TAX COURT CASE UPDATE

Citation:

Gordon Kaufman, et ux. v. Commissioner, T.C. Memo 2014-52, March 31, 2014.

Overview:

In what amounted to a battle of expert witnesses, the Tax Court sided with the IRS's expert in holding that a façade preservation easement that the taxpayers granted to a preservation organization had no value because the façade was already subject to similar restrictions as a result of the property being in an historic district. The court also found the taxpayers liable for the accuracy-related penalty for both substantial valuation misstatement and negligence with respect to the underpayment caused by the easement deduction.

The Facts:

Mrs. Kaufman purchased a house in Boston's South End Historic District (“Historic District”) and granted a façade preservation easement to the National Architectural Trust (“NAT”). She and her husband retained Mr. Hanlon, an appraiser who was recommended by NAT, to determine the value of the easement. He concluded that the easement resulted in a 12 percent reduction in the house's value. On their joint return, the Kaufmans deducted the amount that the appraiser had determined.

The Tax Court first heard this case in 2010. At that time, the court found that the contribution failed to comply with Regulation Section 1.170A-14(g)'s requirement to be enforceable into perpetuity because a pre-existing mortgage on the property would entitle the bank to condemnation proceeds in preference to NAT upon the happening of certain events (134 T.C. 182). In *Kaufman*, (136 T.C. 294), the Tax Court reconsidered and re-affirmed its earlier holding.

Thereafter, the Court of Appeals for the First Circuit vacated the Tax Court's opinion. The First Circuit disagreed with the Tax Court's determination that the provision in the subordination agreement associated with the mortgage, which gave the lender priority on insurance and condemnation proceeds, violated Regulation Section 1.170A-14(g) (*Kaufman*, (CA 1 2012) 110 AFTR 2d 2012-5278).

Discussion:

Mr. Hanlon was certified by the Commonwealth of Massachusetts as a residential real estate appraiser. In the one year period surrounding the Kaufman appraisal, he had done eight other façade easement appraisals, all of which were done for NAT. Other than those nine reports, he had no experience in appraising partial interests in real property.

In preparing to complete his first appraisal of a façade easement, Mr. Hanlon spoke with someone at NAT to get an idea of how appraisals of façade easements were done and what had been accepted by the IRS. His notes of that conversation indicate that NAT told him that the range of values for façade easements is between 11 percent (for properties in highly regulated areas) and 15 percent (in less regulated or unregulated areas). His notes from that conversation also said: "Could use 11.5% - 12.5%". After he completed a draft of the first of those appraisal reports (stating a reduction in the property's fair market value of 11 percent), he mailed a copy of that draft to NAT, who suggested that he add a particular paragraph to his report. Almost verbatim, NAT's suggestion appeared in the Kaufman appraisal and in his earlier appraisals.

Because Mr. Hanlon was unaware of any sales in the Boston area of residential properties encumbered by façade easements, he was unable to determine the value of the property following the contribution of the façade easement to NAT using comparable-sales data. Instead, he determined the pre-easement value of the property and then noted 12 differences between the Historic District's restrictions and those in the easement. These included: a) unlike the Historic District's restriction, which applied to exterior walls, roof, and yard which were visible from the public way, the easement applied to all exterior walls, chimneys and roofs of the building and to the land; b) the easement was granted in perpetuity while the Historic District ordinances might change over time to reflect changes in political, economic and aesthetic needs and tastes in a community; and c) the Historic District ordinances contained relief for economic hardship, which the easement did not. He then assigned particular percentages to each of those differences but did not provide support for those percentages.

He acknowledged in court that this was a method unique to him and was not a generally accepted appraisal practice or valuation method. He also conceded that, notwithstanding those supposed comparative disadvantages of the easement agreement, neither the easement nor the Historic District restrictions hampered the potential for developing the property to its highest and best use "as the property is currently improved to its highest and best use as a single family home."

He also looked to an article published by an IRS employee (“Primoli article”) that concluded that façade easements are generally valued at 10 to 15 percent of the property’s value.

