Oral Argument Is Not Yet Scheduled

IN THE

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

17-1266

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

Petitioner-Appellant,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

ON APPEAL FROM THE UNITED STATES TAX COURT

PAGE PROOF BRIEF FOR PETITIONER-APPELLANT

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CERTIFICATE AS TO PARTIES, RULINGS, AND RELATED CASES

A. *Parties and Amici*. This is a tax case brought under 26 U.S.C. § 6226 in which appellant seeks review of a determination by the United States Tax Court readjusting partnership items of RERI Holdings I, LLC ("RERI") for its 2003 tax year. RERI was a limited liability company that has now been dissolved. During the year at issue, the members of RERI were individuals, a trust, and privately held companies. None of the privately held companies that had an ownership interest in RERI had a 10 percent or greater ownership interest.

Appellant, Jeff Blau, is the tax matters partner of RERI and filed the notice of appeal in this case. During the course of the proceedings before the Tax Court, Mr. Blau replaced Harold Levine as RERI's tax matters partner. Mr. Levine, as then-tax matters partner of RERI, filed the petition in the Tax Court initiating this action. Appellee is the Commissioner of Internal Revenue (the "Commissioner").

B. *Rulings under Review*. Appellant seeks review under 26 U.S.C. § 6226(g) of the Tax Court's decision dated October 5, 2017, disallowing RERI's charitable contribution deduction for its 2003 tax year and imposing a gross valuation misstatement penalty under 26 U.S.C. § 6662.

C. *Related Cases*. To the best of their knowledge, counsel for appellant is not aware of any previous or pending related cases.

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GLOSSARY

"**AT&T**" refers to AT&T Corp.

"**Bonz/REA**" refers to Bonz/REA, Inc.

"**BB&T**" refers to Branch Banking and Trust Company.

"**Code**" refers to the Internal Revenue Code of 1986 (26 U.S.C.), as amended and in effect during the year at issue.

"**Commissioner**" refers to the Commissioner of Internal Revenue.

"**FPAA**" refers to the Notice of Final Partnership Administrative Adjustment issued to RERI Holdings I, LLC, for its 2003 tax year.

"**Hawthorne**" refers to RS Hawthorne, LLC.

"**Holdings**" refers to RS Hawthorne Holdings, LLC.

"**Property**" refers to the land and web hosting facility owned by RS Hawthorne, LLC.

"**Remainder Interest**" refers to the remainder interest in RS Hawthorne Holdings, LLC, that becomes possessory as of January 1, 2021.

"**RERI**" refers to RERI Holdings I, LLC.

"**Term Interest**" refers to the term of years interest in RS Hawthorne Holdings, LLC, that expires on December 31, 2020.

STATEMENT OF JURISDICTION

This Court has jurisdiction under 26 U.S.C. § 7482[1] over this appeal by the tax matters partner of RERI from the decision entered by the United States Tax Court, on October 5, 2017, in favor of the Commissioner. The Tax Court had jurisdiction over the petition in this case under 26 U.S.C. § 6226(a).

STATEMENT OF THE ISSUES

(1) Whether the Tax Court erred in holding that RERI was not entitled to a charitable contribution deduction for the donation of a remainder interest to the University of Michigan.

(2) Whether the Tax Court erred in holding that a gross valuation misstatement penalty applies.

STATEMENT OF THE CASE

This appeal relates to the tax consequences from the donation of a remainder interest to the University of Michigan in 2003. The facts below were not seriously in dispute and relate primarily to the value of the remainder interest on the date it was donated and the procedural history of this case.

On February 7, 2002, RS Hawthorne LLC ("Hawthorne") acquired land and a 288,000 square foot web hosting facility (the "Property") for $42,350,000. (Doc.

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[1] Citations to the Internal Revenue Code (26 U.S.C.) (the "Code") and the Treasury Regulations (26 C.F.R.) are to the provisions in effect for the relevant years. The provisions pertinent to this case are included in the Addendum to this brief.

271 ¶ 22, A. __; Ex. 271-P at 34, A.__.)[2] The Property was leased by AT&T Corp. ("AT&T") pursuant to a triple-net lease, which had a base term of 15.5 years (2000-2016) and three five-year renewal options. (Doc. 271 ¶ 18, A. __; Exs. 8-J - 12-J, A. __.)

Hawthorne financed its purchase of the Property by borrowing $43,671,739 from Branch Banking and Trust Company ("BB&T"). (Doc. 271 ¶ 24, A. __.) BB&T engaged Bonz/REA, Inc. ("Bonz/REA") to appraise the Property in connection with the loan. (Doc. 271 ¶ 23, A. __; Ex. 24-J, A. __.) Bonz/REA concluded that the Property had a market value of $47 million as of August 16, 2001. (Ex. 24-J at RERI-017934, A. __.)

Hawthorne was wholly owned by RS Hawthorne Holdings, LLC ("Holdings"). (Ex. 83-J, A. __; Ex. 103-J at RERI-042494, A. __.) On February 7, 2002, after Hawthorne acquired the Property, the then-owner of Holdings created two temporal interests in Holdings: a possessory term of years interest (the "Term Interest") to last until December 31, 2020, and a remainder interest which is to become a fee interest on January 1, 2021 (the "Remainder Interest"). (Doc. 271 ¶ 34, A. __; 103-J, A. __.) The Term Interest holder is subject to numerous specified obligations and limitations. (Ex. 103-J, A. __.) If the Term Interest holder fails to

[2] "Doc." references are to documents in the record, as numbered by the Tax Court in its docket sheet. "Ex." references are to the exhibits admitted into the record at the trial in this case. "A." references are to the appendix.

comply with its obligations, the Term Interest terminates and the Remainder Interest holder becomes indefeasibly possessed of the full fee simple absolute estate in and to the membership interest in Holdings. (Ex. 103-J at RERI-042496, A. __.)

