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Graev: Conditional Facade Easement

By Wendy C. Gerzog



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In *Graev v. Commissioner*, the Tax Court decided whether the taxpayers' donations of a facade easement and cash contributions were conditional gifts and therefore disallowable as charitable deductions under the requirements of the regulations.

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The Tax Court decided *Graev v. Commissioner*¹ under fully stipulated facts. In 1999, the taxpayers, residents of New York City, purchased property listed in the National Register of Historic Places for \$4.3 million, subject to a mortgage.

Pre-2004 case law is replete with disallowed facade easements either for overvaluation or unenforceability issues.² Under Notice 2004-41,³ the government advised that it would be scrutinizing the substance of transactions involving real property purchases, charitable organizations, and conservation easements. One example mentioned in the notice described a charitable organization that bought property, placed a conservation easement on the property, and sold the property at a substantially reduced price to a buyer who made a cash "charitable donation" to the organization to reimburse the charity for its financial loss. In that instance, the notice stated that the government may treat the cash donation as part of the buyer's purchase price instead of as a charitable gift.

Later, the National Architectural Trust (NAT), a charitable organization with a mission "to preserve

historic architecture in metropolitan areas across the United States,"⁴ approached Mr. Graev to make a facade easement gift. Having qualms about the latest government ruling, Graev, an attorney, sought the advice of his accountant. Graev then e-mailed NAT with his concerns after the accountants urged caution and Graev asked for NAT's "thoughts especially as it relates to the side letter."⁵

The side letter was NAT's letter to Graev explaining that it was NAT's standard policy to refund the applicable portion of Graev's donation if he couldn't get the promised favorable charitable deduction. Specifically, the letter promised "to join with Graev to immediately remove the facade easement from the property's title."⁶ Referencing the assurance made by NAT both to Graev and to his neighbor, Graev executed the facade easement agreement on September 20, 2004.

A firm appraised the value of the facade easement at \$990,000. At or near the end of 2004, Graev executed a deed that granted a facade easement to NAT and the deed was recorded on February 17, 2005. The conservation deed provided that the easement grant would facilitate preservation, in perpetuity, of the historic structure and of the public open space, but it also stated that the provisions of the deed were not intended to limit the grantee's right "to abandon some or all of its rights hereunder."⁷ The mortgagee joined in the easement agreement and agreed to subordinate its rights to the enforcement of the conservation easement; however, the mortgagee declared to have claims, superior to the grantee, to all insurance or condemnation proceeds.

In 2004 Graev made a total of \$99,000 in cash contributions to NAT, as requested by the trust to subsidize NAT's operating and future monitoring and administrative expenses. In 2005 NAT sent Graev a written acknowledgement of his easement and cash donations, together with the applicable tax forms to submit with his return. Also in 2005, NAT sent two letters to Graev: the first, apprising him of upcoming reforms, including penalties and fines, applicable to taxpayers, promoters, and appraisers

⁴*Graev*, at 5.

⁵*Id.* at 8. The side letter is also referred to as NAT's comfort letter.

⁶*Id.* at 11.

⁷*Id.* at 13.

¹140 T.C. No. 17 (2013).

²*Id.*, slip op. at 6-7, 8-9, n.5.

³2004-28 IRB 31.

involved in “significantly overvalued” facade easement donations; and the second, informing him that the refund offer “may adversely affect the deductibility of the cash contribution as a charitable gift.”⁸ Graev did not ask NAT to remove the refund feature of his donation.

After those NAT letters, the Graevs filed their income tax returns for 2004 and 2005, taking deductions for both the easement and the cash contribution to NAT.⁹ In its September 22, 2008, notice of deficiency, the government disallowed the taxpayers’ charitable deductions because the donations were made “subject to subsequent events.” The taxpayers contended that the side letter agreement was unenforceable under New York law and a nullity under federal tax law.

