Missed Opportunities and More Questions: The Tax Court's Most Recent Decisions Regarding Preservation Easements

By Martha W. Jordan

Martha W. Jordan examines recent Tax Court cases valuing preservation easements. Included in Martha's discussion are whether the value of a preservation easement is increased if the grant of the easement adversely impacts the value of adjacent property, and the ramifications of the IRS's narrow interpretation of the regulations.

At the nascence of the preservation movement, the Tax Court decided a series of preservation easement cases that appeared to establish, rather firmly, the court's distinction between preservation easements and conservation easements for purposes of applying the before-and-after valuation method. The IRS initially adopted the Tax Court's approach but reversed its position in 2007. The Tax Court recently decided four preservation easement cases, two of which, *Whitehouse Hotel Limited Partnership*[1] and *D.J. Simmons*,[2] offered the court the opportunity to clarify whether it would continue to follow its original approach or follow the lead of the IRS. The other two, *J.D. Turner*[3] and *J.M. Herman*,[4] gave the court a chance to clarify the meaning of a "historically important land area."

Unfortunately, viewed from the perspective of advancing the law, none of the cases is particularly edifying. *Whitehouse* and *Simmons* do nothing to clarify the debate regarding the proper approach to follow when valuing a preservation easement. *Turner* and *Herman*, on the other hand, indicate that the court will either take an extremely narrow and conservative approach to defining a "historically important land area" or, possibly, simply represent examples of bad facts making bad law. It all depends on how much deference future courts give them. The most troubling aspect of *Herman* is what it might say about the court's view of development rights easements granted with respect to urban landscapes. *Simmons* and *G. Kaufman*,[5] in which the Tax Court granted summary judgment with respect to the government's motion that the easement in question did not satisfy the requirements for a qualified conservation contribution, indicate that the IRS is adopting a similarly narrow and extremely rigid interpretation of the regulations with respect to façade easements, one which, if *Kaufman* is any indication, the court may also be persuaded to adopt.

This article attempts to shed some light on the court's current approach to preservation easements by addressing some of the unanswered questions raised by these recent cases. First is a discussion of

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what *Whitehouse* and *Simmons* tell us about the Tax Court's current approach to valuing preservation easements. Following that is a discussion of *Turner* and *Herman* and the questions they raise regarding the definition of "historically important land area." Finally, two other points are discussed: whether the value of a preservation easement is increased if the grant of the easement adversely impacts the value of adjacent property, and the ramifications of the IRS's narrow interpretation of the regulations.

Background

As a general rule, the Internal Revenue Code ("the Code") disallows a charitable contribution deduction whenever a taxpayer gives less than his entire property interest to charity;[6] however, one exception to this rule is the deduction for "qualified conservation contributions."[7] A qualified conservation contribution is a charitable donation of a qualified real property interest exclusively for conservation purposes.[8]

The most common qualified conservation contributions are donations of conservation and preservation easements. Conservation and preservation easements are perpetual restrictions on the use that may be made of the encumbered property that are granted to charity to protect one of the conservation purposes sanctioned by the Code.[9] Conservation easements are granted exclusively (1) to protect the natural habitat of fish, wildlife or plants;[10] (2) to preserve open space;[11] or (3) to protect land for use by the general public.[12] Preservation easements are granted exclusively to preserve "an [sic] historically important land area or a certified historic structure."[13] An easement gives the holder a nonpossessory property interest that entitles the holder to use, but not to possess, the encumbered property. In the case of conservation and preservation easements, the holder is given the right to control changes that may be made to the encumbered property. A donation of a conservation or preservation easement that fails to satisfy the requirements of a qualified conservation contribution is an impermissible gift of a partial interest in property, which results in the denial of the charitable contribution deduction.[14]

Conservation and preservation easements protect the conservation purposes enumerated above by granting the charity a development rights easement, a facade easement or some combination of the two. A development rights easement curtails development of land, including in the case of an "air rights easement" development of the air space above or adjacent to existing improvements on the land. Facade easements protect the architectural features of a building by giving the holder of the easement the right to control alterations to the building's facade.

Preservation easements typically comprise a façade easement or a façade easement combined with an air rights easement that prevents the construction of floors, wings or other additions to the historic building. Preservation easements may also incorporate other development rights easements to safeguard the integrity of a historic building's site by protecting the curtilage and any other associated land. Conservation easements, on the other hand, use development rights easements to preserve the natural features of the encumbered property.

A preservation easement must be granted exclusively for the preservation of a certified historic structure or a historically important land area.[15] The definition of "certified historic structure" ("historic building") includes any "building, structure or land area" individually listed on the National Register of Historic Places ("National Register")[16] and any building located in a registered historic district and certified by the Secretary of the Interior as being of historic significance to the district.[17] The term "historically important land area" is not defined by the Code.

Whitehouse and *Simmons:* What is the Tax Court's Current Methodology for Valuing Facade Easements?

Provided the donation of a preservation easement satisfies the requirements of a qualified conservation contribution, the charitable contribution deduction equals the fair market value of the easement.[18] Fair market value is the price property would bring in a sale between a willing buyer and a willing seller, neither of whom is under any compulsion to buy or sell and both of whom have reasonable knowledge of the relevant facts;[19] however, conservation and preservation easements, which are not normally traded in the marketplace, are generally valued indirectly, using the "before-and-after" method of valuation.[20]

The before-and-after method indirectly determines the value of an easement by equating its value with its impact on the value of the encumbered property. Consequently, the traditional approach to the before-and-after method contemplates two appraisals of the encumbered property, one to determine the property's value immediately before the grant of the easement and one to determine its value immediately after; the difference between the two appraisals equals the value of the easement.[21]

A property's "before" value is predicated on its highest and best use immediately prior to the grant of the easement and takes into account any pre-existing restrictions that would limit its development, such as zoning, environmental laws or other limitations on use.[22] A property's "after" value is determined by its highest and best use immediately after the grant of the easement and must take into account any future development permitted by the easement.[23] Highest and best use is the most profitable, legally permissible use of the property and includes any reasonable, probable and economically feasible use to which the property is adaptable.[24]

In *M.G. Hilborn*,[25] the Tax Court's first preservation easement case, the court drew a distinction between facade easements and conservation easements. *Hilborn* concerned a facade easement granted to protect the exterior facade, front and roof of a building located in the French Quarter of New Orleans, a registered historic district.[26] *Hilborn* determined that the before-and-after method was the only feasible valuation method given the lack of an established market for sales of easements and that it had the approbation of Congress so long as it was not "applied mechanically."[27] The court based this latter conclusion on the legislative history of Code Sec. 170(h), which was enacted after the grant of the easement at issue in *Hilborn* but before the case was heard.[28] Rejecting the traditional, dual-appraisal approach to the before-and-after method as a mechanical approach, the court devised its own approach to the before-and-after methodology.[29] The *Hilborn* court used appraisals to calculate the "before" value of the property, but calculated the "after" value by multiplying the "before" value by a "diminution percentage."[30] The diminution percentage represented the extent to which the restrictions of the façade easement reduced the value of the property and was calculated by comparing the restrictions imposed by the facade easement to the pre-existing restrictions imposed by the local historic district.[31]

