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Dan McCall
Georgetown University Law Center

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**THE ROLE OF EASEMENTS IN HISTORIC PRESERVATION:
IMPLICATIONS OF VALUING A PROPERTY RIGHT AS A COMMODITY**

**Dan McCall
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I. INTRODUCTION

Federal tax law allows the owner of a “certified historic structure” to claim a deduction for the charitable donation of a preservation easement.¹ Oftentimes, the owner will also be able to claim a similar deduction from state income taxes.² Further still, the donation might also lead to lower property taxes if the municipality consents to re-appraise the property at a lower value as a result of the easement.³ Thus, the intersection of state and federal law may create a “tax trifecta,” which serves as a powerful economic incentive for property owners to donate preservation easements.

This paper seeks to answer, from the vantage point of local historic preservation, whether § 170(h) of the Internal Revenue Code creates any benefits other than those enjoyed by historic property owners in the form of income tax deductions. In other words, what does an easement do that local preservation laws do not already do?

The paper concludes that historic property owners do typically relinquish something of value when they donate an easement and that preservation easements can be an effective tool to complement existing local regulation primarily because they withstand potential change in local laws.⁴ However, this paper further finds that because the value of a donated easement may not be as great as is commonly believed, so too may the future efficacy of this preservation tool be weaker than currently imagined.

¹ I.R.C. § 170(h) (2004). *See infra* Part II and note 20. Furthermore, the Code uses the term “qualified conservation contribution” rather than “preservation easement.” However, I use the latter term in this paper to refer to a subset of “contributions”—those easements on historic properties, as opposed to, for example, open-space easements that apply to property such as farmland.

² *See e.g.*, D.C. Code Ann. § 42-204 (2004).

³ In Washington, D.C., while it is theoretically possible to get encumbered property re-assessed for local property tax purposes, it is very rare if not unprecedented. Telephone Interview with Philip Appelbaum, Senior Assessor, D.C. Real Property Tax Administration (April 6, 2004).

⁴ *See, e.g.*, Robert Strauss, *Official in Philly Targets Preservation Controls*, WASH. POST, Mar. 22, 2004, at A3 (reporting on a City Council bill that would allow the Council to de-designate historic districts). For a partisan account of how the small town of Monterey, Virginia abolished its historic district, see L.M. Schwartz, “Precedent-Setting Victory for Property Rights: Local Historic District Abolished,” at <http://www.prfamerica.org/HistoricDistrictAbolished.html> (last visited May 10, 2004).

There are at least two main ways that legislation can serve the goals of historic preservation: local regulation of the ilk approved in *Penn Central*,⁵ and tax expenditures that incentivize historic preservation efforts.⁶ Each method reflects a different conception of property. The former conceives of property as interconnected and a non-commodity for the purposes of protecting the “commons.”⁷ The latter instead conceives of property interests that can be severed and valued as a commodity.⁸

The purpose of distinguishing between these two conceptions of property, as reflected in local regulation and in the § 170(h) tax expenditure, is twofold. First, hopefully it helps to situate this provision of the Revenue Code in the context of historic preservation methods.⁹ Second, it highlights the consequences of characterizing a stick from the property bundle, such as an easement, as a commodity.

Penn Central established that historic properties could be landmarked, subject to regulation, without violating the takings clause of the Fifth Amendment.¹⁰ That case, and regulation of property in historic districts more generally,¹¹ can be understood as

⁵ *Penn Cent. Transp. Co. v. New York City*, 438 U.S. 104 (1978).

⁶ I.R.C. § 170(h) (2004); I.R.C. § 47 (2004). For more on the term “tax expenditure,” see STANLEY S. SURREY, *PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES* 6-7 (1973).

⁷ Garrett Hardin, *The Tragedy of the Commons*, 162 *SCIENCE* 1243, 1244 (1968). I use the term “commons” here to refer not to pasture for cattle to graze, but to that portion of a community’s architecture that it deems worth preserving. There exists the same potential for a “tragedy of the commons” because it may be very beneficial for the property owner to add additional stories to a building while the negative effects on the historic quality of a neighborhood will be diffused among others in the community.

⁸ See MORTON HORWITZ, *The Progressive Transformation in the Conception of Property*, in *THE TRANSFORMATION OF AMERICAN LAW 1870-1960: THE CRISIS OF LEGAL ORTHODOXY*,” 145, 149 (1992).

⁹ The easement movement was born prior to *Penn Central* and at a time when local preservation ordinances were less firmly entrenched. For a detailed account of the legislative history of § 170(h), see Stephen J. Small, *The Tax Treatment of the Donation of Easements in Scenic and Historic Property*, *Envtl. L. Rep.* (Mar. 1979); STEPHEN SMALL, *THE FEDERAL TAX LAW OF CONSERVATION EASEMENTS* (2d ed. 1990 & Supp. 1996).

¹⁰ 438 U.S. at 138.

¹¹ See, e.g., *Mahe v. New Orleans*, 516 F.2d 1051 (5th Cir. 1975) (upholding validity of New Orleans historic preservation ordinance as legitimate exercise of police power).

expressing a non-commodity view of property in which an individual's property rights may be restricted for the sake of protecting the commons.¹²

In contrast, the preservation easement deduction contained in § 170(h) persists in treating as a commodity those property rights that extend beyond the current reach of local regulation. If one conceives of the easement as going beyond what a community has collectively decided is required for the sake of the commons, then it makes normative sense to focus on the individual "stick" from the property bundle to arrive at a value of compensation in the form of an income tax deduction. In contrast to *Penn Central*, where the owner received no compensation because it was one of many subject to a comprehensive plan, the owner who donates an easement does receive compensation for going beyond what the comprehensive plan requires. For § 170(h) to maintain its sensible normativeness, however, it is important that an easement actually reflect a donation that is beneficial to the commons.¹³

To understand how the conceptions of property are contextually dependent on a community's regulation of its commons, consider hypothetical owners X and Y. Each owns an historic property, but X lives in a "weak" historic district, while Y lives in a "strong" historic district. X might be able to successfully deduct the value of the donated easement that imposes more stringent controls than those in his district's ordinances, even if the easement's burdens are no stronger than the ordinances in Y's district. Much to the consternation of Y, were he to donate the same easement that X imposed, he should clearly receive no deduction because he has not experienced a further burden. In other

¹² See Joseph Sax, *Takings, Private Property and Public Rights*, 81 YALE L.J. 149, 162 (1972) ("The effects of a vast tower built on a single tract spill over visually onto other lands just as smoke or noise does.").

