(ORAL ARGUMENT HAS NOT BEEN SCHEDULED)

No. 17-1266

IN THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

JEFF BLAU, TAX MATTERS PARTNER OF RERI HOLDINGS I, LLC,

Petitioner-Appellant

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee

ON APPEAL FROM THE DECISION OF THE TAX COURT

PAGE PROOF BRIEF FOR THE APPELLEE

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CERTIFICATE AS TO PARTIES, RULINGS, AND RELATED CASES

A. Parties and Amici. The petitioner-appellant is Jeff Blau, in his capacity as the tax matters partner of RERI Holdings I, LLC. The respondent-appellee is the Commissioner of Internal Revenue. No intervenors or amici appeared in the proceedings before the Tax Court, and none have appeared in the proceedings before this Court.

B. Rulings Under Review. The rulings under review are the opinion of the Tax Court (Judge James S. Halpern) dated July 3, 2017, which is reported at 149 T.C. No. 1, and the Tax Court's decision entered pursuant thereto on October 5, 2017.

C. Related Cases. This case has not previously been before this Court or any other court other than the Tax Court in the proceedings below, and counsel is not aware of any related cases currently pending in this Court or in any other court.

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GLOSSARY

Hawthorne	RS Hawthorne LLC
Holdings	RS Hawthorne Holdings, LLC
I.R.C.	Internal Revenue Code of 1986 (26 U.S.C.)
RERI	RERI Holdings I, LLC
SMI	Future (successor) membership interest in RS Hawthorne Holdings, LLC ("Holdings")
Treas. Reg.	Treasury Regulation (26 C.F.R.)

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STATEMENT OF THE ISSUES

1. Whether the Tax Court correctly disallowed the charitable contribution deduction claimed by RERI because RERI failed to properly verify its claimed deduction.

2. Whether the Tax Court erred in sustaining the Commissioner's determination that accuracy-related penalties are applicable with respect to any underpayment of tax attributable to RERI's invalid charitable contribution deduction.

STATUTES AND REGULATIONS

The relevant statutory and regulatory provisions are set forth in the addendum.

STATEMENT OF THE CASE

This tax case involves RERI's entitlement *vel non* to a charitable contribution deduction of over $33 million that RERI claimed on its 2003 return for the donation of a future membership interest in a limited liability company that RERI donated to the University of Michigan. RERI acquired the future membership interest for less than $3 million just 17 months before donating it to the University, and the University sold it two years later for under $2 million to Harold Levine, the same individual who formed RERI. Levine then sold the future membership interest to another taxpayer for $3 million, who donated it to another charitable organization and, like RERI, claimed a grossly-inflated deduction of approximately $30 million for the donation. Thus, although this case concerns only RERI's claim, it is part of a larger scheme involving multiple taxpayers claiming inflated charitable contribution deductions using the same limited interest in a piece of property.

A. Statement of the facts

In February 2002, RS Hawthorne LLC ("Hawthorne") acquired improved real property with a 288,000 square-foot web-hosting facility constructed thereon (the "Hawthorne property") for $42,350,000. Op. 4-5. The Hawthorne property was subject to a lease by AT&T Corporation for a term of 15.5 years, with three five-year renewal options. Op. 5. Hawthorne financed its purchase with a $43,671,739 loan from BB&T Bank. Op. 5. The loan was secured by a mortgage on the property and was payable in monthly installments through May 2016, at which time a final balloon payment of $11.8 million was due. 3Stip. ¶25. As BB&T required, Hawthorne also obtained an insurance policy naming BB&T as an additional insured that covered payment of the $11.8 balloon obligation. Exs. 75, 76. Hawthorne executed a cure rights agreement in connection with that policy providing that, in the event the insurance company were required to pay the $11.8 million, Hawthorne would immediately transfer ownership of the Hawthorne property to the insurance company for no additional consideration. Ex. 77.

Hawthorne was wholly-owned by RS Hawthorne Holdings, LLC ("Holdings"), and Holdings was wholly-owned by Red Sea Tech I, Inc. Op. 7. In February 2002, Red Sea assigned its membership interest in Holdings to RJS Realty Corp., subject to Red Sea's reservation of the membership interest for a term of years lasting until December 31, 2020. Op. 7. Red Sea thus purported to divide ownership of Holdings into two temporal interests: a term-of-years interest until December 31, 2020, and a future (successor) membership interest (the "SMI") maturing after that date.

Under the assignment agreement, Red Sea was required, among other things, to take all reasonable actions necessary to prevent waste of the Hawthorne property. Ex. 103. The assignment provides, however, that, in the event of a breach by Red Sea or its successors, the recourse of RJS or its successors "shall be strictly limited to" the term-of-years interest. Ex. 103. It further provides:

> In no event may any relief be granted that imposes on the owner from time to time of the [term-of-years interest] any personal liability, it being understood that any and all remedies for any breach of the provisions hereof shall be limited to such owner's right, title and interest in and to [the term-of-years interest].

Ex. 103.

Harold Levine, formerly a tax attorney and chair of the tax group at Herrick Feinstein LLP, a New York law firm, formed RERI in March 2002. 3Stip. ¶¶1, 4-5. Levine arranged for RERI to acquire the SMI (*i.e.*, the future membership interest) that same month for $2,950,000. Op. 9; 3Stip. ¶38. Levine and Ronald Katz, a certified public accountant, told potential investors that they would be able to claim a large charitable contribution deduction for their investment in RERI. *See* Tr. 275-277 (Blau), 395-396, 399 (Ross), 507-508 (Fefferman); *see also* Tr. 47-49 (Och).

On August 27, 2003, RERI donated the SMI to the University of Michigan. Op. 9; Ex. 131. The donation was made in connection with a gift agreement executed the same day between Stephen Ross, one of RERI's partners, and the University, wherein Ross pledged a gift of $4 million to the University toward the construction of an academic center. 3Stip. ¶¶45-49, 91. The gift agreement required that the University "shall hold the [SMI] for a minimum of two years, after which the University shall sell the [SMI] in a manner and to a buyer of its choosing," with the proceeds from the sale being credited toward Ross's pledge. Ex. 125; 3Stip. ¶60. On its partnership return (Form 1065) for

2003, RERI claimed a charitable contribution deduction of $33,019,000 for its donation of the SMI to the University. Ex. 1. RERI was then dissolved in May 2004. 3Stip. ¶57.

In December 2005, the University sold the SMI for $1,940,000 to an entity that (unbeknownst to the University) was owned by Levine and Katz. 3Stip. ¶¶74-81. Levine and Katz then sold the SMI to another taxpayer, Dan Och, for $3 million. 3Stip. ¶¶82, 84. With Levine's assistance, Och contributed the SMI to another charitable organization in December 2006 and then claimed a charitable contribution deduction of $29,930,000 for the donation. 3Stip. ¶¶86-87; Tr. 44-45. Levine engaged Howard Gelbtuch to prepare an appraisal of Och's contribution, based on annuity tables under I.R.C. § 7520, to support Och's claim. 3Stip. ¶87.

B. RERI's 2003 return

RERI attached to its 2003 return (on which it claimed the $33,019,000 deduction) an appraisal that was also prepared by Howard Gelbtuch in which Gelbtuch concluded that the "market value of the leased fee interest in the [Hawthorne] property as of August 28, 2003," was $55,000,000. Ex. 1. Gelbtuch multiplied that amount by an actuarial factor—supplied to him by Levine from annuity tables under I.R.C. § 7520—to derive an "investment value" of $32,935,000 for a remainder interest in the Hawthorne property. Exs. 1, 133; Tr. 226-228. Gelbtuch did not appraise the value of the SMI—*i.e.*, the future membership interest in *Holdings*. Instead, RERI's claimed deduction equals the "investment value" determined by Gelbtuch in a hypothetical remainder interest in the Hawthorne property, increased by appraisal and professional fees. 3Stip. ¶54.

RERI also attached to its return an appraisal summary (Form 8283) indicating that it acquired the SMI by "purchase" on March 22, 2002. The adjacent space provided on the form for the "Donor's cost or adjusted basis" was left blank by RERI. Ex. 1.

C. The IRS audit and the proceedings below

RERI's return was selected for audit by the IRS, which commenced administrative partnership proceedings in accordance with the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, § 402(a), 96 Stat. 324, 648 (1982) (formerly codified at I.R.C.

§§ 6221-6234).[1] In a notice of final partnership administrative adjustment ("FPAA"), the Commissioner disallowed most of RERI's deduction based on his determination that the SMI was worth only $3.9 million. The Commissioner also determined in the FPAA that a 20 percent "substantial valuation misstatement" penalty under I.R.C. § 6662(e)(1) applied. Ex. 2. RERI subsequently filed a petition in the Tax Court challenging the Commissioner's determinations in the FPAA. Doc. 1. *See* I.R.C. § 6226(a) (2003). In amended answers filed in response to RERI's petition, the Commissioner asserted that RERI was not entitled to any deduction at all for its contribution and that a 40 percent "gross valuation misstatement" penalty under I.R.C. § 6662(h)(2) applied. Doc. 16, 99.

After a four-day trial, the Tax Court sustained the Commissioner's determination that RERI was not entitled to any deduction for its contribution to the University because RERI failed to verify its claim as required under I.R.C. § 170 and Treasury Regulation § 1.170A-13(c). Op. 22-28. The court also sustained the Commissioner's determination

[1] Congress repealed TEFRA's partnership provisions in the Bipartisan Budget Act of 2015, Pub. L. No. 114-74, § 1101, 129 Stat. 625, effective for tax years after 2017.

as to the applicability of the gross-valuation-misstatement penalty, based on the court's determination that the annuity tables under I.R.C. § 7520 could not be used to value the SMI and that the SMI was worth only $3,462,886 at the time of the donation. Op. 28-69.

SUMMARY OF ARGUMENT

RERI claimed a charitable contribution deduction of over $33 million for the donation to a university of a future membership interest in a limited liability company (SMI) that RERI had acquired 17 months earlier for less than $3 million, and which the university sold two years later for under $2 million. The Tax Court disallowed the deduction in its entirety based on RERI's failure to comply with the substantiation requirements mandated by Congress to deter abuses by taxpayers claiming inflated charitable contribution deductions. The court further sustained the Commissioner's determination that a 40-percent gross-valuation-misstatement penalty applied, based on the court's finding that the property donated by RERI was worth only $3,462,886 at the time of the donation.

1. The Tax Court correctly determined that RERI was not entitled to any deduction for its donation because RERI failed to verify

its claim as required by I.R.C. § 170(a)(1) and Treasury Regulation § 1.170A-13(c).

First, RERI failed to disclose its cost basis in the SMI on its return—information that the Tax Court found would have alerted the Commissioner to a potential overvaluation had it been disclosed as required. The regulations generally provide that a failure to disclose the cost basis of donated property precludes any deduction, except that a donor's "inability" for "reasonable cause" to provide such information will not result in the disallowance of a deduction if the donor attaches an appropriate explanation to the return. RERI does not contend that its failure to disclose its cost basis in the SMI is excusable under the regulations. RERI instead relies on the judicially-created doctrine of substantial compliance, which has no application here; even if it did, the record supports the Tax Court's rejection of RERI's reliance on it in this case.

Second, RERI also failed to obtain a "qualified appraisal" as required by the regulations because the appraisal by Gelbtuch valued the wrong property and failed to disclose restrictions imposed by RERI on the University's right to use or dispose of the SMI.

