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RECENT CASES / RELEASES

Scheidelman v. Commissioner, 682 F.3d 189 (2d Cir. 2012) vacating and remanding T.C. Memo. 2010–151.

- Architectural easement on townhouse in Brooklyn.
- Tax Court (Judge Cohen) found appraisal was not a "qualified appraisal."
- The court denied deductions for cash contribution, but did conclude that the taxpayer acted in good faith and with reasonable cause and therefore was not liable for penalties.
- 2nd Circuit Court of Appeals vacated the Tax Court holding, finding the appraisal (1) adequately specified the appraiser's method of determining easement's fair market value and (2) adequately specified the basis for determining easement's fair market value.
- Allowed the deduction for cash contribution.
- Found that an incomplete Form 8283 "substantially complied" with the requirements.
- On remand, T.C. Memo. 2013-18, Tax Court assigned zero value to the easement

Rothman v. Commissioner, 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 2nd Circuit's opinion in *Scheidelman* was controlling precedent (*Golsen* Rule)

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

Gorra v. Commissioner, T.C. Memo 2013-254

- Tax Court (Judge Kerrigan) 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).
- Note: 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.

- IRS also claimed critical factual differences.

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).

- Façade easement on townhouse in Boston.
- ***Kaufman I*** (134 T.C. 182 (2010) (Judge Halpern), granted partial summary judgment finding mortgage subordination inadequate.
- ***Kaufman I*** found that IRC §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).
- In ***Kaufman II***, 136 T.C. 94 (2011), the Tax Court reconsidered its ruling. It allowed deduction of cash contributions and denied application of penalties.
- However, the court elaborated on the "enforceability-in-perpetuity" requirements of IRC §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.
- 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. The case is now at the Tax Court per remand and supplemental briefs have been filed by the parties.
- In ***Kaufman IV*****,** T.C. Memo 2014-52**,** the Tax Court determined value of easement to be zero.
- 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 taxpayer's reported value, where the claimed façade easement exceeded the correct value by 400% or more, constituting a gross valuation misstatement and, further, that the 40% 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. Commissioner, 138 T.C. No. 16 (2012) (Judge Hanes) involved an easement over 180 acres of unimproved land.

- The taxpayer bought the land, and the seller financed the sale and held a promissory note and deed of trust.

- The conservation deed was recorded in 2003, but the subordination to the deed was not signed until 2005.

- From 2003 to 2005, the taxpayer had the money to pay off the mortgage, payments on the note were current, and casualty insurance was in place.

- IRS denied the deduction for the conservation easement arguing in part that the donation did not meet the mortgage subordination requirement.

- The taxpayer countered that, although the subordination was not in place upon donation, the risk of default was not possible or "**so remote as to be negligible**." See Treas. Reg. §1.170A-14(g)(3) (remote future events).

- The Tax Court rejected the taxpayers argument, instead following *Kaufman* II on the principle that the subparts of Treas. Reg. §1.170A-14(g) do not modify one another.

- The taxpayers avoided penalties based on a finding of good faith and reasonable cause.

- Taxpayers filed a motion for reconsideration based on *Kaufman III* which was granted. Supplemental briefs were lodged in December 2012.

Butler v. Comm'r, T.C. Memo. 2012-72 (Judge Wells)

- Allowed deduction for easement over forest and farm land, making careful analysis of reserved uses that might damage the conservation values; i.e., the "inconsistent use" rule).

Averyt v. Comm'r, T.C. Memo. 2012-198 (Judge Wells)

- Contemporaneous written acknowledgement may be satisfied by the easement deed itself, although the "no goods or services" language was omitted.

R.P Golf, LLC v. Comm'r, T.C. Memo. 2012-282 (Judge Paris)

- Similar ruling to *Averyt*; less precise language in the deed.

Belk v. Commissioner, 140 T.C. No. 1 (2013) (Judge Vasquez)

- Taxpayers donated a conservation easement over golf course property. The easement provided that the donor might substitute the property subject to the easement with "*an area of land owned by Owner which is contiguous to the Conservation Area for an equal or lesser area of land comprising a portion of the Conservation Area*." The substitute land would have to have economic and conservation values at least equal to the original land.

- IRS denied the deduction, arguing that this substitution provision violated IRC §170(h)(2)(C), which defines a qualifying "interest in property" to include "a restriction (*granted in perpetuity*) on the use which may be made of the real property."

- The Tax Court distinguished cases dealing with perpetuity of *conservation purpose* under IRC §170(h)(5)(a), finding that §170(h)(2)(C) creates a distinct perpetuity requirement relating to the *property* subject to the easement, in addition to protection *in perpetuity* of the conservation *purpose*.

