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EASEMENT SERIES

APPRAISING EASEMENTS

GUIDELINES
for Valuation of Land Conservation and Historic Preservation Easements

A Project of the Land Trust Alliance in cooperation with the National Trust for Historic Preservation.

Third Edition

APPRAISING EASEMENTS

G U I D E L I N E S
for Valuation of Land Conservation and
Historic Preservation Easements

Third Edition

Land Trust Alliance
Washington, D.C.

National Trust for Historic Preservation
Washington, D.C.

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The original text of *Appraising Easements* was written in large part by attorneys in the general counsel's office of the National Trust for Historic Preservation, with extensive assistance from a nationally recognized panel of experts drawn from appraisers, attorneys, and representatives of national, regional, and local conservation and preservation organizations (listed in full on pages xiii and xiv). Its principal authors were Thomas Coughlin and Robert Moyer, both then at the National Trust, and Benjamin Emory, then President and Executive Director of the Land Trust Exchange (subsequently the Land Trust Alliance).

The Third Edition of *Appraising Easements* was updated by Stefan Nagel, a nationally recognized authority in easement law who also prepared revisions to the Second Edition. Mr. Nagel has been Of Counsel to the Law Office of Stephen J. Small, Esq., P.C., of Boston, MA, since 1995 and previously was associate general counsel of the National Trust for Historic Preservation and legal counsel to The Nature Conservancy. The Third Edition was reviewed by Andrew C. Dana, an attorney in private practice in Bozeman, MT; Donna Ratchford Butler, an appraiser specializing in historic commercial property with her own firm, Butler Appraisal Co. in Savannah, GA; and Mark Weston, a principal in the appraisal firm of Hunsperger & Weston, Ltd. of Englewood, CO. Real estate consultant Richard J. Roddewig, president of Clarion Associates, Inc. of Chicago, wrote Appendix D, Sample Easement Appraisal Transmittal Letter and Summary of Conclusions. Julia Miller, editor of the *Preservation Law Reporter*, National Trust for Historic Preservation, provided guidance for extensive revisions to the bibliography.

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PREFACE TO THIRD EDITION

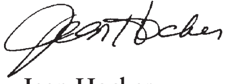
SINCE 1984, WHEN THE FIRST EDITION OF *APPRAISING EASEMENTS* WAS RELEASED, land conservation and historic preservation easements have become increasingly important and widely-used tools to protect the natural resources and cultural values of communities that have been threatened by unwise development. Easements have been tremendously successful over the past 15 years in protecting productive farmland and timberland, water resource areas and vital wildlife habitat, and those open space and cultural resources that make our communities unique and livable.

The proper appraisal of easements is important not only to the nonprofit land trusts and other conservation and historic preservation organizations that accept easement donations, but also to the landowner for whom the donation can represent a substantial tax deduction. *Appraising Easements* does not purport to supplant standards of practices for the appraisal profession, nor does it introduce new appraisal procedures. However, it does consolidate into one text the common practices that are employed in real estate appraisals generally and in easement appraisals specifically.

The first edition of *Appraising Easements* was published after a colloquium was convened by the Land Trust Alliance (then called the Land Trust Exchange) with financial assistance from the National Trust for Historic Preservation. It was then widely acknowledged that comprehensive guidelines were needed to explain the easement appraisal process to individuals in many professional disciplines and walks of life who were beginning to work with conservation easements. Therefore, *Appraising Easements* was written as a public service in the expectation that self-regulation by informed property owners and conservation organizations was the best way to strengthen the use and acceptance of easements as a preservation and conservation tool. Indeed, *Appraising Easements*, whose original text was reviewed by the Easement Valuation Panel listed in the following section, has been tremendously popular since its first appearance. A Second Edition appeared in 1990.

This Third Edition is the first extensive, overall updating of the entire text since *Appraising Easements* initially appeared. Since the Second Edition was printed in 1990, Congress, in response to the savings and loan crisis of the late 1980s, passed the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989. To comply with the act, appraisers must be certified in the states in which they work. Additionally the Uniform Standards of Professional Appraisal Practices was adopted by the Appraisal Standards Board in January 1989. The Third Edition of *Appraising Easements* includes a discussion of how these standards affect the appraisal process and gives detailed information on what to provide an appraiser and what to expect in return.

