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Cc:

Subject: Façade Easement – Appeals training materials

The attached slides are the ones I sent you the end of November, but they now have more on penalties (per your request). I think you were right -- they needed more on penalties. The penalty slides were prepared by . Please let us know if there is anything you want to discuss.

ATTACHMENT

Charitable Contributions of Façade Easements § 170

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Topics

- Charitable Contributions in General
- Charitable Contribution of a Façade Easement
- Substantiation
- Valuation
- Penalties
- Typical issues

Note: all references to code sections are to the Internal Revenue Code and all references to regulations are to the Income Tax Regulations.

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Charitable Contributions in General

Overarching § 170 requirements

- To be deductible under § 170, there must be:
 - A transfer
 - Of property or money
 - To a qualified donee
 - With charitable intent and without receipt of economic benefit
 - Of the donor's entire interest in property (there are exceptions to this rule)
 - Proper substantiation
- See Pub. 526 "Charitable Contributions"

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Charitable Contribution of a Façade Easement

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What is an easement?

- An easement is a non-possessory interest in the real property of another, not a mere contract right.
- Most conservation easements are “negative” easements “in gross.”

What is a façade easement?

- A type of conservation easement which may qualify as a charitable contribution under § 170
- A restriction on making changes to the exterior of a historical structure
- A partial interest in property (an exception to the § 170 “entire interest” rule (§ 170(f)(3)(B)(iii))

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When is a façade easement deductible?

To be deductible, a façade easement must be a “qualified conservation contribution”
§ 170(h)

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Qualified Conservation Contribution

A contribution –

- Of a qualified real property interest
- To a qualified organization
- Exclusively for conservation purposes

§ 170(h); § 1.170A-14

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Qualified Real Property Interest

A façade easement is a “qualified real property interest” if it meets the conservation purpose of –

“the preservation of a certified historic structure”

See § 170(h)(4)(A)(iv)

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Qualified Real Property Interest (cont'd) Certified Historic Structure

A “certified historic structure” means –

- Any building, structure, or land area which is listed in the National Register, or
- Any building which is located in a registered historic district (as defined in § 47(c)(3)(B)) and is certified by the Secretary of the Interior to the Secretary as being of historic significance to the district.

Must be so designated at time of transfer or on due date (including extensions) of return for taxable year transfer is made.

§ 170(h)(4)(C) (2006)

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Qualified Organization

- A “qualified organization” or “eligible donee” must be—
 - Governmental unit;
 - Publicly-supported charity; or
 - Support organization described in § 509(a)(3) that is controlled by a governmental unit or a publicly supported charitable organization.
- Eligible donee must have the commitment to protect the conservation purposes and the resources to enforce the restrictions.

§ 170(h)(3); § 1.170A-14(c)(1)

Pub. 78 provides list of exempt organizations.

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Conservation Purpose

- Historical Preservation
- Visual Access by Public
 - Some visual access is required.
 - If not visible from public way, terms of easement must give public regular opportunities to view property.
 - See § 1.170A-14(d)(5)(iv) & (v) for factors and examples.

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Exclusively for Conservation Purpose

- No inconsistent use —
 - No deduction if contribution would accomplish one conservation purpose while permitting destruction of another significant conservation interest.
 - However, a destructive inconsistent use is allowed ***if*** the use is necessary for the protection of the conservation purpose of the easement.

§ 1.170A-14(e)(2) & (3)

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Exclusively for Conservation Purpose (cont'd) In Perpetuity

- Conservation purpose must be protected in perpetuity.
§ 170(h)(2)(C) & (h)(5)
 - Any retained interest in property by donor and/or donor's successor in interest must be subject to legally enforceable restrictions.
 - For example, the Deed of Easement should be recorded in state land records; the transfer must be complete under state law.
 - Language of deed must adequately protect the conservation purpose and its exclusivity.
 - Remote future event does not defeat perpetuity requirement.
- 1.170A-14(g).
Deed must restrict donee transfers (§ 1.170A-14(c)(2)).

