GIVE IT AWAY NOW: AN UPDATE ON CONSERVATION EASEMENTS, CHARITABLE DEDUCTIONS, AND SUBSTANTIAL COMPLIANCE (PART 2)

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An earlier version of this article was presented at the May 2018 ABA Section of Taxation meeting.

WHITEHOUSE HOTEL LIMITED PARTNERSHIP

755 F.3d 236 (5th Cir. 2014), affirmed in part and vacated in part, remanded (2012) 139 T.C. 304, (opinion by Judge Halpern) on remand from (2010) 5th Cir, 615 F.3d 321, vacating and remanding (2008) 131 TC 112 (opinion by Judge Halpern)

Overview

The Whitehouse saga reached its final resting place following the second decision by the Fifth Circuit (Whitehouse IV) upholding the Tax Court's valuation finding on remand (Whitehouse III), but vacating the Tax Court's decision to impose gross valuation misstatement penalties due to lack of reasonable cause. While expressing sympathy for the taxpayer's arguments that the Tax Court got "highest and best use" wrong, the Fifth Circuit concluded that the Tax Court's decision did not rise to the high standard of "clear error", thus the Fifth Circuit could not overturn the Tax Court's decision to reduce the value of the façade easement by $5.5 million. For a thorough summary of the Whitehouse trilogy of opinions, see "Conservation Easement Confusion in the Tax Court and Fifth Circuit", 25 *Taxation of Exempts*, No. 1 (September/October 2013) at 32.

Penalties

The Fifth Circuit's decision will be helpful to many taxpayers seeking penalty relief in the conservation easement context. Typically taxpayers donating an easement undertake extensive due diligence to determine the proper value of the easement, including consulting with tax professionals and obtaining a qualified appraisal from a qualified appraiser. While these actions should be sufficient to establish reasonable cause (a defense to accuracy related penalties in most cases), the Tax Court in Whitehouse III said that this was not enough because there was no evidence that the taxpayer made an independent good faith investigation of value or asked its professionals to investigate value. In addition, the Tax Court said that such an investigation was warranted because the taxpayer should have known that value reached in the appraisals it relied upon was too high. The Fifth Circuit disagreed, stating "that the tax court imposed an excessively high standard of proof for actual reliance on the advice of competent professionals with respect to this statutory defense." Instead, establishing "reliance on tax professionals was enough." The Fifth Circuit observed that valuing assets is a difficult task, and especially so in the context of an easement where "the valuation is divorced from a negotiated transaction between buyer and seller.…The easement was a gratuitous transfer; the [charity] did not haggle over price and did not pay a final sale price."

Notably, the Fifth Circuit was "particularly persuaded" by the argument that the Commissioner, the Commissioner's expert and the Tax Court all reached different conclusions. Looking at all the facts and circumstances, the Fifth Circuit held that "[o]btaining a qualified appraisal, analyzing that appraisal, commissioning another appraisal, and submitting a professionally-prepared tax return is sufficient to show a good faith investigation" as required by the reasonable cause exception.

HBU or Second HBU?

However, the Fifth Circuit's failed to discredit the Tax Court's unusual "highest and best" use analysis in Whitehouse III. The Whitehouse III "second-best use" decision appears to be contrary to the law and the regulations. The taxpayer contended that the Tax Court's unusual decision that second highest and best use could determine fair market value violated the Fifth Circuit's previous instruction that a determination of highest and best use other than a luxury hotel must be clearly justified. While the Tax Court's highest and best use remand finding appeared to run afoul of the Fifth Circuit's previous guidance that determination was left undisturbed on review. "Though we did call [the IRS's expert's] opinion 'implausible,' we did not instruct the tax court that it was forbidden to accept it." The Fifth Circuit concluded that "we remanded for the Tax Court to establish explicitly the highest and best use of the parcel for valuation purposes.…it did make the finding we requested." While the Fifth Circuit certainly did not condone the Tax Court's highest and best use determination, it refused to go the extra step of finding clear error. Certainly this "second highest and best use" is something that taxpayers will need to be concerned about in the future, as we anticipate the IRS will be using this standard in earnest to drastically reduce conservation easement deductions.

Comment

The Whitehouse IV decision will be hailed by both taxpayers and the IRS. Taxpayers now have another weapon in their arsenal to defend against penalties, while the IRS will attempt to use the Whitehouse III decision to undermine highest and best use claims by taxpayers.

SCHMIDT V. COMM'R

T.C. Memo 2014-159 (Judge Marvel)

Overview

Schmidt v. Comm'r, (T.C. Memo 2014-159), will be hailed as a "win" for taxpayers due to the court's explicit approval of the discounted cash flow approach ("DCF Approach") to valuing the highest and best use of property subject to a conservation easement. Schmidt relates to a conservation easement granted by Leroy Schmidt on property located in northern Colorado in close proximity to forests and mountains. Mr. Schmidt had purchased the property in May, 2000, as raw land with no development entitlements, but had considered possible development opportunities in the years prior to the granting of the easement.

DCF Used

Schmidt seems to be a significant taxpayer victory and will likely prove important for a few reasons. First, Schmidt is another in a line of cases, which includes, Kiva Dunes T.C. Memo 2009-145, where the Tax Court recognizes and adopts the DCF Approach to value a conservation easement. Not only did the Tax Court in Schmidt

approve of the DCF Approach, but the Court decided to apply the approach as it saw fit, rejecting the analyses of both the taxpayer and the IRS. In calculating its own value under the DCF Approach, the Court adopted and rejected elements of each party's DCF model.

The Schmidt opinion is also important to taxpayers because it outlines a framework for how the Tax Court (or, at least, Judge Marvel) would like to see the DCF Approach applied. The Schmidt opinion contains an extensive analysis of the various factors that go into the DCF Approach, including number of lots, retail lot selling prices, retail lot price appreciation rate, timing to obtain entitlements, lot absorption, development costs, marketing/administrative costs and discount rate. This analysis may serve as a blueprint for appraisers, taxpayers and their representatives when valuing future easements. Applying the DCF Approach using the evidence and stipulations submitted by the parties, the Tax Court arrived at an easement value of $1,152,445, which was about $400,000 less than the taxpayer's value and $600,000 greater than the Service's value. However, given Judge Marvel's extensive analysis, this result should be viewed as anything but a mere "compromise."

HBU Determined by Expert

Finally, Schmidt provides another tool in the arsenal of demonstrating the feasibility of highest and best use. Here, the taxpayer, and his advisors and consultants successfully demonstrated that development was reasonably probable. Specifically, the taxpayer hired an expert to prepare a development plan and the expert provided the taxpayer with a letter confirming that proper zoning would likely be obtained if the taxpayer decided to proceed with development. The Tax Court found that new applications for such subdivision plans would have to be resubmitted to the county, but that the need to resubmit did not impair the feasibility of the proposed development plan. This is in direct contrast to Mountanos v. Commissioner, T.C. Memo 2013-138, where the Tax Court was not able to find that the taxpayer had proven that the proposed highest and best use of the property as a vineyard was reasonably probable.

Unaddressed Issues

While the Service apparently raised issues with the taxpayer's compliance with the technical requirements of section 170(h), those issues were not discussed in the Court's opinion and were presumably conceded by the IRS. In addition, the Court's opinion did not discuss conservation purposes of the easement, which must have likewise been conceded by the IRS.

SWF REAL ESTATE, LLC,

T.C. Memo 2015-c63 (Judge Wells)

Overview

On April 2, 2015, Judge Wells issued his opinion in SWF Real Estate, LLC. The case involved a conservation easement donated in late December, 2005 by the taxpayer to Albemarle County Public Recreational Facilities Authority. (The conservation easement deed was recorded in Albemarle County, Virginia. The case was written up in Checkpoint as a disguised sale case along the lines of Virginia Historic Tax Credit Fund 2001, LP, 107 AFTR 2d 2011-1523 (CA4 2011) and the recent Route 231, LLC, T. C. Memo 2014-30. In this case (following the other two cases just mentioned), the Tax Court found that the taxpayer had engaged in a disguised sale relating to the sale of Virginia tax credits to partners for cash.

Court Addresses Valuation Issues

SWF Real Estate will be seen by the conservation easement world as a big taxpayer win. The facts are not too different from what is normally seen and ended up being a battle of experts. Of interest is how Judge Wells addresses a number of valuation related issues.

While normally it is not logical to start at the end, the taxpayer claimed a conservation easement deduction of $7,398,333, Judge Wells concluded that there was an overstatement of only $48,333, resulting in a deduction of $7,350,000, which is a reduction of only .65 percent .

The Court noted the normal rules set forth in the regulations on how to value conservation easements, including as a first step determining if there is a substantial record of sales of easements comparable to the donated easement. The Court found, however, that in SWF Real Estate there was no established market for similar easements. Accordingly, the Court properly moved on to the before and after analysis to determine the value of the donated easement.

Wells then began to review the valuation reports of the parties. Both of the appraisers were very experienced and used similar approaches in their valuation analysis. Since the case is fairly fact specific, the actual

analysis is not extremely important, but the Court did have to address a few notable issues, discussed below.

IRS argued that the Taxpayer's expert appraiser could not be independent and therefore his report was not credible because the taxpayer had given the taxpayer's expert the appraisal report that had been prepared at the time of the easement (by Mr. Stephen G. Williams) and because there was less than one percent difference between the results of the two appraisals as to the ultimate value of the easement. The Court rejected that argument stating:

> We disagree with respondent. Respondent mistakenly presumes impropriety without proving it, i.e., that Mr. Jones must have been improperly influenced by Mr. Williams' appraisal because he had access to it and because their ultimate results were similar. As petitioner points out, Mr. Jones used different valuation methods and different comparable properties, applied different amounts of adjustments, and determined different values for Sherwood Farm before and after the easement. Moreover, Mr. Jones credibly testified that he referred to Mr. Williams' appraisal only for its description of Sherwood Farm as of December 2005. Accordingly, we conclude that Mr. Jones was not improperly influenced by Mr. Williams' appraisal.

IRS argued that Taxpayer's expert report was not credible because the report did not comply with the Uniform Standards of Professional Appraisal Practice (USPAP). The Court noted the following:

> Uniform Standards of Professional Appraisal Practice (USPAP) are promulgated by the Appraisal Standards Board of the Appraisal Foundation, a nonprofit organization comprising other nonprofit organizations that represent appraisers and users of appraisal services. Whitehouse Hotel Ltd. P'ship v. Commissioner, T.C. 112, 126 n.4 (2008) (citing The Appraisal Foundation, Frequently Asked Questions: https://www.appraisalfoundation.org, rev'd on other grounds, 615 F.3d 321 [106 AFTR 2d 2010-5759] (5th Cir. 2010). USPAP is widely recognized and accepted as containing standards applicable to the appraisal profession. Adherence to those standards is evidence that the appraiser is applying methods that are generally accepted within the appraisal profession.
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> Specifically, respondent contended that petitioner failed to list the proper hypothetical conditions of an appraisal completed after an easement is placed on property and that petitioner failed to list several details required for self- contained appraisal reports. The Court disagreed stating:
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> We have previously held that "[f]ull compliance with professional standards [e.g., USPAP] is not the sole measure of an expert's reliability" and that "a noncompliant valuation report is not per se unreliable." Whitehouse Hotel Ltd. P'ship v. Commissioner, 131 T.C. 112, 127 (2008), rev'd on other grounds, 615 F.3d 321 [106 AFTR 2d 2010-5759] (5th Cir. 2010); see also Schwartz v. Commissioner, 348 Fed. Appx. 806, 809 [104 AFTR 2d 2009-6808] (3d Cir. 2009), aff'g T.C. Memo. 2008-117 [2008 RIA TC Memo ¶2008-117]. In the instant case, we decline to accept the merits of respondent's contentions because, as petitioner notes, respondent has not demonstrated how the alleged technical errors render the Jones report unreliable or that the alleged technical errors are reflective of more significant substantive errors. Accordingly, we decline to find that the Jones report is unreliable solely for any alleged failures to comply with USPAP requirements. Instead, we independently review both reports to evaluate the reliability of each and determine the proper valuation of the easement.

Both appraisers described market conditions that impacted their analyses, and the Court found that the taxpayer's expert did a better job substantiating the adjustments that he assumed. The lack of support provided by the IRS expert was noted as follows:

> The reports applied different rates of adjustment to account for the market conditions at the time of the easement. The Pape report adjusted comparable property sales prices by 10 percent per annum to account for changes in market conditions, but did not provide any support for the 10 percent rate. The Jones report adjusted comparable property sales prices by 12 percent per annum to account for changes in market conditions; Mr. Jones based this rate on a price index released by the Office of Federal Housing Enterprise Oversight stating that home prices increased nearly 13 percent from the end of 2004 to the end of 2005. Moreover, the 12 percent per annum rate comports with credible testimony from Mr. Jones

> and Mr. Lewis regarding the rising real estate market in and around Albemarle County during the end of 2005. Because of great demand and pressure to develop large farm lands into subdivisions, real estate prices in Albemarle County were high and increasing rapidly. Accordingly, we conclude that the Jones report used a more accurate rate of adjustment for market conditions and therefore more accurately adjusted the values of comparable properties than the Pape report to account for improving market conditions.

The Court's analysis of comparable sales was not very instructive to us because of the factual nature of that analysis. However, the Court did note the importance of the proximity of comparable properties to the subject property, the relative size of the comparable properties to the subject property, the similarity or not of the topography of the comparable properties (including slope issues and existence of a floodplain) and the difference in time of sale between comparable properties and the subject property.