The Tax Court continued to use this approach throughout the first series of preservation easement valuation cases.[32] In the final case in that series, *G.P. Dorsey, Jr.*, the court was asked to settle a valuation dispute with respect to a preservation easement combining a facade easement protecting the roof, exterior facade, foundation and structural support of an office building with an air rights easement. *Dorsey*, which underscores and refines the court's practice of treating facade easements differently from conservation easements, articulates a three-step approach for valuing a preservation easement combining a facade easement with a development rights easement.[33] The first step is to determine the "before" value of the property.[34] The second, determine the value of the facade easement by calculating the diminution percentage and applying that percentage to the value of the building.[35] The third step is to value the development rights easement, which requires determining the impact of the developments rights easement on the net value of the property, net in this case referring to the property's value reduced by the value of the facade easement.[36]

The *Hilborn* method had one substantial flaw as a valuation method: No one, including the appraisers, knew exactly to what extent releasing control over a building façade impacted the value of the property.[37] They all agreed that it had an impact, so the appraisers used their best judgment to come up with a diminution percentage and the court accepted it.[38]

Notwithstanding the flaws of the *Hilborn* method, the IRS initially embraced it and allowed its use to substantiate the value of a charitable deduction for the donation of a preservation easement.[39] The IRS even developed a range of acceptable diminution percentages for facade easements.[40] In Chief Counsel Advice Memoranda 200738013 ("CCM 200738013"), however, the IRS reversed its position, saying too many donors were simply relying on a "generally recognized" diminution percentage rather than computing the impact of their easement on the value of their property.[41] CCM 200738013 requires donors of facade easements to substantiate their charitable contribution deductions using the traditional, dual-appraisal approach to the before-and-after method.[42]

Approximately one year after the IRS revoked its approval of the *Hilborn* method, the Tax Court decided *Whitehouse*, which addressed the value of a preservation easement combining a facade easement with an air rights easement and encumbering a building located in a registered historic district in New Orleans, the Maison Blanche Building, an outstanding beaux-arts building with a terra cotta facade.[43]

The taxpayer purchased the Maison Blanche Building in 1995 for approximately $10 million and the adjoining Kress Building and its garage in 1997 for $3.4 million.[44] The taxpayer planned to renovate the two buildings into a Ritz-Carlton Hotel in accordance with plans agreed to by the taxpayer, the Ritz-Carlton, and, apparently, the Central Business District Historic District Landmark Commission, which has approval authority for any changes to the exterior facade of the Maison Blanche.[45] Although the two buildings are contiguous, the Maison Blanche Building is approximately seven stories taller than the Kress Building.[46]

On December 29, 1997, the taxpayer donated a "scenic, open space and architectural facade" easement with respect to a portion of the facade and the air rights of the Maison Blanche Building and subject to its reservation of the necessary rights to renovate the buildings.[47] The taxpayer valued the preservation easement at $7.445 million on its 1997 tax return.[48] On audit, the IRS determined that the value of the easement was, at most, $1.15 million.[49] The parties revised their numbers for trial: The taxpayer raised its value to $10 million, and the government lowered its to zero.[50] The Tax Court ultimately determined that the value of the preservation easement was approximately $1.8 million.[51]

The primary question addressed by the *Whitehouse* court was the fair market value of the easement, as both parties agreed that the donation satisfied the requirements for a qualified conservation contribution.[52] Because the easement was granted prior to the issuance of CCM 200738013, it is certain that the appraisal used to substantiate the charitable deduction utilized the *Hilborn* method. At trial, however, the expert witnesses for both sides used variations of the traditional, dual-appraisal method to value the easement; however, their respective approaches differed in three primary ways. First, the taxpayer's expert witness aggregated the Maison Blanche Building with the Kress Building for purposes of determining the property's "before" and "after" values, even though the facade easement encumbered only the Maison Blanche Building.[53] Second, the taxpayer's expert used the three traditional appraisal methods—cost, comparable sales and net income—to calculate the property's "before" and "after" values.[54] Third, when calculating the impact of the easement on the property's value using the comparable sales method, the taxpayer's expert calculated a "before" value but not an "after" value, citing the lack of "precisely comparable" property in New Orleans as justification for this approach.[55] The government's expert, on the other hand, only determined the impact of the easement on the value of the Maison Blanche Building[56] and only used the comparable sales method to calculate the property's "before" and "after" values.[57]

The *Whitehouse* court sided with the government with respect to methodology. The court rejected both the cost approach and the income approach and relied solely on the comparable sales method, which it described as "the most reliable indicator of value when there is sufficient data about sales of properties similar to the subject property" to determine the value of the easement.[58]

Whitehouse appears to upend the Tax Court's approach to valuing facade easements. The court not only abandons its established precedent; it completely ignores it. There is no mention of *Hilborn* or its approach; no mention that the court is deviating from its previous methodology, must less explanation as to why; and no mention of *Dorsey*'s refinement to the *Hilborn* methodology. Not only is there no acknowledgment that the court is deviating from existing precedent, there is absolutely no indication whatsoever that the court might consider facade easements to be different from development rights easements. Judge Halpern, who wrote the *Whitehouse* opinion, also wrote the opinion in the 1997 conservation easement case *C.H. Browning, Jr.*[59] and appears to draw no distinction at all between the two types of property interests.

Approximately one year after *Whitehouse*, the court issued *Simmons*,[60] which addresses the value of two virtually identical facade easements granted in 2003 and 2004 with respect to two row houses in the District of Columbia ("the District").[61] The taxpayer, who neglected to file tax returns for the years in which the easements were granted,[62] claimed the easements were valued at $162,500 and $93,000, respectively.[63] The court ultimately determined that the easements were worth $56,250 and $42,250.[64]

Unlike the other preservation-easement-valuation cases considered by the Tax Court, the primary bone of contention between the taxpayer and the government appears to have been whether the gifts of the facade easements constituted qualified conservation contributions. The government asserted that the easements were illusory; the restrictions they contained duplicated those imposed by the historic preservation laws of the District, which prevented any material changes to the facades or any improvements of the properties.[65] Consequently, the government asserted that the easements had no impact on the value of the properties.[66]

The *Simmons* court, like *Whitehouse* before it, completely ignores existing precedent, only in this case the ignored precedent is *Whitehouse. Simmons* quotes *Hilborn* as authority for the proposition that no established market exists for preservation easements and, therefore, the before-and-after method is the appropriate valuation methodology.[67] The court then appears to follow the *Hilborn* methodology, although it does not explicitly state that it is doing so. The court discusses the parties' "before" valuations and after finding the valuations offered by Mrs. Simmons more persuasive, adopts them.[68] Then, with only a reference to the government's use of "comparables" to determine the "after" value of the properties,[69] the court focuses on, and is ultimately persuaded by, the taxpayer's argument that the restrictions imposed by the easements are more stringent than those imposed by the historic preservation laws of the District.[70] Among the factors the court finds persuasive is the charity's attitude with respect to repairs and maintenance: The charity was more selective with respect to the type of repairs it would allow, even regulating paint color, and in certain instances would require more expensive repairs than those permitted by the District.[71] Also important, the charity was more assiduous about enforcing its easements than the District was about enforcing its historic zoning restrictions.[72] After comparing the restrictions imposed by the easement with those imposed by the District, the court concluded that each easement resulted in a five-percent diminution in value of the encumbered property.[73]

