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N.Y. Real Property Law Journal

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Message from the Section Chair

I want to begin by applauding the efforts of our Membership Committee headed by Harry Meyer and Jaime Lathrop. Under their leadership, our Section's membership has increased by a small but meaningful number, reversing the general declining trend experienced by the Bar Association as a whole. Of course, I also want to welcome all of our new members and encourage anyone reading this *Journal* to join us as well. The benefits of membership in our Section are numerous and include opportunities for professional growth, continuing legal education at a substantial discount, networking and camaraderie that is unmatched.

Our Task Force on Title Insurance Agent Licensing, headed by Karl Holtzschue, has been working feverishly in connection with pending agent licensing legislation and regulations. The members of the Task Force—Tom Hall, Sam Tilton, Gerry Antetomaso and I—have attended hearings conducted by the Department of Financial Services,[1] reviewed many different versions of proposed licensing laws and, in response, issued several legislative memoranda. The outgrowth of our active involvement paralleled the rapid advancement of this issue, which previously remained dormant for long spells. An agent licensing law may even be in place by the time this *Journal* is published.

Title practice has a long history in New York that evolved over the course of time. Attorneys in the State of New York (and formerly, the Colony of New York) were issuing written certifications of title for more than 200 years before the advent of title insurance in the early twentieth century. Indeed, they continue this practice throughout the State. As title insurance became more widespread to where it is almost ubiquitous, non-lawyer title insurance agents proliferated.

For many reasons, the Department of Financial Services and the Governor have determined that it has become necessary to regulate title insurance agents under the Insurance Law, and three legislative bills have been introduced to accomplish that. Chief among the concerns of the Task Force is to clarify all of these bills to remove any lingering ambiguity about the right of lawyers to continue to act as title insurance agents in matters where they are also representing clients in legal matters.

Our Section has been in close contact with David Schraver, President of the New York State Bar Association; Ron Kennedy, Director of Governmental Relations; and Kevin Kerwin, Associate Director of Governmental Relations, in this matter. I want to acknowledge their active participation and thank them for their help, guidance and support, both with the Legislature and with the Committee on Professional Ethics.

Please remember to reserve the date so that you can attend our Summer Meeting, which is scheduled to take place July 17 through July 20, 2014 at beautiful and historic Niagara on the Lake, Ontario, Canada. More details and registration forms will be coming shortly.

In closing, I note the passing of our esteemed member, Keith Osber of Vestal, NY. Keith practiced for over 50 years at Hinman, Howard & Kattell, LLP in Binghamton, NY, and was the Chair of our Section twenty years ago. All who knew him fondly remember that he exuded dignity, professionalism, and a dedication to real estate law.

Benjamin Weinstock

Endnote

1. On October 3, 2011 the New York State Banking Department and the New York State Insurance Department were abolished and the functions and authority of both former agencies transferred to the New York State Department of Financial Services. These were among the oldest regulatory agencies in the State of New York. In fact, the New York State Banking Department, formed in 1829, was the oldest bank regulatory agency in the nation.

Memoriam for Keith Osber

There are few attorneys who practice real estate law in the Binghamton area who have not heard of Keith Osber. Keith was one of the most prominent real estate attorneys in the area. His passion for real estate started in the early years of his practice as an attorney at Hinman, Howard & Kattell, LLP ("HH&K") and propelled him to leadership of the firm's real estate department. Keith served as counsel to many of the area's lenders and was involved in many of the area's largest and most complex real estate transactions.

Keith was devoted to his firm and invested in training HH&K attorneys to become experts in their field. Keith had notoriously high standards and often his name would strike fear in the hearts of the associates assigned to work on his projects. He was toughest on the people he considered to have the most potential. Many of his protégés became successful and distinguished attorneys.

Keith practiced for over 50 years. Of his many achievements, Keith was particularly proud of his involvement with the local and state bar associations. He served as the Chair of the Real Estate Committee of the Broome County Bar Association for many years. His involvement in the New York State Bar Association included serving on the Continuing Legal Education Committee and on the Executive Committee of the Real Property Law Section, which he led as Chair in 1994-95. He was a member of the American Bar Association, having served on the Real Property and Probate Committee since 1965 and the Savings Bank Committee since 1983. He also joined the American College of Real Estate Lawyers in 1990.

Keith received his B.A. from Syracuse University in 1958 and his LL.B. from Syracuse University College of Law in 1961, which explains his dedication to Syracuse Athletics. He rarely missed an S.U. basketball game. The Red Sox were the only sports team he loved more than S.U. Some believe his allegiance to the Red Sox was born from a desire to antagonize the many local Yankees fans.

HH&K attorneys met on the day of Keith's funeral to share stories about Keith and his years in practice. The stories were funny, touching, and most notably confirmed that Keith made an impact on the attorneys with whom he worked.

Keith will be remembered as a brilliant attorney who maintained a high standard of excellence for himself and the attorneys who worked with him. He put his heart and soul into his practice. His clients will certainly remember him as a master negotiator. The reputation Keith established for himself will carry on in the memories of all who worked with him.

By John E. Jones
Hinman, Howard & Kattell, LLP

Can the Mere Presence of Contaminants Reduce a Property's Tax Assessment?

By Shannon M. Jones, Karen M. Richards and Patrick L. Seely, Jr.

Introduction

In 1996, the Court of Appeals held that environmental contamination must be considered in property tax assessment when it impairs market value.[1] An extension of this holding was sought recently when the Court granted leave to hear *Roth v. City of Syracuse*, where the petitioner contended that the mere existence of lead paint in his properties automatically rendered their value almost worthless.[2]

Part I of this article explains basic concepts in property valuation and tax certiorari proceedings. Part II provides a brief summary of cases where the Court examined "costs to cure" and "stigma," concepts revisited by the Court in *Roth*. Part III reviews *Roth*, where the Court held that the mere presence of lead paint does not overcome the validity of a property's assessment without substantial evidence that the contaminant depressed the property's market value.

Part I

Valuation of Property in General

Property is traditionally valued by one of three methods: comparable sales, capitalization of income, or reproduction cost less depreciation. The strict application of the traditional methods proved inadequate to analyze the impact of environmental contamination on value,[3] and over time appraisers developed specialized valuation methods and techniques based upon the traditional methods to account for the effect of contamination on value.[4]

Burden of Proof

It is well-settled that a property valuation by a municipal tax assessor is presumptively valid.[5] A petitioner challenging an assessment has the initial burden of overcoming the presumption of validity by producing substantial evidence that the assessment is erroneous.[6] The substantial evidence standard "requires less than clear and convincing evidence, and less than proof by a preponderance of the evidence, overwhelming evidence or evidence beyond a reasonable doubt."[7] A petitioner need only "demonstrate the existence of a valid and credible dispute regarding valuation."[8] Substantial evidence at this juncture is whether the petitioner's evidence "is based on 'sound theory and objective data' rather than on mere wishful thinking."[9] The burden of rebutting the presumption of validity may be met by testimonial evidence and "the submission of a detailed competent appraisal, based on standard, accepted appraisal techniques and prepared by a qualified appraiser, demonstrating the existence of a genuine dispute concerning valuation."[10] "The ultimate strength, credibility or persuasiveness of [the] petitioner's arguments are not germane during this threshold inquiry."[11]

If the petitioner rebuts the presumption of validity, "a court must weigh the entire record, including evidence of claimed deficiencies in the assessment to determine whether [the] petitioner has established by a preponderance of the evidence that [the] property has been overvalued."[12]

Part II

Valuation of Contaminated Property in New York State

The concepts of stigma and cleanup costs, which were examined in *Roth v. City of Syracuse*, arose in cases decided previously by the Court of Appeals. Stigma was recognized in *Allied Corporation v. Town of Camillus* and was an integral part of the issue in *Criscuola v. Power Authority of State of New York*, while cleanup costs figured heavily in valuing the property in *Commerce Holding Corp. v. Assessors of Town of Babylon.*

In *Allied*, the property, consisting of more than 1,000 acres of wastebeds, settling lagoons, and buffer zones, had been used for many years to receive waste material from an industrial process.[13] Although the waste material was not classified as hazardous and there was no evidence of contamination,[14] the Court noted that "many of the same economic considerations are present, most notably the 'stigma' attached to environmentally damaged land in the eyes of any potential buyers, the risk that undetected or currently unclassified hazardous materials will be identified, and the costs of clean-up and rehabilitation."[15] The *Allied* Court thus recognized that stigma can attach to a site perceived to be, but not actually, contaminated.

The year following *Allied*, the Court of Appeals confronted the concept of stigma in an eminent domain proceeding.[16] In *Criscuola v. Power Authority of State of New York,* the claimants asserted their property was valueless due to cancerphobia and the stigma associated with the public's perception of health hazards from high-voltage power lines built across the claimants' property.[17] The only issue before the Court was whether the claimants were required to show the reasonableness of the public's fear in order to recover consequential damages for the taking.[18] The Court held they were not required to prove reasonableness as a separate, additional component of diminished market value because market value may be adversely affected even if the public's fear is unreasonable.[19] Still, the claimants had to prove the value of the property was diminished "in much the same manner that any other adverse market effects are shown, e.g., by proffering evidence that the market value of the property across which power lines have been built has been negatively affected in relation to comparable properties across which no power lines have been built."[20]

Only a few years after deciding *Criscuola* and *Allied*, the Court of Appeals heard *Commerce Holding Corp. v. Assessors of Town of Babylon.*[21] Considered by many to be the leading case in New York on environmental contamination and tax assessment, the Court clearly held that to the extent it impairs market value, "contamination must be considered in property tax assessment."[22]

The industrial property in *Commerce Holding* was severely contaminated by metal plating operations performed by a former tenant of the property.[23] As a result of the contamination, the property was designated a Superfund site, making Commerce as the owner of the property strictly liable for cleanup costs, and Commerce entered into a consent order with the Environmental Protection Agency to remediate the site.[24]

The Town argued that the trial court erred in reducing the property's value by factoring in the costs to remediate the contamination dollar-for-dollar and urged the Court "to adopt a per se rule barring any assessment reduction for environmental contamination."[25] The Court of Appeals rejected this argument because the State Constitution mandates that property cannot be assessed at more than its full value, a concept typically equated with market value, and "[i]n view of this market-oriented definition of full value, the assessment of property value for tax purposes must take into account any factor affecting a property's marketability."[26] "It follows that when environmental contamination is shown to depress a property's value, the contamination must be considered in property tax assessment."[27]

Recognizing that traditional valuation methods were "inevitably hampered to some extent by the lack of available market data," the Court endorsed a flexible approach to valuing contaminated property.[28] While not prescribing any one valuation method, it listed certain factors—present use of the property, Superfund site status, extent of the contamination, ability to obtain financing and indemnification in connection with the purchase of the property, potential liability for third parties, estimated cleanup costs, and stigma remaining after cleanup—that should be considered to assess the effects of environmental contamination.[29] Based on the contamination and market factors present in *Commerce Holding*, the Court concluded that "cleanup costs [were] an acceptable, if imperfect, surrogate to quantify environmental damage and provide a sound measure of the reduced amount a buyer would be willing to pay for the contaminated property."[30]

Part III

Roth v. City of Syracuse

After *Commerce Holding*, the Court remained silent on the issue of environmental contamination and tax assessment until it decided *Roth v. City of Syracuse*.[31] Petitioner in *Roth* commenced a Real Property Tax Law Article 7 proceeding, alleging the assessor's valuations did not account for the adverse effect that the presence of lead paint had upon the market value of the properties.[32]

The properties were five former single-family homes, located near three major universities, which had long been converted to income-producing student housing.[33] During trial, the City's expert determined the properties' market values by using both a sales comparison approach and an income capitalization method and "concluded that the mere presence of lead paint, without more, did not diminish the market value of the five properties."[34] On Petitioner's motion, the trial court excluded the appraisal reports because the City's expert failed to include the data upon which he relied in developing his opinion of the properties' values.[35] Remaining in evidence was testimony from local property owners and brokers that indicated "lead-based paint would have no adverse effect upon either the sales of the properties or their continued profitable use as student housing rental."[36]

Conversely, Petitioner's expert concluded the market values of the properties were negatively impacted by the mere presence of lead-based contaminants. In utilizing an income capitalization method that determined market value based upon a property's ability to generate income,[37] Petitioner's expert first determined the hypothetical non-contaminated market value of each of the properties, reduced the value by their respective cost to cure figures,[38] and concluded that each of the five properties had a market value of one dollar.[39]

The properties, however, continued to generate income, and Petitioner did not incur any costs to cure because he had not taken any steps to remove the lead paint and restore the properties.[40] In addition, there was no legal requirement to abate the lead paint from the properties.[41]

On the merits, the trial court held that Petitioner failed to meet his burden of proof that the properties were overvalued or that the assessments were incorrect.[42] The appellate court unanimously affirmed.[43]

Before the Court of Appeals, Petitioner relied heavily on *Commerce Holding* to support his position that "even if a property owner is not required by law, or has not agreed by contract, to remediate contamination, the cost to cure contamination should be considered in valuing the property for tax assessment."[44] He argued that *Commerce Holding* stood for the propositions that "it is the calculated cost to cure, not the amount actually expended by the property owner to cure the contamination, that must be deducted from the 'uncontaminated' value to get a proper assessment for tax purposes" and that the calculated cost to cure "does not depend on a legal mandate to actually remediate the pollution."[45] He further contended that stigma depressed the properties' market values.[46] In other words, the mere existence of lead paint automatically diminished the market value of each of the properties.[47]

The Court decided that Petitioner's reliance on *Commerce Holding*, however, was misplaced. *Commerce Holding* did not support his position that the costs to cure the lead paint must be deducted from the uncontaminated value of the properties, even though Petitioner was not required by law or by contract to remediate the lead paint. The Court found that:

> [t]he nature of the contamination and market factors in this case further distinguish petitioner from the property owner in *Commerce Holding*. The property in *Commerce Holding* was a designated Superfund site, and the property owner was strictly liable pursuant to CERCLA and a consent order with the Environmental Protection Agency to remediate the site. Thus, we concluded that 'cleanup costs are an acceptable, if imperfect, surrogate to quantify the environmental damage and provide a sound measure of the reduced amount a buyer would be willing to pay for the contaminated property.' Here, in contrast, there was no evidence that a 'buyer of the property would have demanded an abatement in the purchase price to account for the contamination.' Petitioner admits there was no immediate legal requirement to abate the lead paint from the properties, and the ubiquitous nature of lead paint in residential properties, unlike the unique contamination of the Superfund site in *Commerce Holding*, undermines petitioner's unsupported contention that there is a lead paint 'stigma' depressing market value. Thus, petitioner's proposed remediation costs are not an appropriate factor to be considered in evaluating the tax assessments of these properties.[48]

Petitioner's argument that a finding in his favor was required because the trial court struck the City's appraisal reports also failed.[49]

> Petitioner bears the ultimate burden to rebut the presumption of validity accorded to the tax assessments issued by the City. To carry his burden, petitioner must show that the market value of the properties was diminished by the presence of lead paint, not its mere existence. To hold otherwise would permit a taxpayer to avoid his or her fair share of the tax burden, while, as in petitioner's case, reaping the benefits of a rental market that is unaffected by the presence of the contaminant without having incurred any costs to remediate or abate the lead-based conditions.[50]

Petitioner continued to profit from the rental income generated by the properties, and he did not otherwise demonstrate that the presence of lead paint impaired their market value.[51] Accordingly, the Court found Petitioner "failed to meet his burden and there is no basis to disturb the presumption of validity in the City's favor."[52]

Conclusion

While the petitioner's efforts in *Roth* to extend *Commerce Holding* did not succeed, there are a few lessons to be learned. First, continuing to collect market rents without an obligation to incur any remediation costs does not result in a decrease in a property's valuation merely because contaminants are present. Second, it is difficult to factor cleanup costs when valuing property where much of the market contains the same common contaminants, such as the property in *Roth*, particularly where there is no legal obligation to remediate, as compared to factoring cleanup costs in property containing unique contaminants, such as the property in *Commerce Holding*, where there is a legal obligation to remediate. Finally, and most importantly, whether the alleged diminution in property valuation stems from cleanup costs, stigma, market perception, the extent of contamination, or the property's status as a Superfund site, a property owner must demonstrate the factor that depressed the market value of the property or the assessment is upheld as presumptively valid.

Endnotes

1. Commerce Holding Corp. v. Assessors of Town of Babylon, 88 N.Y.2d 724 (1996).
2. Roth v. City of Syracuse, 21 N.Y.3d 411 (2013). The petitioners-appellants also included several single member limited liability companies that engage in the ownership of real estate. In this article, all are referred to as "Petitioner."
3. *Commerce Holding*, 88 N.Y.2d at 731 (recognizing that traditional valuation methods were hampered by the lack of available market data and endorsing a flexible approach to valuing contaminated property).
4. An in-depth discussion of the methods of valuing property is beyond the scope of this article. *See* Thomas O. Jackson, *Methods and Techniques for Contaminated Property Valuation*, The Appraisal Journal (Oct. 2003) for a discussion on valuing contaminated property.
5. FMC Corp. v. Unmack, 92 N.Y.2d 179, 187 (1998).
6. *Roth*, 21 N.Y.3d at 417.
7. *FMC Corp.*, 92 N.Y.2d at 188.
8. *Id*.

9. *Id.* (citing *Commerce Holding*, 88 N.Y.2d at 732).

10. OCG Limited Partnership v. Board of Assessment Review of Town of Owego, 79 A.D.3d 1224, 1225 (3rd Dep't 2010).

11. *FMC Corp.*, 92 N.Y.2d at 188.

12. *Id.*

13. Allied Corporation v. Town of Camillus, 80 N.Y.2d 351, 353 (1992).

14. *Id.* at 359 (Allied's appraiser stated: "Today there is nothing known to exist in those wastebeds except for the asbestos deposited in specific locations that would indicate that any of the material would be hazardous or toxic, but that doesn't eliminate the possibility that some time in the future that could occur.").

15. *Id.* at 356 (stating "[t]he particularized conditions of such properties make valuation difficult. In most instances, the comparable sales method is inappropriate, as it is in this case. We conclude that on the record the property should have been valued as a specialty.").

