

TAX COURT CASE UPDATE

FCG Valuation Case E-Flash

Authored by Fawntel Romero, AM, and Chris D. Treharne, ASA, MCBA, BVAL of Gibraltar Business Appraisals, Inc., a member firm of FCG

Citation:

Whitehouse Hotel Limited Partnership v. Commissioner of Internal Revenue, Appeal From The United States Tax Court No. 12104-03, August 10, 2010.

Comments:

The U.S. Court of Appeals considered whether the Tax Court properly determined the value of a historic facade easement claimed as an income tax deduction. Ultimately, the Court of Appeals vacated the Tax Court's decision because it failed to consider the highest and best use of the property and failed to consider the easement's effect on a building adjacent to the easement.

While this appeal dealt with the value of a real estate facade easement, it presents issues that are applicable to other appraisal professions, too:

- After considering his extensive real estate appraisal experience, the Appeals Court upheld the Tax Court's ruling that the IRS's expert was qualified to appraise the subject interest even though the taxpayer asserted he lacked significant experience valuing facade easements.
- Strict compliance with the *Uniform Standards of Professional Appraisal Practice* ("USPAP") is not required for an appraisal to be admissible in court. However, failure to comply with USPAP may determine the relevant weight the report will be given.
- On remand, the Tax Court will be required to consider a "reasonable and probable" future event that likely will impact the fair market value of the easement.

Façade Easement Contributed to Nonprofit:

Whitehouse Hotel Limited Partnership owned a parcel of land in New Orleans. The property included the Maison Blanche and Kress buildings. Whitehouse conveyed an easement to a nonprofit corporation on December 29, 1997. The easement prohibited changes to the terracotta façade of the Maison Blanche building. A day after the easement was donated, Whitehouse combined the two properties and developed the area into a single condominium unit.

Whitehouse claimed a charitable-contribution deduction for the easement in the amount of \$7.445 million on its 1997 tax return. The IRS allowed a deduction in the amount of \$1.15 million and asserted a gross undervaluation penalty of 40 percent. In the Tax Court trial, the experts argued, among other things, which property should be valued and the nature of its highest and

best use.

Whitehouse challenged the Tax Court's valuation of the façade easement and the underreporting penalty.

Expert Qualifications and USPAP Compliance Challenged:

Whitehouse asserted that the Tax Court erred in admitting the IRS's expert's opinion based on his qualifications. The IRS's expert was a licensed appraiser in Louisiana with over 25 years of experience. Additionally, he had appraised 50 to 70 hotels, commercial properties near the Maison Blanche building, and the Maison Blanche building itself three times prior. Whitehouse argued that a facade easement appraisal requires additional or different qualifications. The Court of Appeals disagreed with Whitehouse and indicated that an appraiser with the IRS's expert's background is qualified to "value a specific type of interest – even one as 'esoteric and specialized' as a conservation easement."

Whitehouse also challenged whether the IRS's expert's report should have been admissible. Specifically, the IRS's expert's report failed to comply with *USPAP*. The Court of Appeals determined that strict compliance with *USPAP* should not render a report inadmissible. Instead, compliance with *USPAP* should be considered when determining the relevant weight the report should be given.

Material Post Valuation Date Event Knowable:

Whitehouse challenged the Tax Court's valuation because it solely relied on the comparable-sales method. Since reproduction of the property is unlikely, the Tax Court ruled that the replacement-cost method was of little use in determining fair market value. The Tax Court recognized that the income method is typically favored when comparable sales are unavailable, but noted that it is unsatisfactory when the property has no track record of earnings. Without historical data to evaluate, the appraisal's reliability came into question. The Court of Appeals did not determine whether the Tax Court erred in rejecting the replacement-cost and income methods. On remand, the Tax Court was ordered to reconsider all three methods.

In basing its valuation in part on the IRS's expert's analysis, Whitehouse argued that the Tax Court miscomprehended the highest and best use of the Maison Blanche and Kress buildings as a non-luxury hotel rather than as a Ritz Carlton as Whitehouse's expert asserted. The Court of Appeals indicated that the Tax Court would have the ability to decide this issue on remand. The buildings were not combined on the date of the donation of the easement. As a result, the Tax Court concluded that the easement did not burden the adjacent Kress building. The Court of Appeals indicated that the Tax Court was correct in that the easement does not burden the Kress building in the same manner that the easement burdens the Maison Blanche building. However, the condominium declaration was recorded the day after the easement conveyance.

The Appeals Court indicated that a hypothetical buyer would have considered the pending combination of the buildings and the effect of the easement on the value of the entire contiguous property, including the subject property. The Tax Court's valuation was vacated and The Court was asked to consider the easement's impact on fair market value given the "reasonable and probable" combination of the two buildings.

Will Qualified Appraisal by Qualified Appraiser Benefit Taxpayer?

Whitehouse argued that the Tax Court erred in upholding the gross undervaluation penalty because the value of the easement was based on a qualified appraisal prepared by a qualified appraiser and Whitehouse made a good faith investigation of the value of the easement. The Court of Appeals indicated that if necessary, on remand, the Tax Court will need to decide whether Whitehouse showed reasonable cause by relying on its accountants' and attorneys' opinions.