

TAX COURT CASE UPDATE

Citation:

Whitehouse Hotel Limited Partnership v. Commissioner, No. 13-60131 (5th Circuit), June 11, 2014.

Overview:

The Court of Appeals for the Fifth Circuit approved the methods used by the Tax Court in valuing a conservation easement, and approved the Tax Court's valuation amount, but overturned its assessment of a valuation misstatement penalty related to the easement.

The Facts:

Whitehouse Hotel Limited Partnership (“Whitehouse”) spent a total of \$13.4 million to assemble a New Orleans parcel of property containing historic structures. The contiguous buildings at issue were the Maison Blanche structure and the Kress structure. Whitehouse donated a façade easement of the Maison Blanche structure to a Louisiana non-profit corporation. Whitehouse promised to keep the building façade in good repair and to do nothing to the façade to alter its appearance. Because of the nature of the Maison Blanche easement, Whitehouse was prevented from building on top of the Kress building. After the easement donation, the buildings were renovated and turned into first-class hotel space.

Whitehouse obtained two appraisals of the easement, the Roddewig appraisal and the REVAC appraisal. It relied upon the Roddewig appraisal generally, but commissioned the REVAC appraisal to use as a check against the Roddewig appraisal. Roddewig had appraised the Maison Blanche as having a pre-easement value of \$96,000,000 and a post-easement value of \$88,555,000. These amounts represented a large difference from the amount the partnership originally paid (\$8,978,813) less than three years before the Roddewig appraisal.

On its 1997 Form 1065, Whitehouse claimed a charitable contribution deduction of \$7.445 million for the gift of the façade. It attached Form 8283, signed by its appraiser. On audit of the return, the IRS said the value of the gift was only \$1.15 million and also determined that a Code Section 6662(a) accuracy-related penalty applied.

Original Tax Court decision. The original Tax Court case took place in 2008 (*Whitehouse Hotel Limited Partnership, QHR Holding-New Orleans, LTD., Tax Matters Partner*, 131 T.C. 112). Whitehouse’s appraiser considered three methods to evaluate the pre- and post-easement value of the property-replacement cost, income and comparable sales. The IRS’s appraiser only considered the comparable sales method and concluded that the easement had no value.

A Whitehouse employee also presented evidence that Whitehouse consulted with accountants and attorneys about the easement valuation, but did not present any direct evidence of Whitehouse's investigation into the value of the easement. His testimony provided no direct evidence as to what specific advice Whitehouse received from its attorneys and accountants.

Whitehouse did not require the professionals to investigate the value of the easement, and there was no evidence that they had done so.

The Tax Court agreed with IRS and held that because the historic preservation façade easement burdened only the Maison Blanche building, and not the Kress building, the easement's effect on the latter could not be taken into account. Applying the comparable sales valuation method, it found that the value of the easement was \$1,792,301. The Tax Court also held that Whitehouse made a gross valuation misstatement and owed an accuracy-related penalty under Code Section 6662(a).

Appeal of original Tax Court decision to Fifth Circuit. On appeal, the Fifth Circuit ruled that the relevant determination should have been the effect of the easement on the fair market value ("FMV") of the contiguous property owned by Whitehouse. The relevant valuation inquiry should have been whether, in determining what he would pay for the Maison Blanche and Kress buildings, a hypothetical buyer would take into account the combining of the two properties. As a result, the Fifth Circuit vacated the Tax Court's valuation and remanded. The Fifth Circuit said that in making this valuation on remand, the Tax Court should, among other things, reconsider the experts' reports and valuation methods and their conclusions regarding highest and best use. (*Whitehouse Hotel Limited Partnership, QHR Holding-New Orleans, LTD., Tax Matters Partner*, (CA 5 2010) 106 AFTR 2d 2010-5759).

Tax Court's decision, on remand. On remand, the Tax Court did not change its holding with respect to either the value of the easement or the imposition of the penalty. With respect to the penalty, the Tax Court said, while the IRS conceded that Whitehouse satisfied the qualified-appraisal requirement, Whitehouse failed to prove that it made a good-faith investigation of the value of the easement. (*Whitehouse Hotel Limited Partnership, QHR Holding-New Orleans, LTD., Tax Matters Partner*, (2012) 139 T.C. 304).

