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NAVIGATING THE DEFENSES TO VALUATION PENALTIES IN CHARITABLE DEDUCTION CASES

The 'good faith investigation' requirement imbedded in Section 6664(c)(3)'s reasonable cause provision provides courts with ample leeway to deny or grant relief from the imposition of charitable deduction valuation penalties.

***255** The quest to avoid valuation penalties is often an effort to avoid insult to a tax deficiency injury. Before embarking on a journey through the judicially-created maze of law on establishing 'reasonable cause' to avoid valuation penalties in charitable deduction cases, it is important to have a full understanding of the types of penalties that might apply in valuation cases and whether a 'reasonable cause' defense is even available. This requires an understanding of the relevant statutory framework set out in Sections 6662 and 6664.

SUBSTANTIAL AND GROSS VALUATION PENALTIES—HOW THEY WORK

There are two penalties specific to charitable contribution valuations: (1) a 'substantial' valuation misstatement penalty, and (2) a 'gross' valuation misstatement penalty. The substantial valuation misstatement penalty applies if 'the value of property (or the adjusted basis of any property) claimed on any return is 150% or more of the amount determined to be the correct amount of such valuation or adjusted basis....' [FN1] In such instances, Section 6662(a) imposes a penalty of '20 percent of the portion of the underpayment to which [Section 6662(a)] applies.' [FN2]

The 'gross' valuation penalty mirrors the 'substantial' valuation penalty, except the 150% threshold is replaced with a 200% threshold. [FN3] The penalty is ratcheted up from 20% of the portion of the underpayment attributable to the misstatement to 40%. Moreover, as discussed in more detail in this article, there is currently no reasonable cause exception available for a gross valuation misstatement. [FN4]

***256** A couple of examples illustrate the math.

Examples: Taxpayer donates real estate to charity and values the real estate at $1,500,000, resulting in a tax savings of $300,000. The IRS challenges the valuation, claiming the real estate is worth only $100,000, and asserts valuation penalties under Section 6662.

If the value of the real estate is ultimately determined to be $1,000,000 or less (thus the claimed value is 150% of the value ultimately determined), the substantial valuation misstatement penalty will apply (barring a reasonable cause defense). Because the redetermination of value in this case results in a tax deficiency of $100,000, the 20% penalty would be applied to the $100,000 deficiency, resulting in a $20,000 penalty.

If the value of the real estate is ultimately determined to be $750,000 or less (thus the claimed value is 200% of the value ultimately determined), the gross valuation misstatement penalty will apply. Because the redetermination of value results in a tax deficiency of $150,000, the 40% penalty would apply against the deficiency, resulting in a $60,000 penalty.

As demonstrated by these examples, valuation penalties can be substantial. The larger the understatement, the larger the deficiency will be, and the larger the applicable penalty. Moreover, once an overstatement in value reaches the ‘gross‘ valuation level, the penalty percentage increases and the ‘reasonable cause‘ exception is no longer available.

OVERVIEW OF THE STRUCTURE AND HISTORY OF THE CHARITABLE DEDUCTION PROPERTY VALUATION PENALTY EXCEPTIONS

Under the assumption that tax penalties are, at least in part, punitive in nature, Congress provided relief from penalties when a taxpayer had ‘reasonable cause‘ for his or her reporting position. These rules are currently found in Section 6664(c).

The Current Structure of Section 6664(c)

Section 6664(c)(1) provides the general rule that valuation penalties are not imposed with respect to any portion of an underpayment if it is shown there was (1) ‘reasonable cause‘ for such portion of the underpayment and (2) the taxpayer acted in ‘good faith‘ with respect to the tax position. This is the general ‘reasonable cause‘ exception applicable to most Section 6662 accuracy-related penalties.

Section 6664(c)(3), however, modifies the reasonable cause exception for ‘charitable deduction property.‘ Charitable deduction property is defined as ‘any property contributed by the taxpayer in a contribution for which a deduction was claimed under section 170.‘ [FN5] In this case, the reasonable cause exception is not available unless the taxpayer can establish (1) the claimed value of the property was based on a ‘qualified appraisal‘ made by a ‘qualified appraiser,‘ and (2) the taxpayer made a good faith investigation of the value of the contributed property. Furthermore, Section 6664(c)(3) entirely removes the reasonable cause exception for *gross* valuation misstatements of charitable deduction property, thereby making the gross valuation misstatement penalty a strict liability penalty.

The ‘giveth and taketh‘ framework of Section 6664(c) makes it unnecessarily difficult to interpret. The end result however is relatively simple. First, there is no reasonable cause exception to a ‘gross‘ valuation misstatement penalty involving charitable contribution property. Second, in order to qualify for the reasonable cause exception to the ‘substantial‘ valuation penalty with respect to charitable contribution property, the taxpayer must establish (1) the taxpayer had reasonable cause (as that term has been interpreted under prior law), (2) the taxpayer acted in good faith, (3) the value of the charitable deduction property was based on a ‘qualified appraisal‘ made by a ‘qualified appraiser,‘ and (4) the taxpayer made a good faith investigation of the value of the contributed property.

These four elements inevitably overlap, and the courts interpreting Section 6664(c) have intertwined the elements in their analyses. This makes dissecting the elements difficult. Moreover, the reasonable cause analysis involves parsing through the definitions within each of the four elements, and each definition can be complex. For instance, the terms ‘qualified appraisal‘ and ‘qualified appraiser‘ are the subject of extensive regulations (Regs. 1.170A-13(c)(3) and (5)) and have been the focus of several cases before the Tax Court.

The History of Charitable Deduction Property Valuation Penalties and Why It Still Matters

The valuation misstatement penalties discussed above have undergone a series of significant and relevant changes. The most significant of these changes are a result of the 2006 Pension Protection Act (PPA), which substantially altered the relevant provisions by (1) changing the percentage-of-value thresholds defining gross and substantial valuation misstatements and (2) making significant changes to the application of the ‘reasonable cause‘ exception.

With respect to the percentage-of-value thresholds, the PPA lowered the substantial valuation misstatement ***257** threshold from 200% to 150% of final value and the gross valuation misstatement threshold from 400% to 200%. Probably more significant, the PPA eliminated the ‘reasonable cause‘ exception for gross valuation misstatements.