RERI acquired the Remainder Interest on or around March 25, 2002, for $2,950,000. (Doc. 271 ¶ ¶ 37, 39, 40, 42, A. __; Ex. 109-J, A. __.) The $2,950,000 purchase price did not represent the fair market value of the Remainder Interest. (Doc. 271 ¶ 39, A. __.)

RERI donated the Remainder Interest to the University of Michigan on August 27, 2003. (Doc. 271 ¶ 44, A. __; Ex. 131-J, A. __.) No goods, services, or privileges were provided to RERI in exchange for its donation. (Ex. 126-J, A. __; Ex. 127-J, A. __.)

RERI engaged Howard Gelbtuch of Greenwich Realty Advisors in September 2003 to prepare an appraisal of a remainder interest in the Property. (Doc. 271 ¶ 50, A. __; Ex. 132-J, A. __.) Mr. Gelbtuch's appraisal determined values of $55 million for the leased fee interest in the Property and $32,935,000 for the remainder interest. (Ex. 1-J at RERI-002039, A. __.) In reaching his conclusion as to the value of the remainder interest, Mr. Gelbtuch relied on the actuarial tables mandated under 26 U.S.C. § 7520. (Ex. 1-J at RERI-002039, A. __.)

On its 2003 federal income tax return, RERI claimed a charitable contribution deduction of $32,935,000 for its donation of the Remainder Interest.[3] (Ex. 1-J at RERI-002031, RERI-002111, A. __.) RERI attached an appraisal summary (Form 8283) and a copy of Mr. Gelbtuch's appraisal to its tax return. (Ex. 1-J at RERI-002033 - 2110, A. __.)

The Internal Revenue Service ("IRS") issued a notice of final partnership administrative adjustment (the "FPAA") on March 26, 2008, disallowing approximately $29 million of RERI's charitable contribution deduction and asserting a 20 percent substantial valuation misstatement penalty under 26 U.S.C. § 6662(e). (Ex. 2-J, A. __.) RERI challenged the Commissioner's determinations by filing a petition for readjustment of partnership items in the U.S. Tax Court. (Doc. 1, A. __.) The Commissioner's answer summarily denied the petition's substantive allegations. (Doc. 3, A. __.) In two separate amendments to answer, the Commissioner claimed that (1) RERI's deduction should be reduced to zero or, in the alternative, $1,940,000, and (2) a 40 percent gross valuation misstatement penalty under 26 U.S.C. § 6662(h) applied. (Doc. 271 ¶¶ 14, 15, A. __.)

The case was tried before the Honorable James Halpern, and briefing was completed by October 2, 2015. On July 3, 2017, the Tax Court issued an Opinion

[3] During all relevant times, RERI was treated as a partnership for federal income tax purposes.

in which it determined, *sua sponte*, that RERI was not entitled to a charitable contribution deduction for its donation of the Remainder Interest because a box on the appraisal summary attached to RERI's tax return was left blank. (Doc. 293 at 26-28, A. __.) Although the court determined that RERI was not entitled to a deduction based on a substantiation issue, it went on to determine the value of the Remainder Interest. In determining value, the court set aside the actuarial tables prescribed by 26 U.S.C. § 7520 and determined a fair market value of $3,462,886, and concluded that any underpayment resulting from the court's adjustment to value was subject to a 40 percent gross valuation misstatement penalty. (Doc. 293 at 68-69, A. __.) On October 5, 2017, the Tax Court entered its decision. (Doc. 298, A. __.) This appeal followed.

SUMMARY OF THE ARGUMENT

RERI was entitled to a deduction for its charitable contribution to the University of Michigan. It was reversible error for the Tax Court to disallow that deduction and impose a 40 percent penalty. The only rationale for disallowing RERI's charitable contribution deduction offered by the Tax Court was the fact that RERI left a box relating to basis information blank in an attachment to its tax return -- a ground raised for the first time in the case in the court's Opinion and on which the taxpayer never had an opportunity to be heard. It is undisputed that RERI's basis has no bearing on the amount of the charitable contribution deduction to which it is entitled, and even the IRS did not complain that it was prejudiced by the blank box on the attachment. Accordingly, the holding below should be reversed.

Even though the only basis for the Tax Court's disallowance of the deduction was failure to complete a form, the court nonetheless proceeded to impose a 40 percent penalty on an entirely unrelated ground. The 40 percent penalty cannot apply where, as here, the underpayment of tax is not "attributable to" a valuation misstatement. Moreover, the Commissioner failed to meet a statutory prerequisite to the imposition of any penalty because he declined to produce any evidence of a statutorily mandated administrative approval. The Tax Court further erred by disregarding a congressional mandate to value remainder interests using prescribed actuarial tables. That error was compounded by the court's reliance on a fundamentally flawed report submitted by the government's expert witness. Finally, the Tax Court erred when it concluded that RERI did not meet the reasonable cause exception to the application of the penalty because the partnership's investigation of value was not a good faith investigation as a matter of law. In reaching that conclusion, the Tax Court applied an overly burdensome standard that is inconsistent with the court's own method for determining value. Accordingly, the decision should be reversed.

ARGUMENT

The standard of review for questions of law decided by the Tax Court is *de novo*, while the standard of review for the Tax Court's findings of fact and its disposition of mixed questions of law and fact is clear error. *Jombo v. Comm'r*, 398 F.3d 661 (D.C. Cir. 2005).

