TAX COURT CASE UPDATE

Citation:

Leroy S. and Connie M. Schmidt v. Commissioner, T.C. Memo 2014-159, August 6, 2014*.*

Overview:

The Tax Court determined that an easement donated on land that a taxpayer intended to develop and subdivide, but on which he ultimately constructed a single personal residence, was worth about $500,000 less than the amount reported by the taxpayer, but about $1 million more than the amount asserted by the IRS. The Court disagreed with aspects of the valuation methodology employed by both parties' experts and provided a detailed and thorough account of the "proper" application of the discounted cash flow method.

The Facts:

Leroy Schmidt was a restaurant owner who also considered becoming a builder. Prior to buying the land at issue, he built eight homes in partnership with other builders, but had never developed a subdivision from raw land. On May 5, 2000, Mr. Schmidt purchased an approximately 40-acre parcel of relatively flat, vacant land in Colorado (“subject property”) for $525,000, with the intention of subdividing and developing it. The subject property was raw land with no development entitlements. On June 7, 2000, Mr. Schmidt retained the services of David F. Jones and Land Resource Associates (“LRA”) to provide land planning and consulting services with respect to developing the subject property. Mr. Jones informed Mr. Schmidt of the possibility of developing the subject property in conjunction with an almost-70-acre adjoining parcel, which King's Deer Development, LLC was in the process of purchasing from Red Rock Ranch, Inc., with the intent of developing it. On some date not specified in the case, Mr. Schmidt agreed to jointly pursue the development of the two properties as a residential subdivision called "Raspberry Ridge."

Mr. Jones began the entitlement process for both landowners and the application process for rezoning the properties for 2.5-acre subdivisions. On November 2, 2001, Mr. Jones sent Mr. Schmidt a cost estimate for the subdivision, splitting the costs 40/60 between Mr. Schmidt and King's Deer. Mr. Jones estimated development costs of $42,437 per lot and utilized a $250,000 average lot sales price.

At some point in 2002, King's Deer cancelled its purchase and abandoned the Raspberry Ridge subdivision and Mr. Schmidt ultimately chose not to develop the subdivision with any co-developer. He inquired about the likelihood of the county approving the development applications, and in a letter, LRA explained that the relevant agencies had already signed off on the suitability of the property for rezoning. On May 9, 2003, Mr. Schmidt and Red Rock Ranch executed a $1.25 million purchase agreement for the adjacent property, but he terminated it on August 5, 2003. The Tax Court noted that, at the time of termination, it was "highly probable" that the zone change and preliminary plan applications would have gone through. The court further noted that Mr. Schmidt could have severed the subject property from the adjacent property and just pursued rezoning, etc. for it separately under the existing applications.

At some point during the development process, Mr. Schmidt considered granting a conservation easement on the subject property and engaged a firm (“the appraiser”) to value the proposed easement. After inspecting the property and reviewing various information, the appraiser concluded that the "before" value of the subject property was $2 million and the "after" value was $400,000, assigning a $1.6 million value to the proposed easement. On July 3, 2003, Mr. Schmidt entered into a due diligence agreement with respect to the proposed conservation easement, which was ultimately accepted by the county's board of commissioners, and began constructing a personal residence on the subject property. On August 1, 2003, he executed an easement deed granting a conservation easement on the property and permitting one home on it.

Mr. Schmidt (on joint returns filed with his wife) claimed a charitable contribution deduction of $1.6 million on a Form 8283, Noncash Charitable Contributions, attached to their 2003 return. They claimed $325,407 of the contribution on the 2003 Schedule A, Itemized Deductions, and carried over the remainder of the deduction and claimed portions of it on their 2004, 2005, and 2006 returns.

On November 28, 2011, the IRS issued a notice of deficiency to the Schmidts with respect to the 2003 through 2006 tax years. The IRS determined that: (i) the Schmidts failed to meet the requirements of Code Section 170 in claiming a charitable contribution deduction for the easement; or (ii) alternatively, that the correct value of the easement was $195,000.

