

MAY 2011

TRUSTEE RESPONSIBLE FOR LOSS IN CRAT VALUE

*Investments violated prudent investor rules,
resulting in greatly diminished remainder.*

A testamentary charitable remainder annuity trust created in 1984 was to pay 6% to Susan Cole for her life. The remainder was to pass to the Los Angeles County Museum of Art, to purchase Japanese and Chinese art. The trust was initially funded with \$1.3 million. In 2001, Michael Schiff became the successor trustee. At the time, Cole was in her mid-60s and had a life expectancy of 26 years.

Schiff was requested to provide annual letters for auditing the market values of trusts naming the Museum as beneficiary. In 2001, the trust had \$437,101 in cash, \$417,563 in equities and \$78,288 in debt securities. The Museum calculated that the present value of the remainder interest was about \$25,000. In his 2002 letter, Schiff enclosed an FMI LLC Short Form Investment Management Contract, indicating that there were no periodic statements, but the investment paid 12.54% annually in quarterly payments for at least 28 consecutive quarters. At the end of that time, the full \$650,000 investment was to be returned. Schiff's 2003 letter contained the same information. In 2004, his letter said it had been necessary to renegotiate the FMI investment by taking a promissory note from DollarWorks, Inc. to FMI in the amount of \$650,000, together with interest. The principal and interest, due in August 2008, was secured by 157,500 shares of DollarWorks stock. The Museum was informed that, because of the shortfall in interest over the original 12.54% rate, it would be necessary to pay Cole's annuity from trust principal.

In 2006, Cole renounced her life income interest in the trust, assigning it to the Museum. When the Museum learned that the assets would be distributed outright, it requested information about the value of the trust. In 2007, the Museum asked the court for a formal accounting and for a surcharge, alleging that Schiff had breached his duty to invest and manage trust assets. The Museum said the FMI and DollarWorks investments violated the prudent investor rules, resulting in losses. The Museum received \$39,000 in interest payments on the promissory notes, which ceased after October 2007. The total amount received by the Museum, including the interest, was less than \$80,000. Schiff argued that the Museum's action fell outside the three-year statute of limitations period. The Museum had actual notice of the investments based on his 2002 letter, nearly five years prior to when it filed suit, he claimed.

The trial court found that Schiff had breached his duty by violating the prudent investor rules, for failing to diversify the trust's investments. It ordered him to pay damages of \$532,701, which excluded the interest earned after the trust distribution. The Court of Appeals of California affirmed, noting that the limitations period arises when sufficient information is received to put a beneficiary on notice of a claim. Neither the 2002 nor 2003 letters, nor the FMI contract, put the Museum on notice. Both letters had assured the Museum that the contract was performing and paying quarterly interest. The Museum was led to believe that trust assets were "guaranteed and secured," said the court. It wasn't until the 2004 letter that the Museum had any reason to suspect trust mismanagement (*Museum Associates v. Schiff*, No BP067911).

EASEMENT DEDUCTIONS TAKE A BEATING

Tax Court looks at substantiation, perpetuity issues in rejecting donors' positions.

The Tax Court has been busy lately reviewing deductions claimed for charitable facade easements and conservation easements. The results have not been favorable for donors.

***Schrimsher v. Comm'r.*, T.C. Memo. 2011-71**

In December 2004, Randall Schrimsher executed a preservation and conservation easement agreement, granting a facade easement for the "Times Building" in Huntsville, Alabama to the Alabama Historical Commission. The agreement provided that, in consideration for "TEN DOLLARS, plus other good and valuable consideration," Schrimsher conveyed a preservation and conservation easement in perpetuity. Language also provided that the agreement "sets forth the entire agreement of the parties."

Schrimsher claimed a charitable deduction of \$705,000, part of which was carried forward to later years. The IRS disallowed the deduction, claiming that Schrimsher failed to satisfy the substantiation requirements of Code §170(f)(8) and, alternatively, had failed to establish the fair market value of the easement, as required under Code §170(f)(11). The donor's Form 8283 omitted several items of required information and was not signed or dated by the donor, the appraiser or a representative of the donee.