I. THE TAX COURT ERRED IN DISALLOWING A $33 MILLION TAX DEDUCTION SIMPLY BECAUSE AN IRRELEVANT BOX ON AN ATTACHMENT TO A TAX RETURN WAS LEFT BLANK

As required by applicable Treasury regulations, RERI attached to its 2003 tax return an appraisal summary (Form 8283) in which it provided information about its charitable contribution of the Remainder Interest to the University of Michigan. (Ex. 1-J at RERI-002033 - 2035, A. __.) RERI also attached the entire 75-page appraisal prepared by Howard Gelbtuch of Greenwich Realty Advisors. (Ex. 1-J at RERI-002036 - 2110, A. __.) However, the Tax Court, *sua sponte*, held that RERI was not entitled to any deduction for its charitable contribution because the box on Form 8283 for "Donor's cost or adjusted basis" was left blank. (Doc. 293 at 26-28, A. __.) Because neither the government nor its counsel had challenged the appropriateness of the deduction based on the Form 8283, neither party briefed the issue. The question whether RERI's appraisal summary satisfies the regulations' substantiation requirements is a mixed question of law and fact and therefore is reviewed for clear error. *See Comm'r v. Simmons*, 646 F.3d 6, 9 (D.C. Cir. 2011).

The information left blank – RERI's tax basis in the Remainder Interest – has no bearing on the amount of the charitable contribution deduction to which RERI is entitled, which even the Tax Court acknowledged. Tellingly, the Commissioner, who bore the burden of establishing that RERI was not entitled to a deduction for its donation, never argued that the deduction should be disallowed due to missing tax basis information. The Tax Court's holding is flawed, misapplies the longstanding rule that substantial compliance with the reporting requirements is sufficient, and should be reversed.

A taxpayer claiming a charitable contribution deduction for property worth more than $5,000 must satisfy substantiation requirements set forth in the regulations. 26 C.F.R. § 1.170A-13(c). One such requirement is that the taxpayer must attach an appraisal summary (Form 8283) to the tax return on which it is claiming the deduction. 26 C.F.R. § 1.170A-13(c)(2)(i)(B). The regulations describe the information required to be included on a Form 8283. 26 C.F.R. § 1.170A-13(c)(4)(ii). The taxpayer's cost or adjusted basis in the donated property is generally required to be included on a Form 8283. 26 C.F.R. § 1.170A-13(c)(4)(ii)(E).

The Tax Court has long recognized that "[s]trict compliance with the [substantiation requirements of 26 C.F.R. § 1.170A-13] is sufficient to win a deduction, but it isn't necessary." *Cave Buttes, L.L.C. v. Comm'r*, 147 T.C. 338, 349

(2016). Rather, the appropriate standard is whether a taxpayer has substantially complied with the substantiation requirements. *See Bond v. Comm'r*, 100 T.C. 32, 41 (1993).

In concluding that strict compliance with the substantiation requirements of 26 C.F.R. § 1.170A-13 is not necessary, the Tax Court in *Bond* considered "whether the requirements relate 'to the substance or essence of the statute.'" *Bond*, 100 T.C. at 40-41 (quoting *Sperapani v. Comm'r*, 42 T.C. 308, 331 (1964)). While the reporting requirements of 26 C.F.R. § 1.170A-13 "are helpful to [the Commissioner] in the processing and auditing of returns on which charitable deductions are claimed", the Tax Court noted that they "do not relate to the substance or essence of whether or not a charitable contribution was actually made." *Id.* at 41. Thus, the court concluded that the substantiation requirements of 26 C.F.R. § 1.170A-13 are "directory and not mandatory," and substantial compliance, rather than strict compliance, with those requirements is sufficient. *Id.* at 41; *see also Scheidelman v. Comm'r*, 682 F.3d 189 (2d Cir. 2012).[4]

Consistent with the foregoing, the regulations themselves recognize that strict compliance with the substantiation requirements of 26 C.F.R. § 1.170A-13 is not

[4] The issue of whether substantial compliance is sufficient for purposes of 26 C.F.R. § 1.170A-13 was raised before this Court in *Commissioner v. Simmons*, 646 F.3d 6, 12, n. 3 (D.C. Cir. 2011). The Court, however, did not decide the issue because it concluded that the Tax Court had not erred in finding that "Simmons fully 'complied with the substantiation requirements'". *Id.*

required, as they excuse the failure to attach ***any*** Form 8283 to the tax return. Specifically, the regulations allow a taxpayer who has not attached a Form 8283 to its tax return to cure the omission by providing the appraisal summary to the IRS within 90 days of a request from the IRS. *See* 26 C.F.R. § 1.170A-13(c)(4)(iv)(H). Given that the regulations allow a taxpayer a deduction where the taxpayer has omitted the Form 8283 in its entirety, it would be an absurd result to deny a deduction for a taxpayer who has attached to its return a substantially complete appraisal summary.

Taken together with the appraisal attached to RERI's return, the Form 8283 was substantially complete, as it "provided sufficient information to permit [the Commissioner] to evaluate . . . [the] reported contributions, as intended by Congress." *Simmons v. Comm'r*, 98 T.C.M. (CCH) 211, 215, 2009 WL 2950610, at *7 (2009), *aff'd* 646 F.3d 6 (D.C. Cir. 2011) (quoting *Smith v. Comm'r*, 94 T.C.M. (CCH) 574, 2007 WL 4410771 (2007)). Indeed, the Commissioner ***did*** evaluate RERI's contribution and, after conducting an audit, allowed a portion of RERI's charitable contribution deduction. (Ex. 2-J, A. __.)