16. Criscuola v. Power Authority of State of New York, 81 N.Y.2d 649 (1993).

17. *Id.* The City of Syracuse questioned the applicability of *Criscuola* in a tax certiorari case. In Roth v. City of Syracuse, *Criscuola* was referenced in the following context:

> However, we also made clear that the effect of environmental contamination or hazards should be considered only if the "environmental contamination is shown to depress a property's value" (*id.* [*Commerce Holding*] at 729, 649 N.Y.S.2d 932, 673 N.E.2d 127; *see also* Criscuola v. Power Authority of State of New York, 81 N.Y.2d 649, 602 N.Y.S.2d 588, 621 N.E.2d 1195 [1993]).

Fourteen years before the Court decided *Criscuola*, the Love Canal disaster brought attention to the role environmental contamination could play in health and also the role it could play in property values. Love Canal was a neighborhood in the City of Niagara Falls where homes and schools were built on a site used to bury toxic waste. It was described as "an environmental time bomb gone off" and "what may very well be the first of a new and sinister breed of environmental disasters." Robert P. Whalen, M.D., Commissioner of Health, *Love Canal – Public Health Time Bomb: A Special Report to the Governor and Legislature* (Sept. 1978). The pervasive and severe presence of hazardous waste in the soil caused the Legislature to declare the properties in Love Canal were in a "state of great and imminent peril to the health of the general public." 9 Op. Counsel SBEA No. 58 (N.Y. Bd. Equal. & Ass.), 1989 WL 362672 (citing RPTL § 1700). There was a "planned exodus of 235 families" from Love Canal. Robert P. Whalen, M.D., Commissioner of Health, *Love Canal – Public Health Time Bomb: A Special Report to the Governor and Legislature* (Sept. 1978). Legislation was passed to purchase Love Canal properties "at their market value without any consideration to any deleterious effects of the discovery of the danger to the general health on the market value of those properties." 9 Op. Counsel SBEA No. 58.

18. *Criscuola*, 81 N.Y.2d at 651.

19. *Id.* at 652.

20. *Id.*

21. *Commerce Holding*, 88 N.Y.2d at 724.

22. *Id.* at 729. The Town also argued the property's market value would be unaffected by the presence of contamination because Commerce, by consent order, agreed to pay the cleanup costs even if it sold the property. *Id*. at 730. This argument was "belied by the reality that a purchaser of the site, on notice of the environmental contamination, would nevertheless be liable for the cleanup costs under CERCLA" and would demand "an abatement in the purchase price to account for the contamination notwithstanding the existence of the consent order." *Id.* The Town also argued that providing a reduction in assessment would shift "the cost of environmental cleanup to the innocent taxpaying public in contravention of the public policy of imposing remediation costs on polluting property owners and their successors in title." *Id.* at 727. The Town's "attempt to frame its policy argument in terms of environmental culpability—the guilty polluter versus the innocent tax paying public" failed to take into account that CERCLA is a strict liability statute that imposes liability on property owners without regard to fault. *Id.* at 729 n.3.

23. *Id.* at 728.

24. *Id.* Designation as a Superfund site was pursuant to the Comprehensive Environmental Response, Compensation and Liability Act of 1980. The Court noted that CERCLA is a strict liability statute that imposes liability on property owners without regard to fault. *Id*. at 729 n.3, (citing 42 U.S.C. § 9607[a] [responsible party and owner are liable]).

25. *Commerce Holding*, 88 N.Y.2d at 725, 729. The Town also unsuccessfully argued, alternatively, that if Commerce could "reduce its property value by the cost to cure, then the cost must be projected and discounted to reflect the reality that cleanup would be done in stages." *Id.*

26. *Id.* at 729 (citing N.Y. Const. Art. XVI, § 2 ("The concept of 'full value' is equated with market value, or what 'a seller under no compulsion to sell and a buyer under no compulsion to buy' would agree to as the subject property's price.").

27. *Commerce Holding*, 88 N.Y.2d at 729.

28. *Id.* at 731.

29. *Id.* at 732.

30. *Id.* at 725 (the market factors were the property's designation as a Superfund site, Commerce's strict liability for cleanup costs pursuant to CERCLA, and a consent order being in place).

Commerce's property was valued by the use of the income capitalization approach (the property was income-producing) to determine its value in an uncontaminated state, combined with a downward environmental adjustment in the amount of outstanding cleanup costs. While the Court could not say the methodology was erroneous as a matter of law, it was "cognizant of the potential of this valuation method to overstate the effects of environmental contamination." *Id.*

In *Bass v. Tax Commission of City of New York*, a case cited by both the petitioner and respondent in *Roth*, a contaminant was present, but it was the extent of contamination that was a critical factor in assessing its effects on the property's value. 179 A.D.2d 387 (1st Dep't 1992), *leave to appeal denied*, 80 N.Y.2d 751 (1992). The basis of the petitioner's overvaluation claim was the assessor's failure to consider the impact the presence of asbestos had on the value of a large office building. Transcript of the Record at 33-34, 731-38, 753, 867-72, 1949-50, *Bass*, 179 A.D.2d 387 (at trial, the respondent conceded that asbestos permeated 2,500,000 square feet of space). Although many buildings constructed in the same era contained asbestos, the extent of asbestos in the *Bass* office building was unlike that in other buildings—asbestos permeated the structure, making it essentially "a fifty-layer asbestos cake." *Id.* at 1357, 2126. Its presence in the building was causing such physical and functional impairments that it economically impacted the building. For example, flaking and delaminating asbestos created the risk of exposure through circulation in the air conditioning system, and the asbestos caused dramatically higher maintenance costs. *Id.* at 35-39, 142-43, 151-52, 738, 1126, 1751, 1753, 1950 (the cost to repair a sewer trap typically cost $3,000, but in this asbestos-laden property, it cost $100,000 to repair). In order to achieve market rental rates, the asbestos had to be removed, which the owner voluntarily undertook. *Id.* at 33-34, 731-38, 753, 863, 867-69, 871-73, 879, 1949-50. The appellate court concluded the trial court properly arrived at a value by using an approach that reflected a pragmatic adjustment to the economic realities of the building and considered the foreseeable cost of curing the asbestos contamination. *Bass*, 179 A.D.2d at 388. The trial court also properly considered physical and functional obsolescence, such as the location of the building directly off New York Harbor, which subjected it to corrosive forces resulting in frequent and costly repairs unlike other properties. Transcript of the Record at 138, 142, 145-46, *Bass*, 179 A.D.2d 387.

31. *Roth,* 21 N.Y.3d at 414.

32. Petitioner claimed that 42 of his properties were overvalued. The parties agreed to proceed to trial on five of the properties as a test case that would guide the disposition of the remaining 37 properties by Supplemental Order of the trial court. Following the Appellate Division affirmance [78 A.D.3d 1590 (4th Dept. 2010)] of the trial court's decision, the remaining 37 properties were discontinued with prejudice.

33. *See Roth*, 21 N.Y.3d at 414-15; *see also* Transcript of the Record at 10-12, 187, 430-31, *Roth*, 21 N.Y.3d 411. The universities are LeMoyne College, Syracuse University and the State University of New York College of Environmental Science and Forestry. The properties are also located near a medical college, a nursing college, and two major hospital complexes. They were purchased by Petitioner between 1977 and 1979.

    When the properties were purchased, the sellers did not disclose the existence of lead, and Petitioner did not have any tests performed for the presence of lead before purchasing them. *See Roth*, 21 N.Y.3d at 415; *see also* Transcript of the Record at 12-13, 188, *Roth*, 21 N.Y.3d 411. In May 2008, after grieving the assessments, testing revealed the presence of lead-based contaminants. *See Roth*, 21 N.Y.3d at 415. Prior to the test results, however, Petitioner believed, given the age of the rental properties, that lead paint was present in the houses. Transcript of the Record at 79, 185, *Roth*, 21 N.Y.3d 411.

34. *Roth,* 21 N.Y.3d at 415.

35. *Id.*; *see* 22 N.Y.C.R.R. § 202.59(g). The City's expert was permitted to provide testimony critiquing the report of Petitioner's expert.

36. *Id.* at 416. Petitioner had not taken any steps to have the lead paint removed and restore the properties. He also was not required by Federal (15 U.S.C. §§ 2681-92) or State law (Public Health Law §§ 1370-76-a) to remove the lead and the lead-based paint from the properties. Brief of the Respondents'-Respondents', at 39-40, *Roth*, 21 N.Y.2d 411.

37. Petitioner's appraiser wholly adopted the income and expenses as reported by Petitioner without any independent analysis of the reasonableness, explaining that this adoption was based on the belief that due to Petitioner's large property holdings, he essentially set the market in the area. Transcript of the Record at 258-59, 334-35, 337, 339, 349-51, 377-78, 386-87, 392-94, *Roth*, 21 N.Y.3d 411. There was no separate analysis by an accountant testifying to the legitimate nature of the expenses. *Id*. at 15a, 18a-19a. The trial court concluded Petitioner's appraiser failed to consider and analyze all of the approaches to valuation. *Id.* at 20a. He only used the direct income capitalization approach. *Id.* at 270-71, 275, 280-81, 378.

38. *Roth,* 21 N.Y.3d at 415. The cost to cure figures included adoption of the actual cost to conduct the testing, the proposed cost of removing the lead-based paint and restoring the properties to their original conditions prior to the deconstruction proposed to remove the lead paint. The cost of removing the lead was based on intensive labor and maintaining the architectural components of these decorative properties.

39. *Id.* at 415 n.2 (noting that the expert's "calculations actually resulted in negative market values for each of the five properties because the 'cost to cure' exceeded the market value of the properties in a non-contaminated state. Relying on the concept of residual value, [Petitioner's expert] consequently assigned each property a market value of one dollar under the theory that a theoretical buyer would purchase property for one dollar.").

40. *Id.* at 416.

41. He was not required by Federal (15 U.S.C. §§ 2681-92) or State law (Public Health Law §§ 1370-76-a) to remove the lead and the lead-based paint from the properties. Brief of Respondents'-Respondents', at 39-40, *Roth*, 21 N.Y.2d 411.

42. *Roth*, 21 N.Y.3d at 416.

43. Roth v. City of Syracuse, 78 A.D.3d 1590 (4th Dept. 2010) (affirming for the reasons stated in the trial court's decision).

44. Brief of the Petitioners-Appellants at 43-44, *Roth*, 21 N.Y.3d 411.

45. *Id.* at 44. These arguments failed to take into account that the Court's decision in *Commerce Holding* was "[b]ased on the record." *Commerce Holding*, 88 N.Y.2d at 731 (where the property was a Superfund site and Commerce had entered into a consent order with the Environmental Protection Agency). The Town's "contention is belied by the reality that a purchaser of the site, on notice of the environmental contamination, nevertheless would be liable for the cleanup costs under CERCLA." *Id*. at 730. "As Commerce's expert opined, a buyer of the property would have demanded an abatement of the purchase price to account for the contamination notwithstanding the existence of the consent order." *Id*. No such facts were present in *Roth*.

46. Brief of the Petitioners-Appellants at 19, 40-42, 44, *Roth*, 21 N.Y.2d 411.

47. Although despite the fact that Petitioner's appraiser admitted that Petitioner had purchased additional properties in the same area recently and paid more than one dollar. Transcript of the Record at 342, 401, *Roth*, 21 N.Y.2d 411.

48. *Roth,* 21 N.Y.3d at 418 n.2 (citations omitted). Although Petitioner's expert opined that stigma attached to the properties, his report did not account for stigma in the opined value because the cost to cure had already resulted in negative values for each of the five properties.

49. *Id.* at 418.

50. *Id.*

51. *Id.*

52. *Id.*

Shannon M. Jones is an attorney with the City of Syracuse and was one of the attorneys representing the City in *Roth v. City of Syracuse* in the appeals.

Karen M. Richards is an attorney with the State University of New York.

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Is Your Loan a Building Loan? The Answer Might Not Be as Clear as You Think…

By Thomas A. Glatthaar

It is hornbook law in New York that a mortgage loan that is a "building loan" obligates the lender to comply with New York Lien Law Section 22. A "building loan contract" must be filed on or before the date of recording the building loan mortgage made pursuant thereto, in the office of the clerk of the county in which any part of the land is situated;[1] which building loan contract must include a true statement under oath, verified by the borrower, showing the consideration paid, or to be paid, for the loan described therein, and showing all other expenses, if any, incurred, or to be incurred in connection therewith, and the net sum available to the borrower for the improvement.[2] A failure to timely file a building loan contract as required will result in the subordination of the building loan mortgage recorded in connection therewith to any mechanic's liens subsequently filed as a result of work done, materials furnished or services rendered in connection with the project.[3] That same total subordination penalty applies to a timely filed building loan contract where the so-called "Section 22 affidavit" contains a material misstatement of the net sum available for the improvement regardless of whether or not the lender knew or should have known that the affidavit was not correct.[4] Since the statutory penalty for failure to comply with the filing and disclosure requirement is so harsh, it is a given that extraordinary care must be taken to comply with the law. But all of the foregoing begs a single (and, I would submit, not so simple) question: *when is a mortgage loan a "building loan"*? The purpose of this article is to try and answer that question. The question is posed, however, in the context of the decision in *Lehman Brothers Holdings, Inc. v. Genwood Strathallan LLC*,[5] in which the Supreme Court, Monroe County, considered the effect of the New York Lien Law on a common loan structure in which proceeds of a loan are set aside to be available to pay for the costs of a contemplated repair, renovation or reconstruction.

The phrase "building loan" is not defined in the New York Lien Law. However, you can extrapolate from certain definitions in Lien Law Section 2[6] to conclude that a building loan is a loan in which a lender, in consideration of the express promise of an "owner" to make an "improvement" upon "real property," agrees to make "advances" to or for the account of such owner to be secured by a (building loan) mortgage on the real property, whether the advances represent moneys to be loaned or represent moneys to be paid in purchasing from or in selling for the owner bonds or certificates secured by the mortgage placed upon the real property. It would seem, then, that any building loan would have, by its nature, three parts.

First, there must be a mutual agreement whereby one party agrees to erect improvements and the other agrees to make loans for that purpose.[7] The intent of the owner to use the loan proceeds to construct an improvement on real property does not make a loan a building loan;[8] there must be an exchange of an expressed promise to make an improvement on the real property for the agreement to make a loan.

Second, the promise at issue must be a promise of the owner to make an "improvement" on real property. "Improvement" is defined in Lien Law Section 2(4), and includes, without limitation, (i) any work done or materials furnished for the permanent improvement of real property, including the demolition, erection, alteration or repair of any structure on, connected with, or under the real property, (ii) any work done or materials furnished in connection with the installation of lighting or gas fixtures, (iii) the reasonable rental value for the period of actual use of machinery, tools and equipment and the value of compressed gases furnished for welding or cutting in connection with the demolition, erection, alteration or repair of any real property, and the value of fuel and lubricants consumed by machinery operating on the improvement, or by motor vehicles owned, operated or controlled by the owner, or a contractor or subcontractor while engaged exclusively in the transportation of materials to or from the improvement for the purposes thereof, (iv) the value of materials actually manufactured for but not delivered to the real property, and (v) drawings of an architect, surveyor, or engineer of any plans, specifications, or surveys prepared for or used in connection with the improvement, as well as certain brokers' fees.[9] The definition includes within its scope work done to construct a building, install light fixtures (but not the bulbs in them),[10] repair the glass in windows (but not to install the window shades),[11] painting, patching or decorating,[12] and common site work[13] (but not mowing, trimming, pruning, and weeding the lawn).[14] Of course, included within this broad statutory definition are most expenses associated with building out space for rent, or tenant improvements.

Third, there must be an agreement by the lender to make advances to or for the account of such owner to be secured by a (building loan) mortgage on real property. Advances could be in the form of realty or personalty[15] instead of money. The use of the plural has been said to be of some import; that is, that in order for a loan to be a building loan, funds must be advanced in installments over time.[16] I would submit to you that a lender could disburse the full loan proceeds in multiple disbursements on the day of closing (say, to pay off existing mortgages and expenses in connection with the loan, with the balance to the borrower) and that those disbursements constitute "advances" under Lien Law Section 2(18). In fact, it has been held that where all proceeds of a loan were funded to borrower on the date of closing, which borrower was in turn obligated to fund escrow accounts to pay for needed repairs and other work, the loan proceeds were not, as a matter of law, advanced to borrower in one lump sum.[17]

"A classic building loan mortgage is characterized, *inter alia*, by (1) a requirement in the loan agreement that the mortgagor construct a building or improvements with the loan, and (2) a disbursement of the loan in installments—as construction progresses—rather than in one lump sum."[18] The advances made under such a mortgage are for the primary purpose of erecting a building and not merely to pay existing mortgages and bonuses to the lender for making the loan.[19]

It would seem that loans set up in this "classic" way were the norm for many years, but they are clearly not the only way to stumble into the "building loan" morass. In fact, any loan where a portion of the loan is advanced in consideration of the express promise of an owner to make an improvement upon real property is subject to the same limitations and constraints that a "classic" building loan is. In the 1980s it was not uncommon to see so-called "bifurcated" mortgages: a single mortgage securing both the building loan and other (e.g., purchase money) part, with a building loan agreement filed only relating to the building loan portion of the overall loan. Loans structured in this manner fell into disfavor amid concerns that a flaw in the building loan component (e.g., a materially flawed Lien Law affidavit or a failure to file in accordance with Lien Law Section 22) could cause subordination of the entire interest of the lender to any lien filed for work done or materials furnished in connection with the making of the improvement contemplated by the building loan agreement (including the non-construction loan component).[20] This would be the case regardless of the relative size of the building loan component to the entire loan as long as this component otherwise met the definition of a "building loan."

More recently, a twist on this loan structure has become commonplace. In this loan structure, a portion of the loan proceeds is disbursed directly or indirectly into one or more blocked accounts. The funds in these accounts are the borrowers' funds; in fact, interest is paid on these funds by borrower in accordance with the terms of the note, and interest accrues for the borrower on these funds. The escrowed funds are available for one or more uses: sometimes they are used for repair and renovation of the property that are required to be made by the lender; other times they are used for future, currently unidentified tenant improvements; still other times the escrowed funds are used for anticipated capital expenditures, such as lobby renovation or elevator upgrade or replacement, that the borrower and lender expect will be required to be made to keep the building attractive to current and prospective tenants in an increasingly competitive real estate market. It was a loan structure of this nature that was the subject of a priority dispute in the *Genwood Strathallan* case,[21] and the results were, from a lender's perspective at least, problematic.

