Estate Attorneys E-Newsletter

News From Washington:

FLP Discounts Denied – Assets Included

In *Estate of Erma V. Jorgensen et al. v. Commissioner*; No. 09-73250 (3 May 2011), the Ninth Circuit affirmed a Tax Court holding that denied family limited partnership (FLP) discounts.

Decedent Erma Jorgensen had created two family limited partnerships and transferred substantial assets to the partnerships. She intended to use some of the FLP units for gifts to family members. Normally, those FLP units would qualify for discounts for minority interest and lack of marketability.

The IRS issued a deficiency on the grounds that the decedent had retained substantial dominion and control over the assets. As a result, under Sec. 2036(a) the FLP assets were includable in the estate at full value.

On the appeal of the Tax Court case, the estate noted that there had been some benefits retained by the decedent. However, the estate suggested that these retained benefits were "de minimis." Therefore, the estate maintained that only the retained benefits should be included in the estate and the balance of the two FLPs should qualify for appropriate discounts.

The Ninth Circuit reviewed the case. It noted that the decedent had spent $90,000 on personal expenses and the estate had used $200,000 from the FLP to pay estate taxes. In addition, the Tax Court had determined there was "an implied agreement decedent could have accessed any amount" of the FLP assets for personal purposes. Finally, because the FLPs disregarded some partnership formalities and there was no significant or active management of FLP assets, the "bona fide sale" exception did not apply. As a result, the discounts were denied and the full value of FLP assets was included in the estate of the decedent.

Applicable Federal Rate of 3.0% for May – Rev. Rul. 2011-11; 2011-19 IRB 1 (18 Apr 2011)

The IRS has announced the Applicable Federal Rate (AFR) for May of 2011. The AFR under Section 7520 for the month of May will be 3.0%. The rates for April of 3.0% or March of 3.0% also may be used. The highest AFR is beneficial for charitable deductions of remainder interests. The lowest AFR is best for lead trusts and life estate reserved agreements. With a gift annuity, if the annuitant desires greater tax-free payments the lowest AFR is preferable. During 2011, pooled income funds in existence less than three tax years must use a 2.8% deemed rate of return.

No Estate Deduction for Pending Litigation

In *Estate of Gertrude H. Saunders et al. v. Commissioner*; 136 T.C. No. 18; No. 10957-09 (28 Apr 2011), the Tax Court rejected a claim by an estate that litigation could potentially cost the estate $30 million.

The decedent was a resident of Hawaii. Her husband William Saunders, Sr. was an attorney who represented Harry S. Stonehill. Mr. Saunders passed away on November 3, 2003 and the decedent Gertrude Saunders passed away on November 27, 2004.

Mr. Saunders was an estate and tax attorney who had represented Mr. Stonehill. There was an allegation

against Mr. Saunders that he had acted as an IRS informer in 1960 and had reported a Swiss bank account owned by Mr. Stonehill to the IRS. As a result of this allegation, the estate of Mr. Stonehill (who passed away in 2002) brought an action against the estate of the decedent.

Following extended negotiations, the case proceeded to trial in 2007. The jury determined that attorney Saunders had violated his duty of confidentiality to Mr. Stonehill. However, there was no legal cause of injury or damage by Stonehill. Therefore, the jury awarded $289,000 costs to the Saunders Estate.

Following an appeal by the Stonehill Estate, there was a settlement. The Saunders Estate waived its claim for $289,000 for legal fees and paid $250,000 of the Stonehill legal fees.

While the litigation was still in process, the decedent's IRS Form 706 was filed on February 2, 2005. The estate valued the potential litigation claim at $30 million. The IRS denied that deduction and assessed a deficiency of approximately $14 million.

The court reviewed the expert reports. Experienced counsel for the estate John Francis Perkin estimated the potential recovery against the Saunders estate to be $90 million. He determined that the likelihood of that recovery was a 25% to 50% chance. Based on the probability of this recovery, the valuation was initially estimated at $30 million and then subsequently lowered to $25 million.