2. The Tax Court did not err in sustaining the Commissioner's determination that an accuracy-related penalty of 40 percent, based on a gross-valuation misstatement, was applicable. In this regard, RERI waived any challenge to penalties on the ground that the supervisory-approval requirement of I.R.C. § 6751(b)(1) was not satisfied by failing to raise it in the Tax Court. RERI's further argument that the penalties are improper because any underpayment resulting therefrom would not be "attributable to" a valuation misstatement is also meritless.

In determining that the value of the SMI claimed by RERI was grossly overstated, the Tax Court properly determined that the tables under I.R.C. § 7520 for determining the present value of certain interests did not apply to value the SMI. Even if the tables do apply, RERI misapplied them here. The record also fully supports the court's finding that the discount rate applied by the Government's expert to value the SMI was more credible than the rate applied by RERI's expert, resulting in the court's finding that the SMI was worth only $3,462,886 at the time of the donation and, consequently, that the gross-valuation-misstatement penalty was applicable.

Finally, the court correctly determined that the reasonable-cause defense to penalties under I.R.C. § 6664(c) was inapplicable. In this regard, RERI failed to obtain a qualified appraisal and failed to make a good faith investigation of the value of the SMI. In any event, RERI failed to establish that it had reasonable cause or acted in good faith in claiming a grossly-overstated charitable contribution deduction.

The Tax Court's decision is correct and should be affirmed.

ARGUMENT

I

The Tax Court properly disallowed the $33 million charitable contribution deduction claimed by RERI because RERI failed to verify its claimed deduction as required by I.R.C. § 170(a)(1) and Treasury Regulation § 1.170A-13(c)

Standard of review

The Tax Court's determination that RERI was not entitled to a deduction because RERI failed to verify its charitable contribution claim as required by I.R.C. § 170(a)(1) and Treasury Regulation § 1.170A-13(c) involves a mixed question of law and fact that is reviewed for clear error. *See Commissioner v. Simmons*, 646 F.3d 6, 9 (D.C. Cir. 2011).

A. The heightened verification requirements for charitable contribution deductions

Section 170 of the Internal Revenue Code allows an income tax deduction for charitable contributions "only if verified under regulations prescribed by the Secretary." I.R.C. § 170(a)(1). The amount of a contribution of property other than money is generally measured by the property's fair market value at the time of the contribution. Treas. Reg. § 1.170A-1(c)(1).

To curb abuses by taxpayers claiming excessive deductions based on "overvaluations" of donated property, Congress, in 1984, directed the Secretary of the Treasury to prescribe regulations imposing heightened substantiation requirements for charitable contributions. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 155, 98 Stat. 494, 691 (1984); S. Prt. No. 98-169, Vol. 1, at 444-445 (Comm. Print 1984). Congress instructed the Secretary that, in the case of donated property with a claimed value exceeding $5,000, the new regulations shall require taxpayers to obtain a "qualified appraisal," to attach an "appraisal summary" to the taxpayer's return on which the deduction is first claimed, and to include additional information on the return as prescribed by the Secretary "including the cost basis and acquisition date of the contributed property." Deficit Reduction Act, § 155(a).

Congress intended these requirements to deter taxpayers from claiming excessive deductions for charitable contributions by requiring them to disclose on their return information that would alert the Commissioner to a potential overvaluation. S. Prt. No. 98-169, *supra*, at 444-445; *Hewitt v. Commissioner*, 109 T.C. 258, 264 & 265 (1997), *aff'd*, 166 F.3d 332 (4th Cir. 1998) (per curium). The Senate Finance Committee, which first proposed the stricter substantiation requirements, explained that "it is not possible to detect all or even most instances of excessive deductions" relying solely on the IRS's audit program. S. Prt. No. 98-169, at 444. The committee expressed concerns that, given the "subjective nature of valuation," taxpayers would "continue to play the 'audit lottery' and claim excessive charitable contributions" in the hope that their returns would not be selected for audit by the IRS. *Id.* The committee believed that the heightened requirements would be effective in "deterring" incorrect valuations by taxpayers and would also assist the IRS in administering the law. *Id.* at 445.

In response to Congress's directive, the Secretary issued final regulations in May 1988 incorporating the new verification requirements for charitable contributions of property (other than money and certain publicly traded securities) by specified donors, including partnerships, with a claimed value in excess of $5,000. 53 Fed. Reg. 16076-01; Treas. Reg. § 1.170A-13(c). To satisfy these requirements, the donor must obtain a "qualified appraisal," attach a "fully completed appraisal summary" to the return on which the deduction is first claimed, and maintain records containing specified information. Treas. Reg. § 1.170A-13(c)(2)(i). The appraisal summary must disclose, among other information, the "manner of acquisition … and the date of acquisition" of the contributed property by the donor and the donor's "cost or other basis" of the property. Treas. Reg. § 1.170A-13(c)(4)(ii)(E).

Failure to comply with these requirements generally results in no deduction being allowed for the contribution. I.R.C. § 170(a)(1); Treas. Reg. § 1.170A-13(c)(1)(i) ("No deduction under section 170 shall be allowed … unless the substantiation requirements described in paragraph (c)(2) of this section are met."). The regulations provide, however, that if a donor is "unable" for "reasonable cause" to provide information about the acquisition and basis of the contributed property, and the donor attaches an "appropriate explanation" to the appraisal summary, then a deduction "will not be disallowed simply because of the inability (for reasonable cause) to provide these items of information." Treas. Reg. § 1.170A-13(c)(4)(iv)(C)(1). Similarly, a donor's failure to attach an appraisal summary to the return may be excused under the regulations if the donor timely complies with a request by the IRS to supply the appraisal summary, provided that the initial failure to attach the appraisal summary was a "good faith omission" and the requirements of Treasury Regulation § 1.170A-13(c)(3) & (4) are met. Treas. Reg. § 1.170A-13(c)(4)(iv)(H).

B. RERI failed to properly verify its $33 million charitable contribution claim

The Tax Court correctly held that RERI was not entitled to a charitable contribution deduction because RERI failed to comply with the verification requirements of Treasury Regulation § 1.170A-13(c). RERI's claimed deduction failed to satisfy the requirements of the regulations and, thus, was properly disallowed in full by the Tax Court, for two independent reasons: (1) RERI failed to attach to its return a "fully completed" appraisal summary that disclosed RERI's "cost or other basis" in the donated property, and (2) RERI failed to obtain a "qualified appraisal."

1. RERI failed to disclose its cost basis in the SMI

The Tax Court found that the Form 8283 appraisal summary attached to RERI's return indicated that RERI had acquired the SMI by "purchase" on March 22, 2002, but that RERI failed to disclose its cost or other basis in the SMI in the adjacent space provided for the "Donor's cost or other adjusted basis," which RERI left blank. Op. 26; Ex. 1. Treasury regulations required that RERI attach to its return a "fully completed" appraisal summary that disclosed not just the manner and date of its acquisition of the SMI, but also its "cost or other basis" in the SMI. Treas. Reg. §§ 1.170A-13(c)(2)(i)(B) & (c)(4)(ii)(E). The Tax Court correctly determined that RERI's failure to do so was fatal to its claimed deduction. I.R.C. § 170(a)(1); Treas. Reg. § 1.170A-13(c)(1)(i).

RERI does not contend that its failure to disclose its cost basis on its appraisal summary may be excused under any provision in the regulation. Specifically, RERI does *not* argue, and the Tax Court did not find, that RERI's failure to disclose its cost basis is excusable due to "inability" for "reasonable cause" to provide that information, nor did RERI attach to its appraisal summary any explanation for not providing that information. *See* Treas. Reg. § 1.170A-13(c)(4)(iv)(C)(1). Instead, RERI argues that its failure to comply fully with the regulation is excusable under the Tax Court's judicial doctrine of substantial compliance. *See Bond v. Commissioner*, 100 T.C. 32 (1993). To the extent that doctrine has any application here, however, the record fully supports the Tax Court's rejection of RERI's reliance on it under the circumstances of this case.

a. The doctrine of substantial compliance is inapplicable

RERI is mistaken in its underlying argument that mere substantial compliance with the regulation is sufficient. "[A]n income tax deduction is a matter of legislative grace," and "the burden of clearly showing the right to the claimed deduction is on the taxpayer." *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992). Congress, whose sole province it is to grant income tax deductions, expressly precluded any deduction for charitable contributions that are not "verified under regulations prescribed by the Secretary." I.R.C. § 170(a)(1). Notably, the regulation's requirement that the appraisal summary must include the donor's "cost or other basis" in the contributed property, *see* Treas. Reg. §§ 1.170A-13(c)(2)(i)(B) & (c)(4)(ii)(E), was promulgated in response to Congress's specific direction to the Secretary in § 155(a) of the Deficit Reduction Act to prescribe regulations requiring donors to disclose on their return "the cost basis and acquisition date of the contributed property." RERI would have this Court ignore that congressionally-mandated requirement under the regulation. As this Court has recognized, however, "[a]n agency's regulation implementing its authorizing statute 'is binding in the courts unless procedurally defective, arbitrary or capricious in substance, or manifestly contrary to the statute'"—a principle that "applies with full force in the tax context." *Rogers v. Commissioner*, 783 F.3d 320, 325 (D.C. Cir. 2015) (citing *Mayo Foundation v. United States*, 562 U.S. 44, 55 (2011)).

If, in this area of "limitless factual variations," there are circumstances in which less than full compliance with the regulation might be justified, then "it is the province of Congress and the Commissioner, not the courts, to make the appropriate adjustments." *United States v. Correll*, 389 U.S. 299, 307 (1967). In this regard, the

Secretary has, in fact, already provided specific rules under which a donor's failure to provide information about the acquisition or cost basis of contributed property may be excused. Treas. Reg. § 1.170A-13(c)(4)(iv)(C)(1). The Secretary limited the circumstances in which such relief is available, however, to those involving the donor's "inability" for "reasonable cause" to include such information in the appraisal summary. To invoke the "reasonable cause" exception, the donor must attach an "appropriate explanation" to the appraisal summary. *Id.* RERI, however, has never claimed that its failure to supply the donor's cost or other basis on its appraisal summary was attributable to an "inability" for which there was "reasonable cause" and, moreover, failed to attach to its appraisal summary an "appropriate explanation" for not disclosing the donor's cost basis on its appraisal summary. RERI, accordingly, is not entitled to any relief under the regulation and makes no claim to the contrary in its brief. Although RERI asks this Court to fashion its own rules excusing RERI's failure to comply with the requirements of the regulation, its request is improper and should be rejected by the Court. The regulation, including its limited relief provisions, reflect the Secretary's deliberate consideration in an area involving the agency's expertise, after notice and comment by the public, 49 Fed. Reg. 50740-01; it is not for the courts, under such circumstances, to fashion additional exceptions or to enlarge the existing ones beyond their terms by judicial fiat. "The role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner." *Correll*, 389 U.S. at 307; *accord Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-843 (1984).