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Exclusively for Conservation Purpose In Perpetuity (cont'd)

- Note that the “in perpetuity” requirement is in addition to the “exclusively for conservation purpose” requirement.
See §170(h)(2)(C) & § 1.170A-14(e) & (g)
- Mortgagee must subordinate its rights in the property to the right of the donee organization to enforce the conservation purpose in perpetuity. § 1.170A-14(g)(2)
- Extinguishment of easement: Conservation purpose can still be protected in perpetuity if --
 - Extinguished by judicial proceeding, and
 - Sale proceeds used by donee org consistent with conservation purpose
 - §1.170A-14(g)(6)

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Special Rule for Façade Easements
added by Pension Protection Act (PPA), effective
for contributions after 7/25/06

Façade easement not considered exclusively for conservation purpose unless it --

Includes a restriction that preserves the **entire** exterior of the building (including the front, sides, rear and height of the building), and

Prohibits any change inconsistent with historical character.

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**Special Rule for Façade
Easements (cont'd)**

- Donor and donee must enter written agreement certifying (under penalty of perjury) that donee --
 - Is qualified donee with a purpose of historic preservation, and
 - Has the resources to manage and enforce restriction and commitment to do so.

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Special Rule for Façade Easements (cont'd)

- For contributions made in a tax year beginning after 8/17/06, T must include with tax return –
 - Qualified appraisal (within meaning of § 170(f)(11)(E))
 - Photos of entire exterior of building
 - Description of all restrictions on development of building

§170(h)(4)(B)(iii)

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Special Rule for Façade Easements (cont'd)

\$500 Filing Fee

- No deduction allowed for charitable contribution of façade easement if claimed deduction is more than \$10,000 unless T pays \$500 filing fee with the return.
- Effective for contributions made on or after Feb. 13, 2007 (180 days after 8/17/06).

§ 170(f)(13)

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Substantiation

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Substantiation

- Deduction only if “verified” under regulations § 170(a)
- Specific requirements are set forth in 170(f)(8) & (11) and § 1.170A-13. Deduction can be disallowed if not met.
- Proposed regulations, issued August 2008, incorporate recent legislative changes. See REG-140029-07, 2008-40 I.R.B. 828.
- See also Pub. 1771 “Charitable Contributions – Substantiation and Disclosure Requirements”.

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Substantiation Requirements

- Contemporaneous written acknowledgment (CWA) from the donee
- IRS Form 8283
- Qualified Appraisal
- Qualified Appraiser

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Content of CWA

- Description (but not value) of donated property (the façade easement),
- Whether the donee provided any goods or services in exchange for the donation, and, if so
- A description and good faith estimate of the value of goods or services provided by the donee.

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CWA (cont'd)

- Contemporaneous: CWA is contemporaneous if obtained by T on or before the date the T files a return for the year in which the contribution is made, or the due date, including extensions, of such return.

§ 170(f)(8); § 1.170A-13(f)(3)

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Form 8283/Appraisal Summary

If deduction is more than \$500 but not more than \$5,000

- Form 8283 (Section A)

If deduction is more than \$5,000

- Form 8283 (Section B/Appraisal Summary), and
- Qualified appraisal required

If deduction is more than \$500,000

- Form 8283 (Section B/Appraisal Summary)
- Must also *attach* qualified appraisal to return (for contributions made after 6/3/04)

§ 170(f)(11)(B), (C) and (D)

Note that under the “Special Rule for façade easements”, for façade easement contributions made in a taxable year beginning after 8/17/06, a qualified appraisal must be attached to tax return for any amount of deduction. 170(h)(4)(B)(iii)(I) . See slide 18.

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Form 8283 (cont'd)

Appraisal Summary (Section B)

- Date of the contribution
- Fair market value
- Detailed description of property
- How and when obtained
- Cost or other basis
- Name, address, TIN of appraiser, donor, donee
- Declaration of appraiser
- Signed and dated by donee and appraiser
- Donee signature acknowledges
 - Qualified organization
 - Receipt of property and date
 - Form 8282 if disposition within 3 years
 - Unrelated use question

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Qualified Appraisal

(Timing)

- Appraisal must be made --
 - No earlier than 60 days before contribution, and
 - No later than due date (including extensions) of return

§ 1.170A-13(c)(3)(i)(A)

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Qualified Appraisal (Content)

- Detailed description and physical condition of property
- Date of contribution
- Terms of any agreement or understanding related to use or disposition of property
- Name and qualifications of appraiser
- Prepared for income tax purposes
- Date property appraised
- Appraised fair market value
- Method of valuation
- Specific basis for valuation