¹³ Although the donation of an easement entails a particularized analysis of an individual property right, the deduction is nonetheless "community-based" because it involves the expenditure of public funds.

words, the “stick” that X donates is no longer a stick for Y because of the more demanding baseline that Y’s district has drawn to protect its commons.¹⁴

Because this outer, or unregulated, realm of property interests is treated by the Code as a commodity, an owner is likely to donate it only when it is in his economic interest. If the value of some easements may not be as great as is commonly believed, as this paper posits, property owners, assuming they are self-interested and not altruistic preservationists, are more likely to retain non-regulated property interests than they would be were the easements valued as high as is now commonly believed.

Therefore, § 170(h) is a historic preservation tool that complements local regulation because it, for example, encourages the use of easements that last in perpetuity whereas local regulations may change. However, the efficacy of § 170(h) is proportional to the value ascribed to easements. Should the value of easements be lower than currently imagined, owners will be less likely to take this additional step that would be beneficial to the commons.

II. STATUTORY AND REGULATORY SCHEMA

Only qualified conservation contributions are eligible for deductions.¹⁵ For the purposes of historic structures, there needs to be (1) a qualified real property interest, (2) donated to a qualified organization, (3) exclusively for conservation purposes.¹⁶

¹⁴ For a lucid discussion of the significance of forms of property, see Hanoch Dagan, *The Craft of Property*, 91 CALIF. L. REV. 1517, 1534-35 (2003) (“To know if and how the existing configuration of a property form should affect the legal outcome, however, we must analyze the forms of property from a normative and contextual (i.e., legal realist) perspective. The forms of property should affect outcomes to the extent that they help constitute property institutions that serve important human values.”).

¹⁵ I.R.C. § 170(f)(3)(B)(iii) (2004).

¹⁶ I.R.C. § 170(h)(1) (2004); Treas. Reg. § 1.170A-14 (as amended in 1999).

First, a preservation easement counts as a “qualified real property interest” if it is “a restriction (granted in perpetuity) on the use which may be made of the real property.”¹⁷ Second, qualified organizations are typically § 501(c)(3) organizations but might instead be a state or a subdivision of a state.¹⁸ Third, a donor will meet the “exclusively for conservation purposes” test if the donation is for the “preservation of an historically important land area or a certified historic structure” and is protected in perpetuity.¹⁹

Further to the third requirement, a certified historic structure is a structure that is “listed in the National Register” or that is “located in a registered historic district...and is certified by the Secretary of the Interior to the Secretary [of the Treasury] as being of historic significance to the district.”²⁰ The Treasury Regulations impose an additional requirement that there be “some visual public access to the donated property.”²¹ Most properties in an urban environment, such as Washington, D.C. or New Orleans, meet this requirement because the property is visible from a public way. With respect to the “exclusively” requirement, the Treasury Regulations impose another important requirement: a mortgagee must subordinate its rights in the property “to the right of the qualified organization to enforce the conservation purposes of the gift in perpetuity.”²²

¹⁷ I.R.C. § 170(h)(2)(C) (2004).

¹⁸ I.R.C. § 170(h)(3) (2004). *See also* Treas. Reg. § 1.170A-14(c) (as amended in 1999) (requiring that organization have resources to enforce easement, but stating that the organization need not set aside funds to enforce the easement).

¹⁹ I.R.C. § 170(h)(4)(A)(iv) (2004); I.R.C. § 170(h)(5)(A) (2004).

²⁰ I.R.C. § 170(h)(4)(B) (2004). For the definition of “registered historic district,” see I.R.C. § 47(c)(3)(B) (2004). *See also* Treas. Reg. § 1.170A-14(d)(5)(ii)(B) (as amended in 1999) (noting that “historically important land areas” include those buildings in a historic district that “can reasonably be considered as contributing to the significance of the district”).

²¹ Treas. Reg. § 170A-14(d)(5)(iv) (as amended in 1999).

²² Treas. Reg. § 170A-14(g)(2) (as amended in 1999). *See also* *Satullo v. Comm’r*, 66 T.C.M. (CCH) 1697 (1993) (holding that donated easement was not a “qualified conservation contribution” because mortgagee’s interest was superior to the easement holder’s, who failed to have mortgagee subordinate its rights.)

Although the Revenue Code allows for the deduction of a charitably donated easement, it provides no guidance on how to properly value a preservation easement. Treasury Regulations and Revenue Rulings clarify that the value of a preservation easement is its fair market value; however, because there is no real market for easements, the fair market value is derived by subtracting the value of the encumbered property after imposing the easement from the value of the property prior to imposing the easement.²³

There are three main approaches to conducting the “before and after” valuation of an easement: (1) comparable sales, (2) capitalized net operating income, and (3) replacement cost.²⁴ The replacement cost method is often a poor method for determining the value of historic properties, so appraisers tend to rely on the first two methods.²⁵ Furthermore, the income approach typically does not apply well to residential property, which often leaves the comparable sales method the most appropriate method for conducting the before and after valuation of residential property.²⁶

Whichever method is applied, the two most basic steps in the valuation process are determining the “highest and best use” of the property (1) before the easement is imposed and (2) after the easement is imposed.²⁷ For a property owner to establish that

²³ Treas. Reg. § 170A-14(h)(3) (as amended in 1999) (Stating that “the fair market value of a perpetual conservation restriction is equal to the difference between the fair market value of the property it encumbers before the granting of the restriction and the fair market value of the encumbered property after the granting of the restriction.”); Rev. Rul. 73-339.

²⁴ LAND TRUST ALLIANCE, APPRAISING EASEMENTS, GUIDELINES FOR VALUATION OF LAND CONSERVATION AND HISTORIC PRESERVATION EASEMENTS 30-33 (3d ed. 1999) [hereinafter APPRAISING EASEMENTS]. Treasury Regulations call only for the before and after valuation method; these three specific methods are those accepted by and used in the appraisal profession.

²⁵ See, e.g., Dorsey v. Comm’r, 59 T.C.M. (CCH), 600 (1990) (rejecting cost approach because reproduction or replacement of a historic property was too remote a possibility to provide a value); Losch v. Comm’r, 55 T.C.M. (CCH), 915 (1988) (“However, in dealing with an older, historic structure, it is highly questionable whether the replacement cost method can be used to provide meaningful results.”).

²⁶ APPRAISING EASEMENTS, *supra* note 24, at 30.

