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Alms to the Rich: The Facade Easement Deduction

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ALMS TO THE RICH: THE FAÇADE EASEMENT DEDUCTION

Wendy C. Gerzog

This article presents the case for repeal of the façade easement deduction. Proponents of this benefit argue that the deduction encourages historic preservation by reimbursing property owners for relinquishing their right to alter the façade of their property in a way inconsistent with that conservation goal; however, this article shows that there are many reasons to urge its repeal: the revenue loss, the small number of beneficiaries, the financial demographics of that group of beneficiaries; the dubious industries that are supported by the deduction; and the continual marked overvaluation and abuse despite Congressional, court, and administrative review and expense.

After the last major reform effort, the Pension Protection Act of 2006, in 2009 only ninety-four taxpayers claimed the façade easement charitable deduction with an average return deduction of $477,225. While there may be a desire to retain a tax benefit with purported charitable aims, the long history of unbridled abuse even with repeated legislative and administrative response should make it clear that amending the façade easement deduction is an unending proposition. In today’s world, real estate is often subject to regulation that buyers and their neighbors accept in order to retain and increase a community’s property values. The very wealthiest of homeowners who purchase homes in historic districts willingly accept local restrictions on their property’s use. There is no evidence that façade easements significantly alter the behavior of property owners. It provides them with huge tax savings for doing what they would do anyway.

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INTRODUCTION

Donations of façade easements to conservation charities are gifts primarily employed by a small number of very wealthy taxpayers in order to generate huge deductions, with few, if any, benefits to the public and without appreciably interfering with the enjoyment of the taxpayers’ private property interests. After the last major reform, the Pension Protection Act

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1 See Richard Rubin, IRS Cracks Down on Breaks in Land of Rich Americans, BLOOMBERG NEWS (Nov. 22, 2013), http://www.bloomberg.com/news/2013-11-06/irs-cracks-down-on-breaks-in-land-of-rich-americans.html (Dean Zerbe, who examined easement donations as a Republican aide on the Senate Finance Committee said, “I don’t know if I could design a tax break that’s more targeted toward the millionaire set.”); Joe Stephens, U.S. Targets Tax Break Tied to Façade Easements, WASH. POST (July 9, 2011), http://www.washingtonpost.com/local/us-seeks-to-end-tax-break-for-façade-easement-donations/2011/07/05/glQAFsHsH35H_story.html (“Since 2002, the Justice Department estimates that inflated easement deductions have totaled $1.2 billion. ‘These are very wealthy people taking a massive deduction on their taxes, for plenty of nothing,’ said Dean Zerbe, who investigated abusive tax shelters while legal counsel for the Senate Finance Committee.”).
of 2006 (PPA)\textsuperscript{2} in 2009, for example, only ninety-four taxpayers claimed the façade easement charitable deduction with an average return deduction of $477,225.\textsuperscript{3}

The stated public benefit of a façade easement is to preserve historically significant structures\textsuperscript{4} and to give the public a chance to see the exterior of these historic treasures. The rationale for the deduction was to encourage historic preservation by recompensing the property owner for giving up his right to alter the façade of his property in a way inconsistent with that goal.\textsuperscript{5}

It is not clear, however, that taxpayers need that tax benefit, particularly in light of its exorbitant revenue cost. Taxpayers who purchase homes in historic districts know that they will be subject to state and local building restrictions. Allowing a federal income tax deduction where a taxpayer would not have behaved differently if she did not receive a tax benefit results in a waste of revenue.\textsuperscript{6}

Today, homeowners routinely relinquish rights to do what they want with their property in order to protect private property values.\textsuperscript{7} When a


\textsuperscript{4} I.R.C. § 170(h)(4)(A)(iv).


\textsuperscript{6} See STAFF OF JOINT. COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 277-284 (Comm. Print 2005) ("Whenever possible, tax incentives should be targeted to those persons who are most likely to modify their behavior in substantial part because of the provision of the tax benefit. Otherwise, providing such benefits constitutes a windfall rather than an incentive. The present charitable deduction regime for qualified conservation contributions provides a windfall to those taxpayers who grant an easement or other restriction to a qualified organization if the activity or use restricted by the easement or restriction likely would never occur. For example, a person who purchases a residence in a historic district that has homes that were designed and constructed in a particular period and with a particular architectural style generally does not acquire the home with the intention of altering the exterior of the building in a manner that would be inconsistent with the neighboring structures. Similarly, a person who acquires real property located by a nature preserve often is attracted to the area because of the preserve, and in such cases would not alter or use the acquired property for a purpose that would impede or contravene such preservation efforts.") [hereinafter 2005 JOINT COMM. FAÇADE EASEMENT PROPOSAL].

\textsuperscript{7} The Community Associations Institute, a trade association, estimated that HOAs governed 25.9 million American homes and 63.4 million residents in 2012. See Industry Data, National Statistics, CMTY. ASS’N INST. (2013), http://www.caintline.org/info/research/pages/default.aspx; FOUND. FOR CMTY. ASS’N RESEARCH, STATISTICAL REVIEW
homeowner buys a home in an area that has a community association, the buyer purchases her house and must agree to abide by the homeowners association’s rules, which generally restrict alterations to the exterior of the building and to landscaping. In the historic easement and the homeowners’ association restriction scenarios, the limitations on “unsuitable” alterations to the property owner’s and his neighbors’ façades add value to the owner’s property. Those constraints are one of the major reasons that the restrictive uses are so popular; despite individual owners’ grumblings about having given up some of their property rights, in the long run the owners subject to community association rules benefit from conservation of house value and increased market potential when they are ready to sell.

Aside from generating huge deductions for the rich,8 façade easements, ironically, only provide a tax benefit when donors are assured that their easement grant will not depreciate the value of their property. Representatives from conservation charities have commonly explained and reassured potential façade easement donors that they will enjoy large tax benefits from their donations “with little to no practical effect on the use, value, or marketability of the [easement burdened] property.”9 Indeed, much urban renewal is tied to restoring historical homes.10

Fundamentally, charitable deductions are rooted in the policy that donations to qualified organizations support the public good.11 The major

8 See sources cited supra note 1.
10 See Scheidelman v. Commissioner (Scheidelman III), 105 T.C.M. (CCH) 1117 (T.C. 2013), available at http://www.ustaxcourt.gov/InOpHistoric/ScheidelmanMemo.TCM.WPD.pdf, aff’d, 755 F.3d 148 (2d Cir. 2014) (per curiam) (holding that the Tax Court applied the correct legal standard and its determination that the easement had no value was well supported by the facts).
11 See, e.g., William D. Andrews, Personal Deductions in an Ideal Income Tax, 86 HARV. L. REV. 309–15 (1972) (“In the case of many charitable contributions the material goods or services purchased with the contributed funds inure entirely to the benefit of persons other than the donor, and the donor enjoys only the nonmaterial satisfaction of making a gift . . . . A good argument can be made that taxable personal consumption should be defined to include divisible, private goods and services whose consumption by one household precludes enjoyment by others, but not collective goods whose enjoyment is nonpreclusive or the nonmaterial satisfactions that arise from making contributions.”). See generally, e.g., Ellen P. Aprill, Reforming the Charitable Contribution Substantiation Rules, 14 FLA. TAX REV. 275, 279 (2013); Ilan Benshalom, The Dual Subsidy Theory of Charitable Deductions, 84 IND. L.J. 1047 (2009); Johnny Rex Buckles, The Case of the Taxpaying Good Samaritan: Deducting Earmarked Transfers to Charity under Federal Income Tax Law, Theory, and Policy, 70 FORDHAM L. REV. 1243 (2002); Roger Colviniaux, Rationale and Changing the Charitable Deduction, 138 TAX NOTES 1453, 1455 (Mar. 25, 2013) (“Yet
charitable split interest 1969 reforms\textsuperscript{12} were focused on ensuring that the amounts that taxpayers deducted matched the amounts that the charities received. Besides the matching goal of the 1969 provisions,\textsuperscript{13} in order to determine whether the overall effect of a transfer produces a positive net contribution to the public good, I propose inserting an additional factor into that calculus — the amount of loss in the federal fisc due to the high enforcement expenditures caused by almost uniformly overvalued façade

\textsuperscript{12} Tax Reform Act of 1969, Pub. L. No. 91-172, § 201, 83 Stat. 526–62 (1969). In 1969, Congress significantly reformed the charitable deduction and enacted split interest rules to combat valuation abuses where the taxpayer’s deduction exceeded the amount the charity received. See S. REP. No. 91-522, at 86–88 (1969) (“The rules of present law for determining the amount of a charitable contribution deduction in the case of gifts of remainder interests in trust do not necessarily have any relation to the value of the benefit which the charity receives. This is because the trust assets may be invested in a manner so as to maximize the income interest with the result that there is little relation between the interest assumptions used in calculating present values and the amount received by the charity.”).

\textsuperscript{13} With regard to conservation easements, some scholars have questioned whether even that goal is satisfied. See Daniel Halperin, A Better Way to Encourage Gifts of Conservation Easements, 136 TAX NOTES 307, 310 (July 16, 2012) (“Because of the uniqueness of each encumbered property, the variability in easement restrictions, and paucity of easement sales, comparable sales (purchases of similar easements on closely similar properties) would be rare. Therefore, focus is on the supposed decline in the property value for the donor resulting from the imposition of the restriction . . . . Not only is the decline in value difficult to measure, but the approach itself is faulty. Importantly, we have no evidence that the public benefit is equal to the estimated decline in selling price.” (citation omitted)). This article presents a “shelf project” proposal, one that is part of a larger inventory of tax reform proposals. See Calvin Johnson, The Shelf Project: Revenue Raising Proposals to Defend the Tax Base, http://www.utexas.edu/law/faculty/calvinjohnson/shelf_project_inventory_subject_matter.pdf (last visited Oct. 22, 2014); see also Roger Colinvaux, Charitable Contributions of Property: A Broken System Reimagined, 50 HARV. J. ON LEGIS. 263 (2013); Roger Colinvaux, The Conservation Easement Tax Expenditure: In Search of Conservation Value, 37 COLUM. J. ENVTL. L. 6 (2012) [hereinafter Colinvaux, Conservation Value].
Because of the inherent and persistent abuses of overvaluation and of the mounting costs of constant government