Additionally, the Court went into great detail about the types of adjustments and the methods of adjusting the values of the comparable properties, noting specifically a number of errors made by the IRS expert (Pape) that caused the Court to question the overall reliability of the IRS expert's report.

In contrast, the Court did not note any significant material errors during its review of the taxpayer's appraiser's report.

The Court also noted that the IRS contends that Mr. Jones (taxpayer's expert) also made inconsistent adjustments in the Jones report with respect to the sizes of some of his comparable properties.

> In particular, respondent contends that Mr. Jones failed to adjust the value of Blenheim Road downward even though he adjusted the value of Route 612 and Greenmont Farm downward and the three properties are roughly similar in size. We disagree. As petitioner contends, Mr. Jones properly determined that for purposes of the before-easement valuation analysis Blenheim Road would be included in the same size category as Sherwood Farm because both had similar development potential. However, for purposes of the after-easement analysis, a size adjustment was necessary because there was a significant difference between the marketability of Sherwood Farm, which was a 674.65-acre tract of land that could be used only for farming, and the much smaller Route 612 and Greenmont Farm properties, which could possibly be sold to estate home-buyers. Accordingly, we find no inconsistency in Mr. Jones' adjustments.

This analysis shows the Court's disdain for errors, omission and inconsistencies, which the Court found in spades in the IRS report and generally not existent in the Taxpayer's expert report.

The Court's Conclusion

The Court's conclusion regarding how it viewed the two expert reports cannot be improved:

> The Jones report properly accounted for the restrictive nature of the easement and the market conditions at the time of the easement; used more numerous and more accurate comparable properties than the Pape report; and avoided other errors and inconsistencies when adjusting the values of those comparable properties. While we find the Pape report, to be burdened by multiple errors and inconsistencies, we find no reason to question the credibility of Mr. Jones or the reliability of the Jones report. Accordingly, we conclude that the Jones report provided an accurate valuation of the easement on Sherwood Farm and, therefore, that the value of the easement for purposes of a charitable contribution deduction is $7,350,000.
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> On its 2005 Form 1065, SWF reported a charitable contribution of $7,398,333 for its donation of the easement to Albemarle County PRFA, on the basis of a valuation prepared by Mr. Williams. Mr. Williams did not testify at trial, and petitioner relies only on the Jones report for the proper valuation of the easement. Consequently, we conclude that SWF overstated its charitable contribution deduction for its 2005 tax year by $48,333.

CAVE BUTTES V. COMM'R,

147 T.C. No. 10 (Sept. 20, 2016). (Judge Holmes)

Overview

The facts of this case are long and convoluted, involving multiple owners coming into ownership at different times, assuming various roles, and

multiple government entities with different points of view towards the deal. For purposes of this outline, the following facts will suffice:

The taxpayer, Cave Buttes, LLC, consisted of three partners and owned 11 acres in somewhat close proximity to Cave Buttes Dam in the Phoenix, Arizona area. One of the partners, Wolfe, had previously purchased the land sight unseen for the "unbelievable" price of $100,000 in February of 2004 prior to the other partners obtaining an interest. Due to each partner's somewhat differing opinions on how to develop the land, Cave Buttes, LLC, divided those 11 acres into three parcels to expedite dissolution of the partnership, if that proved necessary. The taxpayer became frustrated at the various red tape and other local government pushback it was receiving for its plans to develop the subject parcel. Apparently, local and state authorities were fighting the development over safety concerns for the dam, as well as other zoning and access rights issues.

Eventually, the taxpayer had enough of the fight and started looking at options for the property other than development. Cave Buttes, LLC came to the conclusion that a bargain-sale to the local Maricopa County Flood Control District was its best course of action. The District obtained an appraisal in October 2006, which valued the 11 acres at $765,000. Importantly, that appraisal determined—based on a phone call with a local government employee—that the property was a legally and physically inaccessible home-site.

The taxpayer found this determination "absurd" and sought its own appraisal. In May 2007, it hired two MAI appraisers to reappraise the 11 acres and with the intention of acting prudently decided to use the lower of those two appraisals ($1.5 million rather than $2 million) to substantiate its claimed charitable deduction. The taxpayers completed this transaction receiving $735,000 in cash and taking a charitable deduction for the "bargain" aspect of the transaction ($765,000). The IRS challenged the deduction claiming both technical deficiencies and overvaluation concerns. Subsequently, the taxpayer obtained a third appraisal in preparation for trial, which valued the property at $2.16 million.

Substantiation Issues

The Commissioner raised five substantiation issues regarding the appraisal Cave Buttes utilized to value its deduction for the bargain sale transaction: (1) The appraisal was not prepared by a qualified appraiser and did not include the qualification of the appraiser who prepared the report; (2) the appraisal did not include a sufficiently detailed or accurate description of the property; (3) the appraisal did not include a statement that the appraisal was prepared for income-tax purposes; (4) the date of value is not the date of the purported contribution; and (5) the appraisal utilized a definition of fair market value that was different than the definition provided by Treasury Regulations. The Tax Court addressed each of these claims in turn.

The Appraisal was not prepared by a Qualified Appraiser and did not include the Qualifications of the Appraiser Who Prepared the Report

The Commissioner took a hard line regarding a certain factual anomaly in this case. The appraisal that Caves Buttes chose to utilize for its tax return was actually prepared by two individuals; however, only one of those two people signed the appraisal summary (i.e., Form 8283). The Tax Court took issue with the Commissioner's position in large part because in 2007 when that appraisal was prepared the instructions to Form 8283 did not address who should sign in the case of multiple appraisers. Those instructions were amended in 2012 and now express that in the case of multiple appraisers both must sign the appraisal and Form 8283.

The Tax Court noted that while these instructions were changed in 2012, Form 8283 "to this day includes only one signature line." The court acknowledged that instructions do not carry the weight of law, but explained that "they are useful in illustrating understandable taxpayer confusion." The court reasoned that taxpayers must have been getting confused by these instructions: "Why else would the IRS have changed the instructions to be more clear?" Accordingly, the Tax Court found that Caves Buttes, LLC had substantially complied with the appraisal summary requirements; notwithstanding the failure of one of the appraisers to sign Form 8283. It seems unlikely that the Tax Court would reach a similar decision if the appraisal summary had similar deficiencies under the new instructions to Form 8283.

The Tax Court similarly found substantial compliance with the Regulation when that same appraiser—who failed to sign Form 8283— did not attach his resume to the actual appraisal. The court found that the taxpayer clearly did not strictly comply with Regulation, which requires the appraiser's qualifications to be attached to the qualified appraisal. However, likening the case

to its prior holding in Bond, the court found that the taxpayer had substantially complied with the Regulation because the other appraiser's "qualifications were included in the appraisal, and the Commissioner never previously questioned until post trial briefing whether [the omitted appraiser] was a qualified appraiser."

The Appraisal did not include a Sufficiently Detailed or Accurate Description of the Property

The Commissioner made what the court characterized as a "Gotcha" argument by asserting that the property was improperly described because it was not—in the Commissioners view—three separate lots when transferred. Notwithstanding that Caves Buttes validly recorded the properties division into three lots in February 2007, received stipulations from the District that the property was in fact three lots when transferred in April 2007, and submitted an appraisal of the three-lot property in May 2007, the Commissioner attempted to deny the claimed deduction because it interpreted Arizona law to only effectuate a property split "when the county assessor completes his identification and valuation of the resulting parcels", which did not occur until August 2007.

The court was quick to dismiss the Commissioner's argument pointing out that the statute it relied on pertained to property-tax valuation, which in no way affects the property's value, and that the property division was legally enforceable when recorded in February 2007. This issue should have been resolved much earlier in the proceedings.

The Commissioner raised other concerns regarding the accuracy of the property's description in the appraisal because of the appraiser's characterization of certain evaluative factors. Specifically, the Commissioner took issue with an apparently inaccurate description (difference in one-quarter of a mile and three-quarters of a mile) of the proximity of utilities to the property, as well as the access afforded to the property. The court disagreed with IRS over the purpose of the regulation's requirement that a qualified appraisal adequately describe the property. "We also think these arguments about utilities and access miss the point of the regulation's requirement that an appraisal describe the property. Since the purpose of this requirement is to let the IRS know what's being donated, a description by address and characteristics is enough to strictly comply with the regulation."

The Appraisal did not include a Statement that the Appraisal was prepared for Income-Tax Purposes

The most enigmatic argument put forth by the Commissioner in its all-out attack on this particular appraisal's qualifications was that the appraisal failed to include a statement that it was prepared for income tax purposes. The qualified appraisal contained the following language, "[t]he purpose of this appraisal is to estimate the current Market Value of the fee simple interest in the subject as of the date of the valuation *for filing with the IRS*." (Emphasis added). The court quickly dismissed the IRS contention "that there are magic words required to fulfill this requirement." The court stated that "for filing with the IRS" certainly substantially complied, if not strictly complied, with the regulation's requirement that the appraisal state it was prepared for income tax purposes.

The Date of Value is not the Date of the Purported Contribution

The Commissioner claimed that the appraisal was not qualified because the deed was signed, delivered, and accepted at least 11 days and possibly as many as 21 days prior to the date of valuation for the appraisal. The taxpayer's relied on the Tax Court's holding in Dunlap for the proposition that the appraisal substantially complied with the regulation.

In Dunlap, the appraisal's valuation date was merely one day prior to the date of donation, whereas the taxpayers in Cave Buttes were at least 11 days and possibly 21 days after the date of the bargain sale. In what can only be described as a win for taxpayers, the court found that the substantial compliance doctrine cured the technical noncompliance, because this deal had "a number of moving parts and a somewhat vague closing date."

The court reasoned that "[w]ithout any significant event that would obviously affect the value of the property in those two or three weeks, we agree with Cave Buttes that it substantially complied with the regulation."

The Appraisal Utilized a Definition of Fair Market Value that was Different than the Definition Provided by Treasury Regulations

The Commissioner contested the taxpayer's experts definition of fair market value, which utilized a definition of fair market value established under the Financial Institutions Reform, Recovery, and Enforcement Act

of 1989. The court quickly disposed of this assertion as the definition in the 1989 Act covered all of the requirements of the Regulation's definition of fair market value.

The court noted that the Commissioner only argued that this definition did not strictly comply with the regulation, which the court interpreted as a concession to the taxpayer's claim of substantial compliance. Ironically, the contested fair market value definition that the taxpayer's appraiser used was the very same definition that the Commissioner's own expert used in its appraisal report.

Valuation

Cave Buttes is a taxpayer friendly decision on the issue of valuation and highest and best use. The relevant issue before the Tax Court was "the fair market value of the property. If Cave Buttes is right, that value is greater than what it claimed on the return; if the commissioner is right, that value is less."

The court disagreed with the Commissioner's expert-appraisal because it erroneously claimed that the taxpayer's lacked legal or physical access to the property. Instead, the court found that the taxpayer had "an exceptionally strong claim" to access rights via at least three separate legal rights: After establishing that Cave Buttes, LLC had access to the property, the court shifted its analysis of value to the properties highest-and-best-use based on various zoning restriction. As mentioned, above, the reason for the bargain-sale transaction was the government push back and other red- tape that the taxpayer was experiencing in its efforts to develop the property. The taxpayer argued "that the property was improperly downzoned and the ease of rezoning should have been considered in the highest-and-best-use analysis."

The Commissioner argued that the property's value should not incorporate development of the property that the taxpayers decided not to undertake due its pursuance of the bargain-sale transaction in lieu of development. Essentially, the Commissioner implies that Cave Buttes, LLC would have to actually develop the property to be able to take a deduction equal to value under such a use. In rejecting the Commissioner, the court was emphatic that current use does not define or restrict the potential highest- and–best-use and that value must consider that potential highest-and-best- use assuming such a use is substantiated. "The steps that [the taxpayer] could reasonably and probably take within a reasonable proximity to the valuation date *must* be factored into the valuation." (Emphasis added).

- PBBM-Rose Hill, Ltd. v. Comm'r, No. 26096-14 (Oct. 7, 2016) (bench opinion Judge Morrison) on page 29.

SUBSTANTIAL COMPLIANCE—8283—QUALIFIED APPRAISAL/APPRAISER

SCHEIDELMAN V. COMM'R

682 F.3d 189 (2d Cir. 2012) vacating and remanding T.C. Memo. 2010–151. (Judge Cohen)

Overview

Scheidelman involved an architectural easement on a townhouse in Brooklyn.

In T.C. Memo 2010-151, the Tax Court found that the appraisal was not a "qualified appraisal." The Tax Court also denied deductions for the cash contribution made by the taxpayers, but concluded that the taxpayer acted in good faith and with reasonable cause, and therefore was not liable for penalties.

Second Circuit vacated Tax Court Holding

Second Circuit Court of Appeals vacated the Tax Court holding, finding the appraisal was a qualified appraisal because it: (1) adequately specified the appraiser's method of determining the easement's fair market value; and (2) adequately specified the basis for determining the easement's fair market value. The Second Circuit also allowed the deduction for the cash contribution and found that an incomplete Form 8283 "substantially complied" with the requirements.

Tax Court Remand

On remand, T.C. Memo. 2013-18, Tax Court assigned zero value to the easement.

ROTHMAN V. COMM'R

T.C. Memo. 2012-218

"Qualified appraisal" issue similar to Scheidelman; original opinion, T.C. Memo. 2012-163). In supplemental Opinion, Tax Court acknowledged that the 2nd Circuit's opinion in Scheidelman was controlling precedent (Golsen Rule) (Judge Laro)

Tax Court vacated its previous finding that taxpayer's appraisal was not a qualified appraisal because of the two "qualified appraisal" requirements (statement of method and basis of value) previously addressed by the 2nd Circuit. However, Tax Court nonetheless found the appraisal to be unqualified, based on failures to meet other requirements for qualified appraisals.