RERI claims that "the regulations themselves recognize that strict compliance with the substantiation requirements … is not required" because Treasury Regulation § 1.170A-13(c)(4)(iv)(H) permits donors to cure a failure to attach an appraisal summary to their return in limited circumstances. Br. 10-11. Although the Secretary may prescribe by regulation, pursuant to the authority delegated by Congress, instances in which strict adherence to the substantiation requirements may be excused, it simply does not follow that courts may do the same. The provisions of Treasury Regulation § 1.170A-13(c)(4)(iv)(H), involving a donor's good-faith omission in failing to initially attach an appraisal summary to the return, are plainly inapplicable by their terms in this case, as are the provisions excusing full compliance with the substantiation requirements where the donor establishes reasonable cause for his failure to fully comply. This Court, we respectfully submit, should reject RERI's request that the Court create additional exceptions to the requirements of the regulation.

b. In any event, RERI's appraisal summary did not substantially comply with Treasury regulations

Even if the doctrine of substantial compliance has some place here, the Tax Court did not clearly err in rejecting RERI's reliance on it under the circumstances of this case. The doctrine is of "very limited scope," *Credit Life Ins. Co. v. United States*, 948 F.2d 723, 728 (Fed. Cir. 1991), and should "not be allowed to spread beyond cases in which the taxpayer had a good excuse (though not a legal justification) for failing to comply with either an unimportant requirement or one unclearly or confusingly stated in the regulations or the statute." *Prussner v. United States*, 896 F.2d 218, 224 (7th Cir. 1990) (*en banc*); *accord Volvo Trucks of North America, Inc. v. United States*, 367 F.3d 204, 209-210 (4th Cir. 2004); *McAlpine v. Commissioner*, 968 F.2d 459, 462 (5th Cir. 1992);

Credit Life, 948 F.2d at 726-727 (Fed. Cir. 1991). Under this case law, RERI's failure to disclose its cost basis in the SMI on its appraisal summary is excusable under the doctrine of substantial compliance only if (1) RERI had a good excuse for failing to comply with the regulation *and* (2) the regulation's requirement is unimportant, unclear, or confusingly stated in the regulations or statute.

RERI has provided no justification at all for its failure to disclose on its appraisal summary its cost basis in the donated property, much less demonstrated a good reason for its omission. RERI indicated on the Form 8283 appraisal summary that it had recently purchased the property in March 2002, such that the inference is inescapable that information regarding RERI's cost basis in the property must have been known or readily available to RERI. RERI chose, however, not to disclose it on the Form 8283 because, as the Tax Court found, the "significant disparity" between the claimed fair market value of the property at the time of contribution (over $33 million) and the price RERI paid for it just 17 months earlier (under $3 million), "had it been disclosed, would have alerted [the Commissioner] to a potential overvaluation." Op. 26-27. That, of course, is not a good reason for

RERI's noncompliance. RERI claims there is no evidence to support the Tax Court's finding that the Commissioner would have been alerted to a potential overvaluation had RERI disclosed its cost basis on its Form 8283. Br. 12. But, the court's finding is in accord with Congress's expressed view that requiring donors of property to disclose their cost basis and other information would assist the IRS in detecting excessive charitable deductions based on overvaluations of property. *See* pp. 13-14, *supra*. Moreover, the Tax Court was on solid ground in concluding that a disclosure by RERI that its claimed charitable deduction was more than 10 times greater than the price it had paid for the contributed property only a year before would have alerted the IRS to the distinct possibility that the deduction was excessive.

RERI also failed to show that the regulation's basis-disclosure requirement is "unimportant," "unclear," or "confusingly stated." As to importance, RERI argues that, although there are situations in which a donor's basis could affect the amount of the deduction allowed, "basis is not relevant to the *amount* of RERI's charitable contribution deduction" here. Br. 12 (emphasis added). The obvious flaw in that argument is it wrongly assumes that the *sole* purpose of the basis-disclosure requirement is computational. As the Tax Court explained, "Congress directed the Secretary to adopt stricter substantiation requirements for charitable contributions to alert the Commissioner, in advance of audit, of potential overvaluations of contributed property and thereby deter taxpayers from claiming excessive deductions in the hope that they would not be audited." Op. 26. *See* S. Prt. No. 98-169, at 444-445. The basis-disclosure requirement plays an essential role in accomplishing that purpose: the Senate Finance Committee explained that the donation of "appreciated property" to charities "create[s] opportunities for overvaluations." *Id.* at 444. The committee noted in this regard that "opportunities to offset income through inflated valuations of donated property have been increasingly exploited by tax shelter promoters." *Id.* Congress, therefore, directed that donors be required to disclose "the cost basis and acquisition date of the contributed property," Deficit Reduction Act, § 155(a), because, without that information, the Commissioner has no way of identifying donations of "appreciated property," which was a primary focus of Congress's concern. Indeed, the facts of this case, in which RERI claimed a deduction more than 10 times greater than the price it paid for the contributed property the year before, demonstrate the need for the basis-disclosure requirement in order to deter overvaluations. It thus cannot be said that this requirement is "unimportant." To the contrary, the basis-disclosure requirement is essential to fulfilling one of Congress's primary purposes for requiring stricter substantiation for charitable contribution deductions.

Nor is the basis-disclosure requirement "unclear" or "confusingly stated" in the regulation. RERI's claim, moreover, that the Tax Court's holding "conflicts with the instructions to Form 8283" is incorrect. Br. 13. Consistent with the Tax Court's holding and the regulation, the instructions in effect in 2003 (like the current instructions) appropriately cautioned taxpayers that, "If you have reasonable cause for not providing the information in columns (d), (e), or (f) [*i.e.*, cost basis, date, and manner of acquisition], attach an explanation so your deduction will not automatically be disallowed." Instructions for Form 8283, p. 3 (revised Oct. 1998)[2]; *see also* Treas. Reg. § 1.170A-13(c)(4)(iv)(C)(1). In addition, RERI's reliance on *Dunlap v.*

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[2] Available at https://www.irs.gov/pub/irs-prior/i8283--1998.pdf (accessed July 2018).

Commissioner, T.C. Memo 2012-126 (2012), decided almost a decade after RERI submitted its deficient appraisal summary, is also misplaced, as that case did not even involve the deductibility of a charitable contribution under § 170.

2. RERI failed to obtain a "qualified appraisal"

In addition, the Gelbtuch appraisal obtained by RERI was not a "qualified appraisal" because (1) Gelbtuch appraised the wrong property and (2) the appraisal failed to disclose restrictions imposed by RERI on the University's right to use or dispose of the SMI. The Tax Court did not address this issue in its final opinion.[3] Op. 28 n.12.

a. Gelbtuch appraised the wrong property

Treasury Regulation § 1.170A-13(c)(3)(ii)(A) & (I) specifies that a qualified appraisal "shall include," among other information, a "description of the property … that was (or will be) contributed" and the "appraised fair market value … of the property on the date (or expected date) of contribution." Here, the property that Gelbtuch appraised was

[3] In an interlocutory order issued before trial, the Tax Court determined that summary judgment on this issue was inappropriate because material facts were in dispute. *RERI Holdings I, LLC v. Commissioner*, 143 T.C. 41 (2014).

not the property that RERI donated. Gelbtuch appraised a hypothetical remainder interest in the Hawthorne property. Tr. 265. But the property RERI donated was a future interest in *Holdings*, a limited liability company that (indirectly) owned the Hawthorne property.[4] Ex. 131. That distinction may not be disregarded for purposes of valuing a gift under federal tax law, *Pierre v. Commissioner*, 133 T.C. 24 (2009); *RERI Holdings*, 143 T.C. at 50-53, and it makes a significant difference here.

At the time of RERI's donation to the University, the Hawthorne property was encumbered by a mortgage with an outstanding loan balance of approximately $42,632,884. 3Stip. ¶51. Gelbtuch's appraisal ignored the mortgage and the outstanding debt in concluding that the Hawthorne property had a market value of $55,000,000 on the date of contribution. 3Stip. ¶52; Tr. 265. The value of an interest in Holdings, however, would necessarily have been impacted by the existence of

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[4] The Hawthorne property was owned by Hawthorne, and Holdings was the sole member of Hawthorne. Hawthorne's certificate of formation specified that "no Member shall have any ownership interest in any Company property in its individual name or right, and each Member's interest in the Company shall be personal property for all purposes." Ex. 82.

debt. In that regard, Gelbtuch testified at trial that he would have reached "a different number" in his appraisal had he been asked to appraise an interest in Holdings instead of an interest in the Hawthorne property. Tr. 262-263. That is because, as Gelbtuch confirmed, "the value of the LLC membership interests would be the value of the assets of the LLC *less the liabilities* of the LLC," including the $42.6 million outstanding debt contracted by Holdings' wholly-owned LLC (Hawthorne). Tr. 264 (emphasis added). The Government's trial experts likewise opined that liabilities (including the $42.6 million debt) must be accounted for in valuing the SMI in Holdings. Tr. 582-583 (Abraham); Tr. 696-698, 706-707 (Cragg). *See* Shannon P. Pratt & Alina V. Niculita, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies* 353 (5th ed. 2008) ("In the asset accumulation method, the value of the individual assets (both tangible and intangible) less the value of the liabilities (both recorded and contingent) represents the subject business value."); American Society of Appraisers, *ASA Business Valuation Standards* 9 (Nov. 2009) (describing various methods of valuing a business "based on the value of the assets net of liabilities").

The outstanding debt, however, is not all that differentiates the value of an interest in the Hawthorne property from the value of an interest in Holdings. As the Government's experts explained, the value of the SMI in Holdings is also less marketable than a remainder interest in the Hawthorne property would be, and the owner of the SMI has less control. Exs. 275 (¶¶47-57), 277 (pp. 42-46).

Because Gelbtuch appraised the wrong asset, he failed to account for the outstanding debt of $42.6 million that, as he testified at trial, would have resulted in a different appraisal conclusion had he appraised the correct property. Therefore, the Gelbtuch appraisal failed to include not only a "description of the property … that was contributed," but also its "appraised fair market value," as the regulation requires. Treas. Reg. § 1.170A-13(c)(3)(ii)(A) & (I).

b. Gelbtuch's appraisal failed to disclose applicable restrictions

A qualified appraisal must also include "[t]he terms of any agreement or understanding entered into … by or on behalf of the donor or donee that relates to the use, sale, or other disposition of the property contributed," including the terms of any agreement or understanding that "[r]estricts temporarily or permanently a donee's right to use or dispose of the donated property." Treas. Reg. § 1.170A-13(c)(3)(ii)(D)(1).

RERI's donation to the University was made in connection with a gift agreement requiring that the University "shall hold the [SMI] for a minimum of two years, after which the University shall sell the [SMI] in a manner and to a buyer of its choosing." Ex. 125. RERI and the University further understood that Ross's gift pledge to the University in support of the construction of an academic center "would be funded through the sale of the property interest after two years." Ex. 116; *see also* Ex. 151 ("The University's intent was to hold the properties that were the subject of the Ross Gifts for the two-year period required by the Gift Agreement and then, in accordance with its policy of promptly converting gifts-in-kind to cash, sell the properties.").

Gelbtuch's appraisal failed to discuss either the two-year-hold restriction or the mandatory-sell restriction, which would have informed the IRS of key terms of RERI's contribution. Tr. 180. The two-year-hold requirement restricted the University's "right to dispose" of the property, and the mandatory-sell requirement restricted its "right to use" the property following the contribution; therefore, these restrictions were required to be disclosed in the appraisal. Because they were not, the appraisal was not a "qualified appraisal" for this additional reason.

II

The Tax Court did not err in sustaining the Commissioner's determination that accuracy-related penalties are applicable

Standard of review

This Court reviews questions of law decided by the Tax Court *de novo*, while the Tax Court's findings of fact and its disposition of mixed questions of law and fact are reviewed for clear error. *Jombo v. Commissioner*, 398 F.3d 661, 663 (D.C. Cir. 2005).

