TAX COURT CASE UPDATE

Citation:

Logan M. Chandler, et ux. v. Commissioner, 142 T.C. No. 16, May 14, 2014.

Overview:

The Tax Court has concluded that a preservation easement that taxpayers granted on property to an exempt organization had no value because the façade was already subject to similar restrictions as a result of the property being in an historic district. Therefore, no charitable contribution deduction was allowed. The Court also determined how the resulting gross valuation misstatement penalty applied for deductions in years straddling an amendment to the penalty, as well as what the gain was on the later sale of the property.

The Facts:

Logan M. Chandler and Nanette Ambrose-Chandler owned two single-family residences in Boston's South End Historic District. They granted a façade easement on each property to the National Architectural Trust ("NAT") and claimed related charitable contribution deductions for 2004, 2005, and 2006. Under the terms of each easement, the taxpayers, as the property owners, had to obtain NAT's approval before beginning any construction that would alter the exterior of the building. NAT periodically sent representatives to inspect properties on which it held easements. If the inspector determined that a property owner had made unauthorized changes, NAT could order remediation.

Boston's municipal government had formed local historic district commissions to regulate construction within their jurisdictions. The South End Landmark District Commission ("SELDC") had jurisdiction over the taxpayers' properties. The SELDC's powers closely approximated NAT's powers under the easement agreements with some exceptions: (1) the SELDC had no power to regulate construction that was not visible from a public way and could not require property owners to make repairs; (2) NAT had staff members who performed annual site visits, while the SELDC relied on the public to alert it to potential violations; and (3) NAT had absolute authority to enforce the terms of its easements, even when doing so would produce substantial economic hardship for the property owner, while a property owner who faced significant financial hardship might receive an exemption from the SELDC's enforcement.

In 2005, the taxpayers sold one of the two properties and reported a capital gain, claiming a basis in the property that included $245,150 of improvements in excess of their purchase price. They presented evidence that proved that they had incurred costs of at least $147,824 in improving the property, but were unable to substantiate the cost of the rest of the improvements. The IRS disallowed the deductions because it determined that the easements were valueless. The IRS imposed gross valuation misstatement penalties on the underpayments resulting from the alleged easement overvaluations.

In addition, the IRS found that the taxpayers had understated their gain on the property sale because they had overstated their basis in the property. While the IRS acknowledged that the taxpayers had made improvements to the home, at trial it stated that it believed that they had included their renovation expenses in the wife's business' costs of goods sold, which would have prevented them from also increasing their basis in the property for these expenses. The IRS determined that the taxpayers were liable for accuracy-related penalties under Code Section 6662.

Discussion:

The court found that there was no diminution in value as a result of the additional restrictions under the easement granted to NAT. Relying on its analysis in *Kaufman* (TC Memo 2014-52), in which the court reviewed a NAT easement on a property in the South End Historic District under identical circumstances, the court concluded that the differences in the NAT and SELDC restrictions did not affect property values. The court found the contrary valuations by the taxpayers' expert were not credible. While the court recognized technical differences between the easements and local law, it agreed with the IRS that the restrictions were practically the same.

The court held that the taxpayers could reduce their capital gain by the amount of the basis increase they claimed on the home they sold that was adequately substantiated. However, they were liable for an accuracy-related penalty for the portion of their 2005 underpayment resulting from the unsubstantiated basis increase they claimed on the home they sold.

The court found that the taxpayers had presented credible documentary evidence supporting $147,824 of their basis increase. It found that IRS had failed to persuade it that the taxpayers had included any of these renovation expenses on their 2004 and 2005 Schedules C as cost of goods sold. This was an argument first presented at trial for which the IRS bore the burden of proof. But the court was unwilling to allow the taxpayers to increase their basis in the property by the full $245,150 basis increase they claimed. While pictures presented by the taxpayers of the renovation showed significant renovations, the court could not conclude for sure that they cost more than $147,824 and was unwilling to estimate that the taxpayers had spent more than that.

The court noted that the years in issue here straddled the Pension Protection Act's (“PPA”) effective date; the taxpayers filed their 2004 and 2005 returns before July 25, 2006, but they filed their 2006 return after. The taxpayers valued their easements and claimed deductions of $191,400 and $371,250, but failed to prove that the easements had any value. Under either version of Code Section 6662(h), the valuation misstatements were "gross" and triggered the 40 percent penalty.

However, the facts raised a novel issue concerning the taxpayers' right to raise a reasonable cause defense for their 2006 return. The taxpayers contended that they had reasonable cause for any underpayments and so they should not be liable for penalties. They argued that part of that underpayment resulted from a deduction carried forward from a return they filed before the amended rules under the PPA took effect. Further, they argued that applying the amended reasonable cause rules to their 2006 return would give the penalty amendments retroactive effect.

Conclusion:

The Tax Court found that the taxpayers had failed to prove their easements had any value, so they were not entitled to claim charitable contribution deductions.

The court also concluded that the taxpayers were not liable for gross valuation misstatement penalties for their 2004 and 2005 underpayments because they underpaid with reasonable cause and in good faith. But, they were liable for a gross valuation misstatement penalty for their 2006 underpayment because the rules in effect when they filed their 2006 return did not provide a reasonable cause exception. Further, the court found that denying their reasonable cause defense did not amount to retroactive application of the gross valuation misstatement penalty amendments.