TAXATION

CALIFORNIA LAWYERS ASSOCIATION

presents

2023 Estate and Gift Tax Conference

Current Developments

Friday, March 10, 2023
9:45 am - 11:15 am

Speakers:

Robin Klomparens

John Prokey

Conference Reference Materials

<u>CURRENT DEVELOPMENTS</u>

2023 ANNUAL ESTATE AND GIFT TAX CONFERENCE
SAN FRANCISCO

ROBIN KLOMPARENS – Sacramento

JOHN PROKEY – San Jose

OVERVIEW

Calendar year 2022 introduced many Americans, and their estate plans, to inflation. AFR interest rates are up, the 7520 Rate is up causing retained interests have more value (e.g. unitrust interest in CRT) and future interests have less value (e.g. GRAT and QPRT remainders). Inflation is also causing transfer tax exclusions and exemptions to rise, yet 2026 looms large. In 2022, we also saw an important tax cases, including a transfer tax case all practitioner should read, confirmation on how NOT to make lifetime gifts of cash, and anticipatory assignment of income. On the regulatory side, we saw developments in estate tax clawback, extended time to file portability only Forms 706, and proposed regulations under IRC section 2053. We will explore transfer tax developments from 2022 to guide our planning in 2023 and beyond.

A. REVENUE PROCEDURE 2022-38 – 2023 INFLATION ADJUSTMENTS [JWP]

i. Applicable Exclusion Amount: $12,920,000 (+860,000)

ii. Annual Exclusion Amount: $17,000 (+1,000)

iii. Gifts to Non-US Citizen Spouse: $175,000

iv. Section 2032A Special Use: $1,310,000

v. Section 6166 2-Percent Portion: $1,750,000

vi. Section 6039F (Form 3520) Gifts from Foreign Persons Exceed: $18,567

vii. Trusts and Estates Highest Income Tax Bracket: $14,450

B. RECENT TRANSFER TAX DEVELOPMENTS

1. Intergenerational Split Dollar Survives IRS Assault. Was It Worth IRS' New Legal Theory?

ESTATE OF LEVINE v. COMMISSIONER (2022) T.C. No. 2 [February 28, 2022]

Short Summary: This is yet another intergenerational split dollar case (see *Morrisette* cases and *Cahill*). There are three important lessons to learn from Levine: (i) intergenerational split dollar can work; (ii) proper planning and good facts matter, as such, everyone should read Levine as a model for good facts, even for planning other than intergenerational split dollar; and (iii) watch out when the same person is the decedent's agent and acting under other wealth planning documents.

Here, G1 (via her revocable trust) funded the $6.5 million single premium payment into an ILIT for $17.5 million in life insurance coverage on G1's daughter and son-in-law (two second-to-die policies). The split dollar arrangements provided that: (1) G1 would pay the premiums; (2) the ILIT would own the policies and possess all incidents of ownership, but have no right to the cash value; (3) collateral assignments secured repayment to G1 of an amount equal to the greater of the cash value of the policy or the total premiums paid, not to exceed the value of the policies; (4) they were intended to create economic benefit arrangements; (5) only the Investment Committee of the ILIT (a family advisor) could terminate the arrangements. Under the economic benefit arrangement, the gifts made by G1 were $1,689 and $955, respectively, for the two policies. At G1's death, the policies had a cash value of $6.2 million. The estate reported a $2.1 million value for what G1 would receive at termination of the arrangements. IRS argued gift tax and estate theories attempting to show a transfer by G1 of at least $6.2 million.

IRS first argued that the gift amount was $6.5 million, not the reported $1,689 and $955. The Tax Court rejected this argument because the gift amounts were determined pursuant to IRS rules (also note that the ILIT never had a right to the cash values). Further, IRC 2703 could not apply to the gifts because that section only applies to restrictions on property transferred at death.

On the estate tax side, IRS argued the entire $6.2 million cash value should be included in G1's estate under IRC sections 2036, 2038 and/or 2703. The Court rejected these arguments. IRS argued that the family advisor was merely an agent of G1 and would do whatever G1 said. As a result, IRS argued, the full $6.2 million value should be included in G1's gross estate. IRS' argument stemmed from the family advisor's dual role as: (i) G1's agent under a power of attorney; and (ii) the sole member of the Investment Committee of the ILIT and owing fiduciary duties to the trust beneficiaries. The Court rejected this agency argument due to the fiduciary duties owed in each role and finding there was no conflict between the fiduciary duties. Perhaps importantly, the trust beneficiaries included G1's children and grandchildren. Even though this agency theory was rejected by the Tax Court, be prepared to see this argument again.

2. Wait, What, There Is Clawback After All? Proposed Regulations Detail Exceptions To The General Rule Of No Clawback For Deaths On Or After April 27, 2022

PROPOSED REGULATIONS 20.2010-1(C)(3) [April 27, 2022]

Short Summary: IRC section 2001(g) was included Trump's tax package and was intended to prevent clawback, i.e., taxpayers would not be taxed on lifetime gifts made in excess of the basic exclusion amount (BEA) available at death. Treasury issued final regulations in 2019 confirming how these rules would work (see Treas. Reg. 20.2010-1(c)(1) and (2)). Those Regulations avoided clawback by stating the BEA of an estate is the greater of the BEA <u>used</u> on lifetime gifts and the BEA available in the year of death. Treasury reserved section (c)(3) for exceptions to the general rule of no clawback.

These Proposed Regulations would fill-in the reserved exceptions by allowing clawback for: (i) lifetime transfers includible in the gross estate under IRC sections 2035, 2036, 2037, 2038 and 2042; (ii) transfers made by enforceable promise to extent satisfied as of decedent's date of death (see Rev. Rul. 84-25); (iii) certain transfers described in IRC sections 2701 and 2702; and (iv) transfers that would have fallen within i, ii or iii, but for a transfer, relinquishment, or elimination of an interest within 18 months of decedent's date of death (whether by decedent alone or in conjunction with any other person). These exceptions have important implications for lifetime planning and the fall in the BAE starting under current law in 2026. Consider the 3-year rule of IRC section 2035 and the 18 months in the Proposed Regulations (i.e., June 30, 2024).

3. "Portability Only" Estate Tax Returns – May Now File Late Until Fifth Anniversary Of Decedent's Death

REVENUE PROCEDURE 2022-32 (2022) [July 8, 2022]

Short Summary: IRC section 9100 allows IRS to grant relief for late filing for regulatory deadlines (not statutory deadlines). Thus, if an estate tax return (Form 706) must be filed under IRC section 6018, then there is no relief under IRC section 9100 for a late filing for portability. However, if a Form 706 is not required to be filed under IRC section 6018 and a portability election is desired (a so-called “portability only” return), then the deadline to file the Form 706 is by regulation (by Regulation, same filing date as a required Form 706). Under Rev. Proc. 2017-34, an estate was allowed to file a portability only return late; provided, however, it was filed on or before the second anniversary of the decedent’s date of death. Now, under Rev. Proc. 2022-31 an estate is allowed to file a portability only return late if it is filed <u>on or before</u> the <u>fifth anniversary</u> of the decedent’s date of death. If filed later than that, then a PLR is required to obtain the benefits of portability. Note that if it is later determined that a Form 706 was required to be filed under IRC section 2018, then the late filing relief is unavailable. Make sure you quickly determine <u>all assets and all lifetime gifts</u> made by a decedent.

4. Can’t Assign The Income, Can’t Take A Charitable Deduction, Don’t Receive The Cash – The Trifecta Tax Calamity! KEEFER v. U.S. (2022) 130 AFTR 2d 2022-5002 (N.D. Texas) [July 6, 2022]

Short Summary: Taxpayer assigned his 4% limited partnership interest to a donor advised fund (DAF). The assignment specifically limited what was assigned to the proceeds from the sale of real estate owned by the partnership. As of the date of transfer, there was a letter of intent to sell the real estate owned by the partnership. After the transfer to the DAF, a contract for sale of the real estate was executed, and the real estate sold. The good news is that this timing did not trigger the anticipatory assignment of income doctrine. What did trigger the doctrine is that Taxpayer did not transfer his entire interest in the property to the DAF. As such, the income related to the partnership’s sale of real property remained taxable to the taxpayer (even though Taxpayer would receive none of the proceeds). What’s more, Taxpayer failed to meet the added charitable deduction requirement for gifts to DAFs. When gifts are made to DAFs, the contemporaneous acknowledgement of the gift must state that the charity has exclusive legal control over the assets contributed. Thus, Taxpayer trifecta was: (1) received the taxable income; (2) received no income tax charitable deduction; and (3) received none of the sales proceeds related to the real estate. The Trifecta Tax Calamity!

5. When Is A Gift By Check Completed For Transfer Tax Purposes? It Depends On The State DEMUTH V. COMMISSIONER (2022) No. 18724-19 (U.S.T.C.) [Jul. 12, 2022]

Short Summary: Decedent’s son, acting under a power of attorney, wrote 11 checks totaling $464,000 from Decedent’s account to make gifts to family. Decedent died 5 days later. Of the 11 checks, 1 was paid by Decedent’s bank before death, 3 were deposited on date of death (apparently prior to death). Under PA law, a stop order is allowed on a check until the check is paid. That was the case with 10 of the checks. However, IRS conceded the 3 checks ($70,000) deposited on date of death were completed gifts during life. Thus, at issue were the 7 remaining checks ($366,000). For a gift to be complete, Treasury Regulation § 25.2511-2(b) requires the donor to gift up dominion and control and PA law requires the donor to surrender dominion by irrevocable delivery. The Tax Court found these 7 checks were not completed gifts during life because Decedent could stop payment until the moment of death. Thus, the money was includible in Decedent’s estate for estate tax purposes.

6. Formula General Power Of Appointment – A Multi Generational Tax Planning Opportunity

PLR 202206008 (2022) [February 11, 2022]

Short Summary: This PLR involves a grandfathered GST Trust for the lifetime benefit of Settlor's Son, remainder to Son's descendants, and if none, to the heirs at law of Settlor's wife. Trust requires distribution of all income to Son, and trustee can withdraw principal for the maintenance, education, welfare and comfort of any beneficiary or beneficiaries (in sole and absolute discretion of Trustee not subject to question by any person or persons). Disputes arose as to how Settlor's intent could best be fulfilled. After negotiations, the parties obtained a court approved settlement agreement that would, subject to a favorable PLR, modify the trust to grant Son a formula general power of appointment (GPOA). The formula worked so that Son had a general power of appointment over the largest portion of the trust possible that would not cause estate tax to be due in Son's estate. IRS made three rulings regarding modification of the trust pursuant to the court approved settlement agreement granting Son the testamentary formula GPOA: (i) it will not cause the trust to lose its grandfathered GST status or otherwise become subject to the GST tax; (ii) it will not cause trust property to be includible in Son's gross estate; and (iii) it will cause the trust property subject to the GPOA to be included in Son's gross estate under IRC section 2041(a)(2).

7. IRC Section 2053 Deductions – More Limitations On The Way

PROPOSED REGULATIONS 20.2053-1(C)(3) (2022) [June 28, 2022]

Short Summary: In 2009 Treasury issued final Regulations under IRC section 2035 limiting deduction for expenses and claims against the estate to the amounts actually paid in settlement or satisfaction of the item. Those Regulations resolved a split in the Circuit Courts of Appeal, and Treasury specifically reserved space for present value concepts in the computation of IRC section 2053 deductions. These Proposed Regulations, if made final, would do the following: (i) require a present value discount to date of death for certain amounts paid more than 3 years from decedent's date of death; (ii) deny a deduction for interest on unpaid estate tax (non-6166 interest) to the extent the interest is attributable to executor's negligence, disregard of applicable rules or regulations or fraud with intent to evade tax; (iii) deny a deduction for interest on loans incurred by an estate to pay estate tax or expenses of administration unless certain criteria are met (e.g., necessary to incur loan and a bona fide loan – limiting use of *Graegin* loans); and (iv) impose limits on deductions related to decedent's personal guaranties. These Regulations will be effective for estate of decedent's dying on or after the date the Final Regulations are published (so not yet in effect).

8. IRS Changes The Rules On Toggle CRTs – There Is Now Transfer Tax Exposure

ILM 202233014 (2022) [July 12, 2022]

Short Summary: This PLR deals with a testamentary CRUT. CRUTs are split interest trusts. There is: (i) a life or term interest (referred to for purposes of this ILM as the "unitrust"); and (ii) a remainder that passes to charity at the end of the unitrust. At least of portion of the unitrust must be payable to a non-charitable beneficiary. What happens from an estate tax perspective when you force at least 25% of the unitrust to be paid to the grantor's surviving spouse, and allow the other 75% of the unitrust (the "Toggle Amount") to be paid among the surviving spouse and charity? Well, IRS now says that there is no estate tax charitable deduction and no estate tax marital deduction for the Toggle Amount. Thus, the estate will receive a marital deduction for 25% of the unitrust, a charitable deduction for the CRUT remainder, and no deduction for the Toggle Amount (the other 75% of the unitrust amount). Why no estate tax deduction for the Toggle Amount? Because the amount passing to charity and the amount passing to the surviving spouse cannot be determined. This conclusion is contrary to many prior private letter rulings (see PLRs 200813006, 200832017, 201117005 and 201845014).

9. 9100 Relief Available For Late Form 706-QDT

PLR 202202006 (2022) [January 14, 2022]

Short Summary: A QDOT is a marital deduction trust created for the benefit of a surviving spouse who is not a U.S. citizen. If that surviving spouse later becomes a U.S. citizen, then the surviving spouse needs to file a Form 706-QDT. That form must be filed on or before April 15th of the calendar year following the year the surviving spouse becomes a U.S. Citizen. This filing date is set by Treas. Reg. section 20.2056A-10(a)(2). Since the deadline is regulatory (and not statutory), IRS has authority to grant late-filing relief under 9100. In this PLR, IRS granted an extension of time to file until 120 days from the date of the PLR. Note that an extension of time to file Form 706-QDT can be obtained under IRC section 6081 (but one must know to file the form before one knows to request an extension).

