Taxation of Exempts
Facade Easements

July/August 2014

Kaufman—Another Sad Chapter In The Service's Assault On Facade Easements

By Timothy L. Jacobs[al]

After *Kaufman*, litigation of facade easements will focus on case-by-case value determinations and not on 'one-size-fits-all' legal arguments by the IRS.

***20** Over the past decade, the facade easement program has come full circle. Despite the appearances of significant victories in the circuit courts with respect to technical, legal arguments by the IRS, including the recent decision of the First Circuit in *Kaufman*,[1] the Tax Court has settled on a valuation analysis that has rewarded the victors with zero-value holdings and substantial (sometimes automatic) penalties.

Like other easement cases making their way through the courts, *Kaufman* was a test case for the IRS. The IRS could have simply litigated the case on the basis of valuation—i.e., a battle of expert appraisers. Instead, it went in a different direction and attacked the *Kaufman* easement on a variety of legal grounds that the First Circuit would term 'aggressive.' Consistent with standard practice, the Kaufmans asked their mortgage holder to subordinate its mortgage to the easement. However, again consistent with standard practice, the separate agreement with the mortgage holder reserved its rights to condemnation and insurance proceeds from a judicial extinguishment of the easement. The IRS claimed this reservation violated an obscure provision in the regulations, Reg. 1.170A-14(g)(6)(ii) . In *Kaufman I* and *Kaufman II*, the Tax Court agreed, holding that the easement holder must have an 'absolute right' to the condemnation and insurance proceeds. In *Kaufman III*, the First Circuit disagreed and reversed the Tax Court, respecting the traditional rights of the mortgage holder to such proceeds.

The IRS won the case at the end of the day. On remand, in *Kaufman IV*,[2] the Tax Court agreed with the IRS that the easement had no value because it duplicated local government restrictions on the property's facade. The Tax Court imposed 40% penalties to boot. Things did not start out so bleakly. In the earlier *Simmons* case,[3] the Tax Court and the DC Circuit had found that a 5% reduction in value was appropriate and declined to impose penalties. In *Kaufman IV* and most of the other cases that have gone to trial, however, the Tax Court has retreated to the Service's zero-value position on burden of proof grounds.[4]

The sidebar in the *Kaufman* story is the Service's additional assertion that a cash contribution made by the *Kaufmans* coincident with the donation of their easement was likewise not deductible. There were suggestions from the donee organization that the cash contribution was being made in respect of services that the organization would provide with respect to the ***21** easement. It is fundamental that charitable contributions must be true gifts and not reciprocate value coming back from the donee. But cash contributions are standard practice for many tax-exempt organizations, and it is hard to say that there is a *quid pro quo* in paying money to a charitable organization in respect of a donation of property. That is where the Tax Court and First Circuit ultimately came down, though an earlier Tax Court opinion had reached a contrary result.[5]

In other facade easement cases, the IRS has advocated technical arguments that would have wide-ranging effect. If sustained, the those arguments would not only eliminate most, if not all, facade easements but would substantially curtail other partial interest donations—bona fide or not. Indeed, the cash contribution program at issue in *Kaufman* is not dissimilar to programs used by many tax-exempt organizations. Before examining the *Kaufman* case in more detail, it is important to understand why the IRS decided to take this course and why the courts ultimately declined the Service's invitation to wreak havoc on charitable contributions.

Background to facade easement litigation

In the Tax Reform Act of 1976, Congress specifically recognized the availability of charitable deductions for partial interests in property, including, importantly, conservation easements.[6] The Code has changed somewhat since 1976, but the relevant rules are found in Sections 170(f)(3) and (h) and in lengthy regulations in Reg. 1.170A-14.[7] Section 170(f)(11) and Reg. 1.170A-13 also provide detailed rules on recordkeeping and substantiation applicable to all charitable contributions.

Conservation easements come in two flavors—easements on land, which ultimately rise or fall on the surrender of valuable development rights (an easier analysis for valuation purposes), and easements on building facades in historic areas. It is the latter group that is at issue here. While facade easements can be placed on commercial properties,[8] the recent controversy and this article center on residential properties. And therein lies the problem. Homes in historic areas are often subject to strict restrictions on changes to the facade; there is limited direct evidence that the easement restrictions affect resale value. Add to that the fact that many of those same homes are smack in the middle of the most valuable real estate in the country and were in an escalating housing market when many of the easements at issue were donated (the 2003-2006 period).

Given the difficulties of valuing facade easements, the courts and the IRS developed what everyone in the 'industry' understood to be a safe harbor. It was at one time universally accepted that restrictive easements placed on residences necessarily had *some* effect on the value of the property. The fact that Congress considered facade easements in permitting partial interest donations suggested that this had to be true. The critical question, though, was how much is 'some'? The courts in some early test cases answered that question by settling on a 10% diminution value but with guarded and cautionary holdings.[9] The IRS later responded with a more generous 10% to 15% range in its internal and external publications—a range that was understood by everyone in the know to be a reliable 'safe harbor' for facade easements.[10] The principal IRS publication, an article ***22** by Mark Primoli (referred to herein as 'the Primoli article'), stated: 'Internal Revenue Service Engineers have concluded that the proper valuation of a facade easement should range from approximately 10% to 15% of the value of the property.'[11] The Primoli article was posted, together with other guidance materials relating to conservation easements, on the IRS and National Park Service Web sites.

Had facade easements stayed in the background, as they did in the 1980s and 1990s, it is unlikely that the recent litigation would have occurred. A number of tax-exempt organizations, however, began to actively solicit and promote facade easements. The programs were very successful. From the preservationist perspective, the easements helped to protect important historic areas. From the naysayer perspective, however, the organizations and their affiliates got rich and wealthy homeowners got unintended tax breaks. The naysayers seized the stage.

In July 2004, the IRS struck the first blow. In Notice 2004-41,[12] the IRS advised taxpayers that it might challenge donations of facade easements and cash payments made in connection with facade easement donations. The IRS also advised that it might challenge the tax-exempt status of a charitable organization that participated in these transactions, and might investigate and impose penalties against organization managers, promoters, and appraisers.

In December 2004, *The Washington Post* published a series of articles that focused on the prevalence of facade easements in Washington, D.C. and the tax benefits reaped by wealthy homeowners and some members of Congress.[13] The *Post* was not buying the program and the editors cast a negative light on the tax-exempt organizations that were promoting facade easements —in particular, the National Architectural Trust (NAT) and its co-founders, the same parties involved in the *Kaufman* case and other facade easement litigation. The Post was highly critical of the cash contributions that NAT was receiving as an incident of its taking ownership of the facade easements and NAT's representations to potential donors that facade easements were merely a 'paper concept' that did not actually affect home values.

The *Post* articles attracted the immediate attention of the Chairman and Ranking Member of the Senate Finance Committee, Senators Chuck Grassley (R. Iowa) and Max Baucus (D. Mont.). They promised to end the perceived abuse and tarred the tax-exempt organizations involved as 'snake oil salesmen' peddling bogus tax deductions.[14] Congress and the IRS then set course to take back what they had previously given.

The IRS implemented a wide-ranging initiative to audit charitable deductions claimed by taxpayers who made donations of historic facade easements. On 2/28/05, the IRS added ***23** facade easements to the so-called 'Dirty Dozen' list of 'notorious tax scams' with the following explanation:

> A 'contribution' of a historic facade easement to a tax-exempt conservation organization is another example. In many cases, local historic preservation laws already prohibit alteration of the home's facade, making the contributed easement superfluous. Even if the facade could be altered, the deduction claimed for the easement contribution may far exceed the easement's impact on the value of the property.[15]

In March 2005, the IRS Commissioner announced that the IRS intended to undertake a pre-audit review of 700 facade easements—approximately a third of all easement donations.[16] Later in 2005, the IRS listed facade easement donations in its global settlement initiative, together with other allegedly abusive transactions, requiring the payment of all the resulting taxes and a reduced 5% accuracy-related penalty for voluntary disclosure and concession.[17] It is apparent that the facade easements that ultimately made their way to the courts, including *Kaufman*, had their origins in this IRS initiative.

