Internal Revenue Service Advisory Council 2009 General Report

General Report of the Internal Revenue Service Advisory Council

The Internal Revenue Service Advisory Council (IRSAC) is authorized under the Federal Advisory Committee Act (FACA). The fundamental purpose of IRSAC is to provide an organized public forum for IRS officials and representatives of the public to discuss relevant tax administration issues. IRSAC offers suggestions regarding improvements to IRS operations, policies, programs and procedures. Conversely, IRSAC offers an opportunity for IRS executives to bring issues to a diverse group of tax professionals and to solicit input in seeking to resolve critical issues in tax administration.

IRSAC is currently organized into four subgroups. Three of these subgroups correspond to three of the IRS operating divisions. They are the Wage and Investment Subgroup (W&I); the Small Business/Self-Employed Subgroup (SBSE); and the Large and Mid-Size Subgroup (LMSB). The fourth subgroup, the Office of Professional Responsibility Subgroup (OPR), is new to IRSAC this year. OPR was organized under the Information Reporting Program Advisory Committee (IRPAC) but given the mission of the OPR Subgroup, it was more appropriately placed with IRSAC. In 2007 and 2008, IRSAC had a fourth subgroup, the Tax Gap Analysis Subgroup (Tax Gap), but that subgroup is no longer organized under IRSAC.

The current membership of IRSAC offers a broad spectrum of backgrounds and expertise. The 31 members bring many different perspectives and viewpoints but all are committed to bringing meaningful input and feedback to the Service. The members recognize the work and dedication of IRS support staff from the operating divisions, the Office of Professional Responsibility and the Office of National Public Liaison (NPL) whose personnel participated in the IRSAC Subgroup meetings this year. Their assistance has been of the highest order.

During this past year, the IRSAC Subgroups discussed many issues. The economic downturn in the United States and in the global community continues to be a significant factor in some of the issues addressed by IRSAC, and this downturn is explicitly noted in some of the Subgroup reports. The Recovery Rebate Credit claimed on 2008 individual tax returns appeared to be the most significant challenge for the Service during this past filing season. This credit was of course coordinated with the stimulus check payments issued during 2008. IRSAC commends the Service for its on-line tool, "How Much Was My 2008 Stimulus Payment?" This tool worked well and was of great help to both taxpayers and tax practitioners in preparing accurate 2008 individual 1040 returns.

IRSAC applauds the Tax Return Preparer Review initiated by Commissioner Douglas H. Shulman. There was great opportunity for significant input through three public forums, numerous meetings with various constituent groups and the Notice 2009-60 request for written comments. The general public has long had the mistaken perception that the preparation of tax returns is a licensed and/or regulated profession. Too many taxpayers with deleterious outcomes have learned, after-the-fact, that this is generally not true. The members of IRSAC eagerly await the Commissioner's recommendations to the Secretary of the Treasury at the end of 2009 regarding this Tax Preparer Review.

One of the recommendations in the 2008 IRSAC public report was " The IRS should develop a system to identify all paid preparers through the use of a unique identification number." IRSAC continues to support this recommendation with the understanding that this recommendation is to be considered as only one component in any comprehensive set of recommendations that includes the regulation of tax return preparers. The full Council did not discuss the regulation of tax return preparers as an issue during its sessions this year. However, the Council did have a dialogue with the Commissioner regarding the Tax Return Preparer Review at our July meeting, and the OPR subgroup has included a report that offers comments relevant to this topic.

The following issue relating to the contribution of historic preservation easements was first raised by the W&I Subgroup. Because such a contribution is normally taken as a Schedule A deduction, the issue was developed by the same Subgroup. However, it became apparent that the resolution of the concerns that arose from this issue cuts across operating division lines in the IRS. It would not be feasible for the W&I operating division to be solely responsible to address and give consideration to all the comments and recommendations contained in the report written on this issue. Thus, it is being presented as a full IRSAC issue.

Conclusion

The members of IRSAC appreciate the opportunity afforded us to help serve the Internal Revenue Service and ultimately, and most importantly, the taxpayer. It has been an honor to serve in our capacity as Council members. We hope that our input and feedback which come from outside the confines of 1111 Constitution Avenue have contributed significantly to helping with tax administration issues and problems. We have enjoyed the candid conversations with IRS personnel, and we anticipate that this ongoing partnership between IRS and the Council members will continue to be beneficial to the IRS, the tax professional community and the taxpayer.