Appraising Easements in its first two editions achieved unusual success and widespread recognition, becoming the "bible" in the field for land trusts, historic preservation organizations, appraisers and landowners. It has been favorably cited by the U.S. Tax Court as containing the general principles of easement valuation that guided the court's decision in the benchmark facade easement valuation case, Hillborn v. Commissioner, 87T.C. 677 (1985). Its popularity and value have proven enduring. We expect that the same will be said about the Third Edition in years to come.



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December 1999

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INTRODUCTION

A CHARITABLE CONTRIBUTION DEDUCTION FOR THE GIFT OF A CONSERVATION easement has been allowed by the Internal Revenue Service in revenue rulings since 1964 and by Internal Revenue Code provision since 1976. Because the amount of the charitable contribution deduction is measured by the value of the property donated, the Land Trust Alliance (then the Land Trust Exchange) and the National Trust for Historic Preservation recognized in the early 1980s that a ready reference was needed to guide easement donors, holding organizations and their advisors in the valuation process. Although numerous articles had appeared in technical appraisal journals, there had been no attempt to produce a single, comprehensive outline of the easement appraisal process. *Appraising Easements* was prepared to meet this need.

This need was reinforced by allegations from IRS district offices that taxpayers on occasion were misvaluing easement donations and by taxpayer allegations that the Internal Revenue Service on occasion was not following established appraisal procedures. Moreover, the Internal Revenue Service began to audit preservation and conservation easement donation deductions aggressively. After a series of meetings with representatives of easement holding organizations and the release of *Appraising Easements* in 1984, the IRS modified its position and announced in public information release I.R.-84-125 (Dec. 10, 1984) that it would review donated preservation and conservation easements on a case-by-case basis. The Service stated that where taxpayers' appraisers followed the same "before and after" method outlined in this publication, and used sound appraisal practices that evidence reductions in market values attributable to easements, charitable contribution deductions would be allowable.

For easement donors, holding organizations and their advisors, *Appraising Easements* provides a quick overview of the easement valuation process. For the appraisal professional, *Appraising Easements* provides a checklist of the factors that most directly influence easement valuation. *Appraising Easements* is not intended to supplant the various appraisal societies' standards of practice and professional guidelines for conducting appraisals, nor does it create a new methodology for appraisals of conservation easements. Rather, it consolidates in one document a discussion of the application of commonly-accepted appraisal principles to the specific task of appraising conservation easements.

To provide a context for persons unfamiliar with conservation easements, *Appraising Easements* opens with a brief explanation of how conservation easements work, the role of easements in conservation efforts, the tax rules governing their use and the recently increased tax penalties for misvaluation of donated property. Persons familiar with the use of easements are encour-

aged to begin *Appraising Easements* on page 4 with the discussion of tax penalties for overvaluation of charitable gifts. This discussion is followed by an explanation of the substantiation requirements for charitable gifts imposed by the Tax Reform Act of 1984, which were implemented by Treas. Regs. § 1.170A-13 and expanded by Treas. Regs. §§ 1.170A-1(h) and 1.170A-13(f). The substantiation requirements are followed by a summary of Legal Guidelines In Easement Appraisals. This summary extracts from the Report of the Committee on Finance and the Treasury Regulations those strictures by which everyone appraising conservation easements must abide.

The summary is followed by the chapter entitled "Guidelines for Appraisal Reports for Charitable Contributions of Easements Granted Exclusively for Conservation Purposes," hereafter generally referred to as the "Guidelines." The Guidelines are followed by a brief discussion of the role of the holding organization in the easement appraisal process. *Appraising Easements* concludes with several appendices—Excerpts of Treasury Regulations Relating to Easement Valuation and Substantiation (Appendix A), a Digest of Selected Revenue Procedures, Revenue Rulings and Cases Relevant to Easement Valuation (Appendix B), a reproduced federal Form 8283 with instructions (Appendix C), a sample transmittal letter and appraisal summary for a qualified conservation easement appraisal (Appendix D) and a bibliography of source material for persons interested in further research.

Throughout *Appraising Easements*, the terms "conservation easement" and "easement" are used generically to refer to the variety of conservation interests being protected, including but not limited to "qualified conservation contributions" as this term is defined by § 170(h) of the Internal Revenue Code and Treasury Regulation § 1.170A-14, unless otherwise noted. The terms of individual easements may vary considerably depending upon the property and the conservation interests being served in the gift. Nevertheless, the easement's legal elements, the easement donation and monitoring process and the measurement of the easement's effects on value are sufficiently comparable to allow treating easement valuation generically, with breakouts to illustrate issues unique to particular categories of conservation easements.