Congress struck the next blow—a hammer shot. Initial fallout from the *Washington Post* articles prompted the Joint Committee on Taxation to recommend that facade easements be excluded altogether from the charitable deduction.[18] Congress did not go that far but instead adopted stricter substantiation rules in Section 170(f) and a strict liability penalty regime in the Pension Protection Act of 2006 (PPA). Under the new penalty regime, Congress lowered the threshold for a gross valuation misstatement from 400% of reported value to 200% and eliminated the reasonable cause defense for such misstatements, making the 40% penalty effectively automatic for facade easements with zero or substantially-reduced values.[19]

In its 2009 General Report, the IRS Advisory Council (IRSAC) expressed its concerns regarding the Service's initiative with respect to facade easement deductions.[20] IRSAC explained that [t]here is a belief that the current program, in which the IRS takes a very strict view regarding the value of these donations, is having the effect of diluting the intent of Section 170(h) of the Internal Revenue Code, which provides a tax incentive by means of a charitable deduction for the donation of an historic easement. 'IRSAC further commented: 'The current IRS audit effort strains the agency's resources and may fail to distinguish between a legitimate deduction authorized by statute and an abusive tax shelter.' IRSAC described what everyone in the taxpayer community had understood—that the IRS, in the Primoli article, had established an informal safe harbor of 10% to 15% of the property's value for facade easements. IRSAC noted that the 'easement donating public apparently relied' on this informal safe harbor.

Despite this commentary, the IRS continued to pursue facade easements aggressively—in almost all cases resulting in 'zero value' determinations—and went after the tax-exempt organizations, officers, and appraisers.[21] Enter the body of facade easement cases, including *Kaufman*. [22]

The facts of *Kaufman*

Kaufman involved the contribution of a facade easement and cash to NAT. The taxpayers were husband and wife. Mr. Kaufman was a professor at the Sloan School of Management at MIT. Mrs. Kaufman was a Ph.D. and the president of her own company. The *Kaufmans* owned and lived in a single-family residence (a row house) in the South End historic preservation district in Boston—an area already subject to local restrictions aimed at historic preservation, including approval of exterior alterations.

In 2003, the Kaufmans made an inquiry to NAT regarding its federal historic preservation tax incentive program. Based on the Primoli article, NAT reported to the Kaufmans that the program allowed the owner of a nationally registered historic building to deduct between 10% and 15% of the value of the property. NAT also stated that the program would require very little effort on the Kaufmans' part because, as part of NAT's service, NAT 'will be handling all the red tape and paperwork.' The Kaufmans submitted an application. NAT required a $1,000 deposit with the application. In addition, NAT required its applicants to establish an 'endowment,' set at 10% of the donation tax deduction, for its pledge to monitor and administer the donation in perpetuity.

In December 2003, the Kaufmans entered into a preservation restriction agreement with NAT (the 'Restriction Agreement'). This agreement granted to NAT a facade easement on the *Kaufmans'* residence and made the easement in gross and in perpetuity as required by Section

170(f) and the regulations. The Restriction Agreement contained the following provision designed to satisfy ***24** certain requirements (discussed below) in the applicable regulations:

> In the event this Agreement is ever extinguished, whether through condemnation, judicial decree or otherwise, Grantor agrees on behalf of itself, its heirs, successors and assigns, that Grantee, or its successors and assigns, will be entitled to receive upon the subsequent sale, exchange or involuntary conversion of the Property, a portion of the proceeds from such sale, exchange or conversion equal to the same proportion that the value of the initial easement donation bore to the entire value of the property at the time of donation ... unless controlling state law provides that the Grantor is entitled to the full proceeds in such situations, without regard to the Agreement. Grantee agrees to use any proceeds so realized in a manner consistent with the preservation purposes of the original contribution.

Washington Mutual Bank FA (Tank') held a mortgage on the residence. In order to satisfy regulatory requirements, the Kaufmans were required to subordinate the Bank's mortgage interest to NAT's interest in the facade easement.[23] To accomplish the subordination, the Kaufmans entered into a 'Lender Agreement,' in which the Bank joined in the Restriction Agreement for the purpose of subordinating its rights in the ... [Kaufmans' residence] to the right of ... [NAT] to enforce ... [such agreement] in perpetuity.' The Lender Agreement, however, provided the following condition or stipulation:

> The Mortgagee/Lender and its assignees shall have a prior claim to all insurance proceeds as a result of any casualty, hazard or accident occurring to or about the Property and all proceeds of condemnation, and shall be entitled to same in preference to ... [NAT] until the Mortgage is paid off and discharged, notwithstanding that the Mortgage is subordinate in priority to the Agreement[.]

It is this provision that spurred the key legal dispute in the Tax Court and First Circuit.

The Kaufmans engaged an appraiser recommended by NAT.[24] The appraisal was not completed until January 2004, concluding a value for the easement of $220,800. This value was determined by applying a 12% reduction to the determined $1,840,000 pre-easement value of the Kaufmans' residence. The 12% reduction was derived from the 10% to 15% range set forth in the Primoli article and did not reflect any post-easement valuation. The Kaufmans claimed a deduction of $220,800 on their 2003 return. In addition, the Kaufmans made a cash contribution of $19,872 to NAT (i.e., 10% of the easement deduction less a discount for delays in processing).[25] In March 2007, as part of the IRS initiative, the IRS audited the Kaufmans' easement and determined a zero value together with penalties.

Service's extinguishment proceeds argument

In the *Kaufman* litigation, among a bevy of other technical arguments and the zero-value argument, the IRS argued that the Kaufmans' easement was not compliant with a provision in the regulations related to condemnation and insurance proceeds from the judicial extinguishment of the easement. At the heart of this argument is the treatment of easement properties subject to existing mortgages—a situation apparent in most residential properties.

For an easement donation to be respected under Sections 170(h)(2)(C) and (5)(A), the restrictions and the conservation purposes of the easement must be protected in perpetuity. Reg. 1.170A-14(g) provides rules with respect to the perpetuity requirement. Reg. 1.170A-14(g)(1) states the general rule that the donor's retained interest in the property must be subject to legally enforceable restrictions that will prevent uses of the retained interest that are not consistent with the conservation purposes of the donation. Reg. 1.170A-14(g)(2) addresses mortgages and requires that the mortgagee subordinate its rights in the property to the right of the qualified organization to enforce the conservation purposes of the gift in perpetuity (subordination requirement). Reg. 1.170A-14(g)(6) addresses the specific scenario of a judicial extinguishment of the restrictive easement (the ***25** extinguishment requirement). Reg. 1.170A-14(g)(6)(i) provides:

> If a subsequent unexpected change in the conditions surrounding the property that is the subject of a donation under this paragraph can make impossible or impractical the continued use of the property for conservation purposes, the conservation purpose can nonetheless be treated as protected in perpetuity if the restrictions are extinguished by judicial proceeding and all of the donee's proceeds (determined under paragraph (g)(6)(ii) of this section) from a subsequent sale or exchange of the property are used by the donee organization in a manner consistent with the conservation purposes of the original contribution.

Reg. 1.170A-14(g)(6)(ii) then elaborates on 'proceeds' from the extinguishment:

> [F]or a deduction to be allowed under this section, at the time of the gift the donor must agree that the donation of the perpetual conservation restriction gives rise to a property right, immediately vested in the donee organization, with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction at the time of the gift, bears to the value of the property as a whole at that time.... For purposes of this paragraph (g)(6)(ii), that proportionate value of the donee's property rights shall remain constant. Accordingly, when a change in conditions give rise to the extinguishment of a perpetual conservation restriction under paragraph (g)(6)(i) of this section, the donee organization, on a subsequent sale, exchange, or involuntary conversion of the subject property, must be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction, unless state law provides that the donor is entitled to the full proceeds from the conversion without regard to the terms of the prior perpetual conservation restriction.