10. Is The Life Insurance Valuation Language In Treasury Regulation Section 25.2512-6(a) Mandatory?

DEMATTEO V. COMMISSIONER (2022) No. 3634-21 (U.S.T.C.) [Jul. 21, 2022]

Short Summary: This Tax Court case involves valuation of life insurance policies Taxpayer gifted to trusts for the benefit of Taxpayer's children. Taxpayer filed a motion for summary judgment to determine whether a different valuation method may be used for gift tax purposes. Taxpayer argued that language in Treas. Reg. Section 25.2512-6(a) is discretionary and not mandatory, while IRS argued it is mandatory. The Tax Court found that granting summary judgment would not expedite litigation or avoid an unnecessary trial (depending on certain evidence and findings the issue could become moot), and thus denied the motion for summary judgment.

11. Ability To Be Reimbursed For Income Taxes Paid From IDGT Does Not Make Grantor A Beneficiary Under California Law

AB 1866 – Irrevocable trusts: limitations (2022) [June 21, 2022]

Short Summary: California law generally offers no creditor protection for self-settled creditor protection trusts. Said another way, if the Settlor is a beneficiary of a trust created by the Settlor any provision restraining the voluntary or involuntary transfer of the settlor's interest is invalid against transferees and creditors of the Settlor. This is critical for estate tax purposes because assets subject to claims by decedent's creditors are includable in the decedent's gross estate for estate tax purposes. There was some question as to whether a provision for income tax reimbursement could be included in California IDGTs consistent with Revenue Ruling 2004-64, i.e., does the ability to be reimbursed make the Settlor a beneficiary and thus cause estate inclusion? We thought the answer was "no", but helpfully Probate Code section 15304 is now modified to clarify the question. Now, section (c) provides that, "the settlor shall not be considered to be a beneficiary of an irrevocable trust created by the settlor solely by reason of a discretionary authority vested in the trustee to pay directly or reimburse the settlor for any federal or state income tax on trust income or principal that is payable by the settlor, and a transferee or creditor of the settlor shall not be entitled to reach any amount solely by a reason of that discretionary authority."

12. Non-Resident Trusts Taxed On Income From S Corporation's Sale Of Goodwill

J.P. MORGAN TRUST CO. OF DELAWARE V. FRANCHISE TAX BD. (2022) 79 Cal. App. 5th 245. [May 27, 2022]

Short Summary: This case involves California income taxation of two trusts, the "Family Trust" and the "Evan Trust." Each trust was a shareholder in Pabst, a Delaware corporation taxed as an "S" corporation. Further, Pabst was a "unitary" business, meaning it was two or more business entities commonly owned and integrated in a way that transfers value among the affiliated entities. Unitary businesses are subject to special rules to determine the amount of value or income taxable in California.

Pabst sold its wholly owned subsidiary "Holdings" (which in turn wholly owned two subsidiaries). Pabst treated the sale as an asset sale, classified the income as "business income," and apportioned income from the sale 6.6% to the State of California. Each trust received a California K-1 from Pabst with 99% of the income reported to each trust identified as long-term capital gain from the sale of brand and intangibles, i.e. intangible goodwill.

Each trust was a nonresident of California, i.e., neither had a California resident fiduciary and neither had any California resident noncontingent beneficiary. After receiving the California K-1's, the trustee filed Forms 541 with the State of California and paid $3.6 million in California income tax. The trusts subsequently filed amended Forms 541seeking refunds of the amounts paid.

The FTB denied the refunds, the Office of Tax Appeals issued a decision upholding the FTB's decision to deny the refunds. The trusts then filed action in the California Court of Appeal against the FTB for the refunds. The trusts and the FTB each filed motions for summary judgment.

The trusts argued that as nonresidents of California, the income was not taxable to them. Further, even if the income was California source income, it was not taxable to them. This is because it was from the sale of intangibles and Rev. & Taxation Code section 17952 (and the 2001 *Valentino* case) applies. That section reads as follows:

"For purposes of computing "taxable income of a nonresident or part-year resident" under paragraph (1) of subdivision (i) of Section 17041, income of nonresidents from stocks, bonds, notes, or other intangible personal property is not income from sources within this state unless the property has acquired a business situs in this state, except that if a nonresident buys or sells such property in this state or places orders with brokers in this state to buy or sell such property so regularly, systematically, and continuously as to constitute doing business in this state, the profit or gain derived from such activity is income from sources within this state irrespective of the situs of the property."

The Appellate Court denied the trusts' motion for summary judgment, and granted the FTB's motion for summary judgment, finding as follows: (1) California taxes nonresidents on income derived from sources within this state; (2) the California Regulations (Reg. 17951-2) defines income from sources within California to include income from goodwill, trademarks, or trade-brands having a taxable or business situs in California; (3) the California Regulations (Reg. 17951-4) require the distributive share of business income of an S corporation be apportioned at the corporate level in accordance with the Uniform Division of Income for Tax Purposes Act ("Uniform Act", § 25120 et seq.) and is taxable to the shareholder under the Unform Act as if the income producing activity were undertaken by the shareholder; (4) the distributive share of income that is not business income is determined under the rules of Sections 17951 through 17955 and taxable to the shareholder under those rules as if the income producing activity were undertaken by the shareholder; and (5) even if section 17952 were the applicable section for this business income, the goodwill had a business situs in California because the S corporation's corporate headquarters were in California, the underlying businesses based marketing and sales departments in California, and the S corporation localized the goodwill in connection with its California business.

SUPPLEMENTA MATERIALS

IMPORTANT RULES SO THE ENTITY IS RESPECTED

Need a Business Purpose. It is necessary to have non-tax purposes. These can include:
:

1. Retaining certain assets within the family for a longer period of time.
2. Providing a vehicle for pooling investments for a family, including minimizing investment cost.
3. Creditor protection (including from a divorce).
4. Maintaining centralized management to allow a consistent investment strategy for family assets.

Bad Facts Make Bad Law. Be mindful of these rules**:**

Need sufficient assets to be held outside of the entity.

Proper entity formation and respect.

Ensure that funding is done.

Take time between the steps.

Respect the entity including filing tax returns and opening bank accounts.

Do not commingled assets.

Do not put personal assets in the entity – it should not hold everything.

All distributions and allocation should be pro rata

No payment of personal expenses from the entity for the founder.

No payment of estate taxes from the entity on the founder staff.

Do not form when the taxpayers incapacitated.

Do not form when using a POA.

Document all gifts properly.

Avoid a family member as the lawyer.

Consider using independent counsel for the family members.

New Proposed Regs under IRC Section 2053.

On June 28, 2022, the IRS published Proposed Regulations under Section 2053 which replace the prior regulations finalized in October of 2009. The Proposed Regulations provide guidance on various areas. One such area is the use of present-value principles in determining the amount deductible by an estate for funeral expenses, administration expenses, and certain claims against the estate. In addition, the Proposed Regulations provide guidance on the deductibility of interest expense accruing on tax and penalties owed by an estate, and interest expense accruing on certain loan obligations incurred by an estate. The Regulations also amend and clarify the requirements for substantiating the value of a claim against an estate that is deductible in certain cases. Finally, the Proposed Regulations provide guidance on the deductibility of amounts paid under a decedent's personal guarantee. It is believed that limiting the amount deductible to the present value of the amounts paid after an extended post-death period will more accurately reflect the economic realities of the transaction, the true economic cost of that expense or claim and the amount not passing to the beneficiaries of the estate.

The Proposed Regulations provide a general three-year safe harbor before any present value discounting will be required. This three-year period "takes into account a reasonable time for administering and closing the estate," while not being an overly long amount of time such that the lack of present value discounting would significantly distort the value of the net (distributable) estate. Thus, applying present-value principles in computing the deductible amount of those claims and expenses paid more than three years after the decedent's death "strikes an appropriate balance between benefits and burdens."

The discount rate is the applicable federal rate determined under IRC Section 1274(d) for the month in which the decedent's date of death occurs, compounded annually. Similarly, a liability or expense that is paid more than three years before the anniversary date of the decedent's date of death would be discounted under the Proposed Regulations by the applicable federal rate applicable to the month in which the decedent's death occurs, compounded annually. The midterm applicable federal rate would be used if the liability or expense is expected to be paid between more than three to nine years after the decedent's death, and the long term applicable federal rate will apply if the liability or expense is expected to be paid more than nine years after the date of death.

The Proposed Regulations indicate "reasonable assumptions and methodology can be used" to calculate the present value of the post-grace period payment(s). The revisions and additions are added to Treas. Reg. Section 20.2053-4. They include the need for an appraisal to support the value of the claim which: 1) adequately reflects post-death events that have occurred prior to the date on which a deduction is claimed on an estate's Form 706; 2) *r*eports, considers, and appropriately weighs all relevant facts and elements of value as are known or are reasonably determinable at the time of the appraisal, including the underlying facts of the claim against the estate, potential litigating risks, and the current status of the claim and procedural history; 3) takes into account post-death events reasonably anticipated to occur; 4) identifies an expected date or dates of payment (for purposes of determining the applicability of the present value limitation in § 20.2053-1(d)(6)); and 5) explains in detail the methods and analysis that support the appraisal's conclusions.

When gifts or assets are valued in a decedent's gross estate, courts routinely determine fair market value by looking at transactions occurring after the gift or decedent's date of death, but only if these facts were reasonably foreseeable. Similarly, courts should be permitted to value a deduction under Section 2053 by incorporating relevant post-death facts when interpreting the date-of-death value of a claim.

The Proposed Regulations also provide guidance on calculating the present value of amounts paid or payable, with respect to the grace period under Treas. Reg. Section 20.2053-1(d)(6).

The Proposed Regulations also address personal guarantees and provide that any claims that are based upon the decedent's promise to pay will be deductible only if the promise represents: 1) a personal obligation of the decedent existing at the time of the decedent's death; and 2) the claim must be enforceable against the decedent's estate. A deduction for a claim based upon a promise or agreement is limited to the extent that the promisor's agreement was bona fide and in exchange for adequate and full consideration in money or money's worth. The promisor agreement must have been bargained for at arm's length and the price must have been an adequate or full equivalent reducible to money value. Note, this does not follow state law where an agreement is still enforceable without this requirement.

The Proposed Regulations also discuss the decedent's promise to guarantee a debt of an entity that the decedent had an ownership interest in and indicates that this will satisfy the requirement that it be in adequate and full consideration if at the time the guarantee was given, the decedent had control of the entity as defined in IRC Section 2701(b)(2), or to the extent that the maximum liability of the decedent under the guarantee did not exceed the fair market value of the decedent's interest in the entity at the time the guarantee was given. The Proposed Regulations provide an example. See Example 10-Guarantee. Also, the estate's right of contribution or reimbursement will reduce the amount deductible in a guarantee situation. Payments made to actually satisfy the guarantee after the death of the decedent will be deductible "only to the extent that the debt for which the guarantee is given has not been taken into account in computing the value of the gross estate" under Treas. Reg. Section 20.2053-7 or otherwise.

The Regulations also set forth substantiation requirements for valuations of a claim against an estate. Treasury Regulation Section 20.2053-4(b) and (c) provide exceptions to the general rule that an estate may only deduct amounts that actually are paid by the estate in satisfaction of a claim. Treas. Reg. Section 20.2053-4(b) generally allows a deduction for the value of claims and counterclaims in a related matter, and Tres. Reg. Section 20.2053-4(c) provides a safe harbor which allows a deduction for the value of unpaid claims totaling not more than $500,000. Under each of these exceptions, certain requirements must be satisfied to allow the estate to make use of these exceptions.

One such requirement is that the value of a claim against the estate that is deductible under either Treas. Reg. Sections 20.2053-4(b) or (c) must be determined by a “qualified owner” or “qualified appraisal” performed by a “qualified appraiser” based upon the definitions that apply in the charitable income tax rules under IRC Section 170. As most are aware, these are very strict and onerous rules. The Treasury and IRS have determined that the rule requiring that a “qualified appraisal” be performed by a “qualified appraiser” be replaced with the requirement of a written appraisal that adequately reflects the current value of the claim when the Form 706 estate tax return is completed. The current value of the claim should take into account both post-death events occurring prior to the time a deduction is claimed as well as those events “reasonably anticipated to occur.”

The Proposed Regulations also attack “Graegin loans”. These are debts incurred by an estate to pay administration expenses in order to prevent unwanted liquidation of estate assets to pay estate taxes and other expenses. The government acknowledges that some estates have valid liquidity issues that make it necessary to find a way to satisfy their liabilities and incurring a loan obligation (with interest) may be the only or best way to obtain the necessary liquid funds. However, if liquidity exists prior to the creation of the loan obligation to pay estate expenses and liabilities, the underlying loan may be bona fide but “most likely will not be found to be actually and necessarily incurred in the administration of the estate.” Under these regulations, interest expense is only deductible if: 1) the interest accrues pursuant to an instrument or contractual arrangement that constitutes indebtedness under applicable income tax regulations and general principles of federal tax law; 2) both the interest expense and the loan on which interest expense accrues satisfy the requirement of Treas. Reg. Section 20.2053-1(b)(2) that they are bona fide in nature; and 3) the loan on which interest accrues and the loan's terms are actually and necessarily incurred in the administration of the decedent's estate and are essential to the proper settlement of the decedent's estate (within the meaning of Treas. Reg. Section 20.2053-3(a)).”