Discussion:

Both Mr. Schmidt and the IRS introduced expert testimony on the value of the conservation easement. Mr. Schmidt's appraiser, who was experienced and held several relevant certifications, submitted a report based largely on his 2003 appraisal (concluding a $1.6 million value based on the before and after method, with a "highest and best use" of the property before granting the easement as a residential subdivision, and post-easement as a 40-acre home site). The IRS's expert, who used a before and after method like Mr. Schmidt's appraiser, reached the same conclusions as to the property's pre- and post-easement highest and best use, but applied a market method of valuation and concluded that the subject property had a "before" value of $750,000 and an "after" value of $270,000, with a $480,000 conservation easement value.

After largely rejecting the IRS's arguments to discredit Mr. Schmidt's experts, the court turned to valuing the subject property, using the before and after method. It first noted that, although the parties agreed that both the market and subdivision development methods were appropriate, they disagreed as to which was more appropriate in this case. The court analyzed the properties that the IRS's expert used as comparables and ultimately concluded that they were not sufficiently similar to justify use of the market method. The court then turned to the subdivision development method and applied the following factors in determining the appropriate value:

(1) The number of lots (the subject property would yield 13 2.5-acre lots);
(2) The retail lot selling prices (after rejecting both expert's reports, the court arrived at a mean lot selling price of $220,000);
(3) The retail lot selling price appreciation rate (which the parties agreed was 6 percent per annum);
(4) The time required to obtain entitlements (the court arrived at a timeframe of 12 months within which a prospective buyer could have developed the subject property and begun selling lots from the conservation easement grant date);
(5) The absorption rate of the lots (after rejecting both expert's reports, the court found that all 13 lots would have sold within two years of being offered for sale);
(6) Development costs (which Mr. Schmidt conceded would have been $580,416);
(7) Marketing/administrative costs (which the court determined would have been 10 percent of gross sales); and
(8) The discount rate (which the parties agreed would be 22 percent, including a 10 percent "entrepreneurial-profit factor").

Having determined the above values, the court turned to recalculating the "before" value of the subject property using a discounted cash flow method similar to that used by the parties' experts, but first addressed the "proper application" of that method in this case. According to the court, Mr. Schmidt's expert failed to state how he calculated the present value of the income and expenses from the hypothetical subdivision of the subject property, and the IRS's expert relied on questionable assumptions (such as that the hypothetical developer would receive all income at year-end and pay all development costs at the beginning of the first year). The court ultimately applied the above figures as follows, using a mid-year convention, to calculate the present value of the income and costs associated with the subject property over a three-year period:

1. In Year 1, the lot sale price would be $226,504 (i.e., $220,000 multiplied by 6 percent annual appreciation rate), multiplied by zero (because there are no sales yet), zero marketing costs, and $580,416 of development costs, multiplied by a present value factor based on a 22 percent discount rate to arrive at -$525,484.
2. In Year 2, the lot sale price would be $240,094, multiplied by 6.5 sales to arrive at $1,560,611 in gross sales, less $156,061 in marketing costs for a net of $1,404,550. The present value of this was calculated as $1,042,312.
3. In Year 3, the lot price would be $254,500, multiplied by 6.5 sales to arrive at $1,654,250, less $165,425 in marketing costs for a net of $1,488,825. The present value of this was calculated as $905,617.

Thus, the court ultimately found that, before Mr. Schmidt granted the conservation easement, the "before" value of the subject property was $1,422,445 (by adding the above figures).

Then, the court considered the "after" value of the property, which both experts agreed should be based on sales of comparable properties with similar restrictions to those imposed by the easement. After comparing the two experts' reports, and their methods in arriving at their respective values, the court decided that the IRS's expert's method was more accurate because it relied on comparable properties that were platted for use as a 35 to 40 acre residential building site, whereas Mr. Schmidt's expert relied on comparables that were still subject to possible rezoning and development.

Conclusion:

Accordingly, the court agreed with the IRS's expert that the "after" value of the subject property was $270,000, which means that the value of the conservation easement was $1,152,445.