In *Kaufman*, the IRS argued that the Kaufmans' easement was compromised because, when read in connection with the Lender Agreement, it did not give the donee, NAT, a right to the proceeds of a judicial extinguishment in all circumstances. That is, the mortgagee reserved its rights to condemnation and insurance proceeds in the Lender Agreement. However, as the amicus curiae in the First Circuit explained, this provision is indistinguishable from the model easements adopted by a number of tax-exempt organizations and used in numerous easements—facade easements and other conservation easements.

In 1986, shortly after Treasury promulgated its final regulations, the National Trust for Historic Preservation ('National Trust') published a model historic preservation easement in its publication, the Preservation Law Reporter.[26] The model easement attempted to address the requirements set forth in Reg. 1.170A-14, including the extinguishment requirement in Reg. 1.170A-14(g)(6) . Importantly, the model easement included a provision for the subordination of mortgages similar to the one contained in the Kaufmans' Restriction Agreement, and also included the following reservation for the mortgagee that is a precursor to the one for condemnation and insurance proceeds in the Lender Agreement:

> If a mortgage grants to a Mortgagee the right to receive the proceeds of condemnation proceedings arising from any exercise of the power of eminent domain as to all or any part of the Premises or the right to receive insurance proceeds as a result of any casualty, hazard or accident occurring to or about the Premises, the Mortgagee shall have a prior claim to the insurance and condemnation proceeds and shall be entitled to same in preference to Grantee until the mortgage is paid off and discharged, notwithstanding that the mortgage is subordinate in priority to the Easement.[27]

The accompanying commentary from the National Trust explains this provision:

> [P]aragraph 16 attempts to reconcile the interests of mortgage lenders and those of the easement holder so that the requirement of subordination will not unreasonably interfere with the ability of the property owner to obtain mortgage loans or to obtain the consent of an existing mortgage lender to subordinate. The interest of the mortgage lender is protected in any condemnation proceeding or under any provision of the mortgage loan documents giving the lender the right to receive insurance proceeds as a result of a casualty.[28]

The model easement was first published in 1986 and subsequently published by the Land Trust Alliance in the *Conservation Easement Handbook* in 1988, in the *Model Conservation Easement and Historic Preservation Easement* in 1996, and in the *Conservation Easement Handbook* in 2005.[29] In its amicus brief filed in the First Circuit, the National Trust represented that the model easement has been 'widely circulated since 1986' and that it and variations of it have become the basis for thousands of conservation easements. According to the National Trust, an informal survey suggested that since 2003 there have been over 1,400 easements that derive from the same model easement or otherwise contain provisions that track the language of Reg. 1.170A-14(g)(6)(i) -(ii). Given the wide circulation of the model easement and its acceptance, the IRS was well aware of the manner in which easements were being drafted to address the 'proceeds' requirement in Reg. 1.170A-14(g)(6)(ii) , but nevertheless stood silent until the *Kaufman* litigation. The Service's argument in *Kaufman* would have a broad effect if accepted by the courts—affecting bona fide easements as well as improper easements.

Kaufman I/Kaufman II

The IRS presented its argument under the extinguishment requirement by a motion for summary judgment in the Tax Court. In *Kaufman I*, the Tax ***26** Court granted summary judgment to the IRS, holding that the Kaufmans' easement in combination with the Lender Agreement failed the extinguishment requirement in Reg. 1.170A-14(g)(6). The Tax Court observed that the Kaufmans did not dispute that the Bank was entitled to the proceeds of condemnation or insurance 'in preference' to NAT until the mortgage was satisfied and discharged. In the Tax

Court's view this was fatal. The Tax Court concluded that [t]he right of NAT to its proportionate share of future proceeds was thus not guaranteed.'[30] The Tax Court explained that the requirement in Reg. 1.170A-14(g)(6)(ii) is 'not conditional. Petitioners cannot avoid the strict requirement in [Reg. 1.170A-14(g)(6)(ii)] simply by showing that they would most likely be able to satisfy both their mortgage and their obligation to NAT.[31]

The Kaufmans moved for reconsideration of the Tax Court opinion.[32] On reconsideration, in *Kaufman II*, the Tax Court analyzed the history of restrictive easements and what it believed to be the 'drafters' intent' in Reg. 1.170A-14(g)(6). The Tax Court rejected the Kaufmans' contention that the language of the easement tracked the requirements of Reg. 1.170A-14(g)(6), and that the easement gave the donee a contractual right against the *Kaufmans* for its proportionate share of the proceeds from the sale of property following a judicial extinguishment, finding this insufficient. Analyzing Reg. 1.170A-14(g)(6), the Tax Court concluded that 'we think it the intent of the drafters of [Reg. 1.170A-14(g)(6)]that the donee have a right to a share of the proceeds and not merely a contractual claim against the owner of the previously servient estate.'[33] The Tax Court agreed with the IRS that the 'proceeds' requirement was 'a strict, standalone requirement' and under that provision 'the donee must ab initio have an *absolute right to* compensation from the postextinguishment proceeds for the restrictions judicially extinguished.[34]

Kaufman III

The First Circuit disagreed with the Tax Court and held that the extinguishment requirement in Reg. 1.170A-14(g)(6) was satisfied. The First Circuit had its own view of the 'drafters' intent' in promulgating the regulation:

> Although the extinguishment provision was unexplained when first promulgated, 51 Fed. Reg. 1496, 1505 (Jan. 14, 1986), paragraph (g)(6) appears designed in case of extinguishment both (1) to prevent taxpayers from reaping a windfall if the property is destroyed or condemned and they get the proceeds from insurance or condemnation and (2) to assure that the donee organization can use its proportionate share of the proceeds to advance the cause of historic preservation elsewhere.[35]

The first prong of this interpretation of the regulation is key to the First Circuit's holding and is contrary to the Tax Court's analysis of the ***27** 'drafters' intent.' In the First Circuit's view, consistent with the plain language of Reg. 1.170A-14(g)(6)(ii) , the extinguishment requirement turned on whether the donee had a right to the proceeds superior to *the donor*, not whether the donee had a right to the proceeds relative to *other parties*:

> Certainly the IRS has good reason to assure that the Kaufmans could not recapture the value of what they gave up by granting the easement in order to get the deduction; but the Kaufmans 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.

> The IRS reads the word ‘entitled’ in the extinguishment regulation to mean ‘gets the first bite’ as against the rest of the world, a view the Tax Court accepted in reading ‘entitled’ to mean ‘ha[s] an absolute right.’ But a grant that is absolute against the owner-donor is also an entitlement, and almost the same as an absolute one where third-party claims (here, the bank’s or the city’s) are contingent and unlikely.[36]

The First Circuit observed that ‘the IRS’s reading of its regulation would appear to doom practically all donations of easements, which is surely contrary to the purpose of Congress.’[37] The First Circuit vacated the Tax Court’s grant of summary judgment and remanded the case.[38]

The *Scheidelman* argument.

In the earlier *Scheidelman* case,[39] the Tax Court considered another NAT facade easement. The IRS advanced another technical, legal argument against the easement donation based on the ‘qualified appraisal’ rules.

Under Section 170(0(11), a charitable deduction is not permitted for a conservation easement unless the taxpayer obtains a contemporaneous ‘qualified appraisal’ prepared by a ‘qualified appraiser.’ The regulations include a number of procedural requirements for a qualified appraisal. As relevant here, Reg. 1.170A-13(c)(3)(ii)(J) requires that the appraisal set forth the method of valuation used to determine the fair market value and Reg. 1.170A-13(c)(3)(ii)(K) requires that the appraisal set forth the specific basis for the valuation.