The Tax Court nonetheless disallowed RERI's charitable contribution deduction in its entirety on the grounds that the basis section in the Form 8283 was left blank. Not only was the Tax Court's holding prejudicial to appellant (as the issue had not been raised by the Commissioner), but it overlooks several key points and contradicts the Tax Court's prior holding in *Dunlap v. Commissioner*, 103 T.C.M. (CCH) 1689, 2012 WL 1524660 (2012).

The amount of a charitable contribution deduction typically is based on the donated property's fair market value, not a donor's basis in the property. 26 C.F.R. § 1.170A-1(c)(1). As the Tax Court points out, there are situations where a "donor's basis in the contributed property ***could*** 'affect[] the amount of the deduction allowed.'" (Doc. 293 at 27, n. 11, A. __ (emphasis added).) Here, however, the Tax Court recognizes that basis is not relevant to the amount of RERI's charitable contribution deduction. (Doc. 293 at 27, n. 11, A. __.)

Nonetheless, in reaching its conclusion that the omission of basis is fatal to RERI's charitable contribution deduction, the Tax Court hypothesized that had RERI disclosed the basis amount on its Form 8283 that information would have alerted the Commissioner to a potential overvaluation of the donated property. (Doc. 293 at 26-27, A. __.) This conclusion is simply wrong.

First, there is no evidence in the record to support the Tax Court's conclusion. The court effectively made a finding of fact that the inclusion of basis could have alerted the IRS to an overvaluation. Because there is no evidence in the record to support that finding, it is clearly erroneous.

Second, even if the Tax Court were correct that basis reported on a Form 8283 could alert the IRS to an overvaluation, an omission of any such information should be equally, if not more, useful, as the omission of a number on a line in a tax return is generally the equivalent of entering zero. *See McCaskill v. Comm'r*, 77 T.C. 689, 698 (1981) (explaining that "Many taxpayers, if they are not claiming a particular kind of deduction, do not insert a zero in the space provided for that deduction but simply leave the space blank.").

Third, a taxpayer's basis in donated property does not establish the property's fair market value. In fact, the record in this case establishes that RERI's basis in the donated property bears no relationship to the fair market value of the donated property, as the parties stipulated that the $2.95 million purchase price for which RERI acquired the Remainder Interest (*i.e.*, RERI's basis in the property) did not represent the donated property's fair market value. (Doc. 271 ¶ 39, A. __.)

Fourth, the Tax Court's holding conflicts with the instructions to Form 8283 and its prior holding in *Dunlap v. Commissioner*, 103 T.C.M. (CCH) 1689, which also involved a charitable contribution deduction for the 2003 tax year. In *Dunlap*, the Tax Court explained that the "Instructions for Form 8283 indicate . . . that the donor's cost or basis in the donated property . . . [is] not absolutely necessary. The instructions notify the taxpayer that [this portion] may be left blank if the taxpayer has reasonable cause and attaches an explanation to the return. Instructions for Form 8283 (Rev. 1998)." *Dunlap*, 103 T.C.M. (CCH) at 1706, 2012 WL 1524660, at *29; *see also* 1.170A-13(c)(4)(iv)(C)(1). The Tax Court concluded that, although the taxpayers in *Dunlap* did not show reasonable cause or attach explanations to their returns, the basis information was not necessary to substantially comply with the form's instructions. *Dunlap*, 103 T.C.M. (CCH) at 1706, 2012 WL 1524660, at *29.

Last, the Tax Court's conclusion that RERI is not entitled to a charitable contribution deduction based on an incomplete Form 8283 overlooks 26 C.F.R. § 1.170A-13(c)(4)(iv)(H), which (as stated above) allows a deduction where a Form 8283 is provided to the IRS within 90 days of a request from the IRS. The Commissioner has never asserted that RERI failed to provide the IRS with any requested information concerning RERI's basis in the donated property.

RERI's Form 8283, taken together with the attached appraisal, was substantially complete. RERI's basis in the Remainder Interest has no bearing on the amount of the charitable contribution deduction to which RERI is entitled. Furthermore, the Commissioner never even argued that RERI's deduction should be disallowed because the Form 8283 did not disclose RERI's tax basis.

Based on the foregoing, the Tax Court's holding that RERI is not entitled to a charitable contribution deduction for its donation to the University of Michigan should be reversed.

II. A GROSS VALUATION MISSTATEMENT PENALTY CANNOT BE IMPOSED BECAUSE THE STATUTORY REQUIREMENTS WERE NOT MET

Having erred in disallowing the partnership's charitable contribution deduction for leaving an irrelevant box blank, the Tax Court went on to impose a 40 percent penalty that applies only to underpayments of tax "attributable to" a gross valuation misstatement. In doing so, the Tax Court assumed (incorrectly) that the Commissioner had met his burden of production. As described in Point III, *infra*, the Tax Court's determination of value rests on a series of legal and factual errors. Each one of the Tax Court's errors is an independent ground for reversal.

A. The Gross Valuation Misstatement Penalty Cannot Be Imposed as a Matter of Law Because the Underpayment Is Not "Attributable to" a Valuation Misstatement

In determining that the underpayment in this case is subject to a valuation misstatement penalty, the Tax Court misinterpreted the "attributable to" language in 26 U.S.C. § 6662. The interpretation of a statute is subject to *de novo* review. *See, e.g., Kaseman v. District of Columbia*, 444 F.3d 637, 640 (D.C. Cir. 2006). For the reasons discussed below, the Tax Court's application of the valuation misstatement penalty should be reversed.