14 See David van den Berg, IRS Scrutinizing Conservation Easements, 137 TAX NOTES 19 (Oct. 1, 2012); IRS News Release, IR-2014-31. IRS Bars Appraisers from Valuing Facade Easements for Federal Tax Purposes for Five Years (Mar. 19, 2014) [hereinafter 2014 IRS News Release], available at http://www.irs.gov/uac/Newswire/IRS-Bars-Appraisers-from-Valuing-Facade-Easements-for-Federal-Tax-Purposes-for-Five-Years; IRS Notice 2004-41, 2004-1 C.B. 31 (Jun. 30, 2004) [hereinafter 2004 IRS Notice] (informing taxpayers of increased scrutiny of façade easement deductions); Richard Rubin, IRS Cracks Down on Breaks in Land of Rich Americans, BLOOMBERG NEWS, (Nov. 22, 2013), http://www.bloomberg.com/news/2013-11-06/irs-cracks-down-on-breaks-in-land-of-rich-americans.html ("In this case and dozens like it, the IRS is challenging a complex and obscure tax break that benefits some of the nation’s wealthiest property owners."). In RERI Holdings I v. Commissioner, 107 T.C.M. (CCH) 1488, slip op. at 9 (T.C. 2014), available at http://www.ustaxcourt.gov/InOpHistoric/ReriHoldingsMemo.Halpern.TCM.WPD.pdf, the Tax Court described an economic sham. In certain respects, over-valued façade easement deductions that do not change taxpayer behavior are "economic shams." ("Generally speaking, the term ‘economic sham’ (as opposed to the term ‘factual sham’, i.e., a transaction that did not occur) describes a transaction that actually occurred but that exploits a feature of the Internal Revenue Code without any attendant economic risk." Id.) Because the taxpayer’s property enjoyment is barely impinged and is coupled with a very large tax benefit, façade easement donations also commonly evidence a lack of the donative intent, as required by United States v. American Bar Endowment, 477 U.S. 105, 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."). In American Bar Endowment, the Court rejected a charitable deduction allowance for the so-called donation to the organization when bar members purchased insurance because the insurance premiums were consistent with market value costs and the members’ purchase of insurance was intended to and did serve their own private interests; by their "donations," the bar members did not indicate a desire to benefit the bar association’s charitable works. When a deduction creates a consequence (increased property value) that destroys the rationale for that deduction (to compensate the land owner for his loss in value), and does not appreciably add to the public good, it taints "the motivations of those who would have otherwise donated exclusively out of a sense of altruism." Id.; see Emad H. Atiq, Note, Why Motives Matter: Reframing the Crowding Out Effect of Legal Incentives, 123 YALE L.J. 1070, 1098 (2014) ("Those habituated into thinking of charitable donations as a means for personal gain may fail to cultivate ideal levels of generosity and good will or, alternatively, cheapen their mode of relating to their beneficiaries."). However, the fact that many taxpayers are motivated to make charitable deductions at least in part to enjoy the tax benefit of the deduction is not at issue. "If the motivation to receive a tax benefit deprived a gift of its charitable nature under section 170, virtually no charitable gifts would be deductible." RERI Holdings I, 107 T.C.M. (CCH) slip op. at 13 (citing Scheidelman v. Commissioner (Scheidelman II), 682 F. 3d 189, 200 (2d Cir. 2012), remanded to 105 T.C.M.(CCH) 1117 (T.C. 2013), aff’d, 755 F.3d 148 (2d Cir. 2014)).

15 See Roger Colinvaux, Conservation Easements: Design Flaws, Enforcement Challenges, and Reform, 3 UTAH L. REV. 755, 765–66 (2013) [hereinafter Colinvaux,
oversight, the façade easement deduction has become counterproductive. When the broader calculus approach I have suggested is applied, it is clear that façade easement donations serve private purposes and expend public funds to a greater degree than they foster the public good. Façade easements typically allow property owners to maintain or raise property values just as homeowners’ association rules do in many communities nationwide. Historically accurate façades typically maintain or increase the value of those buildings because the property becomes more desirable real estate. Also, façade easements generally do not reduce valuation because local law restrictions already impose adequate limitations to preserve the historic façades of the buildings and, because the restrictions only apply to the façade of the building, the use limitations on the total square footage of the building are slight.

Finally, repeal is not only warranted but overdue. In 2005, the Joint Committee on Taxation recommended façade easement repeal at least on property where the owner or his family had a personal residence. Even with additional strictures enacted in the PPA, which does not include the Joint Committee’s proposal, façade easements remain rampant with abuse. Many scholars have criticized the abuse, which they would like to eliminate or at least minimize, but only one, Professor Daniel Halperin, has called

_Easement Reform_ (“Unfortunately, the lost economic development value bears no relation to the conservation value of the easement, meaning that the appraised fair market value does not provide a proxy for the public benefit of the contribution.” (citations omitted)); Halperin, _supra_ note 13, at 308–11.

16 See Colinvaux, _Easement Reform_, _supra_ note 15, at 771 (“The result is that valuation uncertainties can be used to benefit donors, often for questionable conservation benefits, and the IRS does not have the enforcement tools it needs, leaving it to fight valuation battles that ultimately provide little to no sense of the public benefit provided.”); Halperin, _supra_ note 13, at 308–11.

17 See infra Part III.A.

18 See Scheidelman v. Commissioner (Scheidelman III), 105 T.C.M. (CCH) 1117, slip op. at 19 (T.C. 2013), available at http://www.ustaxcourt.gov/InOpHistoric/ScheidelmanMemo.TCM.WPD.pdf (the government’s expert “concluded that because only the façade was affected by the easement and the loss of utility was only to the façade, the restrictions would not have a material effect on the market value of the whole property.”), aff’d, 755 F.3d 148 (2d Cir. 2014) (per curiam). Even with the Pension Protection Act (PPA), which requires restrictions to apply to all exterior sides of the structure, there is no limitation applicable to the inside of the building. See infra Part IV.

19 2005 JOINT COMM. FAÇADE EASEMENT PROPOSAL, _supra_ note 6, at 282–87; see 2005 Façade Easement Hearings, _supra_ note 5 (including in the record, without objection, the opening Statement of the Honorable John Lewis despite Lewis’ absence from the hearing).

20 See, e.g., Colinvaux, _Easement Reform_, _supra_ note 15, at 767–71 (suggesting the need for comprehensive reform); Colinvaux, _Conservation Value_, _supra_ note 13 (arguing to retain a tax benefit, but proposing either one geared to the value of the pre-easement property
for the repeal of façade easements. While there may be a desire to retain a tax benefit with purported charitable aims, the long history of unbridled abuse even with repeated legislative and administrative response should make it clear that amending the façade easement deduction is an unending proposition. The costs, the few very wealthy direct beneficiaries of this subsidy, and the questionable industries that are indirectly supported by this deduction should tell even the most sanguine that repeal is the only reasonable action for Congress to take at this time.

I. SO FEW, CLAIMING SO MUCH

While the number of taxpayers seeking a façade deduction is relatively small, the deductions claimed are large and the taxpayers claiming the deductions are most often very wealthy. In 2009, of all individual noncash charitable donations, conservation easements ($483,522) and façade easements ($477,225) constituted “the highest average deduction per

or to a variable tax credit that would match the conservation benefit of the easement); Nancy A. McLaughlin, Perpetual Conservation Easements in the 21st Century: What Have We Learned and Where Should We Go from Here? 3 Utah L. Rev. 688, 722 (2013) (desiring comprehensive statutory and regulatory reforms, possibly modeled on the reforms made in some New England states and California, but observing that the current state of the conservation easement looks like “a grand and hopeful experiment, but one that ultimately could prove to be unsuccessful.”); Nancy A. McLaughlin, Extinguishing and Amending Tax-Deductible Conservation Easements: Protecting the Federal Investment After Carpenter, Simmons, and Kaufman, 13 Fla. Tax Rev. 217 (2012) (seeking clear Service or statutory guidance harmonious with the legislative purpose behind conservation easements).

21 See Halperin, supra note 13, at 311–13 (proposing more broadly that all conservation easement deductions, as well as the estate tax exclusion of section 2031(c), be repealed and replaced by a targeted spending program); Daniel Halperin, Incentives for Conservation Easements: The Charitable Deduction or a Better Way, 74 Law & Contemp. Probs. 29, 45–47 (2011). However, one non-tax scholar whose principal message on conservation easements is to eliminate the perpetuity requirement, stated: “Beyond the questions of proper valuation and justifiable conservation values attained, allowing a tax deduction for conservation easements may not be the best use of public funds. Even with adequately conserved land, providing a public benefit, and properly assessed according to the IRS’s calculation instructions, conservation easements may not be the best choice for land preservation. Depending on the loss of tax revenues, it may be more economically efficient to collect the taxes and use the money to purchase land in fee. (citation omitted).” Jessica Owley, Changing Property in a Changing World: A Call for the End of Perpetual Conservation Easements, 30 Stan. Envtl. L.J. 121, 150–51 (2011).

22 Façade easements support charities that monitor their compliance. Those charities often require the easement donors to make cash donations equal to a certain percentage (generally ten percent) of the value of their easements for that work. This practice in turn often encourages the charity’s acquiescence to an easement donation’s overvaluation. See infra notes 37, 125, and text discussion in Kaufman III in Part III.C.
return." Both were close to one-half million dollars per return. For comparison, the average donation of stock per return was $86,186 in that same year.

### Table 1. Individual Charitable Contributions of Façade Easements from 2005 to 2009

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Returns</th>
<th>Number of Donations</th>
<th>Average Amount Per Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>1,028</td>
<td>1,132</td>
<td>299,080</td>
</tr>
<tr>
<td>2006</td>
<td>1,143</td>
<td>1,145</td>
<td>231,572</td>
</tr>
<tr>
<td>2007</td>
<td>228</td>
<td>242</td>
<td>974,779</td>
</tr>
<tr>
<td>2008</td>
<td>1,180</td>
<td>1,396</td>
<td>32,462</td>
</tr>
<tr>
<td>2009</td>
<td>94</td>
<td>103</td>
<td>477,225</td>
</tr>
</tbody>
</table>

### Table 2. Individual Charitable Contributions of Corporate Stock from 2005 to 2009

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Returns</th>
<th>Number of Donations</th>
<th>Average Amount Per Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>181,192</td>
<td>339,828</td>
<td>90,162</td>
</tr>
<tr>
<td>2006</td>
<td>187,325</td>
<td>429,139</td>
<td>122,745</td>
</tr>
<tr>
<td>2007</td>
<td>202,019</td>
<td>450,824</td>
<td>117,458</td>
</tr>
<tr>
<td>2008</td>
<td>123,510</td>
<td>268,344</td>
<td>99,912</td>
</tr>
<tr>
<td>2009</td>
<td>112,852</td>
<td>231,171</td>
<td>86,186</td>
</tr>
</tbody>
</table>

At least some of the differences in both façade easement and corporate stock donations in 2007 and 2008 could be attributed to the economic downturn occurring in 2008, affecting real estate prices, stock prices, 

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23 2009 Noncash Donations, supra note 3.
24 Id.
26 See sources cited supra note 25.
and charitable giving generally. However, the results for façade easements appear to be anomalies, but it is impossible to determine the causes because, with so few donors, further inquiries run into prohibited identity disclosures of individual taxpayers. Ignoring those years as outliers, the number of façade easement donors is small and the claimed donation is large.

Although one of the only two types of noncash charitable gifts that increased in 2009, from $0.38 billion in 2008 to $0.45 billion in 2009, the number of taxpayers claiming deductions for façade easement contributions decreased. In 2009, there were only ninety-four returns claiming the façade easement deduction, as compared to 112,852 returns claiming deductions for corporate stock.

To underline how few taxpayers benefit from the façade easement charitable deduction, the 2010 and 2011 Internal Revenue Service (Service) statistics for noncash charitable deductions combine all conservation easements into one category. According to the senior analyst preparing this data, there are insufficient data to segregate the statistics for each subcategory, such as façade easements, and therefore to disclose that specific information "would constitute an unlawful disclosure of individual taxpayer data and therefore could not be provided." In 2010, there were 2,933 returns claiming charitable contributions of all types of conservation easements including façade easement donations; in 2011, there were a total of 1,813 conservation easement returns. Again, their numbers pale in


29 Gerald P. Dwyer, Stock Prices in the Financial Crisis, FEDERAL RESERVE BANK OF ATLANTA (September 2009), http://www.frbatlanta.org/cenfs/pubscf/stock_prices_infinancial_crisis.cfm ("Stock prices fell roughly 50 percent from peak to trough from October 2007 to March 2009.").


31 See infra note 33.

32 2009 Noncash Donations, supra note 3.

33 See E-mail from Ruth Schwartz, Statistics of Income Div., Internal Revenue Service, to author (June 4, 2014) (on file with author).