Additionally, the PPA redefined the term ‘qualified appraisal.‘ Most notably, the PPA changed the definition to specifically require, among other things, that an appraisal must be conducted in accordance with ‘generally accepted appraisal standards.‘ Moreover, a qualified appraisal must be performed by a ‘qualified appraiser.‘ Prior to the PPA, in order to be a ‘qualified appraiser,‘ an individual simply had to hold himself or herself out to the public as an appraiser, or had performed appraisals on a regular basis and, because of his or her training and experience, was qualified to appraise the type of property being valued. [FN6] After the PPA, a qualified appraiser must have earned an appraisal designation from a recognized professional appraiser organization or must meet minimum education and experience requirements set forth in regulations. In addition, the appraiser must now demonstrate verifiable education and experience in valuing the type of property subject to the appraisal. [FN7]

The PPA changes were significant, but it is the authors' experience that the pre-PPA statute remains relevant. Charitable valuation cases, like many tax cases, often take years to work through resolution, and it is not uncommon for cases currently in court or under audit to involve tax years prior to 2006. Accordingly, the law in effect prior to the PPA changes is often applicable.

In *Chandler*, 142 TC No. 16 (2014), the Tax Court recently expanded on the applicability of the pre-PPA law by determining that carryover deductions attributable to a contribution made prior to the effect of the PPA changes will be governed by the law in effect during the year in which the carryover deduction is taken, at least in regards to the changes that made the gross valuation misstatement penalty a strict liability penalty. An understanding of the basic facts of *Chandler* helps illustrate its effect.

Chandler involved two facade 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. The court found the value of the preservation easements to be zero. The court next turned to the application of penalties. Importantly for purposes of this article, 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 PPA changes to the penalty provisions applied to tax returns filed after the effective date of the statute (7/25/06), [FN8] but which contained carryover deductions attributable to a donation made prior to the PPA changes. At issue were the PPA changes that made the gross valuation penalty a ‘strict liability‘ penalty by eliminating the ‘reasonable cause and good faith‘ exception to the penalty. The issue was critical because the court determined that the taxpayers had 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 applicability of the reasonable cause exception to the 2004 and 2005 tax years at issue in the case was straightforward because the deductions were claimed *and* reported prior to the effective date of the 2006 changes. The 2006 year, however, reported a deduction attributable to a donation made prior to the PPA changes, but the tax return claiming the carryover deduction was filed after the PPA changes (in 2007). The IRS argued that the strict liability changes should apply due to the filing date of the return. The taxpayers argued that 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.

Based on the holding in *Chandler*, the IRS now has support for the position that any return filed after 8/17/06 [FN9] is subject to the PPA changes to the penalty provisions, regardless of when a charitable contribution claimed on such return was made. This would specifically include denying 'reasonable cause' relief to any taxpayer claiming a carryover of a charitable deduction attributable to a property that was determined to be grossly overstated in value.

It is worth noting that *Chandler* did not resolve the issue of whether the PPA changes that reduced the substantial valuation misstatement percentage from 200% to 150% and the gross valuation misstatement percentage from 400% to 200% apply to carryover deductions taken after the effective date of the PPA change but attributable to a donation claimed on ***258** a return prior to the date. In *Schmidt*, TCM 2014-159, [FN10] and again in *Zarlengo*, TCM 2014-161, [FN11] the Tax Court clarified that the percentage threshold issue was not resolved in *Chandler*, and that the case was limited to the application of the PPA changes to the availability of the reasonable cause exception. Accordingly, the impact of the PPA changes to the gross and substantial valuation misstatement percentage thresholds for carryover deductions taken after 8/17/06 but attributable to a donation claimed on a return prior to 8/17/06 remains unresolved.

ESTABLISHING REASONABLE CAUSE IF AND WHEN IT IS AVAILABLE

Considering the relatively-clear status of the general rules pertaining to valuation misstatement penalties, one would expect some uniformity in the charitable deduction valuation penalty cases. Although the factual-nature of the 'reasonable cause' analysis would lead one to expect some variation in the results when reasonable cause is raised as a defense, one would expect the cases to be reconcilable. After all, uniformity would promote certainty and produce a guide on which taxpayers could base their behavior. The punitive goal of the penalties is not served if application of the penalties is uncertain. Uniformity, or even a reconcilable basis for the results in cases, however, has not occurred.

In order to understand the application of the valuation penalties, an understanding of the recent cases and facts relevant thereto is necessary. Following is a review of what the authors believe to be the most important charitable deduction property valuation penalty cases issued in the last year.

The *Whitehouse* Cases.

One of the most important and anticipated opinions involving valuation penalties is *Whitehouse Hotel Ltd. Partnership*, 755 F.3d 236, 113 AFTR2d 2014-2489 (CA-5, 2014) (*Whitehouse IV*), which was issued by the Fifth Circuit on 6/11/14. This case marks the conclusion of a series of back and forth decisions by the Fifth Circuit and the Tax Court over valuation principles and the role of valuation penalties. [FN12] *Whitehouse* involved a partnership (Whitehouse) that was formed in 1995 for the purpose of acquiring and renovating a historic New Orleans building known as the Maison Blanche Building (the Maison Blanche) for an ultimate purchase price of just over $10 million.

The partnership intended to renovate the Maison Blanche to establish a mixed-use hotel/retail space operated under the Ritz-Carlton brand. In February 1997, negotiations between the partnership and Ritz-Carlton culminated in agreements, pursuant to which the partnership agreed to renovate the Maison Blanche and the adjacent (but not yet acquired) Kress Building. Ritz-Carlton agreed to operate a hotel in the newly renovated buildings. In October 1997, the partnership acquired additional properties in New Orleans, including the Kress Building.

