TAX COURT CASE UPDATE

Citation:

Gordon Kaufman et ux v. Commissioner, 110 AFTR 2d ¶ 2012-5100, July 19, 2012.

Overview:

The Court of Appeals for the First Circuit has vacated a Tax Court decision that disallowed a couple's conservation easement deduction because a provision in the subordination agreement with their lender violated Regulation Section 1.170A-14(g)(6)'s "extinguishment provision." The Court found that the Tax Court's and the IRS's restrictive interpretation of this regulation was unreasonable and inconsistent with Congressional intent.

The Facts:

The easement involved a single-family row house located in a historic preservation district in Boston that was owned by Gordon and Lorna Kaufman. In 2003, they entered into a preservation restriction agreement with the National Architectural Trust under which they granted the trust a facade easement restricting the use of the property. The trust also required the taxpayers to make a cash contribution, calculated as a percentage of the estimated value of the facade easement, to create an endowment to provide for the monitoring and administration of the facade easement.

The agreement provided that if their donation could not be processed in time to qualify for a 2003 deduction, there would be a 10 percent reduction in the cash contribution requirement once the process was completed in 2004. In 2004, an appraiser valued the gift of the easement at $220,800 (that was the purported reduction in the property's fair market value on account of the gift). The taxpayers contributed $16,840 to the trust in 2003, and paid an additional $3,332 in 2004. At the time of the contributions, a bank held a mortgage on the property. The taxpayers acquired a subordination agreement from the bank which subordinated its rights in the subject property to the trust, but which also stated that the bank "shall have a prior claim to all insurance proceeds" from any casualty or similar event.

On their 2003 return, the taxpayers claimed a charitable contribution deduction of $220,800 for the contribution of the facade easement. Because of the limitations on charitable contribution deductions, the taxpayers claimed a charitable contribution deduction for the facade easement of only $103,377 and carried over the balance to 2004. They also claimed a $16,840 charitable contribution deduction in 2003 and $3,332 for their "cash contribution" to the trust.

On audit, the IRS disallowed the deductions. It also assessed accuracy-related penalties under Code Section 6662.

Kaufman I: In *Kaufman* (134 T.C. 182, 2010), the Tax Court granted the IRS's motion for summary judgment with respect to the facade easement contribution. The Court found that the contribution failed to comply with Regulation Section 1.170A-14(g)'s requirement to be enforceable in perpetuity because a pre-existing mortgage on the property would entitle the

bank to condemnation proceeds in preference to the trust in certain events (e.g., casualty).

However, The Court denied the IRS summary judgment for the cash contribution. It found that the taxpayers raised material fact issues with respect to the IRS's arguments that the cash contribution was conditional and as a result violated Regulation Section 1.170A-1(e), or that it was part of a quid pro quo and did not give rise to a deduction. The Court also declined to grant the IRS summary judgment as to the accuracy-related penalties under Code Section 6662(a) because the taxpayers raised genuine issues of material fact regarding the applicability of the reasonable cause defense to those penalties.

Kaufman II. In *Kaufman* (136 T.C. 294, 2010), the Tax Court reconsidered and re-affirmed its holding in *Kaufman I* that the facade easement contribution was not deductible. It also disallowed the taxpayers' charitable contribution deduction of $16,840 for 2003, agreeing with the IRS that they were conditional payments (subject to refund) if the appraisal reported the value of the facade easement to be zero. The Tax Court held that the taxpayers bore the burden of proving that at the end of 2003, the possibility of a zero appraisal value was not so remote as to be negligible, and they did not carry that burden.

The Tax Court also partially sustained the IRS's imposition of accuracy-related penalties, but only on the relatively small amount of the taxpayers' underpayment attributable to the cash payments made to the trust in 2003. The remaining penalties, including those imposed with respect to the disallowed easement deduction, were not upheld. However, the Tax Court held that the taxpayers could claim a charitable contribution for 2004 of the $19,872 cash payments they made to the trust in 2003 and 2004.

Both sides appealed the Tax Court's decision.

Discussion:

After examining the various regulatory requirements associated with the taxpayers' deduction, the Court of Appeals for the First Circuit vacated the Tax Court's opinion. The Appeals Court disagreed with the Tax Court's determination that the provision in the subordination agreement giving the lender priority on insurance and condemnation proceeds violated Regulation Section's 1.170A-14(g)(6)'s "extinguishment provision."

The First Circuit characterized the Tax Court's and the IRS's reading of regulation section as overly restrictive, with the result of foreclosing practically all deductions for easement donations "surely contrary to the purpose of Congress." Although the lender retained priority to insurance proceeds, The Court observed that the taxpayers had no power to make the lender give up this protection. Further, The Court noted that tax liens could potentially trump the trust's right to funds upon extinguishment of the easement. As such, The Court found that the Tax Court's reading of the regulations "entitled" language as requiring that the trust have an "absolute right" to any proceeds was impractical and contrary to the statute's intended purpose. The Court also noted that the word "entitled" could easily be interpreted as meaning that the trust's right is absolute as against the taxpayers.

The Court also rejected the IRS's argument that a provision in the agreement between the trust and the taxpayers, stating that "nothing herein contained shall be construed to limit [NAT's] right to give its consent (e.g., to changes in the Facade) or to abandon some or all of its rights

hereunder," did not effectively preclude changes incompatible with the donation's conversation purpose.

Finally, the IRS's argument that the taxpayers' failure to comply with certain recordkeeping and recording requirements "doom[ed] the appraisal summary" was rejected. Although there were a few small defects in the summary, they were not prejudicial. However, the IRS's claims that the valuation was overstated, and that the appraiser might not have been "qualified" because the taxpayers "had knowledge of facts that would cause a reasonable person to expect the appraiser falsely to overstate the value of the donated property," while not sufficient bases for affirming the Tax Court's disallowance of the deduction, should be examined by the Tax Court.

Accordingly, the First Circuit vacated the Tax Court's summary judgment decision disallowing the easement deduction as a matter of law. However, since the Tax Court's decision not to impose penalties was based on the same flawed reasoning, this issue was re-opened as well.

Conclusion:

The case was remanded to determine the proper value of the easement, taking into account the fact that the home was already subject to neighborhood landmark district rules. Given that the taxpayers were already subject to many restrictions regarding their home's exterior, the easement could be worth very little. The portions of the Tax Court opinion dealing with their cash contributions and the penalty associated with their 2003 cash contribution claim were left intact.