The court reviewed the facts to determine whether the gifts were conditional donations or whether the condition was allowed under the regulations¹⁰ because it was “so remote as to be negligible.” Moreover, as the court stated, “Section 170 and the corresponding regulations provide instruction and limitations that, at least in part, ensure that the donor will be able to deduct only what the donee organization actually receives.”¹¹ The court reviewed the background of the applicable regulation’s language (“so remote as to be negligible”) and the identical language in an older estate tax regulation.¹²

The Supreme Court interpreted the estate tax regulation in *Sternberger*.¹³ Concerned that the donation must match what the charity actually received, the court stated that deductible gifts must be unconditional “unless the possibility that the charity will not take is ‘negligible’ or ‘highly improbable.’”¹⁴ Applying that standard, the Tax Court held that the deduction was only allowable if the possibility that NAT would lose its easement and cash was so remote that it was a negligible risk.

The legislative history of charitable split interests accords with that emphasis. Section 170(f)(3) was enacted in 1969 and denied a deduction for most partial interests in property, including conservation easements, but also allowed a donation of an open space easement in gross that was donated to a

charity in perpetuity. It wasn’t until the 1976 Tax Reform Act that Congress amended section 170(f)(3) to create a deduction for a conservation easement. That provision was later revised and expanded in 1980 to include subsection (h), which defines a qualified conservation contribution. The regulations define the perpetuities requirement as ensuring that the potential for the divestment of the easement be so remote as to be negligible.

The court held that at the time of the easement and cash donations, the potential for the IRS to disallow those deductions and for NAT to remove the easement and return the cash to Graev was not so remote as to be negligible. Although Graev argued that case law at the time of the donation allowed for a donation of between 10 and 15 percent of the value of the property, and that he had deducted a value constituting 11 percent of the property’s appraised value, the court emphasized that at that date, the potential for IRS disallowance was not negligible and that valuation was a separate issue. Indeed, the court stated that Graev acted (for example, filing returns with the deductions and failing to remove the refund feature) in response both to the IRS notice indicating additional scrutiny applicable to overvalued facade easements and to NAT’s second letter warning of the government’s disallowance of a deduction for facade easement donations coupled with refund provisions.

Responding to the Graevs’ argument that the one example provided in Notice 2004-41 did not apply to their specific transaction, the court found that the notice advised more generally that donations relating to conservation easements would involve greater scrutiny, and that Graev was well aware of this intensified IRS examination, as indicated in his correspondence with his accountants. NAT agreed to return Graev’s contributions if the government disallowed deductions for them. Thus the court held that the risk of the government’s disallowing the deduction was “well above ‘negligible.’”¹⁵ According to the court, Graev required NAT’s letter with the refund feature before making his contribution. Also, NAT understood that an IRS disallowance was more than a remote possibility and that was why NAT would routinely issue comfort letters to potential donors.

The court explained that Graev misinterpreted the court’s ruling in *O’Brien v. Commissioner*,¹⁶ in which the taxpayers created a charitable remainder trust in 1964, appointing themselves trustees with broad management powers. The issue in the case

⁸*Id.* at 15.

⁹Their 2004 return was filed on October 10, 2005, wherein they deducted the full \$99,000 cash contribution and \$544,449 for the easement deduction, as limited by section 170(b)(1)(C). They deducted the remaining \$445,551 on their 2005 return. *Id.* at 16-17.

¹⁰Reg. section 1.170A-1(e), -7(a)(3), and -14(g)(3).

¹¹*Id.* at 19.

¹²Reg. section 20.2055-2(b).

¹³*Commissioner v. Estate of Sternberger*, 348 U.S. 187, 194 (1955).

¹⁴*Id.* at 22.

¹⁵*Id.* at 33.

¹⁶46 T.C. 583 (1966), *acq.* 1968-1 C.B. 2.

was whether the donors had retained control sufficient to cause the gift to be incomplete. The return of their contributions was solely in the government's act of disallowance regardless of the correctness of its action, placing "the contingency 'within the control of the Commissioner.'"¹⁷ In *O'Brien*, the court held that the taxpayers had the right to first litigate their position so that the return contingency was not applicable unless the taxpayers lost. The court held that *O'Brien* did not even address the issue of a tax contingency under the section 170 regulations and "did not hold that a tax-treatment contingency can never be a subsequent event that will defeat a contribution and a deduction."¹⁸