Subsequently, the partnership conveyed certain of its rights in the Maison Blanche to a charitable organization committed to protecting historic buildings. The conveyance was made by an ‘Act of Donation of Perpetual Real Rights‘ (the Preservation Easement). The day after it executed and recorded the Preservation Easement, the partnership finalized its plans for converting the Maison Blanche and the Kress Building into a single, indivisible condominium unit (Unit RC). [FN13] Effectively, this condominium regime legally combined the Maison Blanche and Kress Building into a single unit of property. [FN14]

The Partnership claimed a charitable deduction of $7.445 million on its 1997 Form 1065, based on a qualified appraisal (the Cohen Appraisal) prepared by M. Richard Cohen, a qualified appraiser. [FN15] The deduction was taken on the Partnership's 1997 Form 1065, which included the requisite Form 8283.

In 2003, the IRS issued a Notice of Final Partnership Administrative Adjustment (FPAA), disallowing all but $1.15 million of the $7.445 million charitable deduction claimed by Whitehouse. The IRS also asserted a gross valuation misstatement penalty of 40% of the portion of underpayment of tax that year. The partnership filed a petition for redetermination with the Tax Court.

Whitehouse I. The initial Tax Court proceeding, *Whitehouse Hotel Ltd. Partnership*, 131 TC 112 (2008) (*Whitehouse I*), was a classic ‘battle of valuation experts,‘ in which Whitehouse challenged the qualifications of the IRS's expert and his methodology and valuation, and the IRS challenged the partnership's expert's methodology and the property that he considered in his appraisal (i.e., the Maison Blanche *and* Kress Building). The partnership further argued against imposition of the accuracy-related penalty, by asserting the correctness of its valuation and, alternatively, the Section 6664(c)(1) reasonable cause exception.

The Tax Court discarded much of the valuation testimony presented by Whitehouse's expert and concluded that the value of the Preservation Easement was $1,792,301, as compared to the $7.445 million claimed by Whitehouse (i.e. 415% greater than the ‘correct‘ value). As a result, the Tax Court determined, absent a valid reasonable cause defense, a 40% gross valuation misstatement penalty would apply under Section 6662(h).

In order to avail itself of the reasonable cause exception to the penalty application, the partnership had to establish that it obtained a ‘qualified appraisal‘ and that it made a ‘good faith‘ investigation of the value of the ***259** Preservation Easement. The IRS conceded that the partnership obtained a ‘qualified appraisal,‘ thus the reasonable cause exception hinged on the court determining that the partnership made a good-faith investigation of the value of the contributed property. The deductions were claimed in the tax year prior to the PPA.

Because Whitehouse was a partnership, Whitehouse had to argue that someone with authority to act on its behalf made a good faith investigation of the value of the donated preservation easement. [FN16] Although the law on who has the authority to make such an investigation for a partnership is sparse and inconclusive at best,

[FN17] Whitehouse principally relied on the testimony of an employee of its tax matters partner [FN18] and manager to establish its good-faith investigation. The employee testified that the partnership investigated the value of the Preservation Easement and the ‘qualified appraisal‘ valuing the Preservation Easement. However, the Tax Court determined that the employee had no direct knowledge of any efforts made by the partnership to investigate the value of the Preservation Easement because the employee's employer did not become the partnership's manager (or tax matters partner) until well after the conveyance of the Preservation Easement.

Whitehouse then argued that it relied on another appraisal, which it had obtained for reasons unrelated to the charitable contribution. However, the Tax Court rejected the relevance of the second appraisal, noting that it addressed only the before-easement value of the property, as opposed to the value of the Preservation Easement itself. Furthermore, the Tax Court noted that Whitehouse failed to present any evidence relating to professional tax advice that it received from its accountants or legal counsel in filing its 1997 Form 1065. Having found that Whitehouse failed to establish reasonable cause, the Tax Court sustained application of the Section 6662(a) accuracy related penalty on the basis of a gross valuation misstatement (i.e., 40% of the underpayment attributable to such misstatement). The partnership appealed the holding to the Fifth Circuit.

Whitehouse II. In the first appeal, *Whitehouse Hotel Ltd. Partnership,* 615 F.3d 321, 106 AFTR2d 2010-5759 (CA-5, 2010) (*Whitehpuse II*), the Fifth Circuit vacated the Tax Court's valuation holding and remanded the case for a redetermination of the value of the Preservation Easement, making Whitehouse's appeal of the gross undervaluation penalty moot. Nevertheless, the Fifth Circuit addressed the penalty issue in dicta [FN19] by discussing the applicable standards and law relevant to Section 6662, as well as the partnership's burden of proof with respect to the Section 6664(c)(1) reasonable cause exception (including what evidence the Tax Court should consider). In so doing, the Fifth Circuit implied that the Tax Court inappropriately applied the law to the facts before it by (1) disregarding the employee's testimony as lacking credibility because his employer was not the manager of the partnership at the time of the Preservation Easement donation, and (2) finding that the partnership did not provide adequate evidence demonstrating that it sought review from tax advisors. [FN20] In summary, the Fifth Circuit noted that the Treasury regulations provide that a taxpayer demonstrates reasonable cause by showing that he or she exercised ordinary business care and prudence. [FN21] Furthermore, the Fifth Circuit pointed out that when an accountant or attorney advises a taxpayer on a matter of tax law, it is reasonable for the taxpayer to rely on that advice. [FN22] With these criteria and observations in mind, the Fifth Circuit ***260** directed the Tax Court to reconsider the penalty, should it be relevant on remand.

Whitehouse III. Although the Tax Court's opinion in *Whitehouse Hotel Ltd. Partnership,* 139 TC 304 (2012) (*Whitehouse III*), on remand is worth discussion for many reasons relevant to valuation principles, for purposes of this article, it is only important to note that the Tax Court essentially readopted its prior valuation determination, with a negligible adjustment. Indeed, the Tax Court seemed to pay mere lip-service to the Fifth Circuit's instructions; arriving at the same result, while at the same time avoiding another remand.

Turning to the valuation penalty, the Tax Court found it unbelievable that the partnership could reasonably believe, ‘without further investigation,‘ that the building it purchased in 1995 for $8.98 million would be valued by its appraiser just two years later for $96 million. Given the vast differences in these valuations in such a short period, the Tax Court found the lack of further investigation counter-indicative of a ‘good-faith‘ investigation of the Preservation Easement's value. Additionally, just as in *Whitehouse I*, the Tax Court found that the second appraisal obtained by the partnership could not be relied on to establish a good-faith investigation of the value of the Preservation Easement because that appraisal valued only the Masion Blanche itself (not its reduction in value on account of the Preservation Easement).