In *Scheidelman*, the IRS argued that the appraisal, prepared by an appraiser recommended by NAT, was not qualified because it had relied entirely on the percentage reductions from the Primoli article and the early Tax Court test cases. The Tax Court agreed and held that the appraisal failed to satisfy the requirements in Regs. 1.170A-13(c)(3)(ii)(J) and (K). The Tax Court also concluded that the ‘substantial compliance doctrine’[40] and the reasonable cause exception in Section 170(f)(11)(A)(ii)(I) did not save the appraisal. The effect was to disallow the charitable deduction in its entirety as per Section 170(f)(11)(C).

The holding in *Scheidelman I* was, on its face, inconsistent with a prior opinion of the Tax Court, Simmons,[41] which had upheld a facade easement appraisal as a qualified appraisal and was affirmed by the DC Circuit. Although the appraisals were similar and contained the same defects, the Tax Court in *Scheidelman I* reached a contrary conclusion on the qualifications of the appraisal. This IRS argument, too, would have broad-ranging effects not isolated to defective facade easement appraisals.

Other Tax Court cases immediately followed *Scheidelman 1*.[42]

On appeal, in *Scheidelman II*, the Second Circuit disagreed with the Tax Court and vacated its judgment. The Second Circuit concluded that the appraiser’s reliance on the Primoli article was not fatal for purposes of Reg. 1.170A-13(c)(3)(ii)(J) because the appraiser had in fact explained his method of valuation used to determine fair market value:

> Drazner did in fact explain at some length how he arrived at his numbers. For the purpose of gauging compliance with the reporting requirement, it is irrelevant that the IRS believes the method employed was sloppy or inaccurate, or haphazardly applied—it

> remains a method, and Drazner described it. The regulation requires only that the appraiser identify the valuation method `used`; it does not require that the method adopted be reliable. By providing the information required by the regulation, Drazner enabled the IRS to evaluate his methodology.[43]

In addition, the Second Circuit concluded that the appraiser had sufficiently supplied the bases for his valuation—namely, IRS publications, tax court decisions, the appraiser's past valuation experience, and the location of the house in the regulatory environment in New York City. 'The Primoli article and the *Hilborn* case yielded the initial range of 10 percent to 15 percent diminution in value; whether that range is accurate or reliable is not at issue on this appeal.[44] The Second Circuit observed that the subject appraisal was 'nearly identical' to the appraisal approved by the Tax Court in *Simmons*.

The IRS took another run at the qualified appraisal argument in *Kaufman III*—the Second Circuit decided *Scheidelman II* while the First Circuit case was awaiting decision. The argument again failed. The First Circuit characterized the Service's argument as 'largely an attempt to convert an inherently factual issue into a set of violations of the procedural requirements of section 1.170A-13 in disregard ***28** of their language and purpose.'[45] As the First Circuit explained:

> The procedural regulations requiring an appraisal report and summary are designed to provide information 'sufficient to permit [the IRS] to evaluate the [taxpayer]'s reported contribution and monitor and address concerns about overvaluation.' But whether the valuation was overstated, grossly or otherwise, is a factual question different from whether the formal procedural requirements were met, either strictly or under the 'substantial compliance' doctrine which may forgive minor discrepancies.[46]

The First Circuit's holding in *Kaufman III* seemingly ends the Service's qualified appraisal argument.[47]

Cash contributions argument.

The National Park Service (NPS) maintains a Web site that provides relevant information on historic easements, including facade easements. As the Tax Court observed in *Kaufman II*, the NPS Web site recognizes the practice of requiring cash contributions incident to easement donations:

> Many easement holding organizations require the easement donor to make an additional donation of funds to help administer the easement. These funds are often held in an endowment that generates an annual income to pay for easement administration costs such as staff time and travel expenses, or needed legal services.[48]

Cash contributions are a common practice for conservation easements. Nonetheless, the IRS decided in the facade easement cases to challenge the deductions as part of an unconstrained argument.

In *Scheidelman I*, the Tax Court accepted the Service's argument despite the prevalence of the practice and the absence of any direct benefits to the donors. The Tax Court said it is well established that [a] payment of money or transfer of property generally cannot constitute a charitable contribution if the contributor expects a substantial benefit in return.[49] The Tax Court held that the taxpayers had not met their burden of providing evidence necessary to establish either (1) that in return for the payment of cash to NAT they received nothing of substantial value or (2) their entitlement to a partial deduction because the payment exceeded the value of any benefits received.

In *Kaufman II*, the Tax Court went in a different direction. The Tax Court concluded that the Kaufmans' cash contribution to NAT was not a *quid pro quo* for benefits from NAT or a fee for services. Acknowledging that '[o]nly unrequited payments to qualified recipients are deductible,'[50] the Tax Court determined that 'it is difficult to see how the cash donation benefits the donor other than in making possible the contribution of the associated property and giving rise to an added charitable contribution deduction (an acceptable benefit).'[51]

The Tax Court also rejected the Service's argument that the cash contribution represented a fee for services, but did so on burden of proof grounds (because the IRS had raised the issue by answer, and so had the burden of proof). The Tax Court noted that for the IRS to succeed with its fee-for-services argument, the evidence must show a *quid pro quo*; i.e., that, reciprocally, the Kaufmans made a payment and NAT provided services of substantial value. Although there was some evidence of NAT providing services to the Kaufmans—e.g., providing forms and agreements, obtaining approvals, and negotiating with the Bank and state agencies—the Tax Court concluded that the evidence was ambiguous as to whether the Kaufmans' payments reciprocated NAT's undertakings. The IRS did not appeal the Tax Court's holding regarding cash contributions to the First Circuit.

After *Kaufman II* was decided, the Second Circuit decided *Scheidelman II*, disagreeing with the Tax Court's holding in Scheidelman

> ***29** While Scheidelman's $9,275 donation might be described as a prerequisite of the Trust's acceptance of the easement donation, the Trust gave the taxpayer no 'goods or services,' or 'benefit,' or anything of value in return for her making the money gift. The only transfer of benefit was what the taxpayer gave to the Trust in the two gifts. Earlier cases applying the quid pro quo principle concerned bargained-for exchanges for services desired by the taxpayer, such as religious or adoption services. But Scheidelman received no such benefit from the Trust in exchange for her cash donation. A donee's agreement to accept a gift does not transfer anything of value to the donor, even though the donor may desire to have his gift accepted, and may expect to derive benefit elsewhere (such as by deductibility of the gift on her income taxes).[52]

The Second Circuit observed that contributions toward operating expenditures are commonplace among entities like NAT that hold and administer facade easements, citing the NPS Web site to the same effect. The Second Circuit went one step further and made a sweeping statement: 'When a cash contribution (even mandatory in nature) serves to fund the administration of another charitable donation, it is likewise an 'unrequited gift."[53]

Even though the Tax Court in *Kaufman II* decided the cash contribution issue, in part, on burden of proof grounds, it appears that the Tax Court's holding and the Second Circuit's decision in *Scheidelman II* has put the Service's argument to bed.

Kaufman IV

In *Kaufman IV*, after two Tax Court opinions and a First Circuit opinion, the Tax Court finally addressed whether the Kaufmans' easement had any value. The die had already been cast by the First Circuit.

After deciding against the IRS on its technical arguments, the First Circuit expressed its discomfort with NAT's role in and the specific circumstances of the Kaufmans' donation. It stated that Section 170(h) does not allow taxpayers to obtain six-figure deductions for gifts of lesser or no value.[54] The First Circuit cited a number of factors that tended to show that the easement was 'worth little or nothing.'