35 See Pearson Liddell & Janette Wilson, Individual Noncash Contributions, 2011, 33
relation to the number of returns claiming corporate stock donations for those years: 123,109 returns in 2010\textsuperscript{36} and 112,094 returns in 2011.\textsuperscript{37}

Because the value of a façade easement represents a small fraction of the value of the encumbered property before the creation of the easement, the underlying property values are likely to be many times the value of the deduction—that means that by retaining the façade easement deduction, Congress is benefiting a small number of multi-millionaires.\textsuperscript{38} That is, by means of the façade easement deduction, Congress is giving alms to very wealthy property owners and is not meaningfully providing for the public good.

II. THE FAÇADE EASEMENT CHARITABLE DEDUCTION

The income tax conservation easement deduction is provided for by section 170(h) and is further explained in Treasury Regulation section 1.170A-14.\textsuperscript{39} For the donated land interest to qualify as serving exclusively

\begin{flushleft}
STAT. OF INCOME BULL. 111 (2014) [hereinafter 2011 Noncash Donations].
\end{flushleft}

\textsuperscript{36} 2010 Noncash Donations, supra note 34.

\textsuperscript{37} 2011 Noncash Donations, supra note 35.

\textsuperscript{38} Because most historic structures are subject to local restrictions, the easement’s actual value is likely to be minimal or zero; however, as case law indicates many of the easements were not properly valued but were valued by multiplying the value of the property without the easement by a fixed percentage of between 11 and 12.5 percent. See infra note 131; see also Rothman v. Commissioner, 103 T.C.M. (CCH) 1864 (T.C. 2012), vacated in part, 104 T.C.M. (CCH) 126 (T.C. 2012) (holding on reconsideration that the taxpayer’s appraisal “still fails to satisfy 8 of 15 requirements” for a qualified appraisal). Thus, if the average façade deduction is $300,000, by that improper valuation method but often used percentage, the value of the historic home is somewhere between $2.4M and $2,727,273 (i.e., $300,000 divided respectively by .125 and by .11).

\textsuperscript{39} I.R.C. § 2031(c)(8)(B) provides an estate tax exclusion for qualified conservation easements, but that exclusion of estate tax value is not available to façade easements. This estate tax provision identifies those easements with reference to the definition of “a qualified conservation contribution (as defined in section 170(h)(1) of a qualified real property interest (as defined in section 170(h)(2)(C)), except that clause (iv) of section 170(h)(4)(A) shall not apply, and the restriction on the use of such interest described in section 170(h)(2)(C) shall include a prohibition on more than a de minimis use for a commercial recreational activity.” (emphasis added)). The I.R.C. § 2031(c) conservation easement exclusion was enacted as part of the Taxpayer Relief Act of 1997, P.L. 105-34, § 508(a). If the executor so elects, the estate may exclude the lesser of a maximum of forty percent of the value of the land subject to the qualified conservation easement, reduced by any amount of estate tax charitable deduction claimed under I.R.C. § 2055(f) for the same land, or $500,000 from the value of decedent’s gross estate. That provision was amended by the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, § 551(a), amending I.R.C. §§ 2031(c)(2) and (c)(8), removing most of the geographical limitations of the statute. Before the 2001 act, the exclusion was restricted to land located close to a metropolitan area, national park,
conservation purposes, it must satisfy the requirements of both subsections 170(h)(4) and 170(h)(5). Gift and estate tax deductions are allowable wilderness area, or urban national forest; with the 2001 amendment, the exclusion is available to conservation easements attached to any land within the United States or a U.S. possession.

40 I.R.C. § 170(h)(4) provides:

(A) In general. — For purposes of this subsection, the term "conservation purpose" means — (i) the preservation of land areas for outdoor recreation by, or the education of, the general public, (ii) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem, (iii) the preservation of open space (including farmland and forest land) where such preservation is — (I) for the scenic enjoyment of the general public, or (II) pursuant to a clearly delineated Federal, State, or local governmental conservation policy, and will yield a significant public benefit, or (iv) the preservation of an historically important land area or a certified historic structure.

(C) Certified historic structure — For purposes of subparagraph (A)(iv), the term "certified historic structure" means any building, structure, or land area which

(i) is listed in the National Register, or

(ii) is located in a registered historic district (as defined in section 47(c)(3)(B)) and is certified by the Secretary of the Interior to the Secretary as being of historic significance to the district.

A building, structure, or land area satisfies the preceding sentence if it satisfies such sentence either at the time of the transfer or on the due date (including extensions) for filing the transferor's return under this chapter for the taxable year in which the transfer is made.

I.R.C. § 170(h)(5) provides:

Exclusively for conservation purposes — For purposes of this subsection —

Conservation purpose must be protected — A contribution shall not be treated as exclusively for conservation purposes unless the conservation purpose is protected in perpetuity.

No surface mining permitted —

In general — Except as provided in clause (ii), in the case of a contribution of any interest where there is a retention of a qualified mineral interest, subparagraph (A) shall not be treated as met if at any time there may be extraction or removal of minerals by any surface mining method.

Special rule — With respect to any contribution of property in which the ownership of the surface estate and mineral interests has been and remains separated, subparagraph (A) shall be treated as met if the probability of surface mining occurring on such property is so remote as to be negligible.
under sections 2522(d) and 2055(f), respectively.41

Congress enacted and has maintained the deduction to reimburse owners of historic buildings for the additional cost incurred in maintaining and insuring the buildings and to recompense the owners for the loss in property value due to their restricted use.42 Nowadays, many communities have homeowners’ associations that restrict an owner’s property usage in order to maintain or increase property values in that community.43 Congress likewise enacted a rehabilitation credit to renovate these structures.44

All of the conservation easement Internal Revenue Code (Code) provisions provide exceptions to the general rule that donations that contain both charitable and noncharitable interests are nondeductible.45 Indeed, because of the opportunities for abusive shifting of benefits to the noncharitable beneficiary, Congress, the courts, and scholars have continually acknowledged the potential for and existence of abuse with

41 I.R.C. § 2522(d) provides: “A deduction shall be allowed under subsection (a) in respect of any transfer of a qualified real property interest (as defined in section 170(h)(2)(C)) which meets the requirements of section 170(h) (without regard to paragraph (4)(A) thereof).” I.R.C. § 2055(f) provides for an identical description of the deduction for estate tax purposes.

42 See, e.g., Federal Historic Preservation Tax Incentives Program (1976). However, the initial legislation lacked clarity in its requirements. See Glass v. Commissioner, 124 T.C. 258, 279 n.16 (2005) (“Congress did not in the TRA 1976 define (or indicate the meaning of) either the word ‘exclusively’ or the term ‘exclusively for conservation purposes.’ Nor does the legislative history of the TRA 1976 shed any light on the meaning of that word or that term.”). Likewise, the statute is not particularly helpful in explaining the “exclusively for conservation purposes” requirement. “The statute contains no further specific guidance as to when a contribution of a qualified real property interest that is protected in perpetuity will be exclusively for conservation purposes.” Id. at 277. However, the court in Glass did find some assistance in subsequent tax legislation. According to the conference report for the Tax Reduction and Simplification Act of 1977: “it is intended that a contribution of a conservation easement *** qualify for a deduction only if the holding of the easement *** is related to the purpose or function constituting the donee’s purpose for exemption *** and the donee is able to enforce its rights as holder of the easement***and protect the conservation purposes which the contribution is intended to advance. The requirement that the contribution be exclusively for conservation purposes is also intended to limit deductible contributions to those transfers which require that the donee hold the easement *** exclusively for conservation purposes (i.e., that they not be transferable by the donee in exchange for money, other property, or services).” H.R. Rep. 95-263, at 30–31 (1977) (Conf. Rep.), cited in Glass at 279.

43 Today, many homes are purchased in developments with community homeowners rules. See supra note 7. Moreover, zoning has traditionally restricted area usage. See Bradley C. Karkainen, Zoning: A Reply to the Critics, 10 J. LAND USE & ENVTL. L. 45 (1994).

44 See I.R.C. § 47.

45 For the prohibition against split interest gifts, see I.R.C. § 170(f)(3), specifically I.R.C. § 170(f)(3)(B)(iii) for the exception of conservation easements to this rule.
regard to split interest transfers. \(^{46}\)

III. THE ABUSES: REVIEW OF RECENT CASE LAW

A. Overvaluation and Questionable Devaluation

With façade easements, overvaluation and inaccurate appraisals are endemic. The Service issued Notice 2004-41 \(^{47}\) to notify both donors and charities that the government was going to scrutinize conservation easements and not only deny deductions, but also, where warranted, to impose penalties and excise taxes and revoke a charity’s tax exempt status. According to the Service, however, abuses relating to façade easements persist. \(^{48}\)

Scholars and the courts have appreciated the difficulty in valuing split interest property donations that provide a benefit not only to the charity but also to the donor. With conservation easements that require the donee to monitor and enforce the easement in perpetuity, the quid pro quo value of the donation is even more difficult to calculate. \(^{49}\) Façade easement charities typically require a cash donation equal to a percentage of the value of the donated easement. That practice, according to some courts, contributes to

\(^{46}\) See, e.g., Turner v. Commissioner, 126 T.C. 299, 317 (2006) (citing S. REP. No. 96-1007, at 9–10 (1980) ("[T]he committee believes that provisions allowing deductions for conservation easements should be directed at the preservation of unique or otherwise significant land areas or structures * * * the committee bill would restrict the qualifying contributions where there is no assurance that the public benefit, if any, furthered by the contribution would be substantial enough to justify the allowance of a deduction. * * *").

\(^{47}\) 2004 IRS Notice, supra note 14 ("This notice informs taxpayers that the Service will, in appropriate cases, reduce or disallow deductions claimed by taxpayers under section 170 of the Code for transfers in connection with conservation easements. This notice also informs participants in these transactions that they may be subject to other adverse tax consequences, including penalties, excise taxes, and loss of tax-exempt status, as appropriate.").

\(^{48}\) See, e.g., INTERNAL REVENUE SERVICE, Conservation Easements, IRS.GOV (Apr. 17, 2014), http://www.irs.gov/Charities-&-Non-Profits/Conservation-Easements ("Another problem arises in connection with historic easements, particularly façade easements. Here again, some taxpayers are taking improperly large deductions. They agree not to modify the façade of their historic house and they give an easement to this effect to a charity. However, if the façade was already subject to restrictions under local zoning ordinances, the taxpayers may, in fact, be giving up nothing, or very little. A taxpayer cannot give up a right that he or she does not have."); 2014 IRS News Release, supra note 14.

\(^{49}\) Halperin, supra note 13, at 311 ("Donors maybe giving up very little, particularly because the burden on a donor depends on the holder’s monitoring and enforcing the use restrictions over the long term. Also, an easement’s benefit to the public may be much less than the purported loss to the donor. The professional staffs of the JCT and the Senate Finance Committee expressed similar reservations in 2005.” (citations omitted)).
the easement itself being overvalued: the charity that gains more from a higher valuation is not likely to question even a conspicuously large easement value.\(^{50}\)

In *Friedberg*,\(^{51}\) a 2013 façade easement case involving tax year 2003 and a claimed deduction of $3,775,000,\(^{52}\) the taxpayer’s appraiser listed among “downward” factors of a façade easement full development loss, possibly more maintenance costs, no choice or change in the building exterior, and the fact that future owners would not be able to benefit tax-wise from adding a façade easement to the property.\(^{53}\)

In *Gorra*,\(^{54}\) a 2013 case involving a façade charitable deduction in tax years 2006 and 2007,\(^{55}\) even where the court agreed that the taxpayers’ easement was more restrictive than local law and served a valid conservation purpose in perpetuity, the court reduced the taxpayers’ claimed easement value of $605,000 to $104,000, which represents approximately an eighty-three percent reduction in valuation. As such, the easement created only a two percent diminution of the building’s value.\(^{56}\)

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\(^{50}\) See supra note 22; infra Part III.C. Kaufman III and accompanying notes.