DUNLAP V. COMM'R

T.C. Memo. 2012-126

In Dunlap, the easement encumbered the Cobblestone Loft Condominium, which is a seven-story loft building in the Tribeca North Historic District of New York City. All of the petitioners owned units within Cobblestone during 2003. The Cobblestone board of managers (the "Cobblestone Board") had general oversight over the property and consisted of five people who are elected at an annual meeting.

In 2003, the Cobblestone Board was introduced to the National Architectural Trust ("NAT") regarding the potential for a conservation easement over the façade of the Cobblestone Loft Condominium. The Cobblestone Board granted the façade conservation easement to NAT in December of 2003. The facade easement deed restricts the Cobblestone Board's ability to undertake any alteration, construction, or remodeling of Cobblestone's facade without the express written consent of NAT.

The IRS raised many technical and value related contentions with respect to the easement donation, including:

- The Cobblestone Board did not have power to grant a facade easement to NAT;
- The façade easement deed was not recorded until 2004, rendering the deductions claimed in 2003 invalid;
- Petitioner's Form 8283 failed to adequately substantiate the charitable deductions;
- The façade easement granted is invalid under section 170(h) and the related regulations;
- Even if the façade easement were valid, it had no value;
- Cash payments to NALT were not deductible gifts; and
- The petitioner was subject to accuracy related penalties.

The court did not address most of these contentions because it determined that the easement had no value, rendering an analysis of the other IRS contentions unnecessary: "Because we find that the facade easement donated to NAT had no value, we only address that argument, the cash contribution issue, and the accuracy-related penalties."

Important to the court's analysis was a determination that the burden of proof would not shift from the petitioners to the respondent under Code section 749(a)(1). The court made this determination because the "petitioners failed to introduce credible evidence with respect to the fair market value of the facade easement donated to NAT and, as a result, section 7491(a)(1) does not shift the burden of proof to respondent with respect to that issue."

The court refused to give "any probative weight" to the petitioners' expert reports because it determined that their experts' conclusions as to value lacked credibility. Therefore, the court determined that the petitioners failed to produce sufficient credible evidence with respect to the easement's fair market value and disallowed the petitioners' deduction. "Considering the expert reports and other evidence, we find that petitioners have failed to meet their burden of proving that the value of the Cobblestone facade easement was greater than zero. We conclude that petitioners are not entitled to any deductions resulting from donation of the Cobblestone facade easement."

The court did find that the taxpayers substantially complied with their appraisal summary—Form 8283—requirements, even though the Form 8283 omitted the taxpayers' cost basis in the donated easement, when the donor acquired the property it donated, and how the donor acquired the property it donated. The court reasoned the petitioners had filled "in the most pertinent information on their Forms 8283." The court also noted that the instructions to Form 8283 indicate that the portions omitted by the petitioners "are not absolutely necessary," and the regulations provide for reasonable cause exceptions for omissions. This seems to conflict with the Tax Court's en banc opinion in RERI Holdings, I, discussed below.

FRIEDBERG V. COMM'R

T.C. Memo 2013-224 (Judge Wells)

Overview

The Tax Court held that an appraisal submitted by the taxpayer was a "qualified appraisal" as defined in Treasury Regulation Section 1.170A-13(c)(3) and rejected the IRS's claim that the appraisal was not qualified because it was not reliable and improperly applied the methodology used to value the property. In doing so, the Tax Court reversed its earlier decision to grant a summary judgment in favor of the IRS.

Second Circuit Impact

Taxpayer had filed a motion for reconsideration following the Second Circuit's decision in Scheildelman v. Comm'r (682 F.3d 189 (2d. Cir. 2012)). In Scheildelman the Court of Appeals held "it is irrelevant that the… [Commissioner] believes that the method employed was sloppy or inaccurate, or haphazardly applied." Applying the standard, the Tax Court held, "any evaluation of accuracy is relevant for purposes of deciding whether the appraisal is qualified." Whether the appraiser properly applied the methodology was not relevant, so long as the appraisal provided the IRS with sufficient information to evaluate the underlying methodology. Finally, Tax Court held that (under Scheildelman) the analysis in the appraisal need not support its conclusion, so long as "it was 'incontestably there.'"

Tax Court also rejected the IRS's attempt to disqualify the appraiser. Service presented evidence from a deposition in which the appraiser admitted that he had never valued certain development rights that were part of his valuation of the easement. The Tax Court held that under the plain language of the regulation, the appraiser need only make a declaration that he or she is qualified to make the appraisal: "the regulation does not direct the Commissioner to analyze the appraiser's qualifications to determine whether he or she has sufficient education, experience, or other characteristics." Therefore, even if the appraiser's declaration is "unconvincing" the appraiser still meets the qualified appraiser standard under the Treasury Regulations as long as the requisite declaration is present.

In sum, an appraisal constitutes a qualified appraisal under this case as long as it meets the technical requirements of the regulations, regardless of accuracy or reliability. In Friedberg, the Tax Court held that the appraisal qualified because it stated the methodology applied by the appraiser and outlined the specific basics for its conclusion, despite the fact that the court "questioned whether the appraisal is reliable or properly applied methodology to reach its conclusions" and that the court explicitly disagreed with the appraiser's analysis. Similarly, the appraiser qualified because his declaration met the requirements of the treasury regulations, even if statements in the declarations were unsupported by facts discovered by the IRS.

GORRA V. COMM'R

T.C. Memo 2013-254 (Judge Kerrigan)

Overview

The Tax Court ruled on "Qualified appraisal" issue similar to Scheidelman; and also in 2d Circuit). In responses filed August 24, 2012, IRS denied that Scheidelman was controlling precedent (notwithstanding the Golsen Rule).

Comment

More detailed requirements for qualified appraisals were enacted beginning with the 2006 tax year (PPA of 2006). IRS claimed that these rules create a functionally different "statutory scheme" under which a "qualified appraisal" is evaluated. The Tax Court in Gorra seems to have rejected that claim of a new statutory scheme as a result of the PPA of 2006.

IR 2014-31

Overview

News release announces that the IRS office of Professional Responsibility (OPR) has reached a "settlement" with a group of appraisers accused of participating in the understatement of federal tax liabilities by overvaluing façade easements given pursuant to Section 170(h) of the Code.

Under this settlement, the appraisers admitted to violating Sections 10- 22(1) and (2) of Circular 230, which means they admitted to a failure to exercise due diligence in the preparation of documents relating to IRS matters and failing to determine the correctness of written representations made to the Treasury Department. The appraisers agreed to a 5 year suspension from valuing façade easements and "undertaking any

appraisal services that could subject them to penalties under the Code".

A similar fate was imposed upon another appraiser in early 2013, but the restrictions on that appraiser were made permanent in a court order that imposed restrictions through a permanent injunction.

A similar injunction was slapped on the Trust for Architectural Easements in 2011 relating to different concerns that the IRS worried about in July, 2011.

ZARLENGO V. COMM'R

T.C. Memo 2014-161 (Judge Vasquez)

Overview

In Zarlengo, et al v. Comm'r (T.C. Memo. 2014-161), the Tax Court issued a limited "win" for the taxpayer, holding that substantial compliance with the substantiation regulations was sufficient to support the taxpayer's claim for a façade easement donation. The Tax Court did, however, disallow the charitable deductions claimed in the year the easement was granted because the easement deed was not recorded until the following year, holding that the perpetuity requirement was not met until the deed was recorded, thus only a portion of the carryover deductions could be claimed. In addition, the Tax Court slashed the value of the easement and imposed penalties for gross valuation misstatement in the later years.

The taxpayers, a divorced couple, donated a façade easement on a townhouse that they jointly owned to the National Architectural Trust (the "Trust"). The husband deducted the full amount of his half of the charitable contribution in 2004, the year the taxpayers donated the property to the Trust. The wife deducted only a portion of the charitable contribution in 2004 and carried the remainder over into 2005 through 2007. Though the conservation easement deed was signed in September 2004, the Trust did not record the deed until January 2005. The IRS claimed the "contribution date" of the conservation easement was not until January 2005, when the deed was recorded. The IRS also argued that the taxpayers failed to properly substantiate the value of their donation pursuant to the Treasury Regulations.

Applying New York law, the Tax Court held that the contribution did not occur until the following year when the deed was recorded (and therefore legally enforceable against subsequent purchasers) because prior to that time the easement was not protected in perpetuity. As a result, the deductions taken in 2004 were disallowed. The Tax Court then concerned whether deductions carried over into 2005 through 2007 could be taken by the wife taxpayer.

The IRS argued that the deductions in the later years should be disallowed because the appraisal filed with the return failed to comply with several of the substantiation requirements outlined in the Treasury Regulations, including: (1) the appraisal was prepared more than 60 days prior to the contribution; (2) the appraisal failed state the date or expected date of the contribution; (3) the appraisal failed to provide the terms of any agreement or understanding; (4) the appraisal failed to determine the "fair market value"; and (5) the appraisal was not prepared by a qualified appraiser because an employee of the appraisal assisted in the drafting of the report.

Substantial Compliance

While the appraisal arguably failed to comply with each of these requirements, the Tax Court held that the appraisal substantially complied with the requirements in Treasury Regulation 1.170A-13(c)(3) where: (1) the date of the appraisal was within 60 days of the signing of the deed in September 2004 (as opposed to the January 2005 recording date); (2) in the appraisal summary the Trust acknowledged that it received the easement on September 22, 2004; (3) the appraisal report attached a copy of a sample deed; (4) the term "market value" as defined in the appraisal report was close to the definition of "fair market value" in the regulations; and (5) there was no indication that the opinions or conclusions in the appraisal report were those of anyone other than the appraiser who signed the report. Accordingly, the taxpayer satisfied the requirement to substantiate her conservation easement.

Value

The Tax Court then considered the expert testimony as to value, finding that both experts were not completely reliable and that each expert report served as more of an advocacy piece. Of note, the Tax Court dismissed the Service's expert, finding that his "conclusory analysis demonstrates his preconceived notion that conservation easements have no value." Instead of adopting the value proposed by either expert, the Tax Court chose a value between the two, finding that

the easement caused a 3.5 percent diminution in value of the property, reducing the claimed easement value from $660,000 to $157,500.

Penalties

With respect to penalties, the Tax Court found that the taxpayers established reasonable cause for the claimed deduction, thus penalties did not apply for the 2004 and 2005 tax years. However, the 2006 changes to the penalty provisions by the Pension Protect Act converted the gross valuation misstatement penalty (i.e., claiming the value of property is 200 percent or more than the amount determined to be correct) to a strict liability penalty. As a result, any understatement in the wife's 2006 and 2007 return was subject to the 40 percent gross valuation misstatement penalty. This is a good reminder to taxpayers that valuation problems in post-2005 returns can lead to hefty penalties.

GEMPERLE V. COMM'R

T.C. Memo. 2016-1 (Judge Halpern)

Overview

In Gemperle, two pro se taxpayers quickly learned the harsh complexities of conservation easement law first-hand while defending a façade easement granted over their Chicago residence. The taxpayers' appraiser, who was selected from a list provided by the donee, valued the easement contribution at $180,000. The taxpayers failed to attach a copy of the appraisal report to their return and failed to fully complete the Form 8283 appraisal summary as required by law. Further complicating the situation, the taxpayers also failed to include the appraiser on their witness list for trial.

The Trial

At trial, the court granted the IRS's motion to exclude the taxpayers' appraisal from evidence, holding that the taxpayers' failure to produce their appraiser as a witness for trial deprived the IRS of its right to cross-examine the expert witness at trial. The court then disallowed the deduction entirely because of the taxpayers' failure to comply with the technical requirement that a qualified appraisal be attached to the filed return on which the easement deduction was claimed. After reaching these two conclusions, the issue of accuracy-related penalties was all that remained.

In addition to testifying themselves, the taxpayers called three other witnesses at trial. However, none of these witnesses were qualified as experts nor did any of the witnesses purport to value the easement. Instead, the only evidence of value in the record came in the form of an IRS appraisal that concluded the façade easement "had a value in the range of zero to $35,000." Noting that the taxpayers "failed to furnish admissible evidence that their façade easement had any determinable value," the court concluded that the value of the façade easement was $35,000 which represented the "high end" of the range established by the IRS's appraisal. Based on this value, the court concluded that the taxpayers overvalued the easement by more than 200 percent on their returns and were therefore liable for the 40 percent gross valuation misstatement penalty.

Penalties Applied

Like the decision in Bosque Canyon Ranch, T.C. Memo. 2015-130 this case represents another instance in which accuracy- related penalties have been applied where a charitable deduction was disallowed for purely technical reasons. While the Bosque Canyon Ranch court applied accuracy-related penalties without ever addressing value, the court in Gemperle made a value determination in order to assess the gross valuation misstatement penalty. As long as the gross valuation misstatement penalty is in play, we anticipate that the IRS will continue to make valuation an issue in future cases where the deduction is disallowed on purely technical grounds.

RERI HOLDINGS I, LLC V. COMM'R

149 T.C. No. 1 (July 3, 2017). (Judge Halpern)

Overview

The Tax Court dealt a blow to taxpayers in RERI Holdings I, LLC v. Comm'r, 149 T.C. No. 1 (2017) ("RERI Holdings"). The taxpayer—RERI Holdings I, LLC—purchased a remainder interest in an LLC owning real property (a web hosting facility in Hawthorne, California leased by AT&T) for 2.95 million dollars and donated the remainder interest to the Regents of the University of Michigan three days later claiming a charitable deduction in excess of 33 million dollars. In RERI Holdings, the Tax Court disallowed a taxpayer's $33 million charitable deduction in total because the donor did not report

the cost or adjusted basis of the donated property on IRS Form 8283.