²⁷ Hilborn, 85 T.C. at 689. For a visual aid, see Appendix A.

there is a use higher and better than the current use, the owner must show such use is reasonably probable in the near future.²⁸

Key to understanding whether an easement's burden is greater than that already imposed by local law is the requirement that local zoning and preservation laws be considered. The Regulation calls for considering "any effect from zoning, conservation, or historic preservation laws that already restrict the property's potential highest and best use."²⁹ Because an easement is a binding agreement between the property owner and the donee organization, the parties have flexibility in deciding the easement's terms. One example of how an easement might facially go beyond the scope of local regulations is for the easement to apply to all sides of the property. Because most local preservation regulation applies only to what is visible from a public right-of-way, then an easement which applies to all sides—including those portions not visible from a public right of way—goes beyond local regulation. For example, in Washington, D.C., preservation regulation is dramatically reduced for additions or alterations if they are done to part of the property, such as the rear, that is not visible from a public way.³⁰ In contrast, an easement might be imposed on all sides of an historic building.³¹ On its face then, the easement will exceed the regulations' control, but ascribing a value to that difference is a thornier task.

²⁸ *Id.*

²⁹ Treas. Reg. § 170A-14(h)(3)(ii) (as amended in 1999); *see also* S. Rep. 96-1007, 15 ("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.").

³⁰ Although the Washington, D.C. statute and regulations do not expressly limit the review of alterations or additions to visible portions, *compare* D.C. CODE ANN. § 6-1101-1107 (2004) *and* D.C. Mun. Regs. tit. 10, § 2505-2510 (2004) *with* the Historic Preservation Design Guidelines, promulgated by the Historic Preservation Review Board, entitled "Additions to Historic Buildings," 8, 11 *available at* <http://planning.dc.gov/planning/frames.asp?doc=/planning/LIB/planning/preservation/pdf/000015b4.pdf> (last visited May 10, 2004). It is unusual for a municipality to have control over "all four walls."

³¹ *See, e.g.*, the easements of L'Enfant Trust, *available at* <http://www.lenfant.org/2004deed.doc> (April, 2004), and Foundation for the Preservation of Historic Georgetown, *available at* [http://preservegeorgetown.org/document.htm\(2004\)](http://preservegeorgetown.org/document.htm(2004)).

III. WHAT THE OWNER GIVES UP: ACCOUNTING FOR LOCAL LAW

Do property-owners in historic districts give up anything when they donate preservation easements, or, given that these owners already face local preservation and zoning ordinances, is the donation an empty, tax-motivated gesture? The approximately six cases on point establish that, notwithstanding local preservation laws, these owners do give up something additional—for example, the right to higher rental income or the right to make additions that would have otherwise been approved.³² A review of the caselaw is helpful to understanding what owners give up but also highlights concerns that the typical value of a donated easement may not be as great as is commonly believed.³³ As a result, a lower value for easements may weaken this alternative method of historic preservation.

As a result of imposing a preservation easement, the property owners in each of the six cases experience a diminution in property value ranging from ten to twenty percent. All of these cases concern the proper valuation of the easement donated. Within this small body of case law, four cases—*Hilborn*, *Losch*, *Nicoladis*, and *Dorsey*—are helpful in parceling out what portion of the diminution is attributable to an easement that does more than local regulations. Due to a dearth of analysis, the remaining two cases, *Richmond* and *Griffin*, do not clearly articulate how the easement in question went beyond local law but nonetheless comprise part of IRS precedent of relying on a ten percent diminution factor.

³² See *Richmond v. United States*, 699 F. Supp. 578 (D. La. 1988); *Dorsey v. Comm’r*, 59 T.C.M. (CCH) 592 (1990); *Griffin v. Comm’r*, 56 T.C.M. (CCH) 1560 (1989); *Losch v. Comm’r*, 55 T.C.M. (CCH) 909 (1988); *Nicoladis v. Comm’r*, 55 T.C.M. (CCH) 624 (1988); *Hilborn v. Comm’r*, 85 T.C. 667 (1985); see also *Granger v. Comm’r*, No. 87-2455-0 (D.C. Kan. 1988) (not discussed here because this case is not illustrative of the impact of local preservation laws; the case instead focused on the issue of whether taxpayers could recover litigation costs from the government, which the court held took a stance that was not “substantially justified.”).

³³ See discussion *infra* Part IV.

Hilborn v. Commissioner

Hilborn is the first case involving an easement on a historic property and is significant for at least two reasons. First, the opinion articulates how the extra financial burdens incurred in donating the easement at issue went beyond local ordinances. Second, as discussed below in Part IV, the case appears to be the origin of confusion that there is something akin to a rule or a guaranteed factor of diminution.³⁴

The taxpayers were members of a partnership that acquired an office building in New Orleans' Vieux Carre historic district.³⁵ At issue in the case was not whether the easement qualified under § 170(h), but what the value of the deduction should be. In the Tax Court's findings of fact, it noted that the Vieux Carre Commission's "Façade Easement Policy" was to apply a higher standard than what was already required of buildings in the district; in some cases, this standard required those seeking to donate an easement to first restore the property.³⁶ Indeed, the Commission made acceptance of the donation conditional on expending \$185,000, exclusive of façade repairs, to renovate the building.³⁷ The partnership then entered into an easement agreement that required it to spend an additional \$47,800 to renovate the exterior façade.³⁸ The court agreed with the taxpayers' expert that the easement imposed "substantial additional burdens" beyond the existing zoning laws and the Commission's requirements because the easement required rehabilitation and also prevented a higher and better use of the property

³⁴ See APPRAISING EASEMENTS, *supra* note 24, at 10 ("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.").

³⁵ 85 T.C. at 677.

³⁶ *Id.*

³⁷ *Id.* at 680.

³⁸ *Id.*

attainable but for the easement's restriction on assembling the property with a corner lot.³⁹

However, although the court agreed with the taxpayers' appraiser that the easement created burdens more substantial than the IRS appraiser found, it nonetheless held that those burdens were adequately reflected in the IRS appraiser's finding of a ten percent diminution in value.⁴⁰ The taxpayers' appraiser told the court that his twelve percent diminution factor was wholly subjective, while the court found that the IRS appraiser used an objective methodology.⁴¹

Losch v. Commissioner

Losch marked a continuation of the IRS reliance on a ten percent diminution factor but is helpful because the opinion includes a description of how the easement, which extended to the interior of the property, was more stringent than local law. *Losch* is also significant because of the court's comments on its institutional capacity to decide valuation disputes.⁴²

Losch centered on the valuation of an easement that the Losch couple had imposed on property located in Washington, D.C.'s Dupont Circle historic district.⁴³ The easement donated was somewhat unique in that it also contained restrictions on what

³⁹ *Id.* at 691.