§ 1.170A-13(c)(3)(ii)

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Qualified Appraiser

Appraiser must declare on appraisal summary that he or she --

- Holds self out as appraiser or regularly performs appraisals
- Is qualified by experience, education, etc., to value type of property being valued
- Understands § 6701 civil penalty for aiding understatement of tax

§ 1.170A-13(c)(5)(i)(D)

For returns filed after February 16, 2007, the declaration required under § 1.170A-13(c)(5)(i) must include an additional statement that the appraiser understands that a substantial or gross valuation misstatement resulting from an appraisal of the value of property that the appraiser knows, or reasonably should have known, would be used in connection with a return or claim for refund, may subject the appraiser to a civil penalty under § 6695A.

Notice 2006-96

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Qualified Appraiser (cont'd)

Donor's knowledge that appraisal exceeds FMV can disqualify appraiser for that donation.

§ 1.170A-13(c)(5)(ii)

Appraiser cannot be donor, donee, person who sold or gave property to donor

- Cannot be agent, related person, or employee
- Cannot be regularly used by donor; must perform majority of appraisals for others

- Fee cannot be based on percentage of appraised value

§ 1.170A-13(c)(5) & (6)

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Pension Protection Act of 2006

Applies to returns filed after 8/17/06

New requirements for Qualified Appraisal
and Qualified Appraiser

- Appraisal must be conducted by qualified appraiser in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed by the Secretary.

§ 170(f)(11)(E)(i)(II)

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PPA New Requirements (cont'd):

- Qualified Appraiser:
 - Has earned appraisal designation from recognized professional appraiser organization or has met requirements in regulations;
 - Regularly performs appraisals for compensation;
 - Must demonstrate verifiable education and experience in valuing the type of property subject to the appraisal, and
 - Has not been prohibited from practicing before the IRS any time in prior 3 years.

§ 170(f)(11)(E)(ii)

effective for returns or submissions filed after 8/17/2006

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Notice 2006-96

Section 3.02

- Provides transitional guidance after PPA and before regulations issued
- Appraisal treated as qualified if it complies with existing regulations (if consistent with PPA), and
- Is conducted by qualified appraiser in accordance with generally accepted appraisal standards.
- Appraisal will be treated as satisfying generally accepted appraisal standards if, for example, appraisal is consistent with substance and principles of USPAP.

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Notice 2006-96 (cont'd)

Sections 3.03 & 3.04

Qualified Appraiser treated as meeting new requirements of § 170(f)(11)(E) if –

Appraisal designation awarded on basis of demonstrated competency in valuing type of property for which appraisal performed

Appraiser makes written declaration that background, experience, education and membership in professional associations qualifies him or her to appraise this type of property

Appraiser has minimum experience for appraisals of real property if –

For returns filed on or before 10/19/06, meets requirements of existing regulations

For returns filed after 10/19/06, is licensed or certified for type of property being appraised in state of property location

Penalty declaration: For returns filed after 2/16/07, appraiser must make written declaration of knowledge of new §6695A civil penalty

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Additional PPA changes Affecting Façade Easements

- Deduction up to 50% of T's contribution base
 - Carryover of deduction for up to 15 years
 - Effective for contributions made after December 31, 2005, through December 31, 2009
- § 170(b)(1)(E); Notice 2007-50; (termination date extended to 12/31/09 by Food, Conservation and Energy Act of 2008)

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Valuation

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Fair market value General Rule

- FMV is “the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.”
§ 1.170A-1(c)(2)
- If property is LTCG, deduction is generally (but not always) FMV; otherwise, reduce by appreciation. §170(e).
- See Pub. 561 “Determining the Value of Donated Property”

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Comparable Façade Easement Sales

- If substantial record of sales of façade easements comparable to donated easement exists, then FMV should be based on the sales prices of those easements.