\(^{51}\) Friedberg v. Commissioner (*Friedberg II*), 106 T.C.M. (CCH) 360 (T.C. 2013), supplementing *Friedberg I*, 102 T.C.M. (CCH) 356 (T.C. 2011) (granting the government summary judgment on the basis that the taxpayers’ appraisal, which applied a percentage diminution rather than the required “before and after” valuation method and which considered property outside of New York City, was not a qualified one). The court granted the taxpayers summary judgment on their motion for reconsideration in light of *Scheidelman v. Commissioner* (*Scheidelman II*), 682 F.3d 189 (2d Cir. 2012). The second circuit in *Scheidelman II* held that the regulation dealing with an appraisal’s identification of his valuation method only requires that he report that method, and not that there be an adequate basis for or reasonable use of that method. *Scheidelman II* at 196–97. The *Friedberg II* court held that the taxpayers’ expert’s appraisal was a qualified one prepared by a qualified appraiser under *Scheidelman II* because it “includes a specific basis for [the appraiser’s] valuation . . . . However, we specifically do not opine on the reliability and accuracy of the methodology and specific basis of valuation in the [taxpayer’s appraiser’s] appraisal, a matter we leave to be decided at trial.” *Friedberg II*, slip op. at 8.

\(^{52}\) *Friedberg II*, slip op. at 5. The taxpayers made a required $350,000 cash contribution to monitor the property. *Id.* slip op. at 1.

\(^{53}\) *Id.* slip op. at 4.

\(^{54}\) Gorra v. Commissioner, 106 T.C.M. (CCH) 523 (2013).

\(^{55}\) *Id.* (The 2007 deduction related to the 2006 façade easement contribution, which, because of the percentage limitations in I.R.C. § 170(b) on current year deductibility, had to be carried over as a deduction into the following year).

\(^{56}\) The taxpayer also made a $45,000 cash contribution to cover monitoring costs as required by the charity. *Id.* slip op. at 2. In 2009, the charity allowed the taxpayers to add a retractable awning to the building’s façade because it “determined that the awning was consistent with the historical character of the property.” *Id.* slip op. at 6.
The court thereby imposed a gross valuation penalty\textsuperscript{57} under such circumstances, resulting in a forty percent penalty on the portion of the underpayment attributable to the gross valuation misstatement.

Most of the homes involved are already subject to local building restrictions. Thus, taxpayers who purchased their homes in a historic district bought them with concomitant expectations of maintaining historic façade easements. Moreover, those restrictions were imposed to maintain and improve property values. In \textit{Scheidelman}, the court held that the taxpayers’ easement had zero value because the easement echoed local restrictions. Likewise, in \textit{1982 East}, the court did not find that the easement provided any “additional meaningful protection not already guaranteed by the LPCs enforcement of local law.”\textsuperscript{58} Indeed, in that case, the bank mortgagee checked to ascertain that the collateral value of the building would not be affected by the imposition of the easement and “concluded that it would not.”\textsuperscript{59} The taxpayers’ experts in \textit{Dunlap}\textsuperscript{60} did not explain how the charitable easement was more restrictive than the regulations imposed by the New York City Landmarks Preservation Commission.

Similarly, recently in \textit{Chandler},\textsuperscript{61} the South End Landmark District Commission (SELDc) already regulated the two properties subject to façade easements. “The SELDC’s powers closely approximate [the charity’s] powers under the easement agreements with some exceptions.”\textsuperscript{62} The court held that the taxpayers’ expert’s appraisal was totally unreliable.

\textsuperscript{57} I.R.C. § 6661(h).
\textsuperscript{58} 1982 East, LLC v. Commissioner, 101 T.C.M. (CCH) 1380, slip op. at 10 (2011), available at http://www.ustaxcourt.gov/InOpHistoric/1982EastLLC.TCM.WPD.pdf (“Thus it is local law and the rules of the LPC that preserve the subject property and not the rights which [the charity] possessed under the deed of easement.”).
\textsuperscript{59} Id. slip op. at 4.
\textsuperscript{60} Dunlap v. Commissioner, 103 T.C.M. (CHH) 1689 (T.C. 2012) (This case is a consolidated case with taxpayers who owned units in the Cobblestone Loft Condominium (Cobblestone), which is located in a historic district in New York City, and who granted façade easements to the same charity); see Wendy C. Gerzog, \textit{Façade Easement: Inexpert Valuation}, 136 Tax Notes 199 (July 9, 2012). In \textit{Seventeen Seventy Sherman Street LLC v. Commissioner}, 107 T.C.M. (CCH) 1599 (T.C. 2014), although the court did not need to decide this issue because it held that the taxpayer had not proved that it had transferred a greater value for its interior and exterior easement grants than the property it received in return, the taxpayer had claimed a $7,150,000 charitable deduction for property already subject to some exterior restrictions by the Denver Landmark Preservation Commission.
\textsuperscript{62} Id. slip op. at 6. Those exceptions included that the local law restrictions only covered construction publicly visible, they relied on public complaints for violation notification, and they contained an exemption from enforcement for owners who could show that they would thereby encounter significant financial hardship. \textit{Id}
The encumbered property was located in or near Boston, but the appraiser used "comparables" from New York City and New Orleans; the sample was too small; the New Orleans valuation was based on a settlement amount when the buyer discovered that the property sold was encumbered by an easement; only one of the four Boston property appraisals was not "seriously flawed"; and the appraiser made subjective adjustments that the court dismissed as unhelpful. Significantly, however, while the appraiser determined that one data point property sold for between 12.8% and 18.5% less than two other properties because of the differences in their encumbrances, the court found that the deed of that property contained substantially similar limitations to the other property's easements. According to the court, "This indicates that the difference in price resulted from some other factor that [the appraiser] did not consider. This error undermines [the appraiser's] credibility concerning not only this comparison, but the entire report."

At the same time, the court rejected the government's appraisal that showed an appreciation in value in Boston encumbered property after the easements were granted because it did not specify how much of that increase was due to renovations property owners had made. Although the taxpayers pointed to distinctions between the easement and local law limitations, the court held that, like in Kaufman IV, those differences were not likely to be meaningful to a buyer. Rejecting the taxpayers' appraisal report in its totality as not credible, the court held that the taxpayers had not proved any value for their façade easement contribution.

Despite that the properties were already subject to local rules and regulations requiring them to maintain the historic features of their house,

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63 The court considered the out of state easements unpersuasive. Id. slip op. at 12 ("The values of easements in other markets tell us little about easement values in Boston's unique market.").

64 The taxpayers' appraiser made major adjustments based on his own subjective rating of the properties' condition. "Because of these significant subjective adjustments, [the appraiser's] conclusions flowing from these comparisons largely reflect his opinion rather than the objective market values of the easements. When an appraiser makes numerous adjustments to a subject property’s comparables, the subject property’s valuation becomes less reliable." Id. slip op. at 14. The taxpayers' appraiser's report also had procedural mistakes. "He calculated the easement values by dividing the difference in sale prices by the encumbered property’s price. He then applied that percentage to the before value of petitioners' properties to calculate the easement values. He should have divided the difference in sale prices by the unencumbered property’s sale price. We have adjusted the data in his report to account for this error." Id. slip op. at 11 n.3.

65 Id. slip op. at 15.

66 Id. slip op. at 15–16 ("Mr. Bowman selected nine recently encumbered Boston properties that sold between 2005 and 2011.").
the easement values for which the taxpayers had claimed charitable
deductions were very large: 61 York Acquisition, LLC, $10,730,000
(partnership level deduction); 67 1982 East, $6,570,000 (partnership level
deduction); 68 Carpenter, $385,600; 69 Chandler, $191,400 (the Claremont
property easement) and $371,250 (the West Newton easement); 70 Dunlap,
$237,000; 71 Friedberg, $3,775,000; 72 Gorra, $605,000; 73 Graev,
$990,000; 74 McSweens, $2,210,464; 75 Scheidelman, $115,000; 76
Schrimsher, $705,000; 77 Simmons, $162,500 (Logan Circle) and $93,000
(Vermont Avenue), 78 and Van Wyhe, $801,121. 79

Memo. LEXIS 274 (T.C. 2013) (Despite its façade easement deduction claim, the court
disallowed any deduction on the ground that because the partnership owned only the first
fourteen levels of a twenty story building, it could not satisfy the statutory requirement that
its grant of a façade easement restrict the entire exterior of the historic structure as required
under I.R.C. § 170(h)(1)).

68 1982 East, LLC v. Commissioner, 101 T.C.M. (CCH) 1380 (T.C. 2011), available

69 Carpenter v. Commissioner, 103 T.C.M. (CCH) 1001 (T.C. 2012). Carpenter was a
consolidated case, involving other taxpayers with substantially similar facts. Carpenter
claimed a deduction on her 2004 return; Van Wyhe, partly on his 2004 return with
carryovers on his 2005 and 2006 returns; the McSweens, partly on their 2003 and 2004
returns, with carryovers on their 2004 and 2005 returns. See I.R.C. § 170(b).

70 The Chandlers deducted a part of this amount over three tax years (2004–2006). See
I.R.C. § 170(b).

71 This figure represents the Dunlaps’ claimed façade easement deduction (i.e., their
share of the total Cobblestone easement appraised value of $8,171,000).

72 Friedberg v. Commissioner (Friedberg I), 102 T.C.M. (CCH) 356 (T.C. 2011).


75 The McSweens were taxpayers in the consolidated Carpenter case. See supra note 69.

76 Scheidelman v. Commissioner (Scheidelman I), 100 T.C.M. (CCH) 24, slip op. at 11
WPD.pdf.

77 Schrimsher v. Commissioner, 101 T.C.M. (CCH) 1329 (T.C. 2011) (The taxpayers
deducted $193,180 in 2004 and took carryover deductions of $206,699 in 2005 and $120,724
in 2006. The court denied the façade easement deduction on the basis that the taxpayers did
not receive a contemporaneous written acknowledgement of their donation as required under
I.R.C. § 170(f)(8)).

78 Simmons v. Commissioner, 98 T.C.M. (CCH) 57924 (T.C. 2009), aff’d 646 F.3d 6
(D.C. Cir. 2011). The taxpayer had donated the larger deduction easement in 2003 and the
other easement in 2004, taking the full deduction respectively in the applicable year. The
Tax Court reduced these easement values to $56,250 (Logan Circle) and $42,250 (Vermont
Avenue).

79 Van Wyhe was a taxpayer in the consolidated Carpenter case. See supra note 69.
Very recently, in Zarlengo,80 the Tax Court reduced the total value of the façade easement deduction claimed from $660,000 to $157,500. Even though the buyer of the townhouse, who did not know about the easement when he made an offer of $4,605,500, did not change his offer after he learned about the easement, the court nevertheless applied a 3.5% diminution to what the court determined was the townhouse’s pre-easement value of $4.5 million when the easement was recorded in 2005. The court allowed a 2005 deduction of $78,750 (and any appropriate carryover deductions for 2006 and 2007) to Ms. Sander-Zarlengo for her one-half interest in the townhouse because the court held that the applicable local restrictions, although similar to those under federal law, were less extensive than the federal limitations.

B. As if that weren’t enough — if no deduction is allowed, I want that easement removed from my property and my cash contribution returned to me!

Façade easement charitable deductions have encouraged an increase in bogus deductions as a result of the “I’d like to have my cake and eat it too” mentality that has led to the encouragement of transfers contingent on receiving the charitable deduction. Both cash required donations (required by the charity to fund the statutorily imposed duty of monitoring the easement in perpetuity) and the transferred property interest (the easement itself) are revocable either by the consent of the parties or in the event of a denial of the deduction.