⁴⁰ *Id.* at 698.

⁴¹ *Id.* at 699.

⁴² *Losch*, 55 T.C.M. (CCH) 921 (1988) ("At this point we feel constrained to reiterate once again our doubts as to the efficacy of using the judicial process to resolve valuation issues... Additionally, we believe that resolution of these issues by settlement or other procedures short of court proceedings will often result in a value which is fairer to both parties. The parties and their experts will generally have a fuller knowledge of the pertinent facts and greater expertise than does this Court which must rely only on 'a cold record and dry briefs' to form the basis of its conclusion.")

⁴³ 55 T.C.M. at 910.

could be done to the interior of the property;⁴⁴ with respect to control of the interior, then, it clearly restricted more than local preservation ordinances. The taxpayers' appraiser concluded that part of the decline in value stemmed from a \$25,000 loss of the right to develop the property to the extent of zoning regulations and a \$10,000 loss in any potential opportunity that would become available in the future because of changes in future zoning laws.⁴⁵

The taxpayers presented testimony from a former zoning board official and Historic Preservation Review Board official that an additional two floors of residential space would probably have been approved under existing regulations.⁴⁶ Nonetheless, the court found that the \$25,000 portion of the loss was too speculative because, although the taxpayers did account for existing regulations in calculating the before and after value of the property, they did not offer any evidence of the economic feasibility of a two-floor addition project.⁴⁷ In other words, the addition could not be considered the property's "highest and best use" because the possibility of such a project was too remote.⁴⁸

In rejecting the \$10,000 diminution attributed to potential future changes in local law, the court did nothing more than to say that the figure was too speculative. The rejection of that figure, however, is significant because it demonstrates that however sound the policy argument may be for encouraging perpetual easements on top of potentially unstable local law, there is no authority suggesting that potential future change in local laws is to be included in valuation.⁴⁹ In other words, while the

⁴⁴ *Id.* at 912.

⁴⁵ *Id.* at 914.

⁴⁶ *Id.* at 915.

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.*

Regulations require that the easement be compared with local ordinances during the valuation process, the comparison is for the purpose of determining whether the easement imposes any additional restrictions on reasonably likely uses of the property—not for ascribing an additional value for the easement’s quality of being perpetual.

When conducting the “comparable sales” analysis to determine the easement’s value, the taxpayers’ appraiser unsurprisingly found that the imposition of an easement did cause a noticeable diminution in value while the IRS appraiser’s comparable sales analysis was inconclusive.⁵⁰ Nonetheless, the IRS stayed close to the ten percent figure used in *Hilborn* because, despite the inconclusiveness of the comparable sales analysis, the IRS appraiser found a ten percent diminution reasonable.⁵¹ However, the court opted to find a fifteen-percent diminution, through the comparable sales approach, because of one particular comparable sale, also on New Hampshire Avenue, that supported a fifteen-to twenty-two-percent diminution.⁵² Although the comparable sales analysis did support finding a diminution in value, this method of analysis did not articulate what the owner gave up as clearly as did the income capitalization method.

The IRS appraiser’s income capitalization analysis showed that, as a result of the easement, the owners lost rental value due to the inability to install an elevator as a result of the interior easement and increased insurance and reserve costs.⁵³ The court averaged its own findings on the “comparable sales” (\$116,250) and income capitalization (\$143,000) methods and concluded that the easement’s value was \$130,000;⁵⁴ given the

⁵⁰ *Id.* at 918.

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.* at 921.

court's finding that the "before" value of the property was \$775,000, the taxpayers ended up with a property value diminished by roughly seventeen percent.

Although the current use of the building was also the highest and best use, the taxpayers in *Losch* nonetheless secured a substantial deduction because of the atypical easement that extended to the interior, the favorable comparable sales analysis, and the even more favorable income capitalization analysis. Sixteen years after *Losch*, a comparison of a more typical easement donation suggests that the likely diminution in value may often be below that won in *Losch*. Most easements do not grant the easement holder control over a property's interior and are therefore not likely to be as restrictive as the easement in *Losch*.

Furthermore, because the income capitalization method of valuation does not apply to residential property, the comparable sales analysis is the favored method of valuation. As discussed in Part IV, there is a substantial and growing body of easements in several areas that should make the comparable sales analysis more conclusive than it has been in the past.⁵⁵ Given that residential property owners generally have one leg to stand on (comparable sales analysis), then such owners would deduct lower amounts or nothing at all if comparable sales analyses show that the easements have minimal to no impact on property value.

⁵⁵ At the time of this writing, there were approximately 901 easements recorded in Washington, D.C. (L'Enfant Trust holds 697, Foundation for the Preservation of Historic Georgetown holds 98, National Trust holds 14, Preservation Trust holds 82, Tri-State Architectural Trust holds 10). E-mail from Carol Goldman, President, L'Enfant Trust (March 31, 2004, 12:15 EST) (on file with author); E-mail from Peter Jost, Trustee, Foundation for the Preservation of Historic Georgetown (March 31, 2004, 10:02 EST) (on file with author); E-mail from Paul Edmondson, General Counsel, National Trust (April 1, 2004, 2:27 EST) (on file with author); E-mail from Ray Gooch, Preservation Trust (April 1, 2004, 3:04 EST) (on file with author); Telephone Interview with Karen Leonel, Tri-State Architectural Trust (April 5, 2004). See also APPRAISING EASEMENTS, *supra* note 24, at 9 ("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.").

Nicoladis v. Commissioner

Nicoladis is yet another instance of reliance on a ten percent diminution factor—both by the IRS appraiser and the taxpayers’ appraiser. As in *Losch*, the court showed its institutional reluctance to quibble with the ten percent figure that both sides relied upon for part of the valuation.⁵⁶

The taxpayers were members of a Louisiana partnership.⁵⁷ The property at issue consisted of a two-and-one-half story building with attached, vacant lots.⁵⁸ Interestingly, with respect to the building itself, both parties stuck to the ten percent figure used in *Hilborn*.⁵⁹ The taxpayers took note of the *Hilborn* decision when they requested that their appraiser conduct a second appraisal in light of that decision.⁶⁰

The parties diverged most clearly in their arguments regarding the difference between the easement and the regulations that already applied to the property.⁶¹ The taxpayers argued that, after donating the easement, the highest and best use of the vacant portion was as a parking lot because it had forsaken the ability to develop that lot.⁶² In contrast, the IRS appraiser argued that the taxpayer could not have developed that lot even before donating the easement because the public was likely to object to such development.⁶³ The taxpayer won on this point because the court found that the IRS expert only speculated about opposition while the taxpayer presented testimony from a

⁵⁶ 55 T.C.M. at 629 (“For lack of evidence to the contrary, we accept this figure. We will not impose our judgment on the issue without sufficient reason to doubt the experts and evidence upon which to base our opinion.”) See discussion *infra* Part IV.