1: When the Kaufmans donated the easement, their home was already subject to local historic district rules that severely restrict alterations to buildings in the neighborhood. The Kaufmans' appraiser acknowledged in his report that there was `much overlap' in the restrictions in the easement and in the local historic district, and the differences he noted between the two sets of restrictions were arguably of no 'economic significance.[55]

2: The Kaufmans were surprised at the size of the valuation and were very concerned about the effect on the resale value of their home. In an effort to reassure them, a NAT representative told the Kaufmans that experience showed that such easements did not reduce resale value. 'In areas that are regulated by local historic preservation ordinances and bodies such as Boston historic neighborhoods (including yours) ... properties with an easement are not at a market value disadvantage when compared to the other properties in the same neighborhood.'[56] As the First Circuit characterized it, 'this could easily be the IRS's opening argument in a valuation trial.'[57]

3: 'As indicated by the large cash contributions required of donors, NAT had a substantial economic incentive for itself in facilitating such conservation easements; and to this end and because of the 10 percent target for donations, it also had a stake in assuring a high valuation.'[58]

4: 'Similarly, the appraiser, who admitted receiving fees for a succession of such appraisals for Trust easements, assuredly had an interest in remaining on the list of those recommended by the Trust to potential donors.'[59]

The Tax Court picked up these themes of taxpayer ignorance, NAT overreaching, and lack of appraiser independence in holding against the Kaufmans on valuation grounds and penalties. The Tax Court wrote a detailed 86-page opinion that excoriated the appraiser and the Kaufmans, concluding the Kaufmans' easement had zero value.

In *Kaufman IV*, the *Kaufmans* presented the opinion of their expert, Timothy J. Hanlon, who had prepared the original appraisal and concluded that the easement had a value of $1,840,000 for the easement. The Tax Court questioned Hanlon's independence and credibility. NAT had put Hanlon on a list of what it represented to the Kaufmans and other donors to be qualified appraisers. The appraisal Hanlon performed for the Kaufmans was one of nine appraisal reports that, beginning in 2003 and continuing through approximately the end of 2004, Hanlon completed with respect to contributions of facade easements to NAT. Other than those nine reports, Hanlon had no experience in appraising partial interests in real property.

NAT was actively involved in Hanlon's first appraisal, even adding suggested language, and appears to have directed him to the Primoli article and the IRS 'safe harbor.' NAT ***30** suggested that the range of value for facade easements ranged from 11% for properties in highly regulated areas and towards 15% in less regulated or unregulated areas. With respect to the 11% figure, NAT advised that '95% fall in this percentage' and an appraisal [c]ould use 11.5%- 12.5%.' Hanlon used this same methodology in each of the nine appraisals he performed for NAT easements, including the Kaufmans' appraisal.[60]

The Tax Court explained that 'NAT was not indifferent to the values Mr. Hanlon determined, nor was he indifferent to what would please NAT,' describing NAT as Mr. Hanlon's 'patron.' Although the Tax Court declined to hold that these facts were fatal, the court explained that 'we do not ignore or disregard Mr. Hanlon's closeness to NAT and the singularity of his experience in valuing facade easements for clients and for a patron all interested in establishing high values for the easements; we weigh those factors in the balance of whether—and the degree to which—to accept Mr. Hanlon's expert testimony.[61]

The Tax Court ultimately gave no weight to Hanlon's appraisal or his testimony. Hanlon's appraisal relied almost exclusively on the Primoli article and the early test cases from the Tax Court. He used the 15% upper bound of the range in the Primoli article and then 'deconstructed' it into 'smaller, component percentages' reflective of the burdens that he thought were imposed by a facade easement. He then made adjustments to those component percentages to reflect what he believed to be the differences and similarities between the local historic district restrictions and the Restriction Agreement, concluding that the value of the facade easement was 12% of the pre-easement value of the property. Hanlon conceded that this method was unique to him and not a generally accepted appraisal practice or valuation method.

The Tax Court determined that Hanlon's methodology was not reliable. First, Hanlon's starting point of a 15% reduction was `based on neither reliable market data nor specific attributes of the property.'[62] According to the Tax Court, [w]hether it is an upper or lower bound, there is no standard percentage to which one may make adjustments to arrive at a value appropriate for a particular property.'[63] Moreover, the Tax Court refused to accept the component percentages that Hanlon assigned to the twelve constituent burdens that he identified. Those component percentages were not derived from market data and were simply Hanlon's derivations. While acknowledging that the lack of general acceptance is not itself fatal, the Tax Court concluded that it is a factor suggesting the method is not reliable. Accordingly, the Tax Court found Hanlon's method not to be reliable and assigned it no weight.

The Service's expert opined that the easement had zero value based on a comparative analysis of the easement and historic district restrictions. In response, the Kaufmans argued that there were differences in the two sets of restrictions, summarizing the factors that Hanlon had considered in his appraisal:

1: The additional regulation and bureaucracy that resulted from the donation of the facade easement.

2: The new regulation on the rear and roof of the property under the Restriction Agreement.

3: The impact of potentially higher maintenance and insurance costs to comply with the terms of the Restriction Agreement.

4: The risk that the owner of the property might face legal action to compel compliance with the Restriction Agreement.

5: The restrictions on the yard and yard improvements under the Restriction Agreement.

Note that the Tax Court had accepted similar differences in *Simmons* (second level of enforcement, oversight, and approval), and *Gorra*[64] (restrictions on rear of property), but the Tax Court in *Kaufman IV* did not buy them.

The Tax Court agreed with the analysis of the Service's expert that the restrictive components of the Restriction Agreement are 'basically duplicative of, and not materially different ***31** from, the South End Standards and Criteria.'[65] The Tax Court was not convinced that a buyer would attribute much significance to the slight differences, if any, in the restrictions relating to the roof and yard, and there was no evidence in the record to support Hanlon's reliance on higher maintenance and insurance costs. Moreover, considering NAT's e-mail correspondence to the Kaufmans and the resale study by the Service's expert, the Tax Court did not see any evidence of the easement's effect on resale value. Siding with the Service's expert, the Tax Court concluded that the Kaufmans' easement had zero value.[66]

When an easement donation is determined to have zero value, the immediate effect is that there is a 'gross valuation misstatement' for penalty purposes—i.e., the valuation misstatement will exceed the 400% (pre-PPA) or 200% (post-PPA) threshold—triggering the possibility of a 40% penalty.[67] Under the PPA, Congress eliminated the reasonable cause defense in Section 6664(c)(3) for gross valuation misstatements. The Kaufmans' returns were filed before the 7/25/06 effective date of the PPA, so they could still avail themselves of the defense, provided (1) the claimed value of the property was based on a qualified appraisal made by a qualified appraiser, and (2) in addition to obtaining such appraisal, the taxpayer made a good-faith investigation of the value of the contributed property.[68]

Although the Tax Court questioned Hanlon's independence and the credibility of his appraisal, the court followed *Scheidelman II* and concluded the qualified appraisal requirement was satisfied. However, the Tax Court found that the Kaufmans did not make a good-faith investigation of the value. Mr. *Kaufman* admitted that he had not compared the restrictions imposed by the Restriction Agreement to the local historic district restrictions. After reviewing the appraisal, he sent an e-mail to NAT expressing his concern that 'the reduction in the resale value of the property due to the [facade] easement [is] so large as to overwhelm the tax savings that accrue from it. Mr. *Kaufman* was concerned about the resale value of his home. However, NAT attempted to allay his concerns by assuring him that properties in neighborhoods (such as Kaufman's) subject to local regulation and also subject to preservation agreements were not at a market disadvantage when compared to neighboring properties not so additionally burdened.