When completing IRS Form 8283 (an attachment to the tax return), the taxpayer (or likely, its tax professional) left blank the space for "Donor's cost or other adjusted basis." The Tax Court determined that omitting the donor-taxpayer's cost or adjusted basis from IRS Form 8283 caused the donation to fail to comply with Treasury regulation section 1.170A- 13(c)(4)(ii)(E). Accordingly, the taxpayer's entire deduction was disallowed. To add insult to injury, the Tax Court also imposed a harsh penalty for a "gross valuation misstatement."

Comment

RERI Holdings is surprising in light of the Instructions to IRS Form 8283, which indicate that the cost or adjusted basis may be left blank if the taxpayer has reasonable cause for not completing the form and attaches an explanation of that reasonable cause. Moreover, the Instructions to Form 8283 indicate that taxpayers' deductions will not be disallowed for failing to complete Section B of IRS Form 8283, if the taxpayers provide the IRS a complete IRS Form 8283 within 90 days of IRS request. The court's holding does not indicate if the taxpayer attached an explanation for why the basis was not provided or subsequently provided the basis within 90 days of IRS request.

The taxpayer in RERI Holdings donated a remained interest in property, not a conservation easement. And while the IRS Form 8283 substantiation requirement applies generally to all contributions of property, there are specific provisions in the Instructions to IRS Form 8283 (Rev. 2014) for contributions of conservation easements. The IRS provides specific provisions in the Instructions to Form 8283 to clarify how donors should complete IRS Form 8283 for property possessing unique characteristics, such as conservation easements. It is arguable that RERI Holdings should not apply in the conservation easement context because the specific provisions impart different regime of rules for completing IRS Form 8283.

MECOX PARTNERS, L.P., V. UNITED STATES

2016 WL 398216 (S.D.N.Y. Feb. 1, 2017)

In Mecox, the taxpayer donated an open space and architectural façade easement over a historic building in the Greenwich Village Historic District. The taxpayer and the National Architectural Trust (the "NAT") executed a document entitled "Conservation Deed of Easement" in December 2004. The taxpayer claimed a deduction on its 2004 1065 tax return claiming a $2.21 million deduction, which was filed in July 12, 2005. However, the Deed of Easement was not recorded with the New York City Department of Finance, Office of the City Register until the following calendar year, on November 17, 2005.

In granting the government's motion for summary judgment, the Southern District of New York held "[a]s a matter of law, Mecox did not make a "qualified conservation contribution" in 2004, because the Conservation Deed of Easement was not effective until it was recorded on November 17, 2005." The consequence of this recording error was a total disallowance of the taxpayer's $2.21 million deduction.

The district court explained that "in a federal tax controversy, state law governs the taxpayer's interest in the property while federal law determines the tax consequences of that interest." The case deals a great deal with recording laws in New York—an analysis of which is beyond the scope of this outline—but to summarize the courts analysis it determined that "[u]nder New York law, an instrument purporting to create, convey, modify, or terminate a conservation easement is not effective unless recorded."

The court also supported its decision with references to the Tax Court's opinion in Zarlengo, discussed above.

PERPETUITY — DURATION OF TIME

WACHTER V. COMM'R

142 T.C. No 7 (Mar. 11, 2014) (Judge Buch)

Overview

The Tax Court agreed with the IRS that a conservation easement in North Dakota was disqualified for a charitable contribution deduction because the North Dakota law under which the easement was granted limits easements to a maximum duration of 99 years. The IRS determined, and the Tax Court agreed, that the 99-year limit kept the easement from protecting its conservation purposes "in perpetuity."

PERPETUITY — "THE" PROPERTY

BELK V. COMM'R

U.S. Court of Appeals, Tenth Circuit, No. 13-216, December 16, 2014, aff'g 140 T.C. No. 1 (2013), see also, T.C. Memo 2013-154 (2013). (Judge Vasquez)

Overview

The Fourth Circuit handed down its decision in Belk v. Comm'r, which is the first Appellate court opinion to interpret the Section 170(b)(2) requirement of a "qualified real property interest" in the context of donating a conservation easement. The Fourth Circuit held that to be a "qualified real property interest," an easement must cover a fixed parcel of land. Consequently, it held that a provision allowing a substitution of the underlying land violated a perpetuity component of "qualified real property interest." The Fourth Circuit also refused to give effect to a savings clause in the easement deed that prohibited the Land Trust from agreeing to any amendment (including an amendment to substitute the underlying land) if the amendment would cause the easement to fail to qualify as a charitable donation under Section 170(h). This decision will have far-reaching implications for taxpayers considering donation of conservation easements, and also for tax planners who use savings clauses in various contexts to protect the anticipated tax treatment of agreements.

Right to Substitute

The easement in Belk was donated to the Smokey Mountain National Land Trust (now Southeast Regional Land Conservancy; the "Land Trust") in 2004 on 410 acres. The easement deed allowed the Belks and the Land Trust to mutually agree to substitute a portion of the land covered by the conservation easement with an adjacent parcel of land of equal or greater in size, value and ecological features (the "Substitution Clause"). Because the parties could agree to substitute easement property, the Tax Court disallowed the charitable deduction because it found that the easement was not a perpetual restriction on the use of real property, and therefore was not a "qualified real property interest" under I.R.C. section 170(h)(2)(C). The interpretation of this provision had never been addressed by any court or in any IRS guidance.

On Appeal, the Belks claimed that Congress intended for easements themselves to be perpetual, and to perpetually protect the conservation purposes of the easement, but that Congress did not intend to require that the specific land underlying the easement be fixed in perpetuity. Such a requirement would deny land trusts flexibility to address most future changes and events. The Fourth Circuit disagreed. It found that Congress' use of the term "the" in the phrase "a restriction (granted in perpetuity) on the real property" meant Congress required the easement to attach to a defined parcel of real property that could never be changed by an agreement of the land trust and landowner.

Notably, the Fourth Circuit limited the holdings of Simmons and Kaufman, two Court of Appeals decisions holding that an easement deed meets the perpetuity requirements of the Code, even if it gives the donee the right to abandon the easement altogether. The Fourth Circuit reasoned that Simmons and Kaufman concerned only perpetual protection of the conservation purpose (§ 170(h)(5)(A)) and did not address perpetuity of the use restrictions (§ 170(h)(2)(C)). Under Simmons and Kaufman, a deduction did not fail merely because the land trust could choose not to enforce the easement. But under the Fourth Circuit's decision in Belk, a deduction fails if the landowner and land trust can agree to relocate the easement to other property.

Savings Clause

The second notable aspect of the Belk opinion is the discussion of savings clauses. A savings clause is a tool used by tax planners to protect the anticipated tax consequences of an agreement in the event a provision of the agreement would defeat that preferred tax treatment. The Fourth Circuit previously rejected certain savings clauses that were triggered by "conditions subsequent" that nullify a transaction if there is an adverse determination by a Court or the IRS. However, the savings clause in Belk prohibited the Land Trust prospectively from agreeing to any amendment that would cause the easement to fail to qualify for a charitable deduction under I.R.C. section 170. If the tax law developed such that a particular amendment would negate the deduction, the Land Trust was prohibited from agreeing to it.

The Fourth Circuit disagreed with the Belks' claim that the clause was "interpretive," serving to guide the Land Trust concerning types of amendments that were appropriate. Instead, the Fourth Circuit found that no interpretive assistance was needed where the deed

included a provision such as the Substitution Provision that, in its view, was so evidently inconsistent with I.R.C. section 170(h)(2)(C). The Fourth Circuit disregarded the fact that an adverse decision was not necessary for the savings clause to be operative, saying this was a "distinction without a difference." The Court found that the easement deed plainly permitted substitutions, and concluded that the only time the savings clause would be invoked to prohibit offending substitutions would be following an adverse determination by the IRS or a Court. The Court apparently did not consider to be sufficient the Land Trust's exercise of its judgment not to amend. In this context, the Fourth Circuit opinion can be viewed as broadening the types of savings clauses that will be deemed void for tax purposes.

BALSAM MOUNTAIN, LLC V. COMM'R

T.C. Memo 2015-43 (Judge Morrison)

Overview

The Tax Court issued its opinion in another Conservation Easement case, Balsam Mountain Investments, LLC v. Commissioner, T.C. Memo 2015-43 (J. Morrison) that involves an easement given in Jackson County, NC relating to a 22 acre tract of property. The Easement deed reserved to the landowner rights to make minor alterations of boundary lines. The Tax Court agreed with the IRS contention that the easement property was not a qualified real property interest because the easement agreement permits the grantor to change what property is subject to an easement, citing Belk. The Tax Court found that the easement did not apply to an "identifiable, specific piece of real property" and that the gift did not constitute a gift of a "qualified real property interest." The taxpayer tried to distinguish Belk because the case did not involve substitution for other lands and only allowed substitution for five percent of the land initially subject to the easement. The Tax Court said that difference does not matter as the easement was not an interest in an "identifiable, specific piece of property."

BC CANYON RANCH II, L.P. V. COMM'R

867 F.3d 547 (5th Cir. 2017) On August 11, 2017, the Fifth Circuit issued an important decision in Bosque Canyon Ranch II, L.P. v. Comm'r, 867 F.3d 547 (5th Cir. 2017) ("BC Ranch II"). BC Ranch II is significant for the land trust community because the Fifth Circuit, severely limited the breadth (at least in the Fifth Circuit) of Belk v. Comm'r, 140 T.C. 1 (2013), aff'd, 774 F.3d 221 (4th Cr. 2014).

Bosque Facts

Bosque involves conservation easement granted by two limited partnership, which were intended to protect and preserve certain Texas ranch land that provides habitat for gold-cheeked warblers. The easement also protected watershed, scenic vistas and mature forest. The partnerships were owned by investors (in the partnerships), who were given the right to build ranch homes on select five-acre sites ("homesite parcels"), with the rest of the land reserved for conservation, recreation and agricultural use. To be clear, the homesite parcels were not part of the conserved area, but were contiguous to it. The easements could only be amended with the land trust's consent and then only to modify the boundaries of the homesite parcels, but not to increase the size of the homesite parcels to more than five acres. In addition to the homesite parcels conveyed to the various investors for their investment in the partnerships, the investors also received a membership interest in a to-be- formed Bosque Canyon Ranch Association, which would own all the other property other than the homesite parcels.

What Happened in the Tax Court?

The IRS disallowed the charitable deduction on various grounds, claimed that the distribution of the homesite parcels constituted disguised sales (resulting in income or gain to the partnership; the sales price in the disguised sale being equal to the amount contributed by each investor for his interest in the partnership) and asserted accuracy-related penalties, including the gross valuation misstatement penalty. After a four week trial, the Tax Court (Judge Foley) agreed with the IRS and disallowed the deductions in full, holding that: (1) the conservation easements were not granted in perpetuity because the ability to make amendments to the boundary lines of the homesite parcels violated the perpetual restriction requirement under Belk; (2) the donors failed to make appropriate baseline documentation available to the land trust at the time of the grant of the easements under Reg. Section 1.170A-14(g)(5)(i) (discussing documentation necessary to allow the land trust to properly monitor the protected properties); and (3) the gross valuation misstatement penalty was applicable because the disallowance of the deductions caused the value of the deductions to be

zero. Additionally, the Tax Court held that the facts in Bosque constituted a disguised sale transaction and that the partnerships' receipt of the limited partners' entire contributions to the partnerships were receipts from such disguised sales.

Fifth Circuit Vacates and Remands

All of these issues were appealed to the Fifth Circuit, which had a completely different view of the world than the IRS and Judge Foley. Specifically, the Fifth Circuit: (1) vacated the Tax Court's holding regarding the perpetuity of the easements and the baseline documentation (in other words finding that the taxpayers were correct on those issues), and remanded to the Tax Court for it to consider other grounds asserted by the Commissioner to support the disqualification of the easements as charitable deductions but not addressed by the Tax Court (outlined in footnote 30 of the decision); (2) vacated the Tax Court's determination that the entirety of the partners' contributions were disguised sales and remanded for the Tax Court to determine the correct amount of any taxable income resulting from the disguised sales; and (3) vacated the imposition of the gross valuation misstatement penalty and remanded to the Tax Court to determine the value of the contribution and whether the gross valuation misstatement penalty is applicable, and if so, the proper amount of such penalty.

Belk Conflation and Floating Homesites

Bosque involved conservation easements granted by two limited partnerships that were intended to protect thousands of acres of Texas ranch land that provides habitat for gold- cheeked warblers and to protect watershed, scenic vistas and mature forest. The partnerships were owned by investors (in the partnerships) who were given the right to build ranch homes on select five-acre sites ("homesite parcels"). The rest of the land was reserved for conservation, recreation and agricultural use. To be clear, the homesite parcels were not part of the conserved area, but were located contiguous to it.

The easements in Bosque could only be amended with the land trust's (in this case, the North American Land Trust, or NALT) consent and then only to modify the boundaries of the homesite parcels, but not to increase the size of the homesite parcels to more than five acres. One of the main issues in the case was whether the ability to amend the easements, with the land trust's approval, to modify the boundary of the homesite parcels, violated the perpetuity requirement of Section 170(h)(2)(C). In that regard, the IRS argued and the Tax Court agreed that such a right to amend to change the boundary of an easement disqualified the easement, citing Belk. The Fifth Circuit found Belk distinguishable and held that reliance on Belk was misplaced.

