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7th Annual

Recent Developments in Federal Tax Valuation

featuring

Jack Bogdanski

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RECENT DEVELOPMENTS IN FEDERAL TAX VALUATION

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Douglas K. Newell Faculty Scholar
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I. INTRODUCTION

The world of federal tax valuation continued to turn at high speed in the past year. This outline covers some of the more notable developments of the last 12 months or so. Most of the material is adapted from the cumulative supplement to my treatise, FEDERAL TAX VALUATION, or from columns I have written for the journal ESTATE PLANNING.[1]

II. "NET, NET" GIFTS

Steinberg v. Commissioner,[2] a decision reviewed by the entire Tax Court, saw that court abandoning one of its prior valuation precedents, *Estate of McCord v. Commissioner.*[3] In *Steinberg*, the court allowed a taxpayer to reduce the value of taxable gifts to reflect the donees' assumption of liability for any estate tax that might result from application of Section 2035(b). The new decision is a 180-degree turnaround from the court's prior ruling on the subject.

A. Facts

The taxpayer made a net gift to her children, and as part of the transaction the donees agreed to pay the resulting gift tax. They also agreed to pay any additional estate tax that might be triggered by Section 2035(b) if the donor died within three years of making the gift. Under that Code provision, if death occurs within the three-year period following the gift, the gift tax paid is made part of the gross estate and subjected to estate tax. The donees' obligations to pay both taxes were memorialized in a binding, written agreement negotiated with independent counsel on all sides.

In calculating the value of the gift for gift tax purposes, the donor netted out the gift tax liability that the children agreed to pay – a routine step in such computations, and one long accepted by the IRS.[4] The donee's assumption of the donor's gift tax liability is treated as consideration paid to the donor by the donee, thus reducing the amount of the gift.[5] But the donor also took a discount for the donees' assumption of the contingent liability to pay any additional estate tax that might be incurred if she died within the three-year lookback period under Section 2035(b). Since she was already 89 years old at the time of the gift, that possibility was hardly remote; it was a greater than 1-in-3 possibility, according to Census data. On a net gift of about $71.6 million, the discount

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[1] Citations to page numbers in recent Tax Court memorandum decisions are as found in the .pdf versions of the opinions published on the Tax Court's official website. Earlier page numbers, marked as "(RIA)," are from the RIA Tax Court Memo reports.

[2] 141 TC No. 8 (2013).

[3] 120 TC 358 (2003), *rev'd*, 461 F3d 614 (5th Cir. 2006).

[4] *See, e.g.,* Rev. Rul. 81-223, 1981-2 CB 189 (interaction of net gift and unified credit); Rev. Rul. 75-72, 1975-1 CB 310 (calculation of net gift).

[5] *See* IRC § 2512(b); Reg. §§ 25.2511-1(g)(1) (last sentence), 25.2512-8.

claimed for the assumed contingent liability was more than $5.8 million. The IRS denied the discount, and in the Tax Court, it moved for summary judgment on the issue, relying on the Tax Court's 2003 decision in *McCord*.[6]

B. Majority Opinion

In a decision reviewed by the entire Tax Court, Judge Kerrigan, to whom the case was originally assigned, denied the IRS's summary judgment motion. She and seven other judges voted to overrule *McCord*, and another six judges found different reasons to conclude that the case did not warrant summary judgment in the government's favor. Only one judge dissented.

The slim majority's opinion reconsidered *McCord*, in which the court had previously ruled out any discount for the assumed Section 2035(b) liability. Judge Kerrigan concluded that that prior decision, which was subsequently reversed by the Fifth Circuit on this issue, was in error and should no longer be followed. The *Steinberg* majority's analysis looked at two aspects of *McCord*: first, its ruling that the contingent liability under Section 2035(b) was too speculative to merit any value reduction under the venerable Supreme Court decision in *Robinette v. Helvering*[7]; and second, its ruling that the discount was not warranted under the "estate depletion theory" of consideration adjustments under the gift tax. On both counts, the majority found its conclusions from 2003 to have been incorrect.

Taking up the *Robinette* point first, the majority noted that in *McCord*, it had found that the dollar amount of any projected liability under Section 2035(b) depended on too many political variables to support a discount. These included changing tax rates and exemption amounts, and even the very existence of the federal wealth transfer taxes. But the Fifth Circuit had reversed on that ground, noting that a willing buyer of the property being transferred by gift would surely have required that the accompanying liability under Section 2035(b) be taken into account in setting the price for the property.

Although *Steinberg* is not appealable to the Fifth Circuit, the majority took that circuit court's observations to heart. Unlike *Robinette*, the majority said, the present case did not rest on probabilities such as that of childbearing, which defy actuarial science; instead, it involved the donor's mortality, as to which statisticians are quite accomplished. Regarding the possibility of changing tax rates and exemption amounts, Judge Kerrigan noted that valuation discounts for capital gain taxes are commonplace in valuing corporate stocks, and there, tax rates and exemptions are also subject to legislative change.

The majority then addressed the IRS's assertion, bolstered by the Tax Court opinion in *McCord*, that the discounts should not be allowed because the donee's liability assumption under Section 2035(b) does not increase the value of the donor's property for future inclusion in his or her

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[6] *Supra* note 3.

[7] 318 US 184 (1943).

gross estate. According to *McCord*, the promise to pay future estate taxes does not benefit the donor, but rather benefits her estate. In *Steinberg*, the government was even more blunt about it: The donees who signed the agreement to pay the Section 2035(b) tax were the same individuals who would wind up, as beneficiaries of the estate, bearing the burden of that tax, even without an agreement. Thus, at most, the net gift agreement might have shifted liability among estate beneficiaries, but it did nothing to offset depletion of the donor's estate by means of the gifts.

The majority disagreed with this view. "When the donees assumed the potential section 2035(b) estate tax liability," it declared, "[the donor's] assets may have been relieved of the potential estate tax liability. This assumption, which we have determined may be reducible to a monetary value, also may have replenished [the donor's] assets." And the court completely reversed field on the distinction made in *McCord* between the donor and her estate; the two are one and the same, the majority said, for purposes of judging whether the consideration transferred by the donee should count as consideration, reducing the gift.

Finally, the majority quickly disposed of the IRS's argument that the net gift transactions were not part of the ordinary course of a business. Factually, that assertion was true, but it does not necessarily lead to the conclusion that a transaction is a gift, or that consideration received in exchange for a gift is not bona fide. For all of these reasons, the IRS's summary judgment request was rejected.

C. Concurrences and Dissent

Two concurrences were filed -- one by Judge Goeke, which only Judge Lauber joined, and another by Judge Lauber, which five other judges (including Judge Goeke) joined. These six jurists agreed that the IRS should not be granted its requested summary judgment, but they also opined that *McCord* should not be overruled.

Judge Goeke agreed with the taxpayer that the estate of the donor was not being depleted to the extent of the assumed liability. The estate's right to have the donees pay the Section 2035(b) tax would be includible in the gross estate of the donor, presumably under Section 2033, if she died within the three-year period. But Judge Goeke disagreed with the taxpayer that the value of that right would be the same as the amount of the gift tax valuation discount taken at the time of the gift. Given that the donor would be deceased and the tax due and payable, the value of the indemnity right would be much larger – a substantial risk, the concurrence said, that the family assumed in drafting the net, net gift.

Judge Lauber's concurrence took issue with the majority's overruling of *McCord*. First, he saw no need to reach the question of the speculative (or nonspeculative) nature of the contingent liability at the summary judgment phase of the case. Neither party had raised that issue in their arguments for and against summary judgment. And since that aspect of the case was not properly before the court, Judge Goeke reasoned, neither was the prospect of discarding *McCord* as precedent.

The concurring judges also questioned whether the "estate depletion theory" was ripe for decision – particularly, the IRS's argument that the net gift agreement at most merely shuffled Section 2035(b) liability among beneficiaries. It was not clear from the record who the beneficiaries of the donor's estate were; in fact, the donor was still alive. Thus, it was impossible to know whether the agreement made any real difference as to who might be required to pay the Section 2035(b) liability. (Of course, because the decedent was still alive in 2013, there would be no actual Section 2035(b) liability, but the question of fair market value in 2007 looks to hypothetical, rather than actual, events subsequent to the date of the gift.) According to Judge Lauber, the IRS's mere-apportionment theory should still be available at trial, where the underlying facts could be developed.

Judge Halpern dissented. Crunching the numbers of a hypothetical case with facts along the same lines as *Steinberg*, he demonstrated the gift tax savings achieved by the net, net gift arrangement. He then argued that the plan placed the donor's family in a more favorable position than the one they would have enjoyed had the donor simply paid the gift tax herself. That result, the dissent argued, is contrary to the policy behind Section 2035(b). That provision recognizes both the tax-inclusive nature of the estate tax base and the tax-exclusive nature of the gift tax base. It seeks to prevent taxpayers from avoiding the tax-inclusive estate tax by making deathbed transfers that would then be subject only to the tax-exclusive gift tax.

Under the analysis the taxpayer urged, the dissent said, the valuation discount taken at the time of the gift would be subject to neither gift tax nor estate tax. Section 2035(b) would impose estate tax only on the gift tax actually paid by the donees, which would be reduced on account of the discount. Although the dissent did not say so explicitly, Judge Halpern's calculations suggest that he did not believe that Section 2033 would include any value in the gross estate on account of the indemnity rights against the donees under the net gift agreement. He pointed to a journal article,[8] written by one of the taxpayer's lawyers and an appraiser, that made no mention of the Section 2033 inclusion in touting the transfer tax advantages of the net, net gift discount concept.

D. Tale of the Tape

Here is a set of unofficial calculations that attempt to mirror and expand those generated by the dissent. The figures are based on a wealth base of $100 million held by an 89-year-old taxpayer, who has already used up all of her annual exclusions and unified credit, at a time when (as in 2007) transfer tax rates are 45 percent, the Section 7520 rate for present-valuing future sums is 5.6 percent, and human life expectancies are determined under Census Bureau Table 90CM.[9] For relative ease of illustration, they assume, in harmony with the current assumptions for valuing successive interests,[10] that the decedent's wealth will neither appreciate nor decline in value. Most importantly, they assume that the gift tax discount that the taxpayer argued for in *Steinberg* is allowed.

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[8] Arlein & Frazier, "The Net, Net Gift," 147 Tr. & Est. 25 (Aug. 2008).

[9] In December 2013, the maximum federal transfer tax rate would be 40 percent, the Section 7520 rate 2.0 percent, and human life expectancies a bit longer, calculated under Census Bureau Table 2000CM.

[10] *See* J. Bogdanski, Federal Tax Valuation ¶ 5.05[2][f] (1996 & Supps.).

If the taxpayer holds onto her $100 million and dies with it, the estate tax will be $45 million:

Estate tax without lifetime gift

Item	*Amount*
Wealth to transfer	$ 100,000,000
Estate tax at 45%	$ 45,000,000

If she gives it all away during her lifetime, either through a net gift or by making the largest gift possible while paying the gift tax herself, the gift tax is just over $31 million:

Net gift (or maximum gross gift)
without IRC § 2035(b) discount

Variable	*Item*	*Amount*
u	Wealth to transfer	$ 100,000,000
x	Net gift (*u* / 1.45)	68,965,517
y	Gift tax on net gift (*x* × .45)	$ 31,034,483

And assuming that she outlives the Section 2035(b) period, the estate tax is zero. Leaving aside income taxes, which should not be overlooked the way they are in these figures, lifetime giving beats transfers at death by a country mile.

At issue in *Steinberg*, though, was a net, net gift, and the question whether a discount is appropriate for the additional assumption of the potential Section 2035(b) liability. To calculate the hoped-for gift tax discount and its impact on gift tax liability, two sets of complex, but by no means impossible, computations are necessary.

First, one must come up with a factor to reflect the probability that the Section 2035(b) tax will ever be imposed on the estate, and hence on the donees. As can be seen from this table, for an 89-year-old donor, the probability is negligible: There is a 13.8 percent chance of her dying in the first year, a 13.0 percent chance of her dying in the second year, and a 12.1 percent chance of her dying in the third year. The valuation factor should also take into account the time value of money, calculated using the Section 7520 rate, as the Section 2035(b) tax may not be due for up to three years. Here, the resulting factor is 35.1 percent:

Present-value and probability factor
(using Table 90CM)

Year	*Age*	*90CM*	*PS*	*PD*	*PV*	*PD x PV*
0	89	19783				
1	90	17046	0.861649	0.138351	0.94697	0.1310143
2	91	14466	0.731234	0.130415	0.896752	0.1169499
3	92	12066	0.609918	0.121316	0.849197	0.1030214
4	93	9884				
Total						0.3509856

90CM = Survivors to Age from 100,000 births in Census sample
PS = Probability of survival from age 89 to Age
PD = Probability of death during Year
PV = Present value of deferred obligation at 5.6% per annum

Whatever the Section 2035(b) tax might be, the proper gift tax discount should be 35.1 percent of that amount.

That brings intrepid estate planners to the second set of calculations, which seek to determine how much the Section 2035(b) estate tax burden would be if actually imposed. That in turn depends on how much gift tax is paid on the present gift, which in turn depends on how much the net, net gift is. And that hinges on how much the discount is, which ultimately is driven by how much the Section 2035(b) tax would be if imposed. The circle is unbroken, but simultaneous equations from ninth-grade algebra arrive at the proper figures:

Net, net gift of $100 million
with IRC § 2035(b) discount

Variable	*Item*	*Amount*
u	Wealth to transfer	$ 100,000,000
v	Discount for assumed IRC § 2503(b) liability	4,672,839
w	Discounted gift ($u - v$)	95,327,161
x	Net, net gift (w / 1.45)	65,742,870
y	Gift tax on net, net gift (x × .45)	$ 29,584,291
z	Present-value and probability factor	0.351

Assumptions: Gift in April 2007 (IRC § 7520 rate = 5.6%), donor aged 89, no annual exclusion or unified credit available.

Simultaneous equations

$v = y \times .45$ (potential estate tax) $\times z = .15795y$
$w = \$100,000,000 \quad v$
$x = w / 1.45$
$y = .45x$

On the facts in the example, the discount appears to be about $4.7 million, reducing the gift tax to only about $29.6 million, and saving the donor about $1.45 million in gift tax. If the donor outlives the three-year period in Section 2035(b), the government apparently never hears from that $1.45 million again. The donee liability lapses along with the contingent estate tax, but no additional taxable transfer from donor to donee appears to result at that time.

E. Consequences Under Section 2035(b)

The taxpayer, the Goeke concurrence, and the dissent really went their separate ways in theorizing what would happen if the maker of a net, net gift dies within the three-year inclusion period. All started off in agreement that the gift tax actually paid – about $29.6 million on our assumed facts – comes back into the donor's gross estate, where at a 45 percent rate it would create an estate tax liability of about $13.3 million.

Application of Section 2035(b)
if death within three years

Item	*Amount*
Gift tax paid within three years of death	$ 29,584,291
Estate tax rate	.45
Estate tax increase under IRC § 2035(b)	$ 13,312,931

But it is there that the agreement ended.

The dissent worried that nothing else would be included in the gross estate, meaning that the overall transfer tax would be only $42.9 million – the $29.6 million of gift tax and the $13.3 million estate tax under Section 2035(b). Compared to subjecting the entire $100 million to the estate tax – which is what Section 2035(b) seeks to simulate – there would be a shortfall of about $2.1 million. That amount, of course, is the 45 percent transfer tax multiplied by the $4.7 million gift tax discount. Under this approach, the discount apparently escapes wealth transfer taxation permanently.