The Tax Court rejected that this represented a good-faith investigation, considering NAT's statements: 'It is somewhat odd, and not at all persuasive, that, in support of their argument that

Gordon Kaufman verified that the $220,800 value for the facade reached by Mr. Hanlon was correct, petitioners bring to our attention Mr. Bahar's [NAT's] email, in which, whether Gordon Kaufman accepted it or not, Mr. Bahar expressed his opinion that the conveyance of the facade easement to NAT had little or no effect on the value of the property.'[69] The Tax Court dismissed the Kaufmans' reliance on their tax return preparer because he testified that he did not express any opinion to the Kaufmans regarding whether the valuation was reasonable and had `no idea whatsoever' as to whether the value was accurate. It also dismissed any reliance on the Primoli article because there was no evidence the Kaufmans actually reviewed that article.

Because the Tax Court found that the Kaufmans did not make a good-faith investigation of the value reported on their returns, they could not rely on the reasonable cause defense. However, 'for the sake of completeness,' the Tax Court also evaluated whether there was reasonable cause. The Tax Court dismissed the Kaufmans' asserted reliance on their tax return preparer, because there was no evidence he had any experience reviewing easement values and, as noted, had not given them any advice as to the value's reasonableness. Citing Mr. *Kaufman's* sophistication as an MIT professor specializing in analytical studies and the NAT e-mail correspondence, the Tax Court found that the Kaufmans 'had reason to question the conclusion in the Hanlon appraisal that the facade easement was worth $220,800.'[70] The Tax Court said it was certain that, 'as an MIT professor specializing in analytical statistics, [Mr. Kaufman] is qualified to have an opinion about the statistical rigor of Mr. Bahar's claims,' and 'there was obvious discordance between Mr. Bahar's resale statistic and Mr. Hanlon's value conclusion, suggesting that one or the other was (or possibly both were) in error. Yet Gordon Kaufman, who was particularly well equipped to apply statistical rigor both to Mr. Bahar's data and to Mr. Hanlon's value conclusion, chose to do neither.'[71] The Tax Court thus sustained the Service's assertion of 40% gross valuation misstatement penalties.

For completeness, the Tax Court also addressed the Service's alternative position that ***32** the 20% penalty for negligence or substantial understatement of tax applied. Of note here is that the Tax Court disagreed with the Kaufmans that they had a `reasonable basis' for their return position under Reg. 1.6662-3(b)(3) (negligence penalty) and 'substantial authority' under Section 6662(d)(2)(B). The Tax Court rejected the Kaufmans' reliance on the Primoli article and the asserted 'safe harbor' range established by the IRS and the Tax Court:

> While we have on occasion accepted expert testimony that a facade easement reduced the value of the subject property by a particular percentage, e.g., *Hilborn v. Commissioner*, 85 TC 677, 698-699 (1985), we have cautioned that there is no general safe-harbor percentage with respect to the value of facade easements, *Nicoladis v. Commissioner*, 1988 Tax Ct. Memo LEXIS 187, at * 21 (`[V]aluation itself is still a question of facts and circumstances.'). Petitioners can rely neither on caselaw nor on IRS engineers' statements that the proper value of facade easements 'should' range between 10% and 15% of the value of the encumbered property to overcome the facts that the value of the facade easement that Lorna Kaufman contributed to NAT was nil.[72]

The Tax Court likewise sustained, in the alternative, the Service's imposition of 20% penalties against the Kaufmans.

Aftermath

At this point in the story, the IRS has lost all its technical, legal arguments.[73] First, it has lost its attempt to establish a per se zero-value standard in *Simmons*, both in the Tax Court and in the DC Circuit. Second, it has lost its attempt to use longstanding language in mortgage documents against taxpayers in *Kaufman III* in the First Circuit. Third, it has lost its attempt to bootstrap deficiencies in valuation analysis into a default under the qualified appraisal requirements, both in Scheidelman II in the Second Circuit and in *Kaufman III.* Fourth, it has lost its attempt to deny charitable deductions for standard cash contributions made to tax-exempt organizations for monitoring and administration purposes in *Scheidelman II* and in *Kaufman II* in the Tax Court. Fifth, it has lost its attempt to turn standard 'consent' provisions in easement documents into a violation of the perpetuity and conservation purposes requirements in *Kaufman III* and in Simmons in the DC Circuit.[74] But the victory ultimately went to the IRS in *Kaufman IV*.[75]

With the Service's legal arguments held to be unsound, the current state of the facade easement litigation is focused on valuation —i.e., the typical battle of appraisers. Taxpayers have the opportunity to prove that their facade easements have value. However, reliance on a 'safe harbor' diminution value and the Primoli article is out. In order to prevail, taxpayers must engage appraisers who can advance credible differences between the easement restrictions and local government restrictions. This strategy was partially successful in *Simmons* (5% reduction) and *Gorra* (2% reduction).

There are three major obstacles. First, the Tax Court's most recent opinion in *Chandler*[76] signals a possible reversal of its position in *Simmons*. Judge Joseph Goeke, who authored *Simmons*, declined to engage in that same type of analysis and, referring to the analysis in *Kaufman IV*, stated: 'We see no reason to break with that result here.'[77] The Tax Court may have reached the limit of its patience with all the litigation in the facade easement area. Second, the Tax Court in *Kaufman IV* signaled that taxpayers will be held to a higher standard of due diligence in investigating the value of their facade easements and that their relative personal sophistication will be taken into account in evaluating reasonable cause. This was not the case in some of the earlier facade easement cases, in which penalties were not imposed. Third, the PPA has made effectively automatic the 40% penalty—i.e., taxpayers must substantially ***33** prevail on their valuation and slide under the 200% threshold for a gross valuation misstatement if they are to escape these penalties. And then they must still defend against 20% substantial understatement and negligence penalties, which may be difficult after *Kaufman IV*.[78]

From the practice perspective, taxpayers and practitioners must be mindful of the arguments made by the IRS in the facade easement cases—not only for conservation easements but other contributions. There is now a large body of case law for the IRS to pick through in order to make fanciful arguments and many traps for the unwary. Taxpayers should question the credentials and independence of appraisers—a problem identified in the *Kaufman* litigation.

Conclusion

As the discussion above indicates, the litigation in the facade easement area has produced results that are messy and sometimes inconsistent. Despite the expression of concerns from IRSAC and others, the IRS adopted an aggressive and comprehensive litigation strategy that appears to have its roots in its contempt for some of the practices of NAT and the negative press on facade easements. It is difficult to fault the taxpayers who have been caught up in this litigation when Congress and the IRS itself come to the table with unclean hands. The IRS was rebuffed by the courts in its vain attempt to eliminate the facade easement by all-encompassing technical arguments. Nonetheless, the courts have sustained the Service's position of zero value and application of substantial penalties.

The Tax Court has settled on a valuation analysis that produces zero-value holdings and substantial (sometimes automatic) penalties.

There is limited direct evidence that facade easement restrictions affect resale value.

The naysayers seized the stage.

The Kaufmans lived in an area already subject to local restrictions aimed at historic preservation, including approval of exterior alterations.

The Kaufmans engaged an appraiser recommended by the donee.

The First Circuit disagreed with the Tax Court and held that the extinguishment requirement in Reg. 1.170A-14(g)(6) was satisfied.

In *Scheidelman II*, the Second Circuit concluded that the appraiser's reliance on the Primoli article was not fatal.

The First Circuit cited a number of factors that tended to show that the easement was 'worth little or nothing.'

In *Kaufman IV*, the Tax Court excoriated the appraiser and the Kaufmans, concluding the *Kaufmans'* easement had zero value.

At this point in the story, the IRS has lost all its technical, legal arguments.

There is now a large body of case law for the IRS to pick through in order to make fanciful arguments.

This article presents the views of Timothy Jacobs and do not necessarily reflect those of Hunton & Williams or its clients, or Taxation of Exempts. The information presented is for general information and education purposes. No legal advice is intended to be conveyed; readers should consult with legal counsel with respect to any legal advice they require related to the subject matter of the article.

