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specific topic:**

- **Stocks, Yachts and the Slugging Shortstop: Remember the Big Picture on Step Transactions**
- **Art: Sometimes Eagle Contributions Don't Fly... But Sometimes They Do**
- **Conservation Easements and Subordination: Aren't You Glad I Didn't Say Banana?**

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I Didn't See That Coming... Lessons from Unusual Charitable Gifts

In March of 2015, passengers boarded AirAsia Flight 223 in Sydney destined for Kuala Lumpur, the capital of Malaysia and a center for global commerce. They were more than a little shocked when they landed in Melbourne, Australia, instead!¹ How did this happen?

The flight plan was derailed by a series of errors. The pilot entered the departure airport as the destination airport, which caused the navigation system to malfunction and the plane to head off in the wrong direction. In-air attempts to fix the problem only led to further complications, in part because the pilot had also entered incorrect longitudinal information. This 6,835-mile positional error landed them on a completely different continent than their intended destination. The Australian Transport Safety Bureau commended the Melbourne air traffic controllers for directing the surprise airliner to a safe landing. The situation was resolved successfully when a team of well-trained professionals provided guidance for those who had gone wildly off-course.

This can be the case in charitable giving when a client's "brilliant" plan simply does not meet the prevailing legal requirements. While it is not possible to prepare for every uncommon charitable gift, it is extremely beneficial to consider the treatment of unusual gifts. The guidance of a trained professional, of course, can make all the difference in keeping someone on course when making an unusual gift.

Stocks, Yachts and the Slugging Shortstop: Remember the Big Picture on Step Transactions

Picture this: The 1985 National League series between the Los Angeles Dodgers and the St. Louis Cardinals. The series is tied at 2-2, and in the ninth inning, the game is tied at 2-2. The Cardinals' best defensive fielder, shortstop Ozzie Smith (aka "the Wizard of Oz"), is up to bat. He's a decent switch hitter, but, to this point, all of his career 28 home runs have been hit right-handed. In a strategic move, the Dodgers' manager sends in a pitcher who forces Ozzie to bat left-handed. It didn't work. Ozzie hit a home run to right field—one of the most unexpected home runs ever. Ozzie did not suddenly become the next Babe Ruth. He was still the same player after the home run as he was before, but an observer who only watched this one playoff game might not have understood the big picture of Ozzie's talents and limitations.

When dealing with a situation in which a client is making multiple charitable contributions, focusing only on a single gift can create issues for the donor. In fact, it may be necessary to consider whether multiple contributions are part of a "step transaction" and, as such, would be considered a single transaction for tax purposes.²

The "step transaction doctrine" is used to recharacterize a formerly separate series of transactions or steps into a single transaction for tax purposes. This doctrine is generally applied to avoid abuse of the tax code. It is perhaps best explained by looking at an example.



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S. Prestley Blake, an owner of the Friendly Ice Cream Corporation, was known throughout New England for his charitable contributions.³ Blake also enjoyed boats and purchased the yacht *America*, a replica of the vessel the America's Cup race was named for.⁴ After trying his hand at charters, tours and personal yachting, he felt it simply required too much time and worry, and it was no longer in his best interest to keep the craft. Blake ultimately met with Kings Point Fund, Inc. This qualified charitable organization under IRC 501(c)(3), associated with the U.S. Merchant Marine Academy, indicated that it would be grateful to accept the yacht along with a proposed \$10,000 annual contribution toward the ship's maintenance costs.

Blake was so impressed with Kings Point that four days after their meeting about the yacht, he initiated a gift of stock to Kings Point—35,000 shares of Friendly Ice Cream Corporation to be used for the advancement of their training program for young cadets.⁵ Blake's adjusted basis in the stock was \$98, the market value was \$686,875, and Kings Point was able to sell the shares for a total of \$701,689.

A few weeks later, the Kings Point directors were informed that Blake had donated \$714,000 worth of stock, which was then sold, and that \$675,000 of the proceeds was to be used to purchase the *America* from Blake. The directors were also informed that the remainder of the Blake donation was to be used for the maintenance of the vessel. Blake and Kings Point agreed to the sale, and then Kings Point sold the *America* for a \$200,000 profit.

The question succinctly stated by the Second Circuit Court of Appeals was whether the taxpayer may consider the transfer of the stock as a charitable contribution and the transfer of the yacht as a sale, or is the transfer of the stock a sale followed by the contribution of the yacht? The U.S. Tax Court found that the "transactions were undertaken pursuant to an understanding arrived at in advance" and that this was sufficient to sustain the Commissioner's position.⁶

At the trial court and on appeal, Blake argued that the transactions were separate from one another, not part of a step transaction, and that Kings Point was under no obligation to purchase the yacht. The Court of Appeals did not agree.

