilities, topography, and financing. The Service's expert, in comparison, used an income approach that divided a capitalization rate into a number that he erroneously represented as the net income of the Kiva Dunes Golf Course. The Tax Court rejected this valuation, however, because it omitted expenses that, when subtracted from net income, resulted in a negative number.

In reaching its determination of the easement's value, the Tax Court accepted much of the methodology of the taxpayer's expert. It faulted him, however, for failing to adjust his "after" value of the property upward to reflect the cost associated with converting the comparable properties into golf course properties akin to the Kiva Dunes property. After adjusting for this oversight and for the fact that the conservation easement enhanced nearby property owned by the taxpayer, the court assigned an FMV to the conservation easement of \$28.7 million, which was approximately 94% of the taxpayer's claimed value. Additionally, the court denied the Service's asserted overvaluation penalty. The Service did not appeal the Tax Court's decision.

Whitehouse Hotel

In contrast to the taxpayer's success in *Kiva Dunes Conservation*, the Tax Court found that the taxpayer in *Whitehouse Hotel*, 131 TC No. 10 (2008), grossly overstated the value of its charitable contribution deduction for a facade easement, resulting in both an assessed tax deficiency and valuation misstatement penalty. The taxpayer, a limited partnership, acquired property containing historic structures adjacent to the French Quarter in New Orleans with the intent of renovating the buildings into first-class hotel space. Prior to the start of renovation, it donated a facade easement on one of the buildings to the Preservation Alliance of New Orleans. Terms of the easement re-

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quired the taxpayer to maintain the original appearance of the facade. Relying on an appraisal of the easement, the taxpayer claimed a charitable contribution deduction of \$7.4 million. The IRS reduced this value to \$1.2 million and asserted an accuracy-related penalty for gross overvaluation.

At trial, the taxpayer offered an expert appraiser other than the one whose value had been relied upon in preparing the tax return containing the charitable contribution deduction. This expert determined the property's "before" and "after" values by using the cost, income, and comparable sales approaches, with modifications for the uniqueness of the property. Based on the difference between these "before" and "after" valuations, he concluded that the FMV of the facade easement was \$10 million. In contrast, the expert for the IRS relied exclusively on the comparable sales approach to conclude that the facade easement had no value. The IRS, however, asked only that the value be reduced to \$1.2 million.

Both experts agreed that the highest and best use of the property before the easement donation was mixed use development containing hotel and retail space. They differed, however, in their assessment of the property's best use after the easement donation. The taxpayer's expert believed the facade easement reduced the number of hotel rooms that could be constructed above an adjacent building, also owned by the taxpayer. The expert for the IRS, in comparison, believed the facade restrictions imposed no burden on the property's development.

After examining the language of the easement and local law, the Tax Court determined that the facade easement did not deprive the taxpayer of the ability to add hotel rooms above the adjacent building. It also

concluded, on the basis of earlier judicial decisions and the specifics of the taxpayer's property, that the cost and income approaches were unreliable because they required too many subjective estimates when applied to the valuation of older, historic structures or property lacking a record of earnings. The court therefore computed the "before" and "after" values of the property using the comparable sales approach, with adjustments for differences in the size, zoning, financing, location, and layout of the corresponding properties. This method assigned an FMV to the facade easement of \$1.8 million. Comparing this value to the charitable contribution deduction claimed by the taxpayer, the court sustained the asserted accuracy-related penalty.

Lessons

Kiva Dunes Conservation and *Whitehouse Hotel* provide contrasting illustrations of the factors an appraiser must consider when valuing conservation easement donations. In *Kiva Dunes Conservation*, the taxpayer's appraiser had extensive knowledge of the local real estate market and its zoning requirements. His proposed subdivision properly included features that enhanced the property's desirability, adding to its "before" value both in terms of lot price and absorption rate. His analysis was fully documented and his assumptions were supported by collaborating records and testimony. Further, his choice of valuation methods was appropriate for the property and it reflected an understanding of local market conditions.

In contrast, the expert for the IRS had no familiarity with the local real estate market, having visited the area only twice in connection with his appraisal. His interpretation of local zoning rules consequently was faulty, and the value assigned to his proposed subdivision was based on inconsistent assumptions. Additionally, his use of the income approach in determining the value of the property after the easement donation was inappropriate because it omitted certain expenses that, had they been included, would have shown the Kiva Dunes Golf Course to be unprofitable.