The Tax Court further found that the partnership failed to provide evidence on the content of any professional advice or opinions with respect to the charitable contribution claimed on its 1997 Form 1065.

Whitehouse IV. On appeal for the second time, the partnership argued that the Tax Court's remand opinion exhibited evidence of ‘judicial insubordination that infects the entire Remand Opinion.‘ The Fifth Circuit seemed to acknowledge (as would anyone who reads the Tax Court opinion) that the Tax Court applied its mandates in an ‘unenthusiastic‘ manner, but held that such ‘begrudging compliance‘ was sufficient. Accordingly, the Fifth Circuit upheld the Tax Court's valuation determination.

The Fifth Circuit next addressed the valuation misstatement penalty. Because the Fifth Circuit did not overturn the Tax Court's valuation determination, the taxpayer's avoidance of the gross valuation penalty hinged on its ability to establish ‘reasonable cause‘ (under pre-PPA rules). The Fifth Circuit noted that this required basing the claimed deduction on a qualified appraisal and, in addition, making a good faith investigation of the Preservation Easement's value. The ‘qualified appraisal‘ requirement had been stipulated, leaving the ‘good faith investigation‘ the essence of the determination.

The Tax Court seemed to accept that the partnership relied on advice from attorneys and accountants when it filed its return containing the deduction of the Preservation Easement, but noted that the partnership did not require the professionals to investigate the value of the easement, which is required under Section 6664(c)(3)(B). The issue before the Fifth Circuit was whether the steps taken by the partnership, including following the advice of accountants and tax professionals, even if they did not specifically investigate the value set forth in the ‘qualified appraisal,‘ was sufficient to show a good faith investigation of the value of the contributed property.

The Fifth Circuit ultimately vacated the Tax Court's penalty determination, finding that the partnership established reasonable cause. Although not entirely clear, the Fifth Circuit seemed to conclude that the partnership's reliance on the advice of accountants and tax professionals who were familiar with the donation established a good faith investigation of the value of the Preservation Easement. [FN23] The determination is somewhat surprising because no evidence was presented establishing that the accountants and tax advisors investigated or opined on the *value* of the preservation easement. However, the Fifth Circuit also noted that the partnership ‘analyzed‘ the ‘qualified appraisal‘ and commissioned another appraisal (although this was not done in connection with the donation of the Preservation Easement.)

Kaufman

The *Whitehouse* opinions are helpful in understanding what evidence a taxpayer might present to establish that an investigation was made of the value of contributed property. Another recent case, *Kaufman*, TCM 2014-52, sheds light onto the ‘good faith‘ requirement relevant to the investigation of value.

Kaufman involved the donation of a preservation easement by individual taxpayers. The central issue in the first *Kaufman* case (*Kaufman I*) [FN24] was whether the taxpayers properly subordinated the outstanding mortgage on their eased property, as required in applicable statutory and regulatory provisions relating to conservation easements. [FN25] Based on its interpretation of Section 170(g)(6), the Tax Court granted summary judgment to the IRS on the technical issue, but held that a genuine issue of material fact existed as to other issues. [FN26] In a second opinion after trial on the remaining issues (*Kaufman II*) [FN27] the Tax Court reaffirmed its ruling on the technical issue. The taxpayers appealed.

The First Circuit reversed the Tax Court on the technical issue, and remanded the case. [FN28] Interestingly for purposes of this article, however, the First Circuit addressed, in dicta, issues ***261** concerning the value of the easement (issues not technically before the court). The court went to great lengths to describe how certain evidence indicated the facade easement had been overvalued (e.g., a letter obtained by the taxpayer that, in essence, assured the taxpayer that he was not giving the charitable organization anything of value), and it explained how penalties (civil and criminal) might be appropriate in such situations. The First Circuit's statement about penalties, quoted below, is illustrative of the importance of the 'good faith' element of the reasonable cause exception to valuation penalties.

> To reject overly aggressive IRS interpretations of existing regulations is hardly to disarm the IRS. Without stifling Congress' aim to encourage legitimate easements, one can imagine IRS regulations that require appraisers to be functionally independent of donee organizations, curtail dubious deductions in historic districts where local regulationsalready protect against alterations, and require more specific market-sale based information to support any deduction. Forward looking regulations also serve to give fair warning to taxpayers.
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> If taxpayers still do not get the message, the penalties regime is formidable, *see, e.g.,* 26 U.S.C. § 6662(h)(l) (40 percent penalty for gross valuation misstatements); and, for willful abusers, there are criminal penalties, *e.g.,* 26 U.S.C. § 7201 (prison term up to five years). The Justice Department has already secured a permanent injunction against the trust to prohibit some of the practices alluded to in this case. [citation omitted] The IRS is properly zealous to protect the revenues and over the long run it has been given tools to do so.

Accordingly, although the First Circuit denied the Service a swift victory based on technical arguments, the court was not hesitant to express its opinion about potential valuation abuses, and the role of penalties to curtail such abuses.

On remand, the Tax Court picked up the First Circuit's lead and determined that a 40% gross valuation misstatement penalty was applicable. [FN29] At issue was whether the taxpayers could establish that they qualified for the reasonable cause exception.

The court first addressed whether the taxpayers obtained a 'qualified appraisal' by a 'qualified appraiser.' The IRS argued that the appraisal was not qualified because it was not performed by a 'qualified appraiser,' as that term is defined in Reg. 1.170A-13(c)(5) . [FN30] Specifically, the IRS argued that the appraiser falsely overstated the value of the Preservation Easement and that a reasonable taxpayer would have realized such. However, the Tax Court rejected this argument, finding that, although the taxpayers may have 'had reason to question his valuation,' there was insufficient evidence to establish that the appraiser acted 'falsely' with respect to the appraisal of the Preservation Easement. Moreover, the court found that although there were many errors and potential methodology issues with the appraisal report, the regulatory 'procedural requirements' were met such that the appraisal was 'qualified.' As stated by the Tax Court, '[w]hether the valuation was overstated, grossly or otherwise, is a factual question different from whether the formal procedural requirements were met, either strictly or under the 'substantial compliance' doctrine, which may forgive minor discrepancies.'