If *Simmons* did not exist, *Whitehouse* would have greater significance, but as it is, it is hard to determine exactly how significant *Whitehouse* is, or *Simmons* for that matter. More importantly, neither case provides any guidance to future donors of easements or to their appraisers regarding the proper valuation methodology for preservation easements. Should future appraisers distinguish facade easements from development rights easements and treat preservation easements that combine the two as transferring two property interests or only one? More importantly, are facade easements fundamentally different from development rights easements and, if so, how? And, does that difference compel the use of a different valuation methodology for facade easements? If the use of a different methodology is indicated, what methodology? Is it the one used in *Hilborn* or something different? The existence of CCM 200738013 precludes taxpayers and their appraisers from relying on *Hilborn* to substantiate a charitable contribution deduction on their return, but *Simmons* leaves the door open for using the *Hilborn* methodology to value a facade easement at trial, as does some *dicta* in *E.A. Bruzewicz*, a recent district court case.[74] Lastly, neither case does anything to shed light on the unanswered question from *Hilborn* and its progeny: How does one quantify the impact of loss of control over decisions relating to the façade on the value of the easement?

Turner and *Herman:* What is the Meaning of "Historically Important Land Area"?

The Code does not define the term "historically important land area." Neither do the regulations, although they do list three examples, all of which are based on the legislative history.[75] The first is an independently significant land area, defined as a land area meeting the National Register Criteria for Evaluation, and any related historic resource.[76] Another example is any land, including any improvements located thereon, that is located within a registered historic district and that can reasonably be considered as contributing to the significance of the district.[77] The third example listed in the regulations is any land area, including any related historic resources, adjacent to property individually listed on the National Register and contributing to the integrity of the listed property.[78] An adjacent land area contributes to the integrity of the listed property if its physical or environmental features contribute to the historic or cultural integrity of the listed property.[79]

Turner and *Herman* offered the Tax Court two opportunities to bring some clarity to what is meant by historically important land area. Unfortunately, depending on how much credence is given to the rulings in these two cases, they may result in a very narrow definition of this term. In both cases, the IRS challenged the respective taxpayer's deduction on substantive grounds, in both cases the IRS won, and in both cases, the IRS deserved to win. The problem is that in both cases the court indicates it will take a very conservative, if not hostile, approach to defining historically important land area, and one cannot tell if the hostility is the court's reaction to the actions of the respective taxpayers or to a broad definition of historically important land area.

In *Turner*, the taxpayer, a real estate lawyer, owned and was attempting to sell for development approximately 30 acres, called the Grist Mill Property.[80] The Grist Mill Property was located in a historical overlay district near Mount Vernon and was zoned R-2, which meant that a maximum of two single family dwellings per acre could be built on the property; re-zoning was required to increase the permitted number of dwellings, but the taxpayer would have faced various obstacles, including the necessity of seeking approval from the Architectural Review Board for the historical overlay district and possible objections from the Mount Vernon Ladies Association and other groups.[81] Regardless of any zoning constraints, approximately one-half of the Grist Mill property was unavailable for any sort of development as it was located in a flood plain.[82] Consequently, the maximum number of dwellings that could be built on the property under the current zoning was approximately 30, not 60, as one would think if one simply checked the zoning restriction.

As part of his efforts to develop and to sell the property, Mr. Turner represented to various parties that the Grist Mill Property could be developed into 60 lots.[83] Concurrent with the sale of the Grist Mill property to a developer, an easement was granted to the county that said that the taxpayer had the right to develop the Grist Mill Property into 62 lots but voluntarily agreed to limit the number of dwellings built on the property to 30.[84] The appraisal substantiating the charitable deduction assumed the Grist Mill Property could be developed into 60 lots.[85]

The IRS challenged the charitable contribution deduction on the grounds that *inter alia* the donation did not satisfy the requirements of a qualified conservation contribution because the easement was not contributed exclusively for conservation purposes.[86] Mr. Turner claimed that the easement satisfied the requirements for both an open space easement and a historic preservation easement.[87] The court determined that it satisfied neither and, therefore, never reached the issue of whether it was granted "exclusively" for conservation purposes or any of the other challenges raised by the IRS.[88]

It is impossible to argue with the outcome of this case. There are various facts that demand denial of Mr. Turner's charitable contribution deduction. Put bluntly, the case does not pass the smell test. Furthermore, the number of times that the court reiterates that the property could only be developed into 30 lots as opposed to the 60 lots claimed by Mr. Turner indicates the court was greatly influenced by Mr. Turner's misrepresentation of the facts and by its belief that the easement didn't restrict the development rights at all.[89] At best, the taxpayer had given up the right to seek re-zoning, which, if successful, would have permitted development of the property into 45 lots; however, it is unclear from the case whether even that right was given up. A conservation or preservation easement must comprise a *perpetual* restriction on the encumbered property,[90] but the court says "nothing in the deed limits the landowner's ability to seek rezoning to denser development classifications," which implies that the easement's restrictions do not run with the land.[91] If the restrictions do not run with the land, the easement is not a qualified conservation contribution.

What is problematic about *Turner* is the court's interpretation of the requirements for an easement granted with respect to a historically important land area. The IRS, according to the court, conceded that the Grist Mill Property was a "historically important land area";[92] however, the court said the easement did not satisfy the requirements for a qualified conservation contribution because it failed to preserve a historic structure or historically important land area.[93] The court pointed out that there is no historic structure on the Grist Mill Property and that the restrictions of the easement fail to preserve the natural state of the Grist Mill Property.[94] Had the court stopped there, there would be nothing really controversial about its ruling; however, the court went on to imply that a taxpayer who owns property that is adjacent to a historic property cannot claim a charitable deduction for an easement granted to preserve the integrity of the historic structure's site because the taxpayer does not own the historic structure that is being protected.[95] The court appeared to restrict the definition of a historically important land area to land that has historical significance in its own right, such as a battlefield, and land that is associated with a historic structure owned by the donor. This conclusion is contrary to the legislative history cited by the court and incorporated into the regulations, which says that a historically important land area includes land "the physical or environmental features of which contribute to the historic or cultural importance and continuing integrity of certified historic structures such as Mount Vernon."[96] The question should not have been whether the taxpayer owned Mount Vernon, but whether the land encumbered by the easement contributed to Mount Vernon's integrity of location. Even more troubling, the court reiterated this interpretation in *Herman*.