The Court focused on Blake's argument about the obligation of the fund.⁷ However, the court avoided the application of any specific state law through the application of the theory of promissory estoppel to Kings Point.

We need not decide which of the three states' law would govern, however, because we are certain that each state would consider the Fund legally obligated to purchase the *America* under a theory of promissory estoppel on the facts of this case. Under this theory, a mere gratuitous promise by the Fund that it would purchase the *America* became legally binding when Blake acted in reliance on such an assurance.⁸

As a result the Court found against Blake and in favor of the Commissioner:

Thus, whether or not the "understanding" the Tax Court found here was legally enforceable under state law, we hold that where there is an understanding that a contribution of appreciated property will be utilized by the donee charity for the purpose of purchasing an asset of the contributor, the transaction will be viewed as a matter of tax law as a contribution of the asset—at whatever its then value is—with the charity acting as a conduit of the proceeds from the sale of the stock.



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This makes the taxpayer/putative donor taxable on the gain of the stock though entitled to deduct the value of the asset given, whatever that value in fact is.⁹

Interestingly, the Court of Appeals also commented on the realities of charitable giving, noting that even if Kings Point had the legal freedom to do as it wished with the proceeds from the stock, there is no way that Kings Point would have done anything other than purchase the yacht. The Court noted:

The Fund directors knew that, if they reneged in the face of Blake's strong "expectation," they would probably never get another vessel donation. Reneging on understandings of this sort is scarcely the stuff on which charitable loyalty is made.

An isolated look at Blake's stock donation shows a simple charitable contribution. However, just as with Ozzie Smith, a look at the bigger picture reveals a different story.

Art: Sometimes Eagle Contributions Don't Fly... But Sometimes They Do

In 1954, Robert Rauschenberg began work on *Canyon*—a mixed-media assemblage incorporating painting, collage and other items. He also attached a stuffed bald eagle to the lower part of the canvas.¹⁰ This unusual artistic addition created a significant legal problem. Federal law provides for civil and criminal penalties for any person who acts to "take, possess, sell, purchase, barter, offer to sell, purchase or barter, transport, export or import" a bald eagle.¹¹

Under permit from the Fish and Wildlife Department, noted gallery owner Illena Sonnabend could continue to own *Canyon*, but only if it were publicly displayed on loan to a museum.¹² When she died in 2007, Mrs. Sonnabend owned art worth hundreds of millions of dollars, meaning that a good deal of the estate settlement involved negotiating the value of her art collection. A dispute arose over *Canyon* that can be summarized as follows:¹³

- The estate argued that since the work could not be legally sold, its value was \$0 for estate tax purposes.
- The IRS disagreed and assigned a value of \$65 million to the artwork, then added an undervaluation penalty and interest to the estate tax bill.¹⁴

How could something that could not be legally sold be worth so much? According to an attorney for the estate, the IRS initially "suggested" the work was worth around \$15 million, and once that was refused, the IRS issued the formal notice of deficiency for the \$65 million.¹⁵ The IRS has long held that there is a market for illegal or contraband art, and, therefore, value ascribed to the artwork.¹⁶ Rather than continue to litigate the issue, the estate donated *Canyon* to the Museum of Modern Art in New York City, where the work still resides.¹⁷

Nothing but the Feathers, Ma'am

While *Canyon* was created with a whole stuffed eagle attached, the case of *Sammons v. Commissioner* involved a donated art collection including items related to bald eagles, which the Ninth Circuit Court of Appeals referred to as "eagle artifacts."¹⁸ Myron and Dorothy Sammons were collectors of art from the American West who gathered



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and then donated a series of artifacts to the Museum of North American Cultures. The contribution included artifacts from the Plains and Plateau Indians, such as "painted buffalo hides, buckskin clothing, medicine pipes, war bonnets, human scalps, medicine rattles made from buffalo scrotums and many other items."¹⁹ In the case, the Sammons disputed three issues with the Commissioner: 1) the valuation attributed to the collection; 2) the assessment of a negligence penalty; and 3) a disallowance of the deduction for the "eagle artifacts" as against public policy.

The eagle artifacts in question "consisted of thirty-five items that incorporated feathers, claws, or other parts of birds protected under the Bald Eagle Protection Act, 16 U.S.C. §§668-668d, the Migratory Bird Treaty Act, 16 U.S.C. §§703-711, and the Endangered Species Act, 16 U.S.C. §§1531-1543."²⁰ The IRS argued that the Sammons should not be allowed a deduction since the eagle artifacts violated the applicable federal statutes, and as a result, the Sammons would not have had legal title to the items, or even if they had legal title, allowing the deduction would still frustrate the public policy established by Congress to protect the birds. At the trial, the Tax Court rejected both of the IRS arguments, and the Ninth Circuit did likewise.

