LAW360

Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

IRS Takes Uncharitable View Of Property Donation Deductions

By **Ronald Levitt and Tucker Thoni** (August 22, 2018, 4:12 PM EDT)

Ronald Levitt

Deductions of charitable contributions of real property, especially conservation easements, have lately been squarely within the crosshairs of the IRS. During an audit, the IRS will carefully scrutinize anything of value arguably received by the donor in conjunction with making the charitable contribution of property. The thing of value could be property, cash, enhancement to the taxpayer's other property, city council approval, quid pro quo consideration or another substantial benefit. If the donor receives something of value, the IRS contends that the taxpayer lacked the donative intent to make a charitable contribution and instead was a purchaser of whatever it received in the transaction[1] or that the benefit received was worth more than the property contributed.

Tucker Thoni

In a prior article, we addressed the "Top 6 IRS Attacks on Conservation Easement Deductions." This article addresses a recent line of cases from the U.S. Tax Court disallowing taxpayers' charitable deductions that appears to change the ways that the enhancement rules work. In these cases, the tax court has shown a particular sensitivity to charitable contributions wherein the taxpayer arguably receives something beneficial in conjunction with making a charitable contribution — other than the corresponding charitable deduction. The line of cases discussed below could be the next wave of attack the IRS pursues against charitable contributions of real property.

A common thread in these cases is reliance on a United States Supreme Court case in support of the position that taxpayer receipt of a "substantial benefit" results in a total disallowance of a deduction under Internal Revenue Code 170 — i.e., United States v. American Bar Endowment.[1] For instance, in Wendell Falls Development LLC v. Commissioner,[2] the Tax Court used the substantial benefit analysis in American Bar Endowment to disallow a taxpayer's charitable deduction because of discussions the taxpayer had with local government officials that suggested a quid pro quo arrangement, the fruit of which (i.e., maintaining the property as a park) the court determined enhanced the value of other property owned by the taxpayer.

Triumph Mixed Use Investments III LLC v. Commissioner

In May 2018, the Tax Court issued an opinion disallowing in full a taxpayer's charitable deduction for a contribution of real property. This case provides an important reminder to be wary of potential pitfalls

when donating real property, including negotiations with government or other public officials that could be characterized as a quid pro quo arrangement.

In Triumph Mixed Use Investments, the taxpayer was a developer of a large planned unit development in Lehi, Utah. The developer was producing new development plans to utilize additional development credits. As part of this process, the developer was required to get the city council's approval of its new development plans.

Before submitting development plans to the city council, the taxpayer asked the city's development review committee and the planning commission to review the plans. The committee indicated that the city of Lehi wanted all of the open space to be donated to the city concurrent with the approval and recording of the new plans. The planning commission agreed to approve and recommend that the city council approve the development plans if the open space areas were dedicated to the city and the city council followed suit.

The Tax Court framed the question as whether the taxpayer "actually made a charitable contribution or whether the transfer was part of a quid pro quo arrangement as the Commissioner alleges." The court cites to U.S. v. American Bar Endowment,[3] which holds that a taxpayer is not entitled to a charitable deduction when the taxpayer receives a substantial benefit that has a value equal to or in excess of the value of what was contributed.

The Tax Court concluded that the donation of the open space property was part of a quid pro quo arrangement, finding that the taxpayer donated it in exchange for the city council's approval of the development plans. The court further found that the taxpayer failed to prove that the contributed open space was worth more than the substantial benefit it received (i.e., city council approval); the taxpayer "failed to report or establish the value of the consideration received."[4] Accordingly, the Tax Court disallowed the taxpayer's $11,040,000 charitable deduction in full and imposed an accuracy-related penalty of 20 percent.