The court in *Genwood Strathallan* addressed the question of whether a mortgage loan, advanced in whole or in part into an escrow account to fund certain required repair work, is a building loan mortgage, and answered in the affirmative. The transaction involved the refinance of an existing mortgage on property in Rochester, N.Y.[22] At the time of closing (January 30, 2007), the lender made a first mortgage loan in the amount of $12.75 million (evidenced by a consolidated, amended and restated note of even date) and a second in the amount of $1.75 million. The bulk of the loan proceeds were used to take an existing mortgage by assignment. In addition, at least some portions of the first mortgage loan were advanced by lender at closing into two interest-bearing escrow accounts, which were to be disbursed pursuant to a First Repair Escrow Agreement ("First Repair Escrow Agreement") that was entered into at closing. The First Repair Escrow Agreement requires the borrower to perform certain repairs and deferred maintenance at the property, and provides that "…the escrows shall be used for the…work." It also affirmatively states that the escrow deposits secure the borrower's obligation to complete the work.[23] The consolidated mortgage documents with respect to this loan were recorded promptly after closing.

Further, the parties also entered into a Second Repair Escrow Agreement ("Second Repair Escrow Agreement") at the closing, and opened another interest-bearing escrow account for the same.[24] This Second Repair Escrow Agreement covered different required work than the first agreement but otherwise contained the same material terms. This Escrow Agreement was funded by an advance made by the lender several months after closing, which advance was secured by a second mortgage on the property. Funding for this loan took place subsequent to closing, and the second mortgage was recorded in August 2007.[25]

Defendant M&T Remodeling Services, Inc. ("M&T") performed work at the property.[26] M&T was not paid and filed a lien in the amount of $299,500.00 in April 2009. When the borrower defaulted on the mortgage loans, lender commenced a mortgage foreclosure action, naming and serving numerous defendants, including M&T. M&T answered the complaint and asserting its lien and requesting a determination of priority. The lienholder argued that, even though the notes, loan agreement and the first and second mortgages contained no promise on the part of the borrower to make improvements on the property, the loan agreement when read in tandem with the First Repair Escrow

Agreement and the Second Repair Escrow Agreement is a building loan contract as defined in New York Lien Law Section 2(13). The court agreed with M&T on this point and, in doing so, the court underscored the following points:

1. The work set forth in the First and Second Repair Escrow Agreements was "required" by the Lender, and the existence of the escrow accounts was to secure the borrower's "obligation" to perform under the First and Second Repair Escrow Agreements.[27]
2. There was a timeline for the completion of the work. This, in the court's view, seems to re-enforce the point that the work was not discretionary, though it is difficult to ascertain how important an element this is.[28]

Further, the court dismissed the argument that the loans are not building loans because the funds were advanced in a lump sum rather than installments.[29] The money, the court pointed out, was not made available to the borrower in one lump sum; the borrower was required to fund the escrows, and those escrowed funds could not be used for the purposes *other than* as specified in the First and Second Repair Escrow Agreements. The court quoted a commentator who criticized the escrow mechanism as an effort to avoid Lien Law requirements that may not work with approval, and pointed out that such an arrangement still required periodic disbursements from the escrow account. In view of the foregoing, the court imposed the "harsh…statutorily imposed penalty" in Lien Law Section 22, subordinating the entire first and second mortgages to the filed liens.[30]

To many practitioners, the *Genwood Strathallan* holding did not come as a surprise. The First and Second Repair Escrow Agreements provided documentary evidence to the court showing that the borrower had agreed (promised) to make an improvement (repair) on real property as a condition precedent to making the loan. Having read those Agreements and having concluded that the two Agreements contained express promises to make improvements on the real property, the court's holding was almost a given.[31] However, many of the loans that we see and that are structured generally along these lines are not so clear-cut. For example, many of the mortgage loans that I see are, as in *Genwood*, fully funded to the borrower at closing. Borrower is obligated to fund one or more blocked accounts on the date of closing. These accounts are in borrower's name, but funds can be drawn from the account only by the lender or with the lender's consent, and there is a written agreement that allows borrower to request funds to be drawn for its benefit only to pay for tenant improvements (or capital expenditures) that *may be made in the future* (and for which invoices, lien waivers, etc. are to be provided by the borrower at that time) or to reimburse the borrower for expenses already incurred by borrower at the time of the draw for the tenant improvements (or capital expenditures). The borrower is not contractually obligated to make improvements in most of these instances (and almost certainly is not so obligated at the time of the loan closing); however, making improvements is oftentimes a condition precedent to the disbursement of these funds from the blocked accounts. So while the making of the loan is not conditioned on an express promise to make improvements on real property, the borrower's obtaining of all of the proceeds of the loan *is* conditioned on such a promise. There is, I believe, real concern in the lending community that mortgage loans structured in this manner may also be subject to the same argument and line of attack as the one that undercut the priority of the mortgage loan in *Genwood*.

As with any open questions related to building loan issues, where the penalties for violating the statute are unduly harsh and bear no connection to the damages sustained or proven, the prudent practitioner should err on the side of caution. Any loan structured along the lines set forth above should be viewed as (at least) potentially vulnerable to the argument that it is a building loan, and counsel should proceed accordingly. There are, in fact, a number of ways to restructure a loan to circumvent these arguments, or to minimize the risk of the loss of priority or minimize the application of the so-called "subordination penalty" in New York Lien Law Section 22. Use of these devices, however, is conditioned on the recognition, first and foremost, that a priority issue exists. Accordingly the question of whether a loan is a building loan is one that should be asked any time loan proceeds are to be used to fund accounts that will be used by the borrower to fund "improvement" on the property.

Endnotes

1. N.Y. Lien Law § 22 (McKinney 2010).
2. *Id.*
3. *P.T. McDermott Inc. v. Lawyers Mortg. Co.*, 232 N.Y. 336 (1922); *but see Altshuler Shaham Provident Funds, Ltd. v. GML Tower LLC*, 28 Misc. 3d 475, 900 N.Y.S.2d 846 (Sup. Ct. Onondaga Cnty. 2010), *aff'd*, 83 A.D.3d 1563, 921 N.Y.S.2d 601 (4th Dep't 2011), *appeal denied*, 86 A.D.3d 934, 926 N.Y.S.2d 838 (4th Dep't 2011), *appeal denied*, 18 N.Y.3d 892, 963 N.E.2d 778 (2012), *mod.*, 21 N.Y.3d 352 (2013), where the New York Court of Appeals held that the failure to file a building loan agreement did not result in a subordination of the whole building loan mortgage, but only with respect to the portion of the loan lent for improvements and that, accordingly, the proceeds of the loan which were lent for the purchase of the property are not subject to the subordination penalty.
4. *Nanuet Nat'l Bank v. Eckerson Terrace Inc.*, 47 N.Y.2d 243 (1979); *FSLIC v. 52 Park Assoc.*, 710 F. Supp. 490 (S.D.N.Y. 1989).
5. *Lehman Bros. Holding Inc. v. Genwood Strathallan, LLC*, 2011 N.Y. Misc. LEXIS 6154 (Sup. Ct. Monroe Cnty. Oct. 11, 2011).
6. *See* definition "Building loan contract," N.Y. Lien Law § 2(13) (McKinney 2013); *see* definition "Building loan mortgage," N.Y. Lien Law § 2(14) (McKinney 2013).
7. *Weaver Hardware Co. v. Solomovitz*, 235 N.Y. 321 (1923); *Juszak v. Lily & Don Holding Corp.*, 224 A.D.2d 588 (2d Dep't 1996).
8. *Herbert Constr. Co. v. The Greater N.Y. Sav. Bank*, 225 F.3d 645 (2d Cir. 2000); *Finest Inv. v. Sec. Trust Co. of Rochester*, 96 A.D.2d 227 (4th Dep't 1983).
9. N.Y. Lien Law § 2(4) (McKinney 2010).

10. *Waring v. Burke Steel Co., Inc.*, 69 N.Y.S.2d 399 (Sup. Ct. Monroe Cnty. 1947).
11. *Spitz v. M. Brooks & Son*, 210 A.D. 438, 440 (1st Dep't 1924).
12. *Sica & Sons, Inc. v. Ciccolo*, 39 Misc. 2d 698 (Westchester Cnty. Ct. 1963); *see also New York Artcrafts, Inc. v. Marvin*, 29 Misc. 2d 774, 775 (Dist. Ct. Nassau Cnty. 1961).
13. *W. L. Dev. Corp. v. Trifort Realty, Inc.*, 44 N.Y.2d 489, 496 (1978); *In re Elm Ridge Assoc.*, 234 F.3d 114, 122-23 (2d Cir. 2000).
14. *Application of Magowan*, 203 N.Y.S.2d 35, 37-38 (Sup. Ct. Suffolk Cnty. 1960).
15. *Weaver Hardware Co. v. Solomovitz*, 235 N.Y. 321, 335-36 (1923).
16. *Id.* at 333-34.
17. *Lehman Brothers Holdings, Inc. v. Genwood Strathallan LLC*, 2011 N.Y. Misc. LEXIS 6154 (Sup. Ct. Monroe Cnty. Oct. 29, 2011).
18. *Juszak v. Lily & Don Holding Corp.*, 224 A.D.2d 588 (2d Dep't 1996).
19. *York Mortg. Corp. v. Clotar Constr. Corp.*, 254 N.Y. 128, 136-37 (1930). Notwithstanding the foregoing, one could have a building loan where no portion of the proceeds would be available to pay for the improvement. *See F.L. Mitchell Corp. v. Sheets*, 172 A.D.2d 1050 (4th Dep't 1991).
20. *Amsterdam Sav. Bank v. Terra Domus Corp.*, 97 A.D.2d 41, 43-44 (3d Dep't 1983); *but see Altshuler Shaham Provident Funds, Ltd. v. GML Tower LLC*, 28 Misc. 3d 475, 480 (Sup. Ct. Onondaga Cnty. 2010), *aff'd*, 83 A.D.3d 1563 (4th Dep't 2011), *aff'd as modified*, 21 N.Y.3d 352, (2013) (to limit the imposition of the so-called "subordination penalty" at least with respect to the priority of loan proceeds taken by assignment which proceeds were used for purchase money purposes).
21. *Lehman Bros. Holdings, Inc. v. Genwood Strathallan LLC*, 2011 N.Y. Misc. LEXIS 6154 (Sup. Ct. Monroe Cnty. Oct. 29, 2011).
22. *Id.*
23. *Id.*
24. *Id.*
25. *Id.*
26. *Lehman Bros. Holdings, Inc. v. Genwood Strathallan LLC*, 2011 N.Y. Misc. LEXIS 6154 (Sup. Ct. Monroe Cnty. Oct. 29, 2011).
27. It is unclear whether the failure to complete the "required" work, or to do so within the time frames set forth in the First and Second Repair Escrow Agreements, would constitute a default under the mortgage, or simply preclude the borrower from gaining access to the escrowed funds.
28. *See Lehman Bros. Holdings*, at 13.
29. *Id.*
30. *Id.* at 8 (citing *Atl. Bank of N.Y. v. Forrest House Holding Co.*, 234 A.D. 2d 491 (2d Dep't 1996)). It is interesting, to me at least, to note that, had the existing mortgage not been consolidated with the new first in this case, it is likely that the existing mortgage would not have been subordinated to the mechanic's lien so long as the First and Second Repair Escrow Agreements made no reference to this existing mortgage and the funds needed to acquire it.
31. Though, in light of the recent holding in *Altshuler*, the scope of the subordination penalty may be subject to question.

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Façade Easement Donations: Where Matters Stand Now

By Joel E. Miller[1]

1. Introduction

For better or worse, it is an indisputable fact that the Internal Revenue Code ("the Code") allows deductions for charitable contributions, which need not be in the form of money, but may be in the form of property.[2]

However, not all items of property can qualify. A major limitation on deductibility is that, as a general rule, no deduction is allowed if what the taxpayer donates is "an interest in property which consists of less than the taxpayer's entire interest in such property."[3]

There are, however, important exceptions to the less-than-all-is-not-good-enough rule, and one of those is the subject of this article—the "donation" of what is commonly referred to as a "façade easement."

As will be seen, the use of the word "donation" is a bit of a stretch. When a taxpayer "donates a façade easement," he is not parting with an item of property that he could sell. What he is actually doing is making an enforceable promise not to do certain things to property that he continues to own. That will be further explained at 4.1, below.

As a preliminary matter, it may be noted that, dispelling some early optimism about the IRS's supposedly very liberal attitude toward such "donations" (especially as to the amount of the resultant deductions where they were allowed), the IRS has made it quite clear that it will thoroughly scrutinize any such claimed deduction,[4] and the courts have in general not been reticent in limiting or entirely rejecting extravagant taxpayer claims in this area.

This article will discuss (a) what kind of property a taxpayer must own in order to "donate a façade easement," (b) where such a "donation" fits in the structure of the Code, (c) how such a "donation" is made, (d) the requirements for qualification, (e) how the amount of an allowable deduction is determined, and (f) the effect on the taxpayer's income-tax basis.

2. What the Taxpayer Must Own

A taxpayer can "donate a façade easement" only if he owns what the Code refers to as a "certified historic structure,"[5] which, insofar as here relevant, is in turn defined as "any building which is located in a registered historic district…and is certified by the Secretary of the Interior to [the IRS] as being of historic significance to the district."[6] Satisfying these requirements is generally not problematic, and this article does not discuss them.

3. Where "Façade Easement Donations" Fit in the Code

The Code does not provide directly that "a façade easement donation" is an exception to the less-than-all-is-not-good-enough rule. Rather, the Code says that a deduction is allowable for "qualified conservation contributions"—which can include "donations" of "façade easements"—and provides that "the term 'qualified conservation contribution' means a contribution (A) of a qualified real property interest, (B) to a qualified organization, (C) exclusively for conservation purposes."[7] How those requirements, and certain others, are to be satisfied in the case of the "donation" of a "façade easement" is discussed below. (In the interest of ease of reading, in the balance of this article the terms "donation" and "façade easement" will not be enclosed in quotation marks.)

4. The Six Requirements

There are what may be viewed as six requirements that a façade easement donation must satisfy in order to qualify for a deduction—one having to do with what the donation must consist of ("the nature-of-the-interest requirement"), one having to do with to whom the donation must be made ("the eligible donee requirement"), one having to do with the purpose of the donation ("the purpose requirement"), one having to do with how long the donated interest must be expected to last ("the perpetuity requirement"), one having to do with the need for a "qualified appraisal" ("the qualified appraisal requirement"), and one having to do with other prescribed submissions ("the other required submission requirements"). These six requirements are discussed separately below. As will be seen, two of the others partially overlap the perpetuity requirement.

4.1 The Nature-of-the-Interest Requirement

In the words of the Code, the donation must be of an "interest in real property" which interest is "a restriction (granted in perpetuity) on the use that may be made of the real property."[8]

Using slightly different terminology, the regulations refer to a "perpetual conservation restriction," which is defined as "a restriction granted in perpetuity on the use which may be made of real property—including, an easement or other interest in real property that under state law has attributes similar to an easement (e.g., a restrictive covenant or equitable servitude)."[9]

It is thus clear enough that (contrary to what one might have expected) the mere "granting" of a use restriction can for this purpose constitute the conveyance of an "interest" in real property, provided of course that the restriction is perpetual. In other words, for this purpose an owner who has promised another person that he (the promisor) will not do certain things with his own property is treated as having divided the property into two pieces and conveyed one of those two pieces to the other person. In this article, the promisor is referred to as "the donor," the promisee is referred to as "the donee," the property that the donor started with is referred to as "the original property," the piece of the original property that the promisor conveyed to the donee is referred to as an "easement," and the piece of the original property that the donor retained is referred to as "the encumbered property."[10]

Inasmuch as "perpetuity" is part of another requirement, it is unclear why it is included in the provisions dealing with the nature of the interest that must be donated. In any event, the "perpetuity" requirement is discussed at some length at 4.4, below.

4.2 The Eligible Donee Requirement

The Code provides that the donation must be to "a qualified organization,"[11] and defines that term.[12] Without minimizing the importance of the subject, this article does not focus on that definition.

It should be noted, though, that the Code requires that "the donor and donee enter into a written agreement certifying, under penalty of perjury, that the donee (I) is a qualified organization…with a purpose of…historic preservation, and (II) has the resources to manage and enforce the restriction and a commitment to do so."[13]

For the most part, this language is clear enough (although one may question the appropriateness of requiring a donor to swear to things about the donee).

4.3 The Purpose Requirement

The Code provides that the donation must be "exclusively for conservation purposes"[14] and goes on to provide a list of such purposes, one of which is "the preservation of…a certified historic structure."[15]

The Code then provides what it refers to as "special rules with respect to buildings in registered historic districts."[16] Because of the critical importance of the first of such rules, it is here quoted virtually in full:

> In the case of any contribution of a qualified real property interest which is a restriction with respect to the exterior of a building…, such contribution shall not be considered to be exclusively for conservation purposes unless—
>
> (i) such interest—
>
> (I) includes a restriction which preserves the entire exterior of the building (including the front, sides, rear, and height of the building), and
>
> (II) prohibits any change in the exterior of the building which is inconsistent with the historical character of such exterior….

Applying this requirement does not appear to have been troublesome.

4.4 The Perpetuity Requirement

It is safe to say that, of the six requirements, this is the one that has proven to be the most problematic.

That is not because of any doubt about its existence. Congress was emphatic when it imposed the requirement. The Code states in the clearest terms that "[a] contribution shall not be treated as exclusively for conservation purposes [i.e., as satisfying the purpose requirement] unless the conservation purpose is protected in perpetuity."[17] It is easy enough to say that, but, in the real world, how can such protection be guaranteed? There are several ways that the "conservation purpose" might be defeated, and, as discussed below, it is unclear, as to some of them at least, exactly what is required for this requirement to be satisfied.

The regulations do attempt to provide guidance as to the perpetuity requirement, although, as indicated below, in some respects with limited success.[18] Some of the potentially purpose-destroying possibilities are discussed in the following paragraphs.

4.4.1 Ultra-Remote Possibilities

In one respect, the regulations take a taxpayer-favorable position. They provide that the possibility of a destruction of the donee's interest as the result of some act or event need not be taken into account "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."[19] A number of taxpayers whose claimed deductions were challenged by the IRS as not satisfying the perpetuity requirement urged a broad construction of this provision, but, although the taxpayer has on occasion been successful,[20] the provision has generally been narrowly construed by the courts.[21]

Obviously, not all possible acts or events that can destroy the donee's interest fit into the category of being so unlikely that they can be ignored, and the regulations deal specifically with three different kinds of acts or events that the drafters evidently regarded as being not too improbable. The following paragraphs discuss those three and then mention some that the regulations do not specifically address.

