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Facade Easement: Inexpert Valuation

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In *Dunlap*, the Tax Court found insufficient evidence of value for the taxpayers' charitable contribution of a facade easement. However, the court held for the taxpayers on their cash charitable contribution and penalties.

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Dunlap[1] involved facade easement transfers to the National Architectural Trust (NAT), a qualified charity that preserves building easements across the country, although most are in New York City.[2] In *Dunlap* the Tax Court rejected the taxpayers' experts' evidence of the value of their facade easement and, consequently, denied the taxpayers' claim of a charitable deduction. Although allowing a deduction for their cash contributions to NAT to enforce the easement and not finding any penalties applicable, the Tax Court held that despite two valuation reports written by accepted valuation experts, the taxpayers had not established any value for their easement.

The taxpayers, Loren and Nancy Dunlap, owned one of the 31 units in the Cobblestone Loft Condominium in Tribeca, Manhattan. The Cobblestone bylaws require approval from the condominium board to alter common areas. Andrews Building Corp., which provides everyday management services for Cobblestone, introduced NAT to the condominium board. Daniel Reardon, an employee of a company related to NAT, made a presentation to the board about participation in the Federal Historic Preservation Tax Incentives Program. NAT introduced Steven McGrath, treasurer of the Cobblestone board, to a law firm that had previously assisted NAT regarding facade easement donations. The board hired the law firm to represent it, and McGrath signed a waiver of any possible conflicts arising from the firm's representation of NAT and Cobblestone.

Andrews Building Corp. distributed informational material to the unit owners, notifying them of the law firm's representation, and it stated that if they granted NAT a facade easement, they "would be entitled to a tax deduction of 10 percent to 15 percent of the value of the unit."[3] Although the law firm's opinion letter to the board was dated "as of December 31, 2003," a footnote in the letter referred to a document not released until July 2004. The opinion letter was signed by the firm, but not by an individual attorney, and was distributed to the owners at an unknown date.

The board hired Miller Samuel to prepare an appraisal for the facade easement donations. In December 2003 the National Park Service declared Cobblestone a certified historic structure for charitable contribution and conservation purposes in accordance with the Tax Treatment Extension Act of 1980. The board approved, and McGrath executed, the facade easement deed, which NAT accepted and registered on December 29, 2003. The facade easement deed prevented the board from changing Cobblestone's facade without NAT's express written agreement, and it required that any changes adhere to all pertinent government laws and regulations.

The Miller Samuel appraisal of the facade easement, completed March 14, 2004, and supplemented on March 22, 2004, included statements that:

- the valuation date was "as of" December 28, 2003;

[1]*Dunlap v. Commissioner*, T.C. Memo. 2012-126, *Doc 2012-9303*, *2012 TNT 85-5*.

[2]*Dunlap* involved several cases with different taxpayers. For the different taxpayers, it involved different numbers of years, but the span of years at issue for any one of the taxpayers covered a year or years from 2003 to 2005. Also, the government made various concessions for several of the taxpayers. When they filed their petitions in the Tax Court, most of the taxpayers resided in New York; however, one individual lived in Nevada, and one couple lived in Connecticut.

[3]*Dunlap*, T.C. Memo. 2012-126, at 8.

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- the easement's value was approximately $8.2 million, or 12 percent of Cobblestone's value, based on before- and after-easement values;
- the cost and income valuation methods were unreliable to value individual condominium units; and
- the market data analysis method best reflected market conditions.

The New York City Landmarks Preservation Commission (LPC) — which designates local landmarks and historic buildings — promulgates regulations a little different from NAT's, including enforcement provisions. LPC staff investigate alleged violations of LPC regulations. Besides being subject to the LPC as a historic property, Cobblestone is one of the few buildings with a ''sound, first-class condition'' designation under LPC regulations. As such, it is subject to a more stringent preservation standard, which is applied in perpetuity. Moreover, Cobblestone has a continuing maintenance agreement with the LPC to inspect its property every five years.

To obtain a completed IRS Form 8283, ''Noncash Charitable Contributions,'' which is required to qualify for a facade easement donation deduction, Cobblestone unit owners had to make cash contributions to NAT equal to 7 percent of their individual unit's share of the easement donation for NAT to monitor and enforce their facade easement.[4] On their income tax returns prepared by a return preparer at Faucett, Taylor & Associates LLP, the taxpayers claimed a facade easement charitable deduction of $237,000 ($126,670 in 2003 and a carryover of the remaining amount for 2004) and a cash charitable deduction for $16,588 paid to NAT in 2004.[5]

The Tax Court considered three questions: (1) whether the donated facade easement had any value; (2) whether the cash payments to NAT were contributions under section 170(c) or whether they were nondeductible conditional gifts; and (3) whether the taxpayers were liable for penalties under section 6662(a) and (h).