The Tax Court noted that charitable contributions of more than \$250 must be substantiated with a contemporaneous written acknowledgment from the donee organization. The acknowledgment must include the amount of cash or a description of any noncash property, and must state whether any goods or services were received in consideration. If goods or services were provided by charity, the acknowledgment must give a good faith estimate of the value. Schrimsher argued that the facade easement agreement constituted a contemporaneous acknowledgment. The IRS did not dispute that the agreement was a contemporaneous acknowledgment, but said that it failed to state whether any goods or services were received. The reference to "ten dollars and other good and valuable consideration" is merely boilerplate and should be disregarded, said the IRS. Schrimsher said that it was clear that the agreement was the "entire agreement," and that no cash or compensation was exchanged.

The court found that even if the historical commission provided no consideration for

Schrimsher's contribution, "the written acknowledgment must say so" in order to satisfy the requirement of Code §170(f)(8)(B)(ii). The facade easement did not specifically state that no goods or services were provided. Schrimsher, therefore, was not entitled to the charitable deduction, said the court, which granted the IRS's motion for summary judgment. The court said that, because the deduction was disallowed for failure to obtain a contemporaneous written acknowledgment, it was not necessary to address the issue of the appraisal.

1982 East, LLC v. Comm'r., T.C. Memo. 2011-84

In December 2004, 1982 East LLC (1982 East) contributed a facade easement and unused development rights in a parcel of property to the National Architectural Trust (NAT). The parcel, a rectangular lot with a five-story townhouse built in 1894, was located in the Metropolitan Museum Historic District. It was subject to New York City landmark and zoning laws, which required approval from the Landmarks Preservation Commission before changes could be made to the building.

The deed of easement prohibited 1982 East from erecting new or additional exterior improvements on the property or in the open space above and surrounding the property without the consent of NAT. The easement was to run in perpetuity. It also provided that in the event the easement was extinguished through a judicial decree, NAT would be entitled to a proportionate share of the proceeds. The bank that held the mortgage on the property agreed to subordinate its rights to NAT's rights to enforce the conservation purpose of the donated property, although it maintained a prior claim to all insurance until the mortgage was satisfied.

An appraiser put the value of the facade easement and unused development rights at \$6.47 million, which the partners claimed on their individuals returns. The IRS disallowed the deduction on the grounds that the conservation purpose of the easement was not protected in perpetuity. 1982 East argued that the easement met the perpetuity requirements of Code §170(h)(5)(A) because the bank had subordinated its interest to the right of NAT to enforce the restrictions. The Tax Court agreed with the IRS that NAT was not guaranteed a proportionate share of the proceeds in the event of a casualty or condemnation until the mortgage was paid. At any point prior to that, said the court, the possibility existed that the bank could deprive NAT "of value that should have otherwise been dedicated to the conservation purpose." The court was also not convinced that NAT's rights would be protected under New York law protecting certified historic structures. The court added that it is local law and the rules of the landmarks commission that preserve the property, not the rights that NAT acquired under the deed of easement, so the donors did not satisfy the requirements of Code §170(h)(4) regarding contributions for conservation purposes.

Kaufman v. Comm'r., 136 T.C. No. 13

The Tax Court revisited this case, after granting partial summary judgment for the IRS in 2010 (*Kaufman v. Comm'r.*, 134 T.C. 182). The donors had executed a facade easement on a single-family residence located in a historic preservation district in Boston. The bank holding the mortgage on the property agreed to subordinate its rights to the property to the rights of National Architectural Trust to enforce

the easement in perpetuity. Under the agreement, the bank would have a prior claim to all insurance proceeds resulting from any casualty, hazard or accident, and to all proceeds of condemnation, until the mortgage was paid off. The court initially ruled that the contribution failed to comply with Reg. §1.170A-14(g), which requires that the easement restrictions be enforceable in perpetuity. The taxpayers asked for a rehearing, arguing that the agreement, in conjunction with the lender's agreement, complies with the regulations.

The court said it stood by its earlier ruling, noting that following any judicial extinguishment of the facade easement, NAT might not receive its proportional share of any future proceeds. The donors' failure to give NAT an absolute right to a fixed share of the post-extinguishment proceeds causes the gift to fail, said the court, adding that the transfer "failed to satisfy the enforceability-in-perpetuity requirements" of Reg. §1.170A-13(g).