But perhaps the dissent was overly worried. In addressing the "estate depletion theory," the taxpayer argued that there would be an additional amount included in the gross estate under Section 2033 – the value of the indemnity rights – and that the rights would be included at the same amount as the discount previously taken for gift tax purposes. If that is so, then at least where Section 2035(b) applies, the $4.7 million discount comes back into the gross estate, and the additional $2.1 million of estate tax is collected from either the estate or its beneficiaries.

The Goeke concurrence would make matters even better for the government under Section 2035(b). It would include the indemnity rights in the gross estate at their value on the date of death, taking into account, as Section 2033 typically does, the decedent's demise.[11] Presumably that would

[11] *See, e.g.,* Goodman v. Granger, 243 F2d 264 (3d Cir. 1957), *cert. denied*, 355 US 835, *discussed in* J. Bogdanski, *supra*, at ¶ 2.01[3][c][v].

increase the Section 2033 inclusion to the full face amount of the estate tax inflicted by Section 2035(b), which would put the estate in a worse position than if the donor had never made a lifetime gift at all. Under this view, the total transfer tax burden on the facts of the example would be nearly $48.9 million.

Additional estate tax on indemnity rights under Goeke concurrence

Item	*Amount*
Rights against donees	$ 13,312,931
Estate tax rate	.45
Estate tax increase under IRC § 2033	$ 5,990,819

Total transfer tax if death within three years

Item	*Amount*
Without estate tax on indemnity rights	$ 42,897,222
Counting only gift tax discount as estate asset	$ 45,000,000
Under Goeke concurrence	$ 48,888,041

Which of these views of Section 2035(b) prevails? The answer cannot be found in the *Steinberg* majority opinion, and it may be years before it is known.

F. Cans of Worms

Some of the discussion in the majority opinion made seasoned observers wince. For example, the majority's analogy to the built-in gain taxes applicable in valuing closely held stocks seemed to misunderstand what those discounts actually represent. The opinion made repeated reference to capital gains under the individual income tax; the cases it cited, however, are about the discount applicable to C corporation stock reflecting the *corporate* capital gain tax inherent in the *corporation's* appreciated property.[12] And while the main point of the analogy has to do with fluctuating, preferential capital gain tax rates, C corporation capital gains do not enjoy a rate preference, nor have corporate rates changed in many years.[13]

In addition, the discount for built-in corporate taxes has been the source of much disagreement and confusion over several decades. Courts cannot settle on how to quantify the

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12 Estate of Jelke v. Commissioner, 507 F3d 1317 (11th Cir. 2007), *cert. denied*, 555 U.S. 826 (2008); Estate of Dunn v. Commissioner, 301 F3d 339 (5th Cir. 2002); Estate of Jameson v. Commissioner, 267 F3d 366 (5th Cir. 2001); Eisenberg v. Commissioner, 155 F3d 50 (2d Cir. 1998) (acq.); Estate of Davis v. Commissioner, 110 TC 530 (1998).

13 *See* IRC § 11.

discount,[14] and the Tax Court itself has made at least one misstep in searching for a reliable methodology.[15] It is hardly a body of law that one should feel inspired to hold up as a model for solving different valuation problems.

The majority opinion also drifts at one point into a discussion of intent, always a shaky foundation for a tax rule. In distinguishing *Murray v. United States*, a decision of the former Court of Claims (now the Federal Circuit),[16] the Tax Court noted that the taxpayer in *Murray* had not intended to reduce the value of taxable gifts when he imposed on trust beneficiaries the obligation to pay the estate tax. In contrast, the taxpayer presently before the Tax Court clearly intended that the net gift agreement lower the amount of the taxable gift. It is always an awkward moment when a tax avoidance motive helps the taxpayer's case. (More defensibly, the *Steinberg* court also noted that the value of the assumed liability under the three-year rule of Section 2035(b) was less conjectural than the open-ended obligation in *Murray*, to pay all of the decedent's estate tax, whatever it might be and whenever it might be imposed.)

Even without an invitation to mischief in the court's discussion, some estate planners have a boundless appetite for game-playing, and the holding of *Steinberg* seems likely to open the chute for even more breathtaking discount planning maneuvers in the future. For example, donees may next agree to assume not only the gift tax on the gift plus the additional estate tax under Section 2035(b), but also the additional estate tax resulting from including the Section 2035(b) indemnity in the gross estate under Section 2033 – all grossed up to reflect all rounds of inclusions under Section 2033 that might result from a previous round. The gift tax discounts would presumably only get larger, and if the donor lives more than three years, the IRS would seemingly never recoup any of the lost transfer tax revenue.

G. Trial and Appeal

Although *Steinberg* will no doubt be hailed as an important taxpayer victory, it may be too early for estate planners to break out their noisemakers and party hats. Judge Kerrigan denied the government's summary judgment motion, but it is not entirely clear that the taxpayer will prevail at trial.

The majority noted, "[W]e conclude that there are genuine factual disputes about the issue," and later added: "The event of [the donor's] survival three years after the date of the gift is speculative, and whether it is too speculative or highly remote is a factual issue." Is it? Survival issues for purposes of federal tax valuation have long been governed, as a matter of law, by the

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[14] *See* Bogdanski, "Discount for 'Built-in' Corporate Taxes is Far from Settled," 36 Estate Planning 38 (June 2009).

[15] *See* Bogdanski, "Discounts for 'Built-in' Gain Taxes: The *Litchfield* Fallacy," 37 Estate Planning 37 (June 2010).

[16] 687 F2d 386 (Ct. Cl. 1982).

Section 7520 tables, unless the individual whose life is in question is terminally ill, which the donor in *Steinberg* obviously was not. What additional facts is the judge planning to try?

The majority also declared, "The value of the amount of section 2035(b) estate tax liability in this case may be predictable." "May be" implies room for argument, and one wonders what will be relevant in that regard. The proper discount rate to use for present-valuing the liability? Fluctuating tax rates and exemption amounts? The politics of tax reform?

The six-judge concurrence also suggested that the trial should concern itself both with the question of whether the Section 2035(b) tax is too speculative, and with factual issues surrounding the IRS's assertion that the net gift agreement did not change the beneficiaries' liability for that tax from what it would have been under state law. Specifically, Judge Lauber mentioned as important facts the decedent's estate plan and the identity of its beneficiaries; the applicability of New York law; and how much the net gift agreement changed what would have been the liability and enforcement picture in the absence of an agreement. Whether Judge Kerrigan will take the concurring judges up on these suggestions of factual inquiries is unknown at this writing.

In any event, *Steinberg* should now proceed to a trial of some sort, and a final decision by the Tax Court could be many months away. Barring an unusual interlocutory appeal, practitioners probably will not know for a long time whether the government will acquiesce in the Tax Court's new position. Any appeal would lie to the Second Circuit.

H. Conclusion

To admit one's mistakes is admirable, and the Tax Court has earned another badge of esteem in that regard. In backing down from an earlier position that was panned by the Fifth Circuit, *Steinberg* discards a hard-and-fast rule that provided certainty, if not correctness.

III. CHARITABLE EASEMENT WARS

Conservation easements and facade easements have generated an enormous volume of federal tax litigation in the last few years. The controversies were easy to see coming. Entering into restrictive real estate covenants in favor of qualifying nonprofit organizations may give rise to charitable contribution deductions,[17] wealth transfer tax discounts,[18] and even a special exclusion for

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[17] *See* IRC §§ 170(f)(3)(B)(iii), 170(h), 2055(f), 2522(d).

[18] *See generally* Reg. § 25.2703-1(a)(4) (easements in favor of charities not covered by IRC § 2703, negating estate and gift discounts for certain restrictions on sale or use of property); Boltar LLC v. Commissioner, 136 TC 326, 337-338, 340 (2011) (in determining value of property before restrictive easement was imposed, pre-existing easements should be taken into account); Fiske v. Commissioner, TC Memo. 1984-494, at 1982 (donor's agreement to restrict use of property reduced its value); Rev. Rul. 85-99, 1985-2 CB 83 (parcel conveyed to charity under deed with covenant restricting it to agricultural use had lesser value than unrestricted property).

estate tax purposes.[19] Perceived abuses of these benefits have engendered hostility on the part of the IRS. Now the cases are reaching the federal courts of appeals, and new cases are working their way through trial courts.

The latest opinions provide guidance on several issues surrounding the deductions and exclusion. The cases address: (1) the substantiation requirements surrounding the donation, including the necessity of obtaining a "qualified appraisal" of the restriction; (2) the question whether expert testimony on valuation of the easement is admissible in court; (3) valuation of the restriction itself; (4) the rule that the charitable interest must be protected "in perpetuity"; (5) the rule disallowing a deduction for a contribution if there is a possibility that it might be returned to the donor; (6) offset of the deduction by any return consideration received by the donor; and (7) special rules on facade easement donations.

A. Substantiation Rules

Substantiating one's charitable contributions is essential to obtaining deductions for them.[20] In a case of a contribution of a substantial item of property, these rules include a mandate that the taxpayer obtain[21] (and in some cases attach to the return claiming the deduction[22]) a "qualified appraisal" of the donated property; failure to do so results in automatic denial of the deduction.[23] The taxpayer must also obtain from the donee a contemporaneous written acknowledgment that includes a description of the gift, a statement whether the taxpayer received a *quid pro quo*, and if so, the value of that benefit.[24] The substantiation requirements apply to contributions of conservation and facade easements.

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[19] *See* IRC § 2031(c).

[20] *See* IRC §§ 170(f)(8), 170(f)(11)-(12), 170(f)(17).

[21] *See* IRC § 170(f)(11)(C); Reg. § 1.170A-13(c).

[22] *See* IRC § 170(f)(11)(D).

[23] For a heart-rending illustration, see Mohamed v. Commissioner, TC Memo. 2012-152 (charitable donation deduction denied entirely for want of "qualified appraisal"; taxpayer concededly donated millions of dollars' worth of real estate to charitable remainder unitrust). The appraisal must also value the correct property. In one recent case, a deduction was denied for a charitable contribution of stock, in large part because the taxpayers' appraisal covered the issuing corporation's only assets, two apartment buildings, instead of its stock. Estate of Evenchik v. Commissioner, TC Memo. 2013-34.

[24] *See* IRC § 170(f)(8). For an example of a deduction being disallowed for lack of a proper acknowledgment, see Boone Operations Co. v. Commissioner, TC Memo. 2013-101, at 17-21 (neither agreement with transferee nor form filed with tax return showed value of goods or services received by taxpayer).

1. "Qualified Appraisal"

Friedberg. Friedberg v. Commissioner[25] was a rerun of a decision the Tax Court made in 2011. In the earlier proceeding,[26] the court tossed out an easement contribution deduction on the ground that the taxpayer's appraisal was not qualified. At issue was a deduction for a 2003 contribution of a facade easement and development rights on an 1884 Queen Anne brownstone in a historic district on the upper east side of Manhattan. The taxpayers bought the building for $9.4 million and spent another $4 million on renovations; based on an appraisal, they deducted about $3.78 million on account of the easement donation. The IRS challenged the deduction on the ground that the appraisal was not qualified; the court originally agreed with the IRS's assertion.

Specifically, the government argued that the report was defective in that it omitted four of the 11 elements required by the governing regulations[27]: the contribution date, the date on which the property was appraised, the method of valuation, and the "specific basis" of valuation. Noting that the Tax Court accepted substantial compliance with the substantiation regulations, Judge Wells held that the first two of these were immaterial, but that the last two "relate to the substance or essence of the contribution."[28] The taxpayers said that their appraiser, Michael Ehrmann of Jefferson & Lee Appraisals, Inc. of Pittsburgh, used the prevailing "before and after" approach to determine the value of the facade easement, and the report said its findings were based on comparable sales; the court examined whether that was in fact the case.

Although Ehrmann's "before" value was developed from what the court called "a textbook example" of the comparable sales approach, his "after" value was a different matter. Instead of finding sales of encumbered buildings in New York City around the time of the donation, he instead used sales from the mid-1980s in Washington, D.C., and other types of transactions relating to easement-encumbered properties in New Orleans in the mid-1990s; from these, he extrapolated a percentage diminution in value, which he then applied to the "before" value of brownstone to arrive at a value of the easement. His analysis of his alleged comparables was so flawed that it constituted, in the words of the court, "a hodgepodge of approaches, most of which were unreasonable."[29] Although Ehrmann did consult transactions that he felt were comparable, that was not enough to satisfy the court that he had adequately described his methods.

In contrast, the original Tax Court decision found that the report *was* a "qualified appraisal" with respect to the development rights inherent in the property, whose use was also restricted by the

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[25] TC Memo. 2013-224.

[26] TC Memo. 2011-238.

[27] Reg. § 1.170A-13(c)(3).

[28] TC Memo. 2011-238 at 1618-1619 (RIA).

[29] *Id.*, at 1620.

charitable donation.[30] The appraiser analyzed five sales of development rights with respect to other properties in the vicinity of the taxpayer's building; despite numerous math errors and erroneous assumptions, the court found that this discussion adequately "explained the method of valuation and the specific basis for the valuation." It was not, the court said, "merely a mechanical application of some predetermined figure." Therefore, the government's motion for summary judgment was denied as to the donation relating to development rights,[31] leaving live valuation issues with respect to those rights. But the bottom line did include a grant of partial summary judgment for the IRS on the charitable contribution deduction of the easement; it was held not deductible at all.

After the Tax Court handed down its summary judgment opinion, but while the valuation issues on the development rights lingered, the Second Circuit decided *Scheidelman v. Commissioner*.[32] In it, the appeals court reversed a 2010 Tax Court decision[33] that an appraisal was not "qualified" because it did not state a method or a "specific basis" for the expert's valuation. The Tax Court had concluded that the appraiser did not employ a valuation method when he determined the post-easement value of encumbered property by subtracting from the pre-easement value a percentage derived from Tax Court cases and an article published in an IRS program document. The Second Circuit reversed, ruling that the appraiser's technique and its disclosure were sufficient to satisfy the procedural requirement that the valuation method be stated. "[I]t is irrelevant," the panel said, "that the IRS believes the method employed was sloppy or inaccurate, or haphazardly applied – it remains a method, and [the expert] described it. The regulation requires only that the appraiser identify the valuation method 'used'; it does not require that the method adopted be reliable."[34]

The appeals court also held that the appraisal sufficiently demonstrated the "specific basis" for its value conclusion. In addition to stating its reliance on Tax Court decisions and the IRS article, the expert chose from a range of values based on the encumbered property's location in Brooklyn. "[W]hether that range is accurate or reliable is not at issue on this appeal," the Second Circuit noted, adding: "The Commissioner may deem [the appraiser]'s 'reasoned analysis' unconvincing, but it is incontestably there."[35]

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[30] *Id.*, at 1630-1632.

[31] *Id.*, at 1626-1629. The IRS also claimed that the taxpayers had not attached a fully completed appraisal summary to their tax return, as is also required by the regulations. Although the summary did omit some of the details required, the taxpayers attached to their return Ehrmann's entire report, which contained all the information required in the summary. This, the court held, constituted substantial compliance with the regulations' requirements.

[32] 682 F3d 189 (2d Cir. 2012).

[33] TC Memo. 2010-151.

[34] 682 F3d at 196-197.

[35] *Id.*, at 198.

The taxpayers in *Friedberg* filed a motion for reconsideration of the court's original opinion, on the qualification of the Ehrmann appraisal, in light of *Scheidelman*. The Tax Court granted the motion, and after more than a year's worth of deliberation, it reversed itself. The appraisal was deemed to be "qualified," after all.