The court also rejected Graev's argument that there was no possibility that NAT would return the property. The court analyzed New York's conservation easement law and held that while NAT's letter alone would not satisfy the state's extinguishment requirements, the recorded deed sufficiently reserved NAT's power to abandon the easement in compliance with New York law. Therefore, the court found that this possibility was "more than negligible."¹⁹

Likewise, the court was unmoved by Graev's contention that the doctrine of merger extinguished NAT's refund letter. The court cited, as an exception to that principle, a clear intention by the parties to have a particular provision of a contract survive the deed. Graev required NAT's letter before making his donation and thus the letter clearly qualified as an inducement for him to make the contribution. Even when NAT offered to rescind the letter, Graev declined that offer. Therefore, the court found that the parties intended the letter to survive the deed and that the doctrine of merger did not apply.

Finally, Graev argued that the letter was a nullity under *Commissioner v. Procter*.²⁰ In *Procter*, a trust provided that a noncharitable gift would revert to the donor if a court later determined that the transfer would be subject to gift tax. The court held that the trust provision was void as contrary to public policy because it (1) discourages the government's tax collection by nullifying the audit of returns; (2) renders the court's decision moot by canceling the gift the court has adjudged; and (3) disturbs a final judgment.

The taxpayer in *Procter* had asserted that under the terms of the trust, the gift was not to become effective if a court found the transfer to be subject to

the gift tax. However, the circuit court held that such a clause in the trust could not prevent the imposition of the gift tax because the clause would discourage the government's tax collection and the gift tax should not be so easily avoided. Furthermore, the court refused to allow that kind of "trifling with the judicial process."

The Tax Court in *Graev* held that *Procter* was inapplicable because recognizing that the refund feature in NAT's letter would not prevent Graev from being taxed on his contribution would not undo a judicial decision, would not discourage tax collection, would not render the case moot, and would not undo the judgment in the case. The court concluded that at the time of the donation, the possibility that the IRS would disallow Graev's deduction and that NAT would thereby return both the easement and cash contributions to Graev was not "so remote as to be negligible" in contravention of the regulations. Therefore, the court disallowed both donation deductions.

Analysis and Conclusion

It is ironic that the taxpayers in *Graev* cited to *Procter* to sustain their position. If anything, the facts in *Graev* reflect the very behavior so repugnant to the *Procter* court.

When a charitable donation is conditional on receiving a tax deduction, it is difficult to accept that the primary goal of the taxpayer is to make a gift to a charity. In *United States v. American Bar Endowment*,²¹ donative intent was central to allowing a charitable deduction. That is, while the charitable deduction is often an incentive for making or increasing a charitable gift, no one may contract with a charity to make a donation dependent on getting a tax benefit. If all charitable gifts were conditional on receiving a tax deduction, that limitation would place a heavy burden on charities. They would not know if they were receiving funds and could not rely on using those "donations" until several years in the future. Yet, of course, most donors actually want the charity to be able to apply their funds to the charity's exempt purpose.

It is also difficult to value a conditional gift at its fair market value, because a transfer of property with a refund feature must surely be heavily discounted. Alternatively, if the gift is viewed as a

¹⁷*Graev*, op. at 37, citing *O'Brien*, at 591 (quoting *Surface Combustion Corp. v. Commissioner*, 9 T.C. 631, 655 (1947), *aff'd*, 181 F.2d 444 (6th Cir. 1950)).

¹⁸*Id.* at 38.

¹⁹*Id.* at 45.

²⁰142 F.2d 824 (4th Cir. 1944).

²¹477 U.S. 105, 117-118 (1986) ("The sine qua non of a charitable contribution is a transfer of money or property without adequate consideration. The taxpayer, therefore, must at a minimum demonstrate that he purposely contributed money or property in excess of the value of any benefit he received in return." *Id.*).

precondition, the completed gift and deduction should not occur until the statute of limitations has run.

As a general policy matter, extending that notion would add extreme complexity to tax administration. What if, for example, payments of expenses were refundable on the condition of a deduction disallowance? What possible positive policy goal would that serve?

This case and others suggest reasons to eliminate the facade easement deduction. The reduction in value because of the easement is often more hypothetical than real. Adding a refund "guarantee" based on the tax benefits to the donor makes the transfer more a commercial transaction than a charitable gift.

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