



NATIONAL TRUST
for HISTORIC PRESERVATION

1785 Massachusetts Avenue, NW
Washington, DC 20036
(202) 588-6000 • Fax (202) 588-6272



**National
Housing &
Rehabilitation
Association**

1400 16th Street, NW, Suite 420
Washington, DC 20036
(202) 939-1750 • Fax (202) 265-4435

December 13, 2007

Mr. Stephen T. Miller
Commissioner, Tax Exempt and Government Entities
Internal Revenue Service
1750 Pennsylvania Ave NW
Washington, DC 20006

Dear Mr. Miller:

This is to follow up on our meeting earlier this fall, in which we discussed the concerns of our two organizations (and our constituent members) related to the current audit environment with respect to charitable contributions of conservation easements on historic structures. We greatly appreciate your taking the time to discuss these issues with us.

To address further the issues we discussed in that meeting, we would ask you to confirm in writing several points that you and your colleagues made during our conversation, so that we will be in a position to inform current and potential donors about the views of the IRS on this subject.

First, as we indicated during the meeting, we have heard concerns from a number of our constituent members that the Service may be using a zero-based "rule of thumb" in its examination of charitable contributions of conservation easements on historic structures. We understand from our discussions with you that this is not the case, and we believe that it would be reassuring to current and potential easement donors to know that it is the position of the Service that each contribution under examination will be reviewed on its own merits. *Consequently, we would ask that the IRS confirm that there is no general policy or practice within the IRS of directing or encouraging its staff, on examination, to find a zero or de minimis value for conservation easement contributions for historic structures.*

Second, during our meeting we also discussed concerns raised by our constituent members that public statements made by the IRS in the past have suggested that easement donations on historic structures in locally-regulated historic districts are *per se* valueless because they do no more than replicate local regulatory controls. Specifically, over the past several years, the IRS has made a number of statements (including in past annual listings of its "Dirty Dozen Tax Scams") suggesting that taxpayers who donate easements on historic structures already subject to local landmarks or zoning laws are claiming unjustified deductions because

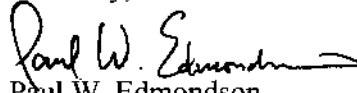
they are not giving up rights that they had in the first instance. While we do not question the IRS's statement that it has found instances of taxpayer abuse in this area, our experience is that the level of local regulatory controls varies considerably—from very weak to very strong—and that in many cases easements are far more restrictive than local regulatory controls. We believe that generalizations in this area may be extremely misleading, and we understood from our meeting that you and your colleagues recognize that the valuation impact of local regulatory controls may vary from case to case. *Consequently, in order to correct any mistaken impression resulting from previous statements in this area, we would ask that you clarify that it is not the view of the IRS that conservation easements on historic structures in locally regulated historic districts are per se valueless—but that, instead, the valuation of each easement must be determined on a case-by-case basis through a qualified appraisal that considers the specific terms of the easement and the specific nature of restrictions imposed by local land use or similar laws.*

Finally, we would ask you to confirm that, although the Service is undertaking a compliance initiative with respect to conservation easements, *the IRS compliance initiative is not intended to deter donations of legitimate conservation easements on historic structures made by taxpayers who comply with the applicable requirements of the Internal Revenue Code (including the changes made by the Pension Protection Act of 2006), Treasury Regulations, and IRS Notices, and who claim a reduction in value of the historic structure attributable to the imposition of the conservation easement that was donated to a qualified donee organization.*

We believe that the IRS's clarification of these issues would help to reassure current and potential donors of conservation easements on historic properties that the IRS will evaluate easement donations on their individual merits and continue to respect individual easement donations that follow the requirements of the code and regulations.

Thank you again for your attention to this matter.

Sincerely,



Paul W. Edmondson

Vice President & General Counsel

National Trust for Historic Preservation



Peter Bell

Executive Director

National Housing

& Rehabilitation Association

cc: Nancy Todd, Office of the Senior Technical Advisor, TEGE



COMMISSIONER
TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

MAR 13 2008

Mr. Paul W. Edmondson
Vice President and General Counsel
National Trust for Historic Preservation
1785 Massachusetts Avenue, NW
Washington, D.C. 20036

Dear Mr. Edmondson:

I am pleased to respond to your inquiry concerning qualified conservation contributions granted to preserve certified historic structures.

