Deficient Appraisal Reports and Expert Testimony Will Cost Parties Contesting Valuation Issues before the IRS or the Tax Court

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Two recent cases illustrate the importance of good appraisals and good expert testimony when trying valuation issues in the United States Tax Court. The first case is Boltar, L.L.C., et al. v. Commissioner, 136 T.C. No. 14 (April 5, 2011). The taxpayer in the Boltar case took a charitable deduction for the donation of a conservation easement in the amount of $3,245,000. The Internal Revenue Service took the position that the fair market value of the conservation easement was $42,400. Given the discrepancy in the opinions as to value, the weight the court would give to the valuation experts on both sides would be extremely significant.

The court first notes that, under Section 1.170A-7(c) of the Treasury Regulations, 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 granting the restriction. The court cited three deficiencies in the appraisal report filed by the taxpayer:

1. The report did not provide both a before and after value of the subject property;
2. The report did not value all of the contiguous parcels owned by the taxpayer and encumbered by the conservation easement as required by applicable Treasury Regulations; and
3. The 174 unit condominium project that was deemed the “highest and best use” for the property was not physically possible on the 8 acre subject property.

Because of these and other deficiencies in the taxpayer’s appraisal report, the Internal

Revenue Service argued that the report should be excluded upon application of principles expressed in the case of Daubert v. Merrell Dow Pharmaceutical, Inc., 509 U.S. 591 and rules 702 and 703 of the Federal Rules of Evidence. The court then cited the language of Rule 702 of the Federal Rules of Evidence to the effect that the testimony must be based upon sufficient facts or data and must be the product of reliable principles and methods, and that the witness must have applied the principles and methods reliably to the facts of the case. The court concluded that the appraisal report was not admissible under Rule 702 of the Federal Rules of Evidence because it was not the product of reliable methods and assumed unrealistic scenarios rather than the facts of the case. Without any admissible evidence regarding value for the taxpayer, the court found that the value of the conservation easement established by the Internal Revenue Service was correct.

In the case of the Estate of James J. Mitchell, et al. v. Commissioner, T.C. Memo 2011-94 (April 28, 2011), the court again ruled on valuation issues with respect to two parcels of real property and two valuable oil paintings. Both parcels of real property were subject to long term leases, and the expert retained by the taxpayer calculated the fair market value using the income capitalization method. The expert retained by the Internal Revenue Service applied a novel leased buyout method of evaluation.

The court found that the experts hired by the taxpayer used the proper methods for determining value and were most persuasive. In considering the value of the paintings, the court cited the qualifications and experience of the appraisers hired by the taxpayer. The court carefully reviewed the methodology of each appraiser and particularly the use of comparables. Interestingly, the appraisals were reviewed by the IRS Appraisal Office (the art panel) which made a recommendation that contained a wide range of value. The court, after careful analysis, found the appraiser hired by the taxpayer to be more persuasive and held for the taxpayer on all the evaluation issues.

A taxpayer employing a valuation expert to substantiate a non-cash charitable contribution of property should ensure that the expert (i) is qualified to make appraisals of the type of property being valued and (ii) prepares a “qualified appraisal” report, a term that is defined in Section 1.170A-13 of the Treasury Regulations. A qualified appraisal report will include, among many other items, a description of the method of valuation that the expert used to determine the fair market value of the property and the specific basis for the expert’s conclusions, such as comparable sales transactions. Experts that do not customarily prepare appraisal reports to substantiate charitable contribution deductions may be unaware of these and other requirements of a qualified appraisal report, or they may be inexperienced in defending their appraisal reports before taxing authorities and the courts, leaving the taxpayer with inadequate substantiation of the charitable contribution deduction.

The Boltar and Mitchell cases point out the need to select and use qualified valuation experts in all litigation matters involving valuation issues. To hire the cheapest valuation expert is clearly a penny wise and pound foolish approach.

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