Before analyzing the facts, the Fifth Circuit explained that Congress has consistently and historically provided bipartisan support for the use of conservation easements (citing legislative history from 1980) to protect important lands. The Fifth Circuit recognized that the easements at issue did indeed protect certain land in perpetuity, subject only to a few reserve rights that both the land trust and the land owner agreed could be exercised without having an adverse effect on the protected conservation purposes. The Court also recognized that an amendment to make minor modifications of boundary lines of the homesite parcels, all within the four corners of the ranch property, could only be made with the approval of the NALT. In distinguishing Belk, the court noted that: (1) NALT had to approve any such amendments (giving a nod to the importance of land trusts in conservation easement operations); and (2) the homesite parcels could not be increased in size and that the external boundaries of the easement area nor the total acreage of the easement could change.

The Fifth Circuit observed that in Belk the easement could be moved, lock, stock and barrel, to a tract or tracts different and remote from the original easement property, allowing the donor to change the nature of the eased property and possibly undermining the appraisal of the property. But in the present case, the Court noted that those problems did not exist, comparing Bosque more favorably to the facts in Commissioner v. Simmons, 646 F. 3d 6 (D.C. Cir. 2011) and Kaufman v. Shulman, 687 F. 3d 21 (1st Cir. 2012). The Fifth Circuit noted that its sister circuits (in those cases) ruled that the conservation easements were perpetual even though the trust (in such cases) could consent to the partial lifting of certain restrictions. Highlighting the common sense reasoning in Simmons and Kaufman, the Fifth Circuit recognized "that an easement may be modified to promote the underlying conservation interests and that the need for flexibility to address changing or unforeseen conditions on or under property subject to a conservation easement

clearly benefits all parties, and ultimately the flora and fauna that are their true beneficiaries."

The Fifth Circuit's final lasso regarding perpetuity is found in its final point: "Most IRC provisions that intentionally create narrow 'loopholes' to cover narrowly specific situations are deemed to have been adopted in an exercise of legislative grace, and thus are subject to strict construction." But the Fifth Circuit recognized that Section 170(h) was adopted at the insistence of conservation activists (not property-owning, potential donor taxpayers), by an overwhelming majority of Congress, with the hope that adding thousands of acres of primarily rural property for various conservation purposes would never be developed. Accordingly, the Fifth Circuit found that the usual strict rules of construction of tax loopholes "is not applicable to grants of conservation easements made pursuant to Section 170(h)." Indeed, it appears that the Fifth Circuit does not believe that a conservation easement is even a tax loophole, but instead is a tax incentive Congress overwhelmingly created to encourage conservation.

The Fifth Circuit's final comments regarding loopholes demonstrates that the Fifth Circuit does not agree with the hyper technical approach we have seen the IRS and some courts take in analyzing whether a conservation easement grant satisfies the requirements of Section 170(h). While this case applies that point of view to the perpetuity requirement of Section 170(h)(2)(c) and clearly distinguishes how Belk has been applied in the past, the theory would also apply to other issues that the IRS uses as a hammer to deny deductions with respect to grants of conservation easements where good conservation, which Congress clearly supports, is taking place.

MORTGAGE SUBORDINATION

MINNICK V. COMM'R

T.C. Memo. 2012-345

In September of 2006, the taxpayers donated a conservation easement on their 74- acre parcel of land in the foothills near Boise, Idaho to the Land Trust of Treasure Valley, Inc. On or about December 26, 2007, taxpayers filed an amended income- tax return for 2006. On the amended return, they reported that the value of the easement was $941,000.

The deed of conservation easement granted by the taxpayer contained the following warranty regarding their ownership of the property: "Grantor [i.e. Minnick] warrants that * * * [he] owns the Property in fee simple and has conveyed it to no other person, and that there are no outstanding mortgages, tax liens, encumbrances, or other interests in the Property that have not been expressly subordinated to the Easement."

Contrary to the warranty provision in the easement deed, there was a mortgage encumbering the property at the time of the donation, which was held by U.S. Bank. U.S. Bank did not subordinate its interest to the land trust by the time the easement was granted.

The taxpayers argued that a subordination agreement executed in September of 2011 (nearly five years after the donation) satisfied the mortgage subordination requirement in Treasury Regulation 1.170-14(g)(2). The Tax Court found this "argument [to be] unavailing" based on its prior decision in Mitchell v. Commissioner, 138 T.C. 324, 332, (2012), which held that a mortgage subordination agreement must be in place at the time that the conservation easement is granted to satisfy the regulation's perpetuity requirements. .

The court also rejected the taxpayers argument that the perpetuity concerns furnished by the lack of mortgagee subordination to the land trust should be disregarded, because the likelihood of default by the taxpayer was so-remote-as-to- be-negligible. The court relied again on Mitchell wherein the Tax Court determined that "the likelihood of default is irrelevant."

The court assessed an accuracy related penalty equal to 20 percent of the understatement. The court found that the taxpayers did not exercise reasonable cause because: (1) the taxpayers did not obtain timely mortgage subordinations, which the warranty provision in the deed would have alerted the taxpayers to if a good faith investigation had been made: (2) while taxpayers solicited general advice about conservation easements from their CPA, they did not solicit or receive advice with respect to the deductibility of the particular easement they granted; and (3) that the taxpayers hiring of an appraiser to determine the value of the easement did not constitute reasonable cause for the accuracy-related penalty.

KAUFMAN V. SHULMAN[1]

T.C. Memo 2014-52, 687 F.3d 21 (1st Cir. 2012) aff'g in part, vacating in part, and remanding, 136 T.C. 94 (2011). (Judge Halpern)

Overview

Façade easement on townhouse in Boston. This case went through four decisions.

In Kaufman I (134 T.C. 182 (2010)), the Tax Court granted partial summary judgment finding mortgage subordination inadequate. Specifically, the Tax Court found that I.R.C. section 170(h)(5)(A) (perpetuity requirement) violated because subordination gave the lender a priority claim to proceeds from condemnation or casualty. The court ruled that the donee must be entitled to a proportionate share of proceeds if the easement is extinguished under Treas. Reg. §1.170A-14(g)(6)(ii) (extinguishment provision). The court interpreted donee's rights to proceeds from the extinguishment of the easement to include proceeds from third-part contracts, such as insurance contracts.

In Kaufman II, 136 T.C. 94 (2011), the Tax Court reconsidered its ruling and an elaborated on the "enforceability-in-perpetuity" requirements of I.R.C. section 170(h)(5)(A). It clarified that the easement failed not because the mortgage was not protected from foreclosure (i.e., not subordinated) but because the easement was not protected in the event of judicial condemnation or other casualty loss. It allowed deduction of cash contributions and denied application of penalties. The court also disallowed a portion of the cash donations and imposed a negligence penalty on that donation (but not on the easement).

In Kaufman III, the 1st Circuit rejected the Tax Court's reasoning on the extinguishment provision holding the interpretation to be an unreasonable "impromptu reading that is not compelled and would defeat the purpose of the statute." The 1st Circuit also rejected arguments that the donee might abandon the easement, or that the taxpayer failed to meet substantiation requirements by not including a summary appraisal or fully completing Form 8283. The 1st Circuit vacated the Tax Court's decision on this point.

In Kaufman IV, T.C. Memo 2014-52, the Tax Court determined value of easement to be zero and penalties were imposed. Tax Court criticized the taxpayer's appraiser and concluded that the appraisal method used was not reliable. The court further stated that it was convinced that the restrictive provisions in the Preservation Agreement were duplicative of local zoning ordinance and related restrictions, thus the easement did not materially diminish the value of the row house that is subject of the easement.

Tax Court determined that the taxpayers' reported value, where the claimed façade easement exceeded the correct value by 400 percent or more, constituting a gross valuation misstatement and, further, that the 40 percent gross valuation misstatement penalty should be imposed.

While finding that the easement value was based on a qualified appraisal made by a qualified appraiser (forced by the Circuit Court of Appeals decision) the Tax Court ultimately found that the taxpayers' reliance on their accountant and appraiser did not satisfy their burden to show that they conducted a good faith investigation of value or acted with reasonable cause.

Underlying the Court's determination (as well as the Court's value determination) was unfortunate evidence that came to light during trial. The donee of the easement had represented to Mr. Kaufman (the donor), a sophisticated MIT Emeritus Professor of Statistics, that the easement would not reduce the value of the underlying property. Despite these written communications, the Kaufmans proceeded, without further investigation, to claim the charitable deduction based on the appraisers estimate.

MITCHELL V. COMM'R

U.S. Court of Appeals, Tenth Circuit, No. 13-9003 (January 6, 2015) (Judge Haines)

Overview

The Tenth Circuit upheld the Tax Court's decisions in Mitchell v. Comm'r, 138 T.C. No. 16 (2012), mot. for reconsideration denied, T.C. Memo 2013-204, to completely deny the taxpayer's deduction for the donation of a conservation easement where the donor failed to subordinate the mortgage on the property to the conservation easement.

The taxpayer in Mitchell donated a conservation easement over 180 acres of unimproved land to a local land trust. Tenth Circuit was to decide whether donated

conservation easement was protected "in perpetuity". Because "perpetuity" is not defined in the Code, IRS issued regulations outlining the requirements for perpetual protection. One of these requirements is that a mortgage on any property subject to the conservation easement must be subordinated to the easement (to prevent the mortgage lender from foreclosing on the property and extinguishing the easement). See 26 C.F.R. § 1.170A-14(g). The Treasury Regulations further provide that a deduction will not be disallowed based on some potential future event that could defeat the donee's interest if the possibility of such future event "is so remote as to be negligible." Id.

Tax Court

The taxpayer in Mitchell did not subordinate the mortgage at the time of the easement; and instead subordinated the mortgage two years later. The Tax Court denied the deduction in full, determining that the Regulations require subordination "at the time of the donation" for the donation to meet the requirements of a "qualified conservation contribution."

Tenth Circuit

On appeal, the taxpayer argued she was entitled to the deduction despite failing to strictly comply with the subordination requirement because: (1) the regulations do not require subordination at the time of the contribution; and (2) the possibility that the bank would foreclose on the mortgage was so remote as to be negligible.

The Tenth Circuit disagreed, strictly interpreting the regulation to require subordination prior to claiming the deduction and also agreed with the Commissioner's interpretation that the regulation requires that the mortgage be subordinated "at the time of the donation." The Tenth Circuit also held that the "so remote as to be negligible" standard did not apply to mortgage foreclosures, which are not such "remote" future events. In addition, the "so remote as to be negligible" standard could not include mortgage foreclosures because the Regulations explicitly contemplated the possibility of foreclosure and included a requirement that mortgages be subordinated. In so holding, the Tenth Circuit limited the D.C. Circuit's application of this standard in Simmons, 646 F.3d 6 (D.C. Cir. 2011), explaining that, unlike a mortgage foreclosure, the possibility that a donee would abandon its rights under an easement is a remote future event where the donee had never abandoned its rights previously.

Comment

The Tenth Circuit's decision in Mitchell, like the Fourth Circuit's holding in Belk, reflects a harsh view by the courts when it comes to strict compliance with the Treasury Regulations. In both cases, the taxpayers donated a very valuable restriction on their property to a charitable organization. And the donated restrictions in both cases were, as a practical matter, protected in perpetuity. However, the deductions were denied in full because the taxpayers failed to technically comply with the Treasury Regulations and the Code.

RP GOLF V. COMM'R

T.C. Memo 2016-80 (Judge Paris)

Overview

The Tax Court in RP Golf disallowed a $16 million deduction for a conservation easement donation where the taxpayer failed to subordinate two mortgages prior to the donation of the conservation easement. The donation at issue in RP Golf covered 277 acres of property, which included a golf course. The original purchase of the property in 1997, which included the easement property, was financed by a bank, which received a security interest in the underlying property. The owner subsequently obtained a second loan, which was also secured by the property. On December 29, 2003, the taxpayer donated an easement to the local land trust. The banks did not sign the consents to subordinate their mortgage interest until April 14, 2004—though the consents by their terms were effective as of December 30, 2003. This case is another example of how both the IRS and the Tax Court are harshly punishing taxpayers who fail to comply with highly technical rules and regulations associated with gifts of conservation easements.

Positions of the Penalties

The IRS claimed that because the mortgages were not subordinated at the time of the easement donation, the conservation purposes were not protected in perpetuity, as required by Section 170(h)(5)(A). The taxpayer claimed that the banks had orally agreed to the subordination at the time of the easement, but didn't execute that subordination until later.

Tax Court Holding

The Tax Court followed a recent line of cases strictly construing the mortgage subordination requirement

in the regulations, and requiring that the mortgage be subordinated at the time of the easement donation. The Tax Court also looked at Missouri law, as well as the mortgage agreements themselves, to determine whether the claimed oral agreement to subordinate was sufficient to protect the land trust's rights in the easement. The Court concluded that any oral agreement was not enforceable as between the parties, and certainly not enforceable against third parties.

Comments

The RP Golf case follows the Tax Court and Court of Appeals precedent strictly construing the requirement to subordinate mortgages before the easement is donated, despite the fact that all of these cases involve easements that had no adverse events occur between the date of donation and date of subordination. While these decisions appear to fly in the face of Congress's continued support of the conservation easement program, they have shaped the landscape of easement donations where taxpayers must ensure that every "i" is dotted and every "t" is crossed. Even a small misstep may have dire consequences.