The Code imposes an accuracy-related penalty on underpayments of tax where the underpayment is "attributable to" certain conduct that is explicitly penalized under 26 U.S.C. § 6662(b). For example, the Code imposes a 20 percent penalty where an underpayment is attributable to negligence or disregard of the rules or regulations. 26 U.S.C. § 6662(b)(1).

The Code also imposes a penalty where the underpayment of tax is attributable to a valuation misstatement. 26 U.S.C. § 6662(b)(3). Where the underpayment is attributable to the taxpayer claiming a value or basis that is 200 percent or more of the correct amount, a 20 percent substantial valuation misstatement penalty applies. 26 U.S.C. § 6662(a), (b)(3), (e)(1). Where the underpayment is attributable to the taxpayer claiming a value or basis that is 400 percent or more of the correct amount, a 40 percent gross valuation misstatement penalty applies. 26 U.S.C. § 6662(h)(2). Thus, in order for a valuation misstatement penalty to apply, the underpayment of tax must be *attributable to* a "valuation misstatement." 26 U.S.C. § 6662(a), (b)(3). The "attributable to" language of the statute requires causation. *See Van Scoten v. Comm'r*, 439 F.3d 1243, 1258 (10th Cir. 2006).

When the Commissioner challenges a taxpayer's treatment of an item, he will sometimes challenge it on valuation-related grounds (*e.g.*, an overvaluation of property) and on non-valuation-related grounds (*e.g.*, that the taxpayer failed to meet a requirement of the governing Code provisions). That raises the possibility of dual causes for a single underpayment. When a taxpayer loses on non-valuation grounds, a question arises as to whether the underpayment can be attributable to a valuation misstatement. The U.S. Courts of Appeals for the Fifth and Ninth Circuits have held that a valuation misstatement penalty did not apply where the Commissioner had prevailed on disallowing deductions on non-valuation grounds. *Todd v. Comm'r*, 862 F.2d 540 (5th Cir. 1998); *Gainer v. Comm'r*, 93 F.2d 225 (9th Cir. 1990). Other circuits have disagreed. *See, e.g., Fidelity Int'l Currency Advisor A Fund, LLC, v. United States*, 661 F.3d 667 (1st Cir. 2011).

In 2013, the Supreme Court addressed the application of a valuation misstatement penalty where the underpayment arose from the disallowance of tax losses because the partnerships from which the losses flowed lacked economic substance. *United States v. Woods*, 134 S. Ct. 557 (2013). The government argued that the valuation misstatement penalty applied because the lack of economic substance caused the taxpayer's basis to be overstated, leading to the disallowed tax loss. The taxpayer argued that the determination that the partnerships lacked economic substance was independent from a misstatement of basis. *Id.* at 567. Thus, the taxpayer argued that a valuation misstatement penalty could not apply. *Id.*

The *Woods* Court rejected the taxpayer's position, concluding that the basis misstatement and the economic substance determinations were not independent of one another, but instead were "inextricably intertwined". *Id.* Implicit in the Supreme Court's holding is that a valuation misstatement penalty may not apply where the ground for disallowance is independent of valuation.

Here, the Tax Court disallowed RERI's charitable contribution deduction based on a failure to fill in a box on a Form 8283 attached to RERI's tax return. Yet, the penalty is being imposed for a misstatement in value of the donated Remainder Interest. These two grounds (one a technical substantiation issue, and the other value) are "independent legal grounds," as one has no bearing on the other. There can be no argument that the substantiation grounds are "inextricably intertwined with" the valuation question. The determination that the partnership failed to complete every box on a form amounts, at most, to "negligence or disregard of rules or regulations." *See* 26 U.S.C. § 6662(b)(1). Yet, the Commissioner did not assert a negligence penalty under 26 U.S.C. § 6662(b)(1). Accordingly, the Tax Court's holding that a valuation misstatement penalty applies here was wrong as a matter of law and should be reversed.

B. The Commissioner Did Not Meet His Burden of Production When He Failed to Introduce Evidence of a Statutorily Required Administrative Approval

The Commissioner bears the burden of production with respect to penalties. 26 U.S.C. § 7491(c). The Tax Court held that the Commissioner "met his burden of production . . . regarding the appropriateness of the gross valuation misstatement penalty" in this case. (Doc. 293 at 60, A. __.) However, in reaching that conclusion, the Tax Court did not consider whether the Commissioner complied with the administrative approval requirement mandated by statute, an issue on which the

Commissioner presented no evidence. Accordingly, the Tax Court's holding that the Commissioner satisfied his burden of production with respect to the penalty must be reversed.

There are two administrative provisions that must be satisfied before a penalty may be imposed. The first is that the Secretary must include with his penalty notice information concerning the name of the penalty, the section of the Code under which the penalty is imposed, and a computation of the penalty. 26 U.S.C. § 6751(a). The Commissioner arguably satisfied that requirement when he issued the FPAA and filed his second amendment to answer. (Ex. 2-J, A. __; Doc. 96, A. __.)

The second administrative provision requires that the immediate supervisor of the individual making the initial penalty determination approve the penalty in writing. 26 U.S.C. § 6751(b). The Commissioner took the position that "section 6751(b) has no application here" and presented no evidence as to whether the penalty determinations in this case were approved. (Doc. 253 at 44, A. __.) In support of his position, the Commissioner argued that "assessment does not occur until the decision of the Tax Court has become final." (Doc. 253 at 44, A. __.) As demonstrated by the recent decision of the U.S. Court of Appeals for the Second Circuit, the Commissioner's position should be rejected. *Chai v. Comm'r*, 851 F.3d 190 (2d Cir. 2017), *aff'g in part, rev'g in part* 109 T.C.M. (CCH) 1206 (2015).