Herman is another case in which the outcome is clearly correct but there is ample cause to worry about the court's extremely restrictive definition of a historically important land area. Mr. Herman owned a building in the nationally and locally designated Upper East Side Historic District.[97] During a six-month period in 1988, Mr. Herman deeded the property to his wholly owned limited liability company, which then assigned the air rights back to him along with a contractual undertaking to assist him with the development, transfer, or sale of the air rights.[98] Although the deed transferring title to the property was recorded, the assignment was not.[99] In 2003, Mr. Herman contributed a development rights easement to the National Architectural Trust with respect to the air rights.[100] The development rights easement prevented development of 10,000 of the 22,000 square feet of air rights (approximately 45 percent) but did not specify which 10,000 could not be developed.[101] On his 2003 individual tax return, Mr. Herman claimed a charitable contribution deduction slightly in excess of $21 million as a result of the donation of the development rights easement.[102] The IRS disallowed the deduction in total, and Mr. Herman sued for a refund.[103]

The issue before the *Herman* court was whether the donation made by Mr. Herman met the requirements set forth in Code Sec. 170(h) for a qualified conservation contribution. Mr. Herman and the government disagreed with respect to whether the development rights easement constituted a preservation easement; in particular, the parties disagreed with respect to whether the exclusive purpose for the donation of the development rights easement was "the *preservation* of an [sic] historically important *land area* or a certified historic *structure*."[104] Ultimately, the court agreed with the government that the donation failed to meet the standard required for a qualified conservation contribution.[105] Oddly, neither the IRS nor the court questioned whether the failure to record the assignment of the air rights from the limited liability company to Mr. Herman prevented the subsequent grant of the easement with respect to those rights from constituting a *perpetual* restriction, one prerequisite for a qualified conservation contribution.

The *Herman* court divided its discussion into two parts. The first concerned whether the easement protected a "historically important land area" or a "certified historic structure" as required by Code Sec. 170(h)(4)(A)(iv).[106] The second, whether the conservation purposes of the air rights easement were protected in perpetuity as required by Code Sec. 170(h)(5)(A).[107]

With respect to the first issue, Mr. Herman made various arguments that the air rights easement protected a "certified historic structure," all of which the court rejected. The court noted that neither Mr. Herman's application for evaluation of the significance of the property nor the Park Service's determination that the property was a certified historic structure specified which components of the property were covered by the certification: the apartment building alone; or the apartment building, the underlying land and the air rights. Because the easement in no way restricted alteration or demolition of the building, the court concluded it did not preserve the historic structure, which was the apartment building located beneath the air space to which the easement related.[108] Furthermore, the court concluded that even if the grant of an air rights easement somehow protected the apartment building, the fact that the apartment building might be altered or destroyed meant that the easement "[a] ccomplish[ed] one of the enumerated conservation purposes but ... permit[ed] the destruction of other significant conservation interests," and, therefore, no deduction was permitted.[109] Although Mr. Herman pointed out that the restrictions of the local historic district prevented alteration or destruction of the building, the court said that was irrelevant.[110] The court based its conclusion solely on the restrictions imposed by the easement. The easement permitted the destruction of the most significant conservation purpose—the preservation of the certified historic structure, which was the apartment building.[111]

The court also concluded that the grant of the air rights easement did not protect a historically important land area. The court did not rule on whether the land underlying the apartment building constituted a historically important land area; however, the court said that if it was, the only reason would be its proximity to the apartment building.[112] Instead the court relied on its conclusion that the development rights easement did not preserve the historic significance of the underlying land, which was to serve as the foundation of the apartment building.[113] And, as the court had previously concluded, the air rights easement did not prevent alteration or destruction of the apartment building.[114]

The court also rejected Mr. Herman's argument that a historic building or a historically important land area was preserved by the grant of an easement solely with respect to the air rights associated with such building or land. Relying on *Turner*, the court said it had previously held that "proximity [to a "certified historic structure"] alone does not provide a basis to support a claim of protection of a historical structure."[115] Nor is the "ancillary benefit of limited development" sufficient for an easement to preserve a certified historic structure.[116] Then, implying once again that the court would interpret the definition of historically important land area to include only property that had independent historic significance or property that contributed to the historic significance of a building owned by the taxpayer, the court said the taxpayer had to demonstrate how the conservation easement "preserved any historical structure."[117] Relying on Turner, the court held that, notwithstanding the proximity of the air rights to the historic building and the "ancillary benefit of limited development," a conservation easement with respect to unused development rights does not, in fact, preserve a historically important land area or a certified historic structure.[118]

This last conclusion by the court, especially when it is coupled with the court's rejection of the taxpayer's argument that the easement also qualified as an open space conservation easement, raises concerns as to whether the court will accept easements granted with respect to air rights to protect urban skylines or the public's view of historic buildings. The court fails to recognize that there are many ways to damage or destroy a historic facade without actually altering it or destroying the building of which it is a part. One way is to construct an anachronistic structure near the historic building, thereby destroying its aesthetic appearance or its setting. Air rights easements granted with respect to a historic building or with respect to a building that is adjacent or near a historic building can prevent this. An air rights easement granted with respect to a building adjacent to a historic building encumbered by a preservation easement can also protect the public's view of the protected façade. Consider a situation similar to that in *Whitehouse*, adjacent buildings with a façade easement granted to protect the terra cotta façade of the taller building. Further assume that the owner of the unencumbered building wants to ensure that the public's view of the terra cotta façade on the stories above the common wall shared by the two buildings is forever protected. Should not that taxpayer be entitled to donate a preservation easement with respect to the air rights above the unencumbered building, even if the unencumbered building is not a historic building and even if the owner of the unencumbered building does not own the encumbered building? Surely, the tax law should encourage the grant of that easement.

Herman does provide at least one ray of hope. The court hints it might have reached a different conclusion on different facts, in particular if the development rights easement prevented all development. At one point, the court says:

> It might be argued that the appearance of a structure is "preserved" in an aesthetic sense by an easement that prevents vertical development above its existing height. Assuming arguendo [sic] that there can be circumstances in which an "air rights" easement accomplishes the preservation of a "structure," Mr. Herman's easement nonetheless fails to do so.[119]

The court then proceeds to discuss how Mr. Herman's easement fails to protect the air space next to the building, and instead, permits additional construction.[120] Consequently, the court might have reached a different conclusion if faced with a different set of facts, one in which the air rights easement prohibited all construction or, possibly, even one in which that air rights easement allowed some future development but narrowly and explicitly defined what that development could be.

Whitehouse: To What Extent Does the Impact of a Preservation Easement on Contiguous Property Affect the Value of the Easement?

As noted previously, in *Whitehouse* the taxpayer's expert aggregated the Maison Blanch and the Kress Building for purposes of calculating the property's "before" value and its "after" value. The regulations require the aggregation of any property contiguous with the encumbered property when using the before-and-after method to value an easement ("the Aggregation Rule").[121] When the Aggregation Rule applies, the value of a preservation easement equals the difference between the aggregate value of the contiguous property and the encumbered property immediately before and immediately after the grant of the easement.[122] Contiguous property is property that is adjacent to the encumbered property and owned by the donor or a related party.[123]

One obvious purpose for the Aggregation Rule is to prevent the donor from unjustly benefitting by the grant of the easement: if the grant of the easement increases the value of contiguous property, the Aggregation Rule reduces the value of the easement, preventing the donor from claiming a charitable deduction to the extent that the grant of the easement increases, rather than decreases, the donor's wealth. The Aggregation Rule, however, does not explicitly limit aggregation to just those instances in which the value of the contiguous property is enhanced; it merely says that contiguous property must be aggregated, which implies that appraisers should aggregate whenever the donor or a related party owns contiguous property.[124] The language of the Aggregation Rule, especially when compared with the language in the regulations that requires an appraiser to take into account the impact of the grant of a preservation easement on the value of nearby but noncontiguous property only if the grant increases the value of such nearby property, raises the following question: If the grant of a preservation easement decreases the value of contiguous property, is there a corresponding increase in the value of the easement?