In its supplemental opinion, the court adhered closely to the instruction it had received from the Second Circuit. Under the circuit court's mandate, "any evaluation of accuracy is irrelevant for purposes of deciding whether the appraisal is qualified," Judge Wells explained. Despite its defects, he said, the appraisal report provided "sufficient information to enable respondent to evaluate Mr. Ehrmann's underlying methodology." Echoing the appeals court's words, the Tax Court added: "Although we criticized and disagreed with Mr. Ehrmann's analysis, it was 'incontestably there.'"

Also on reconsideration, the IRS took a shot at the court's prior conclusion that the appraisal was "qualified" in its discussion of development rights. The government pointed out that in discovery, Ehrmann had admitted that he had never appraised development rights; thus, said the government, his appraisal was not qualified, because *he* was not qualified. The court disagreed. The regulations, it said, required only that the appraiser *represent* that he or she is qualified to appraise the property in question; there was no requirement that the representation actually be true. "[T]he 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," the court declared. "[A]n appraiser is qualified if the declaration is present, regardless of whether it is 'unconvincing.'" On this point, the court affirmed its earlier decision.

In explaining the reversal of his prior ruling against the taxpayers, Judge Wells pointed out that *Friedberg* was appealable to the Second Circuit, which had decided *Scheidelman*. He cited the *Golsen* rule,[36] under which the Tax Court follows the law of the circuit to which a case would be appealed, thus avoiding inevitable reversal. But if *Friedberg* had been appealable to a different circuit, would the court have ruled the same way? Is the Tax Court convinced that its earlier ruling in *Friedberg* was erroneous, or will it adhere to that decision in cases arising in other circuits? Alas, a clear answer to that question is not included in the supplemental opinion.

The IRS's chances of ultimately prevailing in *Friedberg* do not seem quite so uncertain, however. Although the Ehrmann appraisal has now survived the minimal scrutiny involved in the procedural context, the Tax Court made no secret of its low regard for the work contained in that report. At one point, the opinion remarked that "we continue to question whether the Ehrmann appraisal is reliable or properly applied methodology to reach its conclusions...." Unless the taxpayers produce a more convincing witness at trial,[37] their chances of prevailing on the valuation issue appear slim.

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[36] *See* Golsen v. Commissioner, 54 TC 742, 757 (1970), *aff'd*, 445 F2d 985 (10th Cir. 1971).

[37] The supplemental opinion in *Friedberg* noted: "[W]e specifically do not opine on the reliability and accuracy of the methodology and specific basis of valuation in the Ehrmann appraisal, a matter we leave to be decided at trial."

Moreover, consider what occurred on remand in *Scheidelman*: The Tax Court considered all the evidence, including the disputed appraisal, and found that the value of the donated easement was zero.[38] It is not inconceivable that the taxpayers in *Friedberg* are destined for a similar disappointment.

Interestingly, while the Tax Court was pondering the motion for reconsideration in *Friedberg*, Ehrmann and his firm consented to an injunction issued by an Ohio federal district court, permanently prohibiting them from preparing or providing appraisals of any property for federal tax purposes. The injunction also bars them from appearing as a witness or providing expert support in cases in which they did not originally appraise a conservation easement, with the exceptions of *Scheidelman,* one other case currently before the Tax Court,[39] and an unidentified dispute which was then in the administrative process before the IRS. Ehrmann and the firm are, however, permitted to defend any appraisal reports they prepared before Jan. 30, 2013.[40] According to his answer filed in the Ohio action, Ehrmann is 70 years old and retired.

Gorra. In *Gorra v. Commissioner*,[41] the Tax Court upheld a taxpayer's appraisal report over an IRS assertion that it was not qualified. At issue was another facade easement, over a narrow, four-story townhouse in the Carnegie Hill section of Manhattan. In preparing their returns, the taxpayers obtained an appraisal from an expert suggested by the charitable donee -- the same donee as was involved in *Scheidelman*. The IRS argued that the appraisal failed in four particulars. First, it did not contain the correct date or expected date of the contribution. The appraisal showed the date as December 11, when in fact the easement was executed by the taxpayers on December 18 and by the donee on December 26, delivered for recording with the city on December 28, and due to a clerical error, not in fact recorded until January 18.[42] The court found that the date in the report was close enough to the actual date to satisfy the requirement.

Second, the IRS noted that the appraiser had used "market value" rather than "fair market

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[38] *See infra* Part III(C)(2).

[39] Chandler v. Commissioner, Docket No. 016534-08 (TC, tried Aug. 12, 2013).

[40] United States v. Ehrmann, Civ. No. 1:13-cv-00214-DAP (N.D. Ohio Feb. 12, 2013) (order of permanent injunction in action brought by U.S. Dept. of Justice under IRC § 7408). For a press release on the case, see U.S. Dept. of Justice, "Ohio Federal Court Bars Appraiser of Historic-Preservation Easements" (Feb. 13, 2013), found at http://www.justice.gov/opa/pr/2013/February/13-tax-192.html (as of Oct. 7, 2013).

[41] TC Memo. 2013-254.

[42] The court excused the delay in recording, noting that under local law, deeds actually recorded are deemed recorded on the date on which they were delivered for recording. Thus, the charitable contribution was properly taken in the earlier year, and it did not violate the perpetuity requirement, discussed *infra* Part III(D). *Id.*, at 40-42

value" as the standard of value, thus omitting any valuation under the proper standard for federal tax purposes. The court disagreed, noting that the definition of "market value" contained in the appraisal was consistent in all important respects with the prevailing definition of fair market value under Section 170.

Third, the court ruled that the appraisal adequately disclosed the method of valuation – the "before and after" approach – under *Scheidelman*. Fourth, the court held that the report also disclosed its "specific basis for valuation," namely, an empirical study of "paired sales data" for New York residential property, in which sales of properties with easements were compared with sales of properties without easements.

Finally, the IRS objected that the appraisal did not comply with generally accepted appraisal standards. Specifically, the government argued that the report violated various aspects of the Uniform Standards of Professional Appraisal Practice. The court waved off these objections with a blunt observation: "Appraising is not an exact science and has a subjective nature."[43] Thus, the appraisal met the criteria for qualification under the substantiation rules.[44]

Pesky. *In Pesky v. United States*,[45] a district court case in Idaho, the IRS moved for summary judgment against taxpayers who had transferred a conservation easement to a charity, on the ground that the appraisal that they obtained in connection with their tax return was not qualified. The motion failed, because the trial court found that there were still issues of material fact as to whether the taxpayers had reasonable cause for their failure to obtain a fully qualified appraisal – such cause being a defense to such failure.[46]

The taxpayers and the charity owned adjacent land, with the taxpayers needing access across the charity's property and desiring the charity's support for their application for permits to pave a driveway to their land. The easement was transferred at the same time as several other agreements between the taxpayers and the charity were executed. The IRS argued that the appraisal the taxpayers obtained was not qualified because it did not discuss the other agreements, or another easement that affected the subject parcel. Even if the IRS arguments were valid, the court said, the factual question remained whether the taxpayers reasonably relied on their advisors in the transaction. Thus, summary judgment was inappropriate.

2. Donee Acknowledgment

The Tax Court has also held in taxpayers' favor in cases in which the IRS argued that they

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[43] *Id.*, at 48.

[44] *Id.*, at 43-49.

[45] 112 AFTR2d 2013-522 (D. Ida. 2013).

[46] See IRC § 170(f)(11)(A)(ii)(II).

did not receive the required acknowledgment from donees of restrictive easements.[47] In *Pesky*, just discussed,[48] the IRS argued that the acknowledgment that the taxpayer received from the charitable donee was not sufficient because it failed to note that the charity had transferred benefits to the taxpayers in exchange for the easement they transferred to the charity, all under contemporaneous agreements. The court refused to grant the IRS summary judgment on the issue, because factual issues remained as to whether the agreements were interrelated.[49]

B. Admissibility of Expert Testimony

For many years, parties have invoked the Supreme Court's *Daubert* decision[50] in an attempt to strike the testimony of opponents' valuation experts in federal tax litigation. In Tax Court, such challenges do not usually succeed, but occasionally they do.[51] The Tax Court's opinion on remand in *Scheidelman*, discussed earlier,[52] shows the court dismissing the work of the taxpayer's trial witness entirely, on the ground that it did "not satisfy the standards of rule 702 of the Federal Rules of Evidence"[53] -- the rule on which *Daubert* is based.

In *Scheidelman*, the taxpayer had obtained an appraisal of their facade easement at the time they contributed it, but at trial, they called a different appraiser – Ehrmann – to be their expert witness. The original appraisal, the court said, "set forth boilerplate standards for valuing property" and made "a claim for 'all that the traffic would bear.'" It was one of 91 reports prepared by the same appraisal firm at the request of the charitable donee of facade easements, using almost identical language and percentages of value reduction based on prior court cases and IRS audits. For that reason, it was ruled "not credible."[54]

Turning to Ehrmann's testimony at trial, the court noted that he relied on market data provided by the donee, inaccurately described the easement at issue in the case, relied on outdated information and data from transactions that were not comparable, and ignored studies suggesting a contrary result. His testimony, the court said, "had all of the earmarks of overzealous advocacy" and

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[47] Often the donee has executed many documents that together constitute the required acknowledgment, even if the classic letter is absent.

[48] *See supra* Part III(A)(1).

[49] 112 AFTR2d at 2013-5228.

[50] Daubert v. Merrell Dow Pharm., Inc., 509 US 579 (1993).

[51] *See, e.g.,* Boltar, LLC v. Commissioner, 136 TC 326, 332-340 (2011).

[52] *See supra* Part III(A)(1).

[53] TC Memo. 2013-18, at 17.

[54] *Id.*, at 13-15.

"does not help the Court...."[55] For that reason, Ehrmann's testimony was given no weight, if it was admitted at all, and the court found that the easement had no value.

C. Valuation of Donated Easements

If the taxpayer clears the legal hurdles posed by the "perpetuity" requirement and the procedural hurdles presented by the substantiation rules and the *Daubert* doctrine, valuation of the donated restrictions becomes the primary issue. It, too, has been a fertile ground for controversy.[56] If an easement donation deduction is allowed at all, the amount is set at the fair market value of the donated interest. Since arm's-length sales of such easements are unusual, the prevailing approach to valuing them is to compare the values of the subject property before and after the imposition of the restrictions – the difference between the two being deemed the fair market value of the easement.[57]

With two valuations required, one before the donation and the other after it, controversy between the taxpayer and the IRS is almost guaranteed. Often the IRS asserts that the taxpayer's "before" value is overstated, because the highest and best use of the property pre-easement was lower than that asserted by the taxpayer. The government is also likely to assert that the restriction at issue permitted greater exploitation of the property following imposition of the easement than the taxpayer admits – thus increasing the "after" value and decreasing the deduction.

1. *Mountanos*

In *Mountanos v. Commissioner*,[58] a charitable contribution deduction was denied, on the ground that the taxpayer had not shown that the donated conservation easement, over northern California ranchland, had any value. Crucial to the IRS's victory in the dispute was the fact that state law forbade the taxpayer's proffered pre-easement highest and best uses, which were vineyard operation, residential development, and other subdivision. Thus, the affected ranch's "before" value was not proven to be any higher than its "after" value, as a recreation site.

The 882-acre ranch was largely surrounded by federal land. Access roads ran through neighboring properties, including the federal land; easement over that property was restricted to

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55 *Id.*, at 16-17.

56 *See, e.g.,* Trout Ranch, LLC v. Commissioner, 110 AFTR 2d 2012-5621 (10th Cir. 2012) (not officially reported), *aff'g* TC Memo. 2010-283; Dunlap v. Commissioner, TC Memo. 2012-126; Butler v. Commissioner, TC Memo. 2012-72; Esgar Corp. v. Commissioner, TC Memo. 2012-35; Simmons v. Commissioner, TC Memo. 2009-208, at 1567-1570, *aff'd on other grounds*, 646 F3d 6 (D.C. Cir. 2011) (court applying 5 percent reduction in value for facade easements); Bogdanski, "Keeping Up the Facade: *Whitehouse Hotel* and *Evans*," 38 Estate Planning 40 (Jan. 2011).

57 *See* Reg. § 1.170A-14(h)(3)(i) (fourth sentence).

58 TC Memo. 2013-138.

single-family use of the ranch. The ranch was under a contract with the county that subjected it to California land preservation laws. The taxpayer's argument that the property could have been used as a vineyard was refuted by the lack of access for that purpose, as well as by the lack of an adequate water supply; a nearby spring required a permit that the taxpayer did not have. Moreover, there was no showing of demand for vineyard land in the vicinity, nor of the economic feasability of a vineyard operation on the site.[59]

Next, the court considered and rejected the taxpayer's theory that the ranch could have supported a 22-unit residential subdivision. Under the state law incorporated into the long-term county contract, the property was restricted to agricultural use, and the agreement, whose contents were not in the record in the tax case, may have restricted such use even more tightly than those state land use laws. The uncertainty was among considerations that the court took into account in rejecting the taxpayer's argument for a relatively high value for the subject property, based on development potential.[60] In addition to sustaining the IRS's deficiency determination, the court also imposed the 40 percent valuation misstatement penalty under Section 6662(h).[61]

2. *Scheidelman*

As has already been mentioned,[62] the Tax Court on remand found zero value for the donated facade easement in *Scheidelman*. The taxpayers' appraisals were found to lack credibility, while the court accepted the testimony of expert witnesses presented by the government. The latter experts emphasized that the property at issue was already subject to restrictions imposed by local government.[63] Moreover, based on the taxpayer's own testimony, the court found that she would not have granted the easement had she believed that it would significantly reduce the value of the property.[64]

3. *Gorra*

In contrast to *Scheidelman*, a New York City facade easement was found to have a positive fair market value in *Gorra*, discussed earlier,[65] but the value was a small fraction of the amount claimed on the taxpayers' income tax returns. The IRS and the taxpayers each produced an expert

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[59] *Id.*, at 9-11.

[60] *Id.*, at 12-16.

[61] *Id.*, at 17-19. For more on the penalty, see *infra* Part XV.

[62] *See supra* Parts III(A)(1), III(B).

[63] TC Memo. 2013-18, at 17-19.

[64] *Id.*, at 20-21.

[65] *See supra* Part III(A)(1).

in the Tax Court. The experts agreed on the "before" value of the subject townhouse – $5.25 million – but disagreed sharply on the "after" value. The IRS expert opined that the post-easement value was $5.3 million, and therefore the easement enhanced, rather than decreased, value; the taxpayers' expert opined that the post-easement value was $4,735,000, leaving an easement value of $465,000. (Based on a different appraisal, the taxpayers had claimed a deduction of $605,000.)

The court rejected the IRS's argument, bolstered by its expert, that the easement was worthless. The court appeared to have difficulty accepting the proposition that a restrictive covenant could have no depressing effect whatsoever on value; moreover, it found that despite the IRS's arguments, the easement was more restrictive than local landmark preservation law, in that it covered the entire exterior of the building, and not just its facade. Moreover, the charity was inspecting the property on a regular basis, as opposed to local government authorities, who acted only on complaint. Thus, some diminution in value was appropriate.