§ 1.170A-14(h)(3)(i)

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“Before and After” Test

- If no record of façade easement sales, use “before and after” test. §1.170A-14(h)(3)(i). But test not applied mechanically (S. Rept. No. 96-1007, 1980-2 C.B. 599, 606)
- FMV of easement is difference between FMV of property before granting of restriction and FMV of property after granting of restriction; two appraisals are required
- If donor receives a benefit from the transfer
 - May be no deduction
 - Deduction only for excess
- If granting of restriction increases value of any other property owned by donor or related party (as defined in section 267(c)(4)), amount of deduction is reduced by that amount

§ 1.170A-14(h)(3)(i) & (ii); § 1.170A-14(h)(4), Examples 7 & 12

Whitehouse v. Commissioner, 131 T.C. No. 10 (Oct. 30, 2008) (use of comparable sales method)

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“Before” Value Highest and Best Use

- Value of the property before the contribution is based on the highest and best use of the property in its current condition, unrestricted by the easement
- “Highest and most profitable use for which the property is adaptable and needed or likely to be needed in the reasonably near future.”
Olson v. U.S., 292 U.S. 246, 255 (1934)
- “Before” value must take into account such factors as --
 - Current use of the property
 - Objective assessment of how immediate or remote the likelihood is that the property, absent the restriction, would be developed
 - Any effect from zoning, conservation, or historic preservation laws that already restrict the property’s highest and best use

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“Before” Value Highest and Best Use (cont’d)

- Special suitability of property for a particular use may be relevant
- Must be a reasonable probability that the property would be so used in the reasonably foreseeable future
- Realistic, objective potential uses must be determined
- Not a “fantasy” test

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“Before” Value Highest and Best Use (cont’d)

- Intent of the particular donor not at issue
- Realistic assessment of what a reasonable owner would do with the property to put it to its best use
- Schwab v. Commissioner, T.C. Memo. 1994-232
- Stanley Works & Subsidiaries v. Commissioner, 87 T.C. 389, 412 (1986)

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“After” Value

- Parties often agree on “after” value
- In some cases, the conservation easement will have no material effect on value, or may enhance rather than reduce value. No deduction is allowable for an easement that has no value.

§ 1.170A-14(h)(3)(ii)

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“After Value” (cont’d) Local Ordinances

- Often there are local ordinances restricting use and changes to façade
- Compare easement to any existing restrictions on property (read deed of easement carefully)
- Easement should be valued only to extent easement restriction is more stringent than other restrictions already on property

§1.170A-14(h)(3) (ii)

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No Safe Harbor/No Percentage Reduction

- Some literature erroneously states that IRS will accept 10-15% reduction in value of property as facade easement valuation
- Tax Court façade easement valuation cases during 1980’s often were in that range
- CCA 200738013 issued August 9, 2007: IRS will not accept appraisal to substantiate FMV of façade easement if the appraisal merely values entire fee before contribution and applies percentage reduction
- Appraisal must do full valuation both before and after contribution
- THERE IS NO SAFE HARBOR!
- NO PERCENTAGE REDUCTION!
- FMV is facts and circumstances
- See Nicoladis v. Commissioner, T.C. Memo. 1988-163

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Reduction in Contribution Amount for Rehabilitation Credit

- Added by PPA, effective for contributions after 8/17/08
- If, during 5 preceding years, T received a rehabilitation credit under § 47 for the building, amount of deduction must be reduced by the following ratio --
sum of credits/FMV of building on date of contribution

§ 170(f)(14)

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Penalties

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Potential Civil Penalties

- Accuracy Related Penalty under § 6662
- Tax Return Preparer Penalties under § 6694
- Appraiser Penalties under § 6695A
- Aiding and Abetting Understatement of Tax liability under § 6701
- Notice 2004-41

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Accuracy Related Penalty § 6662

Taxpayers may be subject to an accuracy-related penalty if they have an underpayment of tax required to be shown on a return. This penalty applies (in relevant part) to any portion of an underpayment that is attributable to:

- Negligence or disregard of rules or regulations
- Any substantial understatement of income tax
- Any substantial valuation misstatement under chapter 1
- Any substantial estate or gift tax valuation misstatement

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Reasonable Cause Exception: § 6664(c) Special Rule for Certain Valuation Overstatements

With respect to “charitable deduction property,” the reasonable cause and good faith exception to the § 6662 accuracy-related penalty does not apply to any underpayment attributable to a substantial or gross valuation overstatement unless --

1. The taxpayer shows that the claimed value of the property was based on a qualified appraisal made by a qualified appraiser, and
2. In addition to getting the appraisal, the taxpayer made a good faith investigation of the value of the contributed property.

