# *Selected Charitable Developments*

By: Grace Allison, Northern Trust[1]

**a. <u>One-time filing relief for small organizations.</u>**

Under IRC Section 6033(j), as added by the Pension Protection Act of 1986, failure by an organization to file the required annual return or notice for three consecutive years will result in revocation of its tax-exempt status. On July 26 of this year, the Service announced that it was providing one-time relief to small exempt organizations that otherwise would have faced revocation under this provision.

Those eligible to file Form 990-N *and* "whose [Forms 990-N are due on or after May 17 and on or before October 15" were simply permitted to retain tax-exempt status by filing on or before October 15.

For small organizations that should have filed Forms 990-EZ , the requirements were more stringent. A special voluntary compliance program required them to:

- file "complete and accurate" Forms 990-EZ or 990 for the relevant three year period by the October 15 deadline;
- submit a signed checklist agreeing to the terms of the voluntary compliance program; and
- pay a sliding-scale compliance fee ranging up to $500.

Comment: The IRS was prompted to this response by the sheer number of tax-exempts in danger of revocation: more than 300,000 small organizations were listed on its website this May as delinquent for the statutory three-year period. Note that organizations required to file Forms 990 and 990-PF were not eligible for this program. Moreover, organizations that failed to take advantage of the Service's offer have a single alternative after 10/15/10: file again for tax-exemption and risk having to pay tax on income received between the revocation date and the renewed exemption.

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**b. Conservation easements: valuation and other issues.**

**(1) Whitehouse Hotel L.P. et al. v. Comm. (5th Cir., 8/12/10), vacating and remanding to the Tax Court.**

In this valuation case, the IRS disallowed $6.295 million of a claimed $7.445 charitable deduction—and imposed a 40 percent understatement penalty. At issue was the value of the contribution, by a developer of luxury hotels, of an historic-preservation façade easement on the Maison Blanche building, located in New Orleans and owned by the developer.

Fortunately for the taxpayer, the Fifth Circuit bent over backwards to indicate its displeasure both with the IRS and with the Tax Court, which had held for the Commissioner. On appeal, as below, a central legal issue was whether, for valuation purposes, the appraiser could take into account the façade easement's effect on another building, the Kress building, that was contiguous to the Maison Blanche building—and also owned by the developer. Citing Treas. Reg. Section 1.170A-14(h)(3)(i) [which provides that "the amount of the deduction in the case of a charitable contribution of a perpetual conservation restriction covering a portion of the contiguous property owned by a donor . . . is the difference between the fair market value of the entire contiguous parcel of property before and after the granting of the restriction"], the Fifth Circuit held that it was appropriate for the taxpayer's appraisal to take the effect of the Kress building into account.

**(2) Lord v. Comm., T.C. Memo. 2010-196 (9/8/10)**

Holding that "the doctrine of substantial compliance is not applicable if significant information is omitted," the Tax Court denied a $242,500 charitable deduction for the donation of a conservation easement. The appraisal at issue was submitted with the taxpayers' 1999 income tax return, which was filed in 2003. It did not include (i) the easement contribution date; (ii) the date the appraisal was performed; or (iii) the appraised fair market value of the easement contribution on the contribution date.

Comment: A 2009 District Court case came to the same result on similar facts. Bruzewicz v. U.S., N.D. Ill., No. 07C4074 (3/25/09). Note that current law requires a qualified appraisal *by a qualified appraiser*. See Notice 2006-96, 2006-46 I.R.B. (effective until issuance of final Treasury regulations), issued 11/13/06 and Prop. Treas. Reg. Sec. 1.170A-17, issued 8/7/08.

**(3) Kaufman v. Comm, 134 T.C. No. 9 (4/26/10)**

On a motion for summary judgment, the Tax Court disallowed the taxpayer's entire $220,800 charitable deduction for donation of a façade easement to the National Architectural Trust. At issue was whether the Kaufmans had complied with the statutory requirement that the restriction on their property be "granted in perpetuity," as required under IRC Section 170(h)(2)(C). The court held that, because the subject property was mortgaged at the time of contribution, there was substantial uncertainty as to whether, as required by the relevant regulations, the National Architectural Trust would be entitled to a portion of any sale, exchange or conversion proceeds "at least equal to that proportionate value of the perpetual conservation restriction" in the event the restriction were extinguished. For the court, the requirement of Treas. Reg. Section 1.170A-14(g)(6)(ii) was "strict" and could not be avoided. Significantly, the mortgage in question gave the lender a "'prior claim' to all proceeds of condemnation and to all insurance proceeds as a result of any casualty, hazard, or accident occurring to or about the property"; this prior claim was "'in preference' to NAT [National Architectural Trust] until the mortgage was satisfied and discharged."

Comment: the Commissioner also challenged the deductibility of the cash contribution required by National Architectural Trust as part of the easement transaction. The court did not grant summary judgment on this issue—or on the imposition of accuracy-related penalties, holding both to raise genuine issues of material fact. Given the traditional role of cash contributions in easement transactions, the court's final decision here will have considerable importance.

**c. Bargain sales: Klauer v. Comm., T.C. Memo. 2010-65 (4/5/10)**

In this memorandum opinion, the Tax Court untangled a complex and idiosyncratic fact situation to grant the taxpayers substantial charitable

deductions for bargain sales of three parcels of real property south of Taos, New Mexico.
Each parcel was acquired by exercise of an option granted under a single, three-phase option agreement. The Agreement, as amended, provided for the purchase of 2,581 acres in a series of six sales.

In each case, the purchase price for each of the "phases" was set by the buyer, the Trust for Pubic Land, and represented "the Trust's estimate of the amount of funds that the Trust hoped Congress might appropriate for the Trust's acquisition of each such phase . . ." Importantly, congressional funding for the Trust was uncertain, and, in the words of the court, "there simply were no guaranties that [it] would receive any congressional (or other) funding for the purchase of a portion, let alone all of the [property.]

Based on this fact pattern, the Tax Court rejected the Commissioner's argument that the six sales (including the three bargain sales) should properly be treated as a single sale under the step transaction doctrine, despite the fact that all were pursuant to options granted in a single, umbrella option agreement.

Comment: had the Commissioner prevailed, the Klauers' charitable deductions would have been reduced to zero: the aggregate sales price for the six parcels was equal to their stipulated aggregate fair market value.

**d. UBTI redux: Bartels Trust v. U.S. (Federal Circuit, 9/7/10).**

On appeal to the Federal Circuit, the Bartels Trust for Cornell University continued to argue, as it had below, that income from the sale of securities purchased on margin was not unrelated business taxable income. At stake was more than $88,000 in unrelated business income tax. Not surprisingly, given the plain language of the statute and the regulations, as well as the legislative history, the Federal Circuit held the underlying investment was indeed debt-financed property and, once again, the government prevailed on a motion for summary judgment.

Comment: a related trust, the Bartels Trust for New Haven, made very similar arguments on the same fact pattern, to the Second Circuit—and lost; Bartels Trust For New Haven v. U.S., 209 F. 3d (2000), *cert. denied*. When presented with this issue twenty years earlier, the Third Circuit also held for the government for similar reasons. Elliot Knitwear Profit Sharing Plan v. Comm., 614 F.2d 347 (1980).