⁵⁷ *Id.* at 628.

⁵⁸ *Id.* at 624-25.

⁵⁹ *Id.* at 627.

⁶⁰ *Id.* at 626.

⁶¹ *Id.* at 627.

⁶² *Id.*

⁶³ *Id.*

Historic District Landmark Commission representative that, prior to the easement, some development was possible.⁶⁴ Finally, the taxpayer won an approximately fourteen-percent reduction because the IRS conceded that, with respect to the adjacent vacant lot, there was some loss of development rights beyond the ten percent reduction.⁶⁵

There were two main factors contributing to the taxpayers' success in obtaining a fourteen percent deduction. First, the court was unwilling to look beyond the ten percent figure upon which both sides relied. Second, the taxpayers presented testimony, rather than speculation, that they had given up some development potential on the adjacent lot. If taxpayers can continue to present solid evidence, such as the testimony in *Nicoladis*, that development potential has been sacrificed, then they should be able to continue claiming deductions. However, as discussed below, sixteen years after *Nicoladis*, there exists the risk that a court might now have sufficient evidence to more forcefully probe whether reliance on a ten percent figure is justified.

Richmond v. Commissioner

Richmond, which involved facts similar to *Hilborn*, is less illustrative of the impact of local preservation laws for two main reasons. (1) The taxpayers presented virtually no evidence to support their argument that they deserved a twenty-five percent diminution in value.⁶⁶ (2) The IRS appraiser, contrary to the *Hilborn* and *Nicoladis* insistence that valuation is a “question of facts and circumstances,” automatically granted a ten percent reduction and also accounted for the easement's requirements that the

⁶⁴ *Id.* at 628.

⁶⁵ *Id.* at 629.

⁶⁶ 699 F. Supp. 578, 580-81.

owners make extra expenditures.⁶⁷ Thus, despite what appeared to be the taxpayers' inability to carry their burden of proof, they still secured a fifteen-percent reduction in value.

Griffin v. Commissioner

Griffin also involved members of a Louisiana partnership who owned property in the same "Central Business District" mentioned in *Nicoladis*.⁶⁸ The property consisted of three adjacent buildings, which were classified as having experienced significant façade changes but that nonetheless still contributed to the historic district.⁶⁹ The taxpayers boldly argued for a fifty-three percent diminution in value, and the taxpayers' appraiser erroneously argued that, after the easement, the buildings had zero value.⁷⁰ The IRS and taxpayer did not differ much regarding the "before" value.⁷¹

Next, the IRS appraiser took the familiar step of granting a ten percent diminution to the easement.⁷² The taxpayers argued to go beyond the ten percent factor used in *Hilborn* because that case involved property in the French Quarter, which imposed tougher restrictions on property than the standard applied to their category of property in the Central Business District; in fact, they argued that, absent the easement, they would be able to demolish the buildings to construct a commercial office building.⁷³ Without much explanation, the court agreed that there was more development potential than in the

⁶⁷ *Id.* at 584.

⁶⁸ 56 T.C.M. at 1560.

⁶⁹ *Id.*

⁷⁰ *Id.* at 1563, n.4.

⁷¹ *Id.* at 1563.

⁷² *Id.* ("The 10-percent factor was based on our opinion in *Hilborn v. Commissioner*....").

⁷³ *Id.* In the absence of testimony that the taxpayers would have been able to demolish the buildings, the court noted that "we doubt that demolition of the existing buildings and construction of a totally new office building would have been permitted").

French Quarter and concluded that under “the totality of the evidence,” the easement caused a twenty percent diminution in value.⁷⁴ Therefore, one half of the taxpayers’ deduction stemmed from the IRS concession that there was a ten percent diminution, and the other half of the deduction stemmed from the court’s opaque finding that regulations touching their property were not as strict as those imposed by the French Quarter. In *Losch* and *Nicoladis*, taxpayers presented testimony that some development would have been allowed absent the easement. In contrast, even if the taxpayers’ district was not as regulated as the French Quarter, *Griffin* did not clearly articulate how the taxpayers had sacrificed the ability to develop their property.

Dorsey v. Commissioner

Dorsey, the most recent case involving an easement valuation dispute in a historic district, contains a more thorough discussion of the impact of local preservation laws and touches similar concerns to those raised in *Nicoladis*. The property involved was a three-story building in New Orleans’ Picayune Place Historic District.⁷⁵ The easement covered all of the exterior surfaces, obligated the owners to make the expenditures that the easement holder found necessary to maintain the building’s character, and prevented changing the use of the building regardless of whether a higher and better use was possible.⁷⁶

Both the taxpayer and IRS agreed that, after the easement, the highest and best use was as a three-story building.⁷⁷ However, the taxpayer argued that the highest and

⁷⁴ *Id.* at 1564.

⁷⁵ 59 T.C.M. at 594.

⁷⁶ *Id.* at 597.

⁷⁷ *Id.* at 599.

best “before” use was as a five-story building.⁷⁸ After applying the “income capitalization” method, the taxpayer argued that the value of the easement donated was approximately \$245,000.⁷⁹ The IRS argued that the highest and best use of the “before” building was actually the same as its current use, and then applied a ten-percent diminution factor to arrive at an easement value of \$46,000.⁸⁰ As for the highest and best “before” use, the court agreed with the taxpayers, who presented testimony from a Historic District Landmarks Commission member and a former director of the office of Safety and Permits that the Commission would have approved additions and set-back requirements probably would have been waived to add two stories to the structure.⁸¹ However, the court then found that the taxpayer had mechanically applied the before and after method of valuation.⁸²

Instead of following the taxpayers’ method, the court performed two steps to find an easement value of approximately \$153,000, which represented a thirty-three percent diminution in value.⁸³ First, the court found that with respect to the loss of control over the building’s exterior, there was no real evidence of comparable sales, and therefore it relied on the ten percent diminution factor, which it applied only to the building itself.⁸⁴ Second, the court arrived at the square footage of development rights that was foregone by the easement.⁸⁵ Next, it determined the percentage of the “before” space that the lost

⁷⁸ *Id.* at 597.

⁷⁹ *Id.*

⁸⁰ *Id.* at 598.

⁸¹ *Id.* at 600.

⁸² *Id.* at 601.

⁸³ *Id.* at 602.