How Easements Work

A conservation easement is a recorded land use agreement in which the property owner conveys to a governmental unit or charitable organization (the "holder") certain rights to be enforced by the holder for public benefit. (For typical easement provisions, see the publications entitled *The Conservation Easement Handbook*, published by the Land Trust Alliance and the Trust for Public Land, and *Model Conservation Easement and Historic Preservation Easement, 1996*, released by the Land Trust Alliance.) The conservation easement assures that the historic, scenic, natural or open space characteristics that make the property significant are fully identified and protected against intentional or inadvertent destruction.

As will be discussed more fully later, the easement must be created in perpetuity for federal tax purposes. Thus, although the easement is a voluntary, negotiated agreement between the original donor and the easement holder, once the easement is imposed and recorded, it binds current and future owners to abide by its terms.

The easement is self-enforcing to a degree: once recorded in the land records, legal notice of its terms will preclude uses of the property in violation of the easement. For example, an easement that prohibits residential subdivision of farmland or wetlands virtually extinguishes the land's development potential, and hence the monetary value associated with such development potential. In this sense, the easement is akin to the targeted application of zoning powers for a special category of property. However, unlike zoning, an easement's provisions cannot be relaxed except under extraordinary circumstances.

In addition to its self-enforcing provisions, the typical easement circumscribes the owner's rights to use the property in ways that might be legally permissible but incompatible with the property's historic or environmental significance. Examples include the obligation to obtain design review and approval for additional construction on undeveloped open space subject to a scenic easement and the obligation to restore or replace deteriorated terra cotta exteriors of a historic structure rather than replacing them with cheaper substitute material. Enforcement of the easement is accomplished through the easement holder's periodic inspections of the property, ongoing consultations with the owners concerning possibly permissible activities and legal action to compel compliance with the easement in the event of a violation of its terms.

The Role of Easements in Land Conservation

Conservation easements represent a midpoint between outright public ownership of significant property on one extreme and government land use regulation on the other. Many properties that are important in the fabric of our daily lives are inappropriate for public ownership; nevertheless, their change or incompatible development would seriously impair the quality of life in a neighborhood, town, region, state or the nation as a whole. Examples abound. Privately-owned lands along the George Washington Parkway and within the historic vista of Mount Vernon, lands adjoining the Blue Ridge Parkway, the Appalachian Trail and many Wild and Scenic Rivers, waterfowl habitats in the Prairie Pothole region of Minnesota and North Dakota, scenic ranch lands in the Rocky Mountain and Plains states, historic districts in Chicago, scenic vistas along the Big Sur coastline in California, timberland in New Hampshire—all are protected by conservation easements.

Some of the conservation values protected by easements might be attained by special purpose zoning or other forms of government land use regulation. In many cases, however, political realities, coupled with the time delays, opposition of vested interests and dilution associated with the government planning process make such forms of land use regulation and protection less effective. Because an easement is a voluntary agreement, the property owner may give away specially-tailored rights in a property, such as the otherwise available right to demolish a historic landmark in the face of economic hardship—a typical relief provision in historic preservation regulation—that could not be acquired through government regulation because of constitutional limitations. Finally, easements are held and enforced by organizations dedicated to conservation. Thus, enforcement is often more rigorous and uniform than can be attained in special purpose zoning.

Tax Rules Governing Use of Easements

The Internal Revenue Code (hereafter referred to as the "Code") authorizes a charitable contribution deduction for the value of a conservation easement that is granted in perpetuity to a "qualified organization" "exclusively for conservation purposes" (Code §§ 170(f)(3)(B)(iii) and 170(h)).

A qualified organization is defined as a publicly-supported charity or unit of government. Most historic preservation and conservation organizations meet the "publicly supported" charity requirements of the Code.

The "conservation purposes" for which easements may be donated are defined in Code § 170(h)(4) in four categories:

"(i) the preservation of land areas for outdoor recreation by, or the education of, the general public,

"(ii) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem,

"(iii) the preservation of open space (including farmland and forest land) where such preservation is—(I) for the scenic enjoyment of the general public, or (II) pursuant to a clearly delineated federal, state, or local governmental conservation policy and will yield a significant public benefit, or
(iv) the preservation of a historically important land area or a certified historic structure."