The governing statute provides: "No penalty … 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." 26 U.S.C. § 6751(b)(1). The purpose of the statute is to ensure that the Commissioner is imposing penalties only where appropriate, and not using them as a bargaining chip in settling matters with taxpayers. S. Rep. No. 105-174, at 65 (1998). In considering the language of the statute and its legislative history, the Second Circuit concluded that 26 U.S.C. "§ 6751(b)(1) requires written approval of the initial penalty determination no later than the date the IRS issues the notice of deficiency (or files an answer or amended answer) asserting such penalty" and that "compliance with § 6751(b) is part of the Commissioner's burden of production and proof in a deficiency case in which a penalty is asserted." *Chai*, 851 F.3d at 221.[5]

The Commissioner presented no evidence on supervisory approval with respect to the substantial valuation misstatement penalty asserted in the FPAA or the gross valuation misstatement penalty asserted in his second amendment to answer.

[5] In light of the Second Circuit's decision in *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017), the Tax Court reconsidered its prior holding relating to the application of 26 U.S.C. § 6751(b)(1) and adopted the Court of Appeals' holding. *Graev v. Comm'r*, No. 30638-08, 149 T.C. __, 2017 WL 6549899 (Dec. 20, 2017); *see also Simonsen v. Comm'r*, No. 29698-14, 150 T.C. __, 2018 WL 1320362, at *9 (Mar. 14, 2018).

Thus, the Tax Court erred as a matter of law in concluding that the Commissioner satisfied his burden of production with respect to his penalty determination. Accordingly, the court's holding should be reversed.

III. A GROSS VALUATION MISSTATEMENT PENALTY CANNOT APPLY BECAUSE THE REPORTED VALUE WAS CORRECT

As discussed above, although the Tax Court denied RERI's charitable contribution deduction in its entirety on substantiation grounds, it proceeded to determine the value of the Remainder Interest for purposes of applying a valuation misstatement penalty. The Tax Court's conclusion as to value should be reversed.

To avoid valuation disputes of precisely the type here, Congress mandated that remainder interests be valued using actuarial tables, fully recognizing that the tables may yield a number that is greater than fair market value. *Anthony v. United States*, 520 F.3d 374, 377-78 (5th Cir. 2008). In the context of gift and estate taxation, this higher valuation benefits the Treasury because it imposes a tax on an amount higher than actual value. Similarly, this rule yields a benefit to taxpayers for income tax purposes when a charitable gift is made of a remainder interest. These results were contemplated by Congress and cannot be set aside lightly.

The tables determine the value of a remainder interest by applying an actuarial factor to the undivided fee interest. *See* 26 C.F.R. §§ 1.7520-1(a), 20.2031-7A. The Tax Court decided not to apply the tables based on its misinterpretation of an exception found only in regulations. (Doc. 293 at 46-47, A. __.) Instead, the Tax

Court primarily relied on a fair market value of the remainder interest in the report of the Commissioner's expert, Michael I. Cragg. Cragg's report was unreliable, used the wrong valuation date, and was founded on an inflated, results-driven discount rate. For the reasons below, the Tax Court's determination should either be reversed or vacated and remanded.

A. The Tax Court failed to apply a statutorily mandated actuarial table resulting in an undervaluation for tax purposes

Congress requires taxpayers and the IRS to use actuarial tables to value "any annuity, any interest for life or a term of years, or any remainder or reversionary interest". 26 U.S.C. § 7520(a). Although there are exceptions to that rule, a long line of cases and the incorporation of the principles of those cases into the regulations make clear that the exceptions are narrow. The Tax Court contravened Congress' clear mandate when it misapplied one of those exceptions to set aside the actuarial tables in valuing the Remainder Interest. The determination of the correct method of valuation to be applied is a question of law. *See Powers v. Comm'r*, 312 U.S. 259, 260 (1941). Thus, the Tax Court's decision to set aside the actuarial tables for purposes of valuing the Remainder Interest should be reviewed *de novo*.

It has long been understood that the use of one-size-fits-all actuarial tables to value all remainder interests, regardless of the type of underlying property, has a tendency to produce values that differ from real world values. *See Cont'l Ill. Nat'l B & T. Co. of Chicago v. United States*, 504 F.2d 586, 594 (7th Cir. 1974). This case is no exception. Application of the tables in this case resulted in a value of $32,935,000 (Ex. 1-J at RERI-002039, A. __), whereas appellant's own expert, James Myers, determined a fair market value of $16,500,000 (Ex. 271-P at 63, A. __).[6] Despite these value mismatches, the law is clear that the tables are to be set aside only in exceptional circumstances.

The use of actuarial tables to value remainder interests has a long history. *See, e.g.*, *Estate of Christ v. Comm'r*, 480 F.2d 171 (9th Cir. 1973) (applying actuarial tables to value life estate as of September 1953). For several decades, the use of actuarial tables was mandated by regulation only. *See, e.g., O'Reilly v. Comm'r,* 973 F.2d 1403, 1407 (8th Cir. 1992). Even though the tables were not required by statute, the courts would set them aside only in exceptional cases. *See, e.g.*, *Bank of Cal. v. United States*, 672 F.2d 758, 759-60 (9th Cir. 1982). "[T]he courts repeatedly have emphasized the limited nature of these exceptions and the important role played by the actuarial tables." *Estate of Gribauskas v. Comm'r*, 116 T.C. 142, 162 (2001), *rev'd*, 342 F.3d 85 (2d Cir. 2003) (reversing the Tax Court on the ground that the

[6] This disparity is entirely predictable. For example, commercial real estate investors in 2003 would typically discount cash flows using rates in the 10 to 11 percent range. (Ex. 271-P at 46, A. __.) Under the tables prescribed by 26 U.S.C. § 7520, however, the discount rate for October 2003 was only 4.4 percent. Rev. Rul. 2003-107, 2003-41 I.R.B. (Oct. 14, 2003). Because lower discount rates produce higher residual values and the rates used for the tables are lower than real world rates, the tables will consistently produce higher values for remainder interests in real estate.

tables produced an unrealistic and unreasonable value result but not disagreeing with the summary of the case law or the important role played by the tables).