⁸⁴ *Id.* *But see* Hilborn v. Comm’r, 85 T.C. 677, 699 (1985) (stating that “land value, being an integral part of improved real estate, cannot be factored out in determining before and after value”).

⁸⁵ *Id.*

rights represented and multiplied that factor by the property's value.⁸⁶ Upon combining the exterior control loss (step one) and development rights loss (step two), the court arrived at the figure of \$153,422.⁸⁷ Although the percentage diminution was actually greater than what the taxpayer had argued, twenty percent, the actual value was smaller because the taxpayer's mechanical valuation led to a substantially higher "before" value.

Similarly to *Nicoladis*, the taxpayers' success here stemmed from two sources. First, because it had no comparable sales evidence, the court relied on the ten percent figure to determine the amount of diminution caused by the loss of control. Second, the court gave weight to testimony that an additional two stories would have been permitted and determined that there was also diminution because of the loss of development rights. As discussed above in the context of *Nicoladis*, such testimony is undoubtedly helpful to showing that the easement in question goes beyond local regulation. However, should comparable sales become more determinative in the future, then reliance on a ten percent diminution is riskier.

Hilborn, *Losch*, *Nicoladis*, and *Dorsey* each articulate what it is that property owners are giving up when they donate a preservation easement. In *Hilborn*, it was documented that the easement went beyond the Vieux Carre Commission's normal standards by, for example, requiring the owners to make extra expenditures and preventing the assemblage of the property with a corner lot.⁸⁸ In *Losch*, it was clear that the interior easement went beyond local regulations and imposed a real burden.⁸⁹ In *Nicoladis*, the taxpayers presented testimony to show that they had lost some

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ 85 T.C. at 680, 691.

⁸⁹ 55 T.C.M. at 912.

development rights because of the easement.⁹⁰ And in *Dorsey*, the taxpayers also successfully presented testimony that they had given up valuable development rights as a result of the easement.⁹¹

However, *Richmond* provides significantly less support for the conclusion that the easement in that case caused a fifteen percent diminution in value. Although the case shared some facts with *Hilborn*, such as expenditures required by the Vieux Carre Commission, the *Richmond* property was already at its highest and best use prior to the easement, unlike in *Hilborn* where there was previously the potential to assemble the property with a corner lot.⁹² So while it seems that some portion of the fifteen percent is supported by the requisite expenditures, there is little explanation for why the IRS decided to grant a fifteen percent diminution.

Griffin also contained an unsatisfactory explanation of why the property warranted a twenty percent diminution, as the court concluded, or even a ten percent diminution, as the IRS argued.⁹³ In these two cases, and even to some extent in cases such as *Losch*, the IRS strategy was to stick to a ten percent diminution factor. Thus, while the Tax Court highlighted that it had not established a ten percent rule in *Hilborn*,⁹⁴ the IRS and many taxpayers nonetheless appear to have proceeded as if there were such a rule.⁹⁵

⁹⁰ 55 T.C.M. at 628.

⁹¹ 59 T.C.M. at 600.

⁹² 699 F. Supp. at 583.

⁹³ 56 T.C.M. at 1563.

⁹⁴ *Nicoladis*, 55 T.C.M. at 629. (“There was a fair amount of discussion by the parties at trial about whether the Court had established a ‘10-percent rule’ in *Hilborn*. We did not there and do not here. *Hilborn* establishes as acceptable the before and after method of valuation, and while under the circumstances of that case a 10-percent figure was relied upon, valuation itself is still a question of facts and circumstances.”)

⁹⁵ One easement holding organization, the National Architectural Trust, suggests that a property owner may receive an 11% diminution. I entered into the Trust’s easement calculator, *available at* <http://www.nat->

IV. IMPLICATIONS OF A POTENTIALLY REDUCED EASEMENT VALUE

Many easements may be overvalued when taxpayers deduct their value as charitable donations, and therefore there is currently too much reliance on a guaranteed minimum ten percent diminution. Nonetheless, there is a laundry list of reasons why preservation easements are an effective historic preservation tool. Primary among these reasons is that easements are perpetual, whereas local law is subject to change.

Cause for Concern Regarding Reliance on a Ten Percent Figure

There are several reasons to be concerned that the *Nicoladis* court was correct in stating that valuation remains a question of “facts and circumstances” and that there is no “ten percent rule.”⁹⁶ Among these reasons is the lack of authority for such a rule from legislative history, statutory authority, or case law. Furthermore, there has been a period of relative dormancy in terms of valuation litigation, and the IRS has recently redacted suggestions of generally appropriate diminution figures. This dormant period and redaction lead one to wonder whether the IRS would proceed differently should more valuation litigation occur in the future.

Beginning with the legislative history behind § 170(h), the Committee of Ways and Means report states that “there may be instances in which the grant of an easement may serve to enhance, rather than reduce, the value of property, and in such instances no deduction would be allowable; for example, where there is a premium in value on

arch-trust.org/participate (last visited May 10, 2004), that I was a 35% bracket taxpayer who owned a piece of property worth \$1,000,000. The calculator then informed me that an easement would be worth \$110,000, giving me a tax savings of more than \$40,000.

⁹⁶ 55 T.C.M. at 629.

property of a historic nature.”⁹⁷ The Committee noted further that it intended that “as the use of conservation easements increases, valuation would increasingly take into account the selling price value, in arm’s-length transactions, of other properties burdened with comparable restrictions.”⁹⁸ In light of this legislative history, property owners may be relying on the good graces of the IRS when it comes to expecting a ten or fifteen percent diminution.⁹⁹ In other words, while the IRS has a track record of applying the ten percent factor in case law, there is no statutory, legislative history, or even case law support for the notion that an easement is sure to produce a ten percent diminution in value. Should, as the Committee report suggests, valuation increasingly take into consideration comparable sales of encumbered properties, then areas such as New Orleans and Washington, D.C. have a substantial pool of such properties that can serve as a basis for comparison.¹⁰⁰

Case law shows that taxpayers’ success was generally due to one of or a combination of three factors: (1) testimony or clear evidence that reasonably likely development rights had been given up; (2) appraisals more generally, typically using the income capitalization method, which established a diminished property value; and (3) a virtually automatic IRS concession of a ten percent diminution. Although case law should clearly be a source for concluding that some percentage deduction follows from a

⁹⁷ S. Rep. 96-1007; Treas. Reg. § 1.170A-14(h)(3)(ii) (as amended in 1999) contains very similar language.

⁹⁸ S. Rep. 96-1007.