After determining that the taxpayers obtained a qualified appraisal, the Tax Court turned to the issue of whether the taxpayers made a good faith investigation that confirmed the value claimed in the appraisal. The Tax Court set an arguably high-bar by stating that the taxpayers had the burden of demonstrating 'how they honestly came to believe that, beyond being simply the amount determined in the ... appraisal, the value of the facade easement was [as claimed by the report].' In doing so, the court readopted its approach to placing the initial burden of proving a valuation misstatement penalty on the IRS (a burden that is met when the IRS establishes the percentage threshold is met), but placing the burden of proving 'reasonable cause' on the taxpayer.

In an attempt to meet their burden, the taxpayers testified that they ‘believed‘ in their own minds that the preservation easement created restrictions that decreased the value of their property, although they failed to quantify the value they believed they were giving up. The taxpayers also testified that their concerns about what they were giving up prompted ***262** them to write a letter to the donee expressing their worries about the large value of the gift; however, the court noted that the donee responded that the preservation easement would not significantly affect the value of their building, i.e., that the easement did not have much economic value. Finally, the taxpayers testified that they provided a copy of the appraisal to their long-time accountant, who reviewed it and determined that it was consistent in form with other appraisals he had seen; however, the court noted that the accountant testified that he did not offer any opinion as to whether the value in the appraisal was reasonable.

The Tax Court ultimately determined that the taxpayers could not establish that they made a good faith investigation of the value of the preservation easement and imposed a gross valuation misstatement penalty.

Pollard

Pollard, TCM 2013-38 is a 2013 opinion in which the Tax Court addressed the application of the gross valuation misstatement penalty and the other accuracy-related penalties. The case involved another conservation easement donation that the IRS determined to be grossly overvalued. Although the deduction was denied on grounds unrelated to valuation, [FN31] the IRS sought to impose accuracy-related penalties under Section 6662 for the years in issue. Moreover, in an Amendment to Answer, as an alternative to the 20% Section 6662(a) penalty for a substantial valuation misstatement, the IRS asserted that the taxpayer was liable for the 40% penalty for a gross valuation misstatement for all years involved.

In a somewhat inverted analysis, after the Tax Court determined that the conservation easement failed because it did not constitute a charitable contribution, it analyzed whether there was a gross valuation misstatement in the years in issue. Because this argument was raised in the Amendment to Answer, the Tax Court noted that the IRS bore the burden of proof and that the gross valuation misstatement penalty was inapplicable if the taxpayer could establish the claimed value of the donated property was based on a ‘qualified appraisal‘ made by a ‘qualified appraiser,‘ and he made a good faith investigation of the value of the contributed property.

The taxpayer was able to establish that he obtained an appraisal of the donated preservation easement and alleged that he relied on the appraisal and made a good faith investigation of the value of the easement. In support, the taxpayer testified that he reviewed the local county website to determine the value of comparable properties and spoke with an expert in land use on the potential value of the property subject to the easement. The IRS, however, contended that the appraisal at issue was not a ‘qualified‘ appraisal because it contained several technical errors, including, most notably, that it did not adequately identify the highest and best use of the conservation easement property.

Similar to its opinion in *Kaufman*, the Tax Court declared that the ‘qualified appraisal‘ requirement does not concern the ‘reliability‘ of the appraisal, but ‘whether the report identified a method of valuation or the basis for the valuation.‘ Like the First Circuit in *Kaufman*, the Tax Court expressed that it was ‘especially concerned‘ with the IRS's attempt to turn the ‘qualified appraisal‘ requirement from a procedural requirement into a substantive analysis of the conclusions reached therein.

The Tax Court ultimately concluded that the taxpayer obtained a qualified appraisal. Additionally, based on the testimony of the taxpayer that he ‘investigated‘ the appraisal by reviewing the county website and confirming the appraisal assumptions with a land use expert, the court concluded that the taxpayer made a good faith investigation of the value of the contributed property as set forth in the appraisal. Accordingly, the court determined that the taxpayer qualified for the reasonable cause exception to any otherwise applicable valuation misstatement penalties.

While determining that the taxpayer had met the reasonable cause exception to either of the valuation misstatement penalties, the taxpayer was not left off of the penalty hook. To the contrary, the Tax Court then noted that the taxpayer had substantial understatements of income tax in the years at issue because the taxpayer's deduction failed to meet the requirements of Section 170. This showing by the IRS satisfied its burden of production, shifting the burden of proving reasonable cause to the taxpayer.

The Tax Court noted that an accuracy-related penalty does not apply to any portion of an underpayment of tax if there was reasonable cause for such portion and that the taxpayer acted in good faith, made on a case-by-case, facts-and-circumstances analysis. Unlike the valuation penalties, a showing of a qualified appraisal, a qualified appraiser, and a good faith investigation of value are not required to satisfy the general reasonable cause standard. The Tax Court noted that the most important factor in a normal reasonable cause analysis is the extent of the taxpayer's efforts to determine his or her proper tax liability and, in a circular sentence, found that ‘(r)eliance on professional advice may constitute reasonable cause and good faith, but it must be established that this reliance was reasonable.‘ Specifically, the Tax Court indicated that the taxpayer must satisfy a three-prong test to establish reasonable reliance on professional advice: (1) the advisor wasa competent advisor who had sufficient experience to justify the taxpayer's reliance; (2) the taxpayer provided necessary and accurate information to the advisor; and (3) the taxpayer relied in good faith on the advisor's judgment. [FN32]

***263** The court was quick to find that the taxpayer had failed to qualify for this Section 6664(c)(1) reasonable cause exception because he could not satisfy his burden of establishing that he acted with reasonable cause or good faith. Specifically, the Tax Court found that the evidence made clear that a quid pro quo transaction had taken place, and that none of the individuals on which the taxpayer relied in the transaction were tax professionals, other than the taxpayer's CPA. The CPA's testimony, however, was insufficient because there was no evidence that the CPA was aware of the quid pro quo nature of the conservation easement.