§ 6664(c)(2)

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Whitehouse Hotel Ltd. Partnership v.
Commissioner, 131 T.C. No. 10 (Oct. 30, 2008)

§ 6662 Accuracy-related penalty applied.
Taxpayer-partnership’s valuation of façade
easement was gross valuation misstatement.

§6664 Reasonable cause exception did not apply.
Taxpayer had obtained qualified appraisal by
qualified appraiser, but Taxpayer-partnership did
not make good faith investigation of value as
required by 6664(c)(2). (No Taxpayer-partner
with personal knowledge made any showing of
investigation.)

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Tax Return Preparer Penalties: § 6694

A tax return preparer may be subject to a penalty for understatement of taxpayer's liability on a return or claim for refund due to (1) an unreasonable position, or (2) willful or reckless conduct.

Unreasonable Position:

- § 6694(a) imposes a penalty on a tax return preparer who prepares a return or claim for refund reflecting an understatement of liability due to an "unreasonable position" if the tax return preparer knew (or reasonably should have known) of the position.
- A position is unreasonable unless (i) there is or was substantial authority for the position, or (ii) the position was properly disclosed and had a reasonable basis.
- No penalty is imposed, however, if it is shown that there is reasonable cause for the understatement and the tax return preparer acted in good faith.

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Tax Return Preparer Penalties § 6694 (cont'd)

Willful or Reckless Conduct --

- § 6694(b) imposes a penalty on a tax return preparer who prepares a return or claim for refund if any part of an understatement of liability was due to:
- a willful attempt in any manner by an income tax return preparer to understate the liability for tax on the return or claim; or
- any reckless or intentional disregard of rules or regulations by a tax return preparer.

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Appraisers and § 6694

- An appraiser may be subject to penalties under § 6694 as a non-signing tax return preparer if the appraisal is a substantial portion of the return or claim for refund and the applicable standards of care under § 6694 are not met.
- The IRS has discretion to impose the §§ 6694 and 6695A penalties in the alternative against an appraiser depending on the facts and circumstances of the appraiser's conduct. The IRS, however, will not stack the penalties under §§ 6694 and 6695A with respect to the same conduct. A separate regulation will provide guidance under § 6695A.

See Preamble to Tax Return Preparer Penalty Final Regulations, 73 Fed. Register 78436 (2008).

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Appraiser Penalties § 6695A

A penalty may be imposed under I.R.C. § 6695A if --

1. A person prepares an appraisal of the value of property and such person knows or reasonably should have known that the appraisal would be used in connection with a return or a claim for refund, and
2. The claimed value of the property on a return or claim for refund which is based on such appraisal results in a substantial valuation misstatement, a substantial estate or gift tax valuation understatement or a gross valuation misstatement.

Effective 7/25/06 for returns involving an appraisal of a façade easement (PPA § 1219(e)(3)).

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Aiding and Abetting Understatement of Tax Liability: § 6701

A penalty may be imposed under § 6701 on any person --

1. Who aids or assists in, procures, or advises with respect to, the preparation or presentation of any portion of a return, affidavit, claim or other document;
2. Who knows or has reason to believe that such portion will be used in connection with any material matter arising under the internal revenue laws; and
3. Who knows that such portion, if so used, would result in an understatement of the liability for tax of another person.

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Notice 2004-41

- In certain transactions involving conservation easements where taxpayers are improperly claiming charitable contributions under § 170, the Service may --
 - Disallow all or part of any improper deductions
 - Impose penalties under § 6662
 - Assess excise taxes under § 4958 against any disqualified person who receives an excess benefit from a conservation easement transaction, and against any organization manager who knowingly participates in the transaction
 - Challenge the tax-exempt status of the organization
 - Review promoters of conservation easement transactions; promoters, appraisers and other persons may be subject to penalties under §§ 6700, 6701 & 6794

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Practical Tips

- Look for the following—
 - Legally-required substantiation; can disallow entire deduction if not properly substantiated
 - § 170(f)(8) statement (CWA)
 - Properly completed Form 8283
 - Is donee qualified? Commitment & resources?
 - Qualified appraisal? Qualified appraiser?
 - Valued using before and after test?
 - Was the taxpayer's use of the property already restricted by local ordinances?
 - Easement language: in perpetuity; inconsistent uses
 - Is easement recorded?
 - Subordination by mortgagee?
 - Any quid pro quo received by donor?