A certified historic structure is further defined as "any building, structure or land area which—(i) is listed in the National Register, or (ii) is located in a registered historic district . . . and is certified by the Secretary of the Interior . . . as being of historic significance to the district."

Generally, taxpayers may deduct the value of cash or their basis in unappreciated property held for one year or less as a charitable contribution against up to 50 percent of their adjusted gross income in the year of donation. Any excess value must be carried forward for a maximum of five years and deducted against up to 50 percent of adjusted gross income in each of the carry-forward years until the amount of the gift is fully used.

The Code provides special rules for gifts of appreciated property held in excess of one year. For gifts of appreciated property held in excess of one year, the taxpayer may deduct the value of the donated property. The deduction is limited, however, to 30 percent of the taxpayer's adjusted gross income, with a five-year carry-forward for any excess value. As an alternative, the taxpayer may elect to increase deductibility to 50 percent of adjusted gross income if the taxpayer first decreases the value of the gift to what would have been long-term capital gain had the donated property been sold rather than donated. In effect, the alternative election limits the deduction to the taxpayer's basis in the donated property. In addition, the Code authorizes unlimited charitable contribution deductions for estate and gift tax purposes.

Special Estate Tax Benefits for Conservation Easements Under Section 508 of the 1997 Tax Bill, As Clarified in 1998

Section 508 of the 1997 Taxpayer Relief Act, as clarified in 1998 and codified at Code § 2031(c), provides incentives for voluntary land conservation through a change in estate tax law that allows executors to exclude from federal estate tax some of the value of certain land encumbered by a qualified conservation easement. The law allows the exclusion from the taxable estate of up to 40 percent of the value of land subject to a qualifying conservation easement that has reduced the value of the underlying land by at least 30 percent. The benefit is gradually reduced according to the extent by which the conservation easement's value falls below 30 percent of the land value. By 2002, the total value that can be excluded under the provision will be $500,000 per estate, which is phased in over five years beginning in 1998. The exclusion applies to any donated easement meeting the requirements of § 2031(c) regardless of when it was donated, provided that the land is still held by the original donor or a member of the original donor's family and other requirements of § 2031(c) are met. While a detailed explanation of this new incentive is beyond the scope of this publication, interested readers may obtain additional information from the Land Trust Alliance or may wish to refer to the most detailed, currently-available explanation reproduced at Volume 78, Number 9 of *Tax Notes*, March 2, 1998, at pages 1171–1184.

Penalties for Overvaluation of Donated Property

The after-tax benefit of a charitable contribution deduction is directly related to the value of donated property. For a taxpayer in the 40 percent marginal tax bracket, a charitable gift of property

worth $10,000 has an after-tax cost of $6,000 or, stated differently, an after-tax cash benefit of $4,000 measured in saved taxes. If the property were worth $20,000, the after-tax cost of the gift would be increased to $12,000 and the after-tax cash benefit would increase to $8,000. These examples do not take into account the capital gains tax that might have been incurred had the property been sold instead of donated.

In the past, some taxpayers may have taken advantage of the tax system by donating appreciated property at inflated values in the expectation that they would not be audited. In the face of allegations of tax-avoidance motivated abuse of the valuation process, Congress enacted a series of compliance provisions, beginning with the Economic Recovery Tax Act of 1981 and subsequently in the Tax Reform Act of 1984. The purpose of these provisions was two-fold: to minimize the attractiveness of what has come to be called the "audit lottery" and to increase taxpayer compliance. Although a detailed discussion of the compliance provisions and tax penalties is beyond the scope of *Appraising Easements*, three penalties merit brief comment: the penalty for overstating the value of charitable gifts, the penalty for understating the value of property for estate and gift tax purposes and the penalty for promoting abusive tax shelters.