***Boltar, LLC v. Comm'r.*, 136 T.C. No. 14**

Boltar, LLC granted the Shirley Heinze Land Trust, Inc., an easement restricting the use of approximately eight acres. The grant would prevent any use that would significantly impair or interfere with the conservation values of the property. Boltar claimed a deduction of \$3,245,000 relating to the easement. The donor attached a Form 8283, along with an appraisal report that claimed the owners could have built a 174-unit condominium project on the property. The appraisers determined the value by calculating the "foregone development opportunity" of the condominiums. The IRS allowed only \$42,400.

Reg. §1.170A-14(h)(3)(i) provides that, in general, the fair market value of a perpetual easement is the difference between the value of the property before the granting of the restriction and the value after the granting. The IRS argued that the donor's appraiser departed from the legal standard, "based on whatever use generates the largest profit."

The Tax Court said that while "Justice is frequently portrayed as blindfolded to symbolize impartiality," the court need not admit "absurd expert opinions." The donor's appraisal failed to take into account a utility easement running through the land, erroneously assumed that the parcel was incorporated in a city and zoned as a planned unit development and failed to consider the likelihood of annexation and rezoning to allow development of the condominium project. Even when made aware of these deficiencies, the appraisers "persisted in their position that the original appraisal was correct." The court refused to admit the appraisal, calling it "too speculative and unreliable to be useful," and adding that it was not the product of reliable methods of valuation. The court limited the deduction to the amount allowed by the IRS.

DIVORCED, BUT STILL GENEROUS

Court approves wife's request for funds to make charitable gifts.

Ronald and Gail Iskierka were in the process of ending their 23-year marriage. Each submitted a budget of anticipated post-dissolution expenses to the court. The

court approved all of Ronald's expenses, but reduced some of Gail's. The court ordered Ronald, who worked full-time, to pay permanent spousal maintenance to Gail, who worked only part-time after raising the couple's children.

One of the expenses to which Ronald objected was a \$100 per month allowance for charitable contributions in Gail's budget. He claimed that in the time since the couple first separated, Gail had made few charitable gifts.

The trial court reviewed the couple's pattern of charitable giving during their marriage and determined that the \$100 was reasonable, amounting to only about 2% of Gail's monthly income. While married, the couple regularly contributed to their church and strove to give 10% of their income when funds were available. The Court of Appeals of Minnesota agreed with the trial court, saying it found the giving history "a sound basis" for including the amount in Gail's budget. The court added that the standard of living while the couple were married, not Gail's giving pattern during their separation, was the relevant measure (*In re the Marriage of: Iskierka*, A09-2350).

ONE FAULTY TRUST BECOMES TWO QUALIFIED TRUSTS

*Charitable lead and remainder trusts
resolve issue of charitable and noncharitable interests.*

Under Henry's will, the residue of his estate was to be held in trust. Income was to be paid to John and Paul for their joint lives, with a fixed amount also to be paid annually to two charities. At the death of the income beneficiaries, the trust was to terminate. Two different charities were to receive outright distributions of one-quarter of the corpus. Sally was to receive 10%, with four other individuals each receiving 7.5%. The remaining corpus was to be divided evenly among an individual and the two charities that had received annual trust distributions.

Because the trust was not qualified under Code §664(d)(2), no charitable deduction would be allowed to Henry's estate. Before the 90th day after the last date (including extensions) for filing the estate's tax return, the executor began judicial proceedings to reform the trust [Code §2055(e)(3)]. The executor proposed to create two trusts – a charitable remainder unitrust and a charitable lead annuity trust. The unitrust would pay income to John and Paul for their joint lives. At the death of the survivor, 25% of the corpus would pass to each of the four charities named in Henry's will. The charitable lead trust will pay a set amount annually to the two charities for 22 years – the actuarial life expectancies of John and Paul. At the end of that time, income will be distributed to Sally and the other individuals in varying amounts.

The IRS determined that the charitable interests in Henry's original trust were reformable under Code §2055(e)(3)(C)(i), because the interests were ascertainable and therefore severable from the noncharitable interests. Although the payments to John and Paul were not expressed in specific dollar amounts or a fixed percentage of the fair market value of the trust property, as required by Code §2055(e)(3)(C)(ii), a judicial proceeding was commenced in a timely manner. The IRS ruled that the proposed reformation would result in qualified trusts, entitling the estate to a charitable deduction (Ltr. Rul. 201115003).