# INSIGHT: Reverse Loophole Exploited by IRS Threatens Economic Revitalization

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A tax loophole is an ambiguity in the tax code or regulations that allows taxpayers to claim a benefit Congress did not intend. When the IRS becomes aware of loopholes, it closes them through guidance, regulations, or legislative proposals. Ambiguities in the tax law, however, are not one-sided. IRS auditors can and do find "reverse loopholes"—ambiguities in the code or regulations used to deny taxpayers a benefit Congress did intend. Taxpayers, unfortunately, have no power to close reverse loopholes short of litigating against the IRS or lobbying Congress. While taxpayers pursue those time-consuming and expensive remedies, IRS officials justify their approach by reasoning that the enforcement shortcut created by the reverse loophole is necessary to combat abuse. When exploiting a reverse loophole, however, the IRS can inadvertently cause significant harm by discouraging behavior Congress sought to incentivize.

The IRS attack on conservation easement deductions is a prime example of the most dangerous type of reverse loophole—one devised by IRS officials to stem abusive behavior by a subset of taxpayers, but applied indiscriminately. Although the stated goal of IRS enforcement efforts in the conservation easement arena is to deny and deter artificially inflated deductions, IRS auditors and attorneys employ reverse loopholes to deny 100% of the tax incentive across the board rather than engage in the more complicated and time-consuming process of valuing individual taxpayers' charitable donations. These enforcement shortcuts are made possible by reading into the regulations previously undisclosed "requirements" that defy Congressional intent and deter investment by well-intentioned taxpayers.

A recent audit report provides a noteworthy example of how enforcement efforts go awry when IRS auditors slide down the slippery slope of a reverse loophole. Following the typical pattern, the audit report cites a laundry list of alleged shortcomings that each disqualify the claimed deduction in its entirety. One item on that list is the rather remarkable contention that the easement failed to protect the historic façade of an office building because the taxpayer *installed a wheelchair accessible ramp* and bricked in an old elevator shaft to comply with the fire code. Congress could not have intended to incentivize historic property owners to discriminate against individuals with disabilities and put occupants' safety at risk when rehabilitating commercial buildings. Indeed, the state and federal agencies charged with balancing historic preservation ideals with modern property use specifically reviewed and approved those elements of the rehabilitation before IRS auditors untrained in historic preservation decided to deny the tax benefit retrospectively.

This audit report is just one example from an aggressive yet unfocused enforcement campaign the IRS launched against hundreds of partnerships and thousands of investors, justified by pointing the finger at the worst offenders. Analyzing this example in context, however, reveals the scope of the damage that can be caused by IRS exploitation of reverse loopholes. Through its misguided assault on all conservation easement deductions, the IRS is deterring investment in historic rehabilitation projects that are critical to the economic development, cultural vibrancy, and infrastructure stability of communities across the country.

## Promoting Preservation and Rehabilitation of Historic Buildings

Incentives to promote preservation and rehabilitation of historic buildings enjoy broad, bi-partisan support for good reason. As Mayor Stephen Benjamin of Columbia, S.C., attests, historic rehabilitation projects transformed a struggling downtown area into a ''thriving center of residential life and commerce.'' Tax Notes (4/6/20 at 122.) Property values in those areas rose 85%, tax revenue increased by $1.5 million, and jobs doubled. Columbia is not alone. A resolution passed during the recent 87th Annual Meeting of the United States Conference of Mayors recognized that significant, sustainable, and economically beneficial transformation of towns and cities across the country would not have occurred without federal tax incentives for the rehabilitation of historic properties. The tax incentives make it economically feasible to rehabilitate historic buildings, maintaining community connection to cultural identity, rather than destroy that history and build new. For this revitalization of communities to continue, the rules investors must follow to qualify for the tax incentives need to be identifiable and applied in a predictable manner.

To secure adequate funding for a historic rehabilitation project, it is often essential to utilize two federal tax incentives—historic tax credits in tax code Section 47 and deductions for charitable contribution of historic preservation easements in Section 170(h)—along with additional state and local incentives. The IRS, however, takes a radically different approach to these two federal incentives. For historic tax credits, a taxpayer's ability to qualify for the incentive is evaluated in stages across the lifespan of the project by experts in historic preservation who apply published standards and guidelines. For historic preservation easement deductions, a taxpayer's ability to qualify for the incentive is challenged long after the project is complete by IRS auditors who have no expertise in historic preservation, yet invent unpublished ''requirements'' to deny the full value of the incentive through a reverse loophole.

The contrast between historic tax credits and historic preservation easements highlights how far the IRS has strayed from its intended role with respect to easement donations. Indeed, when making the deduction for charitable contribution of a conservation easement permanent, the Senate Finance Committee explicitly acknowledged the ''need of potential donors to be secure in their knowledge that a contemplated contribution will qualify for a deduction.'' Senate Report No. 96-1007 (1980). Rather than provide that security through model easement deeds or effective guidance regarding the value of an easement, the IRS has engaged in a wide-ranging attack on conservation easement deductions that has stymied investor interest and stalled redevelopment efforts.

## Balancing Preservation Ideals with Modern Property Use

Rehabilitation of historic buildings requires balancing preservation ideals with modern property use and governing laws. Designated federal, state, and local agencies employ extensive procedures and recognized standards to ensure that rehabilitation projects preserve historic character while meeting requirements for accessibility and safety. Anyone who seeks a Historic Preservation Certification, which is necessary to claim historic tax credits, must submit a three-part application to the state historic preservation office (SHPO), which then forwards applications to the National Park Service (NPS). The first two parts of the application, which evaluate the historic significance of the building and describe the proposed rehabilitation in great detail, are completed and approved prior to construction, while the third part is a certification that the project was completed in accordance with the approved plan.