[a1] TIMOTHY L. JACOBS is a partner in the Washington, DC, and Richmond, VA, offices of Hunton & Williams LLP.

[1] 687 F.3d 21, 110 AFTR2d 2012-5278 (CA-1, 2012) (*Kaufman III*), *vacating and remanding* 136 TC 294 (2011) (*Kaufman II*) and 134 TC 182 (2010) (*Kaufman I*).

[2]

[3] TCM 2009-208, *aff'd*, 646 F.3d 6, 107 AFTR2d 2011-2632 (CA-DC, 2011).

[4] See, e.g., *Chandler*, 142 TC No. 16 (2014); *Scheidelman III*, TCM 2013-18; *Dunlap*, TCM 2012-126; *Evans*, TCM 2010-207.

[5] *Scheidelman*, TCM 2010-151, *rev'd*, 682 F.3d 189, 109 AFTR2d 2012-2536 (CA-2, 2012).

[6] Prior to 1976, it was unclear whether donations of restrictive easements were deductible as charitable contributions under Section 170. In Rev. Rul. 64-205, 1964-2 CB 62, the IRS ruled that a donation of such a right in *perpetuity* entitled the donor to a charitable contribution deduction. In the Tax Reform Act of 1969, however, Congress adopted the general rule that charitable deductions were not permitted for partial interests in property. See Brief for Petitioners-Appellants/Cross-Appellees, *Kaufman II*, case no. 11-2017, 11-2022, at 7-14 (11/22/11) (providing a full history of restrictive easements and Congressional enactments); Amicus Brief of the National Trust for Historic Preservation [hereinafter, 'National Trust`] in Support of Petitioners, *Kaufman II*, case no. 11-2017, 11-2022, at 8-18 (describing history of restrictive easements, Congressional enactments, and Treasury regulations).

[7] The Treasury issued a notice of proposed rulemaking in May 1983. 48 Fed. Reg. 22,940 (5/23/83). Neither the final regulations nor the proposed regulations provides any guidance regarding the requirements at issue in *Kaufman*.

[8] See, e.g., *Whitehouse Ltd. P'ship*, 615 F.3d 321, 106 AFTR2d 2010-5759 (CA-5, 2010), *vacating and remanding*, 131 TC 112 (2008).

[9] *Hilborn*, 85 TC 677 (1985); Nicoladis,TCM 1988-163.

[10] Primoli, 'Facade Easement Contributions,' available at www.preservationeasement.org/home/IRSTaxBrief.pdf; 1994 IRS 'Audit Technique Guide.' In 2003, both the Audit Technique Guide and a revised version of the Primoli article omitted any reference to the 10% to 15% range 'for fear the numbers were being misconstrued.' Scheidelman, *supra* note 5 at 682 F.3d 196, fn. 5; see 'Facade Easement Contributions,' available at www.irs.gov/pub/irs-utl/facade_easement_brief june_2009_fmal_revision_08272009.pdf.

[11] Primoli, *supra* note 10.

[12] 2004-1 CB 31.

[13] 'Loophole Pays Off on Upscale Buildings,' Wash. Post (12/12/04), available at www.washingtonpost.com/wp-dyn/articles/A57445-2004Dec 11 .html; 'Tax Break Turns Into Big Business,' Wash. Post (12/13/04), available at www.washingtonpost.com/wp-dyn/articles/A57445-2004Dec11.html.

[14] Press Release, Grassley, Baucus Hope to End Facade Easement Abuse Effective Today,' United States Senate Committee on Finance (12/17/04).

[15] IR-2005-19, available at www.irs.gov/uac/IRS-Announces-the-2005-Dirty-Dozen.

[16] See Letter from IRS Commissioner Mark Everson to Charles Grassley, Senate Finance Committee Chairman (3/30/05), available at www.finance.senate.gov/imo/media/doc/Letter%20from%20Everson.pdf. See ILM 200738013 (9/21/07) (disavowing the Primoli article and stating that there is no 'generally recognized' percentage of reduction in value for facade easements).

[17] Announcement 2005-80, 2005-2 CB 967.

[18] Staff of the Joint Committee on Taxation, 'Option to Improve Tax Compliance and Reform Tax Expenditures,' JCS-02-05 (1/27/05).

[19] See Sections 6662(h), 6664(c). The new penalty regime was applicable to returns filed after 7/25/06 for facade easements. In addition to *Kaufman IV*, the Tax Court has upheld the 40% penalty in several cases involving post-2006 returns. In *Gorra*, TCM 2013-254, the Tax Court upheld the 40% penalty, rejecting the taxpayers' argument that the penalty represented an excessive fine under the Eighth Amendment of the U.S. Constitution. In *Chandler, supra* note 4, the Tax Court held that the 40% penalty applied to carryover deductions on post-2006 returns, even though the donations occurred prior to 2006.

[20] Available at www.irs.gov/Tax-Professionals/Internal-Revenue-Service-Advisory-Council-2009-General-Report (6/1/14). IRSAC advises the IRS with respect to various policy matters and conveys the public's perception of IRS activities to the Commissioner. See www. irs.gov/Tax-Professionals/Internal-Revenue-Service-Advisory-Council-Facts.

[21] Among other actions, the Department of Justice secured a permanent injunction against NAT preventing it from claiming that the IRS has recognized a 'safe harbor' for facade easement valuations of 10% to 15% and from participating in the appraisal process. See *Kaufman III*, 687 F.3d at 32, fn. 9 (CA-1, 2012) (citing Stipulated Order of Permanent Injunction, *McClain*, No. 11-1087 (DDC 7/15/11)), *vacating and remanding*, *Kaufman II*, 136 TC 294 (2011) and *Kaufman I*, 134 TC 182 (2010).

[22] According to the Post's follow-up investigation, the IRS has denied 70% of facade easement deductions, and Department of Justice estimates were that inflated easement deductions totaled $1.2 billion. Stephens, 'U.S. targeting tax break tied to facade easements,' Wash. Post (7/9/11), available at

www.washingtonpost.com/pb/local/us-seeks-to-end-tax-break-for-facade-easement-donations/2011/07/05/gIQAFsH35H_story.html. The IRS estimated that between 2002 and 2006, the NAT-sponsored easements cost the Treasury revenue of more than $250 million. *Id.*

[23] NAT handled the discussions with the Bank and the Massachusetts Historical Commission. NAT supplied and negotiated the relevant forms and agreements.

[24] One of the Service's major 'pet peeves' with NAT was the fact that it identified appraisers, schooled them in how to prepare the appraisals for facade easements, and recommended them to donors on multiple occasions as part of what the Tax Court would characterize as a 'patron' relationship.

[25] The Tax Court in Kaufman II determined that a portion of the cash contribution was improperly deducted by the Kaufmans in 2003 because that portion was contingent on completion of the appraisal and should have been deferred to the 2004 tax year. The Kaufmans did not contest that holding.

[26] Amicus Brief of the National Trust, *supra* note 6 at 18; see National Trust, 'Preservation Easements: Preservation, Real Estate and Tax Planning Issues,' 5 Preservation L. Rep. 13,001 (Spring/Summer 1987, attached as Ex. A to Amicus Brief).

[27] Amicus Brief, *supra* note 6; National Trust, supra note 26 at 5 Preservation L. Rep. 13,408.

[28] National Trust, *supra* note 26 at 5 Preservation L. Rep. 13,420-13,421.

[29] 29 Amicus Brief of the National Trust, *supra* note 6 at 20.

[30] *Kaufman I*, *supra* note 1 at 134 TC 186.

