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TAX MATTERS

Tax Court's denial of easement deduction deemed unreasonable

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The First Circuit recently held that a Tax Court decision disallowing a couple's deduction for a qualified conservation contribution of a facade easement was an unreasonable and overly restrictive interpretation of the extinguishment provision of Regs. Sec. 1.170A-14. The First Circuit viewed the Tax Court's reading of the regulation as contrary to the intended purpose of the associated statute. The First Circuit's decision is relevant because the Tax Court has applied its own reading of the extinguishment provision in a number of other opinions disallowing conservation easement deductions, and these may be appealed. Also uncertain is whether the Tax Court will alter its interpretation in cases pending before it but appealable to other circuits.

Gordon and Lorna Kaufman granted the National Architectural Trust (NAT) an easement restricting alterations to the facade of their row house in a Boston historic preservation district. NAT required the Kaufmans to make a cash contribution of approximately 10% of the estimated value of the facade easement to create an endowment for future monitoring and administration. It also required the Kaufmans to acquire a subordination agreement from the bank that held a mortgage on the property to satisfy the perpetuity provision of the Code. The Kaufmans complied with both requirements, but the bank limited its subordination by reserving first claim to all insurance proceeds from any casualty.

Under Sec. 170(h) and the associated regulations, an easement grant must be protected in perpetuity for it to be deductible. The regulations further add that no deduction is allowed for an interest in property subject to a mortgage unless the mortgagee subordinates its rights to those of the donee organization. When a change in conditions results in extinguishment of a perpetual conservation restriction, the donee organization "must be entitled to a portion of the proceeds at least equal to the proportionate value" of the conservation restriction (Regs. Sec. 1.170A-14(g)(6)(ii)).

The IRS denied the Kaufmans' deduction for the easement grant and cash contribution. The Tax Court upheld the IRS's determination, finding that the deduction failed to comply with the perpetuity requirement because extinguishment of the easement arising from a casualty would place the bank's claim to insurance proceeds above that of NAT. The court interpreted "entitled" in the regulations to mean an absolute right.

The First Circuit characterized the Tax Court's interpretation as foreclosing practically all deductions for easements because, under this reading, the superpriority of tax liens would "doom practically all donations of easements," which was not Congress's intent. The First Circuit also rejected the IRS's denial of the deduction for failure to comply with recordkeeping and reporting requirements. According to the First Circuit, the minor defects in the appraisal summary did not, by themselves, doom the deduction.

The First Circuit remanded the case to the Tax Court for further review of the value of the easement grant. Although the valuation issue was not in dispute on appeal, the First Circuit commented that the Kaufmans' easement grant might be worth "little or nothing," given the severe restrictions on facade alterations in the historic district of the Kaufmans' home. Thus, it left open the question of whether the Kaufmans gave away any rights beyond those already limited by preexisting municipal restrictions.

Kaufman, No. 11-2017 (1st Cir. 7/19/12), vacating in part and remanding 134 T.C. 182 (2010)

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