In Graev,82 a 2013 case involving tax years 2004 and 2005,83 the court

81 The taxpayers, Dr. Zarlengo and his ex-wife Ms. Sander-Zarlengo, each owned one-half of the encumbered townhouse subject to the façade easement and each claimed one-half of the total easement’s value as a charitable donation. The court held that under New York law, a gift of a conservation easement is not complete until it is recorded; here, that recordation date was January 26, 2005. Also, the court held that the taxpayers had not satisfied the perpetuity requirement for conservation easements under I.R.C. §§ 170(h)(2)(C) and 170(h)(5)(A) until that date. Dr. Zarlengo had filed a joint 2004 return with his current wife in which he claimed his share of the easement deduction; because his 2004 return was the only return before the court, he was denied any deduction. By contrast, Ms. Sander-Zarlengo’s 2005–2007 returns were all under the court’s jurisdiction.
83 The 2005 deduction was a carryover from the 2004 easement grant due to the percentage limitations on current deductibility under I.R.C. § 170(b). Graev, 140 T.C. at 387.
disallowed the taxpayers’ claimed easement value of $990,000. The easement grant had a refundable feature whereby the charity agreed to refund the taxpayers’ easement and cash donation. The charity sent a side letter to the taxpayers explaining their standard policy to refund their donation if the taxpayers could not receive the promised favorable charitable deduction. Specifically, the letter promised, “to join with Graev to immediately remove the façade easement from the property’s title.”

The court held that the potential for the Service to disallow those deductions and for the charity to remove the easement and return the cash to Graev was not so remote as to be negligible. The court stated that by filing returns with the deductions and failing to remove the refund feature of their donations, the taxpayers acted in response both to the Service notice indicating additional scrutiny applicable to overvalued façade easements and to the charity’s second letter warning of the government’s disallowance of a deduction for a façade easement that was coupled with a refund provision. Thus the court held that the risk of the government’s disallowing the deduction was “well above ‘negligible.’” According to the court, Graev required the charity’s letter with the refund feature before making his contribution. Also, the easement charity understood that a Service disallowance was more than a remote possibility and that was why it routinely issued comfort letters to potential donors. Thus, as conditional donations, the court held that the taxpayers’ easement grant and cash donations were nondeductible.

84 Id. at 384. In Graev, the taxpayers also made a required cash contribution of $99,000. Id. at 385.
85 Id. at 383.
86 Id. at 393 (“Accordingly, a conservation easement fails to be ‘in perpetuity’ . . . if, on the date of the donation, the possibility that the charity may be divested of its interest in the easement is not so remote as to be negligible.”).
87 Id. at 397.
88 Id. at 409. One month after Graev, in Carpenter v. Commissioner (Carpenter II), 106 T.C.M. (CCH) 62 (T.C. 2013) available at http://www.ustaxcourt.gov/lnOpHistoric/CarpenterMemo.Haines.TCM.WPD.pdf, the Tax Court wrote a supplemental memorandum opinion on a motion to reconsider its 2012 memorandum opinion Carpenter v. Commissioner (Carpenter I), 103 T.C.M. (CCH) 1001 (T.C. 2012) available at http://www.ustaxcourt.gov/lnOpHistoric/CARPENTER.TCM.WPD.pdf, in light of the First Circuit opinion in Kaufman III. See Kaufman III discussion infra Part III.C.. Although not a façade easement, this case involved a conservation easement that, under Colorado law, could be terminated through the parties’ mutual consent because state law would not apply the cy pres doctrine to restricted gifts. As such, the court held Kaufman III to be inapplicable. Thus, the court denied the taxpayers’ motion for reconsideration. Carpenter II, slip op. at 12, 18–23; see Wachter v. Commissioner, 142 T.C. No. 7, slip op. at 6–7 (Mar. 11, 2014), available at http://www.ustaxcourt.gov/lnOpHistoric/WachterDiv.Buch.TC.WPD.pdf (The court held that where the state restricts an easement’s duration to a maximum of ninety-nine years, the
C. Kaufman: Four Opinions Necessary to Show a Valueless Contribution
(Much Ado About Nothing)

1. Kaufman I

In Kaufman I, the Tax Court granted summary judgment for the government on the issue of the disallowance of a charitable deduction for the value of the taxpayers’ Boston rowhouse façade easement because the easement was not granted in perpetuity. The court held that because the mortgage on the building gave first preference of proceeds distribution to the mortgagee rather than to the charity holding the easement, the easement was not granted in perpetuity.

According to the regulations, when conditions change so that the perpetual easement is extinguished, the donee organization must be entitled its proportionate share of the proceeds. The taxpayers conceded that if a casualty occurred, the bank, as mortgagee, had a prior claim to those funds; however, they maintained as a factual matter, in those circumstances, they would likely have been able to satisfy both the bank and the charity’s claims. The court rejected that reading and stated that the perpetuity obligation is one that does not encompass probabilities but only necessary legal requirements.

conservation easement does not satisfy the perpetuity requirement of the statute. The “so remote as to be negligible” exception in the regulations goes to the likelihood that the property interest will return to the donor, regardless of the length of time it takes for the reversion to take effect).

90 The taxpayers had claimed a charitable deduction of $220,800 related to their easement grant, which because of the income percentage restrictions on current year deductibility in I.R.C. § 170(b)(1)(C), had to be partially deducted in the following year, 2004. Kaufman I at 184.
91 See I.R.C. § 170(h)(2)(C), (5)(A); Treas. Reg. § 1.170A-14(a), (g)(6)(ii) (2009). The court denied the government summary judgment on the other two issues: (1) the deductibility of the conditional cash gift to the charity and (2) the taxpayers’ accuracy related penalty liability under I.R.C. § 6662 because of the presence of genuine issues of material fact. Kaufman I at 182–84.
93 Kaufman I at 186.
94 Id. at 186–87. Kaufman I can be contrasted with Irby v. Commissioner, 139 T.C. 371, 382–83 (2012) (where the source of funds for a bargain sale creating the conservation easement were grants from governmental entities that must use the proceeds “in a manner consistent with the original conservation purposes of the [donors’] contribution . . . .”).
2. Kaufman II

In Kaufman II, the Tax Court reviewed its partial summary judgment in favor of the government and decided the two factual issues (the taxpayers' cash contributions and related penalties) that it had earlier held could not be decided by summary judgment. The court allowed both parties to amend their positions on the taxpayers' 2003 and 2004 cash charitable deductions, which in turn caused a reassignment of their respective burdens of proof. After its amendments, the government bore the burden of proof regarding the increased deficiency and penalty for 2004 from its disallowing the $3,032 deduction, and the quid pro quo ground for disallowing the taxpayers' 2003 $16,840 cash contribution deduction, as it represented new matter for the taxpayers to rebut.

The court in Kaufman II reviewed its grant of partial summary judgment for the government that denied any deduction for the taxpayers' façade easement contribution because it did not satisfy the perpetuity requirements outlined in the regulations and was not a qualified conservation contribution under section 170(h)(1). The taxpayers contended that the agreement in fact required enforcement in perpetuity as defined in the regulations. The government maintained that the combination of the easement and lender agreement did not comply with the extinguishment provision in the regulations.

The court first cited to the treatise Powell on Real Property wherein Powell wrote, "a conservation easement may be terminated without the consent of the holder: through the foreclosure of a pre-existing mortgage or mechanic's lien on property subsequently encumbered by the easement." The court then explained that no deduction is permitted for an interest subject to a mortgage unless the mortgagee subordinates its property rights

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96 In May 2010, before the trial, petitioners amended their petition, claiming a 2004 deduction of $16,840. In June 2010, after the trial, the government amended its answer to increase the taxpayers' 2004 deficiency and to assess an accuracy-related penalty. Both parties agree that the $300 bank fee Kaufman paid to NAT is nondeductible. Kaufman II at 314.

97 Id. at 315.


99 Kaufman II at 302 (referring to Treas. Reg. §§ 1.170A-14(g)(2) and (3)).

100 Kaufman II at 302–03 (referring to Income Tax Reg. § 1.170A-14(g)(6)); see Wall v. Commissioner, 103 T.C.M. (CCH) 1906 (T.C. 2012) (same issue with the same result).

101 Kaufman II at 304 (although Powell also explains that public policy considerations may make the doctrine inapplicable).
to the donee organization’s perpetual conservation enforcement obligation. The court discussed an exception that provides a deduction will not be disallowed if an event that could defeat the interest from passing to the charity is only remotely likely to occur. However, the regulations did not conceive of a mortgage failure as a remote event and the court emphasized that the charity’s property rights must remain the same even when there are changed conditions and an extinguishment of the easement. Thus, on a sale, exchange, or involuntary conversion, the charity must retain its proportionate share of the proceeds. The court interpreted the extinguishment regulations to require that “the donee have a right to a share of the proceeds and not merely a contractual claim against the owner of the previously servient estate.”

The first of the two new issues in Kaufman II was the deductibility of the taxpayers’ conditional cash contributions to the charity. The charity had sent a letter to the taxpayers stating that easement donors were required to contribute a cash endowment to the charity equal to ten percent of the value of the tax deduction. The letter explained that the cash contribution would cover the present and future costs of monitoring the donation in perpetuity. In addition, the letter explained that if the taxpayers did not qualify for a charitable deduction, the donors and the charity would join together to void the easement and the donors would be reimbursed for their appraisal costs and cash contribution.

102 Id. at 305 (citing Treas. Reg. §§ 1.170A-14(g)(1)–(3)). Although the taxpayers argued the applicability of the regulation’s remote and negligible” standard protects against the possibility that “events of such low probability will defeat the donee’s interest in the servient property,” but that the regulation also does not address compensation on actual defeasance. The court explained that: “unlike the risk addressed by the so-remote-as-to-be-negligible standard, in order to satisfy the extinguishment provision, section 1.170A-14(g)(6) . . . provides that the donee must ab initio have an absolute right to compensation from the postextinguishment proceeds for the restrictions judicially extinguished. It is Lorna Kaufman’s failure to accord NAT an absolute right to a fixed share of the postextinguishment proceeds that causes her gift to fail the extinguishment provision. Id. at 312–13.


104 Id. at 297. The form indicated that if the donation could not be processed in time to qualify for a deduction in 2003, the charity would allow a ten percent reduction in the cash contribution to the donor once the process was completed in 2004. Id.

105 Id. In a subsequent letter, the charity explained that the required cash donation would be discounted by ten percent because the taxpayers had been delayed in filing their 2003 tax return because of the uncompleted easement contribution. That resulted in a discounted cash contribution of $19,872, plus fees of $300, with a net amount due of $3,332. That amount was due after the easement had received National Park Service certification, which occurred August 9, 2004. The taxpayers submitted the required payment to the charity, which in turn sent an I.R.S. Form 8283, substantiating the facade easement
The government denied the taxpayers’ deductions of cash contributions to the charity because it asserted they were *quid pro quo* for the services the charity provided regarding the façade easement deductions and because they were conditional on subsequent events (the value of the easement or the allowance of a deduction). In its reply brief, the government agreed that the “expected receipt of a tax deduction is not a benefit that invalidates the deduction” but argued that the deduction must be disallowed because the payments were required.\(^\text{106}\) The government also denied a deduction for $3,032 of the 2004 cash payment to the charity, asserting the taxpayers had “relied on a contemporaneous written acknowledgment that they knew was inaccurate in claiming the erroneous charitable deduction.”\(^\text{107}\) The taxpayers contended that although the payments may have been subject to a refund, in 2004 they became fixed and deductible because the parties’ understanding was that the cash contributions were not refundable. The taxpayers argued that the requirement of a cash contribution was a customary practice and was what allowed the charity and similar organizations to have operating funds to administer their easements, and that the cash donation was not conditional on the charity’s approval of the easement and provision of a Form 8283.\(^\text{108}\)

The court found that before the 2004 appraisal it was possible for the easement to be valued at zero. Therefore, the court held that the taxpayers had not satisfied their burden of proof that they were entitled to a cash contribution deduction for 2003.\(^\text{109}\) However, the court agreed with the taxpayers that the clause in the agreement setting cash payments at ten percent of the donation value was not intended to allow for a refund if the taxpayers’ deductions were disallowed.\(^\text{110}\) Furthermore, the court agreed with the government that *Hernandez*\(^\text{111}\) requires payments to be “unrequited” for them to be deductible. However, the court pointed out that neither party had cited any precedent to support its more specific argument, making it difficult for the court to find any benefit accruing to the taxpayers from the cash contribution apart from its enabling the charitable contribution. Therefore, the court allowed the taxpayers a 2004 cash charitable contribution deduction for $19,872.\(^\text{112}\)

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\(^{106}\) *Id.* at 300–01.