The courts have yet to address this question, but the facts of *Whitehouse* make the question quite apt. The Maison Blanche and the Kress Building are not merely contiguous; they share a common wall,[125] one wall that, because the Maison Blanche Building is seven stories taller than the Kress Building, comprises a portion of its protected facade.[126] Nonetheless, only the taxpayer applied the Aggregation Rule;[127] the government and the court both disregarded it entirely and calculated the value of the preservation easement solely by reference to the easement's impact on the value of the Maison Blanche Building.

One cannot excuse the Tax Court here on the grounds that the issue of the applicability of the Aggregation Rule was not brought before it. The taxpayer challenged the credibility of the government's expert and the reliability of his testimony, citing as one of the grounds for its challenge the expert's failure to apply the Aggregation Rule.[128] The court refused to exclude the expert's testimony, but more germane to our discussion here, in reaching that conclusion, the court was required to read the Aggregation Rule.[129]

Furthermore, the taxpayer directly raised the issue of the applicability of the Aggregation Rule. The taxpayer argued that as a result of the grant of the preservation easement the highest and best use of the property was altered, which prohibited the taxpayer from expanding the Kress Building in a manner that would block the public's view of the protected façade by creating a "servitude of view."[130] The court, however, interpreted this argument as raising, solely, the question of whether the easement encumbered the Kress Building, and looking to local law, concluded it did not.[131] The court never reached the primary implication of the taxpayer's argument—the applicability of the Aggregation Rule.

The taxpayer was not arguing that the easement encumbered the Kress Building. In fact, the taxpayer conceded that the preservation easement did not burden the Kress Building, except to the extent it burdened the common wall between the Maison Blanche and the Kress Building.[132] The taxpayer's assertion that the preservation easement granted the charity a "servitude of view" appears to be the basis for the taxpayer's position that the grant of the preservation easement reduced the value of the contiguous property, the Kress Building, and triggered the Aggregation Rule. Even if the taxpayer had asserted, as an alternative argument, that the easement encumbered the Kress Building with a servitude of view, the physical location of the Maison Blanche and Kress Buildings, the taxpayer's challenge to the admissibility of the expert's testimony for failure to apply the Aggregation Rule, and the taxpayer's use of, and the government's corresponding failure to use, the Aggregation Rule all scream for the court to address the applicability of the Aggregation Rule.

The court, however, ignores the issue, and its ruling that the preservation easement does not encumber the Kress Building is no substitute. If there was a servitude of view encumbering the Kress Building, the Kress Building would not be contiguous property; it would be part of the encumbered property, and the Aggregation Rule would be irrelevant. The court's conclusion that there was no "servitude of view" encumbering the Kress Building raises the question of the applicability of the Aggregation Rule. One might argue that implicit in the court's conclusion that there was no "servitude of view" is the conclusion that the value of the Kress Building was not reduced by the value of the 60 rooms that could no longer be built; however, that does not mean that the grant of the easement did not impact the value of the Kress Building in some other manner. The court should have applied the Aggregation Rule or explained why it was not applicable, especially because once the court rejected the taxpayer's argument regarding the loss of potential rooms, there is an equal chance that the grant of the easement enhanced rather than depressed the value of the Kress Building.

Simmons and *Kaufman*: The IRS's Inflexible Definition of a "Preservation Easement"

In the early façade easement cases, the validity of the charitable contribution deduction was not an issue; the IRS simply conceded that the grant of the easement satisfied the requirements for a qualified conservation contribution and disputed the easement's value.[133] In the more recent cases, such as *Simmons, Turner, Herman* and *Kaufman*, the IRS has, in addition to disputing the taxpayer's valuation of the easement, challenged the validity of the charitable contribution deduction on the grounds that the grant of the easement failed to satisfy the requirements for a qualified conservation contribution.

Obviously, it was inevitable that cases would arise in which the validity of the qualified conservation contribution would be raised. In fact, one major drawback to the IRS's habit of acquiescing to the validity of the charitable deduction in the early cases is that there is little case law defining the parameters of the requirements for a qualified conservation contribution.

In cases like *Herman* and *Turner*, where the taxpayer's behavior is particularly egregious, one finds it difficult to blame the IRS for raising every possible argument, regardless of its credibility, to prevent the taxpayer from benefiting from an unjustifiable and, at least in the case of *Herman*, extremely large tax deduction, especially because the early cases teach that, faced with a high appraisal from the taxpayer and a low appraisal from the IRS, the court is most likely to split the baby somewhere in the middle. One expects the court, however, to recognize the IRS's more extreme arguments for what they are—a very rigid and narrow interpretation of the regulations that may have been adopted as a result of the IRS's history of losing with respect to valuation.

Simmons and *Kaufman* indicate that, for whatever reason, the IRS has adopted a narrow reading of the regulations interpreting qualified conservation contributions and is demanding strict compliance by taxpayers with its interpretation. The *Simmons* court rejected the IRS's stringent interpretation of the regulations, but the *Kaufman* court adopted it. Read together, the two cases send a warning to all taxpayers that they cannot rely on the court to police the IRS's harsh approach with respect to preservation easements.

In *Simmons*, the IRS made several arguments, all of which were rejected by the Tax Court, that the easements conveyed by Mrs. Simmons were not enforceable in perpetuity, as required by Reg. §1.170A-14(g).[134] One of the more ludicrous arguments made by the IRS was that the easement was not enforceable in perpetuity because the grant of the easement gave L'Enfant, the charity holding the easement, the ability to consent to changes to the protected facade.[135] In fact, the IRS went even further and argued that simply endowing L'Enfant with the ability to consent to changes to the façade prevented the easement from protecting any conservation purposes because L'Enfant might consent to a change that was contrary to the purposes of the easement.[136] Pointing out that the grant of the easement required any changes made to the façade to comply with federal, state and local law, the *Simmons* court rejected both of the above arguments.[137] The IRS also tried to convince the court that the easements were not enforceable in perpetuity because they violated the regulations' requirement that any pre-existing mortgages must be subordinated to the easement, but the *Simmons* court disagreed with the IRS's factual assertion that the acknowledgements signed by the mortgagees were inadequate to satisfy this requirement.[138]

Because the *Simmons* court gives the IRS's arguments such short shrift, the motivation behind the arguments does not seem that important. But, then the Tax Court issued *Kaufman*.[139] *Kaufman* appears to remove any doubt that these arguments actually represent the IRS's current interpretation of the regulations and raises concerns as to whether the Tax Court will expend the effort to develop a thoughtful interpretation of Code Sec. 170(h), one that gives proper but not excessive deference to the regulations, or merely adopt the regulations as an extension of the statute.