In *Whitehouse Hotel*, the taxpayer offered a different expert appraiser to the Tax Court than had been employed in valuing the facade easement donation on its tax return (a fact that by itself may have hurt the taxpayer's credibility with the court). This expert had spent four to six days in New Orleans before reaching his conclusion regarding the value of the easement, and his valuation relied largely on the cost and income approaches, both of which were re-

jected by the court as unreliable. The property burdened by the facade easement was an older building and, according to the court, unlikely to be reconstructed if it were destroyed. The cost method consequently was determined to be a poor indicator of value. Likewise, the expert's use of the income approach was judged unreliable because it was based on unsupported assumptions regarding the projected cash flow of the property were it to be renovated into a Ritz-Carlton hotel.

The expert for the IRS, in comparison, had been appraising real estate in Louisiana for over 25 years and had performed appraisals for more than 50 buildings in the New Orleans area that were to be used as, or converted into, hotels. In preparing his appraisal of the facade easement, he inspected the property and studied the zoning restrictions, plat maps, and an engineer's report to confirm the size of improvements made to the building. He also searched the multiple listing service and courthouse records to locate property sales and leases comparable to the taxpayer's property, adjusting for physical differences and special conditions of the sale. In addition, he had previously valued the taxpayer's building on three separate occasions and was extremely familiar with the property.

As these two cases illustrate, the appraiser's choice of valuation methods must be based on an intimate understanding of the property and its potential for development. Determining the property's highest and best use requires the ability to look beyond its current use and to envision how the property might be developed under existing market conditions and within the restrictions of local laws and zoning regulations. The appraiser consequently must be willing to invest the time needed to become knowledgeable about the specific geographic area and market of the property being valued (and the taxpayer must be willing to pay the costs associated with hiring such an experienced appraiser). Additionally, the appraiser must be willing to conclude that not every easement donation materially reduces the value of the encumbered property.

An example of this point occurs in *Turner*, 126 TC 299 (2006). In that case, the taxpayer, a real estate investor, bought 29 acres of real property for \$2.5 million. The property was located in an historic, overlay district with 15 acres in a flood plain. The taxpayer granted an easement on the property limiting development to 30 lots and claimed a charitable contribution deduction for the donation. He then obtained an appraisal of the easement based, in part, on a letter from the town building inspector stating that 60 lots were approved for subdivision on the property. The appraisal, however, failed to consider the historic overlay of the property or the existence of the flood

⁴ CCA 200738013 (9/21/07).

plain—both factors that precluded the subdivision into 60 lots. The Tax Court therefore rejected the donation deduction because the property could still be developed to its maximum value. (It in fact concluded that no conservation easement had been created for federal tax purposes.)

Partial interests

When an easement is donated on only a portion of the donor's property, Rev. Rul. 76-376, 1976-2 CB 53, *clarifying* Rev. Rul. 73-339, 1973-2 CB 68, states that the before-and-after approach should be applied to the entire property, not just the portion on which the easement is granted. An illustration of this rule is provided in *McLennan*, 994 F.2d 839, 72 AFTR2d 93-5115 (Fed. Cir. 1993), *aff'd* 68 AFTR2d 91-5572, (Cl. Ct., 1991). In this case, the taxpayer donated a scenic easement over approximately 170 acres of their 407 acres of residential property to a local tax-exempt conservancy. Expert appraisers for the taxpayer and IRS agreed that after the easement donation the entire property's highest and best use was bulk subdivision. They disagreed, however, on the best use of the property prior to the easement donation.

The Service's expert considered the property as two economic units, the larger of which included acreage subject to the scenic easement. Because this unit contained only agricultural land, the expert concluded that prior to the easement donation the unit's best use was bulk subdivision—the same use as after the donation. The expert consequently concluded that the easement did not affect the FMV of the property.

Both the Claims Court and Federal Circuit, however, found that such a valuation was unreliable because it failed to consider the decline in the value of the remaining unit that included the taxpayer's country estate. The courts, therefore, accepted the opinion of the taxpayer's expert that the portion of the property not burdened by the easement decreased in value as a result of the easement restrictions because its highest and best use was reduced to bulk subdivision.

In some instances, the conveyance of an easement affects not only the property burdened with the easement, but also nearby property. In *Osborne*, 87 TC 575 (1986), the taxpayer constructed and installed drainage facilities over four of seven parcels that he was developing. He then transferred the facilities and easement rights over the facilities to the city of Colorado Springs, which under local law was obligated to provide for the safe discharge of waters in the area. The taxpayer's conveyance of the facilities and easement rights had been encouraged by the city in order to facilitate their repair and maintenance.