Rogers v. Commissioner

In Rogers v. Commissioner,[5] the taxpayers claimed a $1 million charitable deduction for giving a 4.89-acre park to a municipality. The IRS contended that the taxpayers were not entitled to the charitable contribution deduction because they were required to transfer the land to the municipality in order to obtain approval for a subdivision development they were pursuing.[6]

While the facts in Rogers, much like Triumph Mixed Use Investments, involved what appears to be a quid pro quo arrangement, the Tax Court cited the substantial benefit analysis in American Bar Endowment in support of its determination to disallow the taxpayers' charitable deduction in full because the taxpayers lacked the appropriate donative intent.[7]

The Tax Court recognized the proper effect that the receipt of a substantial benefit should have on a charitable deduction: "Where a taxpayer receives consideration for a charitable contribution, he may still deduct as a charitable contribution the fair market value of the property that the taxpayer transferred less the fair market value of the goods that the grantee organization provided in exchange for the contribution."[8] However, the Tax Court explained that the burden is on the taxpayer to show that the value of what it donated exceeded the value of what it received. The court determined that Rogers failed to prove that the value of the donated property exceeded the value of the quid pro quo consideration they received.

Comparison to Seventeen Seventy Sherman Street

The Tax Court previously addressed a factual pattern similar to Rogers and Triumph Mixed Use Investments in Seventeen Seventy Sherman Street LLC v. Commissioner.[9] In Seventeen Seventy Sherman Street, a taxpayer needed a change to a planned unit development, or PUD, and a variance for proposed development of a site that included an existing historic structure. So the taxpayer entered into an agreement with the city of Denver's Community Planning and Development Agency, or CPDA, wherein the CPDA would recommend that Denver's Planning Board approve both the PUD change and the variance if the taxpayer donated an interior and an exterior conservation easement on the existing historic structure. Following CPDA's recommendation, the taxpayer and the city of Denver entered into an agreement conditioning the variance and PUD change on the taxpayer's donation of the conservation easements to a city-approved charity.

The taxpayer conceded that the PUD change constituted consideration worth approximately $2,025,000; however, the taxpayer did not value the CPDA's recommendation of the variance. Instead, the taxpayer contended that the CPDA's recommendation did not constitute valuable consideration affecting the value of its charitable deduction.

The Tax Court disagreed with the taxpayer, determined that the CPDA's recommendation was valuable consideration and found that the taxpayer failed to identify or substantiate the value of the CPDA's recommendation. The Tax Court held that "when a taxpayer grants a conservation easement as part of a quid pro quo transaction and fails to identify or value all of the consideration received in the transaction, the taxpayer is not entitled to any charitable contribution deduction."[10]

The taxpayer "failed to provide any credible evidence to permit [the court] to accurately decide the value of all of the consideration Seventeen Seventy received in the quid pro quo exchange …" Hence, the court disallowed the taxpayer's charitable deduction in full. The taxpayer had failed to meet its burden to prove that the fair market value of what it donated (i.e., conservation easements) exceeded the value of the consideration it received (i.e., CDPA's recommendation of the variance and PUD change), as required by Treasury Regulation Section 1.170-1(h)(1).

Wendell Falls Development LLC v. Commissioner

In Wendell Falls Development LLC v. Commissioner,[11] the Tax Court opinion appears to determine that there is no deduction allowable for a conservation easement that "enhances" the value of other property owned by a donor or that imparts a "substantial benefit" on the donor. The case involved a developer, Wendell Falls, that placed a conservation easement over certain property located within one of its development projects. Wendell Falls then sold the easement-encumbered property (which was restricted to use as a park) to Wake County at what it claimed was a "bargain price."

The taxpayer's representative emailed the donee of the conservation easement — Wake County North Carolina — that it "need[ed] to ensure that the county uses the [contributed] park for its intended use." The parties' intended that the easement property would be maintained as a park. The Tax Court determined that the email "confirmed" that the donor had an "expectation of receiving a substantial benefit."

At trial, the experts called by the IRS and the taxpayer determined that the contribution of the conservation easement did not "enhance" the value of any other property owned by the taxpayer.

However, disregarding the experts' opinions, the Tax Court determined that the donation of the conservation easement created an (unspecified amount of) enhancement to the value of other property owned by the taxpayer — because the court inferred that the presence of a park benefited the yet-to-be-sold adjacent lots, owned by Wendell Falls.

The Tax Court focused on the taxpayer's apparent "expectation" of substantial or enhancement benefits when donating the conservation easement. Indeed, the Tax Court reasoned that the charitable deduction "is not allowable because of [the taxpayer's] expectation" that the property would continue to be utilized as a park once encumbered by the conservation easement and owned by Wake County.