Philip M. Schwab, Senior Vice President with FMV Valuation & Financial Advisory Services also completed an analysis. He reduced the valuation for lack of assignability and estimated a 25% discount, with a net value of $19.3 million.

The IRS submitted a valuation by California litigator James King. He determined that the claim was without merit and had "at most a 3% chance of recovery." Based on this analysis, IRS Valuation Specialist James McCann determined that the value should be $25,449 to $1,500,395.

The court noted that Reg. 20.2053-1(b)(3) permitted a deduction for a claim that is "ascertainable with reasonable certainty." Because the experts in this case for the estate estimated values of $30 million, $19.3 million and $22.5 million, the court determined that the valuation was uncertain. The estate deduction was limited to actual amounts paid during administration.

As a result of the cases such as Saunders, the IRS now limits deductions to actual funds expended on litigation. In effect, the rule of the Saunders case now has been adopted by the IRS.

Realty and Art Estate Valuations Accepted

In *Estate of James J. Mitchell et al. v. Commissioner*; T.C. Memo. 2011-94; No. 17351-09 (28 Apr 2011), the Tax Court determined that the estate valuations were correct.

Decedent James Mitchell was the son of the co-founder of United Airlines. His parents required substantial assets and bequeathed significant real estate and art to the decedent. The real estate included an oceanfront property in Montecito, California, a 4,065-acre ranch along Refugio Road in Santa Ynez, California and paintings by renowned western artists Frederick Remington and Charles Russell.

The decedent's father had created a famous riding group called The Rancheros Vistadores. Every year, there was a one-week trail ride through the ranch. Among the famous participants were former President Ronald Regan and founder of Disneyworld Walt Disney. The decedent was a successful individual who served as the business editor for the *San Jose Mercury News*.

The Montecito beachfront property included a 4,000 square foot home with 167 feet of Pacific Ocean frontage. It was leased to Mark and Lynda Schwartz on a 20-year term agreement. The Santa Ynez ranch was leased to Don and Sue Hanson for a term of 24.75 years.

The painting by Remington is titled "Casuals" and was completed in 1909. The Charles Russell painting is titled "Creased" and was completed in 1911. The Remington Casuals was an 18 x 26 inch oil on canvas depicting a

cowboy and an Indian on horseback. The Russell painting was a 28 x 23 inch watercolor.

The estate filed the IRS Form 706 Estate Tax Return and reported an estate of $17 million. It valued the real estate 95% interest held by the decedent's trust and a 5% interest held by the children's trust. It also determined values for both paintings. The IRS revalued all four assets and accessed a substantial deficiency.

The court reviewed the valuations for all of the various assets. The IRS assumed that the beachfront property was leased at a loss each year. It also estimated the value of a buyout of the lease. The court determined that the estate valuation method correctly showed a lease of $190,500 and actual expenses of $73,200. Because the estate used the correct lease net income and an estimated 3.5% growth rate with a 9.5% discount rate, the court determined that the estate valuation was correct.

With respect to the ranch, IRS expert Donald Bratt projected a 100% increase in value over 61 months. Because the court determined that this was "such extreme growth," his future valuation of $24 million was deemed unreliable. Estate expert Thompson again used a 3.5% appreciation rate and a 9.5% discount rate. This high discount rate was deemed acceptable because of the risk of owning real estate. Therefore, the estate valuation for the ranch was accepted.

Both the estate and the IRS submitted opinions of several appraisers with respect to the Remington and Russell paintings. Estate experts Nancy Escher, Katherine Gellert and Richard Alasko were members of the American Society of Appraisers (ASA) and followed the Uniform Standards of Professional Appraisal Practice (USPAP). All three had extensive experience valuing western artwork. IRS appraisers Peter Fairbanks and Gretchen Wolf were also members of the Appraisers Association of America, but did not have expertise in western art.

