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The appraiser – The role in tax planning and reporting - by Marc Nadeau

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Marc Nadeau

Having had the experience of working in public accounting and studying tax law in graduate school, combined with working in the appraisal profession for nearly 40 years, I have come across a great many instances where the appraiser becomes an important person in the lineage of professionals that are often necessary in the tax planning and reporting process. The following are some examples where appraisers and valuation professionals are integral in both the planning and reporting process:

Donated Property
One of most common instances where an appraiser is both instrumental and required is when a value estimate is needed for donated property. "Donated Property" spans a great many genres and can include: real estate, the development rights of real estate, conservation and preservation easements and personal property such as artwork, securities and intellectual property.

The single most important reference guide for both the appraiser and the taxpayer when it comes to donating property is IRS Publication 561. This publication is quite specific when it comes to defining what an appraiser is, what elements need to be included in an appraisal and even the operative date of valuation for gifted property. For example, the appraisal cannot be made any "earlier than 60 days before the date of contribution of the appraised property".

IRS Definition of a
"Qualified Appraiser"
Taken from Page 10 of Publication 561

"A Qualified Appraiser is an individual who meets all the following requirements:"

1. "The individual either:

a. Has earned an appraisal designation from a recognized professional appraiser organization for demonstrated competency in valuing the type of property being appraised or

b. Has met certain minimum education and experience requirements. For real property, the appraiser must be licensed or certified for the type of property being appraised in the state in which the property is located.

2.The individual regularly prepares appraisals for which he or she is paid.

3. The individual demonstrates verifiable education and experience in valuing the type of property being appraised. To do this, the appraiser can make a declaration in the appraisal that, because of his or her experience, education and membership in professional associations, her or she is qualified to make appraisals of the type of property being appraised.

4. The individual has not been prohibited from practicing before the IRS under Section 330 (c) of title

31 of the United States Code at any time during the 3-year period ending on the date of the appraisal.

5. The individual is not an excluded individual."

In addition, the appraiser must complete Form 8283, Section B, Part III.

A Real Life Experience

Some years ago, a prospective client called my office looking for an appraisal of a parcel of land that was being donated to a qualified non-profit organization. This person explained where this parcel was and the size and that it was located close to Long Island Sound in a somewhat exclusive neighborhood. I believe at the time I quoted $1,500 to do the appraisal and explained that the appraisal had to conform to certain reporting requirements. The prospective client responded by saying that "the cost of the appraisal was way too much and they would have a realtor friend do an appraisal." I cautioned the prospective client, but they wanted no part of what I had to say. Approximately one year after this prospective client called me, they called again explaining that they had been audited by the IRS, the donation was disallowed and that they were likely facing a penalty. They were then told to have an appraisal done by an appraiser that was deemed "qualified" by the IRS.

Partial or Fractional Interest Valuations

A partial interest involves the transfer of a fractional interest in a piece of property. A fractional interest transfer can occur in a number of events including that of:

1: Selling a fractional interest in a property;

2: Buying a fractional interest in a property;

3: Gifting a fractional interest in a property; and

4. Inheriting or bequeathing a fractional interest in a property.

In all of the above instances, a discount is typically applied to the fractional interest for both tax and accounting purposes. Typically, the smaller the interest, the higher the discount. The discount in theory reflects the lack of control of the property, often associated with a minority interest.

Partial Interest Value ~ The Concept

Partial interest valuation is a technique used by appraisers and other valuation professionals to estimate the value of a fractional interest in real estate. Fractional interests in real estate result from the owner's ownership of less than 100% of a given property. The technique involves the valuing of a fractional interest in real property with a discount factor being applied to that fractional interest. A partial interest valuation is reflective of what could be a number of factors including, but not limited to the nature of the property, the percentage of ownership, and the management structure in place. An appropriate “discount factor,” chosen by a valuation professional is critical in the partial interest valuation. Ownership of a partial interest in real property ownership can manifest itself in a number of forms. Those ownership forms include, but are not limited to: general partnerships, limited partnerships, REITs, joint tenancy, tenants in common, tenancy by entirety, family trusts and ownership of shares in a limited liability corporation. The transfer or conveyance of a partial interest can arise from any number of events including: divorce, partnership dissolution, estate planning, donation or sale of a partial interest to an unrelated party and so on. In theory, partial interests are almost always worth less than their fractional value. For example, a $1 million property owned by five different owners, each with a 20% interest, would in pure mathematical terms have a value of $200,000 for each interest. That 20% interest, were it to be marketed or sold to another party would be considered a minority interest.

The nature of a minority interest is that it typically has the following characteristics:

• Lack of marketability;

• Longer than typical marketing time;

• Lack of control;

• Limited or no ability to refinance the property; and

• Limited ability to influence decision-making policies.

Discounts associated with a partial interest can typically range from 20% to 60% of the proportionate value of the interest as it relates to the entire property. In the case of the $200,000 fractional interest above, a discount factor would be applied to the fractional value.

The IRS perspective

The perspective or position of the IRS has frequently been that the discount applied to the fractional interest be limited to the actual cost of partitioning a property. The courts fortunately, have generally recognized that this is both unreasonable and illogical. The fact is that fractional interests for the most part have a very limited market appeal to the general marketplace with the range of appeal varying by the type of property and the percentage of ownership.

The IRS Training Manual for Appeals Officers in fact recognizes and cites several factors that could influence the size of the discount. The following factors are listed in the manual:

• The number of owners;

• The size of the fractional interest;

• The size of the tract;

• The use of the land;

• The availability of financing; and finally

• The cost of partitioning (dividing) the land.

Preservation Easements aka Façade Easements

Another type of donation in effect is that of encumbering a property (typically a property with historic fabric or significance or both). Preservation or façade easements involve the granting of a preservation easement to a qualified organization such as the: National Trust for Historic Preservation, Preservation Connecticut, The New Haven Preservation Trust and many other qualified organizations that exist throughout the country.

The granting of the easement must be in perpetuity and include at a minimum preservation of all sides of the structure. Preservation easements in theory create a perpetual responsibility of the property owner to maintain the history property to a certain standard. That standard can include maintaining the physical fabric of the property such as siding, stonework, windows, columns and often precludes the property owner from making any physical changes to the outside of the structure. Sometimes, preservation easements include that of the interior of the structure and, often include an annual inspection by the preservation group that holds the easement and sometimes opening the property to general public for tours at select times of the year.

The valuing of preservation easements can be approached in multiple ways, most commonly by locating and analyzing sales of properties that were encumbered by a preservation easement and comparing the encumbered property to similar properties that were sold but did not have the encumbrance of a preservation easement. Other methods can include costing out the detailed elements of the building fabric that by the easement contract must be preserved and maintained. In today’s costly environment exterior elements such as columns, brackets, cornices, plinths and quoins (often typical architectural elements of period structures) can be very costly, but priced out and a useful-life schedule developed, essentially creating a sinking fund for those protected architectural elements.

IRS Publication 561 also has a section on valuing properties for conservation contributions along with valuing historic properties.

Summary

There are a multitude of circumstances where an appraiser needs to be called in to assist in a tax planning and/or reporting requirement. That reporting requirement typically involves the IRS. Careful planning on the part of the party (s) associated with the property in question can help assure a successful review, saving time and dollars.

Marc Nadeau, SRA, is a certified general appraiser and president of the Connecticut Chapter of the Appraisal Institute.