While the taxpayer in *Pollard* avoided the valuation misstatement penalties, the taxpayer was unable to skirt the accuracy-related penalty, illustrating how the different reasonable cause exceptions apply and how the burden of proof can have a significant impact on a court's analysis.

Zarlengo

Zarlengo, TCM 2014-161 is a 2014 case in which the Tax Court again addressed the reasonable cause exception. The case involved a facade easement that the taxpayers donated to the National Architectural Trust (NAT), a qualified charitable donee. Although the taxpayers, a divorced couple, intended to donate the easement to NAT in 2004 and obtained all of the paperwork (including an appraisal) in that year, the easement deed was not recorded until 2005.

The husband deducted the full amount of his half of the charitable deduction in 2004, the year the taxpayers donated the property to NAT. The wife deducted only a portion of the charitable contribution in 2004, carrying the remainder over into the 2005 through 2007 tax years. The IRS claimed the ‘contribution date‘ of the facade easement was not until January, 2005, when the easement deed ***264** was recorded. The IRS also argued that the taxpayers failed to properly substantiate the value of the donation.

The Tax Court ultimately denied the deductions claimed by both taxpayers in 2004 on grounds specific to New York state law and the perpetuity requirements relevant to qualified conservation easement contributions. [FN33] The Tax Court, nevertheless, concluded that the wife was entitled to a deduction in 2005, after the easement deed had been recorded. However, the court found that the easement was worth $157,500 (as opposed to the $660,000 value claimed by the taxpayer).

Due to the determined overvaluation (and IRS assertion of penalties), the Tax Court had to address whether the taxpayers were liable for overvaluation misstatement penalties and to which years the penalties applied. The IRS had stipulated that the appraiser the taxpayers relied on was a ‘qualified appraiser.‘ Additionally, the Tax Court determined that, although the appraisal did not meet all the technical requirements of the Treasury regulations, [FN34] it ‘substantially‘ complied with the requirements, and that substantial compliance was sufficient to make the appraisal ‘qualified.‘

The court next turned to the issue of whether the taxpayers made a good faith investigation of the value of the contributed property. Before referencing the ‘good faith investigation‘ element of the reasonable cause analysis, the Tax Court discussed how the taxpayers had consulted with their ‘long-time accountant‘ about the legitimacy of the preservation easement donation. The court discussed how the accountant reviewed the appraisal report and conservation easement deed and that ‘nothing in the documents gave [the accountant] cause for concern as to the accuracy of the appraised value of the conservation easement.‘ The court then determined that the taxpayers satisfied the reasonable cause exception, stating that the taxpayers ‘made a good faith investigation into the value of the conservation easement by obtaining the [qualified appraisal] and the [accountant's] advice.‘ This determination was made despite theabsence of any evidence or testimony indicating that the accountant actually investigated or opined on the value of the contributed property. Accordingly, no penalty was applicable for the 2005 tax year.

Following *Chandler*, the Tax Court reiterated that the changes to the overvaluation misstatement penalties enacted as part of PPA apply to tax returns filed after 7/25/06, including the wife's 2006 and 2007 returns. Accordingly, since the IRS had met its burden of production as to the gross valuation misstatement penalties with respect to the wife, no reasonable cause and good faith defense for 2006 or 2007 could be raised because ‘the PPA makes the gross valuation penalty a strict liability penalty with respect to charitable deduction property.‘

Seventeen Seventy Sherman Street, LLC

In *Seventeen Seventy Sherman Street, LLC*, TCM 2014-124, the Tax Court held that an understanding between the taxpayer and a development company, that the taxpayer would grant conservation easements on its property if the development company assisted the taxpayer in obtaining variances, constituted a quid pro quo, resulting in a complete loss of the related deduction.

As the case related to penalties, once again the burden of proof affected the Tax Court's decision. While the FPAA mailed to the taxpayer challenged the deductibility of the subject conservation easements, the IRS asserted in an amendment to its 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 regulations under Section 6662(b)(1), (2) a substantial understatement of income tax under Section 6662(b)(2), or (3) a substantial valuation misstatement under Section 6662(b)(3).

Because 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 IRS. As to the proposed gross valuation misstatement, the Tax Court did not accept the IRS'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 IRS failed to meet its 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 IRS had met its burden of establishing that the taxpayer acted negligently or with disregard to Section 170 and the regulations thereunder.

To prove that 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 the taxpayer 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 that the taxpayer's disregard of the advisor's advice was not reasonable and in good faith.

HOW TO BE ‘REASONABLE‘

Reconciling the above cases in a meaningful and instructive manner is a difficult task at best. All of the cases facially follow the rule that in order to avoid valuation misstatement penalties for ‘reasonable cause‘ in charitable deduction property cases, assuming it is available, a taxpayer must establish the following:

***265** • The taxpayer had reasonable cause (as that term has been interpreted under prior law).
• The taxpayer acted in good faith.
• The taxpayer obtained a ‘qualified appraisal‘ by a ‘qualified appraiser.‘
• The taxpayer made a good faith investigation of the value of the donated property.

While some courts have addressed each of the four above-referenced elements separately, due to the overlapping nature of the provisions, most courts have in practice reduced the test in charitable deduction property cases to the last two elements.

The IRS has attempted on several occasions to contest the ‘qualified appraiser‘ and ‘qualified appraisal‘ components of the first element. However, *Kaufman* and *Pollard* are illustrative of the courts' unwillingness to find appraisers and appraisals unqualified. The general attitude of the courts has been that, when a taxpayer has attempted to commission a valid appraisal, minor deficiencies in the appraisal or disagreements over the appraisal's conclusions will not cause the appraisal to be unqualified. [FN35]

Accordingly, a taxpayer's ability to avail himself or herself of the reasonable cause defense under Section 6664(c)(2) generally comes down to whether the taxpayer can establish that he or she made a good faith investigation of the value of the contributed property. This leads to the question: How can someone establish that he or she made a good faith investigation of property?