The tax penalty that most directly affects the incorrect appraisal of conservation easements is the targeted overvaluation penalty for charitable contributions in Code § 6659(f). The penalty is imposed on the amount of tax that is underpaid because of a valuation overstatement. It applies only to individuals, closely-held corporations and personal service organizations that have underpaid their income taxes by at least $1,000. The underpayment must be attributable to the overvaluation of property where the overvaluation exceeds by 150 percent the amount determined to be the correct valuation. For charitable contribution deductions claimed on returns filed after 1984, the penalty is a flat 30 percent of the underpayment of taxes. The Secretary of the Treasury is authorized to waive the overvaluation penalty if he determines that the claimed value of the property was based on a "qualified appraisal" prepared by a "qualified appraiser" and that the taxpayer, in addition to obtaining such a qualified appraisal, made a good faith investigation of the value of the contributed property. The terms "qualified appraisal" and "qualified appraiser," which were added to the Code by the Tax Reform Act of 1984 and implemented by Treas. Regs. § 1.170A-13, are discussed in the explanation of the donation substantiation requirements.

A variation of the overvaluation penalty, set out in Code § 6600, applies to underpayments of estate and gift taxes as a result of a valuation understatement. This penalty applies to underpayments of estate or gift tax liability of $1,000 or more that are attributable to a valuation understatement. A valuation understatement occurs where the claimed valuation is 66 2/3 percent or less of the correct value. The penalty is graduated from 10 to 30 percent of the tax underpayment based on the percentage of undervaluation. Property that is valued at 50 to 66 2/3 percent of the correct value is subject to a penalty of 10 percent of the tax underpayment, while property that is valued at less than 40 percent of correct value is subject to a penalty of 30 percent of the tax underpayment. The Secretary of the Treasury is given discretion to waive the estate and gift tax valuation understatement penalty. Unlike the qualified appraiser and independent investigation requirements for waiver of the overvaluation penalty for charitable contributions, however, waiver of the undervaluation penalty may be made on the less stringent showings that there was a reasonable basis for the valuation claimed and that the amount claimed on the return was made in good faith.

The final tax penalty relevant to the overvaluation of easements is the penalty for promoting abusive tax shelters in Code § 6700. The penalty assessed on the promoter is equal to the greater of $1,000 or 20 percent of the gross income derived, or to be derived, from the tax shelter activity. Although the penalty is directed at tax shelter promoters, it may be extended to appraisers, conservation easement holding organizations, attorneys and others who assist in the organization or the sale of investments or other tax advantaged arrangements (presumably including representations as to the deductibility or value of donated property) and who make or furnish a statement (regarding

tax benefits) that they know or have reason to know is false or fraudulent or who make a "gross valuation overstatement."

A gross valuation overstatement is defined as a misrepresentation of value that exceeds by "200 percent the amount determined to be the correct valuation" in circumstances where the valuation of the property "is directly related to the amount of any deduction or credit allowable." As with the original overvaluation penalty and the undervaluation penalty for estate and gift taxes, the Secretary of the Treasury is authorized to waive the promoter penalty upon the less stringent showing that there was a reasonable basis for the valuation claimed and that the valuation claimed was made in good faith.

Substantiation of Charitable Contributions of Appreciated Property and Donee Reporting Requirements

Section 155 of the Tax Reform Act of 1984 imposed substantiation and reporting requirements for charitable gifts of appreciated property whose value exceeds $5,000. Final regulations implementing the substantiation requirements were released on May 5, 1988, and are codified as Treas. Regs. § 1.170A-13(c). The final substantiation regulations are reprinted in Appendix A.

The substantiation requirements apply to individuals, "S" corporations, certain "C" corporations and partnerships. The regulations provide that no deduction will be allowed for charitable contributions of property (other than cash and marketable securities) in excess of $5,000 made after December 31, 1984, unless the donor obtains a qualified appraisal prepared by a qualified appraiser and attaches an appraisal summary (Form 8283, included at Appendix C) to the tax return on which the deduction is first claimed. The qualified appraisal must be made no earlier than 60 days before the date of contribution of the appraised property and no later than the due date (including extensions) for filing the tax return for the year in which the contribution was claimed. The donor must retain the full appraisal report in his or her records; it is not required to be filed with the donor's tax return although for significant donations tax advisors will occasionally counsel their clients to file the full report with the tax return. The appraisal cannot involve a prohibited appraisal fee—i.e., a fee based on a percentage of the appraised value of the property.