In *Kaufman*, the Tax Court granted the IRS summary judgment on its motion that the grant of the easement did not constitute a qualified conservation contribution because the easement was not enforceable in perpetuity.[140] The IRS's argument relied on Reg. §1.170A-14(g)(6)(ii), which addresses the dispersal of any proceeds received due to the extinguishment of an easement. Reg. §1.170A-14(g)(6)(ii) reads as follows:

> (ii) Proceeds. In case of a donation made after February 13, 1986, for a deduction to be allowed under this section, at the time of the gift the donor must agree that the donation of the perpetual conservation restriction gives rise to a property right, immediately vested in the donee organization, with a fair market value that is at least equal to the

> proportionate value that the perpetual conservation restriction at the time of the gift, bears to the value of the property as a whole at that time. ... For purposes of this paragraph (g)(6)(ii), that proportionate value of the donee's property rights shall remain constant. Accordingly, when a change in conditions give rise to the extinguishment of a perpetual conservation restriction under paragraph (g)(6)(i) of this section, the donee organization, on a subsequent sale, exchange, or involuntary conversion of the subject property, must be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction, unless state law provides that the donor is entitled to the full proceeds from the conversion without regard to the terms of the prior perpetual conservation restriction.[141]

The taxpayer in *Kaufman* conceded that, until the pre-existing mortgage was satisfied, the mortgagee has a prior claim to all condemnation and insurance proceeds.[142] Exactly why the mortgagee had a prior claim is unclear; the IRS did not argue that the taxpayer failed to subordinate the mortgage to the easement, but, apparently, any subordination was not absolute. Furthermore, the taxpayer, notwithstanding the concession, argued that summary judgment should not be granted because the question of whether the charity would receive its proportionate share of any proceeds was a question of fact.[143]

The court concluded, based on the taxpayer's concession, that the charity holding the easement was not guaranteed its share of any condemnation or insurance proceeds, as required by Reg. §1.170A-14(g)(6)(ii).[144] The court said that, under Reg. §1.170A-14(g)(6)(ii), the charity's right to a proportionate share of the proceeds "is not conditional. [Taxpayers] cannot avoid the strict requirement in *section 1.170A-14(g)(6)(ii), Income Tax Regs.*, simply by showing that they would most likely be able to satisfy both their mortgage and their obligation to [the charity]."[145] Consequently, the court granted summary judgment.

Several aspects of the court's decision are troubling. First, Reg. §1.170A-14(g)(6)(ii) is simply an interpretation of the Code's requirement that a preservation easement must be granted in perpetuity; nothing in Code Sec. 170(h) speaks to the meaning of perpetuity or what happens if the easement is destroyed as a result of condemnation or rendered valueless because casualty destroys the property. Second, Reg. §1.170A-14(g)(6)(ii) does not give the charity an unconditional right to receive condemnation proceeds; the regulations themselves contain an exception, raising the question of whether there are more. Third, Reg. §1.170A-14(g)(3), which says that "[a] deduction shall not be disallowed ... merely because the interest which passes to, or is vested in, the donee organization may be defeated by the performance of some act or the happening of some event, if on the date of the gift it appears that the possibility that such act or event will occur is so remote as to be negligible," appears to indicate that there is another exception.[146] Neither the Tax Court nor the IRS appear to give any consideration to the question of whether the possibility that the encumbered property will be condemned or destroyed by casualty is so remote as to be negligible.

In *Kaufman*, like it did in *Simmons*, the IRS insisted on a stringent compliance with the regulations. What is troubling is that, unlike the *Simmons* court, the *Kaufman* court agreed with the IRS's interpretation of the regulations and was willing to grant summary judgment in the government's favor—the restraint that the *Simmons* court brought to the IRS's severe interpretation of the regulations is missing. *Kaufman* indicates that taxpayers may not be able to rely on the Tax Court to temper the IRS's extremely narrow interpretation of the regulations.

Simmons also raises concerns that the IRS may even attempt to vitiate the charitable deduction for donations of façade easements with respect to buildings located in local historic districts. A building located in a registered historic district constitutes a certified historic structure if it has been certified by the Secretary of the Interior as being of historic significance to the district.[147] In all of the façade easement cases to date, the encumbered buildings were located in local historic districts, although some of the districts constituted both local historic districts and registered historic districts listed on the National Register. A building in a registered historic district may qualify as a certified historic structure if the district is listed in the National Register or if it is included in a local historic district.[148] Although many registered historic districts satisfy both criteria, the owner's property rights are affected only if the property is included in a local historic district. Listing a historic district in the National Register does not impose any restraints on the owner's property rights; the owner of a building listed on the National Register may alter or demolish it with impunity.[149] Local historic districts, which are created by local zoning ordinances, impose various restrictions designed to ensure preservation of the architectural or historical character of the district on all properties within the district.[150]

Granting a façade easement on a building located in a local historic district has substantially less impact on the owner's property rights than does granting an identical easement on a building located within a registered historic district listed solely on the National Register. A façade easement granted with respect to a building located in a local historic district only curtails the donor's property rights to the extent the easement's restrictions are more stringent than those imposed by the local historic district. Because there are no pre-existing restrictions on a building listed solely in the National Register, any restriction limits the owner's property rights, even a restriction that would, if granted with respect to a building located in a local historic district, simply duplicate one of the restrictions imposed by the local historic district.

Simmons reinforces prior indications that the IRS fears that taxpayers have, either purposefully or through carelessness, been claiming charitable deductions for preservation easements that simply duplicate the restrictions of the applicable local historic district.[151] There really does not seem to be any other explanation for the IRS's substantive challenge to the taxpayer's charitable deduction, unless the IRS has decided to challenge all preservation easements granted with respect buildings located in local historic districts. The amounts claimed by the taxpayer were relatively modest, especially compared to the dollar amounts involved in *Whitehouse*. And, the taxpayer's venality in not filing a tax return does not appear to the basis for the IRS's position: The court remarks more than once that the IRS had not predicated allowance of the charitable contribution on the taxpayer satisfying her obligation to timely file her tax return.[152] In fact, one has to wonder whether similar reasoning prompted the IRS to reduce its value for the preservation easement in *Whitehouse* from $1.15 million to zero. If nothing else, this challenge strengthens the perception that the IRS is narrowing its interpretation of what constitutes a valid preservation easement: The easement in *Simmons* affords the charity the same type of rights that the IRS routinely cited in early private letter rulings as constituting restrictions greater than those imposed by local historic districts.[153]

Regardless of the IRS's motivation in *Simmons*, taxpayers should be reminded that deductions are a matter of legislative grace and are only allowed if the taxpayer satisfies the requirements for the applicable deduction—requirements that the courts tend to interpret narrowly. The charitable deduction for a donation of a preservation easement is predicated on the easement meeting the stringent requirements of a qualified conservation contribution; it is not a blanket blessing for any easement granted with respect to property listed in the National Register. *Turner*, *Herman* and the recent district court case *Bruzewicz*,[154] however, indicate that the lack of cases involving preservation easements in the last few years may have resulted in taxpayer complacency and the assumption that any easement complying facially with the terms of Code Sec. 170(h) is deductible. Wise taxpayers, and their advisors, will see these cases as a wake-up call and take care that their preservation easements satisfy the requirements for qualified conservation contributions in substance as well as in form, and that the easement meet all of the requirements set forth in the regulations. Additionally, wise charities will follow the example of L'Enfant, the charity in *Simmons*, and make sure that their practices protect the conservation purposes of the easement they hold.