4.4.2 The Innocent Purchaser Possibility

The first of the three addressed deemed-to-be-not-that-remote possibilities is that the donor might sell his interest to an unsuspecting purchaser without mentioning the easement. Under the law of most, if not all, states, such a purchaser would take free of the easement (which, it must be remembered, is really only a use restriction) unless he had actual or constructive notice of the existence thereof. Such states typically, if not universally, allow the easement's owner to protect itself by having the easement made a matter of public record. Accordingly, the regulations provide that "[i]n the case of any donation under this section, any interest in the property retained by the donor (and the donor's successors in interest) must be subject to legally enforceable restrictions (for example, by recordation in the land records of the jurisdiction in which the property is located) that will prevent uses of the retained interest inconsistent with the conservation purposes of the donation."[22]

4.4.3 The Foreclosure Possibility

The second of the three addressed deemed-to-be-not-that-remote possibilities is that the holder of a mortgage that encumbered the donor's original parcel prior to the donation might become entitled to foreclose on it. In such an event, the purchaser at a foreclosure sale would, if nothing prevented it, take the original parcel free of the easement. To preclude such a possibility, subparagraph (2) of Regs. §1.170A-14(g) provides that, for post-1986 gifts, "no deduction will be permitted under this section for an interest in property which is subject to a mortgage unless the mortgagee subordinates its rights in the property to the right of the qualified organization to enforce the conservation purposes of the gift in perpetuity." The provision has, quite logically, been held to require that the subordination must be in place at the time that the easement is created.[23]

Presumably, a pre-existing mechanic's lien would be treated as a "mortgage" for subparagraph (2) purposes. However, no case has been found in which the question has been discussed, probably because the life span of a mechanic's lien, unlike that of a true mortgage, is normally of short duration.

A potentially very important (but as yet unresolved) question that has arisen under subparagraph (2) is whether its mortgage-subordination requirement is satisfied where the mortgagee signs a document stating that it is subordinating its mortgage but reserves priority as to proceeds in any case in which the property is destroyed or condemned. The question came up in an interesting way in a case recently decided by the First Circuit.[24] Because the Tax Court had held that the deduction failed for a different reason—i.e., under the "extinguishment" provision (which is discussed at 4.4.4, below)—the Tax Court had not ruled on the mortgage-subordination question.[25] In the course of arguing for a reversal, the taxpayers argued before the appellate court that the mortgage-subordination requirement of subparagraph (2) actually required a decision in their favor. As stated by the First Circuit, "The Kaufmans argue that because paragraph (g)(2) deals expressly with subordination and only requires that 'the mortgagee subordinate[ ] its rights in the property to the right of the qualified organization to enforce the conservation purposes of the gift,' it is per se improper for the IRS to argue that some other right of the bank—here, to insurance and condemnation proceeds—should have been subordinated."[26] The First Circuit made it clear that it found that argument unconvincing, but, because of its ruling in favor of the Kaufmans on the "extinguishment" point, evidently saw no need to rule on their mortgage-subordination contention.

However, as the First Circuit pointed out, "the Kaufmans' argument could be turned against them by reading 'conservation purposes' broadly to include the donee organization's right to post-extinguishment proceeds (which, by regulation, must be used to advance 'conservation purposes.')."[27] That would be an argument that the IRS could make, but the First Circuit was not called upon to rule on the point, the reason being that the IRS had (presumably in order to force a ruling on the "extinguishment" point) "disclaimed this broad reading of paragraph (g)(2)."[28]

However, there would appear to be nothing that would prevent the IRS from urging disqualification under subparagraph (2) in other cases and possibly even in the *Kaufman* case itself on the remand if the case is not settled.

4.4.4 The Uncompensated Judicial Extinguishment Possibility

The third of the three addressed deemed-to-be-not-that-remote possibilities is much less easy to understand. Subparagraph (6) of Regs. §1.170A-14(g), which is labeled simply "Extinguishment,"[29] deals with what appears to be a narrow situation, but, regrettably, the provision is written so poorly that it is difficult to be sure of what it is trying to say.[30]

4.4.4.1 The Text of Sub 6

For the reader's convenience, the entire "extinguishment" provision—which is sometimes referred to in this article as "Sub 6"—is here set forth essentially in full.

Preliminarily, though, it will be noted that the provision consists of two portions (referred to below as "the In-General Portion" and "the Proceeds Portion," respectively) that interplay with one another in a most confusing manner.

> (6) *Extinguishment.* (i) *In general.* If a subsequent unexpected change in the conditions surrounding the property that is the subject of a donation…can make impossible or impractical the continued use of the property for conservation purposes, the conservation purpose can nonetheless be treated as protected in perpetuity if the restrictions are extinguished by judicial proceeding and all of the donee's proceeds (determined under [the Proceeds Portion]) from a subsequent sale or exchange of the property are used by the donee organization in a manner consistent with the conservation purposes of the original contribution.
>
> (ii) *Proceeds.* [F]or a deduction to be allowed…, 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 [Proceeds Portion], that proportionate value of the donee's property rights shall remain constant. Accordingly, when a change in conditions gives rise to the extinguishment of a perpetual conservation restriction under [the In-General Portion], 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.

4.4.4.2 The Scope of Sub 6

A basic question immediately presents itself, namely, what is the intended scope of the "extinguishment" provision. There are various ways that a façade easement might come to an end. Among other things, the building might be destroyed, the property might be taken by eminent domain, or the easement might be nullified by judicial action (with or without compensation to its owner),[31] and it is not entirely clear which kinds of "extinguishment" were meant to be covered by this provision.

If one focuses on the actual terms of Sub 6, one is likely to conclude that—despite the broadness of its title—it covers, not all species of extinguishment, but only certain situations in which, among other things, the easement is nullified by judicial action. The starting point of this analysis is noting that the Proceeds Portion talks only about an extinguishment *"under [the In-General Portion],"* and the In-General Portion, in turn, talks with particularity only about a situation in which two post-donation events occur, namely (1) an "extinguishment" of the easement "by judicial proceeding," *followed at a later date* by (2) a "sale or exchange of the [now entire] property" for an amount of "proceeds."[32] Then, going back to the Proceeds Portion, it would appear to be required that the donee must at that later date receive a certain portion of those proceeds, the requirement making no sense at all if the donee had already (i.e., at the time of the judicial extinguishment) received all that was coming to it.

On the other hand, it must be admitted that, if the "extinguishment" provision is read in the limited way described above, it would follow that some not improbable other purpose-defeating possibilities are treated nowhere in the regulations. However that may be, this article proceeds upon the assumption that Sub 6 refers only to situations in which there is an uncompensated judicial extinguishment followed by a proceeds-producing disposition and that the provision deals not at all with other "subsequent changes" that "make impossible or impractical the continued use of the property for conservation purposes."[33]

4.4.4.3 Some Puzzling Aspects of Sub 6

Even so, there are several puzzling features of the "extinguishment" provision.

For one thing, one may question whether there is any point in including the introductory language contained in Sub 6's first sentence. Is it not always the case that "a subsequent unexpected change in the conditions surrounding the property that is the subject of a donation under this paragraph can make impossible or impractical the continued use of the property for conservation purposes"?

More generally, one must wonder about the intended function of the "extinguishment" provision as a whole.[34] Based upon examination of the provisions that parallel it (i.e., the recordation and mortgage-subordination provisions discussed at 4.4.2 and 4.4.3, above), one would expect the "extinguishment" provision to prescribe things that must be done at the time of the donation. But, with one possible, and seemingly pointless, exception (which is discussed immediately below), it does not do that—at least not in terms. Rather, as noted above, it speaks only of two time-separated possible future events and then goes on to say that, if the easement is extinguished (by un-compensated judicial action) and the (now entire) property is turned into money and/or other property, "the conservation purpose can nevertheless be treated as protected in perpetuity" if "all of the donee's proceeds…are used by the donee organization in a manner consistent with the conservation purposes of the original contribution." But, how is one to know at the time of the original contribution whether the "donee's proceeds" (whatever that means, which is a question that is discussed at 4.4.4.4, below) will or will not be so used? Perhaps the provision is an inartfully expressed requirement as to what the donee must agree to in enforceable form as to what it must do if those two events were to occur.

One sentence (in the Proceeds Portion) does talk specifically about an agreement. It says that "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." It is easy enough to copy the regulations' language into some document signed by the donor, but what does it really mean? If what is donated is not a "property right," saying that it is does not make it so. Also, there would seem to be no effect of the donor's "agreeing" to something about the donation's "fair market value"; that value is whatever it is, no matter what the donor says.

4.4.4.4 The "Donee's Entitled Amount"

The reader will recall that when a donor's property is subjected to a restriction in favor of another person, it is considered for this purpose that the original parcel has been divided into two distinct pieces of property (referred to herein as the "easement" and "the encumbered parcel") each having its own value, the sum of those two values for this purpose being presumed—artificially, of course—to be equal to the value of the original parcel. Thus, immediately after the grant the donee may be considered to own a fraction of that value, which fraction is referred to below as "the Donee's Percentage."

Obviously, values can vary considerably over time, so that the donee's deemed ownership percentage need not always be the same. However, the Proceeds Portion says that, for this purpose, "that proportionate value of the donee's property rights shall remain constant." The intent of that sentence seems clear enough: for the referenced purpose, which requires a determination of the Donee's Percentage at a later point in time (as discussed at 4.4.4.5, below), there is no need to re-determine that percentage.

Immediately after the "shall remain constant" sentence quoted above, the Proceeds Portion continues as follows: "Accordingly [!], when a change in conditions gives rise to the extinguishment of a perpetual conservation restriction under [the In-General Portion], the donee organization, on a subsequent sale, exchange, or involuntary conversion of the subject property "must *be entitled* to a [determinable] portion of the proceeds,"[35] which portion would appear to be the amount determined by multiplying the proceeds amount by the Donee's Percentage. That proceeds portion is referred to below as "the Donee's Entitled Amount."

4.4.4.5 The Mortgagee Priority Issue

That "must be entitled" language of Sub 6 is the source of the "perpetuity" issue that has been dealt with in some reported cases. In those cases, there was a pre-existing mortgage and the mortgagee had signed a document saying that its mortgage was subordinated to the easement, subject, however, to a reservation in the following (or essentially the following) words:

> The Mortgagee/Lender and its assignees shall have a prior claim to all insurance proceeds as a result of any casualty, hazard or accident occurring to or about the Property and all proceeds of condemnation, and shall be entitled to same in preference to [the donee organization] until the Mortgage is paid off and discharged.…

The IRS had contended, and the Tax Court had thrice held,[36] that the "must be entitled" requirement of Sub 6 was not met where there was such a reservation, the reason being that, were there to be a compensation-lacking judicial extinguishment followed by a proceeds-producing disposition, there might not be sufficient proceeds to pay both the mortgage debt and the Donee's Entitled Amount, in which event, according to the IRS and the Tax Court, the donee would not receive from the proceeds what Sub 6 said it must always be entitled to receive therefrom. As the Tax Court itself explained its holding (referring to its earlier opinion in the same case in which it had granted summary judgment to the IRS on the issue):

> [W]e found that [the donee organization's] right to its proportionate share of future proceeds [i.e., the Donee's Entitled Amount] was thus not guaranteed and, since we interpreted the extinguishment provision [i.e., Sub 6] to lay down an unconditional requirement that the donee organization be entitled to its proportionate share of future proceeds [i.e., the Donee's Entitled Amount], the agreement did not satisfy the terms of the provision. As a result, we in effect held that the agreement did not establish a perpetual conservation restriction, and the façade easement was not a qualified real property interest. We found that Lorna Kaufman's contribution of the façade easement to [the donee] was not, therefore, a qualified conservation contribution within the meaning of [Code] section 170(h)(1).[37]

However, the First Circuit disagreed with the Tax Court's must-be-guaranteed-to-be-received-from-the-proceeds conclusion. It is enough, the appellate court held, that the donee can make a claim against the proceeds that is superior to any claim by the donor, notwithstanding that the donee might not receive from those proceeds all of the Donee's Entitled Amount—or, indeed, might receive no part of the proceeds—because someone else (other than the donor, of course) had a prior claim that had taken away all of the proceeds. As the appellate court put it:

> The IRS reads the word "entitled" in the extinguishment regulation to mean "gets the first bite" as against the rest of the world, a view the Tax Court accepted in reading "entitled" to mean "ha[s] an absolute right." But

> a grant that is absolute against the owner-donor is also an entitlement, and almost the same as an absolute one where third-party claims (here, the bank's or the city's) are contingent and unlikely.[38]

The nature of the First Circuit's reasoning is indicated by its reference to claims by "the bank" and "the city." According to the First Circuit, adopting a "first-bite" rule—as opposed to a "before-the-donor" rule—would in effect nullify the statute, the reason being that, according to the First Circuit, a donor "ha[s] no power to make the mortgage-holding bank give up its own protection against fire or condemnation and, more striking, no power to defeat tax liens that the city might use to reach the same insurance proceeds—tax liens being superior to most prior claims."[39] Thus, according to the First Circuit, "given the ubiquity of super-priority for tax liens, the IRS's reading of its regulation would appear to doom practically all donations of easements, which is surely contrary to the purpose of Congress."[40]

Although one can quarrel with the First Circuit's relying on a donor's lack of power vis-a-vis a *mortgagee*,[41] it must be admitted that a *local taxing authority* is unlikely to agree to subordinate its claim in order to help a private citizen obtain an income-tax deduction. Thus, the issue as to realty-tax claims must be faced. It does not necessarily follow, though, that the First Circuit's conclusion as to mortgagee claims is inexorable. There is no absolute necessity of treating "bank" claims the same as "city" claims. Indeed, a court could, for the very reason set forth by the First Circuit, find an implied exception for realty-tax claims, especially in view of the fact that, unlike a mortgage the amount of which could easily cover all of the value of a subsequently burdened parcel, such taxes could be expected to leave enough of the proceeds to cover the Donee's Entitled Amount in almost every case.[42] And it is not unlikely that the IRS itself would agree to (and perhaps formally establish) the existence of a narrow realty-tax-claim exception, while continuing to urge that Sub 6 precludes a deduction where there exists a non-governmental priority-as-to-proceeds reservation such as that made by Ms. Kaufman's mortgagee. Thus, it is far from clear that courts not bound by the First Circuit—including the Tax Court in cases appealable to other Courts of Appeals—would reach the same Sub 6 result as was reached by the First Circuit.

It should be noted that the First Circuit impliedly approved the Tax Court's ruling that it was not enough that Ms. Kaufman's grant gave the donee *a contract claim against the donor.* Both courts held that the donee had to have *a direct claim against the proceeds*—which assumes, of course, that such a thing is possible—the difference between the two courts relating only to what Sub 6 requires as to the donee's place in line.

It should also be borne in mind that a mortgagee-priority reservation, even if it passed muster under Sub 6, might nevertheless doom the deduction under subparagraph (2). As noted above, there has not yet been a resolution of that issue.

4.4.4.6 Sub 6 in Practice

In the case of a façade easement, the "extinguishment" provision is normally attempted to be complied with by simply repeating its language in the document granting the easement, and, unless there is a contrary provision elsewhere (as was true in the last-discussed cases), that would appear to be sufficient.

4.4.5 The Destruction of the Building Possibility

Whatever one's view of its intended scope, it cannot be denied that the "extinguishment" provision does not deal with specificity with the far less improbable possibility that the building might burn down or be otherwise destroyed. In any such event, there presumably would be proceeds, but the restriction obviously cannot attach literally to money. Notwithstanding the regulations' failure to address such a contingency, it must be sufficient, unless the entire concept of a façade easement charitable donation is to be nullified, for the donor and the donee to agree to whatever can be agreed to in order to assure as best as possible that the donee will receive its share of the proceeds and use them for a proper purpose. Clearly, the donee should be included as an insured under any casualty policies covering the structure, and the documents should state in so many words that the donee is directly entitled to its share of any proceeds.

4.4.6 The Condemnation Possibility

Property, even historic buildings, can be taken by eminent domain. Again, in such a situation (as opposed to an uncompensated judicial nullification) there ordinarily would be proceeds. Again, the donor must do all that he can to ensure that the donee receives its requisite share. Among other things, the donor should resist the temptation to include in the deed of easement a provision, not uncommon in other circumstances, to the effect that the donor alone is to receive all of the proceeds. It would seem to be similarly unwise to require the donee to reimburse the donor for its proportionate share of any expenses incurred in order to obtain the award.

4.4.7 The Abandonment Possibility

What about the possibility that the donee might abandon the easement? It would seem that there would be little that the donor might be able to do to prevent such an occurrence. Even if the donor obtained the donee's promise not to give up the easement, that would only give the donor a right of action, as opposed to disabling the donee. However that may be, a review of the cases, as well as an examination of a number of deeds of easement, reveals that donees are, perhaps unwisely, routinely insisting on being given an expressed abandonment right.[43]

In three recent cases—*Kaufman,*[44] *Friedberg,*[45] and *Simmons,*[46] decided by the First Circuit, the Tax Court, and the D.C. Circuit, respectively—the deeds of easement provided that "nothing herein contained shall be construed to limit [the donee's] right to give its consent (e.g., to changes in the Façade) or to abandon some or all of its rights hereunder," and the IRS contended that that language established non-compliance with the perpetuity requirement, due to subparagraph (1) of Regs. §1.170A-14(g), which subparagraph provides that "any interest in the property retained by the donor (and the donor's successors in interest) must be subject to legally enforceable restrictions…that will prevent uses of the retained interest inconsistent with the conservation purposes of the donation." In all three of those cases, the taxpayers prevailed on the point, but not on exactly the same grounds in each case.