The Tax Court disallowed the taxpayer's $1,798,000 deduction finding that, "[n]o deduction for a charitable contribution is allowed if the taxpayer expects a substantial benefit from the contribution." The court's opinion seems to blur the line between expectation of a post-contribution use that may result in enhancement value to other property owned by the taxpayer, the receipt of a substantial benefit, and quid pro quo. Moreover, the court's opinion appears to conclude that enhancement value amounting to a "substantial benefit" results in a per se disallowance of a charitable deduction regardless of whether the value of the contributed property exceeds the value of the benefit received.

The opinion in Wendell Falls does not mention Seventeen Seventy Sherman Street or explain how Wendell Falls failed to identify or value the consideration it arguably received in conjunction with granting the conservation easement — i.e., enhancement to the value of other property owned by Wendell Falls. Indeed, the qualified appraiser for Wendell Falls addressed enhancement in the qualified appraisal and determined that no enhancement in value occurred because of the park donation. Similarly, the appraisal expert employed by the IRS did not determine that the park enhanced the value of other property owned by Wendell Falls.

Wendell Falls arguably did not receive any enhancement benefit with respect to the park. Apart from the sua sponte determination that the park increased the value of other property owned by Wendell Falls, there is no evidence in the record to support a finding that the park caused any enhancement. There is no finding that the taxpayer failed to prove that the conservation easement it donated exceeded the fair market value of any consideration received.

It appears that Wendell Falls met its burden by identifying and substantiating the value of any enhancement in value to its other property, to wit: none. Moreover, such evidence provided by Wendell Falls is uncontroverted by any other valuation evidence in the record. The opinion in Wendell Falls appears to extend the scope of what is required for taxpayers to meet their burden under Treasury Regulation Section 1.170-1(h)(1), as interpreted in Seventeen Seventy Sherman Street. Moreover, the court does not hold that its determined increase in property value, supposedly attributable to the park, vitiated Wendell Falls' donative intent, such as the court did in Rogers.

In Wendell Falls, the court also seems to redefine the substantial benefit analysis in American Bar Endowment; and the new formulation would appear to contradict long standing regulations. Indeed, the opinion appears, by implication, to invalidate both the "Enhancement Regulation"[12] and the "Substantial Benefit Regulation."[13] Invalidating Treasury regulations is an extreme action for the Tax Court to take in a memorandum opinion, so it is unclear if this was actually the court's intent. There is a pending motion to reconsider the opinion in Wendell Falls aimed at clarifying this issue.

Enhancement Regulation

In Wendell Falls, the Tax Court appears to take the unprecedented step of determining that the presence of any enhancement value causes the entire conservation easement donation to be nondeductible. The Tax Court's decision marks a radical departure from prior conservation easement jurisprudence, as well as the Treasury regulations pertaining to the valuation of conservation easement donations.

The enhancement regulation specifically dictates how any increase in the value of other property owned by a taxpayer or related person is to be handled in the context of a "before and after" conservation easement valuation. The enhancement regulation accounts for this possibility by requiring an appraisal of the donated property to account for the value of any such "enhancement," with a reduction in the amount of allowable charitable deduction by such enhancement value.

It is difficult to ascertain the full implication of Wendell Falls. Taken to its logical conclusion, it could mean the presence of any "enhancement" in value to a taxpayer's property causes a conservation easement donation to be nondeductible, notwithstanding the enhancement regulation. Given the frequency with which a conservation easement donation will impact the value of adjacent or proximately located property owned by a taxpayer, relatives or "related parties," the decision could impact a large number of past and future conservation easement donations.

Substantial Benefit Regulation

The substantial benefit regulation does not provide that donor receipt of any substantial benefit automatically disallows the charitable deduction, as the opinion in Wendell Falls seems to indicate. Rather, the substantial benefit regulation directs that the value of financial or economic benefits received by a donor, even if substantial, reduces (rather than disallows) a donor's charitable deduction. If the value of the benefits received by the donor exceeds the value of the contributed property, then the substantial benefit regulation would render the charitable deduction valueless.