The Court noted that while the Sammons may have violated federal law, "it does not follow that the Sammons did not have title to the Eagle Artifacts when they made their contribution."²¹ The Court said:

The Sammons may have made an illegal contract when they bought the Eagle Artifacts, but no one is seeking, or defending, enforcement of the contract of purchase or the subsequent gift. The government might have instituted a proceeding seeking forfeiture of the Eagle Artifacts under the Eagle Protection Act, 16 U.S.C. §668b(b), or the Endangered Species Act, 16 U.S.C. §1540(e) (4) (A), but it has not done so. We conclude that the Sammons had a sufficient ownership interest in the Eagle Artifacts to contribute them to the museum.²²

The Court also struck down the IRS argument that any deduction allowed for the Sammons would frustrate public policy:

...there has been no showing that allowing a deduction for the Sammons' contribution of the Eagle Artifacts to the museum would severely or immediately frustrate national or state policy. No evidence was presented tending to prove that allowance of the deduction would encourage the killing or acquisition of protected bird species. It may be true that persons who presently own artifacts of this nature might be encouraged to donate the items to museums so that they could claim a deduction on their tax returns, but we do not view this as a threat to the national policy of protecting endangered bird species. Nor do we find anything in the record to suggest that by permitting a deduction for the contribution of the Eagle Artifacts, unscrupulous sellers of Indian art are likely to hunt, capture and kill protected eagle species in an effort to manufacture "ancient" artifacts that can be sold to collectors, unsuspecting or not, for spurious donations to charitable organizations. We conclude that public policy does not prevent the Sammons from claiming a deduction for donating the Eagle Artifacts to the museum.²³



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Conservation Easements and Subordination: Aren't You Glad I Didn't Say Banana?

For the typical first grader, there may be no better joke than a “knock-knock” joke, and perhaps no knock-knock joke better than this one, in which the opening portion is often repeated to an almost painful extent: *Knock knock... Who's there? Banana... Banana who? Knock knock... Who's there? Banana... Banana WHO? Knock knock... Who's there? Orange... Orange who? Orange you glad I didn't say banana?*

In charitable contribution planning, there are undoubtedly times when one or both parties feel like the person responding to a knock-knock joke—exasperated, and desperately wishing the person giving the answers would say something different. This can be the case with conservation easements. The IRS will always stick to its interpretation of the letter of the Code and Regs, and too often taxpayers believe the same language is more of a “guideline” than a law. This can result in a number of similar situations being litigated.

In 2015, the IRS Taxpayer Advocate Service noted that conservation easement contributions were its most litigated §170 matter.²⁴ While this can be seen as a “knock-knock” situation, the number of cases does provide clarity for the rest of us. Over the last several years, a number of conservation easement subordination cases have yielded a couple of clear rulings. Donors who want to contribute a conservation easement are on notice that the IRS will adhere strictly to the regulations.

Kaufman

In 1999, Gordon and Lorna Kaufman bought and renovated a house in the South End of Boston. The redbrick rowhouse had been built around 1860 and featured a Venetian Gothic-style façade that distinguished it from neighboring houses.²⁵ During 2003, the Kaufmans began working with the National Architectural Trust to place their unique facade under a conservation easement in a Historic Preservation Agreement, which would allow them to qualify for a charitable deduction for their home.²⁶

Following this transaction (orchestrated by the National Architectural Trust), the Kaufmans claimed a \$16,870 cash contribution to the Trust on their 2003 federal income tax return, and a non-cash donation of \$220,800 for placing the façade into the conservation easement.²⁷ The IRS challenged the Kaufmans on both items. In two Tax Court hearings, the IRS won on the issue of the façade easement (which the Kaufmans appealed), and the Kaufmans prevailed on the issue of the allowance of the cash contribution (which the IRS appealed).²⁸

A key element of the IRS' appeal was that the mortgagee of the property, Washington Mutual, retained a right to have a prior claim on any casualty, hazard or accident proceeds and all proceeds for condemnation, notwithstanding any claims of the Trust in the Historic Preservation Agreement. The IRS argued that this violated the provisions of IRC §170 and 26 C.F.R. §1.170A-14(g).

