Conservation Easement Appraisals for Tax Purposes: Special Problems and Liability Concerns

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Conservation Easement Appraisals for Tax – Where Are We Going This Morning?

- Discuss a challenging, interesting and profitable area of appraisal practice.
- Discuss appraisal issues and related concerns that have arisen in recent Tax Court cases.
- Help with suggestions on appraisal practice to help keep taxpayer clients happy and keep them and you away from the penalties.
- Offer some protective terms for engagement agreements.
- Have a good discussion.
What’s on The Memory Chip?

• Several recent significant Tax Court cases from 2014-15 addressing valuation of CEs.
• Key materials from IRS that appraisers should be familiar with:
  • 2013 Memorandum from IRS Chief Counsel’s Office regarding “Related Parties”
  • Key IRS Publications, including the IRS Conservation Easement Audit Techniques Guide
  • Other useful links. Example: www.google.scholar.com
• Sample agreement.
Looking at the Playing Field

• Located 18 Federal Tax and Circuit Court of Appeals decisions in 2014-15 regarding IRS challenges to taxpayer deductions for CEs.

• These are cases where the taxpayer disagrees with the IRS, has the means to fight, and then files suit in Tax Court.

• Out of the 18 cases, only 2 resulted in anything that could be called a victory for the taxpayer:
  • Palmer Ranch Holdings Ltd. v. Comm‘r, T.C. Memo. 2014-79.
  • SWF Real Estate LLC v. Comm‘r, T.C. Memo. 2015-63.

• One unfortunate appraiser was tied to 3 particularly onerous cases.
Special Note About The Cases Discussed Today

- *None* of the recent 2014-15 cases we will discuss today involve any claim, allegation or indication that the appraiser himself or herself did anything wrong.
- The cases involve very good appraisers doing good work for their clients in a tough battleground.
- We can learn from the court decisions, however, about ways that appraisers might fine tune how they approach CE tax assignments.
- We can also think about ways appraisers might protect themselves from the odd-ball client who brings a professional liability claim blaming the appraiser for an unhappy tax result (a risk that does exist and which has occurred).
But In This Older Case, Maybe the Appraisers Weren’t Doing Such a Good Job – Using a URAR to Appraise a Façade Easement. Believe It or Not?

Rothman v. Comm’r, T.C. Memo. 2012-163 – Tax Court considered an appraisal for a building façade easement deduction:

• Four-story townhome in Brooklyn.
• Façade easement donated to NAT.
• In support of deduction, taxpayer submitted an appraisal.
• Tax Court: “In a uniform residential appraisal report, [the appraisers] estimated the market value of the subject property as $2.6 million as of September 15, 2004.”
• Appraisers then had a boilerplate addendum generally discussing the impact of CEs on property values and offered their “opinion.”
Rothman v. Comm’r:

- Appraisers: “It is our opinion that the presence of the façade conservation easement would alter the market value of the subject property. . . The appraiser cannot precisely estimate the extent to which this ‘loss in value’ will result from the façade easement due to lack of market data. In this situation it is the appraiser’s conclusion that the value of the façade easement on the subject property would be estimated at $290,000, which is approximately 11.15% of the fee simple value of $2,600,000. This conclusion is based on consideration of the range of value that the I.R.S. Has [sic] historically found to be acceptable as well as historical precedents.”
Believe It or Not?
Using a URAR to Appraise a Façade Easement

Rothman v. Comm’r:

• Tax Court: “This Court, in [ ] T.C. Memo. 2010-151, was presented with an appraisal report identical in all material respects, including the typographical errors, to the one petitioners obtained.” (For a different property.)
• Tax Court: “The appraisal applies the wrong standard of value.”
• Tax Court: “Applying a fixed percentage to the before value of the subject property, without explanation, does not constitute a valuation method under section 1.170A-13(c)(3), Income Tax Regs.”
Engagement Letter Tip #1

A good engagement agreement is key for appraiser protection. Every good engagement agreement begins with a good description of the scope and purpose of the engagement.

But don’t say something like this: the purpose of this appraisal engagement assignment is “to determine the decreased value of the subject property resulting from a conservation easement.”