In *Whitehouse*, the Tax Court determined that a taxpayer fell short of this standard even though it had a second appraisal done, relied on various advisors, and had a partnership representative testify that the partnership believed the reported value was accurate. The issue that seemed to bother the Tax Court and drive its determinations was the fact that Whitehouse had purchased the relevant property shortly before the contribution date for a fraction of the value the partnership was claiming on its return. In these authors' view, the Tax Court's decision in *Whitehouse* was driven by this fact more than the steps taken (or not taken by Whitehouse) to establish it made a good faith investigation, which makes it hard to learn too much from the case. However, the Fifth Circuit looked past this issue, finding that the reasonable cause exception was met. In so finding, the court seemed to be persuaded by (1) the existence of multiple appraisals and (2)the role of independent tax return preparation advice, even though the advice was not directly related to value.

The existence of an independent tax advisor also seemed to play a critical role in the good faith investigation analysis set forth in *Zarlengo*, in which the court determined that obtaining an accountant's advice constituted a good faith investigation of the value of the property, even though the accountant did not testify or opine as to the value of the property. This result, however, is hard to reconcile with *Kaufman*, wherein the Tax Court indicated that reliance on an accountant is not sufficient if the accountant does not express an opinion as to the value contained in the appraisal.

Given that the above cases cannot be easily reconciled, a belt-and-suspenders approach to avoiding valuation penalties, when available, is best. First, a taxpayer should always obtain a qualified appraisal of property, and take steps to have his or her tax advisor review the appraisal to determine that it satisfies the relevant statutory and regulatory requirements. Second, the taxpayer will ideally obtain a second appraisal, which will verify and support that the original appraisal determines a reasonable value. This step should, according to *Whitehouse*, help establish a good faith investigation of the value set forth in the qualified appraisal. Finally, the taxpayer should take steps to document additional investigations into the value of the property, such as independently investigating the value of comparable properties (such as what the taxpayer did in *Pollard*). These independent investigations should be documented. If the taxpayer is a partnership,someone clearly authorized on behalf of the partnership should take these steps at the time of the contribution, and any independent partner wishing to raise a partner-level reasonable cause defense (in the event the partnership-level defense fails) should take similar actions.

Perhaps the most important lesson to learn from the above cases is that the ‘good faith investigation‘ requirement imbedded in the reasonable cause provision relevant to charitable deduction property gives the courts a wide degree of latitude to justify denying or granting reasonable cause relief. When the courts determine that the taxpayer tried to honestly arrive at the right result, they have tended to grant relief, regardless of the technical steps taken or not taken by the taxpayer. On the other hand, when the courts have indicated or implied that the taxpayer may not have been genuine as to his or her intentions to report the value of charitable contribution property accurately, they have tended not to grant relief, regardless of the procedural hoops jumped through or documentation obtained by the taxpayer.

The ‘giveth and taketh‘ framework of Section 6664(c) makes it unnecessarily difficult to interpret.

Uniformity, or even a reconcilable basis for the results in cases, however, has not occurred.

In order to understand the application of the valuation penalties, an understanding of the recent cases and facts relevant thereto is necessary.

While the *Whitehouse* cases are helpful in understanding what evidence a taxpayer might present to establish that an investigation was made of the value of contributed property, another recent case, *Kaufman*, sheds light onto the ‘good faith‘ requirement relevant to the investigation of value.

However, *Kaufman* and *Pollard* are illustrative of the courts' unwillingness to find appraisers and appraisals unqualified.

Given that the above cases cannot be easily reconciled, a belt-and-suspenders approach to avoiding valuation penalties, when available, is best.

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[FN1]. Section 6662(e)(1)(A). The ‘correct amount could be determined by a court decision or by agreement with the IRS. If by agreement, a waiver of the penalty might be part of the negotiation.

[FN2]. Section 6662(a).

[FN3]. Section 6662(h)(A)(i).

[FN4]. Section 6664(c)(3).

[FN5]. See Section 6664(c)(4)(A)

[FN6]. Regs. 1.6664-4(h)(2) , 1.170A-13(c)(5) .

[FN7]. Section 6664(c)(3)(B), added by the Pension Protection Act of 2006 (2006 PPA), P.L. 109-280, § 1219(c)(2), 8/17/06; Sections 170(f)(11)(E)(ii), (iii), added by 2006 PPA § 1219(c)(1), in each case, effective with respect to returns filed after 8/17/06 (7/25/06 in the case of a conservation easement relating to the exterior of a building described in Section 170(h)(4)(C)(ii)); Regs. 1.6664-4(h)(2) , 1.170A-13(c)(5) ; Prop. Reg. 1.170A-17(b). Notice 2006-96, 2006-46 IRB 902 provides additional transitional guidance on these definitions.

[FN8]. See note 7 *supra*.

[FN9]. 7/25/06 for preservation easement donations.

[FN10]. See footnote 23 in the case (‘In *Chandler v. Commissioner* we held that provisions of the PPA that removed the reasonable cause defense for gross valuation misstatements under sec. 6662(h) applied to a carryover that the taxpayer claimed on a return filed after the PPA's effective date even though the carryover related to a deduction that arose on a return that the taxpayer filed before that date. However, *Chandler* did not decide whether the pre- or post- PPA rules apply with respect to the determination of whether a substantial or gross valuation misstatement penalty applies in the case of a post-PPA carryover that arose from a deduction claimed on a return before PPA's effective date.‘) (internal citations omitted).

[FN11]. See discussion *infra* about Zarlengo (‘In Chandler we had no need to consider whether the pre-PPA thresholds or the post-PPA thresholds applied to the taxpayers 2006 return....‘).

[FN12]. See Wooldridge, Levitt, and Rhodes, ‘Conservation Easement Confusion in the Tax Court and Fifth Circuit,‘ 41 Real Estate Taxation 129 (2nd Quarter 2014).

[FN13]. Through the renovation plans, the Maison Blanche and Kress Buildings would also be a single *functional unit* in addition to being a single *legal unit* under the condominium regime. For instance, the *porte-cochere* and the air conditioning supply units required for operating the Maison Blanche would be contained in the Kress Building. This led the Fifth Circuit, as discussed later, to determine that, as a practical matter, the buildings would remain functional only while under common control and, thus, any future owner of the Kress Building would also be the owner of the Maison Blanche (vice-versa). See Whitehouse II at 339.