The IRS is looking at actions taken after death that may create illiquidity, as well as estate planning during the decedent’s lifetime that caused post-death illiquidity. For example, estate plans with irrevocable life insurance trusts (ILITs) which are commonly used to as a source of liquidity, outside of a decedent’s taxable estate, may be impacted. Under the Proposed Regulations, without a modification to exclude ILITs, this estate planning technique could limit an estate’s interest deductions because of the pre-death funding arrangement. A non-exhaustive list of factors are considered in determining whether interest expense payable pursuant to such a loan obligation of an estate satisfies the requirements of Treas. Reg. Sections 20.2053-1(b)(2) and 20.2053-3(a).

In general, interest is payable at the underpayment rate in IRC Section 6621 on 1) Any amount of unpaid federal tax; and 2) Any unpaid additions to tax, additional taxes, and penalties (such interest referred to in the Preamble as "Section 6601 interest" and such penalties collectively referred to as "penalties"). According to the Preamble of the Proposed Regulations, the IRS has determined that interest payable on unpaid estate tax in connection with IRC Section 6161 or a deferral under IRC Section 6163 is necessarily incurred in the administration of the estate. Additionally, the Proposed Regulations acknowledge that interest on estate tax installment payments that are authorized under Section 6166 are not deductible for estate tax purposes. Not surprisingly, the Proposed Regulations go on to note that when interest accrues on any unpaid tax or penalty and the interest expense is attributable to an executor's negligence, disregard for the rules or regulations, or fraud with intent to evade tax, the interest expense is neither actually and necessarily incurred in the administration of the estate nor essential to the proper settlement of the estate. The Treasury Department and IRS have determined that this rationale applies to all non-Section 6166 interest, whether the interest accrues in connection with a deferral, underpayment, or deficiency.

The rules in the Proposed Regulations pertaining to whether non-Section 6166 interest satisfies the requirement in Treas. Reg. Section 20.2053-3(a) supplant the rule reflected in Rev. Rul. 79-252, 1979-2 C.B. 333, and in the second holding of Rev. Rul. 81-154, 1981-1 C.B. 470. Together, these two holdings create an implicit presumption that interest accruing on any unpaid portion of tax or penalties in all cases satisfies the requirements to deduct an administration expense, which is inconsistent with the requirement in Treas. Reg. Section 20.2053-3(a) that the expense must be actually and necessarily incurred in the administration of the estate.

Comments can be submitted before these take effect later this year and like with the prior Regulations, it is anticipated that the government will receive a number of comments.

<u>IRS Publishes An Addition To Its Audit Manual Related To Self-Dealing Rules.</u>

On June 29, 2022, the IRS published a non-precedential addition to its manual materials for auditors to discuss if and when monies spent from or transactions entered into between an individual taxpayer and an exempt private foundation will violate the self-dealing rules. The update notes that public recognition that a person or company receives from the charitable activities of a private foundation to which such person has contributed will not "by itself result in an act of self-dealing since generally the benefit is incidental and tenuous. It also indicates that a scholarship or fellowship grant to a non-disqualified person will not be an act of self-dealing when made by a private foundation "in accordance with a program to award scholarships or fellowship grants to the children of employees of a substantial contributor." Reference is made to Revenue Ruling 80-310, where the grant by a private foundation to a university to establish an educational program in manufacturing engineering did not constitute an act of self-dealing because any benefit to the corporation, a disqualified person was incidental. See also Treasury Regulation Section 53.4945-4(b)(5).

Revenue Ruling 77-331 is also referenced which states that general reputation or prestige enhancement that is caused by public acknowledgment of donations is a relatively minor benefit "in the fruits of some charitable program that is of broad public interest to the community." The manual entry also states that a foundation can give its proxy for voting rights at an annual shareholder meeting to the subject company whose stock is being voted when the management of the company includes disqualified persons. Additionally, the Manual cites Treasury Regulation Section 53.4941(d)-2(f)(9), Example 4 and Revenue Ruling 73-407, 1973-2 to support the proposition that the naming of a recreational center after a substantial donor as a condition of a gift and a contribution by a private foundation to a public charity that requires the public charity to change its name to that of a substantial contributor for one-hundred (100) years have been held to not constitute self-dealing by the IRS.

There are also a series of "audit tips" provided which is suggested that an auditor can use to detect private foundation self-dealing. These include such items as reviewing grants to ensure that any disqualified person has no connection to the organization receiving the grant, reviewing certain sections of the Form 990, review assets on the balance sheet to ensure no use by a disqualified person and a variety of others. These should be reviewed if an audit of a Private Foundation is occurring.

INTRA FAMILY NOTES

Bona Fide Loans. There are many issues currently in audit and appeals regarding notes. Some of the general guidelines determining whether there is a bona fide loan or gift are provided below.

- The Service may treat the transfer of assets and property between family members as a gift, although a promissory note was given in return for the transfer. If the loan is not bona fide or there appears to be an intention that the loan would never be repaid, the Service will regard the transfer as a gift.
- Transfers between family members are presumed to be gifts unless the transferor can prove the receipt of "adequate and full consideration in money or money's worth." (Treasury Regulations Sections 25.2512-8; 25.2511-1(g)(1)).
- However, a taxpayer may rebut that presumption by showing that, at the time of the transfer, the transferor had:
    - A real expectation of repayment and
    - An intention to enforce the loan. (*Estate of Lockett v. Commissioner*, T.C. Memo 2012-123 (April 25, 2012),
- The U.S. Tax Court considered the following factors to determine a real expectation of repayment and an intention to enforce the loan:
    - Whether there was a promissory note or other evidence of indebtedness,

- Whether interest was charged,
- Whether there was any security or collateral,
- Whether there was a fixed maturity date,
- Whether a demand for repayment was made,
- Whether any actual repayment was made,
- Whether the transferee had the ability to repay,
- Whether any records maintained by the transferor and/or the transferee reflected the transaction as a loan, and
- Whether the manner in which the transaction was reported for federal tax purposes is consistent with a loan.

Valuation and discounting. Gift and Estate Tax Regulations for valuing notes generally provide that notes can be valued at less than face value plus accrued interest if the donor or estate demonstrates by "satisfactory evidence" that the value is lower. The IRS has conceded in Technical Advice Memoranda that notes need not necessarily be valued at their face amounts.

Treas. Regs. §20.2031-4. For estate tax purposes, the fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus accrued interest, unless the executor establishes that the value is lower (because of the interest rate, date of maturity, or other cause) or that the notes are uncollectible in whole or in part or worthless. If not returned at face value, plus accrued interest, satisfactory evidence must be submitted that the note is either worth less than the unpaid amount or that the note is uncollectible, either in whole or in part, and any property pledged as security is insufficient to satisfy the obligation.

Treas. Reg. Section 25.2512-4. For gift tax purposes, the regulations provide, "the fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus accrued interest to the date of the gift, unless the donor establishes a lower value. Unless returned at face value, plus accrued interest, it must be shown by satisfactory evidence that the note is worth less than the unpaid amount (because of the interest rate, or date of maturity, or other cause), or that the note is uncollectible in part (by reason of the insolvency of the party or parties liable, or for other cause), and that the property, if any, pledged or mortgaged as security is insufficient to satisfy it."

Considerations. Below are eight specific consideration for valuing mortgage and promissory notes as found in *Technical Advice Memoranda 8229001*. Estate, gift, and income tax cases that illustrate these factors follow.

Presence or lack of protective covenants. The more onerous the restrictions on the borrower, the lower the risk for the lender and the lower the required discount);

Nature of the default provisions and the default risk. The default risk is lower and the discount is lower if the borrower has better coverage for making payments, evidenced by factors such as interest coverage ratios, fixed-charge coverage ratios, and debt-equity ratios. The more stringent the default provisions under the note, the lower the risk to the lender then the lower the discount;

Financial strength of the issuer. The key financial ratios mentioned above and current economic conditions, including financial strength of any parties giving guarantees are important, strong financials indicate lower risk and lower discounts;

Value of the security. The higher the value of the security, the lower the risk for the lender and the lower the discount;

Interest rate and term of the note. This analysis goes beyond just determining if the interest rate on the note equals the current market rate. An increase in market interest rates during the term of the note will decrease the value of the note. The longer the term of the note, the more exposed the holder is to interest rate increases and the greater the discount on the note or the higher the required interest rate to offset this risk;

Comparable market yields. The yields from various types of financial instruments may be considered. The most comparable debt instrument is used and adjustments are made for specific risk differences from the comparable instrument. There may be fewer comparables for private transaction notes;

Payment history. If payments are current and are made timely, especially if there is a lengthy history of timely payments, the risk for the lender is lower and the discount is lower; and

Size of the note. There are conflicting impacts here. The borrower may have more ability to repay smaller notes, on the other hand small notes are not as likely to be from larger companies with exceptional financials. Plus, the market for potential buyers of small notes is very limited. Hence, smaller notes may call for varying discounts.

IRC Section 7872. This section provides rules for determining the amount of gifts incurred when making below-market loans. The gift amount is the amount of the forgone interest. I.R.C. §7872(e)(2). The statue does not address other factors that may impact the value of the notes –it just addresses how much gift results as a result of using an interest rate that is lower than the appropriate AFR. For example, the statute does not address the gift tax implication of a note that has an interest rate that is equal to or greater than the AFR.

Even following the adoption of IRC Section 7872, the value of notes are also often discounted using the same factors stated in the general estate tax regulations other than the interest rate used in the notes. There are no proposed regulations issued in conjunction with IRC Section 7872 that override the general gift tax valuation principles for notes under Treas. Reg. Section 25.2512-4. Prop. Reg. Section 25.7872-1, addresses the gift tax implications of below market loans under IRC Section 7872, makes no reference to discounting the value of loans for reasons other than comparison of the interest rate on the note to the AFR. The proposed regulations under IRC Section 2512, issued simultaneously with the proposed regulations under IRC Section 7872, simply reference IRC Section 7872.

Case Law and Other Authority for Gift and Estate Tax Issues. Below are cases and other authority discussing both gift and estate tax issues.

Nath v. Commissioner, T.C. Memo 2023-22 February 27, 2023. Here, advances on future income are taxed when received and are not bona fide loans. However, advances can be bona fide loans where there is the traditional obligation to repay and where other factors are met. In this case, the taxpayer was on both sides of the exchange (approved distribution of funds on the business entity side and was the receiver of funds), hence the court found that special scrutiny was required in such an instance and no bona fide loan existed.

Zorn v. Commissioner, 2023 U.S. Tax Ct. LEXIS 440 January 23, 2023. The Court considered multiple factors such as the ability of borrower to repay; existence/nonexistence of debt instrument; security/interest/repayment date and schedule; records and conduct reflecting the transaction; any repayment by borrower; if lender demanded repayment; likelihood of disguised compensation for services; and testimony of borrower and lender. No one factor is determinative and the list of factors are non-exclusive. The facts in this case however only had one fact in support of a finding of a loan ("loan" written on memo line of checks) yet there were many facts against a finding of a loan ("lender" intent that the funds be an investment, no repayment or demand for repayment, no interest security or debt instrument). Hence no loan existed.

Deitch v. Commissioner, T.C. Memo 2022-86 August 25, 2022. In this case there were multiple factors in favor of a loan arrangement. There were arguments that it could create a joint venture, but in the end the IRS stipulated to a bona fide loan before trial.

Estate of Bolles v. Commissioner, T.C. Memo. 2020-71. Here the issue was whether advances in amounts over $1 million should be treated as loans or as gifts and whether there was an expectation of repayment and intent to enforce the debt. The Decedent, Mary Bolles, provided payments to her children. She kept a person record of her advances and ttreated the advances as loans, and forgave the debt account of each child every year on the basis of the gift tax exemption amount. At the time of decedent's death, Mary and her five children were all beneficiaries to the Bolles Trust. Peter, one of the Decedent's children, was experiencing financial difficulties, and entered into an agreement with the Bolles Trust to use trust property as security for $600,000 in bank loans. The agreement also shows that Peter owed the Bolles Trust $159,828 in back rent, and Peter failed to meet the loan agreements. Decedent transferred over $1 million from the years 1985-2007 to Peter. Peter did not repay the decedent. In 1994 decedent began working with an attorney who assisted her in organizing financial affairs. Decedent signed estate planning documents that did not exclude Peter from distribution but added a formula to account for the "loans" that decedent made to him. The formula adds that the amount of distribution received by the beneficiaries would be reduced by the amount of outstanding loans owed to the trust. The Court first addressed an alternative argument on whether or not interest on the advances may be included in the adjustments. The court states that since the notice of deficiency does not state the interest on the loans, then it should not be included in the adjustments. The Court then addresses the second issue regarding burden of proof on the petitioner regarding the gift issue. The Court finds the issue moot as the case permits a resolution on the record of the trial. The Court finally addresses whether or not the advances were loans or gifts. The Court states that for family loans to be characterized as loans, then there must be an expectation of repayment and intent to enforce the debt. The decedent made no loan agreements or attempt to enforce payments of the loans. It is also clear that the Decedent realized that Peter would not repay the loans by 1989. Accordingly, the amounts of money payed through 1989 were loans due to an expectation of repayment, but the payments after that were gifts. She also never enforced repayment after this time.