However, the court was unwilling to accept the taxpayers' expert's conclusion that the value of the townhouse was diminished 9 percent by the easement. The expert had used a "percentage diminution approach," comparing the prices paid for properties with and without easements. The court disagreed with one of the four comparable properties employed, on the ground that it was much wider than the property at issue and thus more valuable. Overall, the expert found a possible range in diminution of value of between 2 percent and 13 percent The court selected the lower end of the range because the most similar sale, though far from being perfectly comparable, was at that percentage. Thus, the value as found by the court was $104,000.[66]

Because the claimed value was so far removed from the correct value, the 40 percent valuation misstatement penalty was imposed. The court dismissed the taxpayers' argument that the penalty violated the Eighth Amendment because it was an excessive fine; the civil penalty is not covered by that constitutional provision, the court declared.[67]

4. Chief Counsel Advice 201334039

The regulations on valuation of donated easements provide that in determining the "before" and "after" values of the taxpayer's property, contiguous parcels are treated as one. Thus, if an easement burdens one parcel but the taxpayer or a member of the taxpayer's family owns a contiguous parcel, the "before" and "after" valuation should be applied to the two parcels together. "Family" for this purpose is as defined in Section 267(c)(4) -- it includes siblings.[68] If a donation increases the value of another parcel owned by the taxpayer or a "related person" within the meaning of Section 267(b) or Section 707(b), that too must be taken into account in valuing the charitable

[66] TC Memo. 2013-254, at 55-61.

[67] *Id.*, at 61-65.

[68] Reg. § 1.170A-14(h)(3)(i) (fourth sentence).

contribution.[69] The term "family" does not include entities, but the term "related person" does.

This summer, the IRS released a Chief Counsel advice memorandum giving examples of the application of this rule to various hypothetical scenarios. Although the illustrations are unremarkable, they do confirm that property owned by disregarded entities – "tax nothings," as they are sometimes known – is treated for easement valuation purposes as owned by the taxpayer who is deemed the owner under the "check-the-box" regulations.[70]

D. "Perpetuity" Problems

Section 170(h)(1)(C) provides that in order to give rise to a deduction, a conservation easement must be created "exclusively for conservation purposes." Under Section 170(h)(5)(A), this requirement is not satisfied "unless the conservation purpose is protected in perpetuity." Regulations specify that if the restricted property is subject to a mortgage, the mortgagee must subordinate its rights in favor of the donee organization.[71] In addition, the regulations require that the donor agree to share with the donee any proceeds of a disposition of the property following any extinguishment of the conservation restriction. The donee, the rules state, must generally "be entitled to a portion of the proceeds at least equal to" the "proportionate value of the perpetual conservation restriction" to the overall value of the property at the time the easement is granted.[72] The IRS has accused taxpayers of running afoul of these requirements in several court cases.

1. Mortgages

Mitchell I. In *Mitchell v. Commissioner*,[73] the Tax Court denied a charitable contribution deduction where the taxpayer purchased the property at issue on contract, and the seller who held the contract did not subordinate his interest until two years after donation of the easement. The court turned aside the taxpayer's argument that an oral agreement with the seller protected the charitable donee's interest; the agreement, said the court, "had no effect on [the seller's] ability to foreclose on the property and extinguish the conservation easement" if the taxpayer defaulted on her note.[74]

The taxpayer additionally argued that the requirement that the seller's security interest be subordinated was subject to an exception in the regulations for remote contingencies. It states:

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[69] *Id.* (fifth, eighth sentences).

[70] Reg. §§ 301.7701-2, 301.7701-3.

[71] Reg. § 1.170A-14(g)(2).

[72] Reg. § 1.170A-14(g)(6)(ii).

[73] 138 TC 324 (2012).

[74] 138 TC at 338.

> A deduction shall not be disallowed under section 170(f)(3)(B)(iii) and this section merely because the interest which passes to, or is vested in, the donee organization may be defeated by the performance of some act or the happening of some event, if on the date of the gift it appears that the possibility that such act or event will occur is so remote as to be negligible.... For example, a state's statutory requirement that use restrictions must be rerecorded every 30 years to remain enforceable shall not, by itself, render an easement nonperpetual.[75]

The taxpayer argued that there was "a very low probability of occurrence of a set of events that would deprive the charity of its proportional share of proceeds following judicial extinguishment of the facade easement and subsequent sale of the property"; therefore, she contended, the deduction should be allowed despite the lack of subordination.[76] The Tax Court disagreed, holding that the exception did not apply to the subordination rule.

The holding in *Mitchell I* was subsequently called into question by *Kaufman v. Shulman*,[77] a decision of the First Circuit. In *Kaufman*, the taxpayer gave a facade easement over a historic district brownstone to a conservation organization, and as part of the transaction, a bank that held a mortgage on the property agreed to subordinate its interest to that of the charitable donee. The Tax Court, however, ruled that the donation did not comply with the proceeds rule, in that on any sale of the property following extinguishment of the easement on account of changed circumstances, the donee would have only an unsecured claim against the taxpayer for a share of the proceeds. The agreement that the bank signed reserved to the bank a prior claim to insurance and condemnation proceeds so long as the mortgage was outstanding

The First Circuit reversed.[78] It ruled that the IRS's interpretation of the proceeds sharing requirement was too strict. The regulations provision, the court said, was designed to prevent taxpayers from reaping a windfall from any condemnation or insurance proceeds, and to ensure that the charitable donee would receive its proportionate share of the proceeds for use in other historic preservation work. The court said that these purposes were adequately served in the case, even though the lender maintained a priority. The taxpayer, said the appeals court, "had no power to make the mortgage-holding bank give up its own protection against fire or condemnation and, more striking, no power to defeat tax liens that the city might use to reach the same insurance proceeds -- tax liens being superior to most prior claims, including in Massachusetts the claims of the mortgage holder."[79] Since the taxpayer never had the power to give the charity absolute priority, the court said,

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[75] Reg. § 1.170A-14(g)(3).

[76] 138 TC at 333.

[77] 687 F3d 21 (1st Cir. 2012).

[78] 687 F3d 21 (1st Cir. 2012).

[79] *Id.*, at 26-27 (citation omitted).

she could be excused for not procuring a release by the lender.

The circuit court remanded the case to the Tax Court for consideration of the value of the easement. The appeals panel suggested that the value might be small or nonexistent, in that local ordinances already restricted alteration of the facade at issue.[80] At last report, the case was back before Judge Halpern, who had already written two opinions in the case and is now faced with the task of penning a third.

Mitchell II. The taxpayer in *Mitchell* sought reconsideration, in light of *Kaufman*, of the Tax Court's original opinion. In a supplemental opinion, the court rejected the request. Judge Haines ruled that *Kaufman* "addressed legal issues different from the one present in this case."[81] In *Kaufman*, he said, the appeals court decided whether the perpetuity rule was satisfied if the donee had an absolute right against the donor for post-extinguishment proceeds, whereas in the present case, the problem was the failure to obtain subordination in a timely way. The court declined the taxpayer's invitations to interpret *Kaufman* as merely requiring "perpetuating an easement's purpose,"[82] or to find that there was a "functional subordination" of the seller's rights because the taxpayer always had funds available to pay off the balance on the land sale contract.[83]

2. Donee Power to Waive Rights

In *Kaufman*, the easement agreement reserved to the donee the right to waive or abandon its rights under the easement donation. The IRS argued, as it had in previous cases, that this provision violated the "perpetuity" requirement because it allowed uses inconsistent with conservation purposes. The appeals court ruled for the taxpayer. Expressly following the D.C. Circuit's 2011 opinion in *Simmons v. Commissioner*,[84] the First Circuit declared that the regulations could not reasonably be read to impose the rule urged by the IRS. According to the *Kaufman* court, the consequences of the IRS's strict reading of the "perpetuity" requirement "would be to deprive the donee organization of flexibility to deal with remote contingencies."[85]

Kaufman cast doubt on Tax Court precedent on the point. For example, in *Carpenter v.*

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[80] *Id.*, at 31.

[81] TC Memo. 2013-204, at 21.

[82] *Id.*

[83] *Id.*, at 22.

[84] 646 F3d 6, 10 (D.C. Cir. 2011).

[85] Kaufman v. Shulman, *supra*, 687 F3d at 28. The Tax Court had not ruled on this aspect of the IRS's "perpetuity" argument in *Kaufman*, given that it had disallowed the deduction over the proceeds issue.

Commissioner,[86] that court had ruled as a matter of law that when easements can be extinguished by mutual consent of the parties, they fail the "perpetuity" test. Like the taxpayer in *Mitchell*, the taxpayer in *Carpenter* moved for reconsideration. Here again, the motion for reconsideration was denied by Judge Haines.

The Tax Court's supplemental opinion declared that the issues in *Kaufman* and *Carpenter* were different. *Kaufman*, it said, involved "terms in the relevant agreement allowing the donee organization to give its consent to changes in the facade or easement in question or to abandon some or all of its rights under the agreement."[87] In contrast, it said, "No similar provision is at issue in this case."[88] The court said the taxpayers were arguing for a broad rule that protection of the easement's purposes was sufficient if it complied with the regulation on proceeds sharing upon extinguishment of an easement.[89] But that regulation applies only in the case of a judicial extinguishment, not one effected by private agreement of the parties. Thus, said the court, no reconsideration was warranted.

The court's reasoning is hard to follow, much less accept. The contract provision at issue in *Kaufman*, as quoted by the First Circuit, "states that 'nothing herein contained shall be construed to limit the [Trust's] right to give its consent (e.g., to changes in the Façade) or to abandon some or all of its rights hereunder."[90] There is no mention in that language of any judicial proceeding. The appeals court specifically ruled that this was not enough of a potential impairment of the easement to constitute a violation of the "perpetuity" requirement. *Carpenter* is appealable, barring stipulation to the contrary, to the Tenth Circuit.

In *Gorra v. Commissioner*, discussed earlier,[91] the IRS argued that the facade easement in question was not protected "in perpetuity" because the donee was willing to terminate the easement, and the easement deed allowed the restrictions to be extinguished by judicial decree. The court rejected this argument. It noted that when the taxpayers' lawyer inquired of the donee whether the easement could be removed, the donee said no. And the court distinguished *Carpenter* on the ground that the easement before it contained no language allowing termination by mutual consent.[92]

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86 TC Memo. 2012-1.

87 TC Memo. 2013-172 at 19 (citation omitted).

88 *Id.*

89 Reg. § 1.170A-14(g)(6).

90 687 F3d at 27-28.

91 *See supra* Parts III(A)(1), III(C)(3).

92 TC Memo. 2013-254, at 35-40.

3. Donor Power to Substitute Property

The taxpayer clearly stepped over the "perpetuity" line in *Belk v. Commissioner*.[93] There, a deduction of more than $10 million was claimed for a conservation easement created over a golf course. The easement documents allowed the taxpayers to substitute other, contiguous real property for the golf course if (a) the substitute property was of the same or better ecological stability, (b) the substitution did not adversely impact the conservation purposes of the easement, (c) the substitute property was managed so as not to have an adverse impact on the conservation area, and (d) the fair market value of the easement interest was not diminished by the substitution. To make a substitution, the taxpayers would have to submit documentation to the charitable donee showing that these conditions were met; the donee would have to give its consent, but it could not be unreasonably withheld.

The easement was not in perpetuity, Judge Vasquez said, because the taxpayers did not agree never to develop the golf course. The taxpayer argued that the substitution would not harm the conservation purpose of the easement, but the court declared that that was not enough. "[T]he section 170(h)(5) requirement that the conservation purpose be protected in perpetuity," it said, "is separate and distinct from the section 170(h)(2)(C) requirement that there be real property subject to a use restriction in perpetuity."[94] The taxpayer also pointed to a clause in the easement agreement that said that the donee could not agree to an amendment that would cause the charitable deduction to fail; the court ruled that under contract law, the clause would not prevent a substitution. Moreover, the taxpayers had not shown that the parties did not intend that substitution be limited to circumstances in which continued use as open space was impossible or impractical.

E. Possibility of Return of Donation

Another taxpayer misstep can be seen in *Graev v. Commissioner*.[95] There the donor of a building in a New York City historic preservation district donated a facade easement to the same charitable organization involved in previous Tax Court controversies. That donee offered, and the taxpayer accepted, its routine side letter that promised him a refund of the required cash donation accompanying the easement donation if the tax benefits of the charitable contribution deduction were denied. This particular side letter went further, however, promising the taxpayer in addition that the donee would join the taxpayer to remove the facade easement immediately if the tax benefits were not sustained. The taxpayer deducted $990,000 for the easement and $99,000, the amount of cash he contributed to the donee, in the year of the contribution, 2004.

When the IRS turned up the letter on audit, it disallowed both deductions on the ground that they were conditional gifts. Conditional charitable gifts are not deductible unless the possibility that

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[93] 140 TC No. 1 (2013).

[94] *Id.*

[95] 140 TC No. 17 (2013).

the charity will not take and keep the contribution is so remote as to be negligible.[96] The taxpayer argued that the side letter was not enforceable. The Tax Court sided with the IRS.

First, the court said, there was a substantial possibility in 2004 that the IRS would successfully challenge the easement donation. Already the IRS had announced an audit initiative, of which the taxpayer was aware, concerning such deductions.[97] The taxpayer's accountants advised him "to be very cautious" with the transaction, and the mere fact of his requiring the side letter indicated that he regarded the threat of a challenge as worse than negligible. The court also found that the refund of the cash donation and removal of the easement were also non-negligible risks. Although the side letter was not part of the recorded easement, the easement itself did give the donee the power to abandon the easement, and by the side letter, the donee bound itself to do so if the tax deduction was denied.

Moreover, the court found that the donee intended to live up to its contract promises. The side letter was not merged into the easement, and the contract would not be determined void as against public policy, state or federal. Even if the contract were not enforceable, the court added, there was more than a non-negligible possible that the donee might voluntarily lift the easement, so as to protect its reputation among potential donors. In sum, the gift of the easement was held to be conditional, and the deduction was denied.

F. Quid Pro Quo

Another general principle underlying the charitable contribution deduction is that the deduction is reduced by the value of any benefit received by the donor in exchange for the contribution; if the consideration is substantial when compared to the contribution's value, the deduction may be denied entirely.[98] The Pesky case, discussed earlier,[99] provides discussion of that principle in a conservation easement context, although the results of the court case so far have been largely inconclusive.

Pesky involved taxpayers who acquired land adjacent to property owned by the Nature Conservancy (TNC). They bought the land for $1.6 million in 1993, exercising an option that TNC had acquired a few months earlier and assigned to them as part of a group of contracts entered into simultaneously. In those agreements, TNC granted the taxpayers an easement for a driveway over TNC land, and agreed to support the taxpayers' application for local permits to pave that driveway. The taxpayers also transferred cash to TNC, and agreed to convey to TNC at a future date an easement restricting development of the taxpayers' property to a single residence at no greater than

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[96] Reg. §§ 1.170A-1(e) (first sentence), 1.170A-7(a)(3).

[97] *See* Notice 2004-41, 2004-2 CB 31.

[98] *See, e.g.,* Hernandez v. Commissioner, 490 US 680 (1989).

[99] *See supra* Parts III(A)(1), III(A)(2).

a specified height.

The taxpayers then marketed the property and obtained the permits they sought. In 2002, they conveyed the conservation easement to the charity, at the same time obtaining additional driveway easements from other nearby property owners. Just days after transferring the conservation easement, the taxpayers sold their property for $6.9 million plus deferred interest. They claimed a charitable contribution deduction for the conservation easement based on appraisal valuing it at $3 million.