Having found that the taxpayers retained the burden of proof regarding the value of the facade easement because they did not offer credible evidence of its value, the court explained that courts have adopted the ''before and after'' method to determine the fair market value of restrictive easements, subtracting the after-easement value from the property's value before the easement's restrictions. Citing *Hilborn*,[6] the court explained how to compute both the before and the after values. The before value starts with the property's highest and best use value, which is determined by one of the three accepted methods: capitalized net operating income, replacement cost, and comparable sales. The after value also begins with the property's highest and best use value after the easement is attached. Then, the easement's restrictions are compared with existing zoning regulations and other controls (such as local historic preservation ordinances) to determine if, and how much, the easement impairs the use of the property at that time and in the future.[7]

At trial, there was no testimony from anyone from the law firm or from any of the taxpayers' tax return preparers. Although the government subpoenaed the return preparers, it did not have them testify. The taxpayers and the government each submitted two expert reports. All parties accepted the four experts as qualified to value the facade easement.

The court considered the parties' expert reports and testimony. Each of the expert's appraisals used the comparable sales method to determine the before value. Because there were no sales of comparable condominiums subject to easement, the after value was problematic. The government's experts concluded that the easement was valueless because the restrictions of the easements were essentially the same as those imposed by the LPC; Cobblestone's bylaws required board approval for any facade alterations; sales of encumbered units produced substantially appreciated prices; and brokers indicated that the easement did not adversely affect a unit's sale.

One of the taxpayers' experts, Marilyn Weitzman, used the income approach to determine the after value. To apply this method, she calculated a before value based on the assumption that Cobblestone was rental property and then estimated rental revenue for each unit, for each parking space, and for revenue gained from advertisements on its facade. She also estimated expenses and reached a before value of approximately $34.1 million. Then,

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[4]The actual amounts expended by NAT for monitoring and enforcing the facade easements from 2001 to 2007 were small relative to the cash contributions to NAT, and NAT did not begin to monitor Cobblestone until 2006. Each of the taxpayers in this consolidated case had made varying cash contributions to NAT; the government disallowed only three of the couples' cash contributions, including the Dunlaps'.

[5]Neil Faucett was Nancy Dunlap's accountant for more than 20 years, and she forwarded to him all of the facade easement information she had received. The remaining taxpayers' particular facade easement and cash deductions are detailed in *Dunlap*, T.C. Memo. 2012-126, at 25-31.

[6]*Hilborn v. Commissioner*, 85 T.C. 677 (1985).

[7]*Dunlap*, T.C. Memo. 2012-126, at 35-36, citing *Hilborn*, 85 T.C. at 689-690.

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Weitzman valued the after value, eliminating income from facade advertising and increasing some expenses as well as raising the capitalization rate from 5.75 to 6.35 percent. With those adjustments, she valued the after easement at nearly $28.8 million, an approximate reduction of 15.5 percent.

The taxpayers' other expert, Michael Ehrmann, used a comparable sales approach to assess the after value but discounted sales from different years back to a consistent date. He testified that he used in part the discounted cash flow approach, ''which straddles the fence between the comparable sales approach and the income capitalization approach.''[8] Ehrmann compared Cobblestone unit sales with and without attached easements from 2004-2009. Although recognizing that discounting primarily is applied when valuing anticipated revenue, he then discounted those sales to December 29, 2003, the appraisal date. He could not find discount rates applicable to residential condominiums, but he used the average discount rate for multifamily rental housing (9.19 percent), raising that rate to 10 percent on the basis that residential real estate condominiums were riskier investments. Applying that rate to the sales from 2004-2009, he determined that the discounted value of comparable sales was 16.45 percent higher than that of Cobblestone unit sales. Ehrmann then adjusted the 16.45 percent figure and ultimately found a diminution rate of 10 percent from the before-easement value.

One of the government's experts criticized Ehrmann's use of discounting as effecting a great distortion in his sales figures, arguing that there was no reason to employ discounting, which to his knowledge had never been used in this context. He concluded that Ehrmann's method had resulted in a ''mathematical skewing of the resale data'' and that no proper sales comparison had been done.[9]

Finding that the taxpayers' appraisal report values lacked credibility, the court refused to give them any probative weight. That the valuation of Cobblestone as a rental building was about half that of its actual use as a condominium should have informed Weitzman that ''she was not using a constant 'highest and best use' across her valuation.''[10] The court found distortions in her treatment of one-time expenses like insurance, and despite her belief that the NAT easements were more restrictive than those the LPC imposed, it also found that the restrictions placed by NAT were about the same as those limited by LPC. The taxpayers argued that NAT provided an increased enforcement effort; however, Ehrmann, one of the taxpayers' own experts, stated that LPC required inspections of both Cobblestone's interior and exterior to remain ''in a sound, first-class condition.''[11] Cobblestone was not part of NAT's easement monitoring until 2006, and NAT's financial reporting indicated little monitoring and enforcement expenses.