Estate of Duncan v. Commissioner, T.C. Memo. 2011-255. The Tax Court observed that under fiduciary principles, an irrevocable trust would be questioned for loaning money to another trust (even having the same trustee and beneficiaries) if the interest rate was not greater than the AFR, because the AFR is based on the yield on U.S. government obligations. The court was asked to determine whether interest paid on a "Graegin loan" could be deducted as an administrative expense for estate tax purposes. Here, an irrevocable trust created by the decedent's father loaned $6.5 million to the decedent's revocable trust in order to pay estate taxes. The $10.7 million of interest that was due on the loan at the end of 15 years was deducted. Among other things, the IRS argued that the 6.7% interest rate under the note exceeded the long-term AFR of 5.02% and was unreasonable. The court disagreed, stating that a note from the revocable trust is obviously a riskier investment than a government obligation and therefore a higher interest rate than the AFR is justified. The court emphatically said that using the AFR "would have been unfair to the Walter Trust."

Estate of Reynolds v. Commissioner, 55 T.C. 172 (1970). Here, units in a voting trust sold to two of decedent's children for three separate $50,000 secured notes with terms of 10-15 years and no interest except that 4% interest rate applied to late payments. $30,000 of payments were made on each of two the notes and $27,000 of payments were made on the third note. The court agreed with the IRS that the value of each of the notes was only $30,000 and the excess values of the voting trust units over $30,000 constituted gifts. The factors included interest free nature of the note unless a payment was made due to default, large note amounts, ability of children to repay, no interest was ever paid, prevailing interest rates in the years of the transfers, and no showing that any additional payments were ever made on the notes.

Estate of Berkman v. Commissioner, T.C. Memo. 1979-46. This case dealt with unsecured 6% notes from family members with twenty-year terms and balloon principal payments. At the end of the twenty-year term, the borrowers made timely interest payments and were good credit risks. The IRS disallowed any discount from face. The court allowed discount-to-face for estate tax purposes of 50-60% of various notes focusing on low rate of interest because prime rate was 9.75% at death and long term of notes. The discount for gift tax purposes was lower (15%-25%) because the prime rate was only 7% at the date of the gift.

Estate of Smith v. Commissioner, 923 F. Supp. 896 (S.D. Miss. 1996)). In valuing a promissory note that a publicly-held Fortune 500 company owed to the decedent, bearing 6% interest and annual principal payments of about 10% of the face value of the amount of the note at date of death, the court accepted the estate appraiser's methodology. This methodology determined the value of payments based on a discounted cash flow basis, starting with a discount rate of 10.09% then adjusted to 16% rate to account for differences between the note and publicly-traded debt. A 20% lack of marketability discount factor was also applied.

Scher v. United States, 39 AFTR 2d 77-1580 (D.N.J. 1976)). Here, corporate notes were valued at face value at death although the corporation may have been insolvent at that time. Pursuant to 26 C.F.R. Section 20.2031-1(b), the fair market value is the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. According to the court, the requirement that the hypothetical willing but uncompelled buyer and seller used in the market value test have knowledge of relevant facts, does not contemplate knowledge of insider information. It encompasses only punitive knowledge of that data available in the marketplace. Thus, the notes were not worthless merely by the corporation's insolvency because the corporation at that time had a good credit reputation, was paying notes when presented, and potential lenders would not have a need to check the corporation's actual financial status.

Estate of Hoffman v. Commissioner, T.C. Memo. 2001-109. There was a dispute as to the value of two unsecured promissory notes issued from a family partnership held by decedent with a twenty-year term. The IRS and estate appraiser both used a discounted cash flow approach to value the notes. The difference in value between the two was the fair market value discount rate used. The court adopted the IRS appraiser's approach of using a 12.5% discount rate after considering interest rates associated with various debt instruments. At the time, the prime rate was 6% and Treasury yields ranged from 3 to 6%. The court found that the borrower had enough assets to pay off notes at maturity, and that the 12.5% discount rate incorporated the nonmarketable nature of the notes.

Estate of Luton v. Commissioner, T.C. Memo. 1994-539. The court valued the decedent's 41.9% interest in a liquidating trust, the primary asset of which was an unsecured 10% promissory note payable over about 11 years from a company in good financial condition. The court rejected the estate's argument for discounts due to its comparison of bond yields of similar grade and for lack of control. Here, the decedent could sue to compel trustee to sell the note it is retention was impudent under state law. The court allowed a 10% discount in valuing 41.9% interest in liquidating trust for lack of marketability.

Estate of Friedberg, T.C. Memo. 1992-310. A corporation redeemed shares of Rule 144 restricted stock from estate for a down payment and five-year note bearing interest at the short-term rate under IRC Section 6621(b). The IRS was willing to allow only 1% discount on note. The court allowed a 32% discount from face considering: the rate of interest, payment schedule, financial covenants, reporting requirements, restriction that payments could not exceed 15% of the corporation's cash flow in any year, noteholder's possible remedies, corporation's financial condition, yields on comparable securities, and nature of the secondary market for private notes.

Sam Broadhead Trust v. Commissioner, T.C. Memo. 1972-196. The court did not allow any discount from face value plus accrued interest because the estate failed to offer any evidence of a lower value.

Estate of Duncan v. Commissioner, T.C. Memo. 2011-255. The Tax Court reasoned that under fiduciary principals, a trustee of an irrevocable trust would be questioned for loaning money to another trust if the interest rate was not greater than the AFR. This was due to the fact that the AFR is based on the yield on U.S. government obligations. This was true even if the other trust had identical trustees and beneficiaries

Technical Advice Memorandum 9240003. Here, a note was valued for estate tax purposes. The note from the decedent's nephew had a face amount of $215,000 and was cancelled in the decedent's will. It was concluded that the note was worth significantly less than face value because of its uncollectability. Also, and very important, it was determined that the cancellation did not result in taxable income to the nephew because the cancellation was in the nature of a gift.

Frazee v. Commissioner, 98 T.C. 554 (1992). Under IRC Section 7872, a note that bears interest that is equal to or greater than the AFR will not be treated as a gift, merely because of the interest rate that is used on the note. The IRS applied this reasoning here and has continued to consistently applied that position in subsequent private letter rulings.

Helvering v. American Dental, 318 U.S. 322 (1943) held that where a creditor gratuitously forgives a debt, the forgiveness is a gift and not income.

Commissioner v. Jacobson, 336 U.S. 28 (1949) holding that where a creditor cancels a debt involuntarily in an arm's length setting, the cancellation is income and not a gift.

True v. Commissioner, T.C. Memo. 2001-167 The court held that IRC Section 7872 applied to determine the gift tax consequences of a purchase under a buy-sell agreement providing for a note to defer payment, aff'd on other grounds, 390 F.3d 1210 (10th Cir. 2004)

More on Income Tax. Taxpayers want their cake and to eat it too-reducing gift/estate tax but avoiding cancellation of indebtedness income under IRC Section 108 when and if note payments are received that exceed the reported value of the note. The general rule under 108 as to related party debt is as follows:

If a debtor acquires its own debt for less than the amount owed, unless some exception applies, the debtor has COD income. Treas. Reg. §1.61- 12(c)(2)(ii) (when debtor acquires its own debt for less than the adjusted issue price debtor realizes COD income in the amount of the excess of the adjusted issue price over the acquisition price).

IRC Section 108(e)(4) and the Treasury Regulations issued under IRC Section 108(e)(4) expand this rule by treating the debtor as acquiring debt acquired by certain persons related to the debtor. Whether or not the person is "related" to the debtor is determined under IRC Sections 267(b) and 707(b)(1) with a modified definition of "family" and a special rule for entities treated as a single employer under IRC Sections 414, 108(e)(4)(A), (B), and (C).

The debt must be acquired from someone who is not "related" to the debtor to avoid CODI IRC Section 108(e)(4)(A).)

The debt may be acquired directly by a related person or "indirectly" in a transaction in which a holder of the debt becomes related to the debtor after having acquired the debt in anticipation of becoming related to the debtor. Treas. Reg. §1.108-2(c).

Although whether debt was acquired by a holder in anticipation of becoming related to the debtor is generally a question to be determined based on the facts and circumstances, debt is deemed to be acquired in anticipation of becoming related to the debtor if the holder of the debt acquired the debt less than six months before becoming related to the debtor. Treas. Reg. §1.108- 2(c)(2) and (3).

The regulations require disclosure by the debtor in certain other circumstances thought by the Treasury to indicate an indirect acquisition of indebtedness by a related person. Treas. Reg. §1.108-2(c)(4).

Exceptions to the related-party COD income rules exist for (i) debt with a stated maturity date that is within one year of the date the debt is acquired by the related person (or, in indirect acquisitions, the date the unrelated holder of the debt becomes a related person) and that is retired by the maturity date and (ii) debt acquired by securities dealers in the ordinary course of business. Treas. Reg. §1.108-2(e)(1),(2).

In direct acquisitions by a related person, the amount of the debtor's COD income is generally measured by reference to the basis of the related person in the debt on the date the related person acquired the debt. Treas. Reg. §1.108-2(f). More complicated rules apply to determine the debtor's COD income when the acquisition is an "indirect" acquisition or the debt is substituted basis property in the hands of the holder under section 7701(a) (42).

As such – with respect to the acquisition of debt by the debtor or by an affiliate from a related party, e.g., mom – for less that the full amount of the debt – this could result in cancellation of debt income. However, pursuant to IRC Section 102 – an exception to the recognition of CODI – is a gratuitous transfer of the debt – if gratuitous there is no income for purposes of IRC Section 108, however there is a gift for other purposes. If the notes are valued and determined to be valued at less than face value – then the excess value of the note over the current fair market value – is not a gift at all. It is not being gratuitously transferred – and therefor the presumption is that it is CODI.

But, it is not that simple. If a discount in valuation of a note is allowed for estate tax purposes, the note will take a new basis equal to the discounted estate tax value. Therefore, the holder of the note will recognize ordinary income when payments are made, to the extent that the payments exceed the discounted value of the note used for estate tax purposes. For example, Mom lends Child $2,000,000 at the then AFR of 6 percent. When she dies, the value of the note is $700,000, due to valuation issues, even though $1,000,000 is still outstanding. If the note's value for estate tax purposes is $700,000, then when the $1,000,000 is paid, the recipient will have ordinary income of $300,000. If the note is distributed to Child, Child will have cancellation of indebtedness income of $300,000 on the distribution.

The result should be different if an individual receives the note by gift. Under the dual basis rules of IRC Section 1015, the donee's basis in the note would be the donor's basis for purposes of determining the amount of any gain. Therefore, the reduction in value of the note at the time of the gift would not result in a decreased basis for purposes of determining later gain on the note. Note, under IRC Section 1015, the basis for a donor on a gift is the basis in the hands of the donor. So, the donee receives the donor's basis. There are only adjustments downward to basis in a gift situation to FMV if there is a loss reported. Under, the note scenario, no loss would be reported-income is arguably being avoided and IRC Section 1015 does not cover that. So, for income tax purposes, there is in fact a difference in the treatment if the note is gifted versus received as of the date of death.

So, in our prior example, Mom lends Child $2,000,000 at the then AFR of 6 percent. She then gifts the note at a value of $700,000, due to valuation issues, even though $1,000,000 is still outstanding. If the note's value for gift tax purposes is $700,000, then when the $1,000,000 is paid, the recipient will not have ordinary income of $300,000. If the note is distributed to Child, Child will not have cancellation of indebtedness income of $300,000 on the distribution. This is because on a gift Child has the carry over basis of his mom.

Olster v. Commissioner, 79 T.C. 456 (1982), aff'd 751 F.2d 1168. In this case, husband promised to execute promissory note secured by mortgage to wife as a lump sum settlement of past and future alimony payments. IRS attempted to value the notes at face value, but the court determined that the notes were worthless. The note bore an interest rate of 6%, it was payable within one year, it was secured by a mortgage on a parcel of land that was unsuitable for development, at the time of transfer husband was in dire financial straits, and hsband failed to make payments when due.

Kronenberg v. Commissioner, 64 T.C. 428 (1967). This case was an income tax case valuing debt issued by a company in a liquidation. The note was interest-free, nonnegotiable, with no set date for repayment, and the debtor had limited financial resources. The court allowed 37.5% discount from face.

Clayton v. Commissioner, T.C. Memo. 1981-433. An 80% discount on notes was issued as low-interest second mortgages with terms of up to 30 years to facilitate the purchase of homes by high-risk individuals who could not pay down payments and who had a history of being delinquent on payments, small balances on the note meant that foreclosure proceedings were not economically feasible.

Scott v. Commissioner, T.C. Memo. 1979-29. The taxpayer valued a note at a 70% discount based on the sale of a similar note in arm's length transaction. The court concluded that the taxpayer did not show sufficient similarity to the prior transaction and allowed a 30% discount based on the nonrecourse nature of the note, subordinated status of lien, limited nature of security and subsequent default of maker.

ADEQUATE DISCLOSURE

Estate and Gift Tax Returns:

- Gift Tax. According to IRC §6501(c)(9), the statute of limitation for gifts does not toll as to an item reported on a gift tax return unless the item is disclosed in a manner adequate to apprise the IRS of the "nature of the gift and the basis for the value so reported."
- Estate Tax. Although the gift tax "qualified appraisal" rules of Treas Reg §301.6501(c)-1(f)(3) do not apply to the estate tax return, they can serve as a guide.

<u>Remember the Importance of an Appraisal:</u>

Without a valid appraisal IRS will likely audit the return and well respected appraisers lower the audit risk. Poor documentation and inexperienced appraisers increase the audit risk. No taxpayer wants to be low hanging fruit due to no appraisal or an inadequate appraisal. Also, without an appraiser there will be issue if a trial occurs or with a poor appraisal you are stuck with them at trial. The appraiser must be qualified in the asset being valued. The appraisal should be clear and well-reasoned by setting out the background of the business, discuss any agreements and relevant issues and provide data that is properly analyzed.

