Reducing Valuation Error

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Nancy A. McLaughlin, *Conservation Easements and the Valuation Conundrum*, 19 **Fla. Tax Rev.** 225 (forthcoming 2016), available at SSRN.

In this practical and timely article, Nancy McLaughlin undertakes a comprehensive analysis of the case law addressing valuation disputes of conservation and façade easements (conservation easements that are designed to maintain the historic character of a building's façade). She reveals a number of ways in which taxpayers overvalue their easements, and uses what she finds to propose common-sense reforms.

Valuing property for purposes of determining a tax base is usually subjective and often contentious, so valuation-based taxes like the federal transfer taxes are vulnerable to valuation abuse. But property valuation also forms the basis for certain income tax deductions. Section 170(h) of the Internal Revenue Code, enacted in 1980, permits a deduction against the income tax for taxpayers who permanently contribute certain conservation or façade easements to governmental entities or charities. This provision is famously subject to abuse, and McLaughlin points out that valuation abuses have likely worsened over time, while the IRS has also become more adept at identifying abuses. According to McLaughlin's calculations drawn from the case law, façade easement overvaluation by taxpayers in reported cases has increased from an average of about twice the court-determined value in the early cases to more than four times the court-determined value in the more recent cases. In the conservation easement category, overvaluation as determined from the case law has jumped from an average of about twice the court-determined amount to a whopping ten times over that amount in the more recent cases.

McLaughlin first describes the rules governing valuation and the penalties that can be imposed on taxpayers and their appraisers for overstating value. As in the case of the transfer taxes, the value of the charitable contribution of a conservation easement is "fair market value," defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." The Treasury Regulations acknowledge that the best way to value a conservation easement is by reference to records of sales of comparable easements. Unfortunately, such a record is rarely, if ever, available. For this reason, most taxpayers use an alternative method approved by the regulations: the "before and after method." This method values the easement as the difference between the value of the underlying property immediately before the donation and that of the property after its encumbrance by the donated easement. Each valuation is done at the property's "highest and best use."

After carefully and clearly explaining the before and after methodology, McLaughlin launches into the various approaches used in determining fair market value. Here she consults not only the case law and regulations but also the professional valuation literature produced by the appraisal industry, and explains the pros and cons of the various approaches. She then looks at common errors made by appraisers, such as assuming that a property could be rezoned, which she asserts can dramatically increase the value of an appraisal of property before the easement is attached. She also explains certain rules contained in the Treasury Regulations, including those that require the tax deduction to be reduced by benefits that inure to the donor as a result of the easement. McLaughlin then reviews the various overvaluation penalties, including both those that apply to taxpayers and those that apply to appraisers.

McLaughlin then delves into the case law, separately reviewing cases dealing with façade easements and those concerning conservation easements. She concludes, in part, that appraisers often overvalue façade easements by paying too little heed to the mitigating impact of extant historic preservation laws, by using nonlocal comparables in the

"sales comparison approach," and generally misapplying certain methods of valuation. Penalties fail to deter overvaluation, as they are rarely imposed unless they are strict liability penalties. Problems McLaughlin uncovers in the conservation easement area lead her to conclude that appraisers often assert unrealistic highest and best uses, make unrealistic assumptions regarding rezoning possibilities, misapply certain valuation analyses, and fail to consider whether the easement increases the value of other properties owned by the taxpayer. As in the case of façade easements, valuation misstatement penalties are rarely applied unless they are strict liability penalties.

McLaughlin notes that Congress recently made enhanced taxpayer incentives for façade and conservation donations a permanent part of the law, while at the same time failing to pass legislation targeting valuation abuses in the face of the Treasury's calls for reform. McLaughlin agrees with the Treasury that reform is needed, but dismisses its specific proposals as off the mark. One Treasury proposal calls for donee organizations to be subject to penalties and loss of donee status for accepting overvalued easements where these organizations had actual or constructive knowledge that they were overvalued. McLaughlin concludes that such reforms would have little effect for at least three reasons: high values are good for donees, as they increase the likelihood of donations; valuation is necessarily subjective, and therefore knowledge of overvaluation cannot be asserted except in the most egregious cases; and such a rule would incentivize donees to obtain their own valuations, doubling the IRS's opponents in any litigation. McLaughlin also criticizes a Treasury proposal for electronic reporting as unlikely to have an effect in most cases. Finally, she asserts that the Treasury's proposal for creation of a tax credit program as an alternative might actually increase abuse.

McLaughlin offers eight specific proposals for reform. She proposes an increase to the statute of limitations period during which the IRS could challenge the deductions to six years from the current three. She calls for increased and more detailed reporting requirements, and renews her call for the creation of an "Easement Advisory Panel" similar to the Art Advisory Panel that assists the IRS in curbing valuation abuses. She suggests that the Treasury create a comprehensive outline with instructions for a section 170(h) appraisal, similar to the Uniform Appraisal Standard for Federal Land Acquisitions. Appraisals meeting certain criteria that indicate possible abuse should be subject to automatic IRS review, and pre-trial processes for resolving disputes should be improved. Finally, McLaughlin offers concrete proposals for changes to the appraiser penalty provisions and suggests "safe harbor provisions" for certain easement terms so that easements that are valued as though they satisfy legal requirements actually satisfy those requirements.

McLaughlin has apparently been studying and writing about façade and conservation easements for many years. In this comprehensively researched article, she puts her considerable knowledge to use in an effort to suggest reforms designed to make deductions for charitable contributions of certain property interests reflect their actual value. Although experts in the area of conservation easements might have differences with some of McLaughlin's analyses and prescriptions for reform, this paper stands as an example of how a careful legal scholar can produce work that will lead to better laws.

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