The IRS sought summary judgment, on the ground that the taxpayers received a substantial benefit in return for the conservation easement – the option, the driveway easement, and the support for the permit. The district court found that this was a factual question not suitable for summary judgment. The government had "produced evidence that the conservation easement was part of a quid pro quo transaction," the court ruled, but "the evidence is not so convincing as to compel summary judgment in its favor."[100]

On the other hand, the court granted the taxpayers' motion for summary judgment on the question whether they were liable for civil penalties for fraud. The IRS had not met its heavy burden of proving fraud, according to the court.[101]

G. Special Rules on Facades

With a conservation easement affecting a certified historic structure, Section 170(h)(4)(B) requires that the donated easement preserve the entire exterior of the building – front, sides, rear, and height – and forbid any change to the exterior inconsistent with the "historical character" of the building. In *61 York Acquisition, LLC v. Commissioner*,[102] a facade easement over a Chicago building failed to meet this test. Ownership of the building was split between the lower floors, which were offices, and the upper floors, which were residences. An agreement between the owners of the two portions of the building granted to the lower owner rights, including charitable donation rights, over the building's facade. The Tax Court held on summary judgment, however, that since the lower owner did not own the entire exterior of the building, it could not grant an easement that satisfied the Code's requirement. The taxpayer did not have the right to restrict alterations to two sides of the building, nor to several excluded portions of the two sides that were covered by the agreement.

In *Gorra v. Commissioner*, discussed earlier,[103] the IRS asserted that the requirements of Section 170(h)(4) were not met because the restrictions contained in the facade easement were no

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[100] 112 AFTR2d at 2013-5227.

[101] *Id.*, at 2013-5231--2013-5232.

[102] TC Memo. 2013-256.

[103] *See supra* Parts III(A), III(C)(3), III(D)(2).

greater than those already imposed by local landmark preservation laws. The court disagreed, finding that the easement at issue was a "full envelope easement," restricting height and bulk, affecting the rear of the townhouse, and giving the charitable donee complete discretion to reject proposed changes as well as the right to enter and inspect the property. All of these features, the court said, were more restrictive than local law.

H. Moral

Donations of conservation and facade easements offer generous tax benefits, but only if they are planned and executed with great care. The IRS is on the lookout for any defect that can render inapplicable the deductions and exclusions for contributions of such use restrictions. Trips to court on these issues are expensive -- particularly journeys all the way to a court of appeals. A competent appraiser who can produce a report that clearly satisfies the substantiation rules and the *Daubert* test is a must for any easement contribution, and if the property to be encumbered is already pledged as collateral for a loan, close attention must also be paid to complying with the "perpetuity" rules.

IV. HIGHEST AND BEST USE OF REAL ESTATE

Business valuation matters have taken a back seat in the Tax Court in recent days, as controversies over the fair market value of real estate have crowded the court's docket. This trend has been sparked in part by the IRS's campaign to curb perceived abuses of deductions for charitable conservation and facade easement donations,[104] but estate and gift tax inclusion cases have also supplied grist for the judicial mill. Among the issues that have come to the fore in the recent cases has been the highest and best use of property – the use on which valuation is generally based.[105] A handful of cases this year grappled with time-worn issues in this area.

A. Giovacchini

Giovacchini v. Commissioner[106] involved the gift and estate tax inclusion values of about 2,500 acres of rugged, undeveloped land on Monument Peak, not far from the Heavenly Valley ski resort, high above the south shore of Lake Tahoe in northeastern California. The land had been in the decedent's family since the Great Depression; in 1971, the family entered into a contract with the State of California under its conservation laws, whereby property taxes were reduced in exchange for

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[104] *See supra* Part III; *see, e.g.,* Mountanos v. Commissioner, TC Memo. 2013-138, discussed *supra* Part III(C)(1).

[105] *See, e.g.,* Chief Counsel Advice 201319010 (Dec. 28, 2012) (in valuing land donated to National Park Service, examining agent must determine if property's highest and best use is for mining, and what restrictions federal law places on use of property for mining; value should be discounted for costs and delay incurred to remove legal restrictions, if it is even possible). *See generally* J. Bogdanski, *supra* note 10, at ¶ 6.02[2][a].

[106] TC Memo. 2013-27.

voluntary restrictions on use of the property. The agreement, which required 10 years' advance notice to terminate, limited the property's use to "agricultural and compatible uses," and specified that any structures built on it must be "directly related to and compatible with permitted uses." The contract was still in effect on the relevant valuation dates. Conservation groups long expressed interest in buying the property, and in 1998 and 1999, the U.S. Forest Service showed its interest as well.

In 2000, the decedent, through a trust she had previously established, sold a half interest in the property to a limited liability company controlled by her daughters and their spouses. That sale was one of the transactions at issue in the Tax Court case, as the IRS asserted that the purchase price, $2.5 million, was less than the interest's fair market value, and that a taxable gift therefore took place. In October 2001, four days before the decedent's death, the trust and the LLC entered into a contract of sale for 1,730 acres with ALC, a private conservation group. In the sale agreement, it was recited that ALC was seeking "a public agency" to fulfill the obligations of the purchaser. The price was to be 95 percent of the value determined by an appraisal satisfactory to all of the parties, with the other 5 percent slated to be considered a charitable donation. At the time the agreement was signed, ALC did not have a public agency lined up as a buyer.

The appraisal came back with a value of $25 million, and ALC began working to convince the Forest Service to become the purchaser. The Forest Service requested a new valuation, conforming to its appraisal standards and taking into account the assumption that it and the family would be granting each other mutual access rights. The appraiser revised his valuation to $29.5 million, which the Forest Service accepted. The sale closed in 2003, about 16 months after the decedent died; the final acreage conveyed was 1,790 acres, and the purchase price was the full $29.5 million.

The estate and the IRS disagreed vehemently about the value of the half interests sold to the LLC and left in the decedent's gross estate. The taxpayer shifted the burden of proof to the IRS. According to the IRS's expert at trial, the property was worth about $25.1 million at the time of the sale of the half interest to the LLC. He additionally opined that the parcel subsequently sold to the Forest Service was worth the $29.5 million sale price, and the retained acreage worth roughly $6.8 million, at the time of the decedent's death, for a total value of about $36.3 million at that time. The taxpayer's position was that the property was worth about $7.4 million at the time of the sale of the half interest to the LLC, and $8 million at the time of the decedent's death.

The Tax Court ruled that the Forest Service paid more than fair market value of the property when it acquired it; the appraisals on which the price was based were too high, the court said, and the agency did not drive an arm's-length bargain because it was overly eager to obtain the land for its purposes. In the end, the court found that the property had a fair market value of $18.5 million at the time of the intrafamily sale, and a fair market value of $21.3 million on the date of the decedent's death. The results were substantial gift and estate tax deficiencies, but nowhere near as great as those the IRS had asserted.[107]

[107] The court also rejected the IRS's assertion of penalties against the estate.

One question that drew attention during the trial was the highest and best use of the property. The parties agreed that because of the longstanding contract with the state, the highest and best use was as the site of a single residence. But the estate and the IRS disputed how large and fancy a house it could be. The IRS said that it could be an enormous, deluxe "trophy house," whereas the estate argued that "it was required to be something far more modest," because a luxury compound would violate the contractual requirement that the use be "directly related to and compatible with" agriculture.

The IRS produced as a witness a veteran staffer from the county planning department, who testified that the issuance of a building permit would be "a ministerial action" with no review of whether the proposed residence would violate the 1971 contract. There were no local restrictions on the size of a residence, which led the court to observe that "a rancher or farmer need not live in a log cabin." Consequently, the court ruled that the highest and best use was as the site of a "trophy house," although it also determined that even a buyer who intended to erect a palace on the property would not have paid for it what the Forest Service did.

B. *Crimi*

Crimi v. Commissioner[108] involved more than 65 acres of undeveloped land in north central New Jersey, which the taxpayers' S corporation sold to the county in 2004 for $1.55 million. The taxpayers claimed that the property was worth $2.95 million, and that they had thus made a deductible charitable contribution of the difference. The IRS argued, among other things,[109] that the value of the property was only $660,000, and hence that no charitable contribution deduction was appropriate. The taxpayers failed in their bid to shift the burden of proof to the IRS, but the court held for the taxpayers nonetheless.

The land at issue was the site of an old iron mine, and it contained a number of hazards that would have to be remediated before its development could take place. There were freshwater wetlands on the property, and a brook that ran through it was the most environmentally protected type of watercourse under state law. Buffer zones were required around these features, which reduced the square footage of developable land.

At one time, the taxpayers had initiated the process of obtaining the township's approval of a residential subdivision. They obtained an environmental impact statement, which noted that environmental restrictions would restrict, but not impede, the development. Eventually, for reasons not appearing in the record, the taxpayers decided not to pursue the subdivision plan, but instead to transfer the property to the township for open space.

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[108] TC Memo. 2013-51.

[109] The government also argued, unsuccessfully, that the taxpayers had failed to meet the substantiation requirements for charitable contribution deductions – an area in which the IRS has been a real stickler of late.

In the Tax Court, the IRS argued that the highest and best use of the property was in part for conservation, and in part for development into three two-acre residential lots. The government's position relied in part on an environmental protection statute that had passed the state legislature just weeks before the sale closed, and became law less than two weeks after the sale date. Because of this law, the IRS said, the development prospects of the subject land were "highly speculative" at the time of the sale to the township. In contrast, the taxpayers' experts contended that the highest and best use was as a 44-lot subdivision.

The court sided with the taxpayers and ruled that a subdivision was the highest and best use of the property. Although the land was subject to the new law, it was within the law's "planning area," in which development was discretionary, and not within its "preservation area," in which development was strictly regulated. The court also noted with approval the experts' opinions (including that of the IRS's witness) that the presence of the wetlands and stream, though limiting the number of houses that could be built, did not preclude building up to 44 residences. The court also rejected as an "uncorroborated allegation" the IRS's assertion that an endangered turtle lived on the property; the court found that the species was classified as merely threatened, and not endangered. And the government had not established how the presence of such a species might inhibit the subdivision.

Finally, the court observed that New Jersey had an official policy of "smart growth," which encourages dense development. This, said the court, made development at least as likely as conservation. The fact that the township paid $1.5 million to keep the site as open space was further indication to the court that the parcel was not required by the new state law to be kept in its vacant state.

C. *Chapman Glen*

Chapman Glen Ltd. v. Commissioner[110] presented an unusual case, in which a foreign insurance company that had elected to be treated as a domestic corporation lost its status as an insurance company and thus was deemed to have sold all of its assets for their fair market values.[111] Among the assets treated as sold were the corporation's southern California real estate; the value of several groups of parcels were in dispute. The court isolated the highest and best use of each group in performing its valuation.

The first group of parcels was a sand mine. The court agreed with the taxpayer's appraisal expert that the highest and best use of the site was to extract the remaining sand, perform reclamation, and then redevelop or sell the land. Influencing this conclusion were the facts that the property was in poor condition, out of compliance with its county permit, and zoned primarily for agricultural use. In forecasting the future cost to reclaim the property, the court observed that

[110] 140 TC No. 15 (2013).

[111] IRC §§ 354, 367, 953(d)(5).

potential use of property for a landfill, which would produce income or a source of free fill for the mine, was "speculative."

The Tax Court used an income-based approach to value the remaining sand on the site -- present-valuing projected royalties that a third party would pay for extracting the sand, reduced by anticipated mine reclamation costs. To this the court added the residual value that the property would possess after it had been reclaimed and made suitable for development -- a value that the experts derived from comparable sales. In this respect, the analysis resembled the approach often employed in valuing assets with salvage values, or with values at the end of lease terms.

For two other groups of parcels, which were vacant industrial sites, the court also agreed with the taxpayer's expert that the highest and best use was "continued use for open storage or outdoor manufacturing." The final group attracted greater controversy, however. The court faulted the taxpayer's expert, who argued that highest and best use of the vacant site was mining, with only a remote possibility of future residential development. According to the court, he "minimized the fact" that the town "was driving development of the property surrounding" it, and that the property was under option and later sold to a national homebuilding company. The court valued the property group using the option price as its starting point.[112]

D. *Boone Operations*

Sometimes it's not real estate – it's just dirt. *Boone Operations Co. v. Commissioner*[113] called upon the Tax Court to value fill dirt allegedly donated to a city. Interestingly, the issue prompted consideration of the highest and best use of the dirt. There are different grades of fill dirt, suitable for different purposes. Although the highest and best use of the dirt that the taxpayer transferred to the city may have been as capping material for a landfill, the taxpayer did not show that a hypothetical buyer would have purchased it for that purpose, and use of capping material prices was therefore erroneous. Instead, the valuation should have been based on prices paid for a lower grade of fill.[114] The taxpayer's deduction was ultimately denied on the ground that there was no bargain element on the sale of the fill to the municipality.[115]

E. Conclusion

Compared to the wild and woolly process of valuing interests in closely held business and investment entities, one might expect appraisal of real property to be a straightforward affair. As the recent wave of Tax Court litigation about real estate values illustrates, however, there is often plenty of room for argument, not only about what land use regulations permit, but also about whether the

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[112] For further discussion, see *infra* Part XII(A).

[113] TC Memo. 2013-101, at 35.

[114] *Id.*, at 33-37.

[115] *Id.*, at 47-49.

market would price a parcel based on its maximum exploitation. Without competition among willing buyers interested in the highest use, a value at a lower use may win the day.

V. ESTATE TAX VALUES AND INCOME TAX BASIS

Section 1014 and the estate tax go hand-in-hand. The income tax basis of property received from a decedent is the same as the value of the property for estate tax purposes – fair market value on the date of death, fair market value on the alternate valuation date under Section 2032, or the value determined under the special use valuation election of Section 2032A. But what if the value reported on the estate tax return is incorrect? In a later year, when the property at issue is sold, can the seller claim a higher amount as basis than the amount reported on the estate tax return? And if the estate tax is closed by the statute of limitations, does some consistency provision require that the same value be used?

If the taxpayer in the income tax setting was personally involved in preparation of the estate tax return, the judge-made duty of consistency prevents the taxpayer from claiming a higher value than that which was reported for estate tax purposes. What constitutes such participation was the question of the day in *Van Alen v. Commissioner*.[116] The taxpayers in question sold off a majority interest (13/16ths) in a California ranch that had been handed down to them in a testamentary trust established by their late father. At the father's death in 1994, his estate elected special use valuation under Section 2032A. The two children and their stepmother, as the "qualified heirs," all executed the agreement required by that Code section, in which they acknowledged the obligation to pay a recapture tax if the property did not remain a family farm for 10 years. For one of the children, a minor, his mother signed the agreement as guardian *ad litem*.

On the estate tax return, the stepmother, as executor, claimed a remarkably low value for the ranch – far less than what had been suggested by an appraiser who had examined the property. The IRS challenged the value, but as part of a settlement of the estate tax, the Service actually agreed to an even lower Section 2032A value for that particular parcel, while other parcels in the estate had their values increased.

Thirteen years after the decedent died, the trust sold a conservation easement over the ranch and claimed a basis higher than that shown on the estate tax return; it distributed the sale proceeds to the children along with a Schedule K-1 showing a substantial gain despite the higher basis. The children did not report any of the gain. After the IRS issued each of them a notice of deficiency, their tax adviser got in touch with the appraiser from 13 years before, and he turned over his original notes that justified a value that would have created a much higher basis than the value reported on the estate tax return. The result of the increased basis was that the sale produced no gain for the trust.

In the Tax Court, the IRS asserted that the duty of consistency required that the same value be used under Section 1014 as was finally determined in the estate tax case. The taxpayers countered that they were not bound by the estate tax value, in that their stepmother, with whom they had a

[116] TC Memo. 2013-235.

rocky relationship, executed the estate tax return. Moreover, the taxpayers argued, they had produced clear and convincing evidence proving that the value of the ranch for purposes of Section 2032A was much higher than was originally reported.