<u>Remember Jospehine Thompson</u> T.C. Memo 2004-174

Facts: The decedent, Josephine, owned a 20.57 percent block of the stock of Thomas Publishing Co., Inc. (TPC), a closely-held corporation formed in 1898. The decedent's block was the largest block of TPC's common stock held by any one shareholder. Capital Cities/ABC, Inc. owned a l2.656 percent block of the stock, and the rest was owned by various members of Josephine's extended family. None of the shares had been traded in the ten years before Decedent's death. TPC's primary business is the production and sale of industrial and manufacturing business guides and directories, though it also published and sold a variety of news magazines, software comparison guides, and a magazine relating to factory automation, and it owned a product information exchange service and a custom publishing group. TPC also maintained a leading business-to-business website. The business was located in New York and the Decedent also resided there.

TPC had a long history of paying annual cash dividends. The estate's tax return valued the estate's 20.57 percent interest at $1.75 million, or $3.59 a share. This valuation was based on a determination that the undiscounted value of the entire company was $25,784,000, which was then multiplied by the estate's percentage of ownership and discounted by 40 percent to take into account the minority interest and another 45 percent of the remaining value to take into account lack of marketability. This valuation, which took place in 1998, considered the proliferation of the internet to be a "substantial threat to TPC's viability as a business, as luck would have ot, thus decreasing value. Note that the lawyer and the appraiser were both from Alaska and were purportedly fishing buddies. The appraiser had no prior appraisal experience.

A professional appraiser employed by the IRS valued the decedent's stock at $35.273 million, or $72.36 per share, using the comparable public company method and the discounted cash flow method, and applying a 30 percent discount for lack of marketability, and no discount for lack of control. The IRS assessed a deficiency and penalty for understatement of values. Shortly before trial, the IRS reduced its valuation to $32.388 million, because of errors in the original appraisal report.

Issue: What was the proper valuation and did penalties apply?

Analysis: The Tax Court valued the 20.77 percent block of stock at $13.525 million, or $27.75 per share, and refused to impose a penalty for undervaluation. The court found both parties' valuations to be "deficient and unpersuasive." The court noted that the estate's appraisers had relatively little valuation experience, that they valued the interest aggressively and overstated the risks associated with the Internet and technology and by applying excessive discounts. The IRS expert, the court noted, used a "sterile approach" that was concerned only with numbers, and that did not value TPC as a real company, and the companies selected by the IRS expert as comparable were not, the court stated, very similar to TPC. The court noted that "the fact that two companies are both part of the same general industry does not, as respondent's expert implies, make them comparable per se." The court valued TPC by capitalizing its earnings at an l8.5 percent rate, and allowing a 15 percent minority interest discount and a 30 percent lack of marketability discount. Although IRC §6662 allows a 40 percent penalty if the reported value is less than 40 percent of the determined value, the court held that an exception applied. The court refused to allow a penalty for substantial valuation understatement, because the taxpayer's valuation, while wrong, was based on reasonable cause and the taxpayer had acted in good faith. The court noted that the valuation of the stock of TPC was particularly difficult, comparable companies did not exist, and capitalization of income and the discounted cash flow methods involved a number of difficult judgment calls.

In its decision the court seemed to be irritated that the estate, the executors, and the company whose stock was being valued, were all headquartered and based in New York City, and yet the estate hired a lawyer and accountant from Alaska, in an apparent attempt to have the estate audited in Alaska, rather than in New York City. The court stated that the estate's experts were "only marginally credible . . . [and] barely qualified to value a highly successful and well-established New York City-based company with annual income in the millions of dollars." The result of this case however luckily was quite favorable to the estate.

The case was appealed to the Second Circuit (499 F.3d 129, 2007) and the issue here was penalties and under IRC Section 7491, the Service had the burden of proof on the issue of valuation. On Appeal to the Second Circuit, the Estate argued that since the Tax Court rejected the valuation proffered by the Service, the Tax Court was required to adopt the Estate's valuation. The Second Circuit disagreed, stating that "the burden of disproving the taxpayer's valuation can be satisfied by evidence in the record that impeaches, undermines, or indicates error in the taxpayer's valuation." The Second Circuit further noted that the Tax Court is not bound by the opinions proffered by expert witnesses, and that it may reach its own analysis based on the evidence in the record. However, the Second Circuit held, the Tax Court erred in determining its own value by double-counting certain assets in the valuation.

With regard to the undervaluation penalty, the Second Circuit noted that IRC § 6662 requires the Estate to pay an accuracy-related penalty the value if claims are not more than 25 percent of the amount determined to be correct. With respect to the "reasonable cause" exception, the Second Circuit concluded that the Estate did not show "reasonable cause" for its underpayment, and thus it was required to pay a penalty equal to 40 percent of its underpayment. Reliance on an appraiser will not automatically insulate the taxpayer from undervaluation penalties. The court remanded it back to the Tax Court.

After remand, the Tax Court issued a decision in 2009, still refusing to apply penalties. On appeal to the 2nd circuit the court held that they were upholding the Tax court's denial of penalties. 370 F Appix 141 (2010).

The taxpayer was very lucky here on both the valuation result and the abatement of penates but the moral is retain a qualified well respected appraiser as it is doubtful most taxpayers will be this lucky

CHARITABLE DEDUCTIONS AND QUALIFIED APPRAISAL

These attacks are alive and well-not for the taxpayer.

Donations: For any charitable donation of non-cash/non-marketable assets in excess of $5,000 a qualified appraisal must be obtained or the deduction will be denied and penalties can apply. This must be attached to a timely filed return and the Form 8283 must be completed and attached.

A "qualified appraisal" means an appraisal which:

- Is made not earlier than 60 days prior to the date of contribution nor later than the due date of the return on which the deduction is claimed;
- Is prepared by a *qualified appraiser;*
- Does not involve a prohibited appraisal fee; and

Includes:

- A description of the property and its physical condition;
- The date (or expected date) of its contribution;
- The terms of any agreement that relates to the use, sale, or other disposition of the property;
- Treas Reg §1.170A-13(c)(3)
- The name, address and identifying number of the appraiser and the person who employs or engages the appraiser;
- The appraiser's qualifications;
- A statement that the appraisal was prepared for income tax purposes;
- The date (or dates) on which the property was appraised;
- The appraised fair market value of the property on the date (or expected date) of contribution;

- The method of valuation used; and
- The specific basis for the valuation.
- Treas Reg §1.170A-13(c)(3)(ii)

Notice 2006–96. A "*qualified appraisal*" means an appraisal which is:

- treated as a *qualified appraisal* under regulations or other guidance; and
- conducted by a *qualified appraiser* in accordance with generally accepted appraisal standards and any regulations or other guidance.

Appraisal Summary: The term "appraisal summary" means a summary of a *qualified appraisal* that--

- **(A)** — Is made on the form prescribed by the IRS [form 8283];
- **(B)** — Is signed and dated by the donee;
- **(C)** — Is signed and dated by the *qualified appraiser*; and
- **(D)** — Includes the information required by Treas Reg §1.170A-13(c)(4)(ii) (above).

•Treas Reg §1.170A-13(c)(4)

Form 8283, signed by the appraiser and the donee, must be attached to the income tax return on which the deduction for the contribution is first claimed

- A "*qualified appraiser*" means an individual (other than an excluded person) who includes on the appraisal summary a declaration that he or she:
  - Either holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis;
  - Is qualified to make appraisals of the type of property being valued because of his or her qualifications;
  - Is ***not*** an *excluded person*; and
  - Understands that an intentionally false or fraudulent overstatement of the value may subject the appraiser to a civil penalty under IRC §6701 for aiding and abetting an understatement of tax liability.

Treas Reg §1.170A-13(c)(5)

<u>Exclusions</u>. The following persons can<u>not</u> be *qualified appraisers*:

- The donor or the taxpayer who claims a deduction for the contribution;
- A party to the transaction in which the donor acquired the property being appraised unless the property is donated within 2 months of the acquisition and its appraised value does not exceed its acquisition price;
- The donee of the property;
- Any person employed by any of the foregoing persons;
- Any person related to any of the foregoing persons under IRC §267(b), or married to a person who is in a relationship described in §267(b) with any of the foregoing persons;
- An appraiser who is regularly used by any person described above who does not perform a majority of his or her appraisals for other persons.

<u>Fees</u>. In general, the fee arrangement cannot be based on a percentage of the appraised value of the property.

<u>**Notice 2006–96**</u>. A "*qualified appraiser*" means an individual who:

- (i) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations;
    - An appraiser will be treated as having earned an appraisal designation from a recognized professional appraiser organization if the appraisal designation is awarded on the basis of demonstrated competency in valuing the type of property for which the appraisal is performed.
- (ii) regularly performs appraisals for which the individual receives compensation; and
- (iii) meets such other requirements as may be prescribed in regulations or other guidance.
    - An appraiser will be treated as having demonstrated verifiable education and experience in valuing the type of property subject to the appraisal within the meaning of IRC §170(f)(11)(E)(iii)(1) if the appraiser makes a declaration in the appraisal that, because of the appraiser's background, experience, education, and membership in professional associations, the appraiser is qualified to make appraisals of the type of property being valued.
    - An appraiser will be treated as having met minimum education and experience requirements if:
        - For <u>real property</u> the appraiser is licensed or certified for the type of property being appraised in the state in which the real property is located.

For returns filed after February 16, 2007, the declaration required under Treas. Reg. §170A-13(c)(5)(i) must include an additional statement that the appraiser understands that a substantial or gross valuation misstatement resulting from an appraisal which the appraiser knows, or should have known, would be used in connection with a return may subject the appraiser to a civil penalty under IRC §6695A.

- An individual will not be treated as a *qualified appraiser* unless that individual:
- demonstrates verifiable education and experience in valuing the type of property subject to the appraisal; and
- has not been prohibited from practicing before the IRS at any time during the 3-year period ending on the date of the appraisal.

Penalties

IRC §6662. Accuracy-Related. A 20% penalty shall apply to any underpayment attributable to:

- *Negligence* or disregard of rules or regulations.
- Any *substantial understatement* of income tax.
- Any *substantial valuation misstatement* under Chapter 1.
    - There is a *substantial valuation misstatement* under Chapter 1 if the value or the adjusted basis of any property claimed on any return of tax imposed by Chapter 1 is 150% or more of the amount determined to be the correct amount.
- Any substantial estate or gift tax valuation understatement.

There is a *substantial estate or gift tax valuation understatement* if the value claimed on a return is 65% or less of the "correct" amount.

Gross Valuation Misstatements. To the extent that the underpayment is attributable to one or more gross valuation misstatements, the penalty shall be increased to "40%."

- The term "*gross valuation misstatements*" means (i) any substantial valuation overstatement determined by substituting *200%* for 150%; or (ii) any substantial estate or gift tax valuation understatement as determined by substituting *40%* for 65%.

<u>IRC §6694. Understatement by Tax Return Preparer</u>.

- <u>Unreasonable Positions</u>. The penalty shall be equal to the greater of $1,000 or 50% of the income derived by the preparer with respect to the return.

- <u>Willful or Reckless Conduct</u>. The penalty shall be equal to the greater of $5,000, or 50% of the income derived by the preparer with respect to the return.

- <u>Abatement Where Liability Not Understated</u>. If there is a final determination that there was no understatement, the penalty shall be abated.

<u>IRC § 6701. Aiding and Abetting Understatement</u>. Any person who aids or assists in the preparation of a return who knows that a position would result in an understatement shall pay a $1,000 penalty (unless the return relates to the tax liability of a corporation, in which case the penalty shall be $10,000).

<u>IRC §6695A. Appraiser Penalty</u>. If the claimed value of property based on an appraisal results in a substantial or gross valuation misstatement under §6662, a penalty is imposed under §6695A on any person who prepared the appraisal and who knew, or reasonably should have known, the appraisal would be used in connection with a return or claim for refund.

<u>Penalty Avoidance/Defenses</u>

<u>Treas Reg §1.6662-3(b)(3)</u> *Reasonable Basis*.

<u>Treas Reg §1.6662-3(c)</u> *Adequate Disclosure*.

<u>Treas Reg §1.6662-4(d)</u> *Substantial Authority*.

<u>Reliance on Opinion or Advice</u>.

- All facts and circumstances must be taken into account. Reliance may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.

<u>Valuation Misstatements of Charitable Deduction Property</u>.

There may be *reasonable cause and good faith* with respect to an underpayment attributable to a substantial (or gross) valuation misstatement of charitable deduction property only if:

- the claimed value of the property was based on a *qualified appraisal* by a *qualified appraiser*; and

- the taxpayer made a good faith investigation of the value of the contributed property.

But NOTE:

- These requirements ((i) & (ii), above) apply regardless of whether Treas. Reg. §1.170A-13 permits a taxpayer to claim a charitable contribution deduction for the property without obtaining a *qualified appraisal*. and

- The rules requiring a *qualified appraisal* by a *qualified appraiser* to show reasonable cause and good faith with respect to an underpayment attributable to a substantial (or gross) valuation misstatement of charitable deduction property apply in addition to the generally applicable rules concerning *reasonable cause* and *good faith*.

Below Are Just a Few of the Charitable Appraisal Cases*:*

CCA 202302012 on January 10, 2023. This provides clarifications on cryptocurrency qualified appraisals. If a taxpayer makes a charitable contribution of cryptocurrency valued at more than $5,000, a qualified appraisal is required. The IRS also finds that cryptocurrency fails to fall into any category of property exempted from the qualified appraisal rules of §170(f)(11)(C). Even if a taxpayer determines the value of the donated cryptocurrency based on the value reported by a cryptocurrency exchange on which the cryptocurrency is traded rather than by obtaining a qualified appraisal, the reasonable cause exception provided in section 170(f)(11)(A)(ii)(II) will not excuse noncompliance with the qualified appraisal requirement, and a taxpayer will not be allowed the charitable contribution deduction under section 170(a).