As described by the First Circuit in *Kaufman,* the IRS was arguing that the donee's reserved right was "a 'blank check' to the [donee] 'to consent to any type of change, irrespective of its compatibility with the donation's conservation purpose,' and so '[t]he easement fails to include restrictions that "will" prevent uses inconsistent with the conservation purpose as required by [subparagraph (1)].'"[47] The First Circuit rejected that contention. It first quoted (and obviously approved) the following language from the D.C. Circuit's *Simmons* opinion:

> The clauses permitting consent and abandonment, upon which the Commissioner so heavily relies, have no discrete effect upon the perpetuity of the easements. Any donee might fail to enforce a conservation easement, with or without a clause stating it may consent to a change or abandon its rights, and a tax-exempt organization would do so at its peril.[48]

The First Circuit then added the following: "The language of paragraph (g)(1) nowhere suggests the stringent outcome that the IRS seeks to ascribe to it and the consequences of the reading would be to deprive the donee organization of flexibility to deal with remote contingencies. *** In addition, the concern posited by the IRS is within its power to control: the IRS's own regulations require that tax-exempt organizations such as the [donee] be operated 'exclusively' for charitable purposes, a requirement that the IRS can enforce against the [donee]."[49]

Along the same lines, the D.C. Circuit had, after noting the taxpayer's argument that the donee's "interest in preserving its tax-exempt status will prevent it from approving changes inconsistent with the conservation purposes of—let alone abandoning—the easements," concluded that "the deeds do all the Commissioner can reasonably demand to 'prevent' uses of the properties inconsistent with conservation purposes, as required by Treasury Regulations §1.170A-14(g)(1)."[50]

The D.C. Circuit mentioned two other grounds to support its conclusion. It (1) pointed out that "any change in the façade to which [the donee] might consent would have to comply with all applicable laws and regulations, including the District's historic preservation law,"[51] and also (2) relying on the ultra-remote possibilities provision discussed above, concluded that, because the IRS had pointed to no instance since 1978 of Ms. Simmons's donee abandoning its right to enforce easements, "Simmons's deductions cannot be disallowed based upon the remote possibility that [the donee] will abandon the easements."[52]

The Tax Court in *Friedberg* followed the D.C. Circuit as to its interpretation of subparagraph (1). The Tax Court also, as the D.C. Circuit had done, relied in part on local law, concluding that "the terms of the conservation deed, combined with the New York State law governing conservation easements, do not violate the perpetuity requirement of [Code] section 170(h)(5)(A)." Unlike the D.C. Circuit, though, it declined to rely on the ultra-remote-possibility provision. "In the instant case," it said, "the parties have not addressed [the donee's] history of enforcing easements, and there is nothing in the record that would allow us to consider the likelihood that [the donee] would abandon the easement."[53]

There was a recent case in the Tax Court that the taxpayers lost on the abandonment point, but the court's ruling would seem to be aberrational. There, the critical language of the deed of easement actually attempted to limit the donee's rights (a) by requiring the donor's concurrence, (b) by providing that their joint right to extinguish the easement would come into effect only "[i]f circumstances arise in the future such that render the purpose of this Conservation Easement impossible to accomplish," and (c) by limiting the joint right to situations in which "no other parties will be impacted and no laws or regulations are violated by such termination." However, the court (1) refused to consider the likelihood of that "impossibility" occurring and (2) ruled that "[b]ecause petitioners' easements may be extinguished by mutual consent of the parties, the easements fail as a matter of law to comply with the enforceability in perpetuity requirements under section 1.170A-14(g), Income Tax Regs."[54]

4.4.8 The Substitution Possibility

In one recent case, the donor placed a restriction on a parcel of land, but reserved the right to substitute a different parcel, provided that, among other things, "the substitution shall have no adverse affect [sic] on the conservation purposes of the Conservation Easement or on any of the significant environmental features of the Conservation Area." The claimed deduction was disallowed, the court ruling that "because the conservation easement agreement permits petitioners to change what property is subject to the conservation easement, the use restriction was not granted in perpetuity."[55]

4.5 The "Qualified Appraisal" Requirement

A taxpayer seeking a sizable deduction for a façade easement donation must include with his return for the taxable year of the contribution a "qualified appraisal" of the donated property, which appraisal was "conducted by a qualified appraiser in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed [by the IRS]."[56] Both of the key terms "qualified appraisal" and "qualified appraiser" are defined in the Code[57] and discussed extensively in the regulations.[58] This article will not go into the matter, except for the point discussed immediately below.

One of the requirements of a "qualified appraisal" is that it must disclose the method that the appraiser used to arrive at his valuation of the donated property.[59]

What if the appraiser—qualified as he may be—used a patently invalid valuation method? The IRS for a time took the position that, in such an instance, the claimed to be "qualified appraisal" was not such. And the Tax Court agreed.[60] But the Second Circuit did not. As it stated in reversing one of the Tax Court decisions:

> The Tax Court concluded that there was no method of valuation because "the application of a percentage of the fair market value before conveyance of the façade easement, without explanation, cannot constitute a method of valuation."…We disagree.
>
> Drazner did in fact explain at some length how he arrived at his numbers. For the purpose of gauging compliance with the reporting requirement, it is irrelevant that the IRS believes that the method employed was sloppy or inaccurate, or haphazardly applied—it remains a method, and Drazner described it. The regulation requires only that the appraiser identify the valuation method "used"; it does not require that the method adopted be reliable.[61]

It is important to bear in mind that the question of whether a document constitutes a "qualified appraisal" is not the same as whether the method that it employs produces a credible result. As the Second Circuit pointed out:

> Drazner's delivery of a qualified appraisal does not itself entitle Scheidelman to a deduction. *** If the Tax Court agrees with Scheidelman on [certain] remaining issues, it would remain for the Tax Court to determine the value of the Scheidelman easement on the basis of the parties' submissions. Our conclusion that Drazner's appraisal meets the minimal requirements of a qualified appraisal mandates neither that the Tax Court find it persuasive nor that Scheidelman be entitled to any deduction for the donated easement.[62]

In an earlier article in this publication, this writer pointed out that "Ms. Scheidelman's victory on this point may well prove to be pyrrhic. On remand, the Tax Court presumably will rule that, inasmuch as her appraisal relied on the pure percentage-reduction method, she failed to prove the value of the donated easement."[63] That is what has happened.[64]

4.6 Other Submission Requirements

A donor claiming a deduction on his tax return for the donation of a façade easement must, in addition to submitting a "qualified appraisal," also complete and file a Form 8283, together with a number of required attachments. The form must be signed by the taxpayer, the appraiser and the donee.

The Code itself also requires the submission of "photographs of the entire exterior of the building, and…a description of all restrictions on the development of the building."[65]

In the case of a claimed deduction greater than $10,000, the taxpayer must pay a $500 fee at time of filing.[66] There are also recordkeeping requirements that have to be complied with.[67]

5. Amount of the Deduction

Assuming that the taxpayer is successful in establishing that he has made a qualified conservation contribution of a façade easement, it remains to be determined how much (if anything) is the amount of the deduction to which he is entitled as a result.[68]

5.1 A Note on Procedure

The IRS is not, of course, bound by the amount claimed by the taxpayer. The value of any property (including a donated façade easement) is a question of fact, to be determined in the usual way. As a first step, the taxpayer claims a value on his return, which the IRS may challenge. If it does so and the parties do not agree, the IRS issues a deficiency notice stating what it believes the value to be. If the taxpayer takes the matter to court—almost certainly the Tax Court in the first instance[69]—the court will normally hear expert testimony and consider appraisals, but the court is not bound by such items, can decide how much weight (if any) to give to any item, and is free to make its own determination.[70] In general, the IRS's value, if at all supported, is presumed to be correct, with the burden of proof falling on the taxpayer to prove otherwise.[71] Absent such proof to the court's satisfaction, only the amount allowed by the IRS—whether zero or otherwise—is all that the taxpayer can deduct.[72]

Where the original property is directly co-owned (as opposed to, say, property owned by a partnership), all such co-owners must of course join in the donation. It does not necessarily follow, though, that all of their claimed deductions will necessarily be handled together; rather, each one's situation might be treated separately.

5.2 The Congressional Intention

A threshold question is whether Congress intended the amount of the deduction to be limited to the true cost to the donor, as opposed to intending to authorize the deduction of an artificially inflated amount. Despite what one might have expected based on general principles, it cannot be said that it has always been entirely clear that Congress did not mean to allow deductions in excess of the actual detriment to the donor.[73] To begin with, it cannot be doubted that Congress intended to encourage preservation easement donations. And one does not have to be excessively cynical to recognize that a taxpayer whose intention is to benefit himself (and only incidentally the charity) would be less than willing to suffer a true diminution in the actual realizable value of his property (in addition to incurring not inconsiderable transaction costs) in order to obtain a deduction of the same or even lesser amount. It must also be borne in mind that a taxpayer with a true charitable intent has open to him far simpler ways of parting with value. Along these lines, the National Trust for Historic Preservation in the United States, in the words of the Fifth Circuit, "pointed out" in an amicus brief "that valuation of preservation easements is a fundamentally important issue to National Trust because, if such easements are deemed to have little or no value, the tax incentives Congress has established to encourage preservation would be severely weakened."[74]

5.3 The 10%-to-15% Era

Based in part on such considerations, it was believed for a time that the IRS was willing to go along with deductions in excess of actual cost. Reference to a bit of history will be helpful here. Some time ago, an IRS person wrote a brief article that was interpreted as indicating that the IRS would in every case accept an easement valuation between 10 and 15% of the property's original value.[75] Reinforced by that article, the belief grew that the IRS could be counted on to accept an easement value in that range, regardless of the actual facts.[76]

As a result, there grew up an industry of people persuading building owners to take advantage of this supposed great opportunity, i.e., a huge deduction with no appreciable real cost. As reported in one Tax Court opinion, the donor's representative "attended free seminars where [the donee] representatives (none of whom was a lawyer) discussed the significant tax benefits that could be obtained through the contribution of preservation easements to [the donee] with little to no practical effect on the use, value, or marketability of the servient property."[77]

Evidencing the get-a-tax-saving-without-real-cost nature of what was being presented, it was routine for such donees to charge donors a fee—often 10% of the anticipated deduction—for facilitating the process.[78] Such donees would in practice refer the donor to an "expert" who would produce an appraisal that would talk around the subject a great deal and then rather arbitrarily pick a percentage within the supposedly permitted range. Indeed, appraisers who opined that an easement's value was less than 15% considered themselves to be quite conservative. And it was thought that a 10% value was unchallengeable.

To the chagrin of a number of taxpayers (some of whom had parted with rather large sums of money), the IRS did not go along with such pure pick-a-percentage valuations. Although it had previously made its position known in various ways, a particularly clear statement of that position was set forth in a Chief Counsel Advice issued in 2007.[79] The document first posed the issue as follows:

> May an appraisal of a façade easement that values the easement as a percentage of the value of the underlying fee before the granting of the easement, without reference to the actual value of the underlying fee after the granting of the easement, be used to substantiate the fair market value of the easement under §170(h) of the Internal Revenue Code?

The Chief Counsel's answer was straightforward and emphatic:

> No. The value of a donated façade easement depends on the particular facts and circumstance of that property and must be substantiated with a full appraisal of the value of the easement. This value is generally obtained by determining the values of the underlying fee both before and after the contribution, with the easement valued at an amount equal to the difference if any. The Internal Revenue Service will not accept an appraisal to substantiate the fair market value of a façade easement if the appraisal merely values the entire fee before the donation and then applies a percentage thereto.

5.4 The "Before and After" Method

How, then, is the amount of the deduction to be determined? The regulations, which address this subject at some length, state that that amount is to be the easement's "fair market value" and set forth rules under which that value is to be determined. However, as the Fifth Circuit observed, "[notwithstanding this regulatory guidance, valuing preservation easements remains, most understandably, a complex and difficult undertaking that continues to challenge appraisers and the IRS."[80]

As a beginning point, the regulations provide that "[t]he value of the contribution under section 170 in the case of a charitable contribution of a perpetual conservation restriction is the fair market value of the perpetual conservation restriction at the time of the contribution."[81]

Insofar as here relevant, the regulations go on to say that, in the absence of a market for such restrictions, "as a general rule (but not necessarily in all cases) the fair market value of a perpetual conservation restriction is equal to the difference between the fair market value of the property it encumbers before the granting of the restriction and the fair market value of the encumbered property after the granting of the restriction." For obvious reasons, the value of the original property is referred to as the "before" value, the value of the encumbered property is referred to as the "after" value, and the method is known as the "before and after" method.

The following paragraphs, after a brief discussion of a closely related point, discuss separately what guidance there is as to the proper way to establish a "before" value and an "after" value.

Before that, though, it may be noted that the quest for unwarranted deductions was not abandoned. Rather, when it became clear that the simple pick-a-number-between-10%-and-15% approach would not work, another ploy was attempted. Taxpayers began to be referred to appraisers who were enormously optimistic about "before" values and enormously pessimistic about "after" values. Examination of the cases shows that such attempts seldom, if ever, produced the desired results.

5.5 The Effect of Collateral Benefits

It is black-letter law that the amount of any charitable contribution deduction must be reduced by any value that the donor receives as a result of making the donation (other than (i) the income-tax saving resulting from the deduction and (ii) any benefit enjoyed as a member of the general public). Because the "before and after" method focuses only on the property burdened by the granting of the easement, it cannot always be used alone to determine the amount of the deduction. Rather, the value of any incidental benefits to the donor (and other persons that he wishes to benefit) must be taken into account.

The most obvious possible beneficial-to-the-donor effect of the conveyance of a conservation easement is that the value of contiguous property owned by the donor or his family might be enhanced thereby. The regulations deal with such situations as follows:

> The amount of the deduction in the case of a charitable contribution of a perpetual conservation restriction covering a portion of the contiguous property owned by a donor and the donor's family…is the difference between the fair market value of the entire contiguous parcel of property before and after the granting of the restriction.[82]

The regulations then broaden the foregoing by immediately thereafter adding the following:

> If the granting of a perpetual conservation restriction…has the effect of increasing the value of any other property owned by the donor or a related person, the amount of the deduction for the conservation contribution shall be reduced by the amount of the increase in the value of the other property, whether or not such property is contiguous.

Broadening their focus still further, the regulations immediately thereafter add the following:

> If, as a result of the donation of a perpetual conservation restriction, the donor or a related person receives, or can reasonably expect to receive, financial or economic benefits that are greater than those that will inure to the general public from the transfer, no deduction is allowable under this section.[83]

5.6 Determination of a "Before" Value

As to the "before" value, it is normally possible to make the determination by traditional methods. Under such methods, a valuation is supposed to be based on the highest and best use to which the property might reasonably be expected to be put (which may or may not be the property's current use). Obviously attempting to head off inflated valuations, the regulations provide that the determination of a "before" value must not be based on an unrealistic view of what could actually be done with the property absent the new restriction. There are two things in particular that the regulations say must be taken into account (in addition, of course, to what may be deduced from the current use of the property). The regulations state that the determination:

> must take into account…[1] an objective assessment of how immediate or remote the likelihood is that the property, absent the [newly imposed] restriction, would in fact be developed, as well as [2] any effect from zoning, conservation, or historic preservation laws that already restrict the property's potential highest and best use.[84]

Both of these things are important. First, the donor cannot base his "before" valuation on such things as an unsupported hope that a new street might be opened or that zoning might be changed in a favorable way. In addition, the starting point, where restrictions are already in place, is the value as so restricted, not what the value might have been absent any restrictions.[85] Also relevant is the degree to which preexisting restrictions are actually enforced.[86]

5.7 Determination of an "After" Value

The determination of an "after" value is even more challenging than the determination of a "before" value. Here, there is no established methodology.

The regulations offer some assistance by including a paragraph that strings together a few relevant considerations.[87] Immediately following the "before"-relevant language quoted above, the paragraph first notes that:

> [T]here may be instances where the grant of a conservation restriction may have no material effect on the value of the property or may in fact serve to enhance, rather than reduce, the value of property. In such instances no deduction would be allowable.

The paragraph continues by pointing out that:

> In the case of a conservation restriction that allows for any development, however limited, on the property to be protected, the fair market value of the property after contribution of the restriction must take into account the [possible?] effect of the development.

Of particular relevance to the present subject, the paragraph then provides that:

> In the case of a conservation easement such as an easement on a certified historic structure, the fair market value of the property after contribution of the restriction must take into account the amount of access permitted by the terms of the easement.

It then goes back to a more general factor:

> [A]n appraisal of the property after contribution of the restriction must take into account the effect of restrictions that will result in a reduction of the potential fair market value represented by highest and best use but will, nevertheless, permit uses of the property that will increase its fair market value above that represented by the property's current use.

The paragraph concludes with the following rather odd statement:

> The value of a perpetual conservation restriction shall not be reduced by reason of the existence of restrictions on transfer designed solely to ensure that the conservation restriction will be dedicated to conservation purposes. See §1.170A-14(c)(3).[88]

The regulations thus do not go very far in providing guidance for how the amount of an "after" value is to be determined.

To state the obvious, a diminution in value might be minimal or extensive or somewhere in between, and the difficulty lies in determining the correct amount thereof.

The assertion of a zero diminution—i.e., that the "after" value is the same as the "before" value—seems to have been the standard litigating stance of the IRS's experts.[89] However, that assertion has not met with notable success. As the courts have pointed out, the placing of a restriction on property obviously reduces its value to some degree.[90] That is not to say that the courts will never find that there was a zero diminution. It is the taxpayer's burden to show the amount of the diminution, and, absent such a showing, the finding will be that there was none.[91]

As to some kinds of property, where there was precious little on which to base a claimed-to-be "after" value, appraisers often proceeded by a two-step process. They would first, more or less credibly, claim to have determined a percentage reduction as to other kinds of property (sometimes in far-removed locations), and then, with little intelligible explanation, apply a similar percentage to the property with which they were dealing. Not surprisingly, the IRS did not go along, and the Tax Court has strongly backed up the IRS in such disputes.[92]

On the other hand, where comparisons of the selling prices of similar properties with and without an easement can be shown, a so-called "percentage diminution approach" can be used.[93]

5.8 The Current Attitude of the Courts of Appeals

In the three years preceding the writing of this article, four different Courts of Appeals have issued opinions dealing with claimed façade easement deductions. And in all four the taxpayers succeeded at least in part.

But too much should not be read into that fact. As shown below, none of those opinions can fairly be understood as affording a great deal of comfort to potential donors thinking about making inflated valuation claims.

5.8.1 *Whitehouse Hotel L.P. v. Commissioner*[94]

This case was all about the proper valuation of a façade easement that the IRS had conceded had been properly donated. The donor had claimed a value of $7,445,000 but the Tax Court had allowed only $1,792,301. Although the Fifth Circuit disagreed with the Tax Court on a very technical point that had to be considered in arriving at the correct valuation, the appellate court confirmed that "The 'before and after' valuation approach is to be employed where, as here, there is 'no substantial record of sales of easements comparable to the donated easement.'"[95] Moreover, the Fifth Circuit did not accept the donor's claimed value. Rather, it remanded the case for a determination of that amount taking into account the views expressed in its opinion.