\(^{107}\) *Id.* at 315.

\(^{108}\) *Id.* at 315–18.

\(^{109}\) *Id.* at 316 ("Petitioners bear the burden of proving that, at the end of 2003, the possibility of a zero appraisal value was not so remote as to be negligible.").

\(^{110}\) *Id.* at 316–17.


\(^{112}\) *Kaufman II* at 320–22. The court noted that in another case, *McMillan v.*
The second new issue in Kaufman II was the imposition of various penalties,\textsuperscript{113} for which the government bore the burden of proof.\textsuperscript{114} Because of government concessions and because the taxpayers proved reasonable cause and good faith, a statutory defense to the penalties,\textsuperscript{115} the court upheld only the accuracy-related penalty. The court found the taxpayers had been negligent in their 2003 underpayment attributable to the taxpayers’ cash contributions to the charity.

3. Kaufman III

In Kaufman III,\textsuperscript{116} both the government and the taxpayers appealed the 2010 and 2011 Tax Court decisions (Kaufman I & II). The First Circuit Court of Appeals vacated the lower court’s judgments, apart from its holding on the deductibility of the taxpayers’ cash contributions and the accuracy-related penalty on the 2003 cash contribution claim, and remanded the case for the lower court to determine the other issues consistent with the appellate court’s decision.\textsuperscript{117}

In its brief background summary, the appellate court described the taxpayers’ need to have their mortgagee agree to subordinate its interest to the easement charity. In their letter to the mortgagee, they stated that the easement imposed basically the same restrictions as those imposed under

\textit{Commissioner, 31 T.C. 1143 (1959), it had disallowed a deduction for a required fee paid to a charity to place an adopted child in the taxpayers’ home. In that case, the taxpayers’ payment significantly muted to their benefit. By contrast, the court explained that Kaufman’s cash payment to the charity only served to assist her to obtain a charitable deduction and no other benefit. Kaufman II at 318, n.12. Moreover, the court cited Scheidelman v. Commissioner (Scheidelman I), 100 T.C.M. (CCH) 24, slip op. at 11 (T.C. 2010), available at http://www.ustaxcourt.gov/lnOpHistoric/Scheidelman.TCM.WPD.pdf, involving a similar cash payment to the same easement charity in which the court denied a taxpayer deduction. However, in Scheidelman I, the taxpayers had the burden of proof to show the extent to which their payment exceeded the value of their benefit, and they failed to produce any evidence to show that excess. Here, the government had to prove \textit{quid pro quo}, and the court found the evidence ambiguous. Finally, the government failed to provide evidence of the value of Kaufman’s benefit and failed to show that the taxpayers had not substantiated their contribution as required by statute. Kaufman II at 319.}

\textsuperscript{113} I.R.C. § 6662.
\textsuperscript{114} I.R.C. § 7491(c).
\textsuperscript{115} I.R.C. § 6662 (c).
\textsuperscript{116} Kaufman v. Shulman (Kaufman III), 687 F.3d 21 (1st Cir. 2012).
\textsuperscript{117} Id. at 33. Because the Tax Court’s decision not to impose penalties in connection with the claimed noncash contributions were intertwined with its grant of partial summary judgment in Kaufman II, the appellate court also vacated the Tax Court’s holdings on that issue. Id. at 30. In addition, the court also held that each party was liable for its own court costs. Id. at 33.
local law. The court then stated that, if that assertion were true, then the mortgagee "would lose little or nothing by consenting." Likewise, when Mr. Kaufman worried that the easement would reduce the property’s value to a degree that would undermine the tax benefit from the charitable deduction, the charity’s representative "sought to reassure him that it was ‘very unlikely’ that the easement would affect the marketability of the property." The taxpayers received the mortgagee’s agreement to subordinate its rights to the charity’s right to enforce the easement in perpetuity. However, the lender agreement contained a stipulation that gave the mortgagee a prior claim to insurance proceeds from a casualty on, or a condemnation of, the property.

The circuit court’s legal analysis of the conservation easement charitable deduction statute and regulations focused on the subsection (g) of the income tax regulation and specifically paragraph (g)(6) that, the court said, the Tax Court had "relied entirely on" to disallow the taxpayers’ façade easement deduction. The court described what it considered to be the two reasons for the extinguishment provision that requires that the charity be entitled to its pro rata share of insurance proceeds: to prevent a windfall to the easement donor and to insure that the charity could use its share to pursue its charitable purpose elsewhere.

The circuit court’s reading of the Tax Court’s opinion was that although the taxpayers had ostensibly satisfied the extinguishment regulation, the lender agreement provision between the taxpayers and the mortgagee prevents such compliance by granting the mortgagee a superior claim to the easement charity regarding casualty and condemnation insurance proceeds. Regarding the Tax Court’s reading, the appellate court stated that the taxpayers had no power over the mortgagee just as they had no power over a preferential federal or state tax lien. In so doing, the circuit court did not recognize any difference between a statutory preference and one derived by private parties to a contract.

Further, the circuit court stated that "the IRS’s reading of its regulation would appear to doom practically all donations of easements, which is

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118 Id. at 24.
119 Id.
120 Id.
122 Kaufman III at 26. As noted by the court and the taxpayers, moreover, the paragraph applies only where an extinguishment is "by judicial proceeding." Id. at 26 n.3.
123 Id. at 26.
124 Id. at 26–27.
surely contrary to the purpose of Congress."\textsuperscript{125} While that may be true, such an inference may not be accurate because almost all façade easement deductions are taken by very wealthy individuals.\textsuperscript{126} Façade easement holders may either have more clout with their mortgagees than the taxpayers in Kaufman or most façade easement donors may not have the financial need to carry a mortgage on their property.

Finally, the court rejected the government's reading of an easement provision\textsuperscript{127} that it said the government had misinterpreted to mean that the charity had a "blank check" to consent to any statutorily disallowed activity. The appellate court seemed to consider that provision as having no legal effect, that is, as surplusage. Basically, the First Circuit aligned itself with the D.C. Circuit's opinion in Simmons\textsuperscript{128} and agreed that charitable deductions "cannot be disallowed based upon the remote possibility [that the donee organization] will abandon the easements."\textsuperscript{129}

Ultimately, the main thrust of the circuit court opinion was that the case rested on factual findings and therefore granting summary judgment was inappropriate. In its discussion of the taxpayers' valuation overstatement, the court seemed to warm to the government's contention that the easement was valueless, as illustrated by the following court statements: (1) "[g]iven these pre-existing legal obligations the Tax Court might well find on remand that the Kaufmans' easement was worth little or nothing[,]"\textsuperscript{130} and (2) "[i]n an effort to reassure them, a Trust representative told the Kaufmans that experience showed that such easements did not reduce resale value, and this could easily be the IRS's opening argument in a valuation trial."\textsuperscript{131} Finally, the court stated, "we do not question the IRS's concern, transcending this case, that individuals and organizations have

\textsuperscript{125} Id. at 27 (Because of the circuit court's holding on the mortgage subrogation, several Tax Court cases filed a motion for reconsideration); see, e.g., Mitchell v. Commissioner, 106 T.C.M. (CCH) 215 (T.C. 2013) (motion to vacate decision and reconsider the court's earlier opinion in Mitchell v. Commissioner (Mitchell I), 138 T.C. 324 (2012) denied, with the court's holding that Kaufman III decided legal issues (the application of the proceeds regulation) different from the one in Mitchell I (application of the subordination regulation)).

\textsuperscript{126} See infra Part III.C.Kaufman IV; supra notes 124, 38, text in Part I.

\textsuperscript{127} The easement agreement states, "[N]othing herein contained shall be construed to limit the [Trust's] right to give its consent (e.g., to changes in the Façade) or to abandon some or all of its rights hereunder." Kaufman III at 27–28.

\textsuperscript{128} Commissioner v. Simmons, 646 F.3d 6 (D.C. Cir. 2011).

\textsuperscript{129} Id. at 10, cited in Kaufman III at 28.

\textsuperscript{130} Kaufman III at 31.

\textsuperscript{131} Id. The appellate court also noted that the charity "had a substantial economic incentive" to strive for "a high valuation" due to its cash contribution requirement geared to ten percent of the easement's value. Id. at 32.
been abusing the conservation statute "to improperly shield income or assets from taxation."132

4. Kaufman IV

In Kaufman IV,133 the Tax Court held that each party’s appraisal was admissible, but that the taxpayers’ expert’s valuation approach was defective and that the court would not give it any weight. Thus, the taxpayers had not proved their façade easement donation had any value. In addition, the Tax Court imposed a gross valuation penalty on the taxpayers because they had not proved they were entitled to the defense of reasonable cause or good faith.134

On remand from the appellate court, the Tax Court supplemented its findings of fact and opinion. The court found the following facts regarding taxpayers’ appraisal. The taxpayers employed Timothy J. Hanlon, one of the two appraisers recommended by the charity. Mr. Hanlon had written nine reports valuing façade easements for the charity in 2003 and 2004, but had no other experience appraising partial real property interests. Mr. Hanlon spoke with someone at the charity in connection with his first such appraisal and his notes from that discussion indicate that with respect to façade easements in heavily regulated areas, the Service has accepted a value of about eleven percent of the property’s value, that “95% fall in this

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134 Other court façade easement examples of protracted litigation similar to the four Kaufman opinions are the four opinion cases Scheidelman, supra notes 10, 18, 51, 76, and 112, and WhiteHouse Hotel. WhiteHouse Hotel v. Commissioner, 131 T.C. 112, 118, 172, 176 (2008) (The taxpayer’s 1999 claimed deduction was $7,445,000 reduced by the court to $1,792,301 and resulting in the taxpayer’s liability for a 40 percent gross valuation misstatement penalty. “Therefore, on the 1997 Form 1065, the partnership claimed an amount for the value of the servitude slightly more than 415 percent of its correct value”), vacated and remanded, 615 F.3d 321, 324 (5th Cir. 2010), (with the Tax Court on remand valuing the façade easement at $1,857,716, subject to the forty percent penalty. See Whitehouse Hotel v. Commissioner, 139 T.C. 304, 348, 361–62 (2012), aff’d in part (on the valuation issue) and vacated in part and remanded (on the penalty issue), ___ F.3d ___ (5th Cir. 2014) (reversing as clearly erroneous, the court stated, “Obtaining a qualified appraisal, analyzing that appraisal, commissioning another appraisal, and submitting a professionally-prepared tax return is sufficient to show a good faith investigation as required by law.”).
“percentage,” and that he “could use 11.5%-12.5%.”[135]

Mr. Kaufman, a professor emeritus of the Sloan School of Management at M.I.T., a specialist in statistical analysis,[136] emailed a representative of the charity that he was concerned about the resale devaluation of a façade burdened home and asked for statistical documentation on the potential for such an effect. In response, the charity’s representative emailed him that there would be no valuation loss created by the easement.