Congress made the actuarial tables mandatory in 1988. Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100-647, § 5031(a) (1988); 26 U.S.C. § 7520 ("the value of . . . any remainder . . . interest *shall* be determined…." (emphasis added)). "In enacting § 7520(a)(1) and requiring valuation by the tables, Congress displayed a preference for convenience and certainty over accuracy in the individual case." *Anthony v. United States*, 520 F.3d 374, 377 (5th Cir. 2008) (citing *Cook v. Comm'r*, 349 F.3d 850, 854 (5th Cir. 2003)). "While the tables inevitably lead to departures from true value, whatever that might be, the error costs are perceived as small in the aggregate. The tables provide some measure of certainty and administrative convenience that would be disrupted if every attempt to value an annuity deteriorated into a battle of experts regarding market value." *Anthony*, 520 F.3d at 377-78 (internal citations omitted). Here, the Tax Court chose not to apply the tables, and as the Opinion makes apparent, the case deteriorated into a battle of experts regarding market value.

In setting aside the actuarial tables, the Tax Court relied on an exception in the regulations promulgated under 26 U.S.C. § 7520. The exceptions in the regulations, however, incorporate pre-section 7520 case law, T.D. 8630, 60 Fed. Reg. 63,913 (Dec. 13, 1995),[7] and therefore apply only in limited circumstances.

The examples in the regulations demonstrate that the exceptions apply only when the circumstances indicate there is little likelihood that the interest being valued will have any meaningful worth:

- Example 1: The individual who is the measuring life for a life estate is terminally ill. *See* 26 C.F.R. §§ 1.7520-3(b)(4) *Ex.* 2; 20.7520-3(b)(4) *Ex.* 1; 25.7520-3(b)(4); *Estate of Jennings v. Comm'r*, 10 T.C. 323 (1948) (cited in Actuarial Tables Exceptions, 59 Fed. Reg. 30,180, 30,181 (Jun. 10, 1994)).
- Example 2: A decedent's will establishes a trust that gives the decedent's surviving spouse an income interest for life and a remainder interest to their children, and the decedent and the decedent's spouse simultaneously die in an accident. *See* 26 C.F.R. § 20.7520-3(b)(4) Ex. 2; *see also, e.g., Estate of Carter v. United States*, 921 F.2d 63 (5th Cir. 1991) (cited in Actuarial Tables Exceptions, 59 Fed. Reg. 30,180, 30,181).

[7] A preamble to a regulation is evidence of an agency's contemporaneous understanding of its proposed rules. *Wyoming Outdoor Council v. U.S. Forest Serv.*, 165 F.3d 43, 53 (D.C. Cir. 1999).

- Example 3: The trustee has an unrestricted right to invade the corpus of a trust. *See* 26 C.F.R. § 20.7520-3(b)(2)(v) *Ex*. 3.
- Example 4: The corpus of a life estate or term of years will be exhausted prior to its expiration. *See* 26 C.F.R. § 25.7520-3(b)(2)(v) *Ex*. 4; *Froh v. Comm'r*, 100 T.C. 1 (1993) (cited in Valuation Tables, 59 Fed. Reg. 30,100, 30,101 (Jun. 10, 1994)).
- Example 5: The holder of a life estate has unrestricted power to consume the property. *See* 26 C.F.R. § 20.7520-3(b)(2)(v) *Ex*. 5.

Here, the Tax Court determined that the tables should be set aside on the grounds that the Remainder Interest holder did not "enjoy a level of protection consistent with the law of trusts." (Doc. 293 at 43, A. __.) In reaching that conclusion, the Tax Court relied on a provision of the regulations that states that the tables do not apply

> 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 . . . that precede[s] the remainder . . . 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.

26 C.F.R. § 1.7520-3(b)(2)(iii). The court's interpretation of the exception is overly broad and should be rejected.

To support its holding, the Tax Court noted that the Remainder Interest holder did not have the right to sue the Term Interest holder for damages if the latter caused damage to the property. (Doc. 293 at 43, A. __.) The court concluded that "the inability of the [Remainder Interest holder] to recover damages for waste or other acts that prejudice its interests exposes the [Remainder Interest holder] to a sufficient risk of impairment in value that the [Remainder Interest holder] does not enjoy a level of protection consistent with that provided by the law of trusts." (Doc. 293 at 43, A. __.) Effectively, the court treated the regulations as requiring that the provisions governing the Remainder Interest be ***the same as*** the law of trusts. The regulations, however, required the court to consider whether the "effect of the administrative and dispositive" provisions governing the Remainder Interest assured that the property would be "***adequately*** preserved and protected", 26 C.F.R. § 1.7520-3(b)(2)(iii) (emphasis added), not perfectly preserved and protected. The Tax Court's reading of the regulation should be rejected.