The Standards for Rehabilitation, developed by the Secretary of the Interior, are a widely-used guide for federal and state agencies in carrying out their historic preservation responsibilities and have been adopted by historic districts, planning commissions and historic preservation organizations across the country. As defined by the secretary, ''[r]ehabilitation means the process of returning a property to a state of utility through repair or alteration, which makes possible an efficient contemporary use while preserving those portions and features of the property which are significant to its historic, architectural and cultural values.'' 36 CFR 67.2(b). This definition recognizes and affirms that alteration of a historic structure is an inherent part of allowing efficient contemporary use.

Initially developed in 1977 to help property owners, developers, and federal managers apply the Standards for Rehabilitation, the Guidelines for Rehabilitating Historic Buildings provide design and technical recommendations. Notably, the Guidelines devote an entire section to work done to meet accessibility requirements, health and safety code requirements, or energy conservation goals. Specific federal laws, including the Americans with Disabilities Act, require accessibility to certain historic structures and there are rules, regulation, and standards which provide guidance on how to accomplish access in historic areas for people with disabilities. As explained in the Guidelines, ''[t]he goal is to provide the highest level of access with the lowest level of impact'' on historic character-defining features. To achieve this goal, the Guidelines recommend ''working with local disability groups, access specialists, and historic preservation specialists to determine the most appropriate solution to access problems.''

There is nothing in the Standards for Rehabilitation, the Guidelines for Rehabilitating Historic Buildings or any other recognized source of historic preservation principles that suggests that *any* change to a façade defeats the purpose of preserving its historic character. On the contrary, alterations to accommodate modern accessibility and safety requirements are widely acknowledged as an essential aspect of historic rehabilitation.

## Our Example

Our example involves a 5-story industrial building constructed in 1913 that was rehabilitated to serve as an office building in a registered historic district. After a time-intensive process involving deliberate review, significant interaction, and substantial modifications to the initial proposal, both the SHPO and NPS approved the rehabilitation plan.

As required, the developer submitted an extensive, detailed description of the proposed rehabilitation in its Historic Preservation Certification Application. The application proposed a new entry with an accessibility ramp on the exterior of the building and described the efforts to balance preservation of historic character with modern accessibility requirements in detail: ''the switchback ramp will be oriented east-west in order to remain as close up against the building as possible while allowing for appropriate egress space at the top of the ramp and steps'' and will be recessed from the west elevation ''to remain as least intrusive as possible within sightlines of the primary facades.'' The SHPO reviewer paid close attention to the accessibility ramp, requiring certain modifications to the plans. For example, the reviewer found that the proposed stone base on the ramp was too decorative to relate to the historic character of the building and that it should be faced in brick to match the building or left as bare concrete. The developer's architect modified the design for the accessibility ramp multiple times before reaching a consensus with the reviewers from the SHPO and NPS.

The application also described, in detail, the modifications to an old elevator shaft that were required to comply with fire safety codes. Specifically, the proposal explained that the ''existing freight elevator exterior door and subsequent window fenestration within the elevator shaft on the floors above will be infilled with new brick to match the existing, ensuring infill is recessed from the façade to allow the original fenestration pattern to be visible.'' This alteration, which balanced preservation of historic character with fire safety, was likewise reviewed and approved by both the SHPO and NPS.

Although historic preservation specialists designed the accessibility ramp and modified the elevator shaft in accordance with the Standards for Rehabilitation, the Guidelines for Rehabilitating Historic Buildings, and the specific input of both the SHPO and the NPS, the IRS second-guessed all of those experts when it audited the taxpayer's deduction for a historic preservation easement donation. The easement, donated to a reputable non-profit organization that has both the funding and expertise to enforce it, protected the historic character of the façade in perpetuity by requiring that any change conform to the Standards for Rehabilitation and the Guidelines for Rehabilitating Historic Buildings. The IRS audit team, disregarding the nature of rehabilitating a historic structure for contemporary use, identified the accessible ramp and the bricked in elevator shaft as alterations to the original building façade that disqualified the donation.

## Consequences of IRS Audit Approach

Long before launching its recent offensive against conservation easements, IRS recognized that ''Congress wanted to encourage both the rehabilitation of historic structures and the granting of façade easements and provided tax incentives to encourage both.'' Revenue Ruling 89-90. Now, however, IRS auditors with no relevant training in historic preservation are second-guessing the deliberate determinations of experts in the SHPOs and NPS, directly impeding the economic revitalization Congress sought to stimulate through those incentives. IRS auditors utilize a reverse loophole to take the position that *any* change that occurs after an easement deed is granted is a significant alteration to the original building façade and, as a result, the easement fails to protect a conservation purpose in perpetuity. If that were true, the historic preservation easement tax incentive would be unavailable to any property owner who seeks to rehabilitate a historic building rather than observe its demise. The dual tax incentives for rehabilitation and preservation of historic buildings that Congress intended to work hand-in-hand are instead becoming mutually exclusive through IRS exploitation of a reverse loophole. Without both incentives, projects that have the potential to transform communities, increase tax values, provide affordable housing and create jobs will not attract sufficient funding to move forward.

Unpredictable rules deter well-intentioned taxpayers from taking the actions Congress sought to incentivize while simultaneously encouraging abusive taxpayers to push the limits of the ambiguity. When IRS attempts to establish rules through retrospective enforcement rather than prospective guidance, the result is not effective deterrence of abuse. On the contrary, IRS reliance on reverse loopholes in audit and litigation punishes well-intentioned taxpayers, squanders enforcement resources, and impedes Congressional objectives.