In support of its position that the receipt of a substantial benefit results in a total disallowance of the taxpayer's charitable deduction, the Tax Court cites American Bar Endowment, supra. The Tax Court's reliance appears to be misplaced because American Bar Endowment does not hold that receipt by the donor of a substantial benefit automatically disallows a charitable deduction in full. To the contrary, the Supreme Court was clear that "[a] taxpayer may … claim a deduction for the difference between a payment to a charitable organization and the market value of the benefit received in return. ..."

IRS guidance had previously interpreted the Supreme Court's opinion in American Bar Endowment as permitting a deduction so long as the taxpayer knowingly contributed an easement in excess of the value of the benefit received in return.[14] The commissioner's prior interpretation of American Bar Endowment found that a charitable deduction was allowable, notwithstanding the receipt of a substantial benefit, to the extent that the value of what the taxpayer contributed exceeds the value of the substantial benefit(s) received.

It is unclear if the Tax Court intended its opinion to invalidate both the substantial benefit regulation and the enhancement regulation. Nevertheless, the opinion in Wendell Falls can be construed as implicitly invalidating both regulations. It is worth noting that the IRS filed a response in opposition to Wendell Falls' request for reconsideration that Judge Richard Morrison revise the opinion in Wendell Falls— to clarify if the court intended to invalidate the substantial benefit regulation or the enhancement regulation. The IRS response suggests that the IRS interprets the current iteration of the opinion, as written, to be helpful to the IRS when challenging charitable deductions.

Conclusion

As the cases discussed show, the IRS and the Tax Court are very sensitive to quid pro quo arrangements and to situations where taxpayers receive some benefit in conjunction with making a charitable contribution. Property owners making charitable contributions of real property, such as conservation easements, should be wary of representations made when negotiating with government officials about zoning changes, variances, or other approvals.[15] Moreover, taxpayers should be mindful of how the donation of real property may enhance, or appear to enhance, other property owned by the taxpayer or the taxpayer's relatives. If a taxpayer receives a benefit — whether in the form of cash, property, enhancement or government approval — in conjunction with making a charitable contribution, the taxpayer should identify and value, if possible, the benefit received and be prepared to prove that the property it donated was worth more than whatever consideration it arguably received. Carefully structuring and reporting these transactions can avoid the unfortunate result where the charitable deduction is disallowed in full and the taxpayer is hit with a stiff penalty.

In the evolution of the ongoing IRS attack on conservation easements, the line of cases discussed above demonstrate that the IRS will attack charitable gifts of property with contentions of quid pro quo consideration, receipt of enhancement value and the substantial benefit analysis in American Bar Endowment — and the Tax Court appears receptive to such arguments.

Ronald Levitt is a shareholder at Sirote & Permutt PC.

Tucker J. Thoni is an attorney at the firm.

Disclosure: Sirote & Permutt PC represents Wendell Falls Development LLC, a party in one of the cases discussed in this article.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the organization, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] United States v. American Bar Endowment, 477 U.S. 105, 116 (1986).

[2] Wendell Falls Development LLC v. Commissioner, T.C. Memo. 2018-45.

[3] 477 U.S. 105, 116 (1986).

[4] Triumph Mixed Use Investments III LLC v. Comm'r, T.C. Memo. 2018-65 at *42.

[5] Rogers v. Commissioner, T.C. Memo. 2018-53.

[6] Rogers v. Commissioner, T.C. Memo. 2018-53, at *14-15.

[7] Id.

[8] Id. at 15 (emphasis added).

[9] Seventeen Seventy Sherman Street LLC v. Commissioner, T.C. Memo. 2014-124.

[10] Seventeen Seventy Sherman Street v. Comm'r, T.C. Memo 2014-124 at *8.

[11] Wendell Falls Development, LLC v. Commissioner, T.C. Memo. 2018-45.

[12] Treas. Reg. § 1.170A-14(h)(3)(i)(fifth sentence).

[13] Treas. Reg. § 1.170A-14(h)(3)(i)(sixth and seventh sentences).

[14] See IRS CCA 200238041 (Sept. 20, 2002) (citing to § 1.170A-14(h)(3)(i)). See also Field Serv. Advisory, 1998 WL 1984309 (Mar. 3, 1998).

[15] This is an admittedly difficult task in the context of a real estate developer donating real property that is connected in some way with an ongoing development project because communications with local officials regarding zoning and other land use matters appear routine, if not unavoidable, for certain types of development projects.