⁹⁹ See also John Handley, *Fading Ladies? Chicago’s Victorians Fighting the Odds*, CHI. TRIB., Dec. 28, 2003 (Real Estate) (referring to an interview with the preservation easement coordinator for the Landmarks Preservation Council of Illinois, “In return, they get a charitable tax deduction of 15 percent of fair market value of the house.”); Mary Beth Klatt, *Hidden Legacy Architect Leaves Imprint on Chicago Landscape*, CHI. TRIB., April 27, 2003 (Real Estate) (referring again to the same preservation easement coordinator, “homeowners receive a one-time 20 percent tax break on the home’s appraised value....”).

¹⁰⁰ See *Supra* note 55. But see Richard Roddewig, *Preservation Easements: Current Issues* (prepared for ALI/ABA Historic Preservation Law Program in Washington, D.C. Apr. 29-30, 2004) (In referring to ongoing studies of easement-encumbered properties conducted in cities such as Washington, D.C. and Philadelphia, the study notes that challenges such as a limited number of transactions make it difficult to reach a detailed conclusion on easements’ impact on property prices.).

showing that development rights have been sacrificed, property owners, especially residential property owners, should put little stock in the other two factors. All of the property in the six discussed cases was commercial, and as noted above, the income capitalization method is generally inapplicable to residential property. Therefore, case law seems to be a poor source of comfort for residential property owners—at least with respect to any portion of diminution owing to a conclusive appraisal. After all, only in *Losch* did the comparable sales analysis prove fruitful.¹⁰¹

The third factor, IRS concession of a ten percent diminution, does not provide stable footing either. If comparable sales analyses become more conclusive in the future, then it is reasonable to expect that the IRS would not concede a ten percent diminution. Yet even presently, there is risk in relying on a ten percent diminution because of the dormancy in litigating preservation easement cases, the recent IRS redaction from materials available on its website of a suggested diminution range, and also because of courts' institutional capacity to decide valuation cases.

It has been over fourteen years since a case involving the valuation of a preservation easement was decided, and all of the six cases discussed here involved easements that were conveyed between the ends of 1979 and 1981, not long after it became clear that historic property owners could make donations of easements.

The recurring reliance on the ten percent figure appears to stem partially from an IRS brief that formerly suggested that a ten to fifteen percent diminution in value was appropriate. The IRS has since redacted that portion of the brief that suggested a

¹⁰¹ *Losch*, 55 T.C.M. at 918.

generally appropriate diminution percentage.¹⁰² However, it appears that some organizations continue to rely on the older version of the brief.¹⁰³ Confusingly enough, the same suggested diminution range can still be found buried in an IRS audit guide, although this document also appears to have been modified.¹⁰⁴

It seems that a portion of the taxpayers' success was due to the courts' aboveboard institutional discomfort with resolving valuation disputes.¹⁰⁵ Where there was little to support a finding of diminished value, the court would nonetheless look to the IRS argument, which usually conceded diminution by hewing to a ten percent baseline.¹⁰⁶ Because the IRS conceded a ten percent diminution, and the court was unlikely to reach a finding more anti-taxpayer than what the IRS was arguing, the issue was then whether ten percent was all that the taxpayer would get or whether there was diminution greater than ten percent. For future valuation cases, then, this begs the question of how the court would view the parties' relative arguments if the IRS did not concede a ten percent diminution.

¹⁰² Compare Mark Primoli, *Façade Easement Contributions*, available at http://www.irs.gov/pub/irs-utl/facade_easement_brief.pdf (last visited May 10, 2004) with Mark Primoli, *Façade Easement Contributions*, available at <http://www.preservationeasements.org/home/IRSTaxBrief.pdf> (last visited May 10, 2004) (“Internal Revenue Service Engineers have concluded that the proper valuation of a façade easement should range from approximately 10 percent to 15 percent of the value of the property.”). I am grateful to Paul Edmondson, Vice President and General Counsel for the National Trust for Historic Preservation, who made this keen observation to me in a conversation on March 29, 2004. In a conversation with an IRS employee who would not allow his or her name to be used because the comments had not received clearance from the IRS, I learned that the suggested range in the Primoli article was redacted to avoid confusion and to better align IRS stance with I.R.C. § 170(h) and the related Treasury Regulations, neither of which contains a suggested valuation range.

¹⁰³ See, e.g., the Landmarks Preservation Council of Illinois website, which has the ten to fifteen percent figure in bold font, available at http://www.landmarks.org/easement_tax.htm (last visited May 10, 2004).

¹⁰⁴ Compare Richard Roddewig, *Preservation Easements: An Appraiser's Primer on Tax Rules and Valuation Issues*, October 7-8, 2002 (mentioning Chapter 18 of an Audit Manual, which stated that the suggested diminution range was derived from a seminar conducted by IRS engineers in Philadelphia) with the same chapter in the currently available audit guide, available at <http://www.irs.gov/pub/irs-mssp/rehab.pdf> (last visited May 10, 2004).

¹⁰⁵ *Losch*, 55 T.C.M. at 921.

¹⁰⁶ See, e.g., *Dorsey*, 59 TCM 602 (“The only evidence presented on the ‘value’ of [the loss of control over the building’s exterior] was an amount equal to 10 percent of the Property’s total fair market value. We accept it.”).

Easements as an Alternative Historic Preservation Tool

In addition to the benefit that easements are perpetual, easements produce another benefit in the form of private policing when neighbors are given notice that property is encumbered with an easement and when easement holders enforce their easements against violators.¹⁰⁷ Of somewhat smaller benefit is the fact that easements are not prone to attack on constitutional grounds as are ordinances.¹⁰⁸

As an example of easements' staying power, consider the fate of three historic buildings in Charleston, South Carolina. Historic Charleston Foundation owned interior easements on three properties located close to a new federal courthouse annex. In the wake of the Oklahoma City bombing, the General Services Administration ("GSA") wanted to keep the façade of the historic buildings but replace the interior structures to increase security. After a contentious period during which Charleston's mayor attempted to arrange an agreement between the GSA and Historic Charleston Foundation, the GSA finally backed down from its plans. However, just down the street, remodeling was performed on another building for which the easement holder only held an easement on three of the walls.¹⁰⁹

¹⁰⁷ See *Sagalyn v. Found. for the Pres. of Historic Georgetown*, 691 A.2d 107 (D.C. 1997); *Bagley v. Found. for the Pres. of Historic Georgetown*, 647 A.2d 1110 (D.C. 1994); *Found. for the Pres. of Historic Georgetown v. Arnold*, 651 A.2d 794 (D.C. 1994). See also Melissa K. Thompson & Jessica E. Jay, *An Examination of Court Opinions on the Enforcement and Defense of Conservation Easements and Other Conservation and Preservation Tools*, 78 *Denv. U.L. Rev.* 373, 399-408 (2001).