- The *Belk* court denied the deduction, because the substitution provision meant that the conservation easement might be "swapped" and the original property was therefore not subject to a use restriction in perpetuity as required by IRC §170(h)(2)(C).

- This ruling may have implications to other types of easement amendments and modifications of easements.

Crimi v. Comm'r, T.C. Memo 2013-51 (Judge Laro)

- Lack of a qualified appraisal overcome because failure resulted from reasonable reliance on tax professional.

Friedberg v. Comm'r, T.C. Memo 2013-224

- Tax Court (Judge Wells) 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.

- 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."

- Moreover, 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 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.

Mountanos v. Comm'r, T.C. Memo 2013-138

- Tax Court (Judge Kroupa) analyzed whether a conservation easement encumbering ranch property in Lake County, California, which the IRS conceded was a qualified conservation contribution had any value that was deductible under Section 170(h).

- What makes *Mountanos* interesting is the Tax Court's determination of the value of the easement under the before-and-after method. Under this approach, the Tax Court had to determine the highest and best use of the subject property before and after the grant of the easement.

- In its analysis, Tax Court defined the HBU as the highest and most profitable use for which the property is adaptable or needed or likely to be needed in the reasonably near future. The Government successfully argued that the conservation easement resulted in no charitable contribution because the Taxpayer did not satisfy his burden of proof that the HBU of the property was other than recreation both before and after the easement was granted.

- The taxpayers were unable to show that before the grant of the easement, it was reasonably probable that the property could be used partially as a vineyard and partially for residential development (which would have had a higher value than property with a HBU of recreational use).

IRS Release 20140518

- Released on February 18, 2014, by IRS to tell 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.

- 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."

IR 2014-31

- News release that 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 difference concerns that the IRS worried about in July, 2011.

Wachter v. Commissioner, 142 T.C. No 7 (Mar. 11, 2014)

- Tax Court (Judge Buch) 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."

Esgar v. Commissioner, U.S. Court of Appeals, Tenth Circuit, No. 12-9009 (March 7, 2014)

- Tenth Circuit weighed in on the determination of the highest and best use of property, which is a key factor in valuation.

- Taxpayer donated easements on land adjacent to land that taxpayer had used for gravel mining.

- Taxpayers argued that HBU of the eased property prior to easement was gravel mining, IRS argued that the HBU was agriculture.

- Tax Court considered expert reports and determined that it would have been physically possible to mine the property, but there was no demand in the near future.

- Using comparable sales of agricultural lots, the Tax Court (Judge Wherry) T.C. Memo 2012-35 determined easement values equal to less than 1/10th of what the taxpayers originally claimed on returns.

- The taxpayers argued that the Tax Court erred in determining the highest and best use value by looking at current use rather than future development. The Court of Appeals disagreed, finding that the Tax Court properly applied the legal standard, which is to objectively asses the pre-easement highest and best use. Any determination of what that highest and best use was (i.e., agriculture or future development) could only be reversed for clear error, a difficult standard to meet.

- In this case, the Tax Court did not clearly err because there was evidence to support its conclusion that gravel mining was not reasonably foreseeable in the future.

- The Court of Appeals also rejected the taxpayer's claim that the Tax Court improperly relied on eminent domain cases, which look at the "highest and most profitable use" of the property prior to a taking, noting that several other easement cases have likewise relied on the eminent domain precedent.

- Court of Appeals concluded that requirements of Treas. Regs in determining HBU value of a conservation easement do not materially differ from calculation of property value in the eminent domain context.

Palmer Ranch Holdings, Ltd. v. Comm'r, T.C. Memo 2014-79 (May 6, 2014)

- In a new valuation case, the Tax Court (Judge Goeke) considered whether the taxpayer's claimed highest and best use which was based on changing the zoning designation was "reasonably probable."

- The IRS argued that it was not reasonably probable that zoning on the subject property could be changed to increase density from 70 to 100 dwelling units up to a maximum of 352 dwelling units. The Tax Court considered and rejected the four impediments to rezoning asserted by the IRS: 1.) the taxpayer's failed rezoning history on property adjacent to the subject property, 2.) environmental concerns regarding the property, 3.) limited access to outside roads and 4.) neighborhood opposition.