Another point is especially to be noted. The Tax Court had upheld the IRS's imposition of a 40% gross overvaluation penalty, and the Fifth Circuit's action on the valuation point necessitated the vacation of that ruling as well. However, far from ruling that there was to be no penalty, a majority of the panel pointed out that, depending on "the tax court's valuation on remand, *** the penalty may be at issue" and laid down some guidelines to be considered in that connection.[96]

On remand, the Tax Court found the value to be $1,857,716 (in place of the $1,792,301 value that it had previously found).[97]

5.8.2 *Commissioner v. Simmons*[98]

Here, it was the IRS that had appealed, its objection being that the Tax Court had overruled certain of its technical objections to deductibility and had allowed $98,500 of deductions out of $255,500 that the taxpayer had claimed. Although, as noted by the D.C. Circuit, the IRS had argued below that "the easements were of no value," on the appeal the IRS "did not raise the point as an independent basis for objecting to the judgment of the Tax Court."[99] Thus, the appellate court's action was neutral insofar as valuation was concerned.

5.8.3 *Scheidelman v. Commissioner*[100]

In this case, the IRS had persuaded the Tax Court that the taxpayer had not submitted the required "qualified appraisal," so that it was unnecessary to determine the easement's value. Although the Second Circuit disagreed on the appraisal point, it pointedly added that "Our conclusion that [the taxpayer's expert's] appraisal meets the minimal requirements of a qualified appraisal mandates neither that the Tax Court find it persuasive nor that Scheidelman be entitled to any deduction for the donated easement."[101] The Second Circuit also referred to "the prevalent use of overvaluations."[102]

5.8.4 *Kaufman v. Shulman*[103]

In its opinion, the First Circuit seemed intent on sending a signal that valuation shenanigans would not be tolerated, declaring that "[t]he deduction for granting the easement is intended to reflect the value of what the taxpayer has donated" and "Section 170(h) does not allow taxpayers to obtain six-figure deductions for gifts of lesser or no value."[104]

The First Circuit also saw fit to add that, despite its rejection of what it described as certain "aggressive legal positions" taken by the IRS in the case before it, "we do not question the IRS's expressed concern, transcending this case, that individuals and organizations have been abusing the conservation statute 'to improperly shield income or assets from taxation.'"[105] "[T]o reject overly aggressive IRS interpretations of existing regulations," the First Circuit went on, "is hardly to disarm the IRS."[106] The court also suggested that, "to give fair warning to taxpayers," there should be "forward looking" regulations "that require appraisers to be functionally independent of donee organizations, curtail dubious deductions in historic districts where local regulations already protect against alterations, and require more specific market-sale based information to support any deduction."

And, if by chance any reader failed to understand its approach, the First Circuit added the following: "If taxpayers still do not get the message, the penalties regime is formidable; and, for willful abusers, there are criminal penalties. The Justice Department has already secured a permanent injunction against the [donee of Ms. Kaufman's contribution] to prohibit some of the practices alluded to in this case. The IRS is properly zealous to protect the revenues and over the long run it has the tools to do so."[107]

What the First Circuit saw fit to say as to the particular facts of the case before it is also instructive. Although there was no need for the appellate court to make a determination as to the value of what Ms. Kaufman had donated—the Tax Court not having ruled thereon—the First Circuit did take the occasion to make a number of comments, most of them suggesting doubt about whether any sizable deduction could be justified. To provide the reader with the full flavor, some of those comments are set forth below in extenso.

As a starting point, the First Circuit stated that, "although the Kaufmans claimed that the value of the easement donation was $220,800, the IRS has repeatedly pointed to evidence that the true value of the donation was close to zero."[108] The court then indicated a number of items that called the claimed amount into question.

The court first noted that the donated easement added little of significance to the restrictions to which the donor's property was already subject.[109] "Given these pre-existing legal obligations," the court observed, "the Tax Court might well find on remand that the Kaufmans' easement was worth little or nothing."[110]

At an earlier point in its opinion, the First Circuit had taken note of the fact that the Kaufmans had assured the mortgagee that the restrictions set forth in the easement were "essentially the same restrictions as those imposed by current local ordinances that govern this property."[111]

The First Circuit also noted that "The Kaufmans' own appraiser, recommended to them by the [donee], acknowledged in his report that 'there is much overlap in the restrictions imposed by the [easement] and the pre-existing restrictions imposed on the property, particularly by the Landmark Commission.' Although the appraiser listed several ways in which the easement's restrictions differed from the landmark district commission's, whether the differences have any economic significance could be disputed. *** Whether any of the offered distinctions justify *any* deduction is a matter for the remand."[112]

The First Circuit also thought it worth mentioning that "The Kaufmans themselves were surprised at the size of the valuation, albeit out of concern that it implied—as it must if the Kaufmans were conveying anything of value—a substantial reduction in the resale value of their home. In an effort to reassure them, a [donee] representative told the Kaufmans that experience showed that such easements did not reduce resale value." "[T]his," the First Circuit added, "could easily be the IRS's opening argument in a valuation trial."[113]

More generally, the First Circuit pointed out that, because of certain facts, the donee of the Kaufman easement "had a substantial economic incentive for itself in facilitating such conservation easements; and…it also had a stake in assuring a high valuation." "Similarly," the court continued, "the appraiser, who admitted receiving fees for a succession of such appraisals for [the current donee's] easements, assuredly had an interest in remaining on the list of those recommended by the [donee] to potential donors."[114]

Further signaling its skepticism, the First Circuit described a question concerning certain evidence as being whether it would be "admissible for the purpose of proving the value of the easement *(or lack thereof)*."[115]

Still another indication of the First Circuit's jaded view of the valuation submitted by the Kaufmans may be found in some words that it chose to use in the following sentence that it included in a discussion of possible penalties that might be imposed on the Kaufmans: "[T]here is no reason to pursue the subject of the Kaufmans' *fault* before determining first whether their deduction was *legitimate.*"[116]

6. Effect on Donor's Tax Basis

Inasmuch as the donor is regarded as parting with a portion of the original property, his tax basis in the retained portion must be less than was his tax basis in the entire property. On this subject, the regulations provide as follows:

> In the case of the donation of a qualified real property interest for conservation purposes, the basis of the property retained by the donor must be adjusted by the elimination of that part of the total basis of the property that is properly allocable to the qualified real property interest granted. The amount of the basis that is allocable to the qualified real property interest shall bear the same ratio to the total basis of the property as the fair market value of the qualified real property interest bears to the fair market value of the property before the granting of the qualified real property interest. When a taxpayer donates to a qualifying conservation organization an easement on a structure with respect to which deductions are taken for depreciation, the reduction required…in the basis of the property retained by the taxpayer must be allocated between the structure and the underlying land.[117]

It is to be noted that, whether or not a deduction on account of the donation of a façade easement is claimed by a donor, his tax basis in his remaining property is necessarily less than was his tax basis in what he originally owned.

7. Conclusion

As can be seen, the decision whether or not it makes sense to donate a façade easement involves a number of considerations, some of which are not easy to assess.

Endnotes

1. Copyright Joel E. Miller. All rights reserved. This is a reprint of an article that appeared at 30 *Tax Management Real Estate Journal* 9 (2014), published by Tax Management, Inc.
2. See generally §170 and the regulations thereunder. Unless otherwise stated, references to "Section" or "§" are to the Internal Revenue Code, and references to "Regs. §" are to the regulations promulgated by the Treasury Department thereunder.
3. Code §170(f)(3)(A); Regs. §§1.170A-7(a)(1) and -14(a).
4. *See, e.g.,* Notice 2004-41, 2004-2 C.B. 31; Wooldridge, Levitt, Rhodes & Vinson, "Proving the Value of a Charitable Donation May Be the Least of Your Problems," 115 *J. Tax'n* 81 (Aug. 2011) ("[P]ractitioners have never experienced the intensity and variety of scrutiny that is becoming standard practice within the IRS [and] much of the recent IRS focus involves contributions of conservation easements.").
5. §170(h)(4)(A)(iv). Of course, the taxpayer must own the entire exterior of the building. *61 York Acquisition, LLC v. Commissioner,* T.C. Memo 2013-266.
6. §170(h)(4)(C)(ii). A "building…listed in the National Register" can also qualify (§170(h)(4)(C)(i)), but, for no apparent reason, the Code's requirements as to those buildings are somewhat less stringent. *See* §170(h)(4)(B). This article focuses on "registered historic district" buildings, which were the kind dealt with in most or all of the reported "façade easement" cases.
7. §170(h)(1). Some useful brief discussions of the requirements of current law may be found in CCAs 201014056 and 200943033. *See generally* Kirschen & Freitag, 521 T.M., *Charitable Contributions: Income Tax Aspects,* at II.F.1.b.(5) (Qualified Conservation Contribution).
8. §170(h)(2)(C).
9. Regs. §1.170A-14(b)(2). For purposes of Regs. §1.170A-14, "the terms *easement, conservation restriction,* and *perpetual conservation restriction* have the same meaning." Regs. §1.170A-14(b)(2).
10. The Tax Court has used similar language. *See, e.g., Belk v. Commissioner,* T.C. Memo 2013-154 ("When a taxpayer donates a partial interest, he retains the remaining interest in the property. Thus,

the taxpayer is effectively splitting the property into two pieces: (1) the retained portion and (2) the donated portion.").

11. §170(h)(1)(B); *see* Regs. §1.170A-14(a).

12. §170(h)(3). The regulations add that "[t]o be considered an eligible donee under this section, an organization must be a qualified organization, have a commitment to protect the conservation purposes of the donation, and have the resources to enforce the restrictions." Regs. §1.170A-14(c)(1).

13. §170(h)(4)(B)(ii).

14. §170(h)(1)(C).

15. §170(h)(4)(A)(iv); *see* Regs. §1.170A-14(a). A promise not to increase the floor area of such a structure is insufficient. *Herman v. Commissioner,* T.C. Memo 2009-205.

16. §170(h)(4)(B). Other parts of the provision are discussed at 4.2, above, and at 4.5 and 4.6, below.

17. §170(h)(5)(A); *see* Regs. §1.170A-14(a).

18. *See 1982 East, LLC v. Commissioner,* T.C. Memo 2011-84, *slip opin.* at p. 29 ("We do not believe that the regulations interpreting the perpetuity requirement of [Code] section 170(h)(5) are so crystal clear and unambiguous as to make the imposition of the accuracy-related penalty appropriate."). Inasmuch as the law on the subject has developed somewhat since the time of the donation involved in that case (2004), future taxpayers may not fare as well if they fail to satisfy the perpetuity requirement.

19. Regs. §1.170A-14(g)(3). Regs. §1.170A-1(e) is to the same effect.

20. *See, e.g., Commissioner v. Simmons,* 646 F.3d 6, 10-11 (D.C. Cir. 2011). In this case, the IRS urged denial of the claimed deductions based on the fact that the deeds of easement provided that "nothing herein contained shall be construed to limit the Grantee's right to…abandon some or all of its rights hereunder." The Circuit Court, citing *Stotler v. Commissioner*, T.C. Memo 1987-275 (possibility of abandonment of scenic easement by county found to be "so remote as to be negligible," rejected the IRS's contention, saying in part, "the Commissioner has not shown the possibility [the donee] will actually abandon its rights is more than negligible. *** Simmons's deductions cannot be disallowed based upon the remote possibility [the donee] will abandon the easements."). Query whether the court was correct in placing the burden of proof on the IRS. The opposite approach was taken by the Tax Court in the very similar case of *Friedberg v. Commissioner*, T.C. Memo 2011-238, *slip opin.* at p. 66 ("In the instant case, the parties have not addressed [the donee's] history of enforcing easements, and there is nothing in the record that would allow us to consider the likelihood that [the donee] would abandon the easement."). The possibility-of-abandonment issue is discussed at 4.4.7, below.

21. *See, e.g., Kaufman v. Shulman*, 687 F.3d 21 (1st Cir. 2012), *aff'g on this point Kaufman v. Commissioner,* 136 T.C. 294 (2011); *Graev v. Commissioner*, 140 T.C. No. 17 (2013); *Mitchell v. Commissioner*, 138 T.C. 324 (2012), *supplemented*, T.C. Memo 2013-204; *Minnick v. Commissioner,* T.C. Memo 2012-345; *Friedberg v. Commissioner,* T.C. Memo 2011-238, *supplemented,* T.C. Memo 2013-224.

22. Regs. §1.170A-14(g)(1).

23. *See Mitchell v. Commissioner,* 138 T.C. 324 (2012), *supplemented,* T.C. Memo 2013-204; *Minnick v. Commissioner,* T.C. Memo 2012-345. Subparagraph *(2)* also provides that, for pre-1986 gifts, subordination is not necessary "if the donor can demonstrate that the conservation purpose is protected in perpetuity without subordination of the mortgagee's rights."

24. *Kaufman v. Shulman*, 687 F.3d 21, 27 n. 5 (1st Cir. 2012)*, vacating in part on another ground Kaufman v. Commissioner*, 136 T.C. 294 (2011).

25. 136 T.C. at 310-11 ("We think it unnecessary to our result, and reach no conclusion, as to whether the bank subordinated its rights in the property to the right of [the donee organization] to enforce the façade easement so as to satisfy the requirements of section 1.170A-14(g)(2), Income Tax Regs.").

26. *Kaufman v. Shulman*, 687 F.3d 21, 27 n. 5 (1st Cir. 2012).

27. *Id.* (citation omitted).

28. *Id.* There was at least one other case in which the IRS also refrained from urging disqualification under subparagraph (2). *See 1982 East, LLC v. Commissioner,* T.C. Memo 2011-84, *slip opin.* at p. 21 n. 12.

29. Regs. §1.170A-14(g)(6). The drafters of this provision, said the Tax Court in a case that turned on the provision's interpretation, "understood that forever is a long time and provided what appears to be a regulatory version of *cy pres* to deal with unexpected changes that make the continued use of the property for conservation purposes impossible or impractical." *Kaufman v. Commissioner, 136* T.C. 294, 307 (2011), *vacated in part and remanded on another point sub nom. Kaufman v. Shulman,* 687 F.3d 21 (1st Cir. 2012).

30. There is considerable evidence that the regulations received inadequate attention. As a minor example, "apparently the Secretary failed to update the cross-references in the final regulations." *See Kaufman v. Commissioner, 136* T.C. 294, 307 n. 7 (2011), va*cated in part and remanded on another point sub nom. Kaufman v. Shulman,* 687 F.3d 21 (1st Cir. 2012). In any event, it is difficult to agree with one judge's "finding" that "the extinguishment regulation provides taxpayers with a guide, a safe harbor, by which to create the necessary restrictions to guarantee protection of the conservation purpose in perpetuity." *Carpenter v. Commissioner,* T.C. Memo 2012-1, *slip opin.* at p. 18.

31. In the interest of simplicity, this article does not discuss the very real variation of a partial elimination. However, it is likely that similar considerations would control.

32. Curiously, while the In-General Portion talks only about a "sale or exchange of the property," the Proceeds Portion refers (emphasis added) to a "sale, exchange or *involuntary conversion* of the subject property." When the context is considered, it is hard to attribute the variation to anything other than inattention.

33. *See Kaufman v. Shulman,* 687 F.3d 21, 26 n. 3 (1st Cir. 2012) ("paragraph (g)(6) only applies when the easement is extinguished by judicial proceeding").

34. In one recent case, the Tax Court stated that "Under [Sub 6], extinguishment of a conservation easement is permitted by judicial proceeding if subsequent unexpected changes in the conditions surrounding the property make impossible or impractical the continued use of the property for conservation purposes." *Belk v. Commissioner,* T.C. Memo 2013-154.

35. Regs. §1.170A-14-(g)(6) (emphasis added). Although it played no part in the reported cases, for completeness it will be noted that there would appear to be an exception. The provision seems to say that such an entitlement is unnecessary if "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."

36. *Kaufman v. Commissioner,* 134 T.C. 182 (2010*), aff'd on reh'g,* 136 T.C. 294 (2011), *vacated in part and remanded on this point sub nom. Kaufman v. Shulman,* 687 F.3d 21 (1st Cir. 2012*); Wall v. Commissioner,* T.C. Memo 2012-169*; 1982 East, LLC v. Commissioner,* T.C. Memo 2011-84.

37. *Kaufman v. Commissioner,* 136 T.C. 294, 307 (2011) (citations and footnote omitted).

38. *Kaufman v. Shulman,* 687 F.3d 21, 27 (1st Cir. 2012) (citations omitted).

39. *Kaufman v. Shulman,* 687 F.3d 21, 26 (1st Cir. 2012).

40. *Id.*

41. A donor obviously has the power to *ask* a mortgagee for its agreement to subordinate to the donee's entitlement any monetary claim that it (the mortgagee) might have against the proceeds, and, indeed, under subparagraph (2) (which is discussed at 4.4.3, above) there can be no deduction unless the mortgagee agrees to a subordination of some sort. In point

of fact, Ms. Kaufman had sought, and obtained, her mortgagee's at least partial subordination.

42. In this connection, it is worth noting that the realty-tax-lien argument was neither raised in, nor considered by, the Tax Court.

43. *See especially Graev v. Commissioner,* 140 T.C. No. 17 (2013). In two recent cases, the court reported (and seemingly endorsed) the donee's "explanation" that "this type of clause is needed to allow a charitable organization that holds a conservation easement to accommodate such change as may become necessary 'to make a building livable or usable for future generations' while still ensuring the change is consistent with the conservation purpose of the easement." *See Kaufman v. Shulman,* 687 F.3d 21, 28 (1st Cir. 2012); *Commissioner v. Simmons,* 646 F.3d 6, 10 (D.C. Cir. 2011).

44. *Kaufman v. Shulman,* 687 F.3d 21 (1st Cir. 2012).

45. *Friedberg v. Commissioner,* T.C. Memo 2011-238, *supplemented,* T.C. Memo 2013-224.

46. *Commissioner v. Simmons,* 646 F.3d 6 (D.C. Cir. 2011).

47. *Kaufman v. Shulman,* 687 F.3d 21, 27-28 (1st Cir. 2012).

48. *Kaufman v. Shulman,* 687 F.3d 21, 28 (1st Cir. 2012), quoting from *Commissioner v. Simmons, 646* F.3d 6, 10 (2011). The Tax Court in *Simmons* had likewise rejected the IRS's argument. The IRS apparently did not advance the argument before the Tax Court in *Kaufman.*

49. *Kaufman v. Shulman,* 687 F.3d 21, 28 (1st Cir. 2012) (citation omitted).