Finally, finding distortions in Ehrmann's discounting method and no acceptable comparative sales data, the court rejected his appraisal report, saying it incorporated ''an undersampling of sales in the best real estate year (2007) and an oversampling of sales in the worst real estate year (2009).''[12] The court found a 7.89 percent spread in sales value, which it reduced by Ehrmann's adjustments and Cobblestone's agreement with the LPC to a 3 percent spread between the Cobblestone unit sale prices and comparable condominium sale prices, and the court found that difference insignificant.

Siding with the taxpayers on the two remaining issues, the court held that the cash payments to NAT were charitable contributions and were not conditional gifts. Citing its decision in *Kaufman*,[13] the court held that the benefits from NAT enabled the taxpayers to make the charitable contribution. Further, the court found that any benefits the taxpayers received from NAT in return for their cash contributions were incidental and insignificant. Because the court found no evidence indicating that any of the taxpayers' cash contributions would be refunded to them on a subsequent appraisal with a lower easement value, the court rejected the government's argument that the taxpayers had made a conditional gift.

Finally, the court rejected the government's application of the accuracy-related penalties under section 6662(b)(3) and (e) (for valuation misstatement) or (h) to the court's disallowance of the facade easement charitable deductions. The court refused to make unfavorable inferences from the fact that the taxpayers did not call as a witness anyone from the law firm who prepared an opinion letter on the donation of their easement to NAT or anyone from their tax return preparer's firm because the government also did not call them to testify. Asserting other facts such as the taxpayers' disclosure on their tax returns, their substantial compliance with Form 8283, and the taxpayers' reasonable reliance on the Miller Samuel appraisal,

[8]*Dunlap*, T.C. Memo. 2012-126, at 41.
[9]*Id.* at 46.
[10]*Id.* at 48.
[11]*Id.* at 50.
[12]*Id.* at 54.
[13]*Kaufman v. Commissioner*, 136 T.C. 294, 318-319 (2011), *Doc 2011-7123*, *2011 TNT 65-17*. *See* Wendy C. Gerzog, ''Mortgages and Conservation Easements: Not a Good Mix,'' *Tax Notes*, July 25, 2011, p. 437, *Doc 2011-14025*, or *2011 TNT 145-10*.

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the court found that the taxpayers had acted reasonably and in good faith. Also, the court found that the taxpayers met the reasonable cause defense of section 6664(c) because their easement value was based on a ''qualified appraisal'' by a ''qualified appraiser'' and they had made a good-faith inquiry about the easement's value.[14]

Boltar

In *Boltar*,[15] the taxpayer's expert's report lacked before- and after-easement and contiguous-parcel values, in contravention of the regulations' requirements. The report calculations also used prohibitive-use values. Citing *Daubert*[16] and Federal Rules of Evidence Rule 702, the *Boltar* court excluded the taxpayer's expert's report, stating that the report was ''too speculative and unreliable to be useful''[17] and that its factual mistakes showed ''the lack of sanity in their result.''[18]

Hilborn

The sole issue in *Hilborn* was the FMV of a facade servitude that the taxpayers, indirectly as limited partners, had donated to the New Orleans Vieux Carré Commission (VCC).[19] In the course of its negotiations with the VCC, the partnership had agreed to rehabilitate the building, beyond facade repairs, for not more than $185,000, although it ultimately paid more than $55,000 above that amount. Moreover, the partnership had to pay $47,780 for outside repairs and rehabilitation on the buildings. Because there was no established market for valuing the easement, the parties agreed that its value would be the difference between the property without, and then with, the easement.[20]

Rejecting all four of the approaches, the taxpayers' expert concluded that his subjective judgment was the only way to determine the after value. He stated that the easement resulted in ''substantial additional burdens'' such as precluding grouping with the neighboring corner lot and incurring additional administrative difficulties in making VCC's required rehabilitations.[21] He calculated a 12 percent diminution of property value, or $46,000, plus the additional $48,000 burden placed on the easement, resulting in a total easement value of $94,000.