A. RERI waived any challenge to penalties based on I.R.C. § 6751(b)(1) by failing to raise it in the Tax Court

RERI argues, for the first time on appeal, that the Tax Court's decision to uphold accuracy-related penalties against RERI was improper because the Commissioner did not introduce evidence demonstrating compliance with the written, supervisory-approval-of-penalties requirement of I.R.C. § 6751(b)(1). Br. 18-21. This Court, in a recent opinion issued after RERI filed its brief, held that a challenge to penalties under § 6751(b) is waived if not raised by the taxpayer in the

Tax Court. *Mellow Partners v. Commissioner*, 890 F.3d 1070, 1081-1082 (D.C. Cir. 2018); *accord Kaufman v. Commissioner*, 784 F.3d 56, 71 (1st Cir. 2015). RERI never raised this argument in the Tax Court; therefore, the Commissioner had no occasion to present evidence that supervisory approval of the penalties under § 6751(b)(1) was appropriate. By not raising this argument in the Tax Court, RERI waived it.[5] *Id.*

Even if RERI had not waived its § 6751(b)(1) challenge by failing to raise it below, RERI is mistaken in its argument that the Commissioner bears the burden of production under I.R.C. § 7491(c) with respect to the penalties. Section 7491(c) provides that "the Secretary shall have the burden of production in any court proceeding *with respect to the liability of any individual* for any penalty, addition to

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[5] RERI may respond that it raised the issue in a witness list provided to the Commissioner (but not filed with the Tax Court) in advance of trial. That witness list, dated May 18, 2015, identified a "Representative of the Internal Revenue Service" as a potential witness and stated that "Petitioner will call a representative of the Internal Revenue Service concerning the Service's compliance with I.R.C. § 6751." RERI filed a revised witness list with the Tax Court ten days later, however, that did not include an IRS representative (or mention § 6751), and none was called at trial. Doc. 252. Nor did RERI argue in its pretrial or post-trial briefs, or at any other time, that penalties were improper under § 6751(b).

tax, or additional amount imposed by this title." (Emphasis added.) A partnership-level proceeding under TEFRA is not a proceeding "with respect to the liability of any individual" under § 7491(c). *Dynamo Holdings v. Commissioner*, 150 T.C. No. 10 (2018). Partnerships do not pay federal income tax; rather, all income, deductions, and credits of a partnership are allocated to its partners, who pay tax on their distributive shares. I.R.C. §§ 701-704. In a partnership-level proceeding such as this one, the court's jurisdiction is limited to determining the partnership items of the partnership, their proper allocation among the partners, and the applicability of any penalty. I.R.C. § 6226(f). After proceedings at the partnership-level are final, the IRS may undertake further proceedings at the partner level to make any resulting computational adjustments in the tax liability of the partners. I.R.C. § 6230; *United States v. Woods*, 571 U.S. 31, 39 (2013). The court in a partnership-level proceeding thus has no jurisdiction to determine the tax liability of the partners or the personal liability of such partners for penalties. Consequently, the Commissioner does not bear the burden of production with respect to penalties in a partnership-level proceeding like this one. *Dynamo Holdings*, 150 T.C.

No. 10. The case of *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017), on which RERI relies, is distinguishable because it did not involve a partnership-level proceeding under TEFRA.

B. Any tax underpayments resulting from the disallowance of RERI's claimed charitable deduction are "attributable to" a valuation misstatement

The Tax Court correctly held that any tax underpayments (by RERI's partners) resulting from its disallowance of RERI's inflated charitable contribution deduction are "attributable to" a valuation misstatement under I.R.C. § 6662. Op. 34-40.

As noted, the court in a partnership-level proceeding has jurisdiction to determine "the applicability of any penalty … relate[d] to an adjustment to a partnership item." I.R.C. § 6226(f). Section 6662 imposes an accuracy-related penalty on the portion of any underpayment of tax that is "attributable to," *inter alia*, a "valuation misstatement." I.R.C. § 6662(b)(3). In 2003, the penalty was 20 percent of the tax underpayment if the misstated value was 200 percent or more than the correct value ("substantial valuation misstatement"), and the penalty was 40 percent if the misstated value was 400 percent or more than the correct value ("gross valuation misstatement"). I.R.C. §§ 6662(e)(1)(A), 6662(h)(2)(A)(i) (2003).

Here, the Commissioner determined in the FPAA that the substantial-valuation-misstatement penalty applied to RERI "because the claimed value of the [SMI] is in excess of 200 percent of the actual value of the property donated." Ex. 2. In his amended answer filed in the Tax Court, the Commissioner determined that the gross-valuation-misstatement penalty applied "because the claimed value of the [SMI] is in excess of 400 percent of the actual value of the [SMI]." Doc. 99.

Although the Commissioner's penalty determination was based on the SMI's misstated value, the Tax Court ultimately denied RERI's charitable contribution deduction in its entirety because of RERI's failure to properly verify its claim under § 170 and the regulations. The court, however, went on to determine the SMI's value for purposes of its penalty determination, finding that the SMI was worth only $3,462,886 at the time RERI donated it to the University and that the gross-valuation-misstatement penalty was therefore applicable. Op. 60-61. Thus, RERI's claimed deduction of over $33 million was grossly overvalued and, therefore, invalid to the extent it exceeded $3,462,886 without regard to RERI's failure to satisfy the substantiation requirements of the regulations. It therefore follows that the gross-valuation-misstatement penalty is applicable to any resulting underpayment of tax.

RERI argues (Br. 15-18) that any underpayments resulting from the disallowance of its deduction are not "attributable to" a "valuation misstatement" under § 6662 because the Tax Court disallowed its deduction on grounds unrelated to the SMI's value. RERI relies primarily on the decisions of the Fifth and Ninth Circuits in *Todd v. Commissioner*, 862 F.2d 540 (5th Cir. 1988), and *Gainer v. Commissioner*, 893 F.2d 225 (9th Cir. 1990).

These decisions have been rejected by other courts and then were effectively overruled by the Supreme Court in *Woods*, 571 U.S. at 47-48. *See Alpha I, L.P. v. United States*, 682 F.3d 1009, 1027-1031 (Fed. Cir. 2012); *Fidelity Int'l Currency Advisor A Fund, LLC v. United States*, 661 F.3d 667, 672-674 (1st Cir. 2011); *AHG Investments, LLC v. Commissioner*, 140 T.C. 73, 75-85 (2013). As those courts explained, *Todd* and *Gainer* rested on a mistaken interpretation of the "Blue Book," a post-enactment summary of legislation prepared by the staff of the Joint Committee on Taxation. *Alpha I*, 682 F.3d at 1029-1030; *Fidelity*, 661 F.3d at 673-674. The Federal Circuit pointed out that "the flaws in the analysis employed in *Todd* and *Gainer* are so apparent that subsequent panels of the circuit courts deciding those cases have questioned their holdings." *Alpha I*, 682 F.3d at 1029-1030 (citing *Bemont Investments, LLC v. United States*, 679 F.3d 339, 351-355 (5th Cir. 2012) (Prado, J., concurring); *Keller v. Commissioner*, 556 F.3d 1056, 1060-1061 (9th Cir. 2009)). Indeed, in *Chemtech Royalty Associates v. United States*, 823 F.3d 282, 286 (5th Cir. 2016), the Fifth Circuit expressly stated that its decision in *Todd* was "effectively overruled" by *Woods*, 571 U.S. 31.

Accordingly, contrary to RERI's argument, "an underpayment of tax may be attributable to a valuation misstatement for purposes of the statute even when the IRS asserts both a valuation misstatement ground and a non-valuation-misstatement ground for the same adjustment," as is the situation here. *Alpha I*, 682 F.3d at 1030; *accord Fidelity*, 661 F.3d at 673-674; *AHG Investments*, 140 T.C. at 84. This sensible rule aligns with the underlying policy for penalizing valuation misstatements because they "directly impair tax collections and prove difficult to resolve (and presumably are easy to fabricate)." *Fidelity*, 661 F.3d at 672. "[O]ne might think that it would be perverse to allow the taxpayer to avoid a penalty otherwise applicable to his conduct on the ground that the taxpayer had also engaged in additional violations that would support disallowance of the claimed losses." *Id.* at 673; *accord Alpha I*, 682 F.3d at 1030. Here, the Commissioner determined that the penalties applied because RERI grossly overstated the value of the SMI on its return, and the Tax Court agreed that value was grossly overstated. That the Tax Court ultimately disallowed RERI's deduction on non-valuation grounds does nothing to change that fact.

In *Woods*, the Supreme Court rejected an argument similar to the one RERI makes here. The partnership there argued that the underpayments in that case were not "attributable" to the valuation misstatements in question, but rather to an "independent legal ground" that the partnership was a sham. But the Court rejected the argument's "premise," finding that the misstatements and the sham determination were "inextricably intertwined." 571 U.S. at 46-47. The Court's decision provides no support for RERI's contention (Br. 17) that the penalty does not apply, even though a claimed deduction is based on a gross overvaluation, if the deduction *also* is invalid on a separate ground.

C. The Tax Court's determination that the tables under I.R.C. § 7520 did not apply to value the SMI was not clearly erroneous

As noted, the amount of a contribution of property other than money is generally measured by the property's fair market value at the time of the contribution. Treas. Reg. §§ 1.170A-1(c)(1), (2). Unless an exception applies, however, the "fair market value of annuities, interests for life or for a term of years, remainders, and reversions for which an income tax charitable deduction is allowable is the present value of such interests" determined under tables prescribed by the Secretary. I.R.C. §§ 7520(a), (b); Treas. Reg. §§ 1.7520-2(a)(1), 1.7520-1(a). The present value of an ordinary remainder interest is determined under the tables "by multiplying the value of the [undivided] property by the appropriate remainder interest actuarial factor," which is composed of an interest rate component and a mortality component. Treas. Reg. §§ 1.7520-1, 20.2031-7(d)(2)(ii) (2003). If, as here, the remainder interest is to take effect "after a definite number of years," then the tables employ a "term certain" factor in lieu of a mortality component. Treas. Reg. § 20.2031-7(d)(2)(ii) (2003).

There are situations, however, in which departure from the tables is appropriate because the actual facts are inconsistent with the assumptions underlying the tables, such that use of the tables would not reasonably reflect the true value of the interest. *Anthony v. United States*, 520 F.3d 374, 378-379 (5th Cir. 2008). To this end, the regulations specify that a standard actuarial factor under the tables may not be used unless the remainder interest is "adequately preserved and protected" until it takes effect, § 1.7520-3(b)(2)(iii), and is not a "restricted beneficial interest," § 1.7520-3(b)(1)(ii). The courts have further recognized a limited exception if use of the tables would produce an "unrealistic and unreasonable" result. *Anthony*, 520 F.3d at 378; *O'Reilly v. Commissioner*, 973 F.2d 1403, 1408 (8th Cir. 1992); *Negron v. United States*, 553 F.3d 1013, 1020 (6th Cir. 2009) ("The Treasury adopted, rather than superseded, the principles of well-established case law, including the unreasonable and unrealistic results exception, when it adopted Treas. Reg. § 20.7520-3.").

1. The SMI was not adequately preserved and protected

The Tax Court properly determined that the § 7520 tables do not apply to value the SMI because the adequate-protection requirement of Treasury Regulation § 1.7520-3(b)(2)(iii) was not satisfied. The Tax Court's disposition of this issue involved a mixed question of law and fact that is reviewed for clear error.

Section § 1.7520-3(b)(2)(iii) precludes the use of the tables to value a remainder interest—

> unless, consistent with the preservation and protection that the law of trusts would provide for a person who is unqualifiedly designated as the remainder beneficiary of a trust for a similar duration, the effect of the administrative and dispositive provisions for the interest or interests that precede the remainder or reversionary interest is to assure that the property will be adequately preserved and protected (*e.g.*, from erosion, invasion, depletion, or damage) until the remainder or reversionary interest takes effect in possession and enjoyment.

