TAX COURT CASE UPDATE

Citation:

Ramona L. Mitchell v. Commissioner, 138 T.C. No. 16, April 3, 2012.

Overview:

The Tax Court upheld the IRS's disallowance of a qualified conservation contribution deduction with respect to seller-financed property where the taxpayer failed to have a subordination agreement in place on the date of the gift. In so holding, the Court rejected the taxpayer's argument that Reg. §1.170A-14(g)(3)'s "so remote as to be negligible" standard applied in determining whether the subordination requirement was satisfied.

The Facts:

In 1998, Charles and Ramona Mitchell (the Mitchells) purchased a 105-acre parcel of unimproved land from Clyde Sheek for $180,000 (the 105-acre parcel). In 2000, Mr. Mitchell approached Mr. Sheek to buy the remaining 351 acres bordering the south boundary of the 105-acre parcel. Mr. Sheek agreed to sell the 351-acre parcel in 2001 for $683,000, but he did not want all cash. Instead, he wanted retirement income. The parties agreed that, after a down payment of $83,000, the balance of $600,000 would be paid in installments of $60,000 per year plus interest. A promissory note was signed and secured by a deed of trust recorded in January 2001. As a result of the two purchases, the Mitchells owned 456 acres of ranchland, and built their own home on the ranchland in 2001 and 2002.

In December 2002, the Mitchells formed a family limited partnership (partnership) to which they transferred the ranchland, subject to the deed of trust, as well as other investments. On December 31, 2003, the partnership granted a conservation easement on the south 180 acres of unimproved land to Conservancy. The parties executed a deed of conservation easement in gross. At the time the easement was granted, the deed of trust securing the debt to Mr. Sheek was not subordinated to the conservation easement held by Conservancy. From 2003 to 2005, the partnership had the money to pay off the promissory note at any time. All payments to Mr. Sheek were timely made, and casualty insurance was held.

In 2004, the Mitchells hired an appraiser to appraise the conservation easement granted to Conservancy. The appraiser determined that the conservation easement had a market value of $504,000 and issued an appraisal report for the partnership on February 17, 2004. The partnership claimed a $504,000 charitable contribution deduction, which flowed through to Charles and Ramona, who claimed a $504,000 charitable contribution deduction on their 2003 joint return and attached a Form 8283, Noncash Charitable Contributions, along with a copy of the appraisal. On December 22, 2005, Mr. Sheek signed an agreement in which he agreed to subordinate his deed of trust to the conservation easement.

Mr. Mitchell died in 2006. The IRS mailed a notice of deficiency on February 23, 2010, disallowing the deduction.

Discussion:

The IRS argued that the 2003 charitable contribution deduction failed to meet the requirements of Code Section 170, specifically, that the subordination and proceeds requirements were not met. In the alternative, IRS determined that if the Code Sec. 170 requirements had been met, then the amount of the deduction was $100,100.

The taxpayer argued that the subordination agreement entered in 2005 complied with the subordination requirement and that, in determining whether the subordination requirement was met, the Tax Court must consider the negligible standard. The taxpayer also argued that she entered into an oral agreement with Mr. Sheek regarding the ranchland that provided the necessary protection required by Code Section 170.

The Tax Court agreed with the IRS that a subordination agreement signed almost two years after the grant of the easement does not satisfy the subordination requirement. Although the relevant regulation containing the subordination requirement is silent as to when the mortgagee must subordinate its claim, the Court found that a subordination agreement must be in place at the time of the gift. The Court noted, among other things, Mr. Sheek could have instituted foreclosure proceedings in the event of a default on the promissory note, and that the easement was therefore not protected in perpetuity at the time of the gift.

The Court also rejected the taxpayer's argument that the easement was nonetheless protected in perpetuity because the probability of her defaulting on the promissory note was so remote as to be negligible. The Court noted that it declined on multiple occasions to apply the negligible standard to several other provisions within Regulation § 1.170A-14(g), and concluded that the negligible standard similarly should not apply to the subordination requirement. Rather, the subordination requirement imposes strict rules that cannot be avoided by use of the negligible standard.

The taxpayer's argument regarding a purported oral agreement with Mr. Sheek, pursuant to which the Mitchells agreed not to subdivide or develop the ranchland, also was insufficient to show that the conservation easement was protected in perpetuity under Code Section 170(h). The oral agreement had no effect on Mr. Sheek's ability to foreclose on the property. Thus, the contribution wasn't a qualified conservation contribution and was not eligible for a charitable contribution deduction in 2003.

In light of the Court's finding that the subordination requirement was not met, it declined to determine whether the proceeds requirement was met or whether the claimed value of the contribution was correct.

However, the Court declined to impose an accuracy-related penalty, finding that although the Mitchells failed to comply with the requirements for making a charitable contribution of a conservation easement, they acted reasonably and in good faith. Specifically, they hired an accountant and appraiser and, upon learning of the subordination requirement, executed an agreement promptly.

Conclusion:

The Tax Court agreed with the IRS that the subordination requirement in the regulations was not met and disallowed the charitable contribution deduction.