50. *Commissioner v. Simmons,* 646 F.3d 6, 9-10 (D.C. Cir. 2011)

51. *Commissioner v. Simmons,* 646 F.3d 6, 11 (D.C. Cir. 2011).

52. *Commissioner v. Simmons*, 646 F.3d 6, 10-11 (D.C. Cir. 2011).

53. *Friedberg v. Commissioner,* T.C. Memo 2011-238, slip opin. at p. 66, *supplemented,* T.C. Memo 2013-224.

54. *Carpenter v. Commissioner,* T.C. Memo 2012-1. Query whether the court's action was overly harsh, given that the mutual-consent provision added nothing to the donee's ability to release the restriction unilaterally. As the court pointed out in *Commissioner v. Simmons,* 646 F.3d 6 (D.C. Cir. 2011), "[a]ny donee might fail to enforce a conservation easement, with or without a clause stating it may consent to a change or abandon its rights." As to a slightly different aspect of the "extinguishment" provision, while it is true that the *Carpenter* court, in its words, "declined to rule that a conservation deed must require a judicial proceeding to extinguish an easement for the easement to be perpetual," it is doubtful that the "extinguishment" provision truly even "suggests," as the court remarked, "that any extinguishment of a conservation easement [must] be done through judicial proceedings."

55. *Belk v. Commissioner,* 140 T.C. 1 (2013), *supplemented,* T.C. Memo 2013-154.

56. §170(f)(11)(D), (h)(4)(B).

57. §170(f)(11)(E).

58. Regs. §1.170-13(c)(3).

59. §170(c)(3)(ii)(J).

60. *See, e.g., Friedberg v. Commissioner,* T.C. Memo 2011-238, *supplemented,* T.C. Memo 2013224; *Scheidelman v. Commissioner,* T.C. Memo 2010-151, *vacated and remanded,* 682 F.3d 189, *followed on this point by Rothman v. Commissioner,* T.C. Memo 2012-163, *supplemented,* T.C. Memo 2012-18, and *1982 East, LLC v. Commissioner,* T.C. Memo 2011-84, n. 14; Wooldridge, Levitt, Rhodes & Vinson, "Proving the Value of a Charitable Donation May Be the Least of Your Problems," 115 *J. Tax'n* 81 (Aug. 2011), discussing especially *Boltar v. Commissioner, 136* T.C. 326, 335 (2011) (conservation easement affecting land), in which the court, speaking of appraisers, lamented "their willingness to use their resumes and their skills to advance the position of the party who employs them without regard to objective and relevant facts, contrary to their professional obligations," announced that it would not consider "absurd expert opinions," stated that "the cottage industry of experts who function primarily in the market for the tax benefits should be discouraged," and refused to accept a proffered appraisal because "the expert report is so far beyond the realm of usefulness that admission is inappropriate." The Tax Court's *Scheidelman* holding was overturned on appeal, the Second Circuit holding that the subject appraisal, however unconvincing it might be, "accomplishes the purpose of the reporting regulation: It provides the IRS with sufficient information to evaluate the claimed deduction and deal more effectively with the prevalent use of overvaluations." *Scheidelman v. Commissioner,* 682 F.3d 189, 198 (2d Cir. 2012) (internal quotation marks omitted). Based on the appellate court's ruling, the Tax Court reconsidered its holding in *Friedberg*. Nevertheless, the Circuit Court's ruling must not be misunderstood. Contrary to what has been reported, the appellate court held only that the submitted document was a "qualified appraisal," not that the only thing left to be determined was the amount of a necessarily allowable deduction.

61. *Scheidelman v. Commissioner,* 682 F.3d 189, 196-97 (2d Cir. 2012).

62. *Scheidelman v. Commissioner,* 682 F.3d 189, 199 (2d Cir. 2012).

63. *See* Miller, "Boondoggle or Bonanza? Some Thoughts for a New York City Condominium Considering the Donation of a Façade Easement," 28 *Tax Mgmt. Real Est. J.* 167, 176 (2012) (footnote omitted). The method that Mr. Drazner employed is discussed at 5.3, below.

64. *Scheidelman v. Commissioner,* T.C. Memo 2013-18.

65. §170(h)(4)(B)(iii).

66. §170(f)(13).

67. Regs. §1.170A-13.

68. As a separate matter, any allowable deduction is of course subject to all the usual limitations on the amount of a charitable deduction that may be taken into account in any one taxable year of the donor. *See* §170(b).

69. In theory, a taxpayer can pay an asserted deficiency and then sue for a refund, in which event the litigation would ordinarily have to take place either in the U.S. District Court or in the U.S. Court of Federal Claims and not in the Tax Court. However, it is very unlikely that the donor of a sizable challenged conservation easement deduction would take the refund route, and the Tax Court is the only forum open to a taxpayer prior to payment. In any event, there is no reason to believe that the outcome would be different in either of the other courts. Appeals from all of those courts lie to the appropriate Circuit Court of Appeals.

70. *See, e.g., Simmons v. Commissioner,* T.C. Memo 2009-208 (smaller-than-claimed deduction allowed), *aff'd on other issues,* 646 F.3d 6 (D.C. Cir. 2011).

71. *See, e.g., Gorra v. Commissioner,* T.C. Memo 2013-254.

72. *See, e.g., Boltar v. Commissioner,* 136 T.C. 326 (2011) (conservation easement affecting land).

73. Congress has been known to do such a thing. As a well-known example, a taxpayer can donate appreciated investment securities and thereby obtain a deduction for the full value, without recognizing any built-in gain.

74. *Whitehouse Hotel LP v. Commissioner,* 615 F.3d 321, 328 (5th Cir. 2010).

75. *See, e.g.*, *Scheidelman v. Commissioner*, 682 F.3d 189, 196 n. 6 (2d Cir. 2012) ("The appraisal [relied in part on] a government-published article (the 'Primoli article') reporting that 'Internal Revenue Service engineers have concluded that the proper valuation of a façade easement should range from approximately 10% to 15% of the value of the property.' *** The article Drazner relied on, 'Façade Easement Contributions' by Mark Primoli, was written as part of an IRS program focusing on specialized areas of tax law. The Primoli article, in turn, had relied upon a 1994 IRS 'Audit Technique Guide,' used to train tax examiners but not intended to set IRS policy. In 2003 both

the Audit Technique Guide and a revised version of Primoli's article omitted any reference to the ten to fifteen percent range for fear the numbers were being misconstrued."); *Commissioner v. Simmons, 646* F.3d 6 (D.C. Cir. 2011) ("In doing the appraisals, [the taxpayer's appraiser] had relied upon an article prepared by Mark Primoli, an IRS employee, which stated, 'Internal Revenue Service Engineers have concluded that the proper valuation of a façade easement should range from approximately 10% to 15% of the value of the property.' Internal Revenue Service, *Façade Easement Contributions (2000).").*

76. *See* Wooldridge, Levitt, Rhodes & Vinson, "Proving the Value of a Charitable Donation May Be the Least of Your Problems," 115 *J. Tax'n* 81 (Aug. 2011).

77. *1982 East, LLC v. Commissioner,* T.C. Memo 2011-84.

78. *See, e.g., Kaufman v. Shulman,* 687 F.3d 21, 23 , 32 (1st Cir. 2012); *Scheidelman v. Commissioner,* 682 F.3d 189, 193 (2d Cir. 2012); *Dunlap v. Commissioner,* T.C. Memo 2012-1; *Friedberg v. Commissioner,* T.C. Memo 2011-238, *supplemented,* T.C. Memo 2013-224; 1982 *East, LLC v. Commissioner,* T.C. Memo 2011-84, n. 8.

79. CCA 200738013. To the same effect is CCA 200943033 ("The fair market value of an easement should not be determined by applying a percentage reduction to the value of the underlying property before the easement. The IRS does not accept this percentage reduction as a method of valuing an easement.").

80. *Whitehouse Hotel LP v. Commissioner,* 615 F.3d 321, 329 (5th Cir. 2010).

81. Regs. §1.170A-14(h)(3)(i).

82. In a ruling that seems rather strange, the Fifth Circuit, reversing the Tax Court on this point, held that the regulation required that the determination of the "after" value had to take into account the pending *diminution* in the value of an adjacent (but not eased) parcel owned by the donor, the reason being that the donor had formed the intention of burdening the adjacent parcel by, according to the appellate court, "convert[ing] the [burdened and adjacent parcels] into a single indivisible condominium unit." "The easement's not burdening the [adjacent parcel] does not," the court said, "render that building irrelevant for easement-valuation purposes, because the relevant determination is the *effect* of the easement on the fair market value of the entire contiguous property owned by [the donor]." The Tax Court erred, the Fifth Circuit said, by "limit[ing] its inquiry to whether the easement legally bound the [adjacent parcel]; it merely considered a snapshot of the property's legal status as at the date of conveyance." Rather, the appellate court continued, "the tax court should have considered the easement's effect on fair market value in the light of the imminent legal and functional consolidation of the two buildings. In other words, the tax court was correct that, because, on the day of donation, the condominium regime was not yet in effect, a successor could have purchased the [adjacent parcel] separately that day and would not have been bound by the easement; but, *as a matter of valuation,* the tax court erred by not considering the effect on market value of the buildings' pending combination." *Whitehouse Hotel LP v. Commissioner,* 615 F.3d 321, 325, 338-39 (5th Cir. 2010) (emphasis in original), *rev'g on this point* 131 T.C. 112 (2008).

83. The regulations also sensibly provide for an intermediate case, saying that "if the donor or a related person receives, or can reasonably expect to receive, a financial or economic benefit that is substantial, but it is clearly shown that the benefit is less than the amount of the transfer, then a deduction under this section is allowable for the excess of the amount transferred over the amount of the financial or economic benefit received or reasonably expected to be received by the donor or the related person." Regs. §1.170A-14(h)(3)(i).

84. Regs. §1.170A-14(h)(3)(ii). As noted at 4.6, above, the taxpayer must include with his return a "qualified appraisal," and must also complete and file a Form 8283, together with a number of required attachments. The form must be signed by the taxpayer, the appraiser, and the donee.

85. *Dunlap v. Commissioner,* T.C. Memo 2012-126; *1982 East, LLC v. Commissioner,* T.C. Memo 2011-84; *see* CCA 200943033 ("It is possible that the grant of an easement will have no significant effect on the value of the property, particularly if the easement is not more restrictive than local ordinances already in effect.").

86. *See Dunlap v. Commissioner,* T.C. Memo 2012-126 (easement in question had little value because the affected building was one that the local agency was especially vigilant in monitoring).

87. Regs. §1.170A-14(h)(3)(ii).

88. Two things about this statement are noteworthy: (1) contrary to what it suggests, it would seem that, by reducing the "after" value, such restrictions would actually *increase* the easement's "value," and (2) the cited portion of the regulations does not exist.

89. *See, e.g., Gorra v. Commissioner,* T.C. Memo 2013-254 ("Ordinarily, any encumbrance on real property, however slight, would tend to have some negative effect on the property's fair market value.…We do not find respondent's expert report credible insofar as it maintained that an easement would have absolutely no effect on the fair market value of a valuable piece of real estate."); *Dunlap v. Commissioner,* T.C. Memo 2012-126 ("Respondent's experts each appraised the Cobblestone façade easement at zero."); *Simmons v. Commissioner,* T.C. Memo 2009-208 ("Respondent's experts did not find any change in the fair market value of either property as a result of the granting of the easements."), *aff'd on other issues,* 646 F.3d 6 (D.C. Cir. 2011); *Clemens v. Commissioner,* T.C. Memo 1992-436 ("In the notice of deficiency…, respondent assigned a value of $110,000 to the easement in question, yet in these proceedings respondent's expert has taken the primary position that the easement had no value....").

90. *See, e.g.*, *Dunlap v. Commissioner,* T.C. Memo 2012-126 (citations omitted) ("Any encumbrance on real property, however slight, would ordinarily tend to have some effect on that property's fair market value. Even a nominal encumbrance that is placed by the current owner of the property would, at the very least, deprive a subsequent owner of the opportunity of placing a similar encumbrance on that property."); *Simmons v. Commissioner*, T.C. Memo 2009-208 ("We do not find [the IRS's] expert reports credible insofar as they maintain that an easement would have absolutely no effect on the fair market value of valuable real estate."), *aff'd on other issues,* 646 F.3d 6 (D.C. Cir. 2011).

91. In *Dunlap v. Commissioner,* T.C. Memo 2012-126, the court ruled against the taxpayers because they "failed to provide sufficient credible evidence with respect to the fair market value of the façade easement to meet their burden of proving entitlement to their claimed charitable contribution deductions," so that the taxpayers "failed to meet their burden of proving that the value of the Cobblestone façade easement was greater than zero."

92. *See, e.g.*, *Dunlap v. Commissioner,* T.C. Memo 2012-126; *Friedberg v. Commissioner,* T.C. Memo 2011-238, *supplemented,* T.C. Memo 2013-224.

93. *Gorra v. Commissioner,* T.C. Memo 2013 254 (finding a 2% diminution (as opposed to the 9% claimed) and sustaining a "gross valuation misstatement" penalty).

94. 615 F.3d 321 (5th Cir. 2010), *vacating and remanding* 131 T.C. 112 (2008).

95. 615 F.3d at 329, quoting from Regs. §1.170A-14(h).

96. 615 F.3d at 341. Referring to those guidelines, the third judge on the panel objected to "the extended discussion" because in his view "it is dicta and amounts to an impermissible advisory opinion." *Id.* at 343.

97. *Whitehouse Hotel LP v. Commissioner,* 139 T.C. No. 13 (2013).

98. 646 F.3d 6 (D.C. Cir. 2011), *aff'g* T.C. Memo 2009-208.

99. 646 F.3d at 9.

100. 682 F.3d 189 (2d Cir. 2012), *vacating and remanding* T.C. Memo 2010-151.

101. 682 F.3d at 199.

102. *See id.* at 196.

103. 687 F.3d 21 (1st Cir. 2012), *vacating in part and remanding* 136 T.C. 294 (2011).

104. *Kaufman v. Shulman*, 687 F.3d 21, 23, 30 (1st Cir. 2012). It also noted that "Whether the deduction claimed by the Kaufmans exceeded fair market value was not decided by the Tax Court." 687 F.3d at 30.

105. *Kaufman v. Shulman*, 687 F.3d 21, 32 (1st Cir. 2012), citing IRS News Releases IR-2006-25 (2/7/06) and IR-2005-19 (2/28/05).

106. *Kaufman v. Shulman*, 687 F.3d 21, 32 (1st Cir. 2012).

107. *Kaufman v. Shulman*, 687 F.3d 21, 32-33 (1st Cir. 2012) (citations and footnote omitted).

108. *Kaufman v. Shulman*, 687 F.3d 21, 30 (1st Cir. 2012).

109. *Kaufman v. Shulman*, 687 F.3d 21, 31 (1st Cir. 2012).

110. *Id.*

111. *Kaufman v. Shulman*, 687 F.3d 21, 23-24 (1st Cir. 2012).

112. *Kaufman v. Shulman*, 687 F.3d 21, 31 (1st Cir. 2012) (emphasis by the court).

113. *Kaufman v. Shulman*, 687 F.3d 21, 31 (1st Cir. 2012).

114. *Id.*

115. *Id.* at n. 8 (emphasis added).

116. *Kaufman v. Shulman*, 687 F.3d 21, 32 (1st Cir. 2012) (emphasis added).

117. Regs. §1.170A-14(h)(3)(iii).

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Sandy, One Year Later: Issues Facing Property Owners

By Adam Leitman Bailey and Dov Treiman

Real estate lawyers have been and will be the leaders of the rebuilding process of our storm-torn city. One of our most important functions is to prepare for the next storm or potential casualty. In order to improve our lawyering it is essential that we learn the lessons from the storm. For this we turn to the Sandy-related real estate cases on commercial leasing, insurance coverage and other related issues.

There are, in total, five reported real estate decisions that have come down in the aftermath of Superstorm Sandy: two of them landlord-tenant; one of them regarding negligence liability for a fallen crane; one for utility liability for failed power; and one for construction of an insurance policy. Additionally there are seven complaints on file, six of them construing insurance policies and one suing a landlord for alleged negligence. These suits, both completed and pending, can provide useful instruction for the kinds of actions a landowner must take to prepare for the next natural or civil disaster to afflict New York City.

Landlord-Tenant Litigation

In landlord-tenant litigation resulting from storm damage, focus comes first on Real Property Law §227, a provision that overrides the common law so as to allow a tenant to break a lease or tenancy and surrender the premises in the event of disaster.[1] This provision comes into play relatively rarely as, by its terms, it is waivable if the parties arrive at some other agreement. All standard form leases waive this provision and so do nearly all hand-crafted attorney drawn commercial leases. The statute therefore has only a very small body of modern case law. Instead, the case law focuses on the so-called casualty clauses of modern leases.

The most widely available commercial lease forms, those of the Real Estate Board of New York (REBNY), have a common law construing their casualty clause found at Article 9, stating "Destruction, Fire and Other Casualty.… If damaged by fire or other casualty...Tenant shall give immediate notice thereof to Owner and lease shall continue in full force and effect except..."[2] New York's leading case *Vermont Teddy Bear v. 538 Madison Realty*,[3] which construes Article 9 and its complex mechanism for suspending the rent or terminating the lease in the event of casualty. However, neither Article 9, *Vermont Teddy Bear*, nor any other New York case defines just what a casualty is. Rather, under the structures of Article 9, there is no casualty at least until one of the parties to the lease declares there to have been one.

What Is a Casualty?

In *4261 Realty v. DB Real Estate*,[4] Sandy substantially damaged the premises. The question of giving notice under Article 9 was *4261*'s major focus. The notice the tenant gave to the landlord conformed to the lease requirements except as to being "return receipt requested." The Court in *4261* excused that deficiency and held the notice sufficient under the circumstances.[5] The landlord was shown to have actually received the notice and the court also spoke of exigent notice being allowed in exigent circumstances.

However, long before Sandy, *Milltown Park v. American Felt & Filter*[6] had required the notice precisely as defined by the lease in spite of tenant's claim that the landlord had actual knowledge.[7] Thus, the ruling in *4261* is questionable.