We have tracked 26 resold properties to-date on which we held an easement, and none was resold at a loss or had any issues for resale that we are aware of. Over 100 lenders have approved to subordinate their loans to our easements to-date in over 800 cases. **Why would these banks (including yours) approve these transactions if they saw a risk or adverse financial impact on their collateral?**

*One of our directors, Steve McClain, owns fifteen or so historic properties and has taken advantage of this tax deduction himself. He would have never granted any easement if he thought there would be a risk or loss of value in his properties.*[137]

In a letter to their mortgagee, moreover, the taxpayers stated: “[t]he easement restrictions are essentially the same restrictions as those imposed by current local ordinances that govern this property.”[138]

The government’s expert, John C. Bowman III, a Massachusetts certified general real estate appraiser, held a Certificate of Completion for the Valuation of Conservation Easements program offered by the American Society of Appraisers and had served on the Boston Landmarks Commission for ten years, serving as chairman of the commission for six years. “He ha[d] extensive experience appraising partial interests in real property, including conservation easements.”[139] Mr. Bowman reviewed both the Hanlon appraisal and an appraisal prepared by Joan Gootee, a Service employee. His preliminary view on the Hanlon appraisal was that there was no devaluation related to development potential since the property was being used at its highest and best use as a single-family home. In determining the value of the easement, Hanlon used a percentage discount to the unencumbered value of the property and made no appraisal of the “after” easement value despite his acknowledging that the “before and

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[136] Id. slip op. at 4.
[137] Id. slip op. at 11.
[138] Id.
[139] Id. slip op. at 13.
after" approach was the correct appraisal method for conservation easements. Further, Bowman agreed with the conclusion of the Gootee appraisal that the easement duplicated local historic building restrictions. For those reasons, Bowman concluded that the façade easement value was zero.

The court’s opinion began with a discussion of which party held the burden of proof on the value of the façade easement, but ultimately held it need not decide that issue because the court was able to determine "the valuation question on the basis of essentially agreed facts along with the assistance we may find helpful in the parties’ expert’s opinions." On the penalties issue, by statute, the government has the burden of production; but, if it has met that burden, the taxpayers have the burden to prove that they should not be subject to those penalties due to reasonable cause.

Next, the court addressed the valuation issue. The fair market value of a conservation easement is its value at contribution. Where there are no significant comparable sales, the easement’s value is determined by subtracting the "after" (encumbered) value of the property from the "before" (unencumbered) value of the property. The taxpayers contended that its value was $220,800, while the government asserted its value was zero.

In great detail, the court discussed each expert’s report and methodology. The court found that the experts were qualified experts but expressed concern about the close relationship between Hanlon and the charity. The court also stated that the charity had an interest in

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140 Id. slip op. at 14.
141 Id.
142 Id. slip op. at 16.
143 I.R.C. § 7491(c).
144 Kaufman IV slip op. at 17.
145 Id. slip op. at 18.
146 Id. slip op. at 47 ("What does concern us with respect to Mr. Hanlon’s qualification to testify, however, is his close relationship with NAT. His only experience in appraising facade easements is the nine reports that he did with respect to nine facade-easement contributions to NAT. He looked to NAT to learn how appraisals of facade easements were done before he attempted the first of those reports, and he submitted a draft of the first report to NAT for validation before he completed it. He incorporated in his reports wording suggested by NAT. After he completed eight reports, NAT’s director of operations, Ms. Bookwalter, expressed NAT’s satisfaction with his work but required that he add a document (the easement document) to all future reports. The tone of her communication to him suggests that she believed that NAT had a proprietary interest in Mr. Hanlon’s reports. She begins her communication by speaking of “the 8 appraisals you have done for the National Architectural Trust”. (Emphasis added.) Without asking permission from him, she says that NAT would add the easement document to the reports he had already submitted. She
overvaluing an easement due to its ten percent required cash donation and that Mr. Hanlon would benefit by the charity’s continued recommendation of him as an appraiser.\(^{147}\)

The court found that Hanlon’s valuation was primarily based on imposing a percentage on the pre-contribution value of the property. That percentage was derived from unsubstantiated and generalized conclusions of a report the charity provided to him. The court rejected Hanlon’s methodology since even he had conceded “that his deconstruction of the 15% upper bound in the Primoli article into smaller, component percentages reflective of the burdens imposed by a façade easement was a method unique to him and not a generally accepted appraisal practice or valuation method.”\(^{148}\) Likewise, the court rejected similar, unsubstantiated additional percentages that Hanlon applied to value the easement.\(^{149}\)

On the other hand, the court found the testimony of the government’s expert, Bowman, more reliable. Bowman concluded “that the typical buyer would find the restrictions of the preservation restriction no more burdensome than the underlying South End Landmark District Standards and Criteria” and that the façade easement had no value.\(^{150}\) The court thanked him for his work and expressed NAT’s expectation that it would work with him in the future.”\(^{147}\).

\(^{147}\) *Id.* slip op. at 48–49.

\(^{148}\) *Id.* slip op. at 50–51 (The court stated, “Mr. Hanlon’s starting point—that properties in lightly regulated areas suffer a 15% reduction in value on account of the severance and conveyance of a façade easement—is based on neither reliable market data nor specific attributes of the property. It is based on what he believes the courts and the IRS had allowed in prior cases. Whether it is an upper or lower bound, there is no standard percentage to which one may make adjustments to arrive at a value appropriate for a particular property.”).

\(^{149}\) *Id.* slip op. at 52–53 (“When asked how he came to the conclusion that the marketability of property would be diminished by 2%, he answered: “[t]’s common sense” that the more restricted property “is going to have lower marketability.” He did not, however, explain how he got to 2%. He testified that he based the 0.5% that he assigned to “recapture” on “what I felt the limitation on marketability would be.” As to the 1.25% he assigned to “maintenance and insurance requirements in excess of unencumbered properties”, he admitted that he did no analysis to arrive at that figure and “just chose” it. Similarly, with respect to the 0.5% assigned to “legal exposure if easement is breached”: “just judgment.” Simply put, given his limited experience appraising façade easements and his apparent preconception that the component percentages would total 15% in a lightly regulated area, we are not persuaded that Mr. Hanlon’s common sense, feelings, and judgment constitute a reliable basis for the percentage reductions in value that he assigned to each of the constituent burdens constituting a façade easement (and, further, the adjustments he made to those percentages to reflect differences between the burdens imposed by the South End Standards and Criteria and the burdens imposed by the preservation agreement).”).

\(^{150}\) *Id.* slip op. at 55.
compared the easement restrictions with the limitations imposed by local law and held that the taxpayers had not shown that the easement reduced the value of the property. "To the contrary, our own comparison of the two sets of restrictions and Mr. Bowman’s expert testimony [has] convinced us that the restrictive components of the preservation agreement are basically duplicative of, and not materially different from, the South End Standards and Criteria, and we so find."\(^\text{151}\)

An accuracy-related twenty percent penalty\(^\text{152}\) is imposed where an income tax underpayment is due to negligence, a substantial understatement or a substantial valuation misstatement.\(^\text{153}\) Where there is a gross valuation misstatement,\(^\text{154}\) the penalty is forty percent.\(^\text{155}\) A taxpayer may be excused from the penalty upon reasonable cause and good faith;\(^\text{156}\) however, that exception is only available when the taxpayer's valuation 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.\(^\text{157}\) In Kaufman, the government argued for the imposition of a forty percent penalty; the taxpayers claimed they fell within the reasonable cause exception and thus should be exempt from the penalty.\(^\text{158}\)

Although the court found that Mr. Hanlon was a qualified appraiser as defined by the statute,\(^\text{159}\) it also found that the taxpayers did not satisfy the good faith investigation requirement of the exemption.\(^\text{160}\) The taxpayers looked to the charity’s emails to prove they were not liable for the penalty; yet, those very emails indicated that they knew the imposition of a façade easement would not devalue their property.\(^\text{161}\) In determining good faith reliance, the court considers a taxpayer’s educational background and experience. In this instance, Mr. "Kaufman was a sophisticated consumer of

\[\text{151} \text{ Id. slip op. at 63.}\]
\[\text{152} \text{ I.R.C. § 6662.}\]
\[\text{153} \text{ A substantial misstatement is where the claimed value is 200 percent or more of the correct value of the property. See I.R.C. § 6662(e)(1)(B)(i).}\]
\[\text{154} \text{ A gross misstatement is where the claimed value is 400 percent or more of the correct value of the property. See I.R.C. § 6662(h)(1)–(2).}\]
\[\text{155} \text{ I.R.C. § 6662(h)(1).}\]
\[\text{156} \text{ I.R.C. § 6664(c)(1).}\]
\[\text{157} \text{ I.R.C. § 6664(c)(2)–(3).}\]
\[\text{158} \text{ Kaufman IV slip op. at 66.}\]
\[\text{159} \text{ Id. at 71; see I.R.C. § 6664(c)(2)(A).}\]
\[\text{160} \text{ Kaufman IV slip op. at 72.}\]
\[\text{161} \text{ Id. slip op. at 73–74. The taxpayers also claimed that they relied on their accountant for the valuation overstatement; however, the court pointed out that "the value of the façade easement involves an issue (valuation) on which [their accountant] neither was qualified to advise petitioners nor advised them." Id. slip op. at 77.}\]
statistical analyses, and both the [charity's representative's] email and the Hanlon appraisal gave him good reason to question Mr. Hanlon's value conclusion." \footnote{162}

IV. THE PENSION PROTECTION ACT OF 2006

The PPA made numerous changes specifically to the façade easement charitable deduction provisions. First, not only the front of a historic structure, but the entire exterior \footnote{163} must be subject to the easement and its restrictions. \footnote{164} According to its legislative history, to be a qualified real property interest, the entire exterior refers to "the space above the building, the sides, the rear, and the front of the building" \footnote{165} and no part of the exterior may be changed in a way "inconsistent with the historical character of such exterior." \footnote{166} The PPA requires substantiation that the charitable organization is a qualified recipient with "the resources to manage and enforce the restriction and a commitment to do so." \footnote{167} Further, appraisal

\begin{footnotes}
\footnote{162}{Id. slip op. at 80. Alternatively, the court upheld the accuracy related penalties imposed because of negligence or a substantial misstatement as defined under I.R.C. § 6662(e)(1)(A). The court cited to both Mr. Kaufman’s disregard of the error in the Hanlon appraisal and the taxpayers’ carelessness in certifying to the mortgagee that the easement restrictions were virtually the same as those imposed by local law while they were simultaneously claiming large deductions attributable solely to the easement’s restrictions. \textit{Id.} slip op. at 81–82. The court rejected the taxpayers’ argument that there was substantial authority to support their positions and that they had a reasonable basis for their tax treatment. \textit{Id.} slip op. at 85. Finally, the court held that the government met its burden of production on the issue of the existence of substantial understatements and that the taxpayers did not prove either reasonable cause or good faith exceptions for their understatements. \textit{Id.} slip op. at 86.}
\footnote{163}{I.R.C. § 170(h)(4)(B)(i)(I) ("including the front, sides, rear, and height of the building").}
\footnote{164}{See I.R.C. § 170(h)(4)(B)(i)(II) ("prohibits any change in the exterior of the building which is inconsistent with the historical character of such exterior").}
\footnote{167}{I.R.C. § 170(h)(4)(B)(ii) (I)–(II); see 2006 H. Conf. Rep., supra note 165 ("In addition, the donor and the donee must enter into a written agreement certifying, under penalty of perjury, that the donee is a qualified organization, with a purpose of environmental protection, land conservation, open space preservation, or historic preservation, and that the donee has the resources to manage and enforce the restriction and a commitment to do so.").}
\end{footnotes}
requirements were tightened,\(^\text{168}\) including requiring qualified appraisals\(^\text{169}\) by certified appraisers.\(^\text{170}\) The appraiser must sign a declaration that he or she is aware of the penalty imposed on the appraiser who should have known that the appraisal was being used as part of a tax return or refund claim if the appraisal results in a substantial overvaluation. The legislation imposes a $500 enforcement fee to be paid to the Service on a donor claiming the deduction for a façade easement valued at the greater of: three percent of the property's fair market value or $10,000.\(^\text{171}\) Finally, for property receiving or having received a rehabilitation tax credit\(^\text{172}\) for the past five years, there is a requirement that the additional benefit of the façade easement deduction be reduced.\(^\text{173}\) At the same time, the PPA added