[FN14]. The facts contained in this paragraph are derived from Whitehouse I and Whitehouse II. In Whitehouse I, the Tax Court declined to find that, on 12/30/97, the Partnership established a condominium regime by which the Maison Blanche and Kress Building were established as a single condominium unit. The Tax Court would not make this finding based in part on the fact that the Partnership recorded the condominium declaration the day after the Conveyance (which contained the Easement). As a result, the Tax Court determined that this finding would have little, if any relevance, to the Valuation Date issues (i.e., valuation of the Easement). Whitehouse I at n. 9. The Fifth Circuit, however, concluded that the legal combination of the properties should have been considered by the Tax Court when valuing the Easement. See Whitehouse II at 338-39. That being said, the Tax Court again failed to mention the condominium regime declaration on remand, in Whitehouse III.

[FN15]. Due to a serious illness, Mr. Cohen was unable to participate in the trial. Whitehouse II at 325. As a result, the Partnership retained Richard Roddewig to prepare a valuation report for the Easement and to provide expert testimony at trial. Whitehouse I at 119.

[FN16]. Certain partnership audits are governed by special rules enacted in the Tax Equity and Fiscal Responsibility Tax Act of 1982 (TEFRA). The TEFRA rules treat certain items as ‘partnership items,‘ which are determined during the partnership-level proceedings. Penalties, including valuation penalties, are subject to such a partnership-level determination. Accordingly, the reasonable cause defenses available to a valuation misstatement penalty can and should be raised during the partnership-level proceeding. However, if an individual partner also has a partner-level defense specific to himself or herself, the partner cannot raise that during the partnership-level proceeding, but must do so through a refund forum. See e.g. Fears, 129 TC 8 (2007).

[FN17]. See e.g. Murfam Farms, LLC ex rel. Murphy, 106 AFTR2d 2010-5893 (Fed. Cl. Ct., 2010) (Indicating CFO of partnership and individual partner's knowledge can be imputed to the partnership).

[FN18]. The TEFRA procedures create a tax matters partner (TMP) who serves as the representative of the partnership in the TEFRA proceeding. The TMP, who can be designated through various procedures, has special rights to conduct the partnership audit and a broad range of authority and responsibilities concerning the audit.

[FN19]. In a concurring opinion, Circuit Judge Emilio M. Garza refused to take part in certain aspects of the Whitehouse II opinion that he felt addressed moot issues not properly before the court. To this end, Judge Garza noted that such portions of the opinion (including the court's discussion of the penalty issue) constituted impermissible advisory opinion.

[FN20]. To this end, the Fifth Circuit went so far as to specifically note that the Partnership offered evidence that it relied on its accountants' and attorneys' opinions of the Cohen Appraisal. As such, the Fifth Circuit mentioned that a ‘possible‘ issue on remand would be whether the Partnership needed to prove more to show reasonable cause.

[FN21]. Citing Reg. 301.6651-1(c)(1) .

[FN22]. Citing Boyle, 469 U.S. 241, 55 AFTR2d 85-1535 (1985).

[FN23]. The Fifth Circuit's indication that reliance on tax professionals can establish a good faith investigation is further supported by its statement that ‘[a]s we were in our 2010 opinion, we are skeptical of the tax court's conclusion that following the advice of accountants and tax professionals was insufficient to meet the requirements of the good faith defense....‘

[FN24]. Kaufman, 134 TC 182 (2010).

[FN25]. See Section 170(h)(5)(A); Reg. 1.170A-14(b)(2) ; Reg. 1.170A-14(g)(1) and (2).

[FN26]. The other issues consisted of the deductibility of the cash payment made by the taxpayer to the donee and the application of penalties.

[FN27]. Kaufman, 136 TC 294 (2011).

[FN28]. See Kaufman v. Shulman, 687 F.3d 21, 110 AFTR2d 2012-5278 (CA-1, 2012).

[FN29]. *Kaufman*, TCM 2014-52

[FN30]. See Section 170(f)(11) and Reg. 1.170A-13(c)(3)(i)(B) clarifying that a qualified appraisal must be prepared by a qualified appraiser.

[FN31]. The Tax Court, in holding for IRS, found that the external features of the conservation easement transaction was part of a quid pro quo exchange in which the taxpayer received a substantial benefit in the form of a grant of a subdivision exemption request. Accordingly, the Tax Court sustained the IRS's determination that the taxpayer's grant of a conservation easement did not constitute a charitable contribution.

[FN32]. Citing Neonatology Assoc., P.A., 15 TC 43 (2000), *aff'd* 299 F. 3d. 221, 90 AFTR2d 2002-5442 (CA-3,. 2002) and Dunlap, TCM 2012-126.

[FN33]. The IRS argued that the taxpayers were not entitled to deductions because the facade easement was neither (1) a ‘qualified real property interest‘ as defined in Section 170(h)(2)(C) (i.e., ‘a restriction (granted in perpetuity) on the use which may be made of the real property‘) nor (2) donated exclusively for conservation purposes as required under Section 170(h)(5) (i.e., the conservation purpose of the easement was not ‘protected in perpetuity‘). After noting the rule that, ‘[i]n a Federal tax controversy, State law controls the determination of a taxpayer's interest in property while the tax consequences are determined under Federal law,‘ the court concluded that New York law governed when the taxpayers' donation of the facade easement was regarded as complete, but federal taxlaw determined the tax consequences. Because New York law provides that conservation easements in the state are not effective unless they are recorded, the facade easement was not effective (and thus not deductible) until 1/26/05—the date on which it was recorded.

[FN34]. The appraisal was untimely and contained other alleged minor violations of the Treasury regulations, all of which the court determined were non-substantive violations.

[FN35]. Because a ‘qualified appraisal‘ is prerequisite for obtaining a deduction for a non-cash donation of more than $5,000, the ‘qualified appraisal‘ issue is relevant to and has been addressed in many cases in which reasonable cause and penalties were not at issue. In such cases, the IRS has systematically attacked, with very little success, the issue of whether an appraisal was qualified. For a discussion of these hyper-technical arguments and their treatment by the courts, see Wooldridge, Levitt, and Rhodes, ‘Circuit Courts Speak on Conservation Easements, But is the IRS Listening? ‘ 24 Taxation of Exempts 35 (January/February 2013).

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