The Tax Court determined that, to the extent the taxpayer improved his own property, his expenditures should be capitalized. But to the extent he gratuitously benefited the city by providing permanent rather than temporary drainage facilities and by conveying easements for that purpose, he was entitled to a charitable contribution deduction. In valuing the easement donation, the court combined the difference in the value of the four parcels subject to the easement before and after the donation with the decrease in the value of the three contiguous parcels. This approach had the effect of increasing the easement donation because it considered the reduction in the value of both the parcels burdened with the

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easement and those which, while not directly burdened, were nonetheless adversely affected because of their proximity.

Shortcut valuations

Shortcut valuations based on a fixed percent of the property's FMV are unacceptable and should not be used. Instead, easement donations, particularly those involving building facades, must be valued using the comparable sales method or, where there is no established market, the before-and-after approach with adequate consideration given to the particular facts and circumstances surrounding the easement donation. Reliance on an IRS Market Segment Specialization Program Guide or Topical Tax Brief, which at one time suggested a range within which a facade easement might be expected to reduce the value of property, is considered by the Service to be unreliable and by itself will not support an otherwise insufficient valuation.⁴

Appraiser penalties

Frequently, misstatement of an easement's value for tax purposes will subject the donor to an accuracy-related penalty absent a showing of a good faith investigation of the easement's value. The appraiser in such cases may also be subject to penalties and disciplinary action. Under Section 6695A, if an easement valuation is 150% or more of the determined income tax value (or 65% or less than the determined estate or gift tax value), the appraiser may be assessed a penalty equal to the greater of \$1,000 or 10% of the amount of tax attributable to the valuation misstate-

ment, with a maximum penalty of 125% of the appraisal fee. In addition, under certain circumstances and after due notice and opportunity for hearing, the appraiser can be barred from practice before the IRS.

There is a limited exception to the penalty if the appraiser satisfies the Service that the value established in the appraisal is more likely than not the proper value. Currently, there is no guidance as to how an appraiser would assert this defense, but the IRS has promised to provide direction in forthcoming regulations.⁵ Presumably, the Service's appraiser sanctioning process will conform with Standard 3 of the Uniform Standards of Professional Appraisal Practice (USPAP) or similar standards since this position would be consistent with the Service's definition of a qualified appraisal.⁶

Conclusion

As the number of conservation easement donations has grown, so has scrutiny by the IRS and state tax commissions. Under current rules, a contribution of a conservation easement must be made to an eligible donee, and the donation must be supported by a re-

port containing survey and area maps, aerial and on-site photographs, and statements regarding the condition and accuracy of these representations.⁷ In addition, the easement's value must be based on a qualified appraisal prepared by a qualified appraiser.⁸

A qualified appraisal for tax purposes is one that complies with generally accepted appraisal standards, such as the USPAP. Referencing these standards in the appraisal report is advisable since, upon examination, the taxpayer and appraiser bear the burden of defending the report as qualified. But beyond this, the appraisal also must contain detailed supporting documentation for its conclusions and choice of valuation methods. If the comparable sales method is chosen, the suitability of the selected properties must be documented and adjustments must be made for any unusual or distinct property features. Similarly, the use of the income approach must be appropriate and based on a realistic projection of cash flow. Estimates of revenues, operating expenses, depreciation, and other costs are generally unreliable unless the property or a similar property has a record of earnings. Caution also should be exercised in the use of the cost method unless there is clear evidence of a correlation between the property's replacement cost and its FMV. Thus, while this method might be appropriate for a property that is unusual in nature and for which the other valuation methods are not applicable, it is unlikely to be reliable when applied to value historic structures, open spaces, or natural habitats. ■

⁵ IRS Memorandum SBSE-04-0809-015, "Procedures for Implementing the Penalty for Substantial and Gross Valuation Misstatements Attributable to Incorrect Appraisals" (8/18/09), available at www.irs.gov/pub/foia/ig/sbse/sbse-04-0809-015x.pdf.

⁶ IRS Notice 2006-96, 2006-2 CB 902.

⁷ Reg. 1.170A-14(g)(5)(i).

⁸ Reg. 1.170A-13(c)(2); Section 170(f)(1)(E)(ii).