\(^{168}\) I.R.C. § 170(h)(4)(B)(iii) (stating that the taxpayer must include "with the taxpayer's return for the taxable year of the contribution— (I) a qualified appraisal (within the meaning of subsection (f)(11)(E)) of the qualified property interest, (II) photographs of the entire exterior of the building, and (III) a description of all restrictions on the development of the building."). 2006 H. Conf. Rep., supra note 165 states that:

For any contribution relating to a registered historic district made after the date of enactment of the provision, taxpayers must include with the return for the taxable year of the contribution a qualified appraisal of the qualified real property interest (irrespective of the claimed value of such interest) and attach the appraisal with the taxpayer's return, photographs of the entire exterior of the building, and descriptions of all current restrictions on development of the building, including, for example, zoning laws, ordinances, neighborhood association rules, restrictive covenants, and other similar restrictions. Failure to obtain and attach an appraisal or to include the required information results in disallowance of the deduction.


\(^{171}\) I.R.C. § 170(f)(13) ("Contributions of certain interests in buildings located in registered historic districts — (A) In general —No deduction shall be allowed with respect to any contribution described in subparagraph (B) unless the taxpayer includes with the return for the taxable year of the contribution a $500 filing fee. (B) Contribution described — A contribution is described in this subparagraph if such contribution is a qualified conservation contribution (as defined in subsection (h)) which is a restriction with respect to the exterior of a building described in subsection (h)(4)(C)(ii) and for which a deduction is claimed in excess of $10,000. (C) Dedication of fee —Any fee collected under this paragraph shall be used for the enforcement of the provisions of subsection (h)."). See 2006 H. Conf. Rep., supra note 165, at 338–39.

\(^{172}\) I.R.C. § 47.

\(^{173}\) I.R.C. § 170(f)(14) ("In the case of any qualified conservation contribution (as defined in subsection (h)), the amount of the deduction allowed under this section shall be reduced by an amount which bears the same ratio to the fair market value of the contribution as— (A) the sum of the credits allowed to the taxpayer under section 47 for the 5 preceding
what was at that time a two-year provision (for 2006 and 2007) to increase the percentage limitations on current year deductibility of noncash capital gain real property conservation contributions from thirty to fifty percent; that temporary provision has been extended in two-year intervals with the most recent amendment retaining the benefit through 2013.

V. REPEAL, NOT REFORM: POST-PPA PROPOSALS

There have been legislative efforts to reform conservation easements, including façade easements. Some have been enacted into law; other good efforts have not. However, what is clear in the constant patching or “fine

taxable years with respect to any building which is a part of such contribution, bears to (B) the fair market value of the building on the date of the contribution”). That is, the reduced donation deduction amount is calculated by multiplying the value of the façade easement by the fraction that is the same ratio as the sum of those credits for the past five years to the building’s value when the façade easement contribution was made.

If the aggregate amount of credits claimed by the taxpayer within such five year period is $100,000, and the fair market value of the building with respect to which the contribution is made is $1,000,000, the taxpayer must reduce the amount of the deduction by 10 percent (or 100,000 over 1,000,000).

2007 JOINT COMM. EXPLANATION, supra note 165, at 591.


176 See, e.g., 2005 JOINT COMM. FAÇADE EASEMENT PROPOSAL, supra note 6, at 284 (an example of a proposal that was not enacted into law). The Tax Court, in Glass court referred to the 2005 Joint Committee proposal and stated that the Committee characterized section 170(h) as too broad to enable the government to dispute a taxpayer’s claim of a conservation purpose, particularly because both the donor and donee are motivated to agree on that characterization. See Glass v. Commissioner, 124 T.C. 258, 285 n.19 (2005) (citing 2005 JOINT COMM. FAÇADE EASEMENT PROPOSAL, supra note 6, at 286). The Glass court stated that the proposal would not only require the “protection of natural habitats” purpose in section 170(h)(4)(A)(ii) be tied to “a clearly defined governmental policy; i.e., it furthers a specific, identified conservation project,” but also would deny the donor or his family the
One major positive effort for partial repeal of the façade easement was the 2005 Joint Committee proposal. The Committee’s recommendation provided that there would be no deduction for the contribution of a historic façade easement “relating to a certified historic structure that recently has been or is being used or is reasonably expected to be used, by the donor or a family member of the donor as a personal residence (principal or otherwise).” For historic buildings not having a personal residence use, such as commercial, rental, or investment property, the Committee’s recommendation was not for repeal and was more complex. For those easements, its proposal allowed a charitable deduction equal to the lesser of 5% of the value of the building (ignoring the existence of the easement) or 33% of the façade easement’s value. The proposal contained recapture rules if the property was converted to personal residential use within eleven years of the contribution. Donors would be required to report the conversion both to the Service and to the donee easement holder.

While the Committee’s proposal is a vast improvement over current law, its nonresidential use recommendation both incorporates the ever-problematic valuation issue of a façade easement (due to the thirty-three percent alternative) and may engender enforcement issues with its complex recapture provision and reporting requirements. The Committee’s report acknowledged the valuation problem in general terms: “[v]aluation difficulties and conservation purpose issues are especially problematic in the case of a contribution of a partial interest in property, such as easements, because the donor both relinquishes and retains rights and value relating to the underlying property.” Moreover, in its discussion justifying repeal of personal use residential property easements, the Committee noted issues that would likewise apply to nonresidential property easements: “[s]uch personal use cases involve competing public

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177 See Halperin, supra note 13, at 313 (“None of the lesser remedies are recommended here, however, because of the strength of the case for repeal.”).
178 2005 JOINT COMM. FAÇADE EASEMENT PROPOSAL, supra note 6, at 282.
179 Id. The proposal required 100% recapture within two years of the contribution, and a ten percent reduced recapture for each year beginning in the third post contribution year. Id.
180 Id.
181 See supra Part III.A.
182 2005 JOINT COMM. FAÇADE EASEMENT PROPOSAL, supra note 6, at 284.
and private interests, as well as subjectivity regarding valuation of the contributed partial interest, that are not efficiently addressed in a context where proper valuations are expensive and the IRS lacks the expertise or resources to assess conservation purposes\textsuperscript{183} and indeed justified its imposition of a percentage limitation on the deduction because of valuation difficulties.\textsuperscript{184}

While the report states that “weighing competing public and private benefits when the underlying property is the donor’s residence is inherently more difficult than when the underlying property is to be used for investment or commercial purposes,”\textsuperscript{185} it does not explain how it has arrived at this conclusion.\textsuperscript{186} Increased property values are likely to apply to nonresidential property because of historic preservation restrictions just as they adhere to similarly encumbered residential properties.

The latest proposal to amend the façade easement deduction is two-fold: to deny a deduction for not developing the space above historic buildings and to extend the PPA amendments to National Register properties.\textsuperscript{187} The Joint Committee analysis begins with a statement of the continued valuation problems in the area of the charitable contribution of partial property interests. “Whether due to mistake, incompetence, Restrictions on construction impair the value of commercial property more tangibly than they impair the value of residential property. Commercial property derives its value from its ability to generate cashflows. For commercial property, development generally correlates with increased future cashflows. More retail space, more space for tenants, and more room for customers generally increase profitability. Restrictions on the development of commercial property reduce potential for increased future cashflows and thus diminish value.


\textsuperscript{183} Id.

\textsuperscript{184} Id. at 286 (“However, significant valuation concerns justify a cap on the deduction amount for contributions of such other properties. The proposed cap of 33 percent of the value of the easement goes directly to valuation abuses pertaining to easements.”).

\textsuperscript{185} Id. at 285. The report also states, without discussion or explanation, that “[i]n general, property held for business or investment purposes is not subject to the same concerns of competing public and private benefits applicable to property used as a personal residence.” Id. at 286.

\textsuperscript{186} The Chandler court explains the different considerations that apply to commercial property with façade easements:

misunderstanding of the law or facts, or efforts to evade taxes, valuation misstatements are common.”188 Those difficulties are inherently present because (1) there is no market for façade easements,189 and (2) the definition of fair market value requires a buyer and a seller with competing interests190 and that tension is absent between the donor and charitable donee.191 In its analysis, the Joint Committee continued to invoke the concerns expressed in the Service’s 2004 Notice.192 As justification for the first proposed amendment, the Committee again described the difficulty and expense of contesting these easement deductions:

The first part of the proposal provides that a taxpayer may not take a deduction for any reduction in value resulting from forgone upward development of an historic building. As noted by the Treasury Department, “Some taxpayers... have taken large deductions for contributions of easements restricting the upward development of historic urban buildings even though such development was already restricted by local authorities. Because of the difficulty of determining the value of the contributed easement, it is difficult and costly for the Internal Revenue Service to challenge deductions for historic preservation easements.”193

Because the PPA did not subject National Register properties to its additional requirements, the second part of the proposal on façade easements extends those rules to both because of the same policy concerns

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188 2013 JOINT COMM. DESCRIPTION OF 2014 BUDGET PROPOSAL, supra note 187, at 125.
189 Id. at 126 (“[I]n general, there is no market and thus no comparable sales data for such easements.”).
191 2013 JOINT COMM. DESCRIPTION OF 2014 BUDGET PROPOSAL, supra note 187, at 125 (“Unlike in an arm’s length negotiation, in a charitable contribution situation, the interests of a donor and a donee organization are not adverse. A donee organization may have no knowledge of the amount a donor has claimed as the value of the easement and, even if known, has no incentive to question a donor’s inflated value because there is no countervailing tax consequence to the donee if a donor inflates the value of contributed property, i.e., the donee generally does not pay tax on the receipt of the contribution or a subsequent disposition of the contributed property. Some donees may even directly or indirectly support an inflated value in order to secure a desired gift. Such circumstances cause the valuation of property in the charitable contribution context to be a particularly difficult determination.”).
192 Id. at 127 (noting that “[T]he proposal is a direct response to such policy concerns.”); see I.R.S. Notice 2004-41, 2004-1 C.B. 31.
expressed about the first part of the proposal and in order to provide consistency in this area of façade easement charitable donation. 194 While extending the application of the PPA to National Register Properties is another improvement, this latest amendment does not satisfactorily deal with the inadequacies of the PPA or the endemic issues persistent with façade easements.

CONCLUSION

In today’s world, real estate is often subject to regulation that buyers and their neighbors accept in order to retain and increase a community’s property values. The wealthiest of homeowners who purchase homes in historic districts willingly accept local restrictions on the use of their property. There is little reason to retain the façade easement deduction tax benefit and there are many reasons to urge its repeal: the revenue loss, the small number of beneficiaries, the financial demographics of that group of beneficiaries, the continual marked overvaluation and abuse despite Congressional, court, and administrative review and expenses, and the dubious industries that are supported by the deduction, but whose practices contribute to inflated and improper deductions. Very few benefit from the large deductions, least of all the public.