The court held for the IRS. Although the taxpayers were not the executors of the estate, they did have sufficiently identical interests to be bound by the duty of consistency. Their economic interests were the same, because they as estate beneficiaries would have borne the brunt of a higher estate tax if the higher value had been reported. Consulting Ninth Circuit precedent in *Janis v. Commissioner*,[117] which involved a taxpayer who was both an estate beneficiary and co-executor, the court noted that the taxpayers in *Van Alen* "weren't merely just beneficiaries of the estate that had nothing to do with the estate-tax return."[118] They had signed the required Section 2032A election agreements, which in the court's view constituted a significant representation that placed them "in privity" with the executor. Between their economic interests and the agreements, the court held, they were bound by the duty of consistency.

The court also agreed with the IRS that a 20 percent accuracy-related penalty was appropriate, given the taxpayers' failure to report the gain shown on Schedule K-1. Although they consulted a tax advisor about the basis issue, it was not until long after they had filed their returns. The IRS's victory was complete.

VI. PREFERRED STOCK

In *Fish v. Commissioner*,[119] the question was whether one corporation had control over another, which would affect the valuation of the subsidiary's stock held by the parent for purposes of determining whether Section 1239 should apply to a transaction between them. The parent was a wholly owned S corporation, and the subsidiary was a qualified subchapter S subsidiary, ignored for federal income tax purposes under Section 1361(b)(3). As part of a venture capital financing, the subsidiary issued new convertible, redeemable preferred to outside investors. This terminated the qualified subchapter S subsidiary election, and was treated as a Section 351 transfer to a new corporation by the parent company and the new investors.

As part of the transaction, the subsidiary paid a large dividend to the parent; this was treated as "boot" in the deemed Section 351 transaction. Among the assets deemed transferred by the parent to the subsidiary were amortizable goodwill and depreciable equipment. The issue in the case was whether Section 1239 classified the recognized gain from the "boot" as ordinary income, rather than capital gain, as to these assets.

Section 1239 applies only to transactions between related parties. Two corporations are

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[117] 461 F3d 1080 (9th Cir. 2006).

[118] TC Memo. 2013-235, at 27-28.

[119] TC Memo. 2013-270.

treated as related to each other for this purpose if one holds more than 50 percent of the vote or value of the stock of the other. The question was whether the parent controlled the subsidiary under this standard. The parent held 14,034,375 shares of common, and the outside investors held 8,465,625 shares of preferred. Each share of stock generally had one vote, and the two blocks voted together as a single class. Thus, on its face it was an open-and-shut case of voting control – 62.375 percent. However, the contractual relationship between the two blocks of stock was more subtle than appeared at first glance.

Under the articles of incorporation and a shareholders' agreement, the corporation was restricted from taking a number of different actions without the consent of a majority of the preferred stockholders. These included paying dividends to the common while the preferred was in arrears, issuing new shares, merging or consolidating, selling a material amount of its assets, acquiring a subsidiary, materially changing its business, paying salaries greater than $150,000 a year, or going public. In addition, the common stock was entitled to three seats on the five-member board of directors, but one of the directors was required to be independent of management and approved by the preferred, which consent could not be unreasonably withheld. The taxpayers argued that these veto rights reduced the common stock's vote to less than 50 percent.

The Tax Court disagreed. Although one of the common's three directors was required to be independent, in the court's view that "merely reduces the pool of potential candidates" from which the common stock could select its candidate holding the key swing vote on the board.[120] The ability to name the director still rested in the common, especially given the reasonableness requirement placed on the preferred stock's veto. As for the negative covenants on various fundamental changes, the court said that they did not reduce the common stock's voting power below 50 percent because the sole shareholder of the S corporation remained as chief executive officer, president, and primary manager of the subsidiary following the restructuring. Between that and the power to name three directors, the court said, the voting power of the common was not reduced below 50 percent.

On the valuation front, the question was whether the common stock possessed more than 50 percent of the total value of shares of all the subsidiary's outstanding shares. The taxpayers and the IRS each produced an expert witness on the subject. The taxpayer's expert valued the common stock at about $9.1 million and the preferred at about $15.4 million; the IRS's expert set the values at about $14.5 million and about $11.3 million, respectively.

The most significant difference in the appraisals was the assumption made about a hypothetical liquidation of the subject company. The taxpayers' expert assumed an immediate liquidation, which would have entitled the preferred stock to a preference payout as well as participation in the remaining equity of the corporation; that would have left the common stock with less than the preferred. In contrast, the IRS's expert valued the company and its shares on the assumption that it would continue as a going concern. Using the redemption price of the preferred as its value, she also valued the company as a whole; the difference between the two, taking a lack-of-marketability discount into account, was the government's expert's value for the common.

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[120] *Id.*, at 28.

The court disagreed with the taxpayers' expert about the liquidation assumption. It undervalued the common, the court said, by failing to include in the common's value the large dividend paid to the common at the time of the venture capital financing transaction. The better approach, the court said, was to begin with the preferred's redemption price, which under the corporate articles was the greater of its issue price or its fair market value.

Curiously, the voting power analysis never came up in the court's valuation discussion. Given the live dispute between the parties under the voting power prong of the control test, one might have expected the attributes of control to play a role in determining the relative values of the two classes of stock. But it did not appear to affect the court's decision on the valuation issue.

VII. LACK-OF-MARKETABILITY DISCOUNTS

It has been a relatively slow time for business entity valuation in the Tax Court, but the court did issue one opinion this year on the discount for lack of marketability: *Estate of Koons v. Commissioner*.[121] At issue was the fair market value for estate tax inclusion purposes of a 50.5 percent interest (46.94 percent of the voting interests and 51.59 percent of the nonvoting interests) in a family limited liability company that held more than $320 million in cash and only two operating businesses, worth less than $30 million. Shortly before he died, the decedent's four children had accepted the LLC's offer to redeem their shares of the company for cash, the amount to be determined by appraisal. The redemptions had not taken place at the time of the decedent's death; it closed about two months later.

The taxpayer's expert[122] argued for a 31.7 percent lack-of-marketability discount from the decedent's pro rata share of the LLC's net asset value. Using his own study of sales of restricted stocks, he derived an "initial" discount of 26.6 percent, which he then increased for various other factors, including environmental liabilities, noncompetition agreements, restrictions on liquidation, and contractual restrictions on sales of interests. The IRS's expert,[123] meanwhile, argued for a discount of only 7.5 percent, noting that in light of the pending redemptions, which bore only a small risk of not closing, the decedent owned what was soon to become a controlling interest, enabling a willing buyer thereof to get its hands on large amounts of available cash.[124] (The estate's post-redemption share wound up as 70.42 percent of the voting interests and 71.07 percent of the nonvoting interests, or 70.93 percent overall.) The difference between the two discounts was about $38.9 million in value.

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[121] TC Memo. 2013-94.

[122] The enigmatic Mukesh Bajaj.

[123] Francis X. Burns, who often testifies on behalf of the IRS.

[124] The Service's expert did acknowledge transferability restrictions, environmental liabilities, and possibilities of future litigation.

The court sided with the IRS's expert. It rejected the estate's argument that the redemption agreements were not enforceable under state law. And although the LLC's operating agreement restricted distributions, the restriction could be removed by the holder of 70.42 percent of the vote – which is what the decedent's shares were about the become. The court also ruled that the IRS's expert had successfully poked holes in the opposing expert's calculations. Among other defects, the court said, the taxpayer's witness' regression analysis "systematically overstated the relationship between block size and the valuation discount."[125] The bottom line was a win for the IRS.

VIII. UNDIVIDED INTERESTS

Discounts for undivided interests in real property are commonplace, but in recent years questions have arisen about the propriety and proper size of such discounts in the context of personal property, including tangible personal property. Works of art, it seems, are frequently being carved into undivided fractional interests these days, often with tax savings on the agenda.

Estate of Elkins v. Commissioner[126] is the latest case grappling with this issue. It was an estate tax inclusion case, in which the court set the discount for undivided interests, held by a decedent, in an art collection. The other undivided interests were owned by the decedent's children. An agreement among the cotenants provided for shared possession of the art, waived rights to partition, and forbade a sale of the underlying art without unanimous consent of all the co-owners. The children testified that they would never permit the art to be sold outside the family. The court turned this reasoning against the estate, holding that it called for a low discount. Analogizing to the "swing vote" theory underlying some stock valuations, the court reasoned that the children would be strongly motivated to purchase the decedent's interests from a hypothetical buyer, at a higher price than a disinterested buyer would pay for them. Moreover, said the court, " the hypothetical willing buyer and seller would suspect the... children's willingness to pay pro rata fair market value, or something close to it, and they would price decedent's interests in the art accordingly." In the end, the court allowed only a 10 percent discount for the fractional interests.

The Tax Court also declared that the agreement whereby the cotenants waived their rights to partition of the art collection was a use restriction, to be disregarded under Section 2703(a)(2). The co-owners, tenants in common, entered into an agreement whereby unanimous consent was needed to sell "all... or any part" of the collection. The court noted that such a restriction on the sale of the underlying art was already inherent in the co-ownership interests under state law. To give the contract provision content, the court relied on testimony of a partition expert that the sole effect of the clause was to waive the cotenants' rights to partition. By surrendering this right, the court said, the decedent "relinquished an important use of his fractional interests in the cotenant art." Thus, Section 2703(a)(2) applied. In the end, however, the court said that disregarding the restriction "makes little or no difference to our conclusion as to the value of the art." (The estate also conceded that Section 2703(a) negated any valuation discount effects from an intrafamily lease of some of the

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125 TC Memo. 2013-94, at 55.

126 140 TC No. 5 (2013).

art, which expressly prohibited transfer of the cotenants' interests.)

IX. BLOCKAGE DISCOUNTS

Blockage discounts reflect the difficulty of liquidating in the marketplace an unusually large quantity of any given item. Historically developed in connection with publicly traded securities, this discount is sometimes applied to other types of assets as well. For example, this year in *Chapman Glen Ltd. v. Commissioner*,[127] discussed earlier,[128] the Tax Court, at the taxpayer's expert's behest, applied a 15 percent blockage discount to nine groups of parcels of California real estate owned by a foreign entity. Application of the discount to real property is not news, but *Chapman Glen* is noteworthy in that the nine groups included properties of several different types, and three were located in separate locations distant from other six. Typically, the discount requires a showing that the units of property in question would be in competition with each other if placed on the market.[129]

A more straightforward case is *Boone Operations Co. v. Commissioner*,[130] also discussed earlier,[131] in which the Tax Court valued fill dirt transferred by a landfill operator to a city in connection with settlement of litigation. The taxpayer claimed that the transfer was a bargain sale, but the court disagreed. In valuing the fill, the court took into account the volume discount that nearby suppliers customarily allowed to large-quantity purchasers of fill.[132] It also rejected the taxpayer's expert's claims that the price the city was paid for the fill was the result of "extreme pressure" and thus did not reflect its true fair market value.[133] And it refused to add delivery and labor costs to the price determined with respect to comparable sales.

X. GRANTOR-RETAINED ANNUITY TRUSTS AND RESIDENCE TRUSTS

Estate of Trombetta v. Commissioner[134] illustrates an estate plan gone bad. A 72-year-old woman transferred two apartment buildings to a grantor retained interest trust (GRAT), and her home to a qualified personal residence trust (QPRT). By doing so, she hoped to pass these assets to her children at a minimum wealth transfer tax cost – gift tax paid only on the present value of the

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[127] 140 TC No. 15 (2013).

[128] *See supra* Part IV(C); *see also infra* Part XII(A).

[129] *See generally* J. Bogdanski, *supra* note 10, at ¶ 4.02.

[130] TC Memo. 2013-101.

[131] *See supra* Part IV(D).

[132] TC Memo. 2013-101 at 36-37.

[133] *Id.*, at 30-31.

[134] TC Memo. 2013-324.

children's remainder interests, with nothing in her taxable estate. The plan failed to achieve its goals, however, due to a number of mistakes.

First, the terms of the trusts were set at 15 years, thus gambling that she would live to age 87. She died at age 85. Thus, her gross estate would include some value attributable to the trusts. But as to the GRAT, the decedent missed the opportunity to have included in her gross estate something less than the full value of the corpus at her death.[135] She maintained so much control over the GRAT corpus that its entire value was included in her gross estate.[136]

First, the decedent named herself as co-trustee with three of her children, but she retained 50 percent of the voting rights among them; she also made all the decisions and retained signatory authority over dispositions of the real estate. Second, the trust gave the trustees the power to distribute any income over the annuity amount to her, or accumulate it. Third, the decedent deviated substantially from the original trust terms in the amounts she withdrew from the trust. In some months, she took more than the annuity called for by the trust instrument, and in other months she took less, keeping track of the overages and underages but with no binding commitment as to when equilibrium would be restored. Fourth, she remained personally liable on the mortgages on the apartment buildings, which the trust renegotiated. When the trust paid off one of the mortgages, the decedent gave the trust her promissory note for that amount. In effect, the income of the trust was being used to service a debt for which she was personally liable.[137] For all of these reasons, the Tax Court held that the decedent retained the right to all of the income from the GRAT property, thus placing their full date-of-death value in the gross estate.[138]

Interestingly, the estate argued that the transfers to the GRAT were "bona fide sales for full and adequate consideration," exempt from Section 2036, using case law drawn from the family limited partnership realm. The court disagreed, for several reasons. First, the decedent admitted she had made taxable gifts of remainder interests, thus conceding that the value of her retained annuity was less than that of the assets contributed. Second, there was no negotiation in the establishment of the trust; the decedent stood on both sides of the transaction. Third, the court distinguished the family limited partnership cases in that unlike a partnership, in the present case no one other than the decedent received a present interest in the GRAT. Fourth, the court did not believe the assertion that the decedent had the nontax motive of shedding her responsibilities with respect to the buildings, given her continued participation in management. And finally, even conceding that she may have wished to ensure a lifetime income stream, the court found that the decedent's tax motives

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[135] *See* Reg. §§ 20.2036-1(c)(2)(ii), 20. 2036-1(c)(2)(iv), Exs. 1-2.

[136] TC Memo. 2013-324, at 38-39.

[137] The estate was allowed, over the IRS's objection, a deduction for the mortgages under IRC § 2053. *Id.*, at 41-43.

[138] *Id.*, at 25-35.

predominated.[139]

When the decedent learned late in her life that she had cancer, she took steps to try to avoid Section 2036 inclusion. Not only were these to no avail, but in one respect they actually worked to the disadvantage of her family. First, she reduced the GRAT term by two years, in the hope that it would end before her death, which it did. For the QPRT, she revised the term to end in the month of her death, at which time the trust would transfer the property to a charitable remainder unitrust, with the unitrust payout being such that a charitable contribution deduction of $250,000 would arise. Of course, changing the trust term in this way did not defeat application of Section 2036, because the revised term did not end until the end of the month in which the decedent died. After her death, a surviving co-trustee got a California court to reform the trust retroactively, so that it ended with the month *before* the decedent's death.