In reviewing the case in 2012, the First Circuit Court of Appeals reviewed the prongs for a conservation easement under §1.170A-14(g), and noted that the Tax Court had focused solely on paragraph (g)(6) regarding the extinguishment provisions,²⁹ which states that the donee organization must be entitled to a proportionate share of the proceeds that



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result from an extinguishment of a conservation easement. In the case of the Kaufmans, the First Circuit felt that the taxpayers "...had no power to make the mortgage-holding bank give up its own protection against fire or condemnation and, more striking, no power to defeat tax liens that the city might use to reach the same insurance proceeds—tax liens being superior to most prior claims..."³⁰ The Court noted that the IRS views the word "entitled" in the regulation as giving priority and as an absolute right.³¹ The First Circuit disagreed, pointing out that "...given the ubiquity of super-priority for tax liens, the IRS's reading of its regulation would appear to doom practically all donations of easements, which is surely contrary to the purpose of Congress."³²

Mitchell

The Tenth Circuit reviewed the issue of the subordination of a mortgage to a conservation easement in the case of *Mitchell v. Commissioner*.³³ In 1998, the Mitchells purchased 456 acres of ranch property in Colorado from Clyde Sheek, providing a down payment and signing a promissory note for the remainder, with a deed of trust securing the promissory note. The Mitchells eventually transferred the property to a family limited liability limited partnership, with the property still under the deed of trust to Sheek.

In 2003, the partnership granted the Montezuma Land Conservancy a conservation easement on 180 acres and claimed an income tax deduction for it. While the deed met the requirements to create a qualified conservation easement, the Mitchells did not obtain Sheek's agreement to subordinate his mortgage to the conservation easement until 2005.

In 2010, the IRS issued a notice of deficiency based on the fact that the conservation easement was subject to an unsubordinated mortgage at its creation and was not protected in perpetuity as required under the Internal Revenue Code. Ms. Mitchell lost in Tax Court (and again on appeal).

Minnick

Following the ruling in *Mitchell*, the Ninth Circuit Court of Appeals heard the case of Walter Minnick and A.K. Lienhart, a married couple who were developing a property in Ada, Idaho.³⁴ In 2005, Minnick borrowed development money from the U.S. Bank secured by the land, and in 2006, Minnick donated land in a conservation easement to the Land Trust of Treasure Valley. Minnick provided warranties in the conservation deed but did not actually notify the U.S. Bank, much less get the bank to subordinate the mortgage. Following the Notice of Deficiency in 2009, the parties proceeded to Tax Court, where the IRS prevailed, with the Tax Court relying on the ruling in *Mitchell*.

I Did Not Expect That (Unless I Really Did...)

In 1938, a young man named Daniel Corrigan took off in an airplane from Brooklyn after filing his flight plan to fly from New York to California.³⁵ Corrigan had spent a lifetime flying and building planes, and he desperately wanted to complete a transatlantic flight ending in his ancestral homeland of Ireland. However, his application to make the flight was denied again and again. Despite these setbacks, on



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that fateful day, Corrigan left Brooklyn, and 28 hours and 31 minutes later, landed in Dublin. When grilled about his flight without a proper permit, Corrigan simply said his “compass went out” and he thought he was headed to California, thereby creating the legend of “Wrong Way Corrigan.”

Unlike the pilots of the AirAsia flight to Malaysia, Corrigan became a national hero. He may have flown the “wrong way” but only because his preparation and dedication provided him with that opportunity. When faced with an unusual contribution from a donor, make certain that you are prepared with an understanding of the possibilities and the pitfalls. With knowledge and dedication, you can ensure that any gift will land exactly where the donor intended.



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Endnotes

- 1 Corey Charlton, "PLANE CRAZY: AirAsia flight 223 landed in the WRONG COUNTRY after pilot's typing error sent plane to Melbourne instead of Malaysia," *The Sun*, September 7, 2016.
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- 3 *S. Prestley Blake and Setsu Blake v. Commissioner of Internal Revenue*, 697 F2d 473, 12/28/82, Affirming a decision of the Tax Court, 42 TCM 1336, TC Memo. 1981-579.
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- 8 *Id.*
- 9 *Id.*
- 10 For more information and to see a photo of the work of art, see <https://www.moma.org/collection/works/165011>
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- 15 Janet Novak, "Even Rich Heirs Deserve a Fair Shake From the IRS," *Forbes*, February 23, 2012.
- 16 PLR 9152005 (I.R.S. 1991). This PLR was based on Joe Meador's theft of art in WWII, which he bequeathed to family members. In this PLR, the IRS stated:

In this case, because the art objects that are includible in the Decedent's gross estate were stolen and, thus, would, under most circumstances, have been transferrable only in an illicit market, the appropriate market for establishing the fair market value, on the date of the Decedent's death, includes the discreet retail markets of the international network of traffickers in stolen art, as well as the legitimate retail art markets consisting of international auction firms, advertised displays in antiques publications, and legitimate art and antiques dealers.
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- 29 *Id.* at 25.
- 30 *Id.* at 27.
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