The other focus in *4261* centered around landlord's claim that the premises never became wholly unusable so as to trigger a rent abatement and the tenant's claim to the contrary. If the premises were merely rendered partly unusable, then, according to the court, the tenant would be entitled to no abatement. The decision in *4261* denied summary judgment; the court found a triable issue of fact on whether the premises were rendered wholly unusable or merely partially so.[8]

Maiden Lane Properties v. Just Salad Partners[9] is also a case construing Article 9 of the REBNY lease where the tenant gave no Article 9 notice at all, but still claimed the benefits of Article 9's rent abatement allowances.[10] Even more damning to the tenant's position in *Just Salad*, the tenant's claim was entirely based on loss of electricity, tenant's exclusive responsibility under the lease.[11] Weeks of no public utility-provided electricity inspired the tenant to claim an abatement of the rent.[12] The core of the tenant's claim was that as the landlord had supplied (via free standing generators) electricity to its residential tenants, it should also have provided electricity to its commercial tenant, Just Salad.

Given the absolute absence of notice under Article 9, together with the lease's specific exculpation of the landlord from responsibility for electricity, the tenant's loss in a suit focused entirely on failure to provide electricity was essentially inevitable. The lease in question even released the landlord for liability for its own failures to provide electricity except in cases of gross negligence or willful misconduct.

Constructive Eviction

In *Just Salad*, the tenant sought to have the rent abated by reason of "constructive eviction," a situation in which the landlord's upkeep of the premises is so badly performed that the tenant is compelled to abandon all or part of the premises.[13] Key to the concept of constructive eviction, however, is fault on the part of the landlord. Mere happenstance is not fault. In *Barash v. Pennsylvania Terminal Real Estate*, the Court of Appeals set the standard for constructive eviction, writing, "[o]n the other hand, constructive eviction exists where, although there has been no physical expulsion or exclusion of the tenant, the landlord's wrongful acts substantially and materially deprive the tenant of the beneficial use and enjoyment of the premises."[14]

Thus, for a tenant to claim constructive eviction, mere casualty to the premises is insufficient. There must also be proof of the landlord's wrongful acts. Thus, the *Just Salad* court saw no need to even mention constructive eviction in its decision.

Reasonable Preparation

While there have been no Sandy-related decisions that have come down on what a landlord should do to prepare for a storm, one complaint that has been filed shows the kind of claims that landlords have to face on the subject.

In *Manfra, Tordella & Brookes v. 90 Broad Owner*, plaintiff-tenant's theory is that the landlord was liable for neglecting to take supposedly reasonable precautions against flooding caused by Superstorm Sandy such as window boarding and sandbagging.[15]

Among the allegations of the complaint were:

> 32. "Because of its history of flooding and location in low-lying Zone A, Defendant was well-aware that 90 Broad in general, and MTB's offices in particular, were highly susceptible to flooding and would likely experience severe flooding in the event of a major storm, such as Hurricane Sandy."[16]
>
> 37. Defendant was thus fully aware, and warned of the potential flooding that would occur as soon as Sandy made landfall. Despite this knowledge, and expectation of storm-related flooding, Ms. Arce's email did not include any information regarding any steps Defendant took or would take to prevent or at the very least, mitigate, the potential damage to the Building from storm-related flooding.[17]

Some of the preparations our clients have made or are in the process of making include moving facilities higher, encapsulating utilities and lines with waterproof materials, and upgrading their facilities to be more storm resistant or building a barrier preventing water from entering the building. Of course, all of this has been accomplished as a result of Sandy.

Insurance Litigation

Cashew Holdings v. Canopius U.S. Insurance, the only reported decision in Sandy-based insurance law, started in Queens Supreme Court. The case was removed to the Federal District Court where the insured sought a preliminary injunction requiring payment on the insurance policy as a result of Superstorm Sandy and holding the insurance policy in place.[18]

The court found lack of irreparable injury and a lack of likelihood of success as the policy excluded damage due to flood or other causes linked to water precluded issuance of a preliminary injunction.[19] The policy covered wind damage, therefore defining the limits of the insurer's liability. Thus, the court denied the plaintiff a preliminary injunction.[20]

Aside from the preliminary injunction issues, the decision was very much a battle of the experts as to whether plaintiff suffered its damages from the water or the wind. Since typically insurance policies cover for wind, but not for water, that determination is crucial.[21] However, in *Cashew Holdings* the decision was on a preliminary finding of lack of probable success and therefore did not ultimately determine for the case whether the theories of water or wind would eventually prevail.[22]

The court also found that the insurer was under no obligation to renew the insurance policy.[23] The lesson from this case is that the consumer or business should not only be extremely careful in selecting insurance policies, but should be prepared for vastly larger premiums in order to purchase more exotic policies once there is an insurance recovery because of damage from a large-scale storm.

Since *Cashew Holdings* is the only reported Sandy decision on the subject of insurance, there is value in looking at the reported complaints on the subject. Of course, anyone can plead anything, but examination of these complaints is nonetheless instructive in the kinds of issues we can expect to see in the aftermath of a major storm. In *Neptune Food v. Federal Insurance*, for example, an insured sued for business losses caused by Superstorm Sandy.[24] The controversy of the case centered around clauses in the insurance policy dealing with covered perils worsened by uncovered perils. Here, the covered peril is wind and the uncovered peril, water.

In *Bamundo v. Sentinel*, a law firm sought to collect on its loss of business insurance on the theory that its business was shut down by civil authorities that ordered transportation systems shut down and refused the employees of the firm access to their offices.[25] The insurance companies disclaimed coverage, finding that it was not civil authority that shut down the business, but loss of electricity.[26]

In *Lester Schwab v. Great Northern*,[27] (see complaint), *Newman Myers v. Great Northern*,[28] and *Shapiro v. National Fire*,[29] various law firms allege that their respective insurance carrier breached their insurance policies. Each plaintiff entered into an insurance policy with each respective defendant, insuring the plaintiff against any loss of business income it may sustain and against any extra expenses it may incur as the result of a loss to the subject premises by a "covered peril." In these three otherwise unrelated cases, plaintiffs seek to recover for the loss of electricity on the theory that it was caused not by water, but by the explosion at the ConEd plant.[30] Each insurer is claiming that the loss of electricity was due not to the explosion, but to the flooding that destroyed the electrical infrastructure.[31]

Loss of electricity was also the issue in *Just Salad*, *supra*, but there the lease specifically cast all responsibility for the electricity on the tenant.[32] The court therefore rejected the *Just Salad* tenant's purported defense to rent based on the loss of electricity.[33] Underlying all this was the understanding that the tenant should have insured against this loss instead of looking to the landlord.

Utilities

Utilities have always enjoyed special legal protections. This is no more evident than in *Balacki v. Long Island Power Authority*, a small claims case in which the claimant sued in small claims court for loss of food due to loss of refrigeration due to the extended loss of power in the aftermath of Superstorm Sandy.[34] The court found clear evidence that the Power Authority was negligent.[35] However, prevailing case law exempts a power utility from liability for loss of electricity if the published rates claim such an exemption for mere negligence, as opposed to gross negligence.[36]

Quoting the Moreland Commission that had investigated what went wrong with Sandy and why, the court wrote, "Hurricane Sandy was a unique storm which caused an unprecedented interruption of service to LIPA customers." The resulting "power outage" was "inevitable" and was on a scale which would take days for restoration under optimal conditions."[37]

According to the court, it was unable to find gross negligence because under its reading of the case law, "gross negligence" entails the failure to exercise even slight care.[38] Holding that the entirely inadequate precautions of the utility did not rise to that level, it dismissed the complaint.[39]

Conclusion

Because it is impossible to know precisely what the risks will be, attorneys drafting the necessary documents must use both the experience of the past and imaginings of the future to prepare for the worst.

For the landlord, long-term preparation for a storm of any kind must include careful drafting of the lease so as to allocate the risks of the storm to the tenant. For the tenant who typically must accept most of the lease as written, the chief corresponding preparation is getting appropriate insurance policies, covering both the costs of making physical repairs to the premises and the loss of business that can be occasioned by forces entirely exterior to the premises such as loss of electricity, Internet, or potable water.

Endnotes

1. *See* N.Y. Real Prop. Law § 227 (McKinney 2013).
2. *See* 4261 Realty Holding LLC v. DB Real Estate Assets II, LLC, 2013 WL 4437198, 40 Misc.3d 1229, 1231.
3. Vermont Teddy Bear Co., Inc. v. 528 Madison Realty Co., 1 N.Y.3d 470 (2004), 807 N.E.2d 876, 775 N.Y.S.2d 765.
4. 4261 Realty Holding LLC, 2013 WL 4437198, 40 Misc.3d 1229.
5. *Id.*
6. 180 A.D.2d 235, 584 N.Y.S.2d 927 (3d Dept. 1992).
7. Milltown Park v. American Felt & Filter, 180 A.D.2d 235, 584 N.Y.S.2d 927 (3d Dept. 1992).
8. 4261 Realty Holding LLC, 2013 WL 4437198, 40 Misc.3d 1229.
9. Maiden Lane Props. v. Just Salad Partners, 2013 N.Y. Misc. LEXIS 2647, at *4 (N.Y. Civ. Ct. 2013).
10. *Id.*
11. *Id.*
12. *Id.*
13. *Id.* at *6-8.
14. Barash v. Pa. Term. Real Estate Corp., 26 N.Y.2d 77, 83 (N.Y. 1970).
15. Complaint at 1, Manfra v. 90 Board, 2013 WL 373327 (N.Y. Sup. Ct. 2013) (No. 0150926-2013).
16. *Id.* at 32.
17. *Id.* at 37.
18. Cashew Holdings v. Canopius U.S. Ins., 2013 WL 4735645, at *1 (E.D.N.Y. 2013).
19. *Id.* at *3-5.
20. *Id.* at *6.
21. Water Damage, Flooding, and Your Homeowners Policy, http://www.independentinsuranceassociates.com/our-blog/water-damage-flooding-homeowners-policy (last visited Jan. 19, 2014).
22. Cashew Holdings v. Canopius U.S. Insurance, No. 13–CV–4528 (ERK)(SMG), 2013 WL 4735645, at *1, *1 (E.D.N.Y. Sept. 3, 2013).
23. *Id.* at *5.
24. Complaint and Jury Demand at 1, Neptune Food Corporation v. Federal Insurance Company, 2013 WL 3423065 (E.D.N.Y. Jun. 24, 2013). (No. 1:13CV03552).
25. Bamundo, Zwal & Schermerhorn, LLP v. Sentinel Insurance Company, Ltd. et al., 2013 WL 5416999 (S.D.N.Y. Sept. 20, 2013) (No. 1:2013cv06672).
26. *Id.*
27. Lester Schwab v. Great Northern, NY County Index #157622 (2013).
28. Newman Myers Kreines Gross Harris, P.C. v. Great Northern Insurance Company (S.D.N.Y. Apr. 2, 2013) (1:2013cv02177).
29. Shapiro v. National Fire, NY County Index #650037/2013.
30. Christine Simmons, Law Firm Sues Insurer for Denying Sandy Losses, New York Law Journal (Aug. 7, 2013, 12:00AM), http://www.newyorklawjournal.com/id=1202614153271/Law-Firm-Sues-Insurer-for-Denying-Sandy-Losses#ixzz2qyyVjGmv.
31. *Id.*
32. 056312/13, NYLJ 1202598292879, at *6 (Civ NY Schecter).
33. *Id.* at *8.
34. 40 Misc.3d 1220 (Dist. Nas. 2013).
35. *Id.*
36. *Id.*
37. *Id.*
38. *Id.*
39. 40 Misc.3d 1220 (Dist. Nas. 2013).

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Bergman on Mortgage Foreclosures: Mayhem with the Attorney's Affirmation—and a Scary Decision

By Bruce J. Bergman

This is not an issue for commercial mortgage loans, but in the residential arena, lenders and servicers—and conspicuously their lawyers—know about the attorney affirmation needed in New York home loan foreclosures. A foreclosure action cannot proceed unless an affirmation by plaintiff's counsel is submitted attesting to the accuracy of the plaintiff's documents. (AO 548/10 amended by AO 431/11.) The purpose of the affirmation was to assure courts that all was truly in order and that goal seemed reachable if attorneys had to join in swearing to the bona fides of the plaintiff. But it was not designed to become a trap to avoid the ability to foreclose, which in some instances it has become, as a chilling recent case reveals. [*Aurora Loan Services v. Sobanke*, 101 A.D.3d 1065, 957 N.Y.S.2d 379 (2d Dept. 2012)].

Here is the tale. This began as an ordinary case. The foreclosure was instituted; no defendant answered. (Thus there were no defenses.) There being no answers, the plaintiff submitted an order to appoint a referee—the usual next step in the case. The court responded, however, stating that the order could not be considered, and no referee would be appointed, unless within sixty days the plaintiff submitted the "attorney affirmation." The court also decided that if the affirmation was not filed within sixty days, not only would the order of reference be denied, but the complaint would be dismissed as well. (Editorially we could inquire as to where the authority for such a position came from.)

Experience suggests that for many reasons, it can be time consuming to obtain the information necessary and locate the proper parties to prepare the attorney affirmation. It can be surmised that such is what occurred in this case and, facing some delay in being able to prepare the attorney's affirmation, the plaintiff's counsel took the rational step, prior to expiration of the court manufactured deadline, to withdraw its order of reference. This would have then allowed the firm to get the information required for the affirmation.

Instead of responding to the request to withdraw the order of reference, however, and just after the sixty-day deadline had passed, the court, on its own, ordered that the complaint be dismissed—*with prejudice*—and that the notice of pendency be cancelled. This all meant that the mortgage holder could never foreclose the subject mortgage, even though it was undeniably in default and no one had assaulted the legitimacy of the mortgage or the actuality of the default.

Upon appeal, the offending court order was reversed. The Second Department cited the rule that a court's power to dismiss a complaint on its own must be used sparingly and then only when extraordinary circumstances exist to warrant dismissal of a case. (Citing *U.S. Bank, N.A. v. Emmanuel*, 83 A.D.3d 1047, 1048, 921 N.Y.S.2d 320).

Mindful of that principle, and finding that there were no extraordinary circumstances supporting dismissal of the complaint with prejudice and cancellation of the notice of pendency, the appellate division found the trial court to be in error. There was, it found, no delinquent conduct on the part of the foreclosing party's counsel, nor was there any evidence of a pattern of willful noncompliance with court ordered deadlines. Instead, the attorneys had simply requested an opportunity to withdraw its proffered order of reference within the sixty-day deadline so that time could be garnered to respond to the request for the attorney's affirmation.

This is yet another example of a foreclosing plaintiff apparently prevailing—in the end—but at the cost of first facing a shocking order and then being constrained to incur the cost and the time of an appeal.

Mr. Bergman, author of the three-volume treatise, *Bergman on New York Mortgage Foreclosures*, LexisNexis Matthew Bender, is a member of Berkman, Henoch, Peterson, Peddy & Fenchel in Garden City. He is a fellow of the American College of Mortgage Attorneys and a member of the American College of Real Estate Lawyers and the USFN. His biography appears in Who's Who in American Law and he is listed in Best Lawyers in America and New York Super Lawyers.

Real Property Law Section Professionalism Award

Over the years the Real Property Law Section has honored individual real estate practitioners with its Professionalism Award.

Some of the criteria which are used to identify an individual are as follows:

1. The nominee possesses in her/his practice a continuing civility and appreciation for others.
2. The individual possess an outstanding level of competence—legal ability—and achievement.
3. The nominee has in her/his practice made a strong contribution to the development of the practice of law, the improvement of the practice of law, particularly in the field of education—frequent lectures in CLE programs—writings—publications.
4. The nominee over the years has engaged in mentoring of younger attorneys.
5. The nominee has involved herself/himself in Bar activities, both on the local level and the State level, holding positions as an officer or chairing committees, etc.
6. The nominee has been a voice on legal issues.
7. The nominee has throughout his/her career maintained the highest ethical standards.

We are reaching out to you in seeking nominations of individuals who fulfill the ideals listed above. We are hopeful that we can identify outstanding real estate practitioners throughout the State, thereby bringing recognition to these individuals and to their locale.

We have no forms. We do ask that we receive a letter of recommendation and will certainly entertain additional letters and of course endorsements by local county bar associations.

Thank you for your attention to this matter.

Letters, endorsements, etc. should be mailed to :

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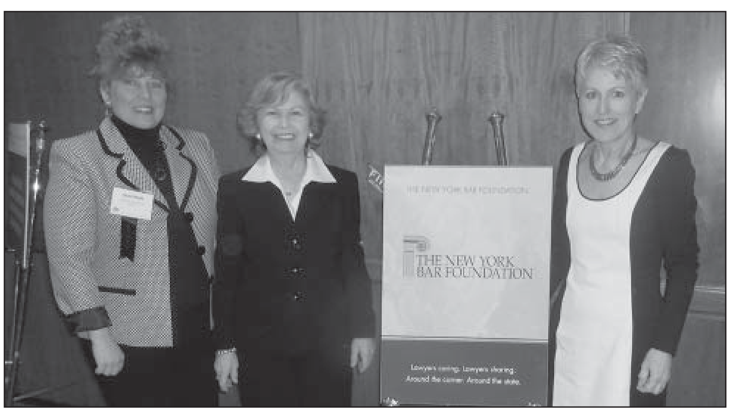
Real Property Law Section

Annual Meeting

Thursday, January 30, 2014
New York Hilton Midtown

Michael J. Berey of the First American Title Insurance Co. (center, holding certificate) was the recipient of the Real Property Law Section Professionalism Award.

Mindy Stern (left) and Joel Sachs (right) with Lorraine Power Tharp Scholarship Winner Leanne Welds from Brooklyn Law School and Mel Mitzner Scholarship Winner Edward Hyde Clarke from Albany Law School.



Rosalyn Mitzner (center) presents a check for $10,000 to Cristine Cioffi (right) and Deborah Auspelmyer (left) of the New York Bar Foundation.

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Articles should be submitted in electronic document format (pdfs are NOT acceptable) and include biographical information.

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For ease of publication, articles should be submitted via e-mail to any one of the Co-Editors, or if e-mail is not available, on a CD, preferably in Microsoft Word or WordPerfect (pdfs are NOT acceptable). Accepted articles fall generally in the range of 7-18 typewritten, double-spaced pages. Please use endnotes in lieu of footnotes. The Co-Editors request that all submissions for consideration to be published in this *Journal* use gender-neutral terms where appropriate or, alternatively, the masculine and feminine forms may both be used. Please contact the Co-Editors regarding further requirements for the submission of articles.

Unless stated to the contrary, all published articles represent the viewpoint of the author and should not be regarded as representing the views of the Co-Editors, Board of Editors or the Section or substantive approval of the contents therein.

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