None of these maneuvers prevented the Section 2036 result, as the Tax Court agreed with the IRS that Section 2035 brought all of both trusts' assets into the gross estate, just as Section 2036 would have.[140] The patch-up of the bungled date on the amendment to the QPRT turned out to be a disaster, however. The court ruled that the estate was not entitled to a charitable contribution deduction for the unitrust, because under the reformed trust, the term ended before the decedent died, thereby depriving the estate of any power to make the charitable disposition. Under the terms of the trust, the residence should have been distributed to the decedent's children. Therefore, the court said, the charitable gifts "turned on the actions of" the trustee of the terminated QPRT, and not on those of the decedent, during her lifetime or in her will. For that reason, the estate tax charitable contribution was denied.[141]

XI. EXPERT WITNESSES IN TAX COURT

The Tax Court excluded an appraisal report from evidence on unusual facts in *Estate of Tanenblatt v. Commissioner*.[142] At issue was the fair market value for estate tax purposes of a 16.667 percent interest in a limited liability company that held a 10-story commercial building in Manhattan. The estate attached to its Tax Court petition a copy of an appraisal it had obtained for purposes of trial. However, the expert who wrote the report was not called to testify in court because she herself was in a dispute with the estate over her fee.

After attaching the appraisal to its pleading, the estate sought to compel the IRS to stipulate to its authenticity, which the estate contended would place it into evidence without the appraiser appearing in court to testify. The court would have none of it, noting that under its procedural

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[139] *Id.*, at 21-25.

[140] *Id.*, at 35-38.

[141] *Id.*, at 43-45.

[142] TC Memo. 2013-263.

rules,[143] experts are called to testify, with their report being submitted to the court and disclosed to the opposition not less than 30 days before the call of the trial calendar. "Petitioner misreads our Rules," the court declared, "if he thinks that Rule 91, governing stipulations for trial, can be used to end-run our procedural rules with respect to expert testimony or to prevent this Court from exercising its gatekeeper function with respect to expert testimony."[144] It added that without the expert appearing before the court, his or her qualifications to opine on technical matters was not established as required by the federal evidence rules.[145]

The substantive valuation issues in the case were three-fold. First, the estate asserted that the interest should have been valued as an assignee interest, rather than as a full-fledged membership interest. Second, the question arose whether the LLC interest should have been valued based solely on the net value of its assets, or whether an income-based approach should also have been employed. Finally, the case presented the perennial question of the appropriate size of the discounts for lack of control and lack of marketability inherent in the LLC interest.

The IRS prevailed across the board on these issues, in large part because without expert testimony in evidence, the taxpayer could not effectively refute the government's arguments. The court reduced the assignee-interest issue to a question of semantics. It held that the proper asset to value was a full-fledged LLC interest, but that a willing buyer would obviously take into account the fact that upon any purchase of the interest, it would become a mere assignee interest unless all of the other members of the company agreed to admit the buyer as a full member. The interest was properly classified as a full interest in the gross estate, the court reasoned, because the decedent had placed the interest in a revocable trust, which became a full member of the LLC. At the decedent's death, the trust became irrevocable, but the trust's interest in the entity was not disposed of in any way that would have changed its nature.[146]

On the question of the valuation approach – net asset value versus a hybrid of that value and an income-based value – the estate argued that since the LLC interest at issue did not have control over the entity, it should be valued giving primary weight to capitalized historical distributions. The court replied that the lack of control should be reflected in a discount, but not by altering the valuation approach. Since the LLC's sole asset was a building, which itself had been valued by both parties using an income approach, and because its shares were not publicly traded, the court adhered to a net asset value approach. This was especially appropriate in that the estate itself had used the net asset value approach in reporting the interest's value on the estate tax return – an admission that had

[143] TCR 143(g).

[144] TC Memo. 2013-63, at 15.

[145] *Id.*, at 19 (citing Fed. R. Evid. 702).

[146] *Id.*, at 22-26. Earlier in the opinion, the court had also noted that the excluded appraisal explained why the decedent's interest should be valued as an assignee interest instead of a membership interest. *Id.*, at 14.

no evidence in the record to refute it.[147] Even if the court were open to an income-based valuation for the LLC interest, it said, the estate had presented no evidence of what such a methodology would produce. The exclusion of the expert's report was therefore fatal.

The same was true in the controversy over appropriate discounts. The estate sought discounts of 20 percent for minority status and 35 percent for lack of marketability, but the court held for the IRS, which conceded only 10 percent and 26 percent, respectively, at trial. While the estate criticized the IRS's expert's methodologies in setting the percentages, the court noted that it "has produced no expert testimony from which we might draw different, greater values in those technical areas of analysis."[148] The message was clear: Pay the appraiser and bring her to court with you, or else.

XII. OPTION PRICES

A. In General

Option prices do not normally control the valuation of the property subject to the option. Fair market value looks for the price that a willing buyer would pay a willing seller in a cash sale. An unexercised option does not represent a sale, and when an option *is* exercised, the price paid is controlled by the option contract, thus adding an element of legal compulsion that is anathema to market valuation.

In *Chapman Glen Ltd. v. Commissioner*,[149] discussed earlier,[150] unusual facts led the Tax Court to conclude that an option to purchase supported a relatively high value for the real estate subject to the option. The option, held by a neighboring owner and in fact exercised about a year and a half after the valuation date, gave the holder the right to buy the subject property for $5 million. The court noted that on the valuation date, it appeared quite likely that the option would in fact be exercised. The local municipality was promoting the development of the property and some neighboring property as a new residential subdivision, and the owner of the adjacent land needed the subject parcel for road access. Under the option agreement, if the neighbor did not exercise the option, it was required to buy an easement from the taxpayer for $2 million, and to make improvements to the taxpayer's land. "[A] hypothetical buyer and a hypothetical seller would both anticipate that the option was going to be exercised at the $5 million strike price," the court said. The court noted that the option holder "may have been a strategic buyer, [but] this does not mean... that a hypothetical willing buyer and willing seller would ignore the fact that the optionee was contemplating buying the property at a future date for $5 million." The judge adjusted the $5 million price downward, however, to reflect rapid appreciation of real property in the vicinity between the valuation date and the exercise of the purchase option.

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[147] *Id.*, at 26-30.

[148] *Id.*, at 31.

[149] 140 TC No. 15 (2013).

[150] *See supra* Parts IV(C), IX.

B. Section 2703

Section 2703 generally disregards contractual transfer and use restrictions, and option prices, placed on property for purposes of valuation under the estate, gift, and generation-skipping-transfer taxes.[151] Thus, buy-sell agreements and similar arrangements among family members concerning family-controlled property and entities are likely to be disregarded. Limited exceptions are made for bona fide business arrangements that are not testamentary devices and that have terms comparable to similar deals entered into in arm's-length transactions.[152]

Section 2703 applies only to agreements entered into, or substantially modified, after October 8, 1990,[153] and taxpayers sometimes seek assurance that changes they are currently making to their family business agreements of older vintage do not bring Section 2703 into play. One such case is Private Letter Ruling 201313001, in which the IRS ruled that an amendment to an old stock purchase agreement did constitute a substantial modification.[154]

Under the original agreement, a son was obligated to purchase from his deceased parent's estate the parent's shares in a corporation in which the son also owned shares. The agreement called for the purchase price to be paid in installments semi-annually over a specified number of years, at a named bank's prime rate. The amendment lengthened the term of the purchase and clarified that the prime rate was to be adjusted semi-annually with each payment; it also changed the name of the bank to its successor bank.

Citing the regulations, the IRS noted that changes that result in an option price more closely approximating fair market value do not constitute substantial modifications for purposes of Section 2703. In this case, the interest rate clarification met that test. As for the stretching out of the payment terms, the Service concluded that it did not result in more than a *de minimis* change to the quality, value, or timing of the rights of any party to the agreement, as interest would be payable at a reasonable rate over the extended.

With many family buy-sell agreements, Section 2703 may not provide a harsher result than would already apply under the law as it existed prior to the effective date of that statutory provision. In cases in which that is true, a private ruling that Section 2703 is inapplicable seems a waste of time and money. But for some, it provides comfort not otherwise achieved.[155]

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[151] See IRC § 2703(a).

[152] See IRC § 2703(b).

[153] Reg. § 25.2703-2.

[154] Priv. Ltr. Rul 201313001 (Dec. 6, 2012).

[155] For an additional case on IRC § 2703, see Estate of Elkins v. Commissioner, discussed *supra* Part VIII.

XIII. INSURANCE COMPANY DEMUTUALIZATION

Litigation continues on the proper allocation of basis when the holder of a life insurance policy issued by a mutual insurance company receives stock or cash in exchange for the ownership rights inherent in the policy, as part of a "demutualization" of the company. After the "demutualization," the policy no longer has the rights of ownership in the company. Those rights shift to the newly issued stock; in some cases, the policyholders receive immediate cash in exchange for the rights. How much basis from the old policy should be assigned to the new stock, or be available to offset the cash receipt? In theory, the answer depends on the relative values of the ownership rights inherent in the pre-change policy and the life insurance rights other than ownership.

The Court of Federal Claims ruled several years ago that the value of the ownership rights cannot be ascertained, so that any cash received can be offset by the full basis of the policy.[156] Now two district court decisions disagree, however.

In one case, the district court allocated the premiums that the taxpayers had paid on their policies between the mutual ownership rights for which the stock was exchanged and the other rights inherent in the policies. The court assigned a basis to the mutual rights equal to the fair market value of some of the stock that the taxpayers received in the demutualization. The insurance companies had determined the number of shares the taxpayers received by a formula that took into account the price at which the stock was being sold in a related initial public offering; each policyholder received stock with a value equal to that of the policies' lost ownership rights. The latter value was based on three components: (1) the value of the policyholders' voting rights, (2) their past contributions to the companies' surpluses, and (3) their projected future contributions to the companies' surpluses. The court allowed a basis equal to the value of the stock received under the first two components of the calculation, but not the third. "[P]rojected future contributions to surplus are a portion of premiums which [the taxpayers] had not actually paid before receiving shares," the court said, "and cannot be considered as a part of basis."[157] Nonetheless, the end result was a sizable tax refund.

In the other district court case, the district court sided with the IRS. It held that the none of the original policy's basis was attributable to ownership rights. Thus, the stock the taxpayer received in the demutualization was assigned a zero basis, and when it was sold, the entire proceeds were taxable as capital gain.[158]

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[156] Fisher v. United States, 82 Fed. Cl. 780 (2008).

[157] Dorrance v. United States, 111 AFTR2d 2013-1280, 2013-1284 (D. Ariz. 2013) (not officially reported).

[158] Reuben v. United States, 111 AFTR2d 2013-620 (CD Cal. 2013) (not officially reported).

XIV. PURCHASE PRICE ALLOCATION

A. Valuation of Goodwill

Sometimes like-kind exchanges under Section 1031 involve collections of assets, and not just real property. In those cases, it is typically necessary to break out values for the various assets traded, because not all of them will be of like kind and therefore eligible for nonrecognition of gain or loss. As the regulations state that the goodwill of two businesses can never be of like kind with each other,[159] the mere existence of goodwill on either side of the swap triggers recognition of at least some of the gain or loss inherent in the transaction.

Deseret Management Corp. v. United States[160] presented a classic case on application of these principles. In 2000, the taxpayer's consolidated group swapped its Los Angeles radio station, KZLA, for four radio stations in St. Louis. The exchange agreement recited consideration on each side of $185 million. KZLA was the only country music station in Los Angeles at the time. While the radio market in Los Angeles was growing, KZLA's revenues were slowly shrinking, and a consultant opined that it was underperforming.

On its consolidated return for the swap, the taxpayer reported that KZLA transferred a relatively small amount of going concern value but no goodwill. It allocated most of the value in the transaction to the station's FCC license, which was highly valuable for a number of reasons, including the designated transmitter location and allowable power. The IRS, on the other hand, asserted that KZLA had about $73.3 million worth of goodwill, which led to a tax deficiency of about $25.6 million. The taxpayer paid the deficiency and sued for a refund in the Court of Federal Claims.

At trial, the IRS and the taxpayer stipulated that the total value of the station was $185 million, that its tangible assets had a value of about $3.38 million, and that its intangible assets other than goodwill and the FCC license were worth about $4.86 million. But what about the other $176.8 million? The taxpayer put it all on "the stick" -- radio jargon for the license, broadcast tower, and the transmitter location. The IRS preferred a residual method for valuing goodwill: It appraised the license at only about $103.5 million, leaving about $73.3 million on goodwill.

The court began by noting several indicia of goodwill. Although it was earning below-average profits, KZLA was the only country station in Los Angeles, which was the top market in the nation for country music recording sales. The taxpayer argued that radio stations can never have goodwill, because audiences are loyal only to formats and personalities, not stations. The court was not convinced, because any business would lose customers if it radically shifted what it was selling; radio stations were not unique in that regard. Thus, a *per se*, industrywide rule that goodwill was always absent could not be adopted as a rule of law.

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[159] Reg. § 1.1031(a)-2(c)(2).

[160] 112 AFTR2d 2013-5530 (Fed. Cl. 2013).

The court next turned to the IRS's valuation of the license, which its expert had performed using a discounted cash flow analysis. The court noted that the expert had changed her assumptions at several stages during and after the trial. She had started with a license value of $131.4 million, which was already substantially greater than the one asserted by the IRS on audit, and in post-trial submissions had increased it to about $157 million. That left goodwill value of about $19.8 million, far less than the $73.3 million on which the tax deficiency had been based.

The court found other flaws in the expert's calculations, regarding her allowance for taxes on the income derived from the license (it amortized the license's basis too slowly) and her discount rate for present-valuing (it was too high). Correcting for these errors, the court found, left goodwill at zero, or even a negative number. Although the taxpayer had the burden of proof, the court declared that it could not "turn a blind eye to the results of defendant's shrinking attempts to value the goodwill supposedly present here...."[161] The IRS's calculations, the court said, essentially satisfied the taxpayer's burden of proof.

The zero goodwill result was corroborated by a cash sale of another Los Angeles radio station in the same year as the KZLA swap. That sale was purely a "stick" transaction – the buyer acquired only the license, the tower, and the antenna, and it changed the format of the station from religious to Hispanic. Although the station had an inferior transmitter location to KZLA, it sold for nearly $65 million more than the recited total value exchanged in the taxpayer's deal.

B. Contractual Allocations

In *Peco Foods, Inc. v. Commissioner*,[162] the purchaser of two poultry processing plants tried unsuccessfully to talk its way around the last sentence of Section 1060(a). That sentence provides that when a taxpayer signs an agreement with another on allocation of purchase price in the purchase or sale of assets that constitute a trade or business, the agreement is binding on the taxpayer (but not on the IRS).

The taxpayer in *Peco Foods* argued that the agreements were ambiguous, but the Tax Court found that there was nothing unclear about them. In one acquisition the allocation consisted of 26 items; in the other, just three categories (real property-land; real property-improvements; and machinery, equipment, furniture and fixtures). Reallocations of the purchase price based on a retroactive appraisal of the components of the factories were rejected. The increased depreciation deductions that the taxpayer and its subsidiaries took on amended tax returns were disallowed.

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[161] *Id.*, at 2013-5547.

[162] 112 AFTR2d 2013-5137 (11th Cir. 2013) (not officially reported), *aff'g* TC Memo. 2012-18.

XV. VALUATION MISSTATEMENT PENALTY

A. Applicability to Tax Shelters

The Supreme Court has resolved a conflict among the circuit courts of appeals on whether the Section 6662(b)(3) penalty, on underpayments of federal income tax attributable to "[a]ny substantial valuation misstatement," applies in cases in which it is found that the transactions in which the taxpayer engaged lacked economic substance. The phrase "substantial valuation misstatement" is a term of art: Outside the transfer pricing context, it means a situation in which the taxpayer's tax return claim of the value or adjusted basis of any property is 150 percent or more of the correct value or basis, as the case may be.[163]

The valuation misstatement penalty is worse than the run-of-the-mill negligence penalty because it escalates from the normal 20 percent of tax understatement to 40 percent thereof if the claimed value or basis is 200 percent or more of the correct figure.[164] But if a taxpayer invests in a tax shelter that is disregarded as being a sham, having no economic substance, having no profit motive, or having a substance that differs from its form, does the penalty apply? In many such cases, the taxpayer has claimed deductions, losses, or credits connected to ownership of an asset, and in the end the tax benefits claimed have been disallowed. Does that imply that the asset had a basis of zero, and thus there was a gross valuation misstatement? The majority of courts, including the Tax Court, agreed with the IRS that it does.[165] The Fifth and Ninth Circuits did not.[166]

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[163] IRC § 6662(e)(1)(A).