Discussion:

In challenging the Tax Court's decision on remand, the taxpayer made the following four arguments. First, that the Tax Court ignored the Fifth Circuit's mandate with respect to the effect of the easement on the Kress Building. Second, that the Tax Court failed to comply with the Fifth Circuit's instruction to find the highest and best use of the parcel, before and after the easement. Third, that the Tax Court erred by rejecting the reproduction cost and income valuation approaches and by rejecting Roddewig's use of non-local comparable sales. Finally, that it was entitled to the good faith defense regarding the gross undervaluation penalty.

The Fifth Circuit ruled against Whitehouse's first two arguments and concluded that the Tax Court did follow the instructions in the remand order. It then went on to analyze the Tax Court's review, on remand, of the three valuation approaches used by Roddewig.

As to the reproduction cost method, the Tax Court rejected this method because reproducing the historic façade after complete destruction would make no business sense. The Fifth Circuit said that it found scarce precedent as to the suitability of the reproduction cost method in the conservation easement context. It did find a Fifth Circuit case which held that reproduction cost is inappropriate absent "a showing that substantial reproduction would be a reasonable business venture" (*Benning Hous. Corp.* (CA 5 1960) 276 F2d 248). The Fifth Circuit noted that the easement provided that Whitehouse had to repair the façade if it was damaged and the buildings not completely destroyed, and that reproduction cost of the façade, as opposed to the

entire building, might be relevant in valuing the easement. But, it concluded that factor was not enough to overcome the Tax Court's conclusion with regard to the reproduction cost method.

As to the income method, the Tax Court rejected this method because the evidence upon which Roddewig's income calculations were based was found to be unreliable. The Tax Court also cited a long line of cases, often affirmed by other circuits, rejecting the income method as not useful if ample comparable sales were available for valuation. The Fifth Circuit then said that, although the income method is not automatically unacceptable for any valuation purpose, no precedent ascribes error to the Tax Court's rejection of it in these circumstances.

As to the comparable sales method, the Tax Court concluded that there were enough local comparable sales to make consideration of non-local comparable sales unnecessary. The Fifth Circuit noted that the Tax Court did not simply reject the use of non-local comparable sales out-of-hand. Rather, it did not consider Roddewig's non-local comparable sales because Roddewig's values varied widely between local and non-local comparable sales.

Conclusion:

The Fifth Circuit concluded that the Tax Court did not err in rejecting the reproduction cost and income valuation methods, nor did it err when it rejected Roddewig's non-local comparable sales.

In overturning the misstatement penalty, the Fifth Circuit began by noting "when an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for a taxpayer to rely on that advice." Nonetheless, it said the statute here requires a "good faith investigation" for donations of charitable property. In sum, reasonable reliance on the word of qualified tax professionals suffices for the general reasonable cause exception. But that leaves open the question of whether Whitehouse's reliance on tax professionals was enough.

The Fifth Circuit went on to say that valuation of assets is a difficult task, even with the advice and counsel of accountants, consultants, and tax attorneys. While noting that it shared the IRS's and the Tax Court's skepticism of the dramatic appreciation of value between the roughly \$8,000,000 purchase price of the Maison Blanche shell and the Roddewig appraisal's \$96,000,000 valuation, it said that it was particularly persuaded by Whitehouse's argument that the IRS, the IRS's expert, and the Tax Court all reached different conclusions. The IRS originally permitted only \$1.15 million as a deduction; its expert at trial said that the easement was worthless.

The Fifth Circuit said that, as it had in *Montgomery Capital*, for the general reasonable cause exception, it reviewed the "totality of the facts and circumstances." Whitehouse obtained a second appraisal as a "check" against the first one and its Form 1065 was prepared by its financial auditors. Obtaining a qualified appraisal, analyzing that appraisal, commissioning another appraisal, and submitting a professionally-prepared tax return is sufficient to show a good faith investigation as required by law. It concluded that the Tax Court's enforcement of the gross undervaluation penalty was clearly erroneous.