The estate experts appraised the Remington at $1.2 million and the Russell at $750,000. The IRS experts determined the Remington to be valued at $2.3 million and the Russell at $2 million. However, the IRS Art Advisory Panel reviewed both paintings. The Art Advisory Panel estimated the Remington to have a value of $600,000 to $850,000. Similarly, the Russell was determined to have a value of $300,000 to $1 million.

Because the IRS valuation was completed by appraisers without expertise in western art and the value was so far in excess of the IRS Art Advisory Panel numbers, the court determined that the estate valuation would be accepted.

In this case, the estate clearly won the "battle of the appraisers." The real estate valuation was accepted because the present value at the end of the lease was determined with a reasonable growth rate. While the 9.5% discount rate was substantial, this was deemed sufficient to reflect the risk premium a probable buyer would require in purchasing a future interest in real estate. Finally, the art valuation by the IRS was rejected because its experts did not have background in appraising western art.

Discounts Denied, Claim Value Reduced

In *Estate of Ellen D. Foster et al. v. Commissioner*; T.C. Memo. 2011-95; No. 16839-08 (27 Apr 2011), the Tax Court denied deductions for discounts claimed on marital trusts and then added a substantially discounted value for a potential claim.

Decedent Ellen Foster was preceded in death by her husband Thomas Foster. He had founded Foster & Gallagher (F&G), Inc in 1951. His company was in mail-order horticulture and was quite successful. In 1991, he and the company entered into a stock restriction agreement that obligated F&G to repurchase stock held by the Foster family upon his demise. The plan was funded by a $50 million policy of paid-up life insurance. The agreement prohibited F&G from borrowing against the cash value or otherwise encumbering the life insurance. Attorney Kavanaugh represented both Mr. Foster and F&G in creating the agreement.

In 1995, Mr. Foster and other owners decided to set up a leveraged Employee Stock Ownership Plan (ESOP). F&G borrowed $70 million in an unsecured loan to fund the ESOP. Mr. Foster sold 3,589,743 shares of F&G common stock to the ESOP for $33.1 million.

On July 11, 1996, Mr. Foster passed away and his estate was transferred into three marital trusts. The three

marital trusts were administered by Northern Trust. By 1998, F&G had experienced financial problems. At the request of F&G, Northern Trust permitted F&G to obtain loans against the $50 million policy. In 2001 F&G filed for bankruptcy and the $50 million insurance policy lapsed for lack of premium payments.

Following the F&G bankruptcy, ESOP beneficiaries filed suit against the Foster estate for breach of fiduciary duty. On May 15, 2004, Ellen Foster passed away.

In 2005, the ESOP suit was settled by the estate. In 2008, the estate successfully pursued a claim against attorney Kavanaugh and received a settlement of $850,000. Later in 2008, the estate was successful at trial on a claim for breach of fiduciary responsibility against Northern Trust and received $17 million.

The estate filed the IRS Form 706 U.S. Estate Tax Return on August 12, 2005. It noted that Northern Trust had frozen the marital trust assets and claimed a 32.4% discount due to this action. The estate also did not include the present value of its potential claims against attorney Kavanaugh and Northern Trust as assets.

The IRS determined that the estate should not be entitled to the 32.4% marital trust discount and also should include the value of the potential claims as assets.

The court noted first that there was a potential claim against the estate due to the ESOP plaintiffs' litigation. However, that claim was deemed not to meet the Reg. 20.2053-1(b)(3) requirement that a claim be "ascertainable with reasonable certainty." Therefore, there was no deduction for that value.

Because of the freeze on the marital trust assets on Northern Trust, the estate claimed a deduction of 34.2%. However, the court noted that this was an action by the trustee that affected the trust beneficiary and not the value of the underlying assets. A purchaser of the assets would be able to resell at an undiscounted price. Therefore, there was no marital trust discount for lack of marketability or lack of control.

