# Reliance on Professional Advice Avoids Valuation Penalty

**06.18.2014**

**BY: THOMAS W. ALDOUS, JR.**

In *Whitehouse Hotel Ltd Partnership v. Commissioner*, No. 13-60131 (6/11/2014), the Fifth Circuit Court of Appeals vacated the Tax Court?s enforcement of a gross undervaluation penalty imposed on a taxpayer claiming a charitable deduction for a historic preservation façade conservation easement because the taxpayer obtained a qualified appraisal, analyzed the appraisal, sought a second appraisal, and submitted a professionally prepared tax return.  The Fifth Circuit deferred to the Tax Court?s determination of value.

**Background**.  In 1995, Whitehouse Hotel Limited Partnership (?Whitehouse?) purchased the Maison Blanche building in New Orleans with the intent to renovate it as a Ritz-Carlton hotel and condominium complex with retail space.  The building was listed on the National Register of Historic Places.  In 1997, Whitehouse conveyed a conservation easement to maintain the appearance of the ornate terracotta façade.  Whitehouse claimed a charitable deduction of $7.445 million.  The Internal Revenue Service allowed a charitable deduction of $1.15 million and assessed a gross undervaluation penalty of 40%.

Whitehouse challenged the IRS?s valuation and the penalty in the Tax Court.  In 2008, the Tax Court determined that the value of the easement was significantly less than claimed by Whitehouse and enforced the gross valuation misstatement penalty.  Whitehouse appealed to the Fifth Circuit which, in 2010, remanded the case to the Tax Court for further consideration of value and vacated the penalty.  On remand, the Tax Court made clear that it disagreed with the Fifth Circuit, but revalued the easement as required by the Fifth Circuit and again upheld the penalty.  The Tax Court determined that the pre-easement value was $12,092,301 and the post-easement value was $10.3 million.  Whitehouse again appealed the Tax Court decision to the Fifth Circuit.  The Fifth Circuit accepted the Tax Court?s findings of value, notwithstanding the Tax Court?s pushback and clear disagreement with the Fifth Circuit?s reasoning, but rejected the imposition of the penalty.

**Valuation Methods**.  The Tax Court rejected the reproduction cost approach in valuing the easement because there would be little business reason to restore a historic structure to its

historic form if it were completely destroyed.  The Fifth Circuit pointed out that the easement itself did not clearly require Whitehouse to restore the building if the building was totally destroyed.  The Fifth Circuit accepted the Tax Court?s finding that Whitehouse failed to show that it would be a reasonable business venture to reproduce the building if it were destroyed.  The Tax Court was not obligated to accept the reproduction cost method for valuation of the easement.

The Fifth Circuit also held that the Tax Court was not required to accept the income approach.  The Tax Court determined that Whitehouse?s appraiser?s income model was prone to error and based on too many unverifiable assumptions.  Because of that, the Tax Court was free to reject the income approach.

The Tax court relied on the comparable sale method to determine the value of the conservation easement.  It rejected non-local comparable sales even though Whitehouse?s appraiser concluded that the luxury hotel market is national, rather than local, and even though the IRS?s appraiser also agreed generally with the concept of looking outside the local area for comparables.  The Tax Court agreed that one could look outside the local market, but believed that the local comparisons were more probative of value.  It was not error for the Tax Court to reject non-local comparable sales.

**The Penalty**.  A gross valuation misstatement penalty is imposed if the taxpayer misstates a charitable deduction by 400% or more.  In 1997, a taxpayer would not be liable for the penalty if the misstatement fell within the reasonable cause exception.  To qualify for the exception, the taxpayer needed to show (1) that the claimed value was based on a qualified appraisal made by a qualified appraiser and (2) that the taxpayer made a good faith investigation of the value of the property.  *See* IRC §6664(c).

Since 2006, the reasonable cause exception no longer applies to a gross valuation overstatement.  It does apply to a substantial valuation overstatement.

**Whitehouse Actions**.  The IRS conceded that the taxpayer?s appraisal was a qualified appraisal.  The issue before the court was whether Whitehouse had made a good faith investigation into the value of the easement.

Whitehouse purchased the building for $8 million in 1995.  It was appraised for $96 million in 1997.  The appraiser determined a post-easement value of $88,555,000.

Whitehouse obtained a second appraisal as a check on the first appraisal.  This second appraisal was only for the fair market value of the building.  It was not an appraisal of the easement.  It was performed by a company that, at the time, was a limited partner in Whitehouse.

Whitehouse relied on its tax counsel and accountants.  Its return was prepared by its financial auditors.  Whitehouse did nothing more to investigate the value of its easement.

The Tax Court rejected the first appraisal.  It concluded that Whitehouse should have done more to investigate the value of the property when the appraised value was significantly more than what

Whitehouse had paid for the property just a few years prior.

The Fifth Circuit disagreed with the Tax Court.  It reasserted the principle that when an accountant or attorney advises a taxpayer on a matter of tax law, it is reasonable for the taxpayer to rely on that advice.  Determining whether a taxpayer acts with reasonable cause must be determined on a case-by-case basis.  It said that the Tax Court ?imposed an excessively high standard of proof for actual reliance on the advice of competent tax professionals.?  The Fifth Circuit concluded that Whitehouse?s reliance on qualified tax professionals was sufficient to qualify as a good faith investigation.  Whitehouse had obtained a qualified appraiser, commissioned a second appraisal as a check and submitted a professionally prepared tax return.

**Conclusion**.  Whether a taxpayer has acted with reasonable cause is determined on a case-by-case basis.  However, the Fifth Circuit determined that the Tax Court clearly erred when it enforced a penalty even though the taxpayer had relied on professional advice.  Therefore, taxpayers will want to have tax counsel involved in charitable gifts and have their returns professionally prepared.  Taxpayers might also want to obtain a second appraiser to verify the value of hard to value gifts.  Taxpayers should also be aware that the Tax Court and the Fifth Circuit do not always have the same views on when professional advice is sufficient to avoid an undervaluation penalty.  Therefore, taxpayers can expect that the Tax Court will continue to enforce undervaluation penalties under similar circumstances unless the case is appealable to the Fifth Circuit.

## Related People

## Related Services

- Private Client & Fiduciary Services