[164] IRC §§ 6662(h)(1), 6662(h)(2)(A)(i). An exception exists for errors made with reasonable cause and in good faith. IRC § 6664(c)(1). In the charitable contribution arena, the exception focuses on whether the taxpayer obtained a "qualified appraisal" and otherwise made a good faith investigation into the value of the donated property. IRC § 6664(c)(3).

[165] *See, e.g.,* Fidelity Int'l Currency Advisor A Fund, LLC v. United States, 661 F3d 667 (1st Cir. 2011) ("[I]t would be perverse to allow the taxpayer to avoid a penalty otherwise applicable to his conduct on the ground that the taxpayer had also engaged in additional violations that would support disallowance of the claimed losses."); Gilman v. Commissioner, 933 F2d 143, 149-152 (2d Cir. 1991), *aff'g* TC Memo. 1989-684, *cert. denied*, 502 US 1031 (1992) (sham sale-leaseback penalized under former IRC § 6659, predecessor of IRC § 6662(b)(3)); Merino v. Commissioner, 196 F3d 147, 155-159 (3d Cir. 1999), *aff'g* TC Memo. 1997-385 (also under former IRC § 6659; penalty imposed for taxpayer's participation in plastics recycling limited partnership, "a pure, unadulterated, tax avoidance scheme totally devoid of economic substance"); Zfass v. Commissioner, 118 F3d 184, 190-191 (4th Cir. 1997), *aff'g* TC Memo. 1996-167 (former IRC § 6659 applied to investment in sham medical education videotape marketing program); Illes v. Commissioner, 982 F2d 163 (6th Cir.1992), *aff'g per curiam* TC Memo. 1991-449, *cert. denied*, 507 US 984 (1993) (IRC § 6659 penalty applied to master recording tax shelter lacking economic substance; "[t]he entire artifice of the... shelter was constructed on the foundation of the overvaluation of its assets"); Massengill v. Commissioner, 876 F2d 616, 619-620 (8th Cir.1989), *aff'g* TC Memo. 1988-427 (penalizing, under former IRC § 6659, cattle-breeding tax shelter investment that lacked economic substance); Gustashaw v. Commissioner, 696 F3d 1124, 1133-1138 (11th Cir. 2012) *aff'g* TC Memo. 2011-195 (valuation misstatement penalty applied to shelter, similar to that

New cases on the subject trickled in over the past year. For example, the Sixth Circuit affirmed the Tax Court's imposition of the penalty on a taxpayer who had engaged in a tax shelter based on transactions in foreign currency (which is property for U.S. tax purposes). The taxpayer purported to assume a sham loan that he said increased the basis of the currency.[167]

The Seventh Circuit joined the Sixth and the rest of the majority when it upheld the Tax Court's imposition of the penalty on a group of tax shelter LLCs that were held to be shams. The shelters involved high-basis, low-value receivables contributed to the LLCs by a foreign retailer; the tax shelter investors inflated their basis in their LLC interests (from which they could pass through losses) by contributing promissory notes on which the LLCs had no intention of collecting. Noting the inter-circuit conflict, Judge Posner declared: "The majority view, which we now join, is that a taxpayer who overstates basis *and* participates in sham transactions, as in this case, should be punished at least as severely as one who does only the former."[168]

B. Effect of Taxpayer Concessions

A subset of the cases on applicability of the penalty involve taxpayer concessions. In *AHG Investments, LLC v. Commissioner*,[169] the full Tax Court ruled that a partner in a partnership could not avoid the valuation misstatement penalty merely by conceding the IRS's case against him on other grounds – namely, under the at-risk rules of Section 465 and the substantial-economic-effect regulations under Section 704(b). The IRS had offered 14 alternative grounds on which to rest the asserted tax deficiency. The taxpayer moved for summary judgment on the penalty, on the ground that his concessions rendered the penalty inapplicable as a matter of law. A unanimous Tax Court

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at issue in *Kerman v. Commissioner*, *infra*, that lacked economic substance); Alpha I, L.P. v. United States, 682 F3d 1009, 1026-1031 (Fed. Cir. 2012), *petition for cert. filed* (taxpayer conceded deficiency under IRC § 465, but could still be penalized under IRC § 6662(b)(3);"[a]n interpretation of the statute that allows imposition of a valuation misstatement penalty even when other grounds are asserted furthers the congressional policy of deterring abusive tax avoidance practices").

[166] Gainer v. Commissioner, 893 F2d 225, 227-229 (9th Cir. 1990), *aff'g* TC Memo. 1988-416 (penalty under IRC § 6659, predecessor to IRC § 6662(b)(3), inapplicable where depreciation deductions and investment credit were denied because equipment had not been placed in service); Heasley v. Commissioner, 902 F2d 380, 383 (5th Cir. 1990) (nonacq.), *rev'g* TC Memo. 1988-408 (IRC § 6659 penalty did not apply "[w]henever the I.R.S. totally disallows a deduction or credit"); Todd v. Commissioner, 862 F2d 540, 542-545 (5th Cir. 1988), *aff'g* 89 TC 912 (1987) (IRC § 6659 inapplicable where deductions and credit for equipment denied because assets had not been placed in service).

[167] Kerman v. Commissioner, 713 F3d 849, 867-874 (6th Cir. 2013).

[168] Superior Trading, LLC v. Commissioner, 112 AFTR 2d 2013-5936, 2013-5939--2013-5940 (7th Cir. 2013) (emphasis in original).

[169] 140 TC No. 7 (2013).

denied the summary judgment.

This came as a surprise, as the court had held to the contrary previously.[170] But at least for cases appealable to circuits other than the Fifth and the Ninth – and it was not clear in *AHG Investments* which circuit would hear any appeal of the case – the Tax Court has now decided that a concession on other grounds does not necessarily rule out the penalty where the Service has asserted alternate grounds that include a "valuation misstatement." Although it acknowledged that its new holding might tend to discourage settlement, the Tax Court said it was preferable to misapplying the law.

Under the court's revised doctrine, the penalty could keep court cases alive even where the taxpayer is throwing in the towel on the underlying tax. The value issue (or basis issue) may have to be litigated in connection with the asserted penalty, even if the underlying tax deficiency has been settled on other grounds. Like the about-faces the Tax Court has done in *Steinberg* and *Friedberg*, discussed earlier,[171] the latest reversal could lead to a greater volume of valuation litigation.

C. Supreme Court Decision

The Supreme Court case, out of the Fifth Circuit, was *United States v. Woods*.[172] It raised the issue of the applicability of the penalty in cases decided on grounds of economic substance. The taxpayers invested in a tax shelter scheme called COBRA, which was successfully attacked by the IRS. The scheme generated tax losses through transactions involving foreign currency options. A Texas district court sided with the IRS, which had denied the losses. "If a transaction lacks economic substance compelled by business or regulatory realities," the trial judge wrote, "the transaction must be disregarded even if the taxpayers profess a genuine business purpose without tax avoidance motivations."[173] In a separate opinion, the district court denied the valuation misstatement penalty, citing the Fifth Circuit precedent on the subject; the Fifth Circuit, adhering to its minority view, affirmed.

A unanimous Supreme Court reversed.[174] Writing for the Court, Justice Scalia rejected the taxpayer's argument that the penalty could not be imposed when there was no factual question at issue in the case, but only the legal question of economic substance. The Court noted that the penalty

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[170] McCrary v. Commissioner, 92 TC 827, 851-855 (1989) (taxpayers conceded that they were not entitled to tax shelter benefits because transaction was license rather than lease).

[171] *See supra* Parts II, III(A)(1).

[172] 109 AFTR 2d 2012-2435 (5th Cir. 2012), *aff'g per curiam* 794 F. Supp. 2d 714 (WD Tex. 2011), *cert. granted*, 133 S. Ct. 1632 (2013).

[173] 794 F. Supp. 2d 710, 713 (WD Tex. 2010), *quoting* Klamath Strategic Investment Fund v. United States, 568 F3d 537, 544 (5th Cir. 2009).

[174] United States v. Woods, Docket No. 12-562 (Dec. 3, 2013).

applied to misstatements of "*adjusted* basis," and that the adjustments necessitate numerous legal inquiries. The taxpayer also argued that the tax underpayment was not "attributable to" a misstatement of value or basis, but rather attributable to an "independent legal ground," namely, that the partnerships in question were shams. The Court disagreed, noting that overstatement of partners' outside basis was "the linchpin of the COBRA tax shelter and the mechanism, by which [the partners] sought to reduce their taxable income."[175] The Court also turned aside the taxpayer's invocation on the "blue book" from the 1981 tax law that created the penalty, first on the ground that the document does not constitute true legislative history and second on the ground that the passage cited by the taxpayer was distinguishable.[176]

At one point some observers believed that the Court might not rule on the penalty at all. The justices ordered the parties to include in their briefs the question whether the district court had jurisdiction to consider the substantial valuation misstatement penalty under the procedural rules for partnership audits and court controversies enacted in 1982, sometimes known as the "TEFRA rules." At oral argument in October, the Court seemed more interested in the jurisdictional question than in the penalty question.[177] In its decision, the Supreme Court held that the district court did have jurisdiction to decide, at the partnership level, whether the penalty could apply where economic substance was lacking. The Court emphasized that partners were still free to assert any defenses in subsequent partner-level proceedings.[178]

D. Section 7701(o)

The codification of the economic substance doctrine in Section 7701(o), and the accompanying strict-liability penalty under Section 6662(b)(6), take much of the pressure off this issue. The penalty under that regime is 40 percent, thus giving the IRS another route by which to punish wayward taxpayers. But the penalty under Section 6662(b)(6) can be negated by disclosure on the tax return[179] – not so with the valuation misstatement penalty – and thus the question decided by the Court may continue to have significance.

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[175] *Id.*, slip op. at 15.

[176] *Id.*, slip op. at 16.

[177] *See* "Transcript Available of Supreme Court Oral Arguments in Valuation Misstatement Penalty Case," 2013 Tax Notes Today 197-12 (Oct. 9, 2013).

[178] United States v. Woods, *supra*, slip op. at 7-11.

[179] *See* IRC § 6662(i)(2).

XVI. SUCCESSIVE INTERESTS

A. Self-Cancelling Installment Notes

Chief Counsel Advice 201330033[180] discusses valuation of a self-cancelling installment note received by a decedent in exchange for corporate stock. As part of a reshuffling of his estate plan, the decedent sold stock to some grantor trusts that he had established, some recently and the others sometime previously. The sale price was paid in promissory notes with a fixed term, but with the feature that the debt would automatically be cancelled upon the seller's death before the notes were fully paid. The notes called for payment of interest only until their final due date; their term was set by the decedent's life expectancy under the mortality tables in effect under Section 7520. Because of the cancellation feature, and with the taxpayer desiring to avoid a gift at the time of the sale, the face amount of the notes was far higher than the fair market value of the stock sold – nearly double that value. The decedent transferred at least some of the notes to a grantor-retained annuity trust. "Very shortly after" the sales, the decedent was diagnosed with a disease, and he died less than six months thereafter.

The IRS ruled that the sales may not have been bona fide, because of the interest-only payment schedule and the fact that the decedent did not need cash flow from the transaction to cover his living expenses.[181] Moreover, the Service declared, the parties may not have had a reasonable expectation that the debt would be repaid, in that it was not clear that the trusts had sufficient funds to make the scheduled balloon payments.

The IRS also ruled that a taxable gift occurred to the extent that the fair market value of the stock exceeded the fair market value of the self-cancelling notes. In valuing the notes, the IRS said, it was inappropriate to use the present-value tables that prevail under Section 7520. Those tables, it said, covered annuities, interests for life or a term of years, and remainders, but not promissory notes. Thus, the IRS said, the note should be valued based on the usual willing buyer-willing seller standard regularly used to determine fair market value for federal tax purposes, and the decedent's life expectancy for this purpose should "tak[e] into consideration decedent's medical history of the date of the gift." The IRS pointed out in its concluding paragraph: "Because of the decedent's health, it was unlikely that the full amount of the note would ever be paid."[182]

Although the heavily redacted memorandum concludes that "there is no estate tax consequence associated with the cancellation of the notes," it also discusses the possibility that some asset would be included in the decedent's gross estate. Given that "there was a legitimate question as to whether the note would be repaid," it left open the possibility that some property – the

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[180] Issued Feb. 24, 2012, but not released until July 26, 2013.

[181] Chief Counsel Adv. 201330033 (Feb. 24, 2012) (distinguishing Estate of Costanza v. Commissioner, 320 F3d 595 (6th Cir. 2003)).

[182] *Id.*

transferred stock, perhaps – might be includible in the decedent's gross estate under Section 2033 or 2038.[183]

B. Reliance on Mortality Tables

A recent Tax Court decision reminds taxpayers that they can rely in tax planning on the mortality tables in effect under Section 7520, even well into their senior years, provided that they are not terminally ill. In *Estate of Kite v. Commissioner*,[184] the court upheld private annuity transactions that a taxpayer had entered into with her children when she was 75 years old. The annuities called for large payments to her from the children commencing 10 years after the closing date and lasting the rest of her life; at the time she entered into the transactions, her life expectancy under the prevailing Section 7520 tables was about 12.5 years. Although she was under 24-hour home medical care, and there was some testimony about her health failing, the decedent's physician wrote her at the time that her health outlook was good for the next several years, and that she had at least a 50 percent chance of living another 18 months. (She in fact lived about three more years.)

Citing the applicable regulations, which compel use of the tables unless the taxpayer has at least a 50 percent chance of dying within one year,[185] and older precedent,[186] the court ruled that the annuities did not constitute taxable gifts. The amounts promised to be paid by the children were held to constitute full and adequate consideration.

C. Discount Rates

The discount rate used in valuing time-divided interests – life estates, terms of years, remainders, reversions, and so on – remained at low levels throughout the past year, although it has begun to climb up again late this summer and this fall. As set with reference to Treasury bill yields by Section 7520, and released each month by the IRS, the past year's rates were as follows:

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[183] *Id.* (citing Estate of Musgrove v. United States, 33 Fed. Cl. 657 (1995)).

[184] TC Memo. 2013-43.

[185] See Reg. §§ 20.7520-3(b)(3)(i), 25.7520-3(b)(3).

[186] Estate of McLendon v. Commissioner, 135 F3d 1017 (5th Cir. 1998).

Month	*Rate (%)*
January 2013	1.0
February 2013	1.2
March 2013	1.4
April 2013	1.4
May 2013	1.2
June 2013	1.2
July 2013	1.4
August 2013	2.0
September 2013	2.0
October 2013	2.4
November 2013	2.0
December 2013	2.0
2013 average	*1.60*

The rate for November 2012 and January 2013, 1.0 percent, was the all-time record low; the high was 11.6 percent in May 1989. Low rates mean that income interests have a relatively low value, and annuity and unitrust interests have a relatively high value, compared with other eras. Remainders and reversions after such interests have just the opposite: relatively high values after income interests, and relatively low values after annuity and unitrust interests.

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