

## Façade Easements after the Whitehouse Hotel Decision

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On August 5, 2010, the Fifth Circuit, in Whitehouse Hotel Limited Partnership v. Commissioner of Internal Revenue, 615 F.3d 321 (5<sup>th</sup> Cir. 2010), vacated a decision by the Tax Court on valuation of a conservation easement and remanded the case back to the Tax Court to review and revise its valuation of the easement and to determine whether a penalty should have been assessed. This decision not only broadens the basis on which to appraise the value of a façade easement and limits when a penalty can be assessed, but it also precludes the IRS from discounting the value of easements of landmarked property, as some feared, they were intending to do.

In 1997 Whitehouse Hotel Limited Partnership ("Whitehouse") owned the Maison Blanche building ("Maison Blanche") and adjacent Kress building ("Kress") in New Orleans and built a 452 room Ritz Carlton Hotel, a 230 room Iberville Suites Hotel and a 75 room Maison Orleans Hotel. As part of this development Whitehouse conveyed an easement of the façade of the Maison Blanche building to the Preservation Alliance of New Orleans, which easement prohibited changes to the building's terra-cotta façade. Whitehouse obtained a "before and after" appraisal and took a deduction of \$7.445 million, which the IRS rejected but allowed a \$1.15 million deduction and assessed a gross misstatement penalty of 40%.

At the Tax Court, Whitehouse's appraiser valued the impact of the easement on both Maison Blanche and Kress buildings, used two appraisal methods (replacement cost and income) but did not use comparable sales, because there were no comparable sales to determine the highest and best use, concluded that the conservation easement reduced the number of rooms in a future luxury hotel by 60, and estimated the conservation easement value to be \$10 million. Conversely, the IRS appraiser concluded there was no difference in the before and after values of the property he appraised: each was \$10.3 million, and determined the value based on the impact only on the Maison Blanche building. Whitehouse, 615 F.3d at 327. The IRS appraiser took the position that the highest and best use of the Maison Blanche building was a mixed use, non-luxury hotel and retail complex, not a luxury hotel like the Ritz-Carlton. He also concluded that the easement did not limit the potential number of rooms. Id. In other words, he opined the easement had no effect on Whitehouse's rights to construct additional rooms on top of the Kress building and used the comparable sales method and disregarded the replacement cost and income valuation methods. [As discussed later the Fifth Circuit noted that the government's appraiser "rather extraordinarily, [he] assigned the easement a value of zero."] Id. The Tax Court rejected the replacement cost method, as inapplicable because there was no likelihood of replacing an historic building, disregarded the income method because there was no specific data on the future income from the hotel, but utilized the comparable sales method and made its own determination. The Tax Court found a before value of approximately \$12.1 million and an after value of \$10.3 million and permitted a deduction of \$1.8 million.

The Fifth Circuit noted that, because the IRS conceded that the façade easement was a qualified gift, the only issue was valuation and, since the Tax Court determined that the comparable sales method was the appropriate method to determine value, the Fifth Circuit remanded the case for reevaluation. Whitehouse had argued that the highest and best use was as a Ritz Carlton, which is a luxury hotel, and not as a non-luxury hotel, which the Tax Court did not address. The Fifth Circuit indicated that the Tax Court should have included the effect of the easement on the Kress building because a hypothetical buyer would consider it in buying Maison Blanche. The Fifth Circuit noted that "regardless of the easement's not *burdening* the Kress building, it *affected* the fair market value of the Maison Blanche and Kress buildings. Accordingly, the Tax Court erred in not determining that effect." Whitehouse, 615 F.3d at 339. The Fifth Circuit held that "in making this valuation on remand, the tax court should, among other things, consider the experts' reports and valuation methods (including, *inter alia*, using non-local comparables) and their conclusions regarding highest and best use as a luxury or non-luxury hotel." Id. at 340.

As a result of the foregoing, the Tax Court must also review the appropriateness of the gross misstatement penalty in the review. With regard to the overvaluation penalty, the Fifth Circuit noted that whether the penalty should be assessed would depend on "whether Whitehouse met its burden of proof for reasonable cause. To demonstrate reasonable cause, a taxpayer "must show that he exercised ordinary business care and prudence....Given that Whitehouse offered proof that it relied on its accountants' and attorneys' opinions...a possible issue on remand is whether Whitehouse needed to prove more to show reasonable cause." Whitehouse, 615 F.3d at 342.

This decision is particularly interesting in light of something that was not raised in the case; the concern by preservationists that the IRS considers façade easements to have minimal value. On March 13, 2008, the Service issued a letter to the National Trust for Historic Preservation indicating that "the challenge for us in enforcing [Internal Revenue Code] section 170(h) is the proper valuation of façade easements....The value of a facade easement depends on the facts and circumstances pertaining to that easement. *Historic structures that are subject to existing local landmark or zoning laws that limit or restrict the owner's ability to change the appearance or use of the structure present additional problems of valuation....An easement is to be valued by considering, among other things, the specific restrictions imposed by the local landmark and zoning laws, the specific terms of the façade easement, and the interplay between them.*" [Emphasis added.]

The problem is that the Treasury Regulations provide that if there is no substantial record of market place sales of comparable easements then the fair market value of the perpetual conservation easement is equal to the difference between the fair market value of the property before and after the granting of the restriction, which is referred to as the before and after valuation. Section 1.170A-14(h)(3)(ii) of the Treasury Regulations provides that if the "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 without 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. See 26 CFR § 1.170A-

14(h)(3)(ii). As a result, there could be instances in which the grant of the conservation restriction may have no material effect on the value of the property.

A local Landmark Preservation Law, such as the one in effect in New Orleans, precludes alterations to the façade of a building designated as a landmark and, as a result, the IRS could have taken the position that a façade easement of a landmark building should provide the owner with little or no income tax deduction because the façade cannot be altered and therefore, the façade easement changes nothing. In that respect the most relevant aspect of the Whitehouse decision is the Fifth Circuit's statement that "rather extraordinarily, [the appraiser] assigned the easement a value of zero," which dicta by the Fifth Circuit appears to negate the concern raised by the March 13, 2008 letter.