Conclusion

In conclusion, the latest preservation easement cases from the Tax Court do little to advance the collective knowledge regarding qualified conservation contributions and the proper methodology for valuing them. As the above discussion shows, each case raises questions rather than answering them. Furthermore, and more troubling, reading the cases together, one cannot escape the niggling suspicion that the court may not have an adequate grasp of the law. There are glaring omissions, like the *Whitehouse* court's failure to acknowledge the existing precedent. And, there are more subtle problems, such as *Whitehouse*'s failure to address the question of whether the Aggregation Rule should have been used to value the preservation easement granted with respect to the Maison Blanche. There are also some complete misstatements of law. For example, the *Herman* court misread Code Sec. 170(h)(4)(B), which requires any contribution of a preservation easement with respect to the exterior of a building located in a registered historic district to preserve "the entire exterior of the building (including the front, sides, rear, and height of the building)."[155] The court thought that restriction applied to easements donated with respect to all historic buildings, but it only applies to easements donated with respect to historic buildings located in registered historic districts.[156] Buildings and structures individually listed on the National Register are exempt.[157] These are little errors when viewed in isolation, but when viewed collectively, errors that indicate that more attention should be paid to the law.

ENDNOTES

[1] *Whitehouse Hotel Limited Partnership*, 131 TC 112 (2008).
[2] *D.J. Simmons*, 98 TCM 211, TC Memo. 2009-208, Dec. 57,934(M).
[3] *J.D. Turner*, 126 TC 299, Dec. 56,522 (2006).
[4] *J.M. Herman*, TC Memo. 2009-205, Dec. 57,931(M), 98 TCM 197.
[5] *G. Kaufman*, 134 TC No. 9, Dec. 58,197.
[6] Code Sec. 170(f)(3)(A). Except as otherwise noted, all citations are to the Internal Revenue Code of 1986, as amended.
[7] Code Sec. 170(f)(3)(B)(iii).
[8] Code Sec. 170(h)(1).
[9] *Id.*
[10] Code Sec. 170(h)(4)(A)(ii).
[11] Code Sec. 170(h)(4)(A)(iii).
[12] Code Sec. 170(h)(4)(A)(i).
[13] Code Sec. 170(h)(4)(A)(iv).
[14] Code Sec. 170(f)(3)(A).
[15] Code Sec. 170(h)(1), (h)(4)(iv).
[16] Code Sec. 170(h)(4)(C)(i).
[17] Code Sec. 170(h)(4)(C)(ii). For preservation easements granted prior to August 17, 2006, the definition of "certified historic structure" included any building, structure or land area located in a registered historic district and certified by the Secretary of the Interior as having historic significance to the district. Code Sec. 170(h)(4)(C)(ii) (before amendment by the Pension Protection Act of 1986). For a discussion of the changes made to Section 170(h) by the Pension Protection Act of 1986, *see* Martha W. Jordan, *The Impact of the Pension Protection Act of 2006 on Qualified Conservation Contributions: The Good, the Bad and the Ugly*, TAXES, July 2007, at 35.
[18] Code Sec. 170(a)(1), (f)(3)(B)(iii), (h)(1), (h)(2)(C), (h)(4).
[19] Reg. §§1.170A-1(c)(2), -14(h)(3)(i).
[20] Reg. §1.170A-14(h)(3)(i).
[21] *Id.*
[22] Reg. §1.170A-14(h)(3)(ii).
[23] *Id.*
[24] *G.P. Dorsey, Jr.*, 59 TCM 592, Dec. 46,585(M), TC Memo. 1990-242.
[25] *M.G. Hilborn*, 85 TC 677, Dec. 42,464 (1985).
[26] *Id.*, at 678–79. Technically, the interest encumbering the property was a servitude, as Louisiana law does not recognize easements; however, the two are functional equivalents. *Id.*, at 682.
[27] *Id.*, at 688–89, citing SEN. RPT. 96-1007 (1980), 1980-2 C.B. 599, 606.
[28] *Id.*, at 688–89.
[29] *Id.*
[30] *Hilbom, supra* note 25, at 699–700.
[31] *Id.*, at 698–99.
[32] *R.E. Losch*, 55 TCM 909, Dec. 44,801(M), TC Memo. 1988-230; *F. Nicoladis*, 55 TCM 624, Dec. 44,709(M), TC Memo. 1988-163; *J.E. Griffin*, 56 TCM 1560, Dec. 45,568(M), TC Memo. 1989-130; *Dorsey, supra* note 24.
[33] *Dorsey, supra* note 24.
[34] *Id.*, at 601.
[35] *Id.*
[36] *Id.*
[37] *Nicoladis*, 1988 Tax Ct. Memo LEXIS 187, at *13 (1988).
[38] *Id.*
[39] CCM 200738013 (Sept. 21, 2007).
[40] *Id.*
[41] *Id.*
[42] *Id.*
[43] *Whitehouse, supra* note 1, at 116. For a more in-depth discussion, *see* Martha W. Jordan, *Law & the Appraiser: Valuation of Preservation Easements after Whitehouse Hotel Limited Partnership v. Commissioner*, 77 APPRAISAL J. 319 (2009).
[44] *Id.*, at 115–16.
[45] *Id.*, at 116–17.
[46] *Id.*, at 116.
[47] *Whitehouse, supra* note 1, at 178.
[48] *Id.*, at 118.
[49] *Id.*
[50] *Id.*, at 129–30.
[51] *Id.*, at 172.
[52] *Whitehouse, supra* note 1, at 114–15.
[53] *Id.*, at 119.
[54] *Id.*
[55] *Id.*, at 130.
[56] *Id.*
[57] *Whitehouse, supra* note 1, at 130.
[58] *Id.*, at 156.
[59] *C.H. Browning, Jr.*, 109 TC 303, Dec. 52,373 (1997).
[60] *D.J. Simmons, supra* note 2, 2009 Tax Ct. Memo LEXIS 213.
[61] *Id.*, at *3.
[62] *Id.*, at *6.
[63] *Id.*
[64] *Id.*, at *30.
[65] *Simmons, supra* note 2, 2009 Tax Ct. Memo LEXIS 213, at *24-25.
[66] *Id.*, at *25.
[67] *Id.*, at *21.
[68] *Id.*, at *23.
[69] *Id.*, at *25.
[70] *Id.*, at *26–27.
[71] *Id.*
[72] *Id.*, at *27.
[73] *Id.*, at *28.
[74] *E.A. Bruzewicz*, DC-IL, 2009-1 USTC ¶50,317, 604 FSupp2d 1197, 1207.
[75] *See* SEN. RPT. 96-1007 (June 19, 1980), 1980-2 CB 599, 605.
[76] Reg. §1.170A-14(d)(5)(ii)(A).
[77] Reg. §1.170A-14(d)(5)(ii)(B).
[78] Reg. §1.170A-14(d)(5)(ii)(C).
[79] *Id.*
[80] Actually, the property was owned, and the donation made, by a limited liability company of which the taxpayer was a member, but the court seems to treat the two as interchangeable.
[81] *Turner*, supra note 3, at 306.
[82] *Id.*, at 302.
[83] *Id.*, at 303.
[84] *Id.*, at 309.
[85] *Id.*, at 303.
[86] *Id.*, at 312.
[87] *Id.*, at 312.
[88] *Id.*
[89] *Id.*, at 303, 319.
[90] Code Sec. 170(h)(2)(C).
[91] *Turner, supra* note 3, at 314.
[92] *Id.*, at 315.
[93] *Id.*
[94] *Id.*
[95] *Id.*, at 315–16.
[96] *Id.*, at 314, *citing* SEN. RPT. 96-1007 (June 19, 1980), 1980-2 CB 599, 605.
[97] *Herman, supra* note 4, 2009 Tax Ct. Memo LEXIS 209 at *5.
[98] *Id.*, at *4-5.
[99] *Id.*, at *5.
[100] *Id.*, at *7.
[101] *Herman, supra* note 4, 2009 Tax Ct. Memo LEXIS 209, at *7–8 (2009).
[102] *Id.*, at *12.
[103] *Id.*, at *13.
[104] *Id.*, *citing* Code Sec. 170(h)(4)(A)(iv).
[105] *Herman, supra* note 4, 2009 Tax Ct. Memo LEXIS 209, at *14 (2009).
[106] *Id.*, at *19.
[107] *Id.*, at *20.
[108] *Id.*, at *23.
[109] *Id.*, *citing* Reg. §1.170A-14(e)(2).
[110] *Id.*, at *31.
[111] *Herman, supra* note 4, 2009 Tax Ct. Memo LEXIS 209, at *31 (2009).
[112] *Id.*, at *35, note 6.
[113] *Id.*, at *35.
[114] *Id.*, at *35.
[115] *Id.*, at *36–37, *citing Turner, supra* note 3, at 316.
[116] *Id.*, at *37.
[117] *Turner, supra* note 3, at 316.
[118] *Herman, supra* note 4, 2009 Tax Ct. Memo LEXIS 209, at *37 (2009), *citing Turner, supra* note 3, at 315–16.
[119] *Id.*, at *26–27.
[120] *Id.*, at *26–27.
[121] Reg. §1.170A-14(h)(3)(i).
[122] *Id.*
[123] *Id.*
[124] *Id.*
[125] *Whitehouse, supra* note 1, at 132.
[126] *Id.*, at 116.
[127] *Id.*, at 125.
[128] *Id.*, at 125–26.
[129] *Id.*, at 125–26.
[130] *Id.*, at 132.
[131] *Id.*, at 134.
[132] *Id.*, at 133.
[133] *See, e.g., Hilborn, supra* note 25, at 699–700; *Losch, supra* note 32; *Nicoladis, supra* note 32; *Griffin, supra* note 32; *Dorsey,*