RP GOLF V. COMM'R

860 F.3d 1096 (8th Cir. 2017). (Judge Paris)

In affirming the Tax Court's opinion in RP Golf v. Comm'r, T.C. Memo 2016-80, the Eighth Circuit joined the Ninth and the Tenth Circuits in holding that Treasury regulation section 1.170A-14(g)(2) requires a mortgage to be subordinated at the time of the gift . Minnick v. Comm'r, 796 F.3d 1156, 1159 (9th Cir. 2015) (nearly five-year gap between easement's conveyance and subordination); Mitchell v. Comm'r, 775 F.3d 1243, 1248 (10th Cir. 2015). (Two-year gap).

In both Minnick and Mitchell, the taxpayers argued—like the taxpayers in RP Golf—that the Code's silence about the timing of subordination allows it after the conveyance of the easement. The Eighth Circuit agreed with its sister circuits that the plain language of Treasury regulation section 1.170A-14(g)(2) requires subordination prior to the donation in order for the deduction to be allowable.

The Eighth Circuit held that "the regulations 'do not permit a charitable contribution deduction unless any existing mortgage on the donated property has been subordinated, irrespective of the likelihood of foreclosure.' (citing Mitchell, 775 F.3d at 1255).

PALMOLIVE BUILDING, LLC V. COMM'R

149 T.C. No. 18 (Oct. 10, 2017) (Judge Gustafson)

Overview

In 2004, the taxpayer, Palmolive Building LLC, donated a façade easement to a land trust encumbering the Palmolive Building on North Michigan Avenue in Chicago, Illinois, which it had purchased in May 2011 for approximately 58.5 million dollars. The taxpayer would claim a charitable deduction in the amount of approximately 33.4 million dollars on its 2004 tax return pursuant to the easement donation.

The IRS argued that the easement deed did not protect the conservation values in perpetuity, as required by Code section 170(h)(5)(A) and Treasury Regulation section 1.170A-14(g)(6)(ii), because the deed provided the taxpayer's mortgagees with prior claims to insurance proceeds.

The IRS also argued that the mortgages on the building were not fully subordinated to the easement as required by Treasury Regulation section 1.170A-14(g)(2) because of the mortgagees' rights to any insurance proceeds in preference of the land trust.

Tax Court Does Not Follow Kaufman III. In Palmolive Building, LLC, the Tax Court's en banc opinion adopted its prior holding in Kaufman I (discussed supra) that taxpayers fail to satisfy the protected in perpetuity requirement of Code section 170(h)(5) if the donee/land trust is not entitled to a proportionate share of any proceeds, including those from third-party contracts—such as insurance contracts.

The court held that allocating insurance proceeds in preference to a mortgagee violated the mortgage subordination requirement. The court explained that the mortgage subordination requirement "is not satisfied simply by including in the Deed a section captioned "Subordination of Mortgages," without regard to what the Deed actually provides and what the mortgagee actually agrees to. Rather, the mortgagee must actually subordinate its interest." Providing the mortgagees a preference to insurance proceeds (which the mortgagees required the taxpayer to maintain) violated the mortgage subordination requirement.

Golsen Rule

The Tax Court acknowledged that it was taking a position already rejected by the 1st Circuit Court of Appeals in Kaufman III. It was able to do this because of the Golsen Rule,[2] which allows a Tax Court to adopt case law from the circuit court of appeals that would hear the taxpayer's appeal (if such an appeal occurred). The taxpayer's appeal would lie in the 7th Circuit Court of Appeals, while Kaufman III was an opinion from the 1st Circuit, so the court determined "we are not bound by the opinion of the U.S. Court of Appeals for the First Circuit in [Kaufman III] … and we will follow [Kaufman I]."

PENALTIES

- Kaufman v. Shulman, T.C. Memo 2014-52, 687 F.3d 21 (1st Cir. 2012) aff'g in part, vacating in part, and remanding, 136 T.C. 94 (2011). (Judge Halpern) on page 66.
- Chandler v. Comm'r, T.C. 142 T.C. No. 16. (Judge Goeke) on Page 34.
- Zarlengo v. Comm'r, T.C. Memo 2014-161 (Judge Vasquez) on page 55.
- Seventeen Seventy Sherman Street v. Comm'r, T.C. Memo 2014-124 (Judge Marvel)

Overview

In Seventeen Seventy Sherman Street v. Comm'r (T.C. Memo 2014-124), the Tax Court held that an understanding between the taxpayer and a development company under which the taxpayer would grant certain conservation easements if the development company assisted in obtaining variances constituted a quid pro quo, resulting in a complete loss of the deduction for such conservation easement.

The property at issue included the El Jebel Shrine, a structure in Denver, Colorado which was completed in 1907 and designated as a landmark. The property also includes an adjacent parking lot. The taxpayer (a Colorado LLC) intended to turn the structure into condominiums. To that end, the taxpayer needed a change to the PUD to allow such development and a variance to allow for the building of a structure on the parking lot. In 2002, the taxpayer began negotiating with Community Planning and Development Agency ("CPDA") regarding the: (1) the proposed PUD change; (2) the imposition of interior and exterior easements; (3) the application for a variance; and (4) rehabilitation of the property. The taxpayer and CPDA entered into a development agreement, under which the CPDA would recommend approval of the proposed PUD and variance request and, if the PUD change was approved, the taxpayer would donate interior and exterior easements to Historic Denver, Inc., a charitable organization. In addition, the taxpayer agreed to undertake certain rehabilitation projects if the variance request was granted. The PUD change would have to be approved by the Denver City Council, and the variance would have to be obtained from the Denver Planning Board.

The taxpayer donated the interior and exterior easements to Historic Denver in December 2003, after obtaining the PUD change and the variance, and claimed a deduction of $7,150,000 as the value of the easements.

IRS Contentions

At trial, the IRS contended that because the taxpayer received consideration in exchange for the easement, which the taxpayer failed to disclose, the charitable contribution had no value. The IRS further argued that the interior easement served no conservation purpose and the value claimed by the taxpayer of the easements was overstated. The taxpayer contended that the consideration received was limited to the PUD change, which was only worth $2,025,000, thus the taxpayer was entitled to a deduction of $5,125,000. The taxpayer further contended that it was not required to disclose the consideration received because the consideration was not received from the donee organization— instead it was received from the city of Denver in the form of a PUD change.

Tax Court's Decision

The Tax Court held that the charitable deduction must be completely disallowed because the taxpayer received a quid pro quo for the donation of the easements. The Tax Court explained that the consideration need not be financial; it can be any other benefit that vitiates charitable intent. The Tax Court further explained that the taxpayer bears the burden of demonstrating that he or she intended to make a charitable contribution in excess of any consideration received.

The Tax Court held that the development agreement as a whole demonstrated that the taxpayer received CPDA's recommendation as to both the PUD change and the variance request in exchange for the easement. In so holding, the Tax Court dismissed the

taxpayer's argument that only the value of the PUD change should be viewed as "consideration" for the easement, which the taxpayer valued at just over $2 million. The Tax Court observed that the nature of the negotiations between the taxpayer and CPDA showed that both recommendations should be viewed as consideration for the easements, despite the fact that CPDA could not approve either the PUD change or the variance. The Tax Court further held that since the taxpayer failed to demonstrate or identify the value of the consideration received in the transaction, the taxpayer was not entitled to any deduction.

Penalties and Burden of Proof

As the case related to penalties, like in many other recent cases, the burden of proof impacted the Tax Court's decision. While the FPAA mailed to the taxpayer challenged the deductibility of the subject conservation easements, the Commissioner asserted in an amendment to his answer that even if the easements were deductible, the fair market value of the easements was only $400,000 (compared to $7,150,000 claimed by the taxpayer). The amended answer further asserted that an accuracy related penalty applied to the underpayment in the form of a gross valuation misstatement, or, alternatively: (1) because of negligence or disregard of rules or regulation under Section 6662(b)(1); (2) a substantial understatement of income tax under I.R.C. section 6662(b)(2); or (3) a substantial valuation misstatement under I.R.C. section 6662(b)(3).

Since the assertion of penalties was raised in an amended answer, the Tax Court assigned the burden of proof on the "new matter" under Rule 142(a) to the Commissioner. As to the proposed gross valuation misstatement, the Tax Court did not accept the Commissioner's expert's opinion that the subject easements had no value, which testimony was refuted at trial by representatives from both the City of Denver and Historic Denver, the recipient of the easement. While concluding that one of the easements at issue had value, the Tax Court found that the Commissioner failed to meet his burden of establishing that the value of the subject conservation easements exceeded 400 percent of the correct value of the easements, meaning that the gross valuation misstatement penalty could not apply.

With respect to the other (non-valuation) accuracy related penalties asserted in the amended answer, the Tax Court found that, because the deductions were disallowed, the Commissioner had met his burden of establishing that the taxpayer acted negligently or with disregard to I.R.C. section 170 and the regulations thereunder.

Reasonable Cause and Good Faith

To prove that the taxpayer had acted with reasonable cause and good faith through reliance on professional advice, the evidence offered at trial included testimony from the taxpayer's tax advisor that he had advised the taxpayer that he had to reduce the value of the claimed deduction by the consideration received in the quid pro quo exchange. Of course, the taxpayer failed to follow that advice. Accordingly, the Tax Court found the Taxpayer's disregard of the advisor's advice was not reasonable and in good faith.

Comment

This case is instructive to developers and property owners who are considering the grant of a conservation easement in connection with a request for zoning changes to develop property underlying or adjacent to the eased property. Carefully structuring and reporting these transactions can avoid the unfortunate result where the easement is disallowed in total and the property owner is hit with penalties.

Seventeen Seventy Sherman Street also is important because it illustrates the confusing differences between the application of the valuation misstatement penalties and the accuracy related penalties and shows how important the burden of proof can be in a court's determination of whether these very potent penalties are applicable.

LEGG V. COMM'R

145 T.C. 13 (2015) (Judge Kerrigan)

Overview

Legg is a conservation easement deduction case centered around the issue of accuracy-related penalties. The taxpayers in Legg claimed deductions totaling more than $1.4 million for an easement they contributed to the Colorado Natural Land Trust. After a timely examination of the taxpayers' returns, the IRS examiner issued an "initial report" that took the primary position that the deduction be disallowed entirely for failure to satisfy certain legal requirements and the alternative

position that the easement's value was $0. The initial examination report computed penalties at 20 percent but also took the alternative position that the taxpayers were liable for the 40 percent gross valuation misstatement penalty under § 6662(h).

Resolved Issues

Following examination, the taxpayers entered into a partial settlement order with the IRS agreeing that: (1) the taxpayers were entitled to a charitable deduction; (2) the value of the conservation easement was $80,000; and (3) the taxpayers satisfied the reasonable cause defense requirements for the 20 percent substantial valuation misstatement penalties under §§ 6662(a) and (b)(3) but that the taxpayers could not invoke the reasonable cause defense against the 40 percent gross valuation misstatement penalty under § 6662(h).

Penalties Determined

At trial, the taxpayers argued that the 40 percent penalty was not properly assessed because the IRS did not satisfy the procedural requirement of § 6751(b) which, in relevant part, provides that no penalty shall be assessed "unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination." The taxpayers argued that asserting penalties as an alternate position in the examination report was not an "initial determination" as required by the statute. In rejecting the taxpayers' arguments, the Court explained that, "Congress enacted section 6751(b) to ensure that taxpayers understood the penalties that the IRS imposed upon them" and, by raising the 40 percent penalty as an alternative position in the examiner's initial examination report, the procedural requirements of § 6751(b) were satisfied. Accordingly, the Court sided with the IRS and held that the taxpayers were subject to the 40 percent gross valuation misstatement penalty.

- Atkinson v. Comm'r, 145 T.C. 13 (2015) (Judge Wells) on page 24.
- Chai v. Comm'r, 851 F.3d 190 (2nd Cir. 2017) versus Graev v. Comm'r, 147 T.C. No. 16 (2016). (Judge Gustafson) (Managerial Approval for Imposition of Accuracy Related Penalties)

Section 6662 Penalties and Supervisory Approval Required by Section 6751(b)

To justify imposing accuracy-related penalties under section 6662 the IRS is required to comply with section 6751(b), which provides: "No penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher local official as the Secretary may designate." I.R.C. § 6751(b).

The meaning "initial determination of such assessment" was hotly contested by the taxpayers in Graev and the IRS. An en banc opinion from the Tax Court held that the written approval under section 6751(b) could be validly obtained at any time before the penalty is assessed. See Graev v. Comm'r, 174 T.C. No. 16, 2016 WL 6996640, at *10 & n.13 (2016). This opinion was troubling because it essentially rendered 6751(b) a nullity, as the IRS had up until the very moment of assessment to get the managerial approval, which undermined the purposes behind section 6751(b).[3]

The Second Circuit clarified the "supervisory approval" requirement in section 6751(b)(1) after the tax court issued its en banc opinion in Graev.

Six months after the tax court issued its en banc opinion in this case, the Second Circuit thoroughly analyzed section 6751(b) and its legislative history, rejected the divided en banc tax court's construction of that statute in Graev, and buttressed the mandate set forth by section 6751(b)(1). See Chai v. Comm'r, 851 F.3d 190 215-23 (2d Cir. 2017). Specifically, the court in Chai held that section 6751(b) "requires written [supervisory] approval of the initial penalty determination no later than the date the IRS issues the notice of deficiency (or files an answer or amended answer) asserting such penalty." Id. at 221 (emphasis added).

As the Second Circuit explained, allowing "an unapproved initial determination of the penalty to proceed through administrative proceedings, settlement negotiations, and potential tax court proceedings, only to be approved sometime prior to assessment would do nothing to stem the abuses § 6751(b) was meant to prevent." Id. at 219.