Remember, down the road, your file may be obtained by the IRS. You don’t want a lawyer cross-examining you to imply that you entered the engagement with any value in mind: USPAP Ethics Rule – “An appraiser must not accept an assignment that includes the reporting of predetermined opinions and conclusions.”
What’s Happening in the Market for CE Appraisal Services?

What are CE clients seeking?

- Accuracy and credibility?
- A high valuation?
- Lower fee?
- Are they ready to accept a detailed engagement that protects you?
- What about the IRS as a client? What do they seek?
Rothman v. Comm’r:

Tax Court set out the basic requirements for a “Qualified Appraisal” supporting a CE deduction under the regulations issued under IRC 170:

- Begins with “an appraisal document prepared by a qualified appraiser no earlier than 60 days before the contribution date and no later than the extended due date of the return first claiming the deduction,“
- Appraisal must include:
  - 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; note: many CE appraisals erroneously describe the underlying property, not the donated easement that is being valued;
Qualified Appraisal – The Basics

• The date (or expected date) of contribution to the donee;
• 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;
• The name, address, and the identifying number of the qualified appraiser; *note: all appraisers working on the valuation need to be named*;
• 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;
• A statement that the appraisal was prepared for income tax purposes;
• The date (or dates) on which the property was appraised;
Qualified Appraisal – The Basics

• The appraised fair market value (within the meaning of § 1.170A-1(c) (2)) of the property on the date (or expected date) of contribution;
• The method of valuation used to determine the fair market value. . .; and
• 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.
Esgar Corp. v. Commissioner (10th Cir. 2014)

- Taxpayers each owned 53 acres of land adjacent to each other in Prowers County, Colorado – 3 separate parcels.
- Land had been split off from larger holding they also owned and that contained a gravel mine.
- Taxpayers donated a CE in December 2004 to the Greenlands Preserve.
- Appraiser concluded HBU of eased property was gravel mining and opined the CEs were each worth $570,500, $836,500 and $867,500.
- In audit, IRS concluded each CE was valueless.
- Three day trial in Tax Court occurred in 2009.
- Court of Appeals aff’d Tax Court ruling.
- Sole issue before the Tax Court was the value of the conservation easements.
Esgar Corp. v. Commissioner (10th Cir. 2014)

- IRS contended HBU was continued agriculture.
- Expert testimony was presented on market for gravel.
- Tax Court decided agriculture was the HBU at time of donation because while “it would have been physically possible to mine the properties in 2004 (or in the future),” and there was no economic demand for such use in that area “in the reasonably foreseeable future.”
- Court commented that taxpayers failed to offer analysis of the remaining gravel availability on the other land they owned which was presently being used as a gravel mine.
- Based on agriculture HBU, the Tax Court determined that each CE was worth about $49,000 (at trial IRS had argued $9,000).
Esgar Corp. v. Commissioner (10th Cir. 2014)

In assessment of the likelihood that the properties would be developed into a gravel mine, the Tax Court found:

1) as of 2004, there was no unfulfilled demand for gravel in Prowers County,
2) demand from the Front Range for Prowers County gravel was not poised to increase in the “reasonably foreseeable future,”
3) supply produced by the four existing Prowers County gravel pits was sufficient to satisfy any increases in demand; and
4) transporting gravel via rail from Prowers County to the Front Range was not a “reasonably foreseeable possibility” in 2004.

What can appraisers do to make their HBU analyses better? What do you see that is commonly missing?
Finally, a taxpayer “wins” one.
- 82 acre parcel in Sarasota County, Florida.
- Included developable acreage, wetlands, bald eagle nest and a wildlife corridor.
- Taxpayer donated CE to county in December 2006 for purposes of public use, conservation and open space.
- Taxpayer’s appraiser estimated the before value of $25.2 million based on assumption property could be successfully rezoned.
- In audit, the IRS disallowed $17 million of the deduction and imposed penalties on taxpayer.
- IRS appraiser opined value before donation was $7.7 million based on HBU in its current zoning (41 SFRs – 2 units per acre).
Palmer Ranch Holdings, Ltd. v. Comm’r, T.C. Memo 2014-79