Chiarelli v. Commissioner, T.C. Memo 2021027 March 3rd, 2021. The Primary issue is whether the petitioner was entitled to noncash charitable contribution deductions and whether petitioner was liable for IRC Section 6662(a) accuracy-related penalties. Chiarelli is a tax attorney who prepares his own tax returns. He argued substantial compliance existed. The court stated that “he failed to make any reasonable attempt to provide the information requested on the forms. In fact, he wholly failed to comply with the substantiation requirements.” The court ruled for IRS and found that substantial compliance did not exist here, but noted in general this is very hard to fit under in this arena. Here however, it was clear that no summary appraisals were even attached. The court also found that no reasonable cause existed so the penalties applied.

Lim v. Commr. of Internal Revenue, T.C.M. (RIA) 2023-011 (Tax 2023). Petitioners were sole shareholders of an S corp. This can be a trap for the unwary when an appraisal is not qualified due to specific rules. Here the attorney fees were prohibited within the meaning of Reg 1.170A-1(c)(6)(i) because these were based on a percentage of the appraised value of the property. “In sum, Mr. Meyer's fee was clearly based, directly or indirectly, on the appraised value of the ABC units allegedly donated to the Foundation on December 31, 2016. Because of his agreement with petitioners constituted a prohibited fee arrangement and for that reason alone, his purported appraisal was not a “qualified appraisal” within the meaning of section 170(f)(11)(D).” Similarly, a taxpayer may not appraise his own property no matter how qualified.

Pankratz v. Commr. of Internal Revenue, 121 T.C.M. (CCH) 1178 (Tax 2021). Here an art dealer was denied a charitable contribution deduction for the donation of a sculpture as there was no appraisal and his assertion alone even though he was an art dealer is not sufficient.

Mann v. United States, (2021) 984 F.3d 317:

Facts: Mann owned a house which she gave to a charity. But the deed was not recorded. The charity employs disadvantaged people to deconstruct properties to use the parts for sale. The charity itself does not perform the demolition work. Second Chance incurred approximately $13,144 in expenses in deconstructing the house. Mann and her husband deducted $675,000 for their gift of the house, $24,206 for their gift of the personal property, and $11,500 for the cash donations. The IRS denied all deductions. The District court granted summary judgement for the government holding that only the cash donations of could be deducted since Mann did not completely convey all rights of the property to the charity. The parties appealed.

Analysis: The Court of Appeals affirmed the ruling of the lower court, because the Mann’s only transferred contractual ownership of the land and did not record the deed.

Dickinson v. Commissioner, T.C. Memo. 2020-128*:*

Facts: A shareholder and chief financial officer of a privately held company desired to donate shares of stock to the Fidelity Investments Charitable Gift Fund. In three years, the shareholder donated appreciated shares to the gift fund. It was clear that that the Gift Fund owned and had exclusive control of the shares prior to the redemption and had full discretion over all conditions of subsequent sale and was not under any obligation to sell the shares.

Analysis: In *Humacid Co. v. Commissioner*, 42 T.C. 894, 913 (1964), the court held that: “the form of this kind of transaction [i.e., as a donation of shares followed by the charity’s redemption of the shares rather than as a sale of shares by the taxpayer followed by a donation of the cash proceeds] if the donor (1) gives the property away absolutely and parts with title thereto (2) before the property gives rise to income by way of a sale.” The donor met the first prong of this test, because they transferred all of their rights in the donated party. The court refused to: “treat a redemption in this type of situation as an anticipatory assignment of income as long as the charity is not legally bound to sell the donated shares and cannot be compelled to surrender the shares for redemption.”

Fakiris v. Commissioner, T.C. Memo. 2017-126:

Facts: George Fakiris was a commercial real estate developer in New York City, and 60 percent partner in Grou Development, LLC. In 2001, the LLC paid $700,000 for a 1929 Staten Island movie and vaudeville house. The LLC planned to raze the theater and construct a high-rise building, but those plans were opposed by the community. The LLC wanted to give the theater to the Richmond Dance Ensemble, Inc., a nonprofit corporation that wanted to restore it and use it for public performances. The LLC then agreed to sell the theater to WEMGO, a qualified public charity that agreed to retransfer the property to Richmond Dance after the latter obtained tax-qualified status. The sales contract prohibited WEMGO from transferring the property for five years, unless directed by the LLC to transfer it to Richmond Dance. The actual deed of transfer, however, included no restriction on WEMGO's ability to retransfer the theater and no power in the LLC to direct a transfer. A qualified appraisal in the year of the transfer to WEMGO valued the theater at $4.5 million. A qualified appraisal by the same appraiser the next year valued it at $5 million. The Tax Court denied the income tax deduction because the LLC's retained power to direct when WEMGO could retransfer the property rendered the gift incomplete for income tax purposes.

Analysis: The taxpayer moved for reconsideration. The court needed to determine the actual value of the theater in order to determine the amount of the overvaluation penalty. Section 6662(e)(1)(a) states that the overvaluation penalty is 20 percent if the valued claimed is 150 percent or more of the correct valuation, or 40 percent if the value claimed is 200 percent or more of the correct valuation. The court noted that in Woods the Supreme Court held that a Section 6662(b)(3) accuracy-related penalty applied even when the transaction was disregarded for lack of economic substance. The Tax Court held that the determination that a donor has not relinquished dominion and control over the gift property is analogous to the determination that a partnership is a sham and does not exist for tax purposes. Here, the Tax Court applied a 40 percent gross overvaluation penalty because the charitable gift was not a completed transfer, without determining the value of the property.

Loube v. Commissioner, T.C. Memo. 2020-3:

Facts: The Loubes bought property with the hopes of destroying the structures and constructing a new residence on the lot. The Loubes agreed to have the Second-Hand Charity deconstruct the property before demolition. An appraiser concluded that the Loube's gift to the charity was over $200,000. The IRS denied the deduction. In the appraisal summary attached to the Loubes' return, they provided no information on their cost or adjusted basis.

Holding: The Tax Court granted the IRS summary judgment denying the entire income tax deduction because an appraisal summary that omits basis data is insufficient to support a deduction.

Campbell v. Commissioner, T.C. Memo. 2020-41:

Facts: Taxpayer bought eyeglass frames and donated the eyeglass frames. An appraisal concluded that the donation was worth around $24 million. With this amount, the taxpayer's return showed a deduction of $225,000. The taxpayer carried the donation over another year. The IRS disallowed the carry-over of the donation because the contribution lacked donative intent.

Holding: The court held that the taxpayer had not complied with the necessary requirements and did not address the argument of donative intent. The Court also held that the letter furnished by the charity was not a contemporaneous written acknowledgement, because the letter did not state if the charity made any goods or services in consideration of the donation. There was also no qualified appraisal

Brannan Sand & Gravel Co., LLC v. Commissioner, T.C. Memo. 2020-76:

Facts: Brannan Sand & Gravel Co., LLC is an asphalt company that contributed a water storage easement to a political subdivision of Colorado and claimed a $200,000 charitable deduction under the rules for conservation easements." The LLC filed its income tax return together with a Form 8283 appraisal summary based on an appraisal prepared by its litigation attorney. The Form 8283 was missing the first page and contained two copies of the second page.

Analysis: Judge Cohen denied the deduction for lack of a qualified appraisal and for failure to substantially comply with the appraisal requirements. The attorney's letter did not include the method of valuation or the specific basis for determining the value, the physical condition of the property, or a statement that the appraisal was prepared for federal income tax purposes. A litigation attorney cannot (and did not) prepare a qualified appraisal.

Joe Mohamed vs Commisioner, T.C. Memo 2012-152.

Facts: Joe and his wife Shirley took a charitable deduction of 18.5 million of for real property contributed to several charities. There was not a qualified appraisal attached to the return. The property in question was sold within 6 months of for almost 22 million. The IRS moved for Summary Judgment and imposed penalties because with no deduction there was a substantial understatement.

Analysis: Judge Homes held that since no qualified appraisal was attached, no deduction. Joe was an appraiser who attached his own appraisal, and even though it undervalued the property under the regulations, he cannot perform the appraisal. At the time the instructions were not very clear but substantial compliance ws not successful. The imposition of penalties was deferred and a trial was conducted on this issue where Joe argued reasonable cause. After trial, a settlement was eventually reached and Joe paid significant tax but no penalties. This case sent shock waves around the world because it seemed so unfair however there must be strict compliance with the qualified appraisal rules.

CONSERVATION EASEMENT

What is it?

- "…any limitation in a deed, will, or other instrument in the form of an easement, restriction, covenant, or condition, …executed by …the owner of the land subject to such easement and … binding upon successive owners of such land, … the purpose of which is to retain land predominantly in its natural, scenic, historical, agricultural, forested, or open-space condition."

  (Cal Civ Code §815.1)

- An interest in land (as opposed to an estate).

Who creates it?

- The owner/all owners of the land to be subjected to the easement.
  - One co-tenant cannot unilaterally create an easement. (Land owned by concurrent owners is held in undivided interests, which cannot be unilaterally partitioned.)

Who can acquire/hold?

- A tax-exempt nonprofit organization …qualified to do business in the state which has as its primary purpose the preservation, protection, or enhancement of land in its natural, scenic, historical, agricultural, forested, or open-space condition or use.
- The state or any city, county, … district, or other state or local governmental entity, if otherwise authorized to acquire and hold title to real property …
- Certain Native American tribes

(Civ Code §815.3)

Who is bound?

- All successive owners of the land.

What is the purpose?

- To keep the land in the condition it was in when the easement was created

How is it created?

- "…by any lawful method for the transfer of interests in real property."

    - "A conservation easement shall be perpetual in duration."(Cal. Civ. Code § 815.2)

- In a writing signed by the owner(s) of the property to be subject to/burdened by the easement. (In a deed, an easement agreement or a declaration of conditions, covenants and restrictions.)

    - Because it involves an interest in real property, creation is subject to the statute of frauds (Civ Code §1624; CCP § 1971)

- "Instruments creating …conservation easements shall be recorded in the office of the county recorder of the county where the land is situated, …and …shall be subject in all respects to the recording laws" (Civ Code § 815.5)

BASIC TERMS

Basic terms of a conservation easement include:

- Restrictions on future use of the property;
- Future permissible uses of the property (including uses permitted with prior consent);
- Inspection and enforcement rights;
- Rights of access;
    - Public access may be required if the grantor desires tax deductibility
- Retained rights and responsibilities (re real property taxes, insurance, and property maintenance);
- Warranties (re title and hazardous materials);
- Indemnification rights;
- Procedures for seeking and granting consent for particular uses, and for modification, assignment and extinguishment of the easement;
- Valuation in the event of extinguishment or exercise of eminent domain, and distribution of the proceeds;
- Administrative costs;
- Transfer fees;

- Subordination, recordation, and other lender-related issues.

FUNDING COSTS FOR MONITORING AND ENFORCEMENT:

Plan for costs associated with enforcement, including:

- Monitoring compliance; and
- Litigation (or the like) to enforce the terms.

Sources of Funding:

- Grantor
- Third party donor
- Grantee
- Public agency

Tax Planning Opportunities

Income Tax

I.R.C. § 170(h) allows an income tax deduction for a *qualified conservation contribution*

- The amount is determined by the grantor's *(qualified) appraisal;*
- A donor can deduct up to 50% of his or her "contribution base" over other charitable contributions for donating a *qualified conservation easement;*
  - "contribution base" = AGI - any NOL carryover
- A donor can carry-forward any "excess" deduction for up to 15 years Qualifying farmers and ranchers can deduct up to 100% of their income
  - Farmer or rancher: someone who receives more than 50% of his or her gross income from the trade or business of farming
    - IRC §2032A(e)(5) defines a "farming activity"

NOTE: To be deductible, a conservation easements fair market value must be substantiated through a "*qualified appraisal*." See discussion above.

Estate Tax

IRC §2031(c) allows an executor to exclude 40% of the value of land subject to a *qualified conservation easement* from estate tax.

- The amount of the exclusion is limited to $500,000, calculated on the value of the property after the easement is in place.
- The value of the land that is *excluded* from the decedent's estate retains a carryover basis (IRC §1014(a)(4)).
  - Even though the property may be acquired from a decedent, the basis of the excluded portion is <u>not</u> stepped up to its fair market value at the decedent's death.

To Qualifying for the IRC §2031(c) Exclusion, the land subject to a *qualified conservation easement* must:

- Be located in the United States;
- Be owned by the decedent or a member of the decedent's family at all times during the 3-year period ending on the date of the decedent's death; and
- Be a *qualified conservation contribution* (within the meaning of IRC §170(h)) granted by the decedent, a member of his or her family, the executor of the decedent's estate, or the trustee of a trust whose corpus includes the subject land as of the date the election is made

Maximum Benefit Allowed:

- To determine the amount of the exclusion, it is necessary to value the land with and without the *qualified conservation easement*, as of the date of the contribution. If the value of the easement is less than 30% of the value of the land without the easement (reduced by the value of any retained development rights), the exclusion percentage is reduced by 2 percentage points for each percentage point that the ratio falls below 30%.
  - <u>Example</u>: If the value of the easement is 25% of the value before the easement (less the value of the retained development rights), the applicable percentage is 30% (i.e., the starting applicable percentage of 40% - 10% {10% = 2(30% - 25%)}.
  - <u>NOTE:</u> If the value of the easement is 10% or less of the value before the easement, the applicable percentage is zero (i.e., no exclusion is available)

Property Tax

- If the value of the property is lowered because of the easement, the property tax should decrease as well

State Income Tax Credit

- California Natural Heritage Preservation Tax Program provides a tax credit for individuals who donate a conservation easement that protects wildlife habitat, parks and open space, archeological resources, agricultural land and water.

