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An Obstructed View: Penalty Imposed for Deducting Conservation Easement

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In recent years, many tax professionals have been promoting transactions to take advantage of the tax benefits of "façade easements," where a taxpayer claims a charitable deduction for granting an easement to preserve the historical façade or similar attribute of a building. Façade easements are particularly popular in New York City. In such cases, the taxpayer claims a deduction equal to the appraised value of the donated easement, which is measured by the reduction in the value of the underlying property caused by the granting of the easement. *Turner v. Commissioner*, 126 T.C. 16 (May 16, 2006), a recent Tax Court case, signals that the Internal Revenue Service as well as the courts are willing to look beyond the façade of the claimed contribution to the substance of the actual property donated. While *Turner* involved open space rather than a façade, its holding may be instructive for façade easements as well.

Background

Taxpayers are allowed to take charitable contribution deductions for the fair market value of qualifying preservation easements. A preservation easement is a voluntary, permanent restriction placed on property by its owner to protect a significant historic, archeological or cultural resource. Pursuant to the easement, which runs in perpetuity with the land, binding all future owners of the property, the owner of the property may be required to maintain a certain historical feature of the property such as a lobby or building façade. For charitable deduction purposes, the value of an easement is determined by comparing the fair market value of the property prior to conveying the easement with the fair market value of the property after the easement has been conveyed. Because an easement puts permanent restrictions on the use of the property, the easement typically has the effect of reducing the fair market value of the property subject to it. In general, the more restrictive or onerous the easement, the greater "value" the easement will have for charitable contribution purposes.

In order for a charitable contribution of a conservation or preservation easement to be deductible, numerous technical requirements must be met. Under section 170(h) of the Internal Revenue Code, a taxpayer is allowed a deduction for a "qualified conservation contribution." A qualified conservation contribution means a contribution of a "qualified real property interest" to a "qualified organization." A qualified real property interest includes a restriction granted in perpetuity on the use of the real property. Qualified organizations include governmental units and certain tax-exempt charitable, religious, and educational organizations. In addition, a qualified conservation contribution must be made exclusively for one of four enumerated conservation purposes. One such purpose is the preservation of open space for the scenic enjoyment of the general public or pursuant to a clear governmental conservation policy (the so-called "open space" purpose). Another enumerated conservation purpose is the preservation of an historically important land area or a certified historic structure. A certified historic structure includes any building, structure, or land area that is either listed in the National Register or located in a registered historic district and is certified by the Secretary of the Interior as being of historic significance to the district.

Turner v. Commissioner

In *Turner*, the United States Tax Court denied the taxpayer's deduction for the contribution of a conservation easement. The taxpayer in that case (Mr. Turner) was a real estate attorney and developer in Virginia. Turner was the 60 percent member and general manager of FAC Co., a limited liability company formed for the purpose of acquiring, rezoning, and developing real property. Over the course of 1997 and 1998, Turner, either individually or through FAC Co., acquired several contiguous parcels of unimproved land located in a historical district of Fairfax County, Virginia. Some of the land was adjacent to the site of a grist mill used by George Washington, and the land was in the general vicinity of Mount

Vernon, President Washington's home. Despite its proximity to historic sites, the land acquired by Turner had no particularly significant historic status.

During the negotiations that culminated in Turner's acquisition of the property, Turner expressed that the highest and best use for the property was either commercial or a combined commercial and residential use, but that due to the realities of local politics, the best use would not be achievable. Turner acquired land for $2,550,000 consisting of 29.3 acres, 15 acres of which were located on a flood plain. Under zoning regulations, no dwelling could be constructed on the flood plain and a maximum of approximately 30 dwellings could be built on the non-flood plain land. If Turner could succeed in having the property rezoned, a maximum of approximately 62 dwellings could have been built on the non-flood plain portion of the property. The facts of the case indicate that achieving rezoning would have been difficult and expensive and that the taxpayer had made no significant attempt to have the property rezoned. Nonetheless, Turner represented to various parties that approximately 62 dwellings could have been built.

Turner ultimately conveyed a conservation easement to Fairfax County restricting the number of building lots to 30, and obtained an appraisal on the reduction in value caused by reducing the maximum dwellings from 62 to 30. The deed contained a description of the historical sites (the grist mill and Mount Vernon) and indicated that the charity operating Mount Vernon wished Turner and FAC Co. to limit construction to 30 single-family residential lots. The deed stated that even though Turner could have built 62 lots, he voluntarily agreed to limit development to 30 lots to better serve the historic and scenic nature of Washington's grist mill. Turner claimed a deduction for a contribution of a qualified conservation easement based on his share of the conservation easement. The entire easement was appraised at $3,120,000 on the assumption that 62 lots could have been built on the property.

The case turned on whether the contribution was exclusively for conservation purposes. Turner argued that the easement satisfied the open space purpose, or alternatively, the historic preservation purpose. The Tax Court, however, found that the contribution did not satisfy either purpose. The Court was not impressed with Turner's argument that limiting the development to 30 lots rather than 62 created "a distinctively open quality" and pointed out that the impact on the scenic view from the grist mill was roughly the same whether 30 or 62 lots were built. The Tax Court also rejected the taxpayer's argument that the historic preservation requirement was satisfied, finding that the attempted easement did not preserve a historic structure or a historically important land area. There was no evidence that anything on Turner's property was historically unique, and mere proximity to a historical structure (such as the grist mill or Mount Vernon) was not sufficient to support a claim of protection of a historical structure.

Significantly, the Tax Court upheld the Internal Revenue Service's determination that Turner was liable for a 20 percent accuracy-related penalty due to negligence or disregard of the rules and regulations. In finding the taxpayer negligent, the court noted that the taxpayer represented to the appraiser that the entire property could have been developed whereas no development was permitted on the 15 acre flood plain (with the result that only 30 lots could have been built on the remaining property as currently zoned). Accordingly, the Tax Court held that Turner exercised a lack of due care and regard, claiming a deduction on assumptions known to be false or erroneous.

Conclusion

The court in *Turner* held that the taxpayer did not satisfy the requirements for a qualified contribution deduction, but underlying this holding was the court's conclusion that Mr. Turner simply did not contribute anything of value. Although façade easements, unlike the easement at issue in *Turner*, typically satisfy the "certified historic structure" requirement, valuation issues are often at the heart of many of the façade easements granted in New York. As *Turner* indicates, a proper appraisal of the diminution in value caused by the façade easement is of vital importance.