Treas. Reg. § 1.7520-3(b)(2)(iii). The "provisions of the arrangement and the surrounding circumstances" must manifest "the transferor's intent … that the entire disposition provide the remainder … beneficiary with an undiminished interest in the property transferred at the time of the termination of the prior interest." *Id.*

Under the law of trusts, "[o]ne of the fundamental common-law duties of a trustee is to preserve and maintain trust assets." *United States v. White Mountain Apache Tribe*, 537 U.S. 465, 475 (2003); *accord* G. Bogert & G. Bogert, Law of Trusts and Trustees § 582, p. 346 (2d rev. ed. 1980)). And "[i]t is well established that a trustee is accountable in damages for breaches of trust." *United States v. Mitchell*, 463 U.S. 206, 226 (1983); *accord* G. Bogert, The Law of Trusts & Trustees § 862 (2d ed. 1965) ("For a breach of trust the trustee may be directed by the court to pay damages to the beneficiary out of the trustee's own funds."); Restatement (Second) of the Law of Trusts §§ 205-212 (1959).

Here, in contrast to the settled law of trusts described above, the assignment agreement that created the SMI explicitly precluded the SMI holder from recovering damages for waste or other acts committed against the Hawthorne property before the SMI takes effect. It states: "In no event may any relief be granted that imposes on the owner [of the term-of-years interest] any personal liability" and that "any and all remedies for any breach … shall be limited to such owner's right, title, and interest in [the term-of-years interest]." Ex. 103. Thus, whereas the law of trusts would provide an action in damages under such circumstances, the SMI holder's only recourse is to take possession of the now-damaged property; but even that remedy is available only after the SMI holder has provided multiple notices of a breach and then waited a period of "not less than 90 days," during which time the waste to the property may continue. Ex. 103. Therefore, the provisions of the assignment agreement are not "consistent with" the preservation and protection that the law of trusts would provide. Treas. Reg. § 1.7520-3(b)(2)(iii).

RERI concedes that the SMI holder "could not sue for damages" for waste committed against the Hawthorne property. Br. 27. RERI nonetheless argues that the SMI holder's interest is "adequately preserved and protected" because of its right to take possession of the property in the event of a material breach.[6] In this regard, RERI contends that the Tax Court erred by "focus[ing] entirely on whether

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[6] RERI's hypothetical example (Br. 28) under which it takes early possession of the property in 2018 and receives "more than $8 million per year in rental payments" afterward is highly speculative. It assumes that the BB&T debt will be timely and full paid in 2016 and that AT&T would renew its lease, or, if it did not, that a new tenant would be promptly found and a lease agreement entered into with similar or more favorable terms.

the inability to sue for damages prevented the terms governing the Term Interest from being consistent with the law of trusts." The Tax Court's analysis in this respect, however, is precisely what the plain terms of the regulation requires: the remainder interest must be adequately protected "*consistent with* the preservation and protection that the law of trusts would provide." Treas. Reg. § 1.7520-3(b)(2)(iii) (emphasis added).

In this regard, we emphasize that the § 7520 tables for remainder interests utilize an interest rate component that assumes the remainder interest will be adequately preserved and protected consistent with the law of trusts. The interest rate component used in the tables simply does not account for the additional risk borne by a remainder interest holder who, like the SMI holder here, lacks the ability to recover damages for waste committed against the property, which the law of trusts would provide. The use of the tables is inappropriate in these circumstances because the lack of the SMI holder's right to recover damages for waste to the Hawthorne property increases its risk, and decreases the value of the remainder interest, in a manner that is not accounted for by the tables. *See Anthony*, 520 F.3d at 382 (The

Treasury regulations "formalized existing case-law exceptions that [were] applicable in cases that presented facts that disproved assumptions underlying the tables"). This very point is illustrated by the fact that even RERI's own trial expert concluded that the appropriate discount rate to be applied to value the SMI was at least 11 percent (the Tax Court found that it was actually 17.75 percent), whereas the interest rate component utilized by the tables was only 3 percent. Op. 51, 58; Ex. 133.

The SMI holder's inability to sue for damages, as the law of trusts would provide, presents additional risk for another reason that is not accounted for by the tables. Namely, Hawthorne executed a cure rights agreement in connection with the insurance policy it obtained to cover the $11.8 million balloon obligation due under the BB&T loan. In that agreement, Hawthorne agreed to transfer ownership of the Hawthorne property to the insurance company for no additional consideration if Hawthorne were to default and the insurance company were required to pay to BB&T the $11.8 million. Ex. 77. In that event, the SMI would become worthless, and the SMI holder would have no recourse against the term-of-interest holder for damages, as would be available under the law of trusts. That additional risk to the SMI holder is not accounted for by the interest rate component in the tables, which assumes the existence of only those risks that are "consistent with" the law of trusts, and it further supports the Tax Court's determination that the tables do not apply here.

2. The SMI was a restricted beneficial interest

The § 7520 tables do not apply for the independent reason that the SMI was also a "restricted beneficial interest." The Tax Court did not reach this issue in its opinion. Op. 43-44.

"A restricted beneficial interest is [a] remainder … interest that is subject to a contingency, power, or other restriction, whether the restriction is provided for by the terms of the trust, will, or other governing instrument or is caused by other circumstances." Treas. Reg. § 1.7520-3(b)(1)(ii). In this case, the Ross gift agreement executed in connection with RERI's donation of the SMI to the University required that the University "shall hold the [SMI] for a minimum of two years, after which the University shall sell the [SMI] in a manner and to a buyer of its choosing." Ex. 125; 3Stip. ¶60. The two-year-hold restriction and the mandatory-sell requirement render the SMI a "restricted beneficial interest" in the University's hands. In particular, the mandatory-sell requirement meant that the University would never come into possession of the Hawthorne property, because it was required to sell the SMI before the expiration of the term-of-years interest. That is the sort of restriction that precludes the use of the § 7520 tables because the term-certain component from the tables assumes that the holder of a remainder interest will ultimately come into possession of the subject property after the applicable term of years. Treas. Reg. §§ 20.2031-7(d)(2)(ii), 20.2031-7(d)(6) (2003).

In addition, the SMI is a restricted beneficial interest for the separate reason that it is also subject to a "contingency." That is, whether the SMI in Holdings will ever take effect is contingent on Hawthorne's successful payment of the BB&T loan, including the $11.8 million balloon payment, in order to avoid transfer of the Hawthorne property to the insurance company pursuant to the cure rights agreement.

3. Even if the § 7520 tables apply to value the SMI, RERI misapplied them here

Even if the § 7520 tables apply to value the SMI, RERI misapplied them here by multiplying the actuarial factor by the value of the wrong property. The present value of an ordinary remainder interest is determined under the tables "by multiplying the value of the [undivided] property by the appropriate remainder interest actuarial factor." Treas. Reg. §§ 1.7520-1(a)(1), 20.2031-7(d)(2)(ii) (2003).

The Gelbtuch appraisal multiplied the actuarial factor provided by Levine by the purported value of the Hawthorne property. But the property that RERI donated to the University was a future membership interest in Holdings. The Gelbtuch appraisal also ignored the $42.6 million mortgage debt that encumbered the Hawthorne property. Tr. 265. The value of an interest in Holdings plainly would have to account for that debt, which was a liability of Holding's wholly-owned subsidiary, Hawthorne. Gelbtuch testified that he would have reached "a different number" in his appraisal had he been asked to appraise an interest in Holdings instead of the Hawthorne property, because, as Gelbtuch confirmed, "the value of the LLC membership interests would be the value of the assets of the LLC less the liabilities of the LLC." Tr. 263-264. *See, e.g.*, Pratt, *Valuing a Business*, *supra*, at 353.

Thus, to value the SMI using the tables, RERI was required to multiply the applicable actuarial factor by the value of a 100-percent membership interest in Holdings at the time of the contribution, not the value of the fee interest in the Hawthorne property. RERI's misapplication of the tables produced an "unrealistic and unreasonable" value of $32,935,000 for the SMI that dictates that the SMI be valued independently of the tables. *Anthony*, 520 F.3d at 378; *Negron*, 553 F.3d at 1020. In this regard, the Tax Court found that the SMI was actually worth only $3,462,886 on the date of contribution, which was close to the value determined by the Government's experts: Mel Abraham determined a value of $3,382,000, and Dr. Michael Cragg determined a value of $2,090,000 as of that date. Op. 18, 59. Even RERI's own expert concluded that the SMI was worth only $16,550,000—barely half of the amount claimed by RERI. Op. 11.[7]

D. The Tax Court's determination of the fair market value of the SMI was not clearly erroneous

Because the § 7520 tables do not apply to value the SMI, the amount RERI would have been allowed to deduct had it complied with the substantiation requirements of the regulation would have been the

[7] If the Court were to determine that the tables apply, a remand would be necessary to determine the SMI's value based on a correct application of the tables.

SMI's "actual fair market value … based on all of the facts and circumstances." Treas. Reg. 1.7520-3(b)(1)(iii). The Tax Court's finding (Op. 59) that the SMI was worth $3,462,886 at the time of the donation was not clearly erroneous.

The Tax Court relied primarily on the widely-accepted discounted-cash-flow method to determine the SMI's value. The discounted-cash-flow method "is based upon the financial theory that the value of an asset is equal to the expected future economic benefits (cash flows), discounted to the present at a rate that reflects the risks in realizing such cash flows." Ex. 275 ¶33. In determining the SMI's value under this method, the court adopted the projection of RERI's expert, James Myers, as to the future cash flows expected to be generated from the Hawthorne property after the year 2020, when the SMI would take effect. Op. 51. But the court found that the 18.99 percent discount rate determined by the Government's expert, Dr. Michael Cragg, for discounting those cash flows to their present value was more credible than the 11.01 percent rate used by Myers. Op. 52.

As the Tax Court explained, Dr. Cragg's discount rate "gives more account to the difference in risk between the expected cashflows during and after the initial period of the AT&T lease." Op. 52. More specifically, the court found that Myers' rate failed to appropriately reflect the risks associated with "uncertainties about whether AT&T would renew its lease, whether a replacement tenant could be found if AT&T declined to renew, and, in either event, what market rents would be at that time." Op. 52-53. Because Dr. Cragg, however, determined his discount rate based on the February 2002 sales price of the Hawthorne property, the court adjusted Dr. Cragg's discount rate down to 17.75 percent to reflect the change in general interest rates between February 2002 and August 27, 2003 (the date of RERI's contribution). Op. 57-58. Based on Myers' projected cash flows and Dr. Cragg's discount rate, as adjusted by the court, the court determined a value of $3,462,886 for the SMI as of August 27, 2003. Op. 59.

None of RERI's arguments challenging the Tax Court's determination as to the proper discount rate supports a finding of clear error.

1. The record supports the Tax Court's discount rate based on Dr. Cragg's analysis

RERI faults Dr. Cragg for using mathematics in his analysis, claiming that he used a "very different approach" to valuation that

RERI suggests was something other than the discounted-cash-flow method. Br. 32-35. Not so.

The Tax Court accepted Dr. Cragg, who has a Ph.D. in economics from Stanford University, as an expert in finance, economics, and valuation. Op. 15. Dr. Cragg opined that the SMI was worth no more than $1.65 million in April 2002, and no more than $2.09 million as of August 27, 2003. Ex. 275 ¶47; Tr. 694. His report specifically states that he used the discounted-cash-flow method to arrive at his conclusions. Ex. 275 ¶33. As Dr. Cragg explained, the discounted-cash-flow model "is expressed by a mathematical relationship between its inputs and outputs. The inputs are discount rates and expected cash flows, and the output is the value." Ex. 275 ¶35. RERI concedes as much. Br. 33 n.11.