The government's expert applied four approaches and determined the easement's value to be $24,500. He confirmed the 10 percent value loss by market values of easement-encumbered properties in New Orleans, although there were only three such sales. Two had no loss in value and the third had a 9 percent diminution. Also, he valued the easement by accounting for renovations to the property after the donation, excluding land value, and assessed the easement at $53,500.

Both parties' experts applied the before-and-after approach, both used market data to calculate the before value, and both looked at the servitude agreement to determine its impact on the after value. The court considered the government's 10 percent diminution more reasonable, but it made adjustments incorporating some points of each party's report.

Kaufman

Like *Dunlap*, *Kaufman* involved a facade easement and an accompanying cash donation to NAT. The question addressed regarding the facade easement, however, was a reconsideration[22] of whether the taxpayer's easement satisfied the ''enforceability

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[14]*Dunlap*, T.C. Memo. 2012-126, at 89.

[15]*Boltar LLC v. Commissioner*, 136 T.C. 326 (2011), *Doc 2011-7257*, *2011 TNT 66-10*. *See* Gerzog, ''Excluding Expert Valuation Testimony,'' *Tax Notes*, Sept. 26, 2011, p. 1423, *Doc 2011-18464*, or *2011 TNT 188-8*.

[16]*Daubert v. Merrell Dow Pharm. Inc.*, 509 U.S. 579 (1993).

[17]*Boltar*, 136 T.C. at 339.

[18]*Id.*

[19]On December 28, 1979, the partnership granted a servitude in perpetuity under Louisiana law, which the court described as essentially a common-law easement in perpetuity.

[20]The taxpayers' expert valued the gift at $94,000, and at $108,400. On brief, the taxpayers asserted a value of $108,400, rather than their expert's figure $94,000, to include $20,000 of indirect acquisition costs allowed by the government's expert but not accounted for by their own expert. The government's expert determined a value of $24,500. The court explained:

> ''Before'' value (Before Value) is arrived at by first determining the highest and best use of the property in its current condition unrestricted by the easement. At this stage the suitability of the property's current use under existing zoning and market conditions and realistic alternative uses are examined. Any suggested use higher than current use requires both ''closeness in time'' and ''reasonable probability.'' Next, to the extent possible, the three commonly recognized methods of valuing property (capitalized net operating income, replacement cost and comparable sales) are used, but are modified to take into account any peculiarities of the property which impact on the relative weight to be afforded each respective method. ''After'' value (After Value) is arrived at by first determining the highest and best use of the property as encumbered by the easement. At this stage the easement's terms and covenants are examined, individually and collectively, and compared to existing zoning regulations and other controls (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. Next, the above-mentioned three approaches to valuing property are again utilized to estimate the value of the property as encumbered by the easement.

Hilborn, 85 T.C. at 689-690.

[21]*Id.* at 691.

[22]In *Kaufman*, the court reviewed its earlier grant of partial summary judgment for the government in *Kaufman v. Commissioner*, 134 T.C. 182 (2010), *Doc 2010-9252*, *2010 TNT 80-12*.

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in perpetuity'' regulatory requirements.[23] According to the regulations, the charity must receive an absolute, immediate, vested right to insurance proceeds following a judicial extinguishment of the easement.

The court held that because the taxpayer's agreement with NAT did not provide NAT with that right, NAT should not receive its share of the proceeds. Further, the court rejected the taxpayers' argument that the risk and events fell under the regulation's remote and negligible exception.

The court held that the government had the burden of proving that the taxpayer's cash contribution lacked donative intent and constituted quid pro quo for NAT's helping the taxpayer obtain a tax deduction, and that the government did not sustain its burden. Neither party cited specific case law precedent for its argument. Also, the evidence was ambiguous; the government had not submitted evidence of the value of the taxpayers' benefit. According to the court, the cash payment assisted the taxpayers solely in obtaining a charitable deduction. The payments ultimately enabled the charity to fulfill its charitable purpose.

Analysis and Conclusion

Dunlap did not present as extreme a situation as the one in *Boltar*. However, the *Dunlap* court did find that both of the taxpayers' experts' reports lacked credibility and thus had no probative value. Although the court held that the reports addressed the property's before- and after-easement values, it found they did not properly calculate its after-easement value. The experts computed that value with multiple distortions and without acceptable comparable sales figures. They also did not explain how the NAT easements were more restrictive than those imposed by the LPC.

To provide an effective report, the expert must employ an acceptable method as defined in the regulations and provide data that reasonably explain the diminution in value caused by the imposition of additional limitations effected by the easement. Fancy footwork will not convince the court that the taxpayers deserve a charitable contribution deduction.

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[23]*See* reg. section 1.170A-14(g)(6).

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