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Conservation Easement Update July 2010

Lessons on Charitable Conservation Contributions from *Scheidelman v. Commissioner*

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On July 14, 2010, the U.S. Tax Court issued its opinion in *Scheidelman v. Commissioner*, T.C. Memo. 2010-151, and the decision provides conservation easement professionals with two important lessons. First, it is critical to have a qualified appraisal that satisfies the requirements of the Treasury Regulations and adequately substantiates the value of the easement, by explaining the methodology used and the property-specific facts forming the basis of the valuation determination. Second, a cash payment by the taxpayer to the easement holder is not considered a deductible charitable contribution if the payment is required by the easement holder as a condition of accepting the easement.

In *Scheidelman*, the taxpayer donated a façade easement over her property in the historic Fort Greene neighborhood of Brooklyn, New York. Scheidelman's appraisal established the fair market value of the property using the three classic methods of valuation (sales comparisons, cost, and income) and it gave the most weight to the sales comparison approach. To determine the value of the easement, the appraiser did not use an established method of valuation but instead he eviewed other court cases and determined that the IRS had found façade easement values of 10-15% of the total property value were appropriate in other cases. Based upon other façade easements for similar properties in New York, the appraisal set the easement value at 11.33% of the value of the property as a whole. As part of the donation process, the easement holder, Natural Architectural Trust ("NAT"), required easement donors to pay a deposit with their application and make an additional payment (10% of the easement value) when the easement was accepted. NAT characterized the payment as an "agreed upon cash donation" even though it was mandatory. Scheidelman did not claim a deduction for her cash payments, but the parties agreed to submit the issue of their deductibility to the court.

The Tax Court found that Scheidelman did not substantiate the donation of the façade easement with a "qualified appraisal" as defined by the Treasury Regulations and therefore the entire deduction was disallowed. The Court ruled that Scheidelman's appraisal lacked a meaningful analysis of the specific, qualitative attributes of the property to support the determination of the easement value. Instead the appraisal "applied mechanically a percentage with no demonstrated support as to its derivation, other than acceptance of similar percentages in prior controversies." The Court also found the appraisal to be deficient for lack of certain information required by Treas. Reg. § 1.170A-13(c)(3)(ii), including a description of the property, the terms of the deed of easement, and a statement that it was prepared for tax purposes. The taxpayer argued that she had substantially complied with the reporting requirements of Treas. Reg. § 1.170A-13, but the Court ruled that "the lack of a recognized methodology or specific

basis for the calculated after-donation value is too significant for us to ignore under the guise of substantial compliance."

With respect to the taxpayer's cash payment to NAT, the Court found that the taxpayer failed to prove that she received nothing of substantial value in return, or that the payment greatly exceeded the value of the benefits received. Therefore, the taxpayer was not entitled to a deduction for any portion of the amount paid to NAT. In making, this conclusion, the Court was not persuaded by NAT's certification to Scheidelman that no goods or services were received in exchange for her payments. The Court's discussion of the principle that *quid pro quo* transfers are not deductible suggests that the Court believed Scheidelman received something of value in exchange for the payments - a holder for her easement and the opportunity to receive tax benefits. Ironically, Scheidelman did not receive any tax benefit in exchange for her easement because her deduction was disallowed. Even so, the Tax Court found that her payments to NAT were not charitable donations.

The first lesson to take away from *Scheidelman* is that an appraiser should take no short-cuts and a qualified appraisal must thoroughly explain the factual basis for the calculation of the easement value which must be specific to the property donated. An appraiser cannot simply rely on other Tax Court decisions, IRS publications and the like to determine an appropriate reduction in value for the easement. In other words, there is no "safe harbor" formula for calculating the value of an easement. In addition to the information required by the Treasury Regulations, a qualified appraisal includes a reasoned analysis of valuation based upon a detailed description of the specific qualities of the donated property and a recognized and appropriate methodology for calculating the before and after-donation value of the property.

The second lesson from *Scheidelman* is that cash payments made to easement holders in connection with an easement donation are not deductible if they are not truly voluntary donations. When a holder will only accept an easement if the donor makes a payment, arguably the payment is made as a *quid pro quo*, in exchange for holding the easement, and it would not represent a charitable contribution. NAT is not the only easement holder requiring cash payments as a condition for holding easements and more land trusts may adopt similar requirements, especially as the economy puts strains on their budgets. Taxpayers cannot assume that payments to the organization holding their easement are deductible. Consequently, easement donors may become reluctant to make cash payment in connection with their easement donation. Organizations like NAT that rely entirely upon these payments for their operating expenses may need to revise their policies and procedures or look elsewhere for funding. This is an emerging issue for practitioners in this field to watch.

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