Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: CC:SB:DET
Attn: Alexandra Nicholaides, Senior Counsel

from: CC:ITA:1
Karin Gross, Acting Branch Chief

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subject: Valuation of Facade Easements

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

May an appraisal of a façade easement that values the easement as a percentage of the value of the underlying fee before the granting of the easement, without reference to the actual value of the underlying fee after the granting of the easement, be used to substantiate the fair market value of the easement under § 170(h) of the Internal Revenue Code?

CONCLUSION

No. The value of a donated façade easement depends on the particular facts and circumstances of that property and must be substantiated with a full appraisal of the value of the easement. This value is generally obtained by determining the values of the underlying fee both before and after the contribution, with the easement valued at an amount equal to the difference, if any. The Internal Revenue Service will not accept an appraisal to substantiate the fair market value of a façade easement if the appraisal merely values the entire fee before the donation and then applies a percentage thereto.

FACTS

Some taxpayers have made charitable contributions of façade easements and have attempted to substantiate their contributions with valuations as described below:

(1) Valuation of the property before the contribution using traditional appraisal methods (such as market data of comparable properties or income capitalization); and
(2) Estimation of the value of the façade easement by applying a percentage to the value of the property before the contribution. The percentage selected is based on a statement that it is "generally recognized" that façade easement contributions result in a loss of value of between 10% and 20% of the underlying property; the appraisals generally use a percentage within that range.

These valuations contain no valuation of the property after the contribution. Certain tax advisors and charitable organizations are misinforming the public about the valuation of contributed façade easements by indicating that the Service allows tax deductions of approximately 10 to 15% of the fair market value of the underlying property.

LAW AND ANALYSIS

Section 170(a) of the Code provides that a deduction shall be allowed for any charitable contribution payment of which is made within the taxable year. Under § 170(c), a charitable contribution means a contribution or gift to or for the use of an organization described in § 170(c)(1)-(5).

Section 170(f)(3) provides the general rule that no deduction is allowed for a contribution of an interest in property which consists of less than the taxpayer's entire interest in the property. However, under § 170(f)(3)(B)(iii), a deduction is allowed for a qualified conservation contribution, even though it is a contribution of a partial interest. Section 170(h)(1) and § 1.170A-14(a) of the Income Tax Regulations provide that a qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. Under § 1.170A-14(b)(2), a qualified real property interest is a restriction granted in perpetuity on the use which may be made of real property, including an easement or similar interest under State law.

Under § 1.170A-14(h)(3)(i), the value of a perpetual conservation restriction is the fair market value of the perpetual conservation restriction at the time of the contribution. If there is a substantial record of sales of easements comparable to the donated easement, the fair market value of the donated easement is based on the sales prices of those comparable easements. If, however, there is no substantial record of market-place sales of comparable easements, generally the fair market value of a perpetual conservation restriction is equal to the difference between the fair market

value of the property before the granting of the restriction and the fair market value of the property after the granting of the restriction. This is generally referred to as the "before and after" approach.

In Rev. Rul. 73-339, 1973-2 C.B. 68, clarified in Rev. Rul. 76-376, 1976-2 C.B. 53, the Service used the before and after approach to value an easement granted on an entire piece of property. Rev. Rul. 76-376 clarifies that, where the easement is only on a portion of the property, the before and after approach should be applied to the entire property, not merely the portion on which the easement is granted.

The before and after approach was approved by the Congress in the legislative history of the 1980 amendments to § 170(f)(3). See S. Rep. No. 96-1007 (1980), 1980-2 C.B. 599, 606. This legislative history provides:

> [C]onservation easements are typically (but not necessarily) valued indirectly as the difference between the fair market value of the property involved before and after the grant of the easement. (See Rev. Rul. 73-339, 1973-2 C.B. 68, and Rev. Rul. 76-376, 1976-2 C.B. 53). Where this test is used, however, the committee believes it should not be applied mechanically (emphasis added).

In explaining the meaning of this statement, the Congress provided numerous examples of factors that should be taken into account in determining the value of each easement. These factors, which have been incorporated in § 1.170A-14(h)(3) & (4) the Income Tax Regulations, suggest that, because each property is unique, the specific, individual attributes of the property both before and after the granting of the easement must be examined, and a "mechanical" application of any valuation methodology is unacceptable.