Section 170(h) of the Internal Revenue Code allows a deduction for the donation of a qualified real property interest for the preservation of a certified historic structure. An example of a qualified real property interest is a restriction (granted in perpetuity) on the modifications that may be made to a historic structure. The Internal Revenue Service recognizes the importance of the preservation of the architectural heritage of the country and is committed to interpreting and enforcing section 170(h) consistent with that purpose and the requirements of the statute.

A challenge for us in enforcing section 170(h) is the proper valuation of façade easements. Proper valuation is also a challenge for donors of such easements. We appreciate your interest in this area and the assistance that you can give to your membership and the public concerning the critical importance of a proper valuation of easements.

The value of a façade easement depends on the facts and circumstances pertaining to that easement. Historic structures that are subject to existing local landmark or zoning laws that limit or restrict the owners' ability to change the appearance or use of the structure present additional problems of valuation. We recognize that these local laws vary, and that façade easements also vary in terms of the rights they surrender or retain with respect to the encumbered property. An easement is to be valued by considering, among other things, the

specific restrictions imposed by the local landmark and zoning laws, the specific terms of the façade easement, and the interplay between them. In short, the value of each façade easement is to be based on the particular facts and circumstances of each property on which the easement is placed and the particular restrictions imposed.

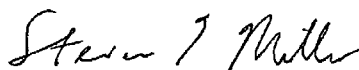
The Internal Revenue Service does not believe that all conservation easements, including façade easements, are intrinsically of little or no value. The applicable rules require that the taxpayer substantiate claimed deductions with a qualified appraisal from a qualified appraiser (Section 170(f)(11)). A key issue in many of these cases is whether the taxpayer's appraisal satisfies these requirements.

Although it is difficult in many instances to properly value a façade easement, such difficulties do not undermine the legitimacy of properly granted façade easements. Congress, in enacting and amending section 170(h), has clearly endorsed a program to encourage the preservation of certified historic structures. As we administer section 170(h), our goal is to carry out Congressional intent faithfully; we wish to do nothing to discourage or deter the donation of legitimate façade easements.

At the same time, it is clear that Code provisions such as section 170(h) attract some who are intent on misuse and abuse, as well as others who have good intentions but who fail to take the steps required to support the claimed deduction. Our enforcement program in the area of façade easements is designed to address these situations. We believe that proper enforcement is necessary to preserve the integrity and the success of the section 170(h) program.

I hope this is responsive to your concerns. For your information, I am also enclosing a redacted copy of a Chief Counsel Advice, dated August 9, 2007, on the subject of the valuation of façade easements. If you have any questions, please call me or Ron Schultz at (202) 283-9910.

Sincerely,


Steven T. Miller

**Office of Chief Counsel
Internal Revenue Service
memorandum**

CC:ITA:B01:SJKassell
POSTS-130982-04

[Third Party Communication:
Date of Communication: <Month> DD, YYYY]

UILC: 170.00-00

date: August 09, 2007

to: CC:SB:DET
Attn: Alexandra Nicholaides, Senior Counsel

from: CC:ITA:1
Karin Gross, Acting Branch Chief

subject: Valuation of Façade Easements

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

May an appraisal of a façade easement that values the easement as a percentage of the value of the underlying fee before the granting of the easement, without reference to the actual value of the underlying fee after the granting of the easement, be used to substantiate the fair market value of the easement under § 170(h) of the Internal Revenue Code?

CONCLUSION

No. The value of a donated façade easement depends on the particular facts and circumstances of that property and must be substantiated with a full appraisal of the value of the easement. This value is generally obtained by determining the values of the underlying fee both before and after the contribution, with the easement valued at an amount equal to the difference, if any. The Internal Revenue Service will not accept an appraisal to substantiate the fair market value of a façade easement if the appraisal merely values the entire fee before the donation and then applies a percentage thereto.