¹⁰⁸ See Richard Roddewig, *Preservation Easements: Current Issues* (prepared for ALI/ABA Historic Preservation Law Program in Washington, D.C. Apr. 29-30, 2004) (describing other benefits such as that easements contain no economic hardship exemption).

¹⁰⁹ Robert Behre, *Federal 'Facadism' Plans Razed*, THE POST & COURIER, Jan. 7, 1999, B1 (quoting Charleston's mayor, "I assume it was that the interior covenants were a barrier to [the GSA] using it as they saw fit."). Appendix B represents another anecdote of easements' staying power in the face of modification or development pressures. The two photos are of adjacent properties on the 900 block of F Street, N.W. At left stands the National Union Building, on which the National Trust holds an easement. On the right is the façade of the Atlantic Building. Interview with Paul Edmondson, Vice President and

V. CONCLUSION

Because easements are treated as commodities under § 170(h), a lower value would undoubtedly result in a decline in the number of easements that are donated. A realignment between the percentage diminution claimed in income tax deductions and the actual, more likely lower, value of easements produces both positive and negative effects.¹¹⁰ The negative effect is that there is likely to be a decrease in the number of donated easements. The positive effect is that a realignment stays true to the normative reasons for granting a deduction in the first place—that a publicly-funded form of compensation, namely a tax expenditure, ought to accurately reflect what someone has done to protect the commons.

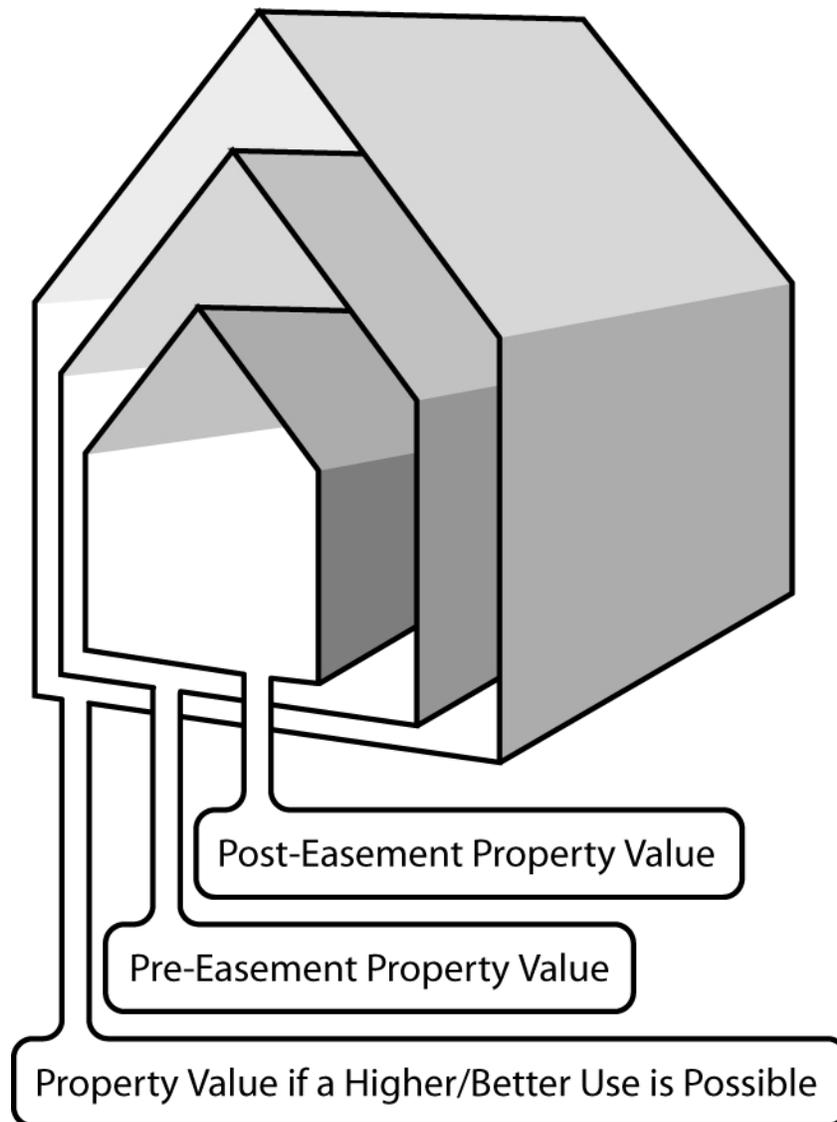
Yet there is some “slippage” between this concept of what is normatively appropriate and the market value of an easement that a taxpayer is able to deduct because the market price cannot perfectly reflect what is beneficial to the commons. Consider the scenario where a comparable sales analysis, or any other valuation method, establishes that an easement has no negative effect on a property’s selling price. In that scenario, the owner will be unable to deduct anything for the donation of an easement and therefore will be unlikely to donate the easement. However, although the easement has no value to the owner, there is still historic preservation value in the easement because it is perpetual. In other words, there is not a perfect match between the burden that an owner suffers via

General Counsel for the National Trust for Historic Preservation in Washington, D.C. (March 29, 2004); E-mail from Carol Goldman, President, L’Enfant Trust (May 10, 2004, 10:57 EST) (on file with author). *See also In re The Atlantic Building*, H.P.A. Nos. 02-261, 02-266 (Aug. 29, 2002) (holding that plan involving demolition of building, but retention of façade, was a plan of special merit).

¹¹⁰ This argument is solely from the viewpoint of historic preservation. That is to say, it does not speak to the contention that a community is better off with a “special merit” exception that does allow for a net utility gain to the community even if it comes as a blow to historic preservation. *See* D.C. CODE ANN. § 6-1102 (2004).

the reduced price that encumbered property commands in the market (i.e. before versus after value) and the historic preservation benefits that are derived from the easement.

APPENDIX A¹¹¹



¹¹¹ The valuation methodology gives the property owner two places in which to articulate that the easement goes beyond local regulations. First, although not required, the owner can show that before imposing the easement, the property could have reasonably been put to a higher and better use. Second, the owner must show that the easement has restricted use of the property in a way that goes beyond preexisting local ordinances. Therefore, the disparity in effect between existing regulations and a donated easement is starkest in those cases where not only is the owner, post-easement, more restricted in his use of the property, but where that owner had not yet put the property to its “highest and best” use prior to the easement.