Section 1.170A-14(h)(3)(ii) provides that, if before and after valuation is used, the fair market value of the property before the contribution must take into account not only the current use of the property but also an objective assessment of the likelihood that the property would be developed absent the restriction, as well as any effect from zoning, conservation, or historic preservation laws that already restrict the property's potential highest and best use. In addition, this regulation provides that there may be instances in which the grant of a conservation restriction may have no material effect on the value of the property. In determining the fair market value of the property after the contribution, § 1.170A-14(h)(3)(ii) requires that, if before and after valuation is used, an appraisal of the property after the contribution must take into account the effect of restrictions that will result in a reduction of the potential fair market value represented by the highest and best use but will, nevertheless, permit uses of the property that will increase its fair market value above that represented by the property's current use.

In Hilborn v. Commissioner, 85 T.C. 677 (1985), the Tax Court engaged in a "before and after" analysis to determine the value of a façade easement. The Court noted that "before" value is reached by determining the highest and best use of the

property in its current condition unrestricted by the easement, and that "after" value is calculated by first determining the highest and best use of the property as encumbered by the easement and by comparing the burdens of the easement with existing zoning regulations and other controls (such as local historic preservation ordinances) to estimate whether, and the extent to which, the easement will affect current and alternate future uses of the property. The Hilborn Court adopted the government expert's analysis because it was more objective than that of the taxpayer's expert, who had used his subjective judgment to conclude that the façade easement had caused a 12% diminution in the before value of the property. Id. at 699.

In Nicoladis v. Commissioner, T.C. Memo. 1988-163, the Court accepted the 10% diminution proposed by both parties but stated:

> We note, however, that by this decision we do not mean to imply that a general "10-percent rule" has been established with respect to façade donations. There was a fair amount of discussion by the parties at trial about whether the Court had established a "10-percent rule" in Hilborn. We did not there and do not here. Hilborn establishes as acceptable the before and after method of valuation, and while under the circumstances of that case a 10-percent figure was relied upon, valuation itself is still a question of facts and circumstances.

Some taxpayers claim reliance upon a Market Segment Specialization Program Guide (Guide) and also upon a Topical Tax Brief, which were posted on the IRS website. These documents at one time suggested a range within which a façade easement might be expected to reduce the value of property. However, they also described the "before and after" method as the proper method by which to value a façade easement, making it clear that a full analysis of the value of the property both before and after the donation was necessary. The Guide expressly stated that its material was designed specifically for training purposes and could not be used or cited as authority for a technical position. Nevertheless, this language was removed from the Guide and the Topical Tax Brief years ago and does not support an otherwise insufficient valuation.

Section 170(f)(11), as added by § 883 of the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004), contains reporting and substantiation requirements relating to the allowance of deductions for noncash charitable contributions. In particular, under § 170(f)(11)(C), taxpayers are required to obtain a qualified appraisal for donated property for which a deduction of more than $5,000 is claimed. More recently, in § 1219 of the Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (2006) (the "PPA"), the Congress imposed increased penalties for inaccurate appraisals and new definitions of qualified appraisals and appraisers for taxpayers claiming charitable contribution deductions under § 170. The new provisions in §§ 6662, 6664, 6695A and 170(f)(11)(E) imposed by the PPA are designed to achieve more accuracy in appraisals used to substantiate charitable contributions under

§ 170. The PPA also imposes new requirements for deductibility of historic easement contributions. See § 170(f)(13), (f)(14), (h)(4)(B) & (h)(4)(C).

The value of each easement is based on the particular facts and circumstances of each property on which the façade is located and the particular restrictions imposed. There was and is no "generally recognized" percentage by which an easement reduces the value of property. Consequently, unless there is a substantial record of sales of easements comparable to the donated easement (in which case the appraisal would be based on the comparables, see § 1.170A-14(h)(3)(i)), an appraisal that does not value the property both before and after the donation will not be accepted by the Service to substantiate the deduction.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

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Please call Susan J. Kassell at (202) 622-5020 if you have any further questions.