FACTS

Some taxpayers have made charitable contributions of façade easements and have attempted to substantiate their contributions with valuations as described below:

- (1) Valuation of the property before the contribution using traditional appraisal methods (such as market data of comparable properties or income capitalization); and
- (2) Estimation of the value of the façade easement by applying a percentage to the value of the property before the contribution. The percentage selected is based on a statement that it is "generally recognized" that façade easement contributions result in a loss of value of between 10% and 20% of the underlying property; the appraisals generally use a percentage within that range.

These valuations contain no valuation of the property after the contribution. Certain tax advisors and charitable organizations are misinforming the public about the valuation of contributed façade easements by indicating that the Service allows tax deductions of approximately 10 to 15% of the fair market value of the underlying property.

LAW AND ANALYSIS

Section 170(a) of the Code provides that a deduction shall be allowed for any charitable contribution payment of which is made within the taxable year. Under § 170(c), a charitable contribution means a contribution or gift to or for the use of an organization described in § 170(c)(1)-(5).

Section 170(f)(3) provides the general rule that no deduction is allowed for a contribution of an interest in property which consists of less than the taxpayer's entire interest in the property. However, under § 170(f)(3)(B)(iii), a deduction is allowed for a qualified conservation contribution, even though it is a contribution of a partial interest. Section 170(h)(1) and § 1.170A-14(a) of the Income Tax Regulations provide that a qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. Under § 1.170A-14(b)(2), a qualified real property interest is a restriction granted in perpetuity on the use which may be made of real property, including an easement or similar interest under State law.

Under § 1.170A-14(h)(3)(i), the value of a perpetual conservation restriction is the fair market value of the perpetual conservation restriction at the time of the contribution. If there is a substantial record of sales of easements comparable to the donated easement, the fair market value of the donated easement is based on the sales prices of those comparable easements. If, however, there is no substantial record of market-place sales of comparable easements, generally the fair market value of a perpetual conservation restriction is equal to the difference between the fair market value of the property before the granting of the restriction and the fair market value of the property after the granting of the restriction. This is generally referred to as the "before and after" approach.

In Rev. Rul. 73-339, 1973-2 C.B. 68, clarified in Rev. Rul. 76-376, 1976-2 C.B. 53, the Service used the before and after approach to value an easement granted on an entire piece of property. Rev. Rul. 76-376 clarifies that, where the easement is only on a portion of the property, the before and after approach should be applied to the entire property, not merely the portion on which the easement is granted.

The before and after approach was approved by the Congress in the legislative history of the 1980 amendments to § 170(f)(3). See S. Rep. No. 96-1007 (1980), 1980-2 C.B. 599, 606. This legislative history provides:

[C]onservation easements are typically (but not necessarily) valued indirectly as the difference between the fair market value of the property involved before and after the grant of the easement. (See Rev. Rul. 73-339, 1973-2 C.B. 68, and Rev. Rul. 76-376, 1976-2 C.B. 53). Where this test is used, however, the committee believes it should not be applied mechanically (emphasis added).

In explaining the meaning of this statement, the Congress provided numerous examples of factors that should be taken into account in determining the value of each easement. These factors, which have been incorporated in § 1.170A-14(h)(3) & (4) the Income Tax Regulations, suggest that, because each property is unique, the specific, individual attributes of the property both before and after the granting of the easement must be examined, and a “mechanical” application of any valuation methodology is unacceptable.

Section 1.170A-14(h)(3)(ii) provides that, if before and after valuation is used, the fair market value of the property before the contribution must take into account not only the current use of the property but also an objective assessment of the likelihood that the property would be developed absent the restriction, as well as any effect from zoning, conservation, or historic preservation laws that already restrict the property’s potential highest and best use. In addition, this regulation provides that there may be instances in which the grant of a conservation restriction may have no material effect on the value of the property. In determining the fair market value of the property after the contribution, § 1.170A-14(h)(3)(ii) requires that, if before and after valuation is used, an appraisal of the property after the contribution must take into account the effect of restrictions that will result in a reduction of the potential fair market value represented by the highest and best use but will, nevertheless, permit uses of the property that will increase its fair market value above that represented by the property’s current use.