Here, the facts establish that, although the Remainder Interest holder could not sue for damages, its rights under the governing instrument more than adequately protected its interest in the underlying property. The Term Interest holder is subject to numerous specified obligations and limitations that preserve the value of the Property during the term. (Ex. 103-J, A. __.) If the Term Interest holder fails to comply in all material respects with any of those conditions and, after notice and a time to cure, does not correct the failure, the Term Interest terminates and the holder of the Remainder Interest "becomes indefeasibly possessed of the full fee simple absolute estate in and to" Holdings. (Ex. 103-J at RERI-042496, A. __.)

If the Remainder Interest holder became "indefeasibly possessed" of the full fee interest under that provision, it would gain full ownership of the property earlier than scheduled. For example, if in 2018 the Term Interest holder fails to pay the property taxes, the Remainder Interest holder would acquire full ownership of the property in 2018 and, rather than being required to wait until 2021, would be entitled to more than $8 million per year in rental payments for 2019 and 2020.[8] For that reason, the effect of the administrative and dispositive provisions governing the Term Interest provides "adequate protection" for the Remainder Interest holder.

The Tax Court ignored the Remainder Interest holder's right to gain the fee estate early if the Term Interest holder commits waste. Instead, the Tax Court focused entirely on whether the inability to sue for damages prevented the terms governing the Term Interest from being consistent with the law of trusts. The question under the regulation is whether the effect of the administrative and dispositive provisions governing the Term Interest provides "adequate protection"

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[8] The Tax Court concluded that the 2021 cash flow could be expected to equal $8,669,276 with a 3 percent annual growth rate. (Doc. 293 at 59, A. __.) Applying the same growth rate assumption to earlier years, the expected 2020 cash flow would be $8,416,773 ($8,669,276/1.03) and the 2019 cash flow would be $8,171,624 ($8,416,773/1.03).

for the Remainder Interest holder. Consequently, the Tax Court misapplied the regulation. Because the Remainder Interest holder is adequately protected, the Tax Court's conclusion was error.

The Tax Court's approach invites the party seeking to avoid the results of the tables to make nuanced comparisons between the taxpayer's contract rights and the law of trusts. The Tax Court's approach contradicts its own position in *Estate of Gribauskas*, where it stated "[T]he enactment of a statutory mandate in section 7520 reflects a strong policy in favor of standardized actuarial valuation of these interests which would be largely vitiated by the [taxpayer's] approach. A necessity to probe in each instance the nuances of a [taxpayer's] contract rights, when those rights neither alter or jeopardize the essential entitlement to a stream of fixed payments, would unjustifiably weaken the law." *Estate of Gribauskas*, 116 T.C. at 163-64.

In this case, the Remainder Interest holder's right to take early possession of the Term Interest rather than suing for damages "does not alter or jeopardize the essential entitlement" to possession of the Property as of January 2021. By setting aside the tables based on nuanced interpretations of trust law without consideration of key rights held by the Remainder Interest holder, the Tax Court "unjustifiably weakened the law," and its decision should be reversed.

B. The Tax Court's valuation determination was skewed by a wildly inflated discount rate

Because the Tax Court set aside the actuarial tables under 26 U.S.C. § 7520, it proceeded to determine the fair market value of the Remainder Interest. The court concluded that the fair market value was \$3,462,886. (Doc. 293 at 59, A. __.) The court committed clear error in reaching that conclusion. Although the clearly erroneous standard is a "generous standard," *McKesson HBOC, Inc. v. Islamic Republic of Iran*, 271 F.3d 1101, 1110 (D.C. Cir. 2001), "[a] finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed." *Anderson v. City of Bessemer City, N.C.*, 470 U.S. 564, 573 (1985). When all the evidence before the Tax Court is evaluated, it becomes obvious that "a mistake has been committed." As discussed below, appellant respectfully requests that the Tax Court's decision as to value be reversed and remanded with instructions that the calculation of value be corrected.

The Tax Court expressed the value of the Remainder Interest as of August 27, 2003, by the following formula:

$$(2021CF \div (r - g)) \times (1 \div (1 + r)^{17.33})$$

(Doc. 293 at 47, A. __.) The court described the variables of the equation as follows: "2021CF" is the projected cash flow from the Property for 2021, "r" is the discount rate, and "g" is the projected growth rate in cash flows after 2021. Doc. 293 at 47.[9]

The positions of the experts on the foregoing components and the Tax Court's conclusions are as follows:

	2021 Cash flows (CF2021)	Growth Rate (g)	Discount Rate (r)	FMV of Remainder Interest
Taxpayer's Expert [Myers]	$8,107,588	3%	11.01%	$16,550,000
Government's Expert [Cragg]	$6,663,522	3.29%	18.99%	$2,090,000
Tax Court	$8,669,276	3%	17.75%	$3,462,885

(Doc. 293 at 51, 59; A. __.)

Appellant agrees with the Tax Court's formula and each component of the formula, except the discount rate[10] (expressed as "r" in the formula). The Tax Court's determination of the discount rate ("r") rests entirely on Cragg's report with a slight modification by the court in an attempt to rescue Cragg from his failure to use the correct valuation date. As discussed below, the extraordinarily high discount

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[9] The first phrase in the formula (2021CF ÷ (r - g)) determines the value, as of January 1, 2021, of all remaining cash flows from the property. The second phrase in the formula $(1 \div (1 + r)^{17.33})$ discounts the January 1, 2021, value back 17.33 years to August 27, 2003, the date of the donation. (Doc. 293 at 47-48, A. __.)

[10] As the Court knows, a "discount rate" is an interest or risk rate that is used to determine the present value of future benefits.

rate used by the Tax Court suppresses the value of the Remainder Interest and is not supported by the evidence