- The Judge disagreed with the IRS argument that the prior zoning failure indicated that denser development would not be approved. The Tax Court distinguished cases where zoning history was similarly used; noting that the denial was 2 years prior to the grant of the easement and that the final order involved a different parcel, not the subject property. The Tax Court also noted that the previous denial was made by a 3-2 vote, suggesting the board's decision could have changed over time. Finally Tax Court observed that significant development had been permitted on other adjoining parcels and that the IRS's own land use planner recognized that there are significant developable areas in the wildlife corridor that run through the property.

- The wildlife corridor and the existence of an eagle's nest and other important animal life in the wildlife corridor made this property a good candidate for a conservation easement. The conservation purpose was not challenged in the case. Interestingly, the Tax Court found that the existence of the wildlife corridor did not decrease the reasonable probability of successful zoning.

- The Tax Court also addressed whether the IRS's argument that road access was not readily available and that neighborhood opposition would have limited such access to emergency use only. The Tax Court disagreed with the IRS for a number of reasons. As stated in the decision, neighborhood opposition alone will not preclude development. Moreover, the IRS position required three assumptions: 1.) that the residents would object to ingress and egress on the property, 2.) that any possible objection would be a factually based argument strong enough to preempt such access and 3.) the Board of County Commissions would find merit in the argument. The Tax Court was not prepared to make these assumptions.

- As to road access, the IRS argued that an applicable access point to the property was not possible without an additional cost to the hypothetical willing buyer to purchase an access easement. The Tax Court noted that since the taxpayer controlled that access point on the adjoining property, the additional costs of granting an easement to himself (the ultimate friendly seller!) would not have been significant. Accordingly, the Tax Court found that the factor did not decrease the probability that the property could have been rezoned.

- Finally, the IRS contended that neighborhood opposition is another factor that would prevent the parcel from being rezoned. For support, the IRS pointed to neighborhood opposition to the taxpayer's attempt to rezone different land parcel. The Tax Court noted that even if one were to assume rezoning the parcel at issue would face neighborhood opposition, to find such opposition effective the Tax Court would have to make the same three assumptions mentioned above. Since the Tax Court was not interested in making those assumptions, it found that potential neighborhood opposition did not bar the reasonable probability of a successful rezoning.

- Accordingly, the Tax Court found that there is reasonable probability that the subject property could have been successfully rezoned to allow for the development of multi-family dwellings at the higher density level assumed in the taxpayer's appraisal evaluation analysis.

- The taxpayer did take a haircut on value because the Tax Court found that the inflation rate assumed by the taxpayer in determining its value was too high, especially given the deterioration of the real estate market and the softening of demand in the applicable tax year (2006).

- With respect to the proposed accuracy related penalty, because the diminution in value was less than 40%, but greater than 20%, the Tax Court had to determine whether the taxpayer was entitled to avoid the accuracy-related penalty under the reasonable cause exception found in Section 6664(c). The IRS's principle argument was that the taxpayer did not inform its appraiser or tax return preparer of an ordinance that would have affected valuation. However, the Tax Court found that the omission did not show a lack of good faith and that the omission would not have affected the tax return preparation. The Tax Court noted that the taxpayer retained a tax attorney to advise it on how to donate the easement in compliance with the Code and that the attorney had retained a licensed appraiser and a land planner. While the Tax Court identified flaws in the appraisal, the Court concluded that these flaws were not due to information contained in the omitted ordinance. Accordingly, the Tax Court (1) found that the actions taken by the taxpayer represented a good faith attempt to determine the easement's value, (2) concluded that Palmer Ranch had reasonable cause and acted in good faith with respect to its underpayment for 2006 and (3) held that taxpayer was not liable for the accuracy-related penalty.

Chandler v. Comm'r, T.C. 142 T.C. No. 16

- On May 14, 2014, the Tax Court (Judge Goeke) issued an opinion in Chandler v. Commissioner. The opinion is consistent with a string of cases denying deductions for preservation easements in the Northeast. Nevertheless, it is worth a second glance due to its statements about the application of "gross valuation" penalties.

- The case involved two façade easements (also known as "preservation" or "conservation" easements) granted on two single-family residences in Boston. The first issue before the court was the value of the preservation easements. In determining that the value of the easements was zero, the court analyzed the appraisal reports submitted by both parties. The court found the taxpayers' appraisal to be flawed, in part because it analyzed "comparable" properties that were located outside of Boston. Although, the court similarly found the report submitted by the IRS to be unpersuasive, it still found the value of the preservation easements to be zero. In so concluding, the court relied on the rationale of *Kaufman v. Commissioner*. In *Kaufman*, the court determined that when there are relatively minor differences in local property restrictions and the requirements imposed by an easement, such differences normally do not reduce the value of the property.