• Appraiser’s assumption was based on extensive work of land planning and engineering firm hired by taxpayer concluding property could have been rezoned to permit 360-unit multifamily development, if the development was clustered on the developable portions of property and sensitive areas left as open space.
• Tax Court court held that the before value was $21,005,278, adjusting the appraiser’s value downward based on its own perception of softening real estate market in 2006.
• With the CE use restrictions in place, the court agreed with taxpayer that potential purchasers of the property would be limited to either nonprofits or government. Court agreed value after CE was $1,050,000.
Palmer Ranch Holdings, Ltd. v. Comm’r, T.C. Memo 2014-79

- Is that extreme – to hire a land use planning firm to develop support for the HBU analysis?

- In general, is it common for appraiser to engage or ask client to engage outside experts for market studies or HBU support?

- When should they?

- Will clients go along with appraiser suggestions?

- What about getting an appraisal review done?
Engagement Letter Tip #2

- **Your Scope of Work**: Carefully address work to be provided now and address what is not included. Many CE assignment may later require additional time and work after completion of the appraisal or lead to required testimony.

“In the event that Appraiser is requested by Client to provide additional services following delivery of the completed report(s) described above or is required by subpoena or other legal process to provide testimony or produce documents relating to Appraiser’s services or report(s) under this Agreement, whether in court, deposition or in any other proceeding, and regardless of the identity of the party requiring such testimony or production of documents, Client agrees to compensate Appraiser for the time incurred by Appraiser in rendering such additional services and/or complying with any subpoena or other legal process at Appraiser’s regular hourly rate in effect at that time and to reimburse Appraiser’s reasonable actual expenses.”
Seventeen Seventy Sherman Street, LLC v. Comm’r, T.C. Memo. 2014-124

- Taxpayer owned a historic building in Denver (Mosque of the El Jebel Shrine of the Ancient Arabic Order of Nobles of the Mystic Shrine) and nearby adjacent parking lot.
- Taxpayer (actually its parent corporation) had paid $3.9 million for the two properties in 2000.
- The shrine was listed on the National Register of Historic Places and designated a historic landmark by the City of Denver – but this designation did not embody strong restrictions.
In 2003, the taxpayer and the City of Denver entered into a development agreement in which the LLC agreed to convey easements protecting interior and exterior elements of the shrine to Historic Denver and to renovate the shrine in exchange for support on zoning changes and approvals that would allow high-rise development on the parking lot.

Pursuant to the agreement, the taxpayer then donated CE to Historic Denver.

Taxpayer claimed a $7.15 million deduction based on the appraised value of the CE.

The LLC took the full deduction, but “forgot” to tell the IRS on their tax return that they had received the favorable zoning and planning treatment in return. Probably didn’t tell the appraiser either.
Big mistake *by the taxpayer* -- as the Tax Court explained:

“A quid pro quo analysis ordinarily requires two parts – we value the contributed conservation easement and we value the consideration received in exchange for the easement. . . . However, when a taxpayer grants a conservation easement as part of a quid pro quo transaction and fails to identify or value all of the consideration received in the transaction, the taxpayer is not entitled to any charitable contribution deduction with respect to the grant of the conservation easement because he has failed to comply with section 170 and the regulations thereunder.”

The $7 million deduction was disallowed. Penalties applied to the taxpayer.
What Should an Appraiser Ask of Clients for a CE Assignment

• Perhaps – for taxpayer’s potential safety (though in the Shrine case, the taxpayer ignored the tax advise) and for appraiser’s own protection, there are key pieces of information appraisers needs confirmed with the client?
  • Any consideration received by the client for the CE?
  • Contiguous land owned?
  • Other land owned?
  • Family members?
  • Related parties?
  • What else?
Treasury Regulation 1.170A-14(h)(3)(i) provides that:

The amount of the deduction in the case of a charitable contribution of a perpetual conservation restriction covering a portion of the contiguous property owned by a donor and the donor's family as defined in section 267(c)(4) is the difference between the fair market value of the entire contiguous parcel of property before and after the granting of the restriction.
IRC Section 267(c)(4) defines the donor’s family to include:

- Brother & Sisters (whole or half)
- Spouse
- Ancestors (parents and grandparents)
- Lineal Descendants (children and grandchildren)
“Enhancement”

Treasury Regulation 1.170A-14(h)(3)(i)

If the granting of a perpetual conservation restriction has the effect of increasing the value of any other property owned by the donor or a related person (IRC 267(b) or 707(b)), the amount of the deduction for the conservation contribution shall be reduced by the amount of the increase in the value of the other property, whether or not such property is contiguous.