The Second Circuit further held that "compliance with § 6751(b) is part of the Commissioner's burden of production and proof in a deficiency case in which

a penalty is asserted" and "therefore part of the IRS's prima facie penalty case." Id. at 221; see also id. at 222 n.26 ("The written-approval requirement—as a mandatory, statutory element of a penalty claim—is distinct from affirmative defenses … which need be raised by the taxpayer.").

Finally the Second Circuit clarified that the term "personal[] approv[al]" in section 6751(b)(1) means something more than a general bureaucratic forwarding of an initial assessment. In so doing, the court observed that "the IRS's current administrative practice requires a supervisor's approval to be noted on the form reflecting the examining agent's penalty determination or otherwise be documented in the applicable workpapers." Id. at 220 (emphasis added).[4]

The Second Circuit also referenced other sections of the IRM which state that "managerial review and approval must be documented in writing in the case file." Chai, 851 F.3d at 220 (quoting IRM 20.1.1.2.3(7) (Aug. 5, 2014)). The court found these procedures, issued by the Commissioner, were "a persuasive signal of the IRS's reading of § 6751 to require, as Congress intended, supervisory approval prior to the issuance of a notice of deficiency." Id.

With respect to Congressional intent for 6751(b), the Chai court explained that Congress enacted section 6751(b) to ensure penalties are imposed fairly and to preclude the Commissioner from threating the imposition of penalties as a tactic to strong-arm settlements. See S. Rep. No. 105-174, at 65 (1998) ("The Committee believes that penalties should only be imposed where appropriate and not as a bargaining chip.").

The Tax Court's application of section 6751(b) in Graev appears to thwart that purpose. Under the interpretation set forth by the Second Circuit Court of Appeals in Chai, the Commissioner has the burden to establish, among other elements, that the initial determination of the penalty was personally approved, in writing, by the immediate supervisor of the person making such determination.

PARTITA PARTNERS LLC V. UNITED STATES

2017 WL 2937689 (S.D.N.Y. July 10, 2017)

On October 25, 2016, the Southern District of New York granted a motion for partial summary judgment that was filed by the United States. See Partita Partners LLC v. United States, 216 F.Supp.3d 337 (S.D.N.Y. 2016) ("Partita I"). The court concluded that, as a matter of law, Partita's donation of the façade easement did not preserve the building's entire exterior, as required by I.R.C. section 170(h)(4)(B), and that Partita therefore was ineligible for the $4,186,000 deduction that it claimed.

The taxpayer then moved for summary judgment contending that the valuation misstatement penalty was inappropriate, because Partita I concluded that the charitable deduction did not satisfy the criteria of Code section 170(h)(4)(B)(i)(I) and disallowed the deduction in total for technical noncompliance. According to the taxpayer, its 2008 underpayment was not "attributable to" a valuation misstatement because the deduction was disallowed on entirely separate grounds that are not related to valuation—i.e., a technical violation.

The Southern District of NY relied on United States v. Woods, 134 S.Ct. 557, 561–62, (2013) in concluding that the gross valuation misstatement penalty was applicable even when the gross understatement results from a total disallowance of the charitable deduction on technical grounds. The court rejected the taxpayer's reliance on a pre-Woods line of cases providing that valuation misstatement penalties were not appropriate following a technical disallowance when the court does not otherwise determine a value for the easement. Todd v. Comm'r, 862 F.2d 540 (5th Cir. 1988).

The posture of the parties—i.e., the taxpayer's motion for summary judgment— somewhat limited the court's analysis on the valuation misstatement penalty. While the court indicated that valuation misstatement penalties could be applied following a technical violation, it is unclear if the disallowance is enough to trigger the penalty or if the court would also have to make a determination regarding the easement's value to apply a valuation misstatement penalty.

The court seemed to indicate that more litigation was necessary to determine the appropriateness of a valuation misstatement penalty. "The government's successful motion for summary judgment as to the deduction's disallowance does not preclude it from continuing to litigate Partita's challenge to the underpayment penalties, which will be decided at trial."

If a successful disallowance by the IRS is enough to trigger the penalty, then the effect of Woods and Paritia is that a gross valuation misstatement penalty will always

be at the IRS's disposal following the disallowance of a taxpayer's deduction due to noncompliance with a technical requirement imposed on qualified conservation easement contributions.

PROCEEDS CLAUSE — EXTINGUISHMENT

CARPENTER V. COMM'R

T.C. Memo. 2012-1

Overview

The easement deed permitted the easement to be extinguished by mutual consent of the donor / taxpayer and the donee / land trust. In a motion for summary judgment, the IRS argued that extinguishment by mutual consent violated the protected in perpetuity requirement of Code section 170(h)(5)(A) and Treasury Regulation section 1.170A-14(g)(1).

IRS Argument

The IRS took the position that the Code and regulations only permit extinguishment pursuant to a condemnation or other judicial proceeding. The Tax Court held that the easement was not enforceable in perpetuity and therefore the taxpayer's deduction was disallowed in total.

Judicial Extinguishment

The court reasoned that the "restrictions [in a deed] are supposed to be perpetual in the first place, and the decision to terminate them should not be solely by interested parties. With the decision-making process pushed into a court of law, the legal tension created by such judicial review will generally tend to create a fair result."

So-Remote-As-To-Be-Negligible

The court rejected the taxpayers argument that the possibility of extinguishment was so-remote-as-to-be- negligible, and adopted the principle expressed in Kaufman II, 139 T.C. 294 (2011) that "the so-remote-as-to-be-negligible standard does not affect the taxpayers obligations under Treasury Regulation section 1.170A- 14(g)(6)(i)."

Overview

On a motion for consideration, the Tax Court rejected the taxpayer's position that the subsequent reversal of Kaufman II by the First Circuit Court of Appeals in Kaufman III affected its holding in Carpenter. The court stated: "we find that the holding in Kaufman III does not apply to this case and thus does not constitute an intervening change in law which would justify granting the motion to reconsider

CARROLL V. COMM'R

146 T.C. No. 13 (2016) (Judge Rume)

Overview

The Tax Court in Carroll denied a taxpayer's deduction for a conservation easement donated in 2005. The donated easement protects approximately 20 acres of land near Baltimore, Maryland. The taxpayer donated the easement in December 2005, and claimed a deduction of $1.2 million. The Court disallowed the deduction due to poor wording of the easement deed concerning the distribution of proceeds if the easement is extinguished, e.g., by condemnation. The Court ruled that the extinguishment language must track the language of the regulation exactly; otherwise the easement fails to meet the requirements of section 170. It is an unfortunate result for the taxpayer because the error probably was inadvertent and could have easily been avoided by a minor edit of the easement deed. This is yet another example of the all-out attack the IRS is making and will continue to make on conservation easement deductions.

Proceeds Clause Problem

The Court concluded that the easement's conservation purpose was not protected in perpetuity because the language regarding extinguishment proceeds was inconsistent with the regulations. Treasury Regulation § 1.170A-14(g)(6) discusses unexpected changes in the conditions surrounding donated property. If the easement is extinguished, and the property is sold, the amount of proceeds that go to the donee must be equal to "the proportionate value that the perpetual conservation restriction at the time of the gift bears to the value of the property as a whole at the time." The easement deed in this case stated that the numerator in this fraction would be the "deduction for federal income tax purposes allowable by reason of this grant," rather than the fair market value of the conservation restriction on the date of the gift. The Court viewed this as allowing a "potential windfall" for the landowner if the easement was extinguished and the deduction was disallowed

for reasons other than value. The Court also held that the requirements in Treasury Regulation § 1.170A-14(g) must be strictly complied with, despite the fact than any potential extinguishment was highly unlikely.

Even though the Court ultimately disallowed the deduction, there are several positive findings in the decision. First, the Court found that the easement was a qualified real property interest based on the land trust's testimony that it would enforce the restrictions in the easement. In addition, the Court found that the donation satisfied the conservation purpose requirement because the easement was accepted by a State agency after a thorough review process and the land was in a highly populated area that benefited from the easement.

- PBBM-Rose Hill, Ltd. v. Comm'r, No. 26096-14 (Oct. 7, 2016) (bench opinion Judge Morrison) on page 29.

QUALIFIED FARMER STATUS

RUTKOSKE V. COMM'R

149 T.C. No. 6 (August 7, 2017) (Judge Jacobs)

Overview

On August 7, 2017 the Tax Court issued Rutkoske v. Comm'r, 149 T.C. No. 6 ("Rutkoske"), which affects the determination of what types of income count for purposes of determining qualified farmer status. See I.R.C. § 170(b)(1)(E)(iv).

This case involved a 2009 conservation easement encumbering 355 acres of land. The taxpayer conveyed the conservation easement as part of a bargain sale transaction with a qualified organization. The taxpayer conveyed the conservation easement to a qualified organization in exchange for $1,504,960, and claimed a charitable deduction of $1,335,040 for the "bargain" aspect of the conveyance.

There was no dispute that the taxpayers, who were brothers, "were in the business of farming. Through numerous entities they owned seven parcels of land in Maryland and Delaware, totaling 1,455 acres in 2009… During 2009 the brothers each rendered at least 2,500 hours of physical labor and management services in growing and harvesting corn, barley, wheat, and soybeans on all of their properties. They borrowed money when necessary and joined the U.S. Department of Agriculture's Farm Service Agency subsidy programs. In fall 2008, the brothers, through Rutkoske Farms, planted wheat on the property and reserved to themselves its harvesting and the proceeds derived from the sale thereof."

The classification as a qualified farmer or rancher has great importance because such individuals are able to deduct a higher percentage of their yearly income for contributions of conservation easements.

Percentage of Contribution Base Limits

Subparagraph (E) of section 170(b)(1) governs the deductibility of a "qualified conservation contribution" by an individual. Section 170(b)(1)(E)(i) generally limits the deduction from such a donation to 50 percent of the donor's "contribution base," defined by section 170(b)(1)(G) as the taxpayer's adjusted gross income (computed without regard to any net operating loss carryback for the taxable year) less the value of his/her other charitable contributions for the year.

Section 170(b)(1)(E)(iv) provides a special rule for contributions of property used in agriculture or livestock production. If the individual is a "qualified farmer or rancher" for the taxable year for which the contribution is made, then that individual may deduct the value of the donation up to 100 percent of the his or her contribution base, less the amount of all other charitable contributions allowable under section 170(b)(1) made during the year. Section 170(b)(1)(E)(v) defines the term "qualified farmer or rancher" as an individual whose gross income from the trade or business of farming (within the meaning of section 2032A(e)(5)) is greater than 50 percent of the individual's gross income for the taxable year.

Section 2032A(e)(5) sets forth activities, the revenues of which constitute income from the trade or business of farming:

- Cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, shearing, feeding, caring for, training, and management of animals) on a farm;
- Handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity so treated; and

- The planting, cultivating, caring for, or cutting of trees, or (2) the preparation (other than milling) of trees for market.

To determine whether the contribution of the conservation easement qualifies for the special rule of section 170(b)(1)(E)(iv), a fraction must be created, the numerator of which is the income derived from the trade or business of farming, and the denominator of which is the donor's gross income. See I.R.C. §170(b)(1)(E)(v).

Trade or Business of Farming

The issue before the Tax Court was how much of the taxpayer's income was derived from the trade or business of farming. The taxpayer took the position that the sale of the conservation easement and the sale of property used in the business of farming constituted income derived from the trade or business of farming.

Tax Court's Holdings

The court acknowledged that the purchase and sale of farming property was necessary activity of a farming business, but was quick to point out that it was not determining the validity of "operational expense deductions or any other provision of the Code that relates to a business' general operations." Rather the court was interpreting "a narrowly tailored provision intended to provide a tax benefit for a specific action, namely, the contribution of conservation easements by qualified farmers." The court refused to expand the scope of what interpreted to be a narrowly tailored Code section.

The Tax Court held that income derived from the sale of a conservation easement encumbering farmland or ranchland is not income derived from the trade or business of farming. Additionally, Tax Court determined that income derived from the sale of property (real and personal) used in the business of farming or ranching is not income derived from the trade or business of farming.

QUID PRO QUO

- Seventeen Seventy Sherman Street v. Comm'r, T.C. Memo 2014-124 (Judge Marvel) on page 72.
- McGrady v. Comm'r, T.C. Memo. 2016-233 (Judge Lauber)

Overview

In McGrady, the taxpayers claimed 2007 made a non-cash charitable contribution and claimed a deduction of $4.7 million. This contribution comprised two distinct gifts, which were components of a complex conservation plan in Bucks County, Pennsylvania undertaken by the township, Heritage Conservancy, the taxpayers, and other private individuals. This resulted in several transactions between numerous parties. See McGrady v. Comm'r, T.C. Memo. 2016-233 at *2-4.

Taxpayers donated to the township in which they lived a qualified conservation easement on their 25–acre homestead property, and they donated to a tax-exempt conservation organization a fee simple interest in an adjoining 20–acre parcel of undeveloped land.

The IRS disallowed these deductions in full. It raised several contentions, including: (1) that the taxpayers overvalued the donated property and were subject to penalties; and (2) that the taxpayers received return benefits in exchange for their gifts ("quid pro quo").

Quid Pro Quo

The IRS claimed that the taxpayers received quid pro quo benefits pursuant to the transactions, which adequately compensated the taxpayers for the property they conveyed. According to the IRS, these quid pro quo benefits negated "[t]he sine qua non of a charitable contribution [i.e.,] a transfer of money or property *without* adequate consideration." United States v. Am. Bar Endowment, 477 U.S. 105, 118 (1986) (emphasis added).