ISSUE: IRS CHALLENGES TO DEDUCTIONS FOR HISTORIC PRESERVATION EASEMENT DONATIONS

Executive Summary

After the release of Notice 2004-41, the IRS implemented a wide-ranging initiative to audit charitable deductions claimed by taxpayers who made donations of historic preservation easements on real property they own. There is a belief that the current program, in which the IRS takes a very strict view regarding the value of these donations, is having the effect of diluting the intent of Section 170(h) of the Internal Revenue Code, which provides for a tax incentive by means of a charitable deduction for the donation of an historic easement. The current IRS audit effort strains the agency's resources and may fail to distinguish between a legitimate deduction authorized by statute and an abusive tax shelter. Among the changes IRSAC recommends are a safe-harbor audit policy and subject to the requirements of FACA, creation of an expert easement advisory board.

Background

An historic preservation easement (1) is a voluntary legal agreement made between a real property owner (donor) and a qualified easement holding organization (donee) to protect an historic property by restricting future changes to or development of the property in perpetuity.

In 1976, Congress provided a financial incentive to easement donation in the form of a charitable deduction (2). Code Section 170(h) contains the authority for treating an historic preservation easement donation as a "qualified

conservation contribution." A qualified conservation contribution gives rise to a charitable deduction equal to the fair market value of the contribution, as determined by a "qualified appraisal" (a term defined by regulation). The Pension Protection Act of 2006 contained language that adjusted several features of the incentive contained in Section 170(h) including tightening the standards for the "qualified appraisal" that supports the deduction, but otherwise left the deduction intact.

Determining the fair market value of a preservation easement has challenged appraisers and the IRS alike, since preservation easements are generally not bought and sold in a market that values them directly. The tax regulations therefore endorse the indirect, "before and after" valuation method, which calls for determining the fair market value of the underlying property before and after an easement encumbrance, and attributing the difference to the easement.

The difficulty of easement valuation resulted in a series of examinations and subsequent litigation. Following a series of Tax Court cases which sustained taxpayers' contentions that easements diminished the value of their properties, the IRS published a Topical Tax Brief which contained the statement that IRS engineers had concluded "the proper valuation" of a preservation easement was approximately 10-15 percent of the property. This document and the court cases had the collective effect of establishing an informal safe harbor for easement valuation of 10-15 percent, upon which the easement donating public apparently relied. (In 2007, an IRS memorandum stated that no safe harbor had been intended. See footnote 4 below.)

In 2004, the IRS released Notice 2004-41 and announced its awareness that taxpayers "may be improperly claiming" Section 170(h) deductions. Preservation easements were subsequently placed on the IRS's "Dirty Dozen" list of tax scams in 2005 and 2006 and on the 2005 list of tax shelters (3). The Commissioner of the Tax-Exempt/Government Entities Division followed by announcing a large scale initiative: over 1/3 of all easement donors—700 out of his estimated total of 2000—would be subject to pre-audit review.

Practitioners observed that the audit outcome almost always resulted in a zero deduction. The grounds asserted to support this position were several: an easement has zero value where local preservation laws are already in place; use of the 10-15 percent informal safe harbor for easement valuation is not appropriate (4); the appraisal failed the technical substantiation requirements and therefore the appraisal was not a "qualified appraisal" under the regulations.

At the same time, IRS also announced its intention to target some of the donee organizations and some of their officers in New York City, Washington, DC, and possibly other cities. IRSAC is aware that the IRS investigations seek to determine whether the donee is a shelter "promoter," and have included some individuals as well. Extensive document demands are used in such investigations. The result is that some donee organizations have discontinued accepting donations, for fear of promoter penalties; at the same time, donors are understandably reluctant to donate to an organization that is under active IRS investigation.

In 2007, some donee organizations apparently met with the IRS to express concern about the chilling effect of the "zero value" audits on the program. The TE/GE Division Commissioner responded in part:

> The Internal Revenue Service does not believe that all conservation easements, including facade easements, are intrinsically of little or no value. …, Congress, in enacting and amending section 170(h), has clearly endorsed a program to encourage the preservation of certified historic structures. As we administer section 170(h), our goal is to carry out Congressional intent faithfully; we wish to do nothing to discourage or deter the donation of legitimate facade easements (5).

This response, together with the removal of easement donations from the "Dirty Dozen" list in 2007, was temporary, as audit examinations, now including the 2006 tax year, thereafter accelerated and continued to usually disallow easement deductions in full. In the majority of preservation easement audits, the IRS has used a professional appraiser who is an IRS employee rather than relying on an independent outside contractor.