The IRS's appraiser, Mr. Bowman, besides being certified by the state as a real estate appraiser, had received certification by the American Society of Appraisers with respect to conservation and preservation restrictions. His report and testimony noted the following:

> ... It was illogical that Mr. Hanlon assumed that the façade easement would result in a diminution in value, considering that he had recognized that there would be no change in the highest and best use of the property.
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> ... By not conducting an appraisal of the property to determine its post-easement-contribution value, Mr. Hanlon did not properly apply Reg. § 1.170A-14(h)(3)(i). Rather, Mr. Hanlon determined the postcontribution value not by appraisal but by discounting the precontribution value that he had determined, so as to reflect the range of discounts he determined. Mr. Bowman believed that Mr. Hanlon's method was flawed because Mr. Hanlon did not determine the postcontribution

value of the property independently from his determination of the precontribution value of the property.

... There was no difference between the terms of the easement and the Historic District restrictions that would likely be recognized by a typical buyer.

... There was no market evidence of difficulty in marketing or financing façade easement-encumbered properties.

... The evidence did not demonstrate a market recognition of diminution in value.

Conclusion:

In ruling in favor of the IRS, the court's principal reasoning coincided with that of Mr. Bowman. The court also noted the following in support of its decision:

... Mr. Kaufman, upon receiving Mr. Hanlon's appraisal, wrote NAT to say that he was concerned that he had given away so much value to NAT. Mr. Bahar of NAT replied by saying that: a) based on NAT's long history with such easements, properties with an easement were not at a disadvantage; b) 'Over 100 lenders have approved to subordinate their loans to our easements to date in over 800 cases... Why would these banks (including yours) approve these transactions if they saw a risk or adverse financial impact on their collateral?'; and c) one of NAT's directors owns fifteen properties 'and has taken advantage of this tax deduction himself. He would have never granted any easement if he thought there would be a risk or loss of value in his properties.'

... Before granting the easement, Mrs. Kaufman needed the agreement of her bank, Washington Mutual, to subordinate its mortgage interest in the property to NAT's interest with respect to the façade easement. To obtain that subordination, she executed a statement to the bank that contained the following: 'The easement restrictions are essentially the same restrictions as those imposed by current local ordinances that govern this property.'

In finding that the taxpayers were liable for the accuracy-related penalty for substantial valuation misstatement, the court first noted that they did not meet the "good-faith investigation" test of Code Section 6664(c)(3). The taxpayers argued that they believed that the easement reduced the value of the property because it contained more restrictions than those imposed by the Historic District. But they gave no indication of doing anything to support that belief. They also noted that their return was prepared by an independent accountant who reviewed Mr. Hanlon's appraisal. But the accountant testified that he only told the taxpayers that the appraisal was consistent in form with other such appraisals he had seen. They then pointed to the Primoli article and argued that their reliance on it, both personally and through their advisors, demonstrated a good-faith investigation. But their accountant's testimony never mentioned the Primoli article, and there was no evidence that the existence of that article influenced the taxpayers' actions.

The court then found that the taxpayers failed to show that they acted with reasonable cause. First, they argued that they relied on their accountant. But the court noted that the accountant neither was qualified to advise the taxpayers about the issue here, i.e., valuation, nor did he advise them about that issue. They then argued that they relied on Mr. Hanlon. But, Regulation Section 1.6664-4(b)(1) provides that reasonable cause and good faith are ordinarily not indicated by the mere fact that there is an appraisal. The court said that the Kaufmans had reason to question the Hanlon appraisal, particularly in light of the information they received from NAT's Mr. Bahar. Mr. Kaufman then said that he did not attribute much significance to Mr. Bahar's letter because he found that it was not based on good statistical methods. But, Mr. Kaufman was a professor of statistics, and he should have done something to reconcile the Bahar conclusion with the opposing conclusion reached by Mr. Hanlon.

In finding that the Kaufmans were also negligent, the court looked to the Washington Mutual document. The Kaufmans testified that they signed this document without understanding what they were signing. The court said that whether that was true, or whether they signed it with understanding, they were, at a minimum, negligent.