The remaining issues were the potential estate claims against Northern Trust and attorney Kavanaugh. Sec. 2031(a) requires an estate to include the value "of all property, real or personal, tangible or intangible, or wherever situated." The two potential claims had value and the primary question was the determination of that value as a date of death. IRS experts Mark Mitchell and Mark House valued the life insurance claim at $4.6 million and the additional claim at $500,000, for a total claim against Northern Trust of $5.1 million. It determined a 50% probability of success.

Estate expert Schaub determined the value of the claim to be $43,474. With a 25% marketability discount, the claimed value was $33,000.

In the view of the court, "neither side's experts in this case have provided an objective and reliable conclusion." Based upon the court determination that there was a 50% probability of success and a 39.5% lack of marketability discount, the court determined the value of the Northern Trust claim in 2005 to be $930,000.

The estate had a split decision but a reasonably good result. It was not able to sustain the claim for a discount on the marital deduction. However, the 2008 receipt of $17 million was given for a 2004 estate value of $930,000.

Unseen Art Gift Deductions Limited

In *Joseph B. Williams III v. Commissioner*; T.C. Memo. 2011-89; No. 2202-08 (21 Apr 2011), the court upheld an IRS assessment against an individual who had unreported overseas income and gifts of appreciated art.

Joseph Williams was employed by Mobil Oil from 1993 to 1998, the tax years in question. He also engaged in a side business as an oil industry consultant to a number of the former Soviet Republics. Without disclosure to Mobil Oil, he pursued various business transactions. Through this consulting, he received $8.86 million in compensation between 1993 and 2000. All payments were transferred to a Swiss bank account. In 1993, Mr. Williams had created a corporation called "ALQI" in the British Virgin Islands. ALQI created a Swiss bank account that received the consulting payments.

Various personal and business expenses were paid from this bank account during these years. Mr. Williams did not report the consulting income on his tax returns.

Subsequently, Mr. Williams was audited and the IRS accessed deficiencies and penalties for the unreported income. He also was the subject of a criminal action by Treasury in 2003 and convicted of tax evasion. He was sentenced to 46 months incarceration.

In 1996, Mr. Williams contacted Abby Art Consultants, Inc. ("Abby"), a corporation in New York City. Following negotiations, Mr. Williams and Abby signed an agreement. He agreed to purchase art that could later be gifted to charity. Williams made an initial payment of $3,600 and agreed to purchase art at a rate equal to 24% of fair market value.

The anticipated first year total payment would be $72,000 for art worth approximately four times that amount. Mr. Williams would pay the balance of the amount due when Abby had received the art. He could then either take possession of the art or direct its donation to an appropriate charitable organization. Abby agreed to obtain an appraisal with the valuation approximately four times the amount that Mr. Williams was to pay for the art items.

In late 1997, Abby acquired art with a valuation of $425,625. Mr. Williams paid $98,400, for a total payment of $102,000 which represented 24% of the claimed fair market value. On December 23, 1997, Mr. Williams signed a deed of gift and transferred the art to a university.

In late 1999, Abby acquired art valued at $250,825. Mr. Williams paid $57,500. On December 21, 1999, he signed a deed of gift to transfer that art to a second university.

In late 2000, Abby acquired art with a value of $102,825. Mr. Williams wrote a check for $4,600 and a second check for $17,158 to Abby. That art was transferred to a third charity with a deed of gift on December 15, 2000.

The IRS accessed a deficiency for the full amount of the unreported overseas consulting income. In addition, it denied the charitable deduction, with the exception of the basis in the art. The IRS also accessed an accuracy penalty for the excessive charitable deduction.

The court initially considered the IRS claim on consulting income. Mr. Williams claimed that ALQI was a valid foreign corporation and, therefore, that he was taxable only on the interest on the $8.86 million and not on the full amount of the consulting income. However, the court determined that ALQI was merely the "receptacle into which Mr. Williams diverted his consulting income" and he was therefore taxable on the full amount.

With respect to the charitable gifts, Mr. Williams indicated that he had committed to making purchases of the approximately $800,000 in claimed fair market value for the art that Abby acquired over the next four years. Because he had committed to that acquisition, the acquisition date should relate back to the 1996 contract for purchase.