Dr. Cragg went on to explain that, "[l]ike any mathematical relationship, the formulas can be easily rearranged." Ex. 275 ¶35. Here, rather than determine future cash flows and a discount rate and then solve for present value, Dr. Cragg (in general terms) simply rearranged the equation by using amounts that could be reliably determined as inputs for the present value and the future cash flows and then solved for the discount rate. Ex. 275 ¶¶35-47. There is nothing remotely suspect or unscientific about that approach, as RERI would have this Court believe.

Dr. Cragg began his analysis by recognizing that the present value of the Hawthorne property was $42.35 million in February 2002, when Hawthorne purchased it for that price in an arm's length transaction. Using the discounted-cash-flow method, the $42.35 million could readily be apportioned between (1) the present value of the projected cash flows from the Hawthorne property through May 2016 (the end of the initial term of the AT&T lease) and (2) the present value of the cash flows after May 2016. That is because, as Dr. Cragg explained, the cash flows during the initial lease term were fixed by the lease agreement and were, therefore, readily ascertainable, as was the appropriate discount rate to be applied to those cash flows because AT&T's credit rating was known. Ex. 275 ¶¶35-38. Using AT&T's 14-year borrowing rate, which Dr. Cragg estimated to be 7.92 percent, Dr. Cragg calculated a present value for the projected cash flows through the initial lease term of $39.06 million. Dr. Cragg thus concluded that the present value of the post-2016 cash flows was $3.29 million, *i.e.*, the difference between the $42.35 million value of the Hawthorne property and $39.06 million. Ex. 275 ¶¶39-42, 91-93.

Dr. Cragg then projected the future cash flows from the Hawthorne property after 2016. To do so, he assumed that AT&T's contracted lease payments for the final year of the initial lease term were the best estimate of what expected market lease rates would be in 2016, at the end of the initial lease term, and he assumed an annual growth rate of 3.29 percent based on an index of U.S. commercial real estate prices. Ex. 275 ¶¶43-45, 96. Having thus determined both the present value of the post-2016 cash flows and the projected cash flows for that same period, Dr. Cragg solved algebraically for a discount rate of 18.99 percent using the discounted-cash-flow formula. Ex. 275¶¶ 45, 97-98. Applying that discount rate to projected cash flows after December 31, 2020, produced a present value for the SMI of not more than $1.65 million in February 2002, and not more than $2.09 million as of August 27, 2003.[8] Ex. 275 ¶¶46-47, 98; Tr. 694.

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[8] Dr. Cragg valued the SMI and the term-of-years interest "as if they were direct interests in the Hawthorne property," noting that his estimate was an "upper bound for the SMI in Holdings at issue because it does not take into account the encumbrance of the BB&T loan and the ownership structure." Ex. 275 ¶31.

As the foregoing demonstrates, Dr. Cragg used reliable inputs based on an arm's length transaction to compute an appropriate discount rate using the discounted-cash-flow method. RERI's contention (Br. 35) that Dr. Cragg used a "novel and untested" method is unsupported.

2. The record supports Dr. Cragg's use of AT&T's corporate bond rate to discount projected cash flows during the initial term of the lease

RERI next argues that the Tax Court committed clear error by accepting Dr. Cragg's use of AT&T's corporate bond rate of 7.92 percent to discount projected cash flows during the initial term of the lease. Br. 35-40. According to RERI, the discount rate should have included a liquidity premium to account for the greater liquidity risk involved in ownership of the Hawthorne property than in ownership of an AT&T bond. The Tax Court properly rejected this argument. Op. 54-55.

First, as the Tax Court pointed out, RERI's own expert, Myers, concluded that an even lower rate of 6.0 percent based on corporate bond yields, plus a 1.5 percent liquidity premium, was an appropriate rate for a "bondable lease structure," which Myers found to be comparable to the AT&T lease in this case. Ex. 271 (p. 47); Tr. 345.

Furthermore, as Dr. Cragg explained, the only relevant risk in determining the present value of projected cash flows during the initial lease term was AT&T's credit risk:

> During the AT&T initial lease period, the cash flows are an obligation of AT&T and fixed by contract. The risk associated with these cash flows is the risk that AT&T would be unable to meet its contractual obligations. This risk is analogous to AT&T defaulting on its debt because lease obligations are approximately on par with a company's debt obligations.

Ex. 275 ¶40. Dr. Cragg therefore concluded that "the discount rate for the cash flows during the AT&T lease can be approximated by the market rate for AT&T corporate bonds with a tenor similar to the remaining time of the lease as of the Valuation Date (14 years)." *Id.*; *see also* Tr. 691. Therefore, it would have been inappropriate for Dr. Cragg to include a liquidity premium to determine the present value of projected cash flows during the initial lease term. Indeed, the whole point of Dr. Cragg's computation in this respect was to apportion the $42.35 million value of the Hawthorne property in February 2002 between (1) the present value of the projected cash flows during the initial lease term and (2) the present value of post-2016 cash flows.

Ex. 275 ¶35. To have included a liquidity premium in computing the former, but not the later, would have improperly skewed the results.

3. The Tax Court appropriately adjusted Dr. Cragg's discount rate

Although the Tax Court found Dr. Cragg's discount rate "more persuasive" than Myers,' it noted that his initial analysis nevertheless suffered "from being directed at a date other than August 27, 2003, the date of RERI's gift of the SMI to the University." Op. 57. The court therefore adjusted Dr. Cragg's 18.99 percent rate downward to reflect changes in interest rates between February 2002 and August 2003. Op. 58. The court's adjusted rate reflected the 13.39 percent risk premium implicit in Dr. Cragg's calculation of the discount rate, plus the 4.36 percent adjusted-federal-long-term rate for August 2003. Op. 58.

RERI argues that the court's adjustment was "inadequate" because "interest rates are only one consideration in determining the correct discount rate." Br. 45. RERI, however, does not identify any other consideration or risk in particular that purportedly renders the court's adjustment inadequate. RERI's argument fails to appreciate, moreover, that the court's adjusted rate retained the 13.39 percent risk premium that was implicit in Dr. Cragg's determination of the discount rate, which already accounted for risks apart from changes in the interest rate. RERI has not established clear error in the court's determination of the appropriate discount rate.

In any event, RERI has failed to establish that its alleged errors would alter the applicability of the 40-percent gross-valuation-misstatement penalty under I.R.C. § 6662(h)(2). In 2003, the substantial-valuation-misstatement penalty applied if the value of property claimed on a return was "200 percent or more of the amount determined to be the correct amount of such valuation." I.R.C. § 6662(e)(1)(A) (2003). And the gross-valuation-misstatement applied if the claimed value of the property was 400 percent or more of the correct value. I.R.C. § 6662(h)(2)(A)(i) (2003). The Tax Court found that RERI's claimed deduction of $33,019,000 was 953.5 percent of the SMI's correct value, so that the gross-valuation-misstatement penalty applied. Op. 60. The court pointed out that the gross-valuation-misstatement penalty would still apply as long as the SMI's actual value was not greater than $8,254,750. Op. 60.

In this regard, Myers performed calculations in his rebuttal report making the adjustments he believed were appropriate to "correct" Dr. Cragg's use of a valuation date other than August 27, 2003. Tellingly, in the first scenario in which Myers assumed a value of $42.35 million for the Hawthorne property in February 2002 (consistent with Dr. Cragg's methodology), his computed value for the SMI as of August 27, 2003, was less than $5 million. Ex. 272 (pp. 5-8). The calculations of RERI's own expert thus confirm that the gross-valuation-misstatement penalty is applicable regardless of the errors assigned by RERI to the Tax Court's adjusted discount rate.

E. The Tax Court properly determined that RERI failed to establish that there was reasonable cause for its grossly overvalued charitable contribution deduction and that it acted in good faith

RERI claims it had reasonable cause and acted in good faith in claiming its $33 million charitable contribution deduction for property worth only approximately $3 million and that, therefore, under I.R.C. § 6664(c)(1), no penalties are applicable. Br. 47-50.

1. Burden of proof

RERI bore the burden to prove reasonable cause and good faith as an affirmative defense to penalties. *Barnes v. Commissioner*, 712 F.3d

581, 584 (D.C. Cir. 2013) (citing *Higbee v. Commissioner*, 116 T.C. 438, 447 (2001)). The Tax Court wrongly assumed, without deciding, that the Commissioner had the burden to prove the absence of reasonable cause on RERI's part with respect to the gross-valuation-misstatement penalty. Op. 62-65.

In enacting I.R.C. § 7491 regarding the burden of proof in income tax cases, Congress was careful to explain that the Commissioner is not required to introduce evidence regarding defenses to penalties, including reasonable cause, because "it is the taxpayer's responsibility (and not the Secretary's obligation) to raise those issues." H.R. Conf. Rep. 105-599, at 241 (1998); *see also Higbee*, 116 T.C. at 446-447. That makes sense because a taxpayer may choose not to assert a reasonable-cause defense; more importantly, because of its nature, the evidence relevant to such defense necessarily will be in the taxpayer's, not the Commissioner's, possession. It would be strange indeed to require the Commissioner to prove the *absence* of reasonable cause in such circumstances.

Tax Court Rule 142, which purports to shift the burden of proof to the Commissioner "in respect of any new matter, increases in deficiency, and affirmative defenses, pleaded in the answer," does not change that result, and certainly not in this case. By its terms, Rule 142 applies only to shift the burden with respect to certain matters that are "pleaded in the answer." While the Commissioner filed an amended answer in the Tax Court asserting the gross-valuation-misstatement penalty, the Commissioner did not—nor was he required to—plead the absence of a reasonable-cause defense by RERI. Doc. 99. *Cf. United States v. Northern Trust Company*, 372 F.3d 886, 888 (7th Cir. 2004) ("[C]omplaints need not anticipate and attempt to plead around defenses.") (citing *Gomez v. Toledo*, 446 U.S. 635 (1980)). Therefore, Rule 142 is inapplicable by its terms as to the issue of reasonable cause because the Commissioner did not, nor was he required to, plead the absence of reasonable cause in his answer in anticipation that RERI might raise that defense to penalties. Indeed, RERI did not even assert reasonable cause as a defense to penalties in its petition. Doc. 1.

We further note that even the Commissioner's assertion of the gross-valuation-misstatement penalty in his answer was not a "new matter" under Rule 142 because it did not require any additional evidence or arguments beyond that which were involved in the substantial-valuation-misstatement penalty asserted in the FPAA. Both penalties are a mathematical function of the difference between the fair market value of the property and the contribution amount.

2. RERI's reasonable-cause defense to penalties is unavailing

A partnership's reasonable cause defense is determined with reference to the conduct and state of mind of its managing partner. *E.g.*, *American Boat Co., LLC v. United States*, 583 F.3d 471, 479 (7th Cir. 2009). Levine was RERI's managing partner. Ex. 106. He was subpoenaed, but not called, to testify at trial because he would have asserted his rights under the Fifth Amendment. 2Stip. ¶242.

In the case of an underpayment attributable to a substantial or gross-valuation overstatement with respect to charitable deduction property, the reasonable-cause defense to penalties under § 6664(c)(1) "shall not apply unless"—

> (A) the claimed value of the property was based on a qualified appraisal made by a qualified appraiser, and
>
> (B) in addition to obtaining such appraisal, the taxpayer made a good faith investigation of the value of the contributed property.