supra note 24.
[134] *Simmons, supra* note 2, 2009 Tax Ct. Memo LEXIS 213, at *12.
[135] *Id.,* at *11.
[136] *Id.,* at *10–11.
[137] *Id.,* at *12.
[138] *Id.,* at *11–12.
[139] *Kaufman, supra* note 5, 2010 U.S. Tax Ct. LEXIS 10.
[140] *Id.,* at *9.
[141] Reg. §1.170A-14(g)(6)(ii).
[142] *Kaufman, supra* note 5, 2010 U.S. Tax Ct. LEXIS 10, at *8.
[143] *Id.*
[144] *Id.*
[145] *Id.*
[146] Reg. §1.170A-14(g)(3).
[147] Code Sec. 170(h)(4)(C)(ii).
[148] Code Sec. 170(h)(4)(C)(ii), 47(c)(3)(B)(i).
[149] 36 CFR §60.2 (1981).
[150] *See, e.g., Simmons, supra* note 2, 2009 Tax Ct. Memo LEXIS 213.
[151] *See also* IR 2004-86 (June 30, 2004).
[152] *Simmons, supra* note 2, 2009 Tax Ct. Memo LEXIS 213, at *8.
[153] *See, e.g.,* LTR 8753015 (Oct. 2, 1987).
[154] *Bruzewicz, supra* note 74, at 1207.
[155] Code Sec. 170(h)(4)(B)(i)(I).
[156] *Id.*
[157] *Id.*

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interest in Partnership and finally, FC contributed $c for its interest in Partnership. Partnership also received both US Business and Non-US Business from the respective parent companies. The two businesses and all of the subsequently acquired assets were each maintained in a separate legal entity owned by Partnership and disregarded for U.S. federal income tax purposes. LLC 1 owned all of US Business, and LLC 2 owned Non-US business. Separate books and records were maintained for each entity, and there were no cross-loans occurring between the two entities. It was contemplated that only FC would lend additional capital to Partnership to fund US Business and Non-US Business.

The Partnership agreement specified that CFC 2 would share only in the income, gains, deductions and losses of Non-US Business and would only have liquidation rights related to the assets of Non-US Business. CFC 2 would not share in any income, gains, deductions or losses from US Business and would not have any rights to the assets of US Business upon a liquidation of Partnership. The parties represented that the allocations of income, gain, deduction and loss provided in Partnership's agreement had substantial economic effect within the meaning of Code Sec. 704(b). US Business and Non-U.S. Business were each operated independently with their own employees, including tax and transfer pricing.

The IRS respected the fact that CFC 2 had no economic interest in any U.S. property, be it a profit or capital interest, a liquidation right or any other interest, and thus CFC 2 should not have a Code Sec. 956 amount with respect to US Business. In other words, the ruling limited CFC 2's recognition of U.S. property owned by the partnership on the CFC's share of income from the property. Thus, CFC 2's "interest in the partnership" pursuant to Reg. §1.956-2(a)(3) was determined by reference to the CFC partner's distributive share of income from the property. In this case, the share of income from the U.S. property was $0.

The question then is whether, in the example we set forth above, CFCx can avoid being considered to have any investment in U.S. property if it is not allocated any of the interest income from the debt instrument. The private letter ruling would suggest that if the partnership happened to have other non-U.S. property investments and the interest on the U.S. loan was allocated away from CFCx towards another partner in a manner that complied with Code Sec. 704(b) and the substantial economic effect test, the answer may be "yes."

IV. Conclusion

The interaction of partnerships and Code Sec. 956 is an area that warrants further clarification. There is no perfect answer here, and any principled rule will no doubt be relied upon by taxpayers affirmatively. Nevertheless, given that the use of partnerships in the international context is so prevalent, this area deserves some clarity and finality that has heretofore been lacking.

Endnotes

1 Unless otherwise noted, all "Code Sec." and "Reg. §" references are to the Internal Revenue Code of 1986, as amended.
2 Code Sec. 956 was enacted as Act Sec. 12(a) of the Revenue Act of 1962 (P.L. 87-834).
3 H.R. Rep. No. 87-1447, 2d Sess., at 58 (1962), 1962-3 CB 405, 462.
4 Code Sec. 951(a)(1)(B).
5 Code Sec. 951(b); Reg. §1.951-1(g).
6 Code Sec. 957(a).
7 Code Sec. 956(a)(1). The amount of U.S. property held by the CFC is determined by reference to the adjusted basis of such property reduced by any liability to which the property is subject (flush language).
8 The statute does not specifically state whose tax year counts for this purpose, but the regulations make it clear that it is the tax year of the CFC, not the U.S. shareholder, that is relevant. Reg. §1.956-1(b) ("the amount of the inclusion is based on the CFC's earnings invested at the close of its … year"); Reg. §1.956-2(a)(1) ("For purposes of Code Sec. 956(a) and Reg. §1.956-1, United States property is (except as provided in paragraph (b) of this section) any property acquired (within the meaning of paragraph (d)(1) of this section) by a foreign corporation (whether or not a controlled foreign corporation at the time) during any tax year of such