The IRS noted that charitable deductions for appreciated property are limited under Sec. 170(e)(1)(A) to fair market value for assets that have been held for over one year (long-term capital gain). Because he did not own the assets for the required holding period, Mr. Williams qualified only for a deduction for cost basis. He also should be required to pay the Sec. 6662(a) accuracy penalty.

The court reviewed the basic requirements for long-term capital gain status. Under the agreement with Abby, Mr. Williams had the option, but not the obligation, to purchase art. As a result, he owned an option to buy art. When the option was exercised by the actual acquisition of art, the holding period then commenced. It appears that the art was purchased by Abby and then held in the New York warehouse with no personal viewing at any time by Mr. Williams. He merely made payment for the 24% of fair market value. The art was then promptly given to a charitable organization.

Because Mr. Williams had acquired an option to purchase additional art for $3,600, the holding periods for the art in 1997, 1999 and 2000 were less than one year. Therefore, his deductions were limited to cost basis.

The Sec. 6662(a) penalty applies if the transaction in the view of a reasonable person is "too good to be true."

Because the implausible plan was to purchase art for 24% of the claimed value and quickly give it to a qualified charity, the accuracy penalty applied.

This and similar appreciated art cases have led to much more restrictive rules on these gifts. For gifts of art, there must now be a qualified appraiser with certification or two years of college level courses in the type of art gifted. The appraiser is now potentially subject to personal penalties. If the claimed deduction is over $20,000, the appraisal and a photo or colored transparency must be attached to the return. There are quite restrictive rules on gifts of partial interests of art. Finally, the IRS Art Advisory Panel meets periodically to review and value art gifts. The Advisory Panel values gifts for both gift and income tax deduction purposes, without knowing which type of gift is involved. Its valuations are deemed quite objective by courts.

Primer on Charitable Deductions Substantiation

In *Bridgett Jeanette Bell v. Commissioner*; T.C. Summ. Op. 2011-54; No. 8048-08S (17 Apr 2011), the Tax Court in a summary opinion denied several charitable deductions, but permitted some on the basis that there was sufficient substantiation.

In 2001 Ms. Bell organized the Holistic Opportunities for Mental Empowerment (HOME), a qualified Sec. 501(c)(3) organization. The five member Board of Directors included her mother, another family member and two other individuals. During 2004, HOME conducted literacy classes at Good Shepherd Missionary Baptist Church (Good Shepherd) in Houston, Texas. The programs were conducted by volunteers from the church.

Good Shepherd owned a house on the adjacent property and desired to remove the house and use the property for a parking lot. Ms. Bell determined that it would be beneficial to move the home to a lot in Cleveland, Texas, a town approximately 50 miles away. Following the moving of the home and expending funds for repairs and renovations after it had been transported to Cleveland, Ms. Bell filed her 2004 Federal Tax Return. She claimed charitable contribution deductions of $37,274. These deductions included cash donations to Good Shepherd or to HOME. The IRS did not dispute those gifts. There also was a claimed deduction for the value of the lot in Cleveland, the cost of moving the relocated house, the cost of repairing and renovating the house, travel expenses for various conferences and cell phone expenses.

The IRS denied deduction for all of the claimed gifts except the cash contributions, citing insufficient substantiation.

Ms. Bell claimed that the lot and the home with improvements in Cleveland had been transferred to HOME during 2004. However, she was unable to produce a recorded deed or even the original warranty deed for the transfer. The court noted that a transfer under Texas law requires delivery of the deed. Because Ms. Bell was unable to show the delivery, the claimed deduction for the lot was denied.

The expense for removing and renovating the home could be determined to be an unreimbursed expenditure that would benefit Good Shepherd Church. Good Shepherd would have had to pay the expense of tearing down the building in order to construct the parking lot. While the cost of the residence and renovations were not deductible as a gift to HOME, they were deemed deductible to the extent that they saved Good Shepherd the cost of razing the property.