[31] *Id.*

[32] Given the significance of the holding in *Kaufman I*, the Kaufmans were supported on reconsideration by several organizations (namely, the Trust for Architectural Easements, the Foundation for the Preservation of Historic Georgetown, National Trust for Historic Preservation, and Capitol Historic Trust), who asked permission to file amicus briefs. The amici were represented by notable tax practitioners—future Tax Court judge Albert G. Lauber and future Assistant Attorney General for the Tax Division Kathryn Keneally. See TC docket no. 015997-09.

[33] *Kaufman II*, *supra* note 1 at 136 TC 309.

[34] *Id.* at 311-313 (emphasis added). The Tax Court rejected the *Kaufmans'* arguments that (1) the subordination requirement in Reg. 1.170A-14(g)(2) governed mortgages, and (2) the Lender Agreement qualified for an exception for remote, future events found in Reg. 1.170A-14(g)(3) , finding that Reg. 1.170A-14(g)(6) was a stand-alone, independent requirement. Id. at 309-313.

[35] *Kaufman III supra* note 1 at 687 F.3d 26.

[36] *Id*. at 26-27 (citations and footnote references omitted).

[37] *Id*. at 27. The Second Circuit agreed with the Tax Court and the IRS that the subordination requirement in Reg. 1.170A-14(g)(2) had no relevance to the issue before the Court. *Id*. and fn. 5.

[38] During oral argument, the First Circuit panel inquired whether the Tax Court's decision would preclude a taxpayer from claiming a deduction for a donation of a facade easement if the property was subject to a mortgage. In response, the government submitted examples of model agreements from the Virginia Outdoor Foundation, the Compact of Cape Cod Conservation Trusts, and the Maryland Environmental Trust, which it asserted did not contain the additional language on condemnation and insurance proceeds found in the National Trust's model agreement and in the *Kaufman* Lender Agreement. Letter from Patrick J. Uda, DOJ Tax Division, Appellate Section, to First Circuit Clerk (5/16/12). The government asserted that '[a] lender agreement, in short, cannot contain additional language that undercuts other perpetuity requirements.' The Kaufmans responded that 'none of the examples subordinates a mortgagee's secured interest to a donee's right to proceeds, as the Tax Court's decision requires.' Letter from Catherine M.A. Carroll, Counsel for Petitioners-Appellants/Cross-Appellees, to First Circuit Clerk (5/23/12). Rather, those examples were silent on proceeds and did not guarantee the donees' right to condemnation and insurance proceeds.

[39] TCM 2010-151 (*Scheidelman I*), vacated and remanded, 682 F.3d 189, 109 AFTR2d 2012-2536 (CA-2, 2012) (*Scheidelman II*).

[40] See *Bond*, 100 TC 32 (1993).

[41] Note 3, *supra*.

[42] *Friedberg*, TCM 2011-238, *reconsidered and vacated*, TCM 2013-224; *Rothman*, TCM 2012-163, *reconsidered and vacated in part*, TCM 2012-218. The Tax Court vacated its prior judgment in *Rothman* to the extent that it relied on *Scheidelman I*, but found that the appraisal was defective for other reasons. See also *Alli*, TCM 2014-15 (on appeal to the Sixth Circuit).

[43] *Scheidelman II*, *supra* note 39 at 682 F.3d 196-197.

[44] *Id*. at 197. See note 9, *supra*.

[45] *Kaufman III*, *supra* note 1 at 687 F.3d 29.
[46] *Id.* (citation omitted).
[47] As described in note 42, *supra*, the Tax Court reconsidered certain pending cases that had relied on *Scheidelman I*. At least two cases described in that footnote, though, have identified other problems in the appraisal to get to the same result-*Rothman* and *Alli*. In addition, although three circuits have seemingly dismissed the argument, it is unclear whether the Tax Court might assert its national jurisdiction and reach a different conclusion in cases appealable to other circuits. Under *Golsen*, 54 TC 742 (1970), *affd*, 445 F.2d 985, 27 AFTR2d 71-1583 (CA-10, 1971), the Tax Court will 'follow a Court of Appeals decision which is squarely in point where appeal from our decision lies to that Court of Appeals,' but is not so constrained in undecided circuits.
[48] *Kaufman II*, *supra* note 1 at 136 TC 318; see NPS Technical Preservation Services, 'Easements to Protect Historic Properties: A Useful Historic Preservation Tool with Potential Tax Benefits,' available at www.nps.gov/tps/tax-incentives/taxdocs/easements-historic-properties.pdf.
[49] *Scheidelman I*, *supra* note 39 at 28 (citing *American Bar Endowment*, 477 US 105, 58 AFTR2d 86-5190 (1986).
[50] *Kaufman II*, *supra* note 1 at 136 TC 318 (quoting *Hernandez*, 490 US 680, 690, 63 AFTR2d 89-1395 (1989)).
[51] *Id*. at 136 TC 318-319.
[52] *Scheidelman II*, *supra* note 39 at 682 F.3d 200 (citations and footnote references omitted).
[53] *Id*. The Second Circuit cited the similar holding in *Kaufman II* in support of its holding.
[54] *Kaufman III*, supra note 1 at 687 F.3d 30.
[55] *Id*. at 31.
[56] *Id*. These comments are similar to the comments that the Washington Post reported in its articles. See *supra* note 10.
[57] *Kaufman III*, supra note 1 at 687 F.3d 31.
[58] *Id*. at 32.
[59] *Id*.
[60] It appears from other facade easement cases that other appraisers recommended by NAT had used this same methodology.
[61] *Kaufman IV*, *supra* note 2 at 48-49.
[62] *Id*. at 51.
[63] *Id.*
[64] TCM 2013-254.
[65] *Kaufman IV*, *supra* note 2 at 63.
[66] *Id*. at 63-64.
[67] See Section 6662(e)(1)(A), Section 6662(h)(2)(A); Reg. 1.6662-5(g) (`The value ... claimed on a return of any property with a correct value ... of zero is considered to be 400 percent or more of the correct amount.') Section 6662(e)(2) provides that the penalties for valuation misstatements will not apply, however, unless the underpayment attributable to the misstatement exceeds $5,000. This floor for the penalty is generally exceeded in most facade easement cases.
[68] Section 6664(c)(3).
[69] *Kaufman IV*, *supra* note 2 at 73-74.
[70] *Id*. at 78.
[71] *Id*. at 79.
[72] *Id*. at 83-84.
[73] But the IRS did prevail in *Graev*, 140 TC 377 (2013). It is 'standard Trust policy' at NAT to return cash contributions to the extent that the IRS has disallowed a deduction, and in some cases to provide 'comfort letters' to donors regarding the same. In *Graev*, NAT went one step further and promised in a 'side letter' to the donor that it would return the cash contribution and unwind the easement if the IRS disallowed the charitable deductions. The Tax Court held that this was a conditional gift under Reg. 1.170A-1(e) . The court was not persuaded by the fact that the side letter might not be enforceable under state law because it found that NAT would in fact honor the commitments made in the letter.
[74] See, e.g., *Gorra*, supra note 16 at 34-35. But see *Carpenter*, TCM 2013-172, *motion for reconsideration denied*. The Tax Court held that the easement was not a qualified conservation contribution because it included language that permitted extinguishment by mutual agreement of the donor and donee. While the Tax Court had permitted consent provisions in the past, it concluded in *Carpenter* that a mutual agreement provision violated the extinguishment provision in Reg. 1.170A-14(g)(6)(i) , which contemplates only judicial extinguishment.

[75] On remand from the Second Circuit, the Tax Court concluded that the easement in *Scheidelman* has zero value. *Scheidelman* TCM 2013-18. On appeal, the Second Circuit affirmed that holding. *Scheidelman IV*, 113 AFTR2d 2014-2591 (CA-2, 2014).

[76] Note 4, *supra*.

[77] *Id*, slip op. at 19 (2014).

[78] But see *id*. (holding that penalties were not applicable for pre-2006 tax returns because taxpayers had reasonable cause and acted in good faith).