- The court next turned to the application of penalties. Importantly, the carryovers (taken in 2005 and 2006) generated by the donations (made in 2004) resulted in multiple years being at issue in the case. This, in turn, raised questions about how (and when) the 2006 Pension Protection Act (PPA) changes to the penalty provisions applied to tax returns filed after the effective date of the statute (July 25, 2006), but which contained carryover deductions attributable to a donation made prior to the PPA changes. The PPA changes to the penalty provision are important to the "gross valuation" penalty for two reasons: (1) The PPA changes caused the 40% penalty to apply anytime a taxpayer overvalues property by more than 200%, as opposed to prior law which required a 400% overvaluation and (2) the PPA changes made the gross valuation penalty a "strict liability" penalty by eliminating the "reasonable cause and good faith" exception to the penalty.

- Because the court determined the value of the preservation easements to be zero, the overvaluation threshold (200% or 400%) was irrelevant. However, the court determined that the taxpayers made a good faith attempt to determine the values of the donated easements, allowing the taxpayers to avoid the 40% penalty under the law in place prior to the PPA changes. The court then determined which years the reasonable cause exception applied to. The application of the reasonable cause exception to the 2004 and 2005 tax years at issue in the case was easy because the deductions were *claimed and reported* prior to the 2006 changes. The 2006 year was a bit trickier because, although it reported a deduction taken prior to the PPA changes, it was filed after the PPA changes. The IRS argued the strict liability changes should apply due to the filing date of the return. The taxpayers argued the reasonable cause exception under the prior law should apply because the easements were granted and the deductions were originally taken prior to the PPA changes. The court found for the IRS, determining that the filing of the 2006 return amounted to a "reaffirmation" of the value originally claimed by the taxpayers.

- The Tax Court's decision is significant. Due to the slow pace at which tax disputes move through the courts and the frequency at which large easement donations result in carryover deductions, there are many unresolved cases involving easements (and other donations) which will be impacted by the decision. The IRS now has support for the position that any return filed after July 25, 2006 is subject to the post-PPA changes to the penalty provisions, regardless of when a charitable contribution claimed on such returns was made.

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 F3d 321, vacating and remanding (2008) 131 TC 112 (opinion by Judge Haplern)

- The ongoing Whitehouse saga reaches what is likely to be 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.

- A thorough summary of the Whitehouse trilogy of opinions is attached to this outline in the form of the article entitled “Conservation Easement Confusion in the Tax Court and Fifth Circuit”, 25 Taxation of Exempts, No. 1 (September/October 2013) at 32.

- The Fifth Circuit's decision will be helpful to many taxpayers seeking penalty relief in the conservation easement context. Typically taxpayers donating 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.

- 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.

- 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

- *Schmidt v CIR*, (T.C. Memo 2014-159) (Judge Marvel), 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.

- *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, T.C. Memo 2014-79 and *Kiva Dunes* T.C. Memo 2009-145 where the Tax Court recognizes and adopts the DCF Approach to value a conservation easement. Here, not only did the Tax Court 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 will 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.”

- 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.

- 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.

Zarlengo v. Comm’r, T.C. Memo 2014-161

- In *Zarlengo, et al v. Commissioner* (T.C. Memo. 2014-161) (Judge Vasquez), 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.

- 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.

- 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% diminution in value of the property, reducing the claimed easement value from $660,000 to $157,500.

- 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% 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% gross valuation misstatement penalty. This is a good reminder to taxpayers that valuation problems in post-2005 returns can lead to hefty penalties.

Seventeen Seventy Sherman Street v. Comm'r, T.C. Memo 2014-124

- In Seventeen Seventy Sherman Street v. Comm'r (T.C. Memo 2014-124) (Judge Marvel), 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.

- 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.

- 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.

- 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, (i) because of negligence or disregard of rules or regulation under Section 6662(b)(1), (ii) a substantial understatement of income tax under Section 6662(b)(2), or (iii) a substantial valuation misstatement under 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% 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 Section 170 and the regulations thereunder.

- 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.

- 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.

Belk v. Comm'r, U.S. Court of Appeals, Tenth Circuit, No. 13-216, December 16, 2014

- 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.

- 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. § 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.

- 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. § 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. § 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.

Mitchell v. Comm'r, U.S. Court of Appeals, Tenth Circuit, No. 13-9003 (January 6, 2015)

- The Tenth Circuit upheld the Tax Court's (Judge Haines) decisions in *Mitchell v. Commissioner*, 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.*

- 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."

- 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.

- 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.