- **NOTE**: This credit is currently unfunded (and can only be claimed if a donor will fund) Public Resources Code §37022

Federal Tax Treatment

Background:

Pre-1969 Act:

- A taxpayer could deduct for income tax purposes the FMV of a scenic easement in perpetuity given to the United States.

The Tax Reform Act of 1969:

- Questioned the deduction for income, estate and gift tax purposes, by adding §170(f)(3), §2055(e), and §2522(c), which specifically deny deductions for most partial interests.
  - However, the Conference Report stated: "The conferees … intend that a gift of an open space easement in gross is to be considered a gift of an undivided interest in property where the easement is in perpetuity." (Emphasis added.) This concept is incorporated in Treas Reg §1.170A-7(b)(1)(ii).

Pre-1976 Act:

- The I.R.S. ruled that easements for the protection of the exterior appearance of a historic building, a hiking and skiing right of way, and a public bathing beach were all deductible for income tax purposes. (Rev. Rul. 75-358, Rev. Rul. 74-583, Rev. Rul. 75-373 & Rev. Rul. 76-331.)

The Tax Reform Act of 1976 and the Tax Reduction and Simplification Act of 1977:

– Substantially amended §170(f)(3)(B) and §170(f)(3)(C). For estate tax purposes, the changes were incorporated into §2055(e)(2). *The Tax Reform Act of 1976:*

– Added §2055(f), effective with respect to transfers made after 1986, and specifically authorized the estate deduction for transfers of easements in real property, defined in §170(h).

— In order to qualify for the §2055 estate and §2522 gift tax deductions for transfers occurring after 1986, the transfers do ***not*** have to be exclusively for conservation purposes.

IRC §170(f)(3)

Denial Of Deduction [for] Contributions Of Partial Interests In Property

In General — In the case of a contribution … of an interest in property which [is] less than the taxpayer's entire interest…, a deduction shall be allowed … only to the extent that the value of the interest contributed would be allowable as a deduction …if such interest had been transferred in trust.

- **Exceptions** — (IRC § 170(f)(3)(B)):
  - a contribution of a remainder interest in a personal residence or farm,
  - a contribution of an undivided portion of the taxpayer's entire interest in property, and
  - a *qualified conservation contribution*.
- **Qualified Conservation Contribution**

For purposes of IRC § 170(f)(3)(B)(iii), the term "***qualified conservation contribution***" means a contribution:

- Of a "***qualified real property interest***" (IRC §170(h)(2))
- To a "***qualified organization***" (committed to protect the conservation purposes and having the resources to enforce the restrictions) (IRC §170(h)(3); Treas Reg §1.170A-14(c)(1))
- **Exclusively for conservation purposes** (IRC § 170(h)(4))

QUALIFIED REAL PROPERTY INTEREST

For purposes of IRC §170(h)(2), the term "***qualified real property interest***" means … the following interests in real property:

- The donor's entire interest …, other than a "qualified mineral interest",
- A remainder interest, or
- A restriction (granted in **perpetuity**) on the use that may be made of the property

Qualified Organization

A *qualified conservation contribution* must made be to a **"*qualified organization*",** which means the organization must: (i) be committed to protect the conservation purposes; and (ii) have the resources to enforce the restrictions). Examples:

- A governmental unit described in IRC §170(b)(1)(A)(v) or (vi) (e.g., a school board),
- A publicly supported charity (IRC §170(b)(1)(A)(vi), §501(c)(3)), and
- An organization controlled by, and operated for the exclusive benefit of a governmental unit or a publicly supported charity (IRC §509(a)(2) or (3))

(IRC §170(h)(3); Treas Reg 1.170A-14(c)(1))

Private foundations are not permitted to receive *qualified conservation contributions* (IRC §509(a)(2))

Exclusively For Conservation Purposes

For purposes of IRC §170(h), the term "***conservation purpose***" includes (IRC §170(h)(4)(A):

1. Preserving land areas for outdoor recreation by, or for the education of, the general public. IRC §170(h)(4)(A)(i).

This necessarily entails public access.

– Examples: preservation of a lake for public boating or fishing; preservation of a public nature or hiking trail. Treas Reg §1.170A-14(d)(2).

2. Protecting a relatively natural habitat of fish, wildlife, or plants, or a similar ecosystem. (IRC § 170(h)(4)(A)(ii))

- Preserving open space, including farmland and forest land:
  - For the scenic enjoyment of the general public (§170(h)(4)(A)(iii)(I); Treas Reg §1.170A-14(d)(4)(i)(B), (ii)); or
  - Pursuant to a clearly delineated federal, state, or local government conservation policy (§170(h)(4)(A)(iii)(II); Treas Reg §1.170-14(d)(4)(i)(A), (iii)).
  - It must yield a significant public benefit (§170(h)(4)(A)(iii); Treas Reg §1.170A-14(d)(4)(i), (iv).)
  - Preserving a historically important land area or a certified historic structure (§170(h)(4)(A)(iv), (h)(4)(B)-(C)).

- If restrictions allow future development, the contribution is deductible only if the restrictions require that any such future development conforms with appropriate government construction or rehabilitation standards within the district.

Historic Preservation **Land areas that qualify as historically important** include:

- An independently significant land area (and related historic resources) that satisfy certain National Register criteria;
- Any land area (and buildings) within a registered historic district that contribute to the significance of the district; and
- Any land not within a registered historic district which is adjacent to a property listed in the National Register of Historic Places, where the features of the land contribute to the historic or cultural integrity of the property.

  Treas Reg §1.170A-14(d)(5)(ii)

Certified Historic Structures

Two categories:

•Any building, structure, or land area that is listed in the National Register; or

•Any building located in a registered historic district and certified by the Secretary of the Interior as being of historic significance.

Treas Reg §1.170A-14(d)(5)(iii)

Special requirements for restrictions with respect to the exteriors of buildings in a registered historic district (*façade easements*). To qualify for the deduction:

- The *façade easement* must include restrictions that: (i) preserve the entire exterior of the building; and (ii) prohibit any change inconsistent with the historical character of the exterior. ***And***
- The donee must enter into a written agreement with the donor and certify that the ***donee:***
  - is a *qualified organization* with a purpose of environmental protection, land conservation, open space preservation, or historic preservation; ***and***
  - has the resources to manage and enforce the restrictions and a commitment to do so.

IRC § 170(h)(4)(B)(i)

- The donor must include with their return for the year of the contribution (IRC 170(h)(4)(B)(iii)):
  - a *qualified appraisal* of the real property interest;
  - photographs of the entire exterior of the building; and
  - a description of all restrictions on the development of the building.
- For structures described in IRC §170(h)(4)(C)(ii), a fee* is imposed under IRC § 170(f)(13):
  - For a restriction with respect to the exterior of a building, a $500 filing fee is required if the deduction exceeds $10,000; and
  - The deduction is ***not*** allowed unless the donor pays the filing fee with the return for the year of the contribution

*The filing fees are expressly designated for the enforcement of the provisions regarding *qualified conservation contributions*. IRC § 170(f)(13)(C)

Historic Preservation: Public Access

In the case of a gift for the preservation of a historically important property, it is *not* necessary for the entire property to be visible to qualify for a deduction. However, the public benefit may be insufficient to justify a deduction if only a small portion of the property is visible.

If the historic property is not visible from a public way, the easement must permit regular viewing by the general public to the extent such viewing is consistent with the nature and condition of the property.

Treas Reg §1.170A-14(d)(5)(iv)(A)

Factors to consider in determining the required amount of public access:

- The property's historical significance;
- The features that are the subject of the easement;
- The accessibility of the site;
- Potential physical hazards to visitors;
- The privacy of individuals living on the property;
- The degree to which public access would impair the conservation purpose of the contribution; and

- The availability of opportunities for public viewing by means other than visits to the site

Treas Reg §1.170A-14(d)(5)(iv)(A)

<u>EXCLUSIVITY</u>

Incidental benefit:

- If the requirements of a *qualified conservation contribution* are otherwise satisfied, a charitable contribution deduction will not be denied because an incidental benefit inures to the donor as a result of conservation restrictions limiting the property's uses. Treas Reg §1.170A-14(e)(1)

Inconsistent Use:

- No deduction is allowed if the property may be used inconsistently with the conservation purpose.
  - Any <u>donor retained interests must be subject to enforceable restrictions</u> that prevent the retained interests from being used inconsistently with the conservation purpose
- No deduction is allowed if the conservation purpose would destroy other significant conservation interests. Treas Reg §1.170A-14(e)(2).
  - However, a use that is destructive of other conservation interests will be permitted if the use is necessary to protect the conservation interests that gave rise to the contribution. Treas Reg §1.170A-14(e)(3).

<u>(Perpetual) Term:</u>

A conservation easement is ***<u>not</u>*** treated as being *exclusively for conservation purposes* <u>unless</u> the <u>conservation purpose is *protected in* ***perpetuity***</u>.

- A gift of a conservation easement for a period of years, with a reversion to the donor at the end of the term, is ***<u>not</u>*** a *qualified conservation contribution.* (IRC §170(h)(5)(A))
- For contributions of property subject to a deed of trust (or similar lien), no deduction is allowed unless the beneficiary/lienholder agrees to subordinate its rights to the right of the donee to enforce the conservation purposes.

If the interest may be defeated by an act or an event, a deduction is ***<u>not</u>*** disallowed if, as of the date of the contribution, the possibility that the act or event will occur is negligible.

- The burden of proof is on the donor to establish the remoteness of the possibility that the act or event will occur.

Example: A donor contributes a conservation easement in a state that requires use restrictions to be (re)recorded periodically to remain enforceable. Notwithstanding the (re)recording requirement, the easement may be treated as protected in perpetuity.

DUE DILIGENCE

Documents to be Reviewed:

Title Reports

- Review the title on the donor's parcel of land and all other property the donor owns in the area.
- Are there any liens or other encumbrances which can "usurp" the easement? (divesting the Donee/the public of the benefit)

Baseline Documentation

- Documentation may include survey maps, maps identifying certain distinct features of the property, aerial photographs, and on-site photographs. The documentation should establish that the property has environmental or ecological significance that is supported by the conservation purposes stated in the easement to support any tax benefits to be claimed
- To facilitate monitoring and enforcement, the baseline documentation must depict the condition of the property subject to the easement at the time the easement is created

Conservation Easement Deed

- Inspect the deed for compliance with IRC §170(h) to ensure the contribution will be eligible for a charitable contribution deduction.
- To be deductible, a conservation easements fair market value must be substantiated through a "*qualified appraisal*."

The Donee

- To ensure that the done is a *qualified organization* and that the easement "conforms" with the donee's purpose and that the done has the capacity and wherewithal to monitor and enforce the terms of the easement in accordance with the conservation purpose it was created to preserve.

SUBSTANTIATION

- **Income Tax Returns**: According to IRC §170(f) and Treas Reg §1.170A-13, taxpayers must maintain the following records to claim deductions for charitable contributions:
  - A receipt showing:
    - The name of the donee;
    - The date and location of the contribution; and
    - A description of the property.
  - *A contemporaneous written acknowledgement* including:
    - The amount of cash contributed and a description of any property other than cash contributed;
    - Whether the donee organization provided any goods or services in consideration for the contribution; and
    - If the donee organization provided any goods or services (other than intangible religious benefits), a description of the goods or services and a good-faith estimate of the value thereof.

- IRC §170(f)(8)
  - Written records must show:
    - the manner and approximate date of the Donor's acquisition of the property; and
    - The Donor's adjusted basis in the property.

VALUATION

(Perpetual) Conservation Restriction:

In general, the value of an easement in the nature of a perpetual restriction on use can be calculated as the net change in the FMV caused by the easement.

- If there is a substantial record of sales of comparable easements, the FMV must be based on the sales prices of the comparable easements. However, because sales of easement s involving perpetual restrictions on use are extremely rare, such easements are usually valued using the "before and after" method. Treas Reg §1.170A-14(h)(3)(i).

In determining the value of property "before and after" the grant of an easement, the 3 traditional valuation methods (comparable sales, capitalization of income, and replacement cost) are utilized.

<u>“Before and after” valuation method</u>:

In applying the “before and after” method, <u>the “before” value</u> is based on the highest and best use of the property unrestricted by the easement.

The following factors may be relevant:

- The current use of the property;
- The property’s realistic and potential uses (regardless of the owner’s use);
- The likelihood that the property would be developed if not restricted;
- The cost of developing and subdividing the property; and
- The effect of zoning, conservation, or historic preservation laws that already restrict the use of the property

Factors relevant in determining the value of property <u>after</u> the easement has been granted:

- The effect of any development permissible in light of the easement;
- The amount of access to the property permitted by the easement; and
- The effect of restrictions that may permit uses of the property that will increase its FMV above the FMV at its current use.

<u>Reduction of Adjusted Basis</u> in Property Retained (Treas Reg §1.170A-14(h)(3)(iii)):

- A donor who makes a *qualified conservation contribution* must reduce the adjusted basis in the property retained by the amount of the adjusted basis of the property allocable to the *qualified real property interest* gifted.
  - The adjusted basis allocable to the *qualified real property interest* gifted is determined by the ratio of the value of the *qualified real property interest* gifted to the value of the property before the granting of the restriction

- The adjusted basis allocable to the *qualified real property interest* gifted is

  = (value of the *qualified real property interest* gifted)/(”before” value of the property)

Case Law And Authority On Easements

Green Valley Investors, LLC, et al., Bobby Branch, Tax Matters Partner v. Commissioner of Internal Revenue, 159 T.C. No. 5. The Tax Court held that Notice 2017-10, which classified syndicated conservation easements as a “listed transaction,” is invalid.” Notice 2017-10

Proposed Regulation 106134-22, (December 6, 2022) . These regulations seek to turn the Notice 2017-10 disclosure requirements into a regulation. The proposed regulations identify certain syndicated conservation easement transactions and substantially similar transactions as listed transactions, which is a type of reportable transaction. Material advisors and certain participants in these listed transactions are required to file disclosures with the IRS and are subject to penalties for failure to disclose. The proposed regulations affect participants in these transactions as well as material advisors.