Form 8283 must include the following information: the name and taxpayer identification number of the donor; a description of the donated property and its condition; the manner and date of acquisition by the donor; the donor's cost or other basis; the name, address and taxpayer identification number of the donee; the date the donee received the gift; the name, address and taxpayer identification number of the qualified appraiser; the appraised fair market value of the gift; the appraiser's declaration of qualifications and acknowledgment that false or fraudulent overstatements of value render the appraiser subject to penalty; and a declaration by the appraiser that the fee charged is not based on a percentage of the value of the property donated and that appraisals prepared by the appraiser are not being disregarded by the IRS pursuant to 31 U.S.C. § 330(c). (Treas. Reg. § 1.170A-13(c)(4)(ii)).

Form 8283 must be signed and dated by the appraiser as well as the donee of the property in question. The regulations clearly state that the "signature of the donee [on Form 8283] does not represent concurrence in the appraised value of the contributed property. Rather, it represents acknowledgment of receipt of the property described in the appraisal summary on the date specified in the appraisal summary, and that the donee understands the reporting requirements imposed by section 6050L and Section 1.6050L-l." (Treas. Reg. § 1.170A-13(c)(4)(iii)). For further discussion of the role of the easement holding organization in the appraisal, see page 39.

The regulations do not help substantially in defining how to evaluate the independence of the appraiser, an issue raised in Section 155 of the Tax Reform Act of 1984. The regulations merely

state that a qualified appraiser is prohibited from being the donor, a party to the transaction in which the donor acquired the property, the donee of the property, any person employed by one of the foregoing parties, an immediate family member of any of the foregoing parties, any person related by marriage to any of the above, or any person "regularly used" by any of the above "and who does not perform a majority of his or her appraisals . . . for other persons." (Treas. Reg. § 1.170A-13(c)(5)(iv)). The committee reports accompanying the 1984 legislation indicate that an appraiser who is regularly retained by a donee could be considered as an employee of the donee in a charitable contribution transaction where a long-standing relationship with the appraiser would cause a reasonable person to question the independence of the appraiser. For further discussion, see page 40.

In an often overlooked direction included in the instructions for Form 8283, the Internal Revenue Service also requires that the taxpayer attach a supplemental statement to his or her Form 8283. The supplemental statement should summarize the conservation purposes of the qualified conservation contribution and summarize the valuation assumptions. A copy of the relevant portion of the Form 8283 instructions is included at Appendix C.

Section 155(b) of the Tax Reform Act of 1984, codified at Code § 6050L, implemented at Treas. Regs. § 1.6050L-1, imposes certain reporting requirements on donees of property valued in excess of $5,000 who dispose of the property within two years of donation. The following information is to be included on Form 8282, which is filed with the Internal Revenue Service: the name, address and employer identification number of the donee filing the form; a description of the property; the name and taxpayer identification number of the donor; the date of contribution; and any amount received by the donee with respect to the disposition. The property donor must be provided with a copy of the information return as well. This should be of great interest to established land trusts that, from time to time, hold conservation easements for new land trusts awaiting their 501(c)(3) determination letter.

Many easement donors and donees neglect the additional substantiation requirements imposed by Code § 170(f)(8) and Treas. Regs. § 1.170A-13(f). These require the donor to obtain a written acknowledgment of any contribution in excess of $250. The acknowledgment must describe the contributed property, indicate whether any goods or services were provided in consideration for the donation and, if goods or services were provided, a "good faith estimate" of their value. The acknowledgment is not filed with the taxpayer's tax return but should be retained in the taxpayer's files.

Legal Guidelines in Easement Appraisals

In an easement appraisal for federal tax purposes, the objective is to estimate the fair market value of the easement. The courts have used the terms fair market value and market value interchangeably. The Treasury Regulations (at § 1.170A-1(c)(2)) define fair market value as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion and both having a reasonable knowledge of relevant facts." The *Appraisal of Real Estate* (eleventh edition, beginning at p. 20) provides a discussion of several current definitions of market value, summarizing them as, "The most probable price in cash [or its equivalent]. . . for which the specified property rights should sell after reasonable exposure in a competitive market under all conditions requisite to fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress." Other measures of value exist, such as investment value and insurable value; however, they may not be relied upon for federal tax purposes.