See IRS Chief Counsel Memo (August 23, 2013) for “related parties”
Engagement Letter Tip #3

Require the client to agree to key facts in writing or client is responsible for providing the information to appraiser, and that appraiser will be relying on the facts and information supplied by client:

- True copy of the final CE documents.
- Confirmation of date of valuation.
- Existence of any consideration received by taxpayer.
- Information about contiguous property and other property owned by the taxpayer and “related parties.”
How Well Does An Appraiser Need to Know the Property?

What things have you seen come up in assignments or cases that affected the valuation of a CE?

- Other restrictions or protections?
- Easements for non-conservation purposes?
- Wetlands? Or other constraints on development?
- Endangered species?
Boltar LLC v. Comm’r, 136 T.C. 326 (2011)

Another CE tax case at the extremes.

And, one that made a very important legal precedent in Tax Court.
Boltar LLC v. Comm’r, 136 T.C. 326 (2011)

Taxpayer’s appraiser had opined value of the donated CE relating to 8 acres of land was about $3.2 million. In audit, in-house IRS appraiser valued it at about $42,000. At trial, IRS’s expert MAI opined it was worth $31,280.

Taxpayer’s appraisal had some problems:
• Boltar had paid $10,000 per acre.
• Did not provide a true before and after valuation of the subjection property
• Did not value all of the contiguous parcels of the taxpayer
• Based the valuation on the physically/legally impossible development of 174 condo units on 8 acres of land – 2.8 acres of which were in a wetland and through which a 50’ pipeline easement ran.
Boltar LLC v. Comm’r, 136 T.C. 326 (2011)

Tax Court excluded taxpayer’s appraisal on the basis of being “unreliable and irrelevant” under FREV 702 and the Supreme Court’s Daubert decision. First time applied in Tax Court. (Jason Daubert writes . . . “DAW-bert” is how I pronounce it.)

Tax Court’s comment in reference to the taxpayer’s appraisers:

In most cases, as in this one, there is no dispute about the qualifications of the appraisers. The problem is created by their willingness to use their resumes and their skills to advocate the position of the party who employs them without regard to objective and relevant facts, contrary to their professional obligations. See Estate of Halas v. Commissioner,
Other Issues in the Recent Cases

Other reasons deductions have been denied or appraisals rejected in 2014-15 cases:

- Changeable boundaries.
- Swappable land.
- Comparables from out of the area – an appraiser used a New Orleans comparable to support a valuation of an easement in Boston.
- Lack of perpetuity – Court of Appeals determined that most CEs not deductible in North Dakota because state law limits them to 99 years = not in perpetuity.
- Using set percentages for effect of easement.
Engagement Letter Tip #4
The Big Warning

“In the event that Client utilizes or submits Appraiser’s appraisal(s) in connection with a tax return or other tax matter, Client understands and agrees that Appraiser and its Personnel provide no warranty, representation or prediction as to the outcome of the tax matter. Client understands and acknowledges that the taxing authority (whether it is the Internal Revenue Service or any state or local tax authority) may disagree with or reject the appraisal(s) or otherwise disagree with Client’s tax position, and further understands and acknowledges that the taxing authority may seek to collect from Client additional taxes, interest, penalties or fees. Client agrees that Appraiser and its Personnel shall have no responsibility or liability to Client or any other party for any such taxes, interest, penalties or fees and Client will not seek damages or other compensation from Appraiser or its Personnel relating to any taxes, interest, penalties or fees imposed on Client or for any attorneys’ fees, costs or other expenses relating to Client’s tax matter. These limitations of liability and damages restrictions shall be in addition to any other limitations and restrictions stated in this Agreement. Appraiser’s Personnel are intended third party beneficiaries of this section.”