Oakbrook Land Holdings, LLC v. Commr. of Internal Revenue, 28 F.4th 700, 708 (6th Cir. 2022), cert. denied, 143 S. Ct. 626 (2023). Here, the Regulation at issue is § 1.170A-14(g)(6)(ii)). “The majority in *Oakbrook* held that the Treasury Regulation complied with the APA when it promulgated this regulation. Specifically, the majority found that Treasury included a concise statement of basis and purpose and adequately responded to comments from interested parties.”

Oconee Landing Property LLC v. Commissioner, T.C.2021

Facts: Carey Station, LLC acquired a 99 percent interest in Oconee Landing Property, LLC, by contributing a 356-acre tract of land in Greene County, Georgia. Within a couple of days, Oconee Landing Investments, LLC (the taxpayer), acquired a 97 percent interest in Oconee Landing Property from Carey Station for $2,440,000 and contributed $1.3 million in cash to Oconee Landing Property. Eight days later, the taxpayer gave a conservation easement to the Georgia Alabama Land Trust. Oconee claimed a $20.7 million donation. The deed provided that, if the easement were eliminated by judicial termination, the donee’s share of the proceeds would be adjusted for any improvements made by the donor. The IRS denied the charitable contributions.

Analysis: The Tax Court denied cross motions for summary judgment, pointing out possible defenses to charging the donee with the value of improvements and requiring the payment of outstanding claims on judicial termination. “Regarding the deed provision that charges the donee with the cost of any improvements made by the donor after the gift, in determining the division of the proceeds of a judicial termination of the easement, the court noted that there appeared to have been no pre-existing improvements, and the taxpayer should have the chance to show that it had reserved no right to make any future improvements, or that any such improvements would be of negligible value. Regarding the deed provision that the proceeds of a judicial termination of the easement should be divided after the satisfaction of prior claims, the court noted that the deed appeared to require that such claims be paid from the donor's share of the proceeds, which would not violate the regulations."

Johnson v. Commissioner, T.C.Memo 2020-79

Facts: Taxpayer was president of a manufacturing company. The President worked from home and did not have an office at the facility. The President bought vacant land around 25 miles from the manufacturing facility. The President built a residence along with some other buildings. In 2007 the taxpayer gave a conservation easement to Colorado Open Lands, a qualified donee, encumbering 116.14 acres of the ranch land (all but five acres), including the area on which the residence stands. The easement restricted the encumbered area from subdivision. The President claimed a $610,000 charitable contribution deduction based on a qualified appraisal. The IRS did not contest the merits of the deduction but claimed that the taxpayer had already deducted more than the value of the easement by the time he got to the years at issue in the case.

Analysis: Tax Court rejects both appraisals and values a conservation easement with its own analysis, valuing the easement at $372,919, the difference between the ranch's fair market value before and after the easement was granted. The Court found, despite the appraiser's being experienced, none of the appraisers' comparable sales to be really comparable. The court concluded that the ranch's before value was $1,021,695 and its after value was $648,775, so it valued the easement at $372,919.

Kissling v. Commissioner, T.C. Memo 2020-53

Facts: Kissling Interests, LLC gave the National Architectural Trust façade easements on three certified historic commercial buildings in the Allentown Historic District of Buffalo, New York. Local law restricted what building owners could do with properties within the district. The LLC deducted $855,900 for the value of the easement. The IRS disallowed the deductions in full, finding that the easements had no effect on the value of the properties because the state restrictions on development were as severe as the easement. The IRS also imposed a gross valuation misstatement penalty under Section 6662(h).

Analysis: The Tax Court allowed a $674,000 deduction which largely sustained the deduction for the façade easement because local government limitations on development of property within an historic district are more weakly enforced. All of the expert appraisers agreed that the highest and best use of the properties, both before and after the easement gifts, was as residential apartment buildings, and all of them determined value by capitalizing net operating income. The court compared the maintenance and preservation requirements imposed by the local agency on structures within the historic district with those imposed by the easement and concluded that the easement restrictions were more severe than the local restrictions, particularly in light of relatively lax enforcement by the local agencies.

Rajagopalan v. Commissioner, T.C. Memo 2020-159.

Facts: Warren Sapp and his business partner, Dr. Kumar Rajagopalan, transferred nearly 120 acres of land in western North Carolina to SS Mountain LLC. They bought the parcels for around $3 million. The LLC contributed a conservation easement over 89.378 acres to the North American Land Trust (NALT), a qualified charitable organization. The easement required that the land be used exclusively for a conservation purpose. The real estate market then crashed, causing some of the contracts not to close. The LLC filed an partnership income tax return reporting a charitable gift of $4.9 million and attached a qualified appraisal. The IRS audited the transactions, denied the deduction, and asserted overvaluation penalties.

Analysis: The Tax Court ruled in favor of the taxpayers. The court noted that this was an unusual conservation easement case, because it could value the property based on a number of truly comparable sales. The court acknowledged that the easement was given at the peak of a real estate "bubble," and that values had since fallen significantly, but stated that the value on the date of the gift was all that was relevant but the easement value was proved by recent sales.

Pine Mountain Preserve, LLP v. Commissioner, 151 T.C. 14 (2018)

Facts: Pine Mountain Preserve donated a perpetual easement in gross to the North American Land Trust (NALT). Each easement indicated that the land would be free of any commercial or residential development. However, in the 2005 and 2006 easements there was an exception that allowed for the building of single-family residencies. The easements did not specify the building areas but merely stated that they had to be approved by NALT. The 2007 easement did not provide for rights to build residential dwellings, but rather it allowed Pine Mountain to build a water tower subject to NALT's approval. The tax court disallowed any deduction with respect to the 2005 easement. With respect to the 2006 easement, the Tax Court held that the lack of specificity regarding the location of the building areas at the outset did not allow for a deduction under Section 170(h). Both the IRS and Pine Mountain Appealed.

Analysis: On appeal, the court first addressed whether or not the 2005 and 2006 easements were grants of qualified real property interests. The Court of appeals reversed the tax court holding that "a broad limitation on the use of the property that applies to the parcel as a whole satisfies the statutory test, even if within that parcel there exists certain narrow exceptions to that limitation. For the 2007 easement, the court of appeals upheld the tax court ruling that a deduction was proper.

Champions Retreat Golf Founders, LLC v. Commissioner, T.C. Memo 2018-146, 11th Cir 2020 reversed

Facts: Champions retreat golf owned an interest in a golf club. Champions contributed to the North American Land Trust (NALT). The easement restricted the ways that Champions could use the easement area. The easement allowed Champions to build structures with an aggregate of up to 10,000 square feet. Champions claimed $10,427,435 charitable contribution deduction. The IRS denied the deduction both for lack of a proper conservation purpose because it viewed the value of the easement at zero. The tax court judge denied the deduction because the easement did not serve a proper conservation purpose. The tax court held that there was not a sufficient presence of rare, endangered, or threatened species. The case was appealed to the eleventh circuit.

Analysis: The 11th Circuit Court was split but ended up vacating the ruling of the Tax Court. The court held that a land could be a wildlife preserve even if there is a golf course on the land. The Court was willing to overlook unnatural features of the land, because there was evidence that endangered species used the land.

Hoffman Properties II LP v. Commissioner, Tax Court 2018 & 2019, 6th Cir affirmed (2020)

Facts: Hoffman Properties owned a historic building in Ohio. Hoffman Properties gave a façade easement and airspace rights to the Association of Historic Preservation. Hoffman reserved the right to change the façade with the donee's consent. The reservation clause provided that the donee was deemed to have consented to any written request to which it failed to respond within 45 days. Hoffman filed a tax deduction of $15 million for the gift. The IRS denied the deduction in its entirety.

Analysis: The Tax Court granted partial summary judgement to the IRS finding that the easement did not protect the conservation purposes of perpetuity because the donee lost enforcement power unless it responded to a change request within 45 days. The court stated that the donor can reserve conditional rights that may affect the conservation purposes only if those rights give the done.

Oakbrook Land Holdings, LLC v. Commissioner, 154 T.C. 180

Facts: Oakbrook gave a land conservation easement to a land conservancy. Oakbrook had bought the land earlier for $1.7 million. Oakbrook claimed a $9,545,000 charitable contribution. The IRS did not allow the claim, because the deed of easement stated that, if the easement were ever extinguished, the proceeds of the disposition of the property would be divided between the donor and the donee by giving the donee an amount equal to the difference between the fair market value of the conservation area as if not burdened by the easement and the fair market value of the conservation area burdened by the easement. The IRS concluded that: "Reg. §1.170A-14(g)(6) requires that a division in such "judicial extinguishment" cases be based on the relative values of the two shares on the date of the gift, with no other adjustments."

Holding: The Tax Court rejected the taxpayer's notion that Treas.Reg.Section 1.170 is not valid, because the regulation was a product of full notice and comment procedures under the Administrative Procedure Act (APA). The Tax Court upholds the validity of a perpetuity regulation, holding that it was properly promulgated under the APA and that its interpretation of the statute is entitled to "Chevron deference," and applies the regulation to deny a charitable deduction." Note, there are many many cases citing Oakbrook Land Holdings that have denied charitable contribution deductions with regard to conservation easements.

*Carpenter v. Commissioner**:*** T.C. Memo 2012-1, T.C. Memo 2013-172 denying motion for reconsideration

The parties in this case allowed for extinguishment of the conservation easements through mutual consent of the parties, which meant the easement did not continue in perpetuity. The Court reasoned that "although the deed conveying the property indicated an intent 'to preserve and protect in perpetuity the conservation values of the property,' the taxpayers retained various rights that caused the conveyance to fail the perpetuity requirement."

*Mitchell v. Commissioner***:** 138 T.C. 324 (April 3, 2012) .T.C. Memo 2013-204 denying motion for reconsideration

The IRS argued that the failure to have the mortgage subordinated to the conservation easement at the time the easement was granted prevented the easement's conservation purpose from being protected in perpetuity. The Court stated that subordination of the mortgage was required at the time the easement was contributed because, absent such subordination, in the event of a taxpayer default on the loan the lender could institute a foreclosure proceeding and eliminate the easement.

*Minnick v. Commissioner**:*** T.C. Memo 2012-345, affirmed 611 Fed Appx 477 (9th Cir. 2015)

In disallowing the deduction, the Ninth Circuit affirmed a 2012 memorandum decision by the Tax Court. The issue before the court was whether Reg. § 1.170A-14(g)(2) requires that the mortgage be subordinated at the time the easement is granted. In this case, it was only after the government raised the issue in its amended answer to the petition for redetermination that the taxpayers secured a subordination agreement from the lender. The Ninth Circuit concluded that the regulation unambiguously required the mortgage to be subordinated at the time of the gift.

I.R.S. INFO 2013-0014**:**

Under the Regulations, a conservation purpose may be treated as protected in perpetuity if, upon a subsequent change in conditions that makes impossible or impractical the continued use of the subject property for conservation purposes, the easement is extinguished by judicial proceeding and all of the donee's proceeds from a subsequent sale, exchange, or involuntary conversion of the property are used by the donee in a manner consistent with the conservation purposes of the original contribution. Treas Reg § 1.170A-14(g)(6)(i).

<u>Belk v. Commissioner</u>: 140 T.C.1 (2013)

he taxpayer granted a conservation easement over his property, a golf course. The terms of the easement permitted the taxpayer to substitute an area of land contiguous to the property covered by the easement for an equal or lesser area covered by the easement. The right to substitute property subject to the easement was limited by numerous rights given to the land trust. The court held that the easement was not a perpetual conservation restriction because the donor was allowed to change what property was subject to the easement.

<u>Irby v. Commissioner</u>: 139 T.C. 371 (2012), T.C. Memo 2013-154

The donee was required to reimburse governmental entities out of potential proceeds if the property was condemned. The Tax Court found that the reimbursement provision was consistent with the conservation purpose and satisfied Treas Reg 1.170A-14(g)(6) because "condemnation of the underlying parcels would result in the proceeds going to the donee charity, and in turn to the governmental entities, which are all qualifying organizations under IRC § 170(c)(1), which would use those funds in a manner consistent with the original conservation purposes. Motion for reconsideration was denied.

<u>TAX BENEFITS EXAMPLE:</u>

Towns undeveloped land located in the US. The FMV of the land is $2,000,000. T contributes a *qualified conservation easement* on the land to a *qualified organization* during her 2018 tax year. The FMV of the land after the grant is $1,250,000. If properly documented/substantiated, T is entitled to a $750,000 charitable contribution deduction on her 2018 income tax return.

- T dies in 2020, still owning the land subject to the easement. On the date of her death, the FMV of the land without the easement is $2,500,000, but is valued at $1,500,000 in T's estate because of the easement. As the date-of-contribution value of the easement ($750,000) exceeded 30% of the date-of-contribution value of the land without the easement ($2,000,000), T's estate is entitled to exclude $500,000, which is 40% of the value of the land in the estate, limited to the $500,000 cap.

T has also excluded from her estate the $1,000,000 "excess" of the FMV of the property excluding the easement over the date-of-death value of the property subject to the easement. Thus the "total" exclusion is $1,500,00