As noted in the Digest of Selected Revenue Procedures, Revenue Rulings and Cases Relevant to Easement Valuation (Appendix B), the Internal Revenue Service has issued several revenue rulings that indicate that the "before and after" method is the correct method to be used in appraising con-

servation easements. The "before and after" method was also recognized by a number of court decisions interpreting the charitable gift of a conservation easement, beginning with Thayer v. Commissioner, T.C. Memo 1997-370 (1977) and including, among others, Hilborn v. Commissioner, 85 T.C. 677 (1985); Symington v. Commissioner, 87 T.C. 892 (1986); Fannon v. Commissioner, T.C. Memo 1986-572 (1986); Nicoladis v. Commissioner, T.C. Memo 1988-163 (1988); Losch v. Commissioner, T.C. Memo 1988-230 (1988); Richmond v. U. S., 699 F. Supp. 578 (E. D. La. 1988); Granger v. U. S., 1989 U. S. Dist. LEXIS 1167 (1989); Griffin v. Commissioner, 56 T.C. 1560 (1989); Fannon v. Commissioner, T.C. Memo 1989-136 (1989); Dorsey v. Commissioner, T.C. Memo 1994-242 (1990); Shapiro v. Commissioner, T.C. Memo 1991-128 (1991); Higgins v. Commissioner, T.C. Memo 1990-103 (1990); Schwab v. Commissioner, T.C. Memo 1990-232 (1994); Clemens v. Commissioner, T.C. Memo 1992-436 (1992); Browning v. Commissioner, 109 T.C. 16 (1997); and S.K. Johnston, III, et al. v. Commissioner, T.C. Memo 1997-475 (1997). As discussed in detail in the Guidelines, beginning on page 11, in the "before and after" method, the value of the taxpayer's entire property is first measured free of the easement, then as encumbered by the easement. The difference in value, if any, is the value of the easement.

In 1980, the Congress addressed the process of easement valuation in some detail. In its report accompanying the tax legislation that made the charitable contribution deduction for gifts of conservation easements a permanent part of the Internal Revenue Code, the Senate Committee on Finance observed:

> The amount of the deduction for the contribution of a conservation easement or other restriction is the fair market value of the interest conveyed to the recipient. However, because markets generally are not well established for easements or similar restrictions, the willing buyer/willing seller test may be difficult to apply. . . . As a consequence, conservation 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. [Citations omitted] Where this test is used, however, the committee believes it should not be applied mechanically.
>
> For example, where before and after valuation is used, the fair market value of the property before contribution of the easement should take into account not only the current use of the property but also an objective assessment of how immediate or remote the likelihood is that the property, absent the restriction, would be developed. Where applicable, valuation of the property before contribution should take into account zoning, conservation, or historic preservation laws that would restrict development of the property. Valuation of the transfer should take into account the impact of the transfer on other property, as in the case where restrictions on one parcel of property serve to increase the value of adjacent property. . . . The committee also intends that, as the use of conservation easements increases, valuation would increasingly take into account the selling price value, in arms-length transactions, of other properties burdened with comparable restrictions.

The Finance Committee Report recognized that the comparable sales (market data) approach might be unavailable or unreliable because of inadequate sales data. Until market data become more reliable, Congress recognized the need to rely on the "before and after" method as the most reliable indicator of value for donated conservation easements. Congress outlined the scope of the easement valuation task but left to the Treasury Department and the appraisal community responsibility for implementing the broad valuation directives contained in the Finance Committee Report. In certain areas of the country, substantial data are now available that may permit appraisers to value conservation easements based on comparable sales. Since *Appraising Easements* was first released in

1984, a number of easement-encumbered properties have sold or been transferred. In areas with significant conservation easement sales data, careful appraisers incorporate such data into their appraisals, even if the data are not sufficient to permit complete reliance on a comparable sales analysis. Thus, for example, market data reflecting sales of easement-encumbered properties will complement a traditional "before and after" appraisal, even if the data are insufficient to support an appraisal based solely on sales of easement-encumbered properties.

The 1986 easement regulations, at Treas. Regs. § 1.170A-14(h), reiterate the Finance Committee's directives. The regulations require the easement donors and their appraisers to "take into account the effect of restrictions that will result in a reduction of the potential fair market value represented by 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." (Treas. Reg. § 1.170A-14(h)(3)(ii)). As the regulation recognizes, a focus on current use is misplaced because current usage may be so uneconomic that virtually any alternate use would be more profitable. Thus, although current usage is considered in evaluating a property's highest and best use, current usage is not by itself determinant of highest and best usage.