Travel related expenses are a charitable deduction under Reg.1.170(A-1)(g). The deductions must be "away from home" and there can be no significant element of personal pleasure or gratification on the trip. Because the taxpayer demonstrated that these trips were for appropriate conventions, board meetings and conferences, they were permitted.

Office supplies purchased for the literary program are permitted as deductions if substantiated. The receipts and cancelled checks for these items were sufficient.

However, a cell phone can be deducted only under Sec. 280(F)(d)(4)(A)(v) because Ms. Bell did not have a detailed list of business use and an allocation between personal use and business use, that deduction was denied.

E-Filing Passes 100 Million Returns

The IRS reported a surge of e-Filing the past weekend just before the tax deadline. With all of the latest returns that have been filed electronically, the IRS reported that 101 million taxpayers now used the e-Filing system resulting in 8.8% growth this year.

The IRS noted that some taxpayers have filed for the automatic six-month extension and will need to complete their tax returns by October of 2011. The IRS will continue to permit e-Filing of returns that are on a proper extension.

The movement toward e-Filing reflects a general increase in Internet use in America. The Pew Research Center studies the movement of Americans to the Internet. The latest statistics show that 80% of all Americans are using the Internet. Over 60% of those users now have broadband at home.

The Pew Internet surveys also give details about online Internet usage. Over 95% of those ages 18 to 29 use the Internet. For age 30-49, the percentage is 87%. Baby boomers age 50-64 are at 78%. Finally, 42% of those over age 65 use the Internet.

As might be expected, individuals with moderate and higher incomes are more likely to use the Internet. Over 90% of those with incomes of $50,000 are now using the Internet. College graduates use the Internet at a 96% rate. Finally the increase in e-Filing is also reflected by a movement to online banking and online giving. Total online giving in 2010 increased to nearly 8% of all charitable gifts.

Einstein Quote on Tax Code Complexity

At an April 13 hearing on the tax code before the Ways and Means Committee, witnesses noted that there is a general consensus on the complexity of the tax code.

One witness quoted Albert Einstein, recipient of 1921 Nobel Prize in Physics. While he was the world expert on the Theory of Relativity, Mr. Einstein also commented that "the hardest thing in the world is to understand the income tax."

At the hearing, Chairman Dave Camp (R-MI) noted there are "nearly 4,500 changes in the last decade – 579 of them in 2010 alone – the code is too complex." Other representatives and witnesses agreed that the sheer size and complexity of the Internal Revenue Code make compliance very challenging.

Annette Nellen represented the American Institute of Certified Public Accountants in the hearing. She indicated that there are five specific steps that could be taken to substantially reduce the complexity and cost of complying with the code. These include the following actions.

1. Higher Education Deductions and Credits – Reduce the Hope Credit, American Opportunity Credit, Lifetime Learning Credit, the tuition and fees deduction and other benefits into one simple credit.

2. Education Phase Out – Create one definition for qualified education expenses and eliminate the multiple phase outs under the current system.

3. Kiddie Tax – For children with unearned income under age 18 or students under age 24, simplify the current method where they pay tax at their parents' rate.

4. Mileage Rates – Create the same mileage rate for business purposes, medical purposes and qualified charitable travel.

5. Alternative Minimum Tax – Repeal the tax because it is too complicated to modify.

Financial Planner Mark Johannessen is a CFP and Managing Director of a McLean, Virginia financial firm. He was President of the Financial Planning Association in 2008 and suggested that there are a number of Internal Revenue Code issues that make financial planning difficult.

First, there are temporary provisions. For example, the 2011 tax rate on dividends is 15%, but the scheduled tax rate on dividends in 2013 is 43.4%. While it's possible that Congress could change the law between now and 2013, it makes investment planning very difficult.