I.R.C. § 6664(c)(2) (2003). "The term 'qualified appraisal' means any appraisal meeting the requirements of the regulations prescribed under section 170(a)(1)." I.R.C. § 6664(c)(3)(C). The Tax Court, without addressing whether Gelbtuch's appraisal was a qualified appraisal, held that RERI's purported efforts to investigate the value of the SMI were insufficient "as a matter of law" to satisfy the statutory requirement of a good-faith investigation. Op. 67. This Court can affirm the Tax Court's decision on any basis supported by the record. *Parsi v. Daioleslam*, 778 F.3d 116, 126 (D.C. Cir. 2015).

The reasonable-cause defense is not available to RERI because, as we demonstrated above, Gelbtuch's appraisal was not a qualified appraisal; and, even if it had been a qualified appraisal, RERI nonetheless failed to make a good-faith investigation of the value of the SMI. In any event, RERI failed to establish that it had "reasonable cause" and "acted in good faith" under § 6664(c)(1).

"Simply *obtaining* an appraisal is not the same as *reasonably relying* on that appraisal." *Kaufman*, 784 F.3d at 70. Gelbtuch's appraisal was defective in multiple respects that should have alerted RERI that it was not reasonable to rely on it. First, Gelbtuch valued the wrong property in his appraisal (*i.e.*, the Hawthorne property), rendering it completely useless for purposes of ascertaining the correct value of the SMI. Levine, of course, knew that the Hawthorne property was not the property that RERI donated to the University because he negotiated the terms of the transfer. 3Stip. ¶72. In addition, the appraisal incorrectly assumed that the Hawthorne property was "free and clear of any and all liens or encumbrances," when in fact it was subject to a mortgage with an outstanding loan balance of approximately $42,632,884 at the time of the donation. Ex. 1; 3Stip. ¶51. The appraisal also failed to include any analysis of, or even mention, the impact of the restrictions that RERI placed on the University's right to use or dispose of the SMI, including the two-year-hold restriction and the mandatory-sell requirement. Levine, however, was aware of those restrictions because he was involved in negotiating the terms of the gift agreement. Exs. 118, 124. These deficiencies in the appraisal made it unreasonable for RERI to rely on it to value the SMI.

RERI claims that it compared Gelbtuch's appraisal results with (1) the $42.35 million that Hawthorne paid to acquire the Hawthorne property in 2002 and (2) an August 2001 appraisal concluding that the Hawthorne property was worth $47 million. Br. 48, 49-50. But, again, both of those transactions involved an entirely different asset—the fee interest in the *Hawthorne property*, not the SMI in Holdings. RERI cannot have relied in good faith on those transactions in seeking to ascertain the correct value of *the SMI*.

Moreover, the $2.95 million price RERI paid to acquire the SMI in March 2002, just 17 months before RERI donated it to the University, was much more probative information in RERI's hands of the SMI's correct value at the time of the donation. *See* Treas. Reg. § 1.6664-4(b) (identifying "the relationship between appraised value and purchase price" as a relevant consideration). RERI could not have reasonably believed under any circumstances that an asset it had only recently acquired the year before could have magically increased in value more than ten-fold, so that it was somehow entitled to a deduction of $33,019,000 for donating an asset that it had acquired the year before for only $2.95 million. The proposition would have struck any reasonable person as "too good to be true." *See 106 Ltd. v.*

Commissioner, 684 F.3d 84, 93 (D.C. Cir. 2012).[9] But Levine's intent in these transactions was to earn a profit from repeated sales of the SMI and assisting multiple taxpayers to claim large deductions for donations of the same limited interest in a piece of property. *See* 3Stip. ¶¶72, 74-87.

[9] In the proceedings below, the Commissioner stipulated that the $2.95 million price for which RERI acquired the SMI "did not represent the fair market value of the SMI in Holdings" at that time. 3Stip. ¶39. The Commissioner so stipulated because he viewed the transaction as having occurred between related parties as part of a larger tax scheme. But the Commissioner did not stipulate, nor should it be implied, that the SMI's value at the time was anything *greater* than the $2.95 million amount for which RERI acquired it.

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

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Attorney for the Commissioner of Internal Revenue

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JACOB EARL CHRISTENSEN
Attorney

ADDENDUM[10]

[10] The relevant statutes and regulations reproduced in the addendum were in effect in 2003, the year in issue.

I.R.C. § 170. Charitable, etc., contributions and gifts

(a) Allowance of deduction.--

(1) General rule.--There shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year. A charitable contribution shall be allowable as a deduction only if verified under regulations prescribed by the Secretary.

* * *

I.R.C. § 6662. Imposition of accuracy-related penalty

(a) Imposition of penalty.--If this section applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies.

(b) Portion of underpayment to which section applies.--This section shall apply to the portion of any underpayment which is attributable to 1 or more of the following:

(1) Negligence or disregard of rules or regulations.
(2) Any substantial understatement of income tax.
(3) Any substantial valuation misstatement under chapter 1.
(4) Any substantial overstatement of pension liabilities.
(5) Any substantial estate or gift tax valuation understatement.

This section shall not apply to any portion of an underpayment on which a penalty is imposed under section 6663.

* * *

(e) Substantial valuation misstatement under chapter 1.--

(1) In general.--For purposes of this section, there is a substantial valuation misstatement under chapter 1 if--

(A) the value of any property (or the adjusted basis of any property) claimed on any return of tax imposed by chapter 1 is 200 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be), or …

* * *

(2) Limitation.--No penalty shall be imposed by reason of subsection (b)(3) unless the portion of the underpayment for the taxable year attributable to substantial valuation misstatements under chapter 1 exceeds $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company (as defined in section 542)).

* * *

(h) Increase in penalty in case of gross valuation misstatements.--

(1) In general.--To the extent that a portion of the underpayment to which this section applies is attributable to one or more gross valuation misstatements, subsection (a) shall be applied with respect to such portion by substituting "40 percent" for "20 percent".

(2) Gross valuation misstatements.--The term "gross valuation misstatements" means--

(A) any substantial valuation misstatement under chapter 1 as determined under subsection (e) by substituting--
(i) "400 percent" for "200 percent" each place it appears,

* * *

I.R.C. § 6664. Definitions and special rules

* * *

(c) Reasonable cause exception.--

(1) In general.--No penalty shall be imposed under this part with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.

(2) Special rule for certain valuation overstatements.--In the case of any underpayment attributable to a substantial or gross valuation overstatement under chapter 1 with respect to charitable deduction property, paragraph (1) shall not apply unless--

(A) the claimed value of the property was based on a qualified appraisal made by a qualified appraiser, and

(B) in addition to obtaining such appraisal, the taxpayer made a good faith investigation of the value of the contributed property.

(3) Definitions.--For purposes of this subsection--

(A) Charitable deduction property.--The term "charitable deduction property" means any property contributed by the taxpayer in a contribution for which a deduction was claimed under section 170. For purposes of paragraph (2), such term shall not include any securities for which (as of the date of the contribution) market quotations are readily available on an established securities market.

(B) Qualified appraiser.--The term "qualified appraiser" means any appraiser meeting the requirements of the regulations prescribed under section 170(a)(1).

(C) Qualified appraisal.--The term "qualified appraisal" means any appraisal meeting the requirements of the regulations prescribed under section 170(a)(1).

* * *

I.R.C. § 6751. Procedural requirements

* * *

(b) Approval of assessment.--

(1) In general.--No penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate.

(2) Exceptions.--Paragraph (1) shall not apply to--

(A) any addition to tax under section 6651, 6654, or 6655; or

(B) any other penalty automatically calculated through electronic means.

* * *

I.R.C. § 7491. Burden of proof

(a) Burden shifts where taxpayer produces credible evidence.--

(1) General rule.--If, in any court proceeding, a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed by subtitle A or B, the Secretary shall have the burden of proof with respect to such issue.

* * *

(b) Use of statistical information on unrelated taxpayers.--In the case of an individual taxpayer, the Secretary shall have the burden of proof in any court proceeding with respect to any item of income which was reconstructed by the Secretary solely through the use of statistical information on unrelated taxpayers.

(c) Penalties.--Notwithstanding any other provision of this title, the Secretary shall have the burden of production in any court proceeding with respect to the liability of any individual for any penalty, addition to tax, or additional amount imposed by this title.

Treas. Reg. § 1.170A-13. Recordkeeping and return requirements for deductions for charitable contributions.

(c) Deductions in excess of $5,000 for certain charitable contributions of property made after December 31, 1984—(1) General Rule—(i) In general. This paragraph applies to any charitable contribution made after December 31, 1984, by an individual, closely held corporation, personal service corporation, partnership, or S corporation of an item of property (other than money and publicly traded securities to which § 1.170A–13(c)(7)(xi)(B) does not apply if the amount claimed or reported as a deduction under section 170 with respect to such item exceeds $5,000. This paragraph also applies to charitable contributions by C corporations (as defined in section 1361(a)(2) of the Code) to the extent described in paragraph (c)(2)(ii) of this section. No deduction under section 170 shall be allowed with respect to a charitable contribution to which this paragraph applies unless the substantiation requirements described in paragraph (c)(2) of this section are met. For purposes of this paragraph (c), the amount claimed or reported as a deduction for an item of property is the aggregate amount claimed or reported as a deduction for a charitable contribution under section 170 for such items of property and all similar items of property (as defined in paragraph (c)(7)(iii) of this section) by the same donor for the same taxable year (whether or not donated to the same donee).

* * *

(2) Substantiation requirements—(i) In general. Except as provided in paragraph (c)(2)(ii) of this section, a donor who claims or reports a deduction with respect to a charitable contribution to which this paragraph (c) applies must comply with the following three requirements:

> (A) Obtain a qualified appraisal (as defined in paragraph (c)(3) of this section) for such property contributed. If the contributed property is a partial interest, the appraisal shall be of the partial interest.
>
> (B) Attach a fully completed appraisal summary (as defined in paragraph (c) (4) of this section) to the tax return (or, in the case of a donor that is a partnership or S corporation, the information return) on which the deduction for the contribution is first claimed (or reported) by the donor.
>
> (C) Maintain records containing the information required by paragraph (b) (2) (ii) of this section.

* * *

(3) Qualified appraisal—(i) In general. For purposes of this paragraph (c), the term "qualified appraisal" means an appraisal document that—

> (A) Relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property nor later than the date specified in paragraph (c) (3) (iv) (B) of this section;
>
> (B) Is prepared, signed, and dated by a qualified appraiser (within the meaning of paragraph (c) (5) of this section);
>
> (C) Includes the information required by paragraph (c)(3)(ii) of this section; and

(D) Does not involve an appraisal fee prohibited by paragraph (c) (6) of this section.