The IRS did not identify any specific benefit that the Taxpayers received in the negotiations. Instead, the IRS lobbed vague aspirations regarding the taxpayers' "supposed ability to steer the entire set of transactions in a way that benefited them. [The taxpayers] were motivated by a desire to protect their privacy and to prevent suburban development from spoiling the attractive views from their residence. … if not ceding petitioners actual control, [Heritage and the Township] allowed them to guide the transactions in a direction that achieved [the taxpayers'] personal goals.

Tax Court Decision

The Tax Court rejected the IRS quid pro quo argument in what should be considered a major taxpayer victory. The Tax Court held that even though taxpayers were involved in negotiations with and benefited somewhat

(buffer to homestead) from the development plan the Township agreed to in those negotiations, that there was no quid pro quo because the taxpayers were mere incidental beneficiaries. In rejecting the IRS's quid pro quo argument, the Tax Court explained that

Whenever a homeowner places a conservation easement over his property, or a neighbor places a conservation easement over neighboring property, the homeowner in a sense "benefits" by having natural landscapes rather than suburban sprawl in his immediate surroundings. When the Township approved a conservation subdivision on the Rorer Tract, petitioners may be said to have "benefited" because the Rorer Tract surrounded their property. But petitioners were mere incidental beneficiaries of this action. Heritage and the Township executed these transactions not to benefit petitioners or the Creeks Bend homeowners but to accomplish their charitable purposes of conserving rural and agricultural land. See McLennan v. United States, 24 Cl. Ct. 102, 107 (1991) (upholding charitable contribution deduction where "[a]ny benefit which inured to * * * [the taxpayer] from the conveyance was merely incidental to an important, public spirited, charitable purpose"), aff'd, 994 F.2d 839 (Fed. Cir. 1993).

Ultimately the court was "unpersuaded by [the IRS] characterization of these events. [The taxpayers] were indeed involved in the negotiations from the outset, but this was inevitable…. There is no evidence that [the taxpayers] had the power to manipulate these negotiations or that the other parties made meaningful concessions to them. The Township and Heritage were single-mindedly dedicated to accomplishing the maximum degree of environmental conservation consistent with the financial realities they confronted."

Penalties and Good Faith Defense

The Tax Court agreed with the IRS that the Taxpayers overvalued the conservation easement contribution, but it did not agree with the alternative value provided by the IRS, so it determined that "the appropriate values lie in between "the values provided by the taxpayers and the IRS. The Tax Court determined that the value claimed by the taxpayers for the fee simple gift was appropriate.

With respect to the conservation easement, the value determined by the court created the potential for both a negligence and substantial understatement of tax penalty and a substantial valuation misstatement penalty. See I.R.C. §6662(a), (b)(1), (b)(3).

The Tax Court held that the taxpayer was not liable for the negligence and substantial understatement of tax penalty because the taxpayer acted in good faith and had reasonable cause for the understatement. The taxpayer relied in good faith on the appraisals performed by Mr. Quinn and on the advice of the tax return preparer who had competently represented them for many years. Mr. Quinn had significant experience valuing real estate in Bucks County. … [The taxpayers'] return preparer was likewise knowledgeable about property donations, including conservation easements. [The taxpayers] made full disclosure of all relevant facts to them both."

The Tax Court found that the Taxpayers also satisfied the additional requirements to have a good faith defense to a substantial valuation misstatement penalty. The IRS did not dispute that Mr. Quinn was a qualified appraised or that the appraisal provided by Mr. Quinn was a qualified appraisal. The taxpayers demonstrated that they made a good faith investigation into the value of the donated conservation easement because they were involved from the outset in the negotiations to formulate a conservation plan for the area, they worked with the township and Heritage Conservancy, were aware of demand for land in the Township, and relied on experts to determine the appropriate method to accomplish the parties conservation goals.

BASELINE

- BC Canyon Ranch II, L.P. v. Comm'r, 867 F.3d 547 (5th Cir. 2017) on page 62.

CONTEMPORANEOUS WRITTEN ACKNOWLEDGEMENT

15 WEST 17TH STREET LLC V. COMM'R

147 T.C. No. 19 (2016) (Judge Lauber)

Overview

The taxpayer donated a conservation easement and claimed a charitable contribution deduction of $64,490,000 on its partnership return for the 2007 tax year. This case involved the substantiation requirement imposed on a donor of charitable property. "In order to substantiate a charitable contribution deduction of

$250 or more, a taxpayer must secure and maintain in its files a 'contemporaneous written acknowledgment' (CWA) from the donee organization. I.R.C. sec. 170(f)(8)(A). The CWA must state (among other things) whether the donee provided the donor with any goods or services in exchange for the gift. I.R.C. sec. 170(f)(8)(B)(ii)."

The substantiation requirements of section 170(f)(8)(A) do not apply to a contribution "if the donee organization files a return, on such form and in accordance with such regulations as the Secretary may prescribe," that includes the information specified in subparagraph (B). I.R.C. section 170(f)(8)(D). As of the date of the opinion (and of this writing), Treasury has not issued regulations to implement the donee-reporting regime referred to in subparagraph (D).

IRS Audit Amended Form 990 Filed

The IRS audited the LLC's 2007 partnership return and determined that the charitable contribution deduction should be disallowed in its entirety. Subsequent to the audit and the case being docket in Tax Court, the donee—Trust for Architectural Easements ("Trust")—filed an amended Form 990, Return of Organization Exempt from Income Tax, that included the information required by section 170(f)(8)(B). The LLC thereafter filed a motion for partial summary judgment, contending that this action by the Trust eliminated, as a matter of law, the need for a CWA.

On its initial Form 990, Return of Organization Exempt from Income Tax, for calendar year 2007, the Trust did not report receipt of a charitable contribution from the LLC. Nor did it report whether it had provided any goods or services to the LLC in exchange for the easement.

Tax Court Decision

The court was faced with a familiar inquiry: whether a Code section "is self-executing in the absence of implementing regulations."

This case thus requires us to address a question that has arisen with some frequency: How should a court respond when a taxpayer or the IRS desires to have a particular tax treatment apply in the absence of the regulations to which the statute refers? In some cases, the Secretary may have affirmatively declined to issue regulations, having concluded that they are unnecessary or inappropriate. In other cases, the Secretary may intend to issue regulations but may have encountered delays because of subject matter complexity or the press of other business. Courts have described the question presented here as whether the statute is "self-executing" in the absence of regulations. … The courts have struggled to define the proper judicial response in these scenarios. In each case, Congress has delegated to an executive branch agency the task of using its expertise to craft appropriate regulations. Under the Administrative Procedure Act and familiar separation-of- powers principles, a court's usual role is to review the regulations an agency has issued, not to conjure what regulations might look like had they been promulgated. On the other hand, if it is absolutely clear that Congress intended that a particular tax benefit or tax treatment should be available, a legitimate question arises as to whether the IRS may prevent that outcome by declining to engage in rulemaking. Commentators have described this scenario as one of "spurned delegations" and the resulting judicial dilemma as one of crafting "phantom regulations."

Tax court ruled that 170(f)(8)(D) was not self-executing and not operative without Treasury regulations. This led the court to conclude that the 990 returns filed land trust did not provide valid substitutes for the CWA.

FRENCH V. COMM'R

T.C. Memo. 2016-53 (Judge Marvel)

Overview

In French, the taxpayer did not receive from the donee organization a timely letter of the sort that normally acts as a "contemporaneous written acknowledgment" (CWA) within the meaning of section 170(f)(8)(B). Taxpayer contended that it nevertheless satisfied the statutory substantiation requirements relying on two documents.

The first was the letter from an MLR representative to Davy and Priscilla French dated June 6, 2006. Because the taxpayers filed their 2005 amended return on or before April 15, 2006, the court determined that the letter was not contemporaneous with petitioners' 2005 return and could not satisfy the substantiation requirements.

The second was is the conservation deed recorded on December 29, 2005. The IRS and the taxpayers disputed whether the conservation easement deed satisfies the contemporaneous written acknowledgment" (CWA)

imposed by Section 170(f)(8)(B)(ii), which requires that a CWA state whether the donee organization provided goods or services in exchange for the donor's charitable contribution.

Did CE Deed meet I.R.C. Section 170(f)(8)?

The Court described the test for determining if a conservation easement deed satisfied the CWA requirement:

> "We have held that a deed of conservation easement may satisfy the substantiation requirements of section 170(f)(8), including subparagraph (B)(ii). … Generally, to satisfy the requirement of section 170(f)(8)(B)(ii), the deed must contain a statement about whether the donee provided goods or services for the contribution. …. When a deed does not contain an explicit statement, this Court has looked to the deed as a whole to determine whether the donee provided goods or services."

The Tax Court determined "that the conservation deed did not state whether the donee provided goods or services in exchange for the charitable contribution. Therefore we must analyze whether the deed taken as a whole shows compliance with section 170(f)(8)(B)(ii)."

In analyzing the conservation easement deed as a whole, the court noted that it "includes provisions stating that the intent of the parties is to preserve the property." However, the conservation easement deed did not include "a provision stating that it is the entire agreement of the parties" (i.e., a merger / integration clause).

The lack of a merger clause led the tax court to conclude "that the conservation deed taken as a whole is insufficient to satisfy section 170(f)(8)(B)(ii), because without a merger clause, the IRS could not have determined by reviewing the conservation deed whether [taxpayers] received consideration in exchange for the contribution of the conservation easement."

310 RETAIL, LLC V. COMM'R

T.C. Memo. 2017-164 (Judge Lauber)

Overview

In 310 Retail, the taxpayer did not receive from the donee organization a timely letter of the sort that normally acts as a "contemporaneous written acknowledgment" (CWA) within the meaning of section 170(f)(8)(B). Taxpayer contended that it nevertheless satisfied the statutory substantiation requirements relying on three documents.

The first two documents were the donee's 990, Return of Organization Exempt from Income Tax. After the time the taxpayer filed its motion for summary judgment but before the court had issued its opinion, the Tax Court released its en banc opinion in 15 West 17th Street LLC v. Comm'r, 147 T.C. No 19 (2016), which held that subsequently filed partnership returns do not satisfy the CWA requirement. The taxpayer acknowledged that the Tax Court's en banc opinion in 15 West 17th Street was dispositive of his contention with respect to the land trust's return.

Tax Court Holding

The Tax Court did find that the easement deed qualified as a CWA: "The deed of easement in the instant case is similar in all material respects to the deed in RP Golf, LLC, and we reach here the same result we reached there. The deed of easement was properly executed by LPCI's president and recorded by the Cook County Recorder of Deeds on December 30, 2005. It thus constituted a 'contemporaneous' acknowledgment. See I.R.C. § 170(f)(8)(C)."

BIG RIVER DEVELOPMENT LP V. COMM'R

T.C. Memo. 2017-166 (Judge Lauber)

Overview

In Big River, the taxpayer did not receive from the done organization a timely letter of the sort that normally acts as a "contemporaneous written acknowledgment" (CWA) within the meaning of I.R.C. section 170(f)(8)(B). The taxpayer contends that it nevertheless satisfied the statutory substantiation requirements because the deed of easement constituted a de facto CWA.

After reviewing relevant case law, the Tax Court "concluded that the deed of easement [in Big River], like the deeds of easement in Averyt and RP Golf, LLC, qualified as a CWA because it included an affirmative indication that the donee organization had supplied no goods or services to the taxpayer in exchange for its gift the deed of easement involved here resembles in material respects the deeds of easement involved in 310 Retail, LLC, and RP Golf, LLC…It thus constituted a "contemporaneous" acknowledgment."

Tax Court Holding

In granting the taxpayer's motion for summary judgment, the Tax Court determined, as a matter of law, that the easement deed satisfied the CWA requirement. The court relied on its prior case law: "We have previously held that a deed of easement may constitute a CWA. See 310 Retail, LLC v. Comm'r, T.C. Memo. 2017-164; RP Golf, LLC v. Comm'r, T.C. Memo. 2012-282; Averyt v. Comm'r, T.C. Memo. 2012-198." (internal citations abbreviated).

QUALIFIED ORGANIZATION

IRS RELEASE 20140518

Overview

IRS Release 20140518 tells a tale of woe in which an organization that considered itself a qualified organization, and had previously received an advanced ruling from the IRS that the organization was exempt from tax under Section 501(a) of the Code as a 501(c)(3) organization, lost its status as an exempt organization under Section 501(c)(3) because it was not being operated for exempt purposes.

In revoking tax exempt status, IRS concluded that the organization was simply a conduit for the entity's president who is described as having vast knowledge and experience in the field of public accounting as demonstrated by his being one of less than 250 non-lawyers nationwide admitted to practice before the US Tax Court to help his clients obtain sizable deductions.

In its analysis, the IRS reviewed in detail three land transactions that the entity had entered into that were deemed to be connected to the president and show that the president's intent and goals were not concerned with environmental or conservation issues, but rather that the president used the organization as a vehicle for enrichment of his clients.

Comment

This Release illustrates that the role of the land trust in conservation easement transactions is very important and that a key to successfully donating a conservation easement includes making sure that the donee of such a grant truly is a "qualified organization." The Release puts all on notice to carefully review each potential donee of a conservation easement to be certain that it satisfies the Code's requirement for being a "qualified organization."

Notes

1 But see, discussion of Palmolive Bulding, 149 T.C. No. 18 (2017) infra.

2 Golsen v. Comm'r, 54 T.C. 742, 757 (1970).

3 There are exceptions to this rule for additions to tax under section 6651, 6654, or 6655 or penalties automatically calculated through electronic means.

4 The Internal Revenue Manual (IRM) provides that workpapers document the procedures applied, texts performed, information obtained, and conclusions reached. IRM 4.46.6.2(2) (Dec. 29, 2009).

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