This concept is perhaps illustrated by the two most significant easement valuation cases to date. The Stanley Works and Subsidiaries v. Commissioner, 87 T.C. 22, CCH Dec. No. 43,274, at 3443 (August 12, 1986) includes extensive analysis of what constitutes a property's "highest and best use." The determination of highest and best use impacts significantly on the value of the easement.

Referencing Hilborn (noted previously), the tax court stated:

> The fair market value of property reflects the highest and best use of the property on the relevant valuation date. Any realistically available special use of property due to its adaptability to a particular business is an element that must be considered in determining the fair market value thereof. [Citations omitted]. The fair market value of property is not affected by whether the owner actually has put the property to its highest and best use. The realistic, objective potential uses for property control the valuation thereof. United States v. Meadow Brook Club, 259 F.2nd 41, 45 (2d Cir. 1958) (emphasis added). (CCH Dec. 43,274, at 3448).

Applying the Meadow Brook test, the court concluded that commercial development of the property in the "reasonably near future" was a "reasonable probability." Id. at 3452. Before donation, the court found that the property's highest and best use was as the site of a pumped-storage hydroelectric facility. Noting that the property after donation of the easement was suitable only for use as farmland, the court attributed the reduction in the value of the property to the open space easement, and held that the value had been reduced by 75 percent.

In June 1987, the tax court handed down its decision in Stotler v. Commissioner, 1987 T.C. Memo 275 (1987), which involved a conservation easement over 1,584 acres in Monterey County, California. The case is noteworthy in two respects. First, it highlights the need to have appraisers prepare thoroughly for an easement donation and any subsequent challenge. Also, the court accepted a reduction in value attributable to the easement that substantially exceeded the price paid for the property by the easement donors only 19 months prior to the donation. The allowed deduction represented a 91 percent decrease in the value of the property.

The court accepted the value attributed to the land and the easement by the taxpayers' appraiser. It noted that the taxpayers' appraiser had extensive experience valuing property in the area. The appraiser had thoroughly considered various valuation factors, including foreseeable, possible development options. In contrast, the IRS appraiser spent only two days in Monterey County, did not consider development options, and was unaware of other factors affecting the land's value.

The first historic preservation facade easement valuation case was decided by the U. S. Tax

Court in Hilborn v. Commissioner, 87 T.C. 677 (1985). Favorably citing *Appraising Easements*, and affirming the "before and after" valuation test outlined in this publication, the court determined that the donation of an easement on a historic property undergoing rehabilitation in New Orleans' Vieux Carre historic district caused a 10 percent reduction in the value of the property as rehabilitated. The decision has served as a valuation benchmark for subsequent historic preservation easement valuation cases, which generally recognized a 12 percent to 15 percent valuation differential attributable to easements. See, e.g., Nicoladis v. Commissioner, 1988 T.C. Memo 163 (1988); Losch v. Commissioner, 1988 T.C. Memo 230 (1988); Richmond v. U.S., 699 F. Supp. 578 (E.D. La. 1988); Granger v. U.S., 1989 U.S. Dist. LEXIS 1167 (1989). Most recently, the U.S. Tax Court recognized a 20 percent value differential (Griffin v. Commissioner, 56 T.C. 1560 (1989)), and a 33 percent value differential (Dorsey v. Commissioner, 1990 T.C. Memo 242 (1990)) attributable to historic preservation easements.

The regulations further require taxpayers to adjust the basis of property subject to easement to reflect that portion of the basis given up in the easement, and in the case of depreciable property, "the reduction in basis must be allocated between the structure and the underlying land." (Treas. Reg. § 1.170A-14(h)(3)(iii)). Unfortunately, the Service has not provided any guidance as to how the allocation of basis between building and land is to be accomplished. The quoted portions of the Treasury regulations are reproduced in Appendix A.

The Treasury Regulations provide the Internal Revenue Service's interpretation of some of the major issues to be addressed in the course of appraising conservation easements. In addition, Internal Revenue Service and court rulings have begun to provide significant guidance in the conduct of easement appraisals. Similarly, some of the professional appraisal societies have published procedures that deal with the appraisal of conservation easements and related conservation interests. The easement valuation guidelines that follow attempt to consolidate in one document the insights, rules and guidance reflected in these materials that relate—directly or indirectly—to appraisals of conservation easements.