The "Dirty Dozen" listing, the revised IRS donation forms for non-cash contributions and Form 990 changes (which newly flag easement donations), the increased examinations of donee organizations and some officers, the high level of audit coverage without settlements, and Appeals Officers sustaining the audit results, have added to the perception that the IRS is overreaching on this issue.

IRSAC believes the current situation requires both sides to expend scarce resources and often fails to distinguish between a true abusive tax shelter and a deduction that is authorized as part of a statutory tax incentive reflecting the stated policy of Congress to incentivize easement donations.

The litigation from the pending challenges is beginning to result in court decisions. In the 2008 *Whitehouse* (6) case, the Tax Court ruled that the donation of an easement in the historic district of New Orleans did in fact diminish the value of the underlying realty despite strong local preservation laws, in that case by about 15 percent (7). In September, 2009, the Tax Court ruling in *Simmons* (8) upheld the validity of an easement donation on two Washington, DC properties. The IRS argued the donation lacked a "qualified appraisal," and that regardless, the value of the donation was zero. The Court rejected the "qualified appraisal" argument and as to valuation, stated in part, "We agree with petitioner that the easements granted do affect the fair market value of the subject properties," in this case a decrease of 5 percent of the value of the property. Several other cases are pending decision.

There is concern that any donor will hesitate to make a donation, regardless of the quality of the appraisal or the legitimacy of the donation, if the donor knows that he or she is thereby "buying an audit." This struggle of audit/examination/litigation likewise takes place regarding an issue – valuation – that taxpayers, the IRS and the courts have historically recognized as inherently subjective and therefore amenable to a more predictable settlement modality such as a safe harbor. The IRS is no stranger to the use of safe harbors in circumstances that would otherwise consume resources to the exhaustion of both sides. In view of these conflicts, IRSAC makes the following recommendations.

Recommendations

1. Permit a taxpayer to revise the taxpayer's appraisal if an IRS audit determines there is a technical deficiency in the "qualified appraisal" requirements of IRS regulations. For this purpose, adopt the "substantial compliance" standard of Bond v. Commissioner, 100 T.C. 32 (1993).
2. Publish an announcement reaffirming IRS's recognition that historic preservation easements may have a non-zero market value in areas which have local preservation laws, with such value to be determined by a "qualified appraisal" per IRS regulation.
3. Adopt a safe-harbor audit policy that "qualified appraisals" (original or revised) will be accepted (absent clear and convincing evidence to the contrary) when the appraised value of the donated easement is equal to or less than 10 percent of the value of the underlying property.
4. Contract with outside appraisers (rather than using appraisers who are IRS employees) as the general rule, rather than the exception, in preservation easement audits where IRS believes an easement valuation is incorrect and therefore conducts its own appraisal.
5. Process taxpayer requests for audit reconsideration (on audits already concluded) using established IRS audit reconsideration procedures, where such requests are based on recommendations 1-3 above.
6. Consistent with the requirements of FACA, initiate an appropriate process for creating an expert easement advisory board to review appraisals and make non-binding findings where the taxpayer and revenue agent do

not agree on the value of a donated easement.

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(1) The term "preservation easement" is used here to refer to a conservation easement that protects an historic building or structure, sometimes known as a "facade easement," since the easement is made with respect to a certified historic structure. This Issue does not discuss another type of conservation easement, commonly known as an "open-space" easement.
(2) Some states have affirmed this characterization. For example, Virginia's website states: "By donating historic preservation easements on their properties owners are eligible for several financial incentives,"...[including a federal tax deduction.] www.dhr.virginia.gov/homepage_general/finance.htm.
(3) The 2005 “dirty dozen” notice states: “In many cases, local historic preservation laws already prohibit alteration of the home’s facade, making the contributed easement superfluous. Even if the facade could be altered, the deduction claimed for the easement contribution may far exceed the easement’s impact on the value of the property.” IR-2005-19.
(4) Chief Counsel Memorandum 200738013 (Sept. 21, 2007) denied there was ever a "safe harbor," informal or otherwise.
(5) Correspondence from Steven T. Miller to the National Trust for Historic Preservation (March 13, 2008), reproduced in amicus brief in Bruzewicz v. United States, (USDC E.D. Ill., Case No. 07 C 4074).
(6) Whitehouse Hotel LP v. Commissioner, 131 T.C. No. 10 (October 30, 2008).
(7) Whitehouse determined that the “before” value of the property, a New Orleans Ritz Carlton hotel, was $12.1 million and the “after” value $10.3 million, representing an easement value equal to 14.8% of the property. The IRS appraiser testified that the easement was valueless.
(8) Dorothy Jean Simmons v. Commissioner, TC Memo 2009-208 (2009).

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