(ii) Information included in qualified appraisal. A qualified appraisal shall include the following information:

(A) A description of the property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was (or will be) contributed;

(B) In the case of tangible property, the physical condition of the property;

(C) The date (or expected date) of contribution to the donee;

(D) The terms of any agreement or understanding entered into (or expected to be entered into) by or on behalf of the donor or donee that relates to the use, sale, or other disposition of the property contributed, including, for example, the terms of any agreement or understanding that—

(1) Restricts temporarily or permanently a donee's right to use or dispose of the donated property,

(2) Reserves to, or confers upon, anyone (other than a donee organization or an organization participating with a donee organization in cooperative fundraising) any right to the income from the contributed property or to the possession of the property, including the right to vote donated securities, to acquire the property by purchase or otherwise, or to designate the person having such income, possession, or right to acquire, or

(3) Earmarks donated property for a particular use;

(E) The name, address, and (if a taxpayer identification number is otherwise required by section 6109 and the regulations thereunder) the identifying number of the qualified appraiser; and, if the qualified appraiser is acting in his or her capacity as a partner in a partnership, an employee of any person (whether an individual, corporation, or partnerships), or an independent contractor engaged by a person other than the donor, the name, address, and taxpayer identification number (if a number is otherwise required by section 6109 and the regulations thereunder) of the partnership or the person who employs or engages the qualified appraiser;

(F) The qualifications of the qualified appraiser who signs the appraisal, including the appraiser's background, experience, education, and membership, if any, in professional appraisal associations;

(G) A statement that the appraisal was prepared for income tax purposes;

(H) The date (or dates) on which the property was appraised;

(I) The appraised fair market value (within the meaning of § 1.170A–1 (c) (2)) of the property on the date (or expected date) of contribution;

(J) The method of valuation used to determine the fair market value, such as the income approach, the market-data approach, and the replacement-cost-less-depreciation approach; and

(K) The specific basis for the valuation, such as specific comparable sales transactions or statistical sampling, including a justification for using sampling and an explanation of the sampling procedure employed.

* * *

(4) Appraisal summary—(i) In general. For purposes of this paragraph (c), except as provided in paragraph (c)(4)(iv)(A) of this

section, the term appraisal summary means a summary of a qualified appraisal that—

(A) Is made on the form prescribed by the Internal Revenue Service;

(B) Is signed and dated (as described in paragraph (c)(4)(iii) of this section) by the donee (or presented to the donee for signature in cases described in paragraph (c)(4)(iv)(C)(2) of this section);

(C) Is signed and dated by the qualified appraiser (within the meaning of paragraph (c)(5) of this section) who prepared the qualified appraisal (within the meaning of paragraph (c)(3) of this section); and

(D) Includes the information required by paragraph (c) (4) (ii) of this section.

(ii) Information included in an appraisal summary. An appraisal summary shall include the following information:

(A) The name and taxpayer identification number of the donor (social security number if the donor is an individual or employer identification number if the donor is a partnership or corporation);

(B) A description of the property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was contributed;

(C) In the case of tangible property, a brief summary of the overall physical condition of the property at the time of the contribution;

(D) The manner of acquisition (e.g., purchase, exchange, gift, or bequest) and the date of acquisition of the property by the donor, or, if the property was created, produced, or manufactured by or for the donor, a statement to that effect and the approximate date the property was substantially completed;

(E) The cost or other basis of the property adjusted as provided by section 1016;

(F) The name, address, and taxpayer identification number of the donee;

(G) The date the donee received the property;

(H) For charitable contributions made after June 6, 1988, a statement explaining whether or not the charitable contribution was made by means of a bargain sale and the amount of any consideration received from the donee for the contribution;

(I) The name, address, and (if a taxpayer identification number is otherwise required by section 6109 and the regulations thereunder) the identifying number of the qualified appraiser who signs the appraisal summary and of other persons as required by paragraph (c)(3)(ii)(E) of this section;

(J) The appraised fair market value of the property on the date of contribution;

(K) The declaration by the appraiser described in paragraph (c)(5)(i) of this section;

(L) A declaration by the appraiser stating that—

(1) The fee charged for the appraisal is not of a type prohibited by paragraph (c)(6) of this section; and

(2) Appraisals prepared by the appraiser are not being disregarded pursuant to 31 U.S.C. 330(c) on the date the appraisal summary is signed by the appraiser; and

(M) Such other information as may be specified by the form.

* * *

(iv) Special rules—

* * *

(C) Manner of acquisition, cost basis and donee's signature. (1) If a taxpayer has reasonable cause for being unable to provide the information required by paragraph (c)(4)(ii) (D) and (E) of this section (relating to the manner of acquisition and basis of the contributed property), an appropriate explanation should be attached to the appraisal summary. The taxpayer's deduction will not be disallowed simply because of the inability (for reasonable cause) to provide these items of information.

* * *

(H) Failure to attach appraisal summary. In the event that a donor fails to attach to the donor's return an appraisal summary as required by paragraph (c)(2)(i)(B) of this section, the Internal Revenue Service may request that the donor submit the appraisal summary within 90 days of the request. If such a request is made and the donor complies with the request within the 90–day period, the deduction under section 170 shall not be disallowed for failure to attach the appraisal summary, provided that the donor's failure to attach the appraisal summary was a good faith omission and the requirements of paragraph (c) (3) and (4) of this section are met (including the completion of the qualified appraisal prior to the date specified in paragraph (c)(3)(iv)(B) of this section).

Treas. Reg. § 1.7520-1. Valuation of annuities, unitrust interests, interests for life or terms of years, and remainder or reversionary interests.

(a) General actuarial valuations. (1) Except as otherwise provided in this section and in § 1.7520–3 (relating to exceptions to the use of prescribed tables under certain circumstances), in the case of certain transactions after April 30, 1989, subject to income tax, the fair market value of annuities, interests for life or for a term of years (including unitrust interests), remainders, and reversions is their present value determined under this section. See § 20.2031–7(d) (and, for certain prior periods, § 20.2031–7A) of this chapter, Estate Tax Regulations, for the computation of the value of annuities, unitrust interests, life estates, terms for years, remainders, and reversions, other than interests described in paragraphs (a)(2) and (a)(3) of this section.

* * *

(b) Components of valuation--(1) Interest rate component--(i) Section 7520 Interest rate. The section 7520 interest rate is the rate of return, rounded to the nearest two-tenths of one percent, that is equal to 120 percent of the applicable Federal mid-term rate, compounded annually, for purposes of section 1274(d)(1), for the month in which the valuation date falls. In rounding the rate to the nearest two-tenths of a percent, any rate that is midway between one two-tenths of a percent and another is rounded up to the higher of those two rates. For example, if 120 percent of the applicable Federal mid-term rate is 10.30, the section 7520 interest rate component is 10.4. The section 7520 interest rate is published monthly by the Internal Revenue Service in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b) of this chapter).

(ii) Valuation date. Except as provided in § 1.7520–2, the valuation date is the date on which the transaction takes place.

(2) Mortality component. The mortality component reflects the mortality data most recently available from the United States census. As new mortality data becomes available after each decennial census, the mortality component described in this section will be revised

periodically and the revised mortality component tables will be published in the regulations at that time. For transactions with valuation dates after April 30, 1999, the mortality component table (Table 90CM) is contained in § 20.2031–7(d)(7) of this chapter. See § 20.2031–7A of this chapter for mortality component tables applicable to transactions for which the valuation date falls before May 1, 1999.

(c) Tables. The present value on the valuation date of an annuity, life estate, term of years, remainder, or reversion is computed by using the section 7520 interest rate component that is described in paragraph (b)(1) of this section and the mortality component that is described in paragraph (b)(2) of this section. Actuarial factors for determining these present values are included in tables in these regulations and in publications by the Internal Revenue Service. If a special factor is required in order to value an interest, the Internal Revenue Service will furnish the factor upon a request for a ruling. The request for a ruling must be accompanied by a recitation of the facts, including the date of birth for each measuring life and copies of relevant instruments. A request for a ruling must comply with the instructions for requesting a ruling published periodically in the Internal Revenue Bulletin (see Rev. Proc. 94–1, 1994–1 I.R.B. 10, and subsequent updates, and §§ 601.201 and 601.601(d)(2)(ii)(b) of this chapter) and include payment of the required user fee.

* * *

Treas. Reg. § 1.7520-2. Valuation of charitable interests.

(a) In general—(1) Valuation. Except as otherwise provided in this section and in § 1.7520–3 (relating to exceptions to the use of prescribed tables under certain circumstances), the fair market value of annuities, interests for life or for a term of years, remainders, and reversions for which an income tax charitable deduction is allowable is the present value of such interests determined under § 1.7520–1.

* * *

Treas. Reg. § 1.7520-3. Limitation on the application of section 7520.

* * *

(b) Other limitations on the application of section 7520—(1) In general—(i) Ordinary beneficial interests. For purposes of this section:

* * *

(ii) Certain restricted beneficial interests. A restricted beneficial interest is an annuity, income, remainder, or reversionary interest that is subject to a contingency, power, or other restriction, whether the restriction is provided for by the terms of the trust, will, or other governing instrument or is caused by other circumstances. In general, a standard section 7520 annuity, income, or remainder factor may not be used to value a restricted beneficial interest. However, a special section 7520 annuity, income, or remainder factor may be used to value a restricted beneficial interest under some circumstances. See paragraph (b)(4) Example 2 of this section, which illustrates a situation where a special section 7520 actuarial factor is needed to take into account the shorter life expectancy of the terminally ill measuring life. See § 1.7520–1(c) for requesting a special factor from the Internal Revenue Service.

(iii) Other beneficial interests. If, under the provisions of this paragraph (b), the interest rate and mortality components prescribed under section 7520 are not applicable in determining the value of any annuity, income, remainder, or reversionary interest, the actual fair market value of the interest (determined without regard to section 7520) is based on all of the facts and circumstances if and to the extent permitted by the Internal Revenue Code provision applicable to the property interest.

* * *

(2) Provisions of governing instrument and other limitations on source of payment—

* * *

(iii) Remainder and reversionary interests. A standard section 7520 remainder interest factor for an ordinary remainder or reversionary interest may not be used to determine the present value of a remainder or reversionary interest (whether in trust or otherwise) unless, consistent with the preservation and protection that the law of trusts would provide for a person who is unqualifiedly designated as the remainder beneficiary of a trust for a similar duration, the effect of the administrative and dispositive provisions for the interest or interests that precede the remainder or reversionary interest is to assure that the property will be adequately preserved and protected (e.g., from erosion, invasion, depletion, or damage) until the remainder or reversionary interest takes effect in possession and enjoyment. This degree of preservation and protection is provided only if it was the transferor's intent, as manifested by the provisions of the arrangement and the surrounding circumstances, that the entire disposition provide the remainder or reversionary beneficiary with an undiminished interest in the property transferred at the time of the termination of the prior interest.

* * *

Treas. Reg. § 20.2031-7. Valuation of annuities, interests for life or term of years, and remainder or reversionary interests.

* * *

(d) Actuarial valuations after April 30, 1999--(1) In general. Except as otherwise provided in paragraph (b) of this section and § 20.7520–3(b) (pertaining to certain limitations on the use of prescribed tables), if the valuation date for the gross estate of the decedent is after April 30, 1999, the fair market value of annuities, life estates, terms of years, remainders, and reversionary interests is the present value determined by use of standard or special section 7520 actuarial factors. These factors are derived by using the appropriate section 7520 interest rate and, if applicable, the mortality component for the valuation date of the interest that is being valued. For purposes of the computations described in this section, the age of an individual is the age of that individual at the individual's nearest birthday. See §§ 20.7520–1 through 20.7520–4.

(2) Specific interests—

* * *

(ii) Ordinary remainder and reversionary interests. If the interest to be valued is to take effect after a definite number of years or after the death of one individual, the present value of the interest is computed by multiplying the value of the property by the appropriate remainder interest actuarial factor (that corresponds to the applicable section 7520 interest rate and remainder interest period) in Table B (for a term certain) or the appropriate Table S (for one measuring life), as the case may be. Table B is contained in paragraph (d)(6) of this section and Table S (for one measuring life when the valuation date is after April 30, 1999) is contained in paragraph (d)(7) of this section and in Internal Revenue Service Publication 1457. For information about obtaining actuarial factors for other types of remainder interests, see paragraph (d)(4) of this section.

* * *