Second, many changes are temporary and Congress tends to act very late in the year. Congress passed the IRA Charitable Rollover for 2010 on December 17. By that date, most individuals had already taken their required minimum distribution. Johannessen indicated that the late date "negatively impacted both the individuals' planned charitable giving" and also the charities who received fewer gifts.

Third, the uncertainty in estate tax law continues to make planning quite difficult. While the current exemption is $5 million and there now is portability for couples, the current law only applies for 2011 and 2012. To do good planning, it is essential to know what the law will be in future years.

Façade Easement Deduction Denied on NYC Townhouse

In *1982 East LLC et al. v. Commissioner*; T.C. Memo. 2011-84; No. 30052-08 (12 Apr 2011), the Tax Court determined that a limited liability company would not receive a charitable deduction for the grant of a façade easement.

Solomon D. Asser is the tax matters partner for a New York City LLC that acquired real estate at 19 East 82nd Street in New York City. In 2002 the LLC acquired the five story townhouse with approximately 10,375 square feet.

The LLC planned to renovate the property and convert it into a single dwelling. After making a down payment of $2 million in cash and then eventually acquiring a $9.35 million mortgage with First Republic Bank, the LLC proceeded to renovate the property.

The property is within the New York Metropolitan Museum Historic District. Because it is in the Special Madison Avenue Preservation District, it is subject to specific New York City landmark and zoning laws.

Mr. Asser was contacted by the National Architectural Trust (NAT) and, following extensive discussions, the LLC decided to grant a façade easement to NAT. There was an initial appraisal on June 7, 2004 and the façade easement transaction was completed on December 30, 2004.

The deed of easement granted NAT the right to enforce a "Protected Façade" easement and also relinquished rights for upper level development (UDRs).

Under the easement, First Republic Bank subordinated its rights in the subject property to NAT in order to permit the charity to enforce the conservation easement. However, the lender agreement also granted First Republic Bank a "prior claim to all insurance proceeds" and the right to take "title to the property by foreclosure."

An appraisal was obtained from a qualified appraiser on February 8, 2005. The façade easement was valued at $2,690,000 and the relinquishment of UDRs was valued at $3,880,000 for a total of $6,570,000. The LLC filed the tax return for 2004 and allocated the deduction to the respective partners.

The IRS audited the partnership tax return and denied the charitable deduction. While the IRS acknowledged that under Sec. 170(h)(1) there was a "qualified real property interest" and a "qualified organization," the IRS claimed that the façade easement failed the "exclusively for conservation purposes" requirement. In the event of a foreclosure by First Republic Bank, then the façade easement would not be protected in perpetuity. Therefore, the façade easement fails the "exclusive" test and there is no charitable deduction.

The court noted that Congress had specifically required a perpetual easement with "legally and enforceable restrictions on the interest in the property." In Reg. 1.70A-14(g)(2), the IRS explained the relationship that could still be permitted with a mortgage. Under that regulation, "the mortgagee must subordinate its rights in the property to the right of the qualified organization to enforce the conservation purposes of the gift in perpetuity." Because the First Republic Bank right was prior and it could foreclose on the property, the façade easement

failed this test.

In addition, Sec. 170(h)(4)(A)(iv) requires that a façade easement preserve a historically important land area. Because this property was within the Metropolitan Museum Historic District, it could not be altered without permission of the appropriate New York body. Therefore, the façade easement was not effective because the New York City rules would require the owners to "preserve the subject property." The deduction failed to qualify because the property was protected by New York law and the easement added no further restrictions.

Because Mr. Asser reasonably relied on professional advisors and demonstrated good faith in his efforts to comply with the law, there was no accuracy-related penalty under Sec. 6662(a).

This is information is brought to you by:

Fremont Bank Wealth Management & Trust Services Department

Greg Finn
Relationship Manager

Fremont – (510) 943-1982
Walnut Creek – (925) 941-1510
San Jose - (408) 232-7720
Carmel - (831) 622-2990

If you do not wish to receive this e-newsletter in the future, please click on "reply" and type "unsubscribe" in the subject line. Thank you.