In Hilborn v. Commissioner, 85 T.C. 677 (1985), the Tax Court engaged in a “before and after” analysis to determine the value of a façade easement. The Court noted that “before” value is reached by determining the highest and best use of the property in its current condition unrestricted by the easement, and that “after” value is calculated by first determining the highest and best use of the property as encumbered by the easement and by comparing the burdens of the easement with 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. The Hilborn Court adopted the government expert's analysis because it was more objective than that of the taxpayer's expert, who had used his subjective judgment to conclude that the façade easement had caused a 12% diminution in the before value of the property. Id. at 699.

In Nicoladis v. Commissioner, T.C. Memo. 1988-163, the Court accepted the 10% diminution proposed by both parties but stated:

We note, however, that by this decision we do not mean to imply that a general "10-percent rule" has been established with respect to façade donations. There was a fair amount of discussion by the parties at trial about whether the Court had established a "10-percent rule" in Hilborn. We did not there and do not here. Hilborn establishes as acceptable the before and after method of valuation, and while under the circumstances of that case a 10-percent figure was relied upon, valuation itself is still a question of facts and circumstances.

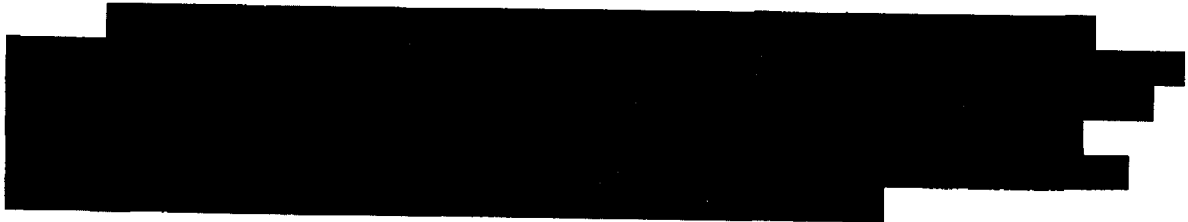
Some taxpayers claim reliance upon a Market Segment Specialization Program Guide (Guide) and also upon a Topical Tax Brief, which were posted on the IRS website. These documents at one time suggested a range within which a façade easement might be expected to reduce the value of property. However, they also described the "before and after" method as the proper method by which to value a façade easement, making it clear that a full analysis of the value of the property both before and after the donation was necessary. The Guide expressly stated that its material was designed specifically for training purposes and could not be used or cited as authority for a technical position. Nevertheless, this language was removed from the Guide and the Topical Tax Brief years ago and does not support an otherwise insufficient valuation.

Section 170(f)(11), as added by § 883 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004), contains reporting and substantiation requirements relating to the allowance of deductions for noncash charitable contributions. In particular, under § 170(f)(11)(C), taxpayers are required to obtain a qualified appraisal for donated property for which a deduction of more than \$5,000 is claimed. More recently, in § 1219 of the Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (2006) (the "PPA"), the Congress imposed increased penalties for inaccurate appraisals and new definitions of qualified appraisals and appraisers for taxpayers claiming charitable contribution deductions under § 170. The new provisions in §§ 6662, 6664, 6695A and 170(f)(11)(E) imposed by the PPA are designed to achieve more accuracy in appraisals used to substantiate charitable contributions under § 170. The PPA also imposes new requirements for deductibility of historic easement contributions. See § 170(f)(13), (f)(14), (h)(4)(B) & (h)(4)(C).

The value of each easement is based on the particular facts and circumstances of each property on which the façade is located and the particular restrictions imposed.

There was and is no "generally recognized" percentage by which an easement reduces the value of property. Consequently, unless there is a substantial record of sales of easements comparable to the donated easement (in which case the appraisal would be based on the comparables, see § 1.170A-14(h)(3)(i)), an appraisal that does not value the property both before and after the donation will not be accepted by the Service to substantiate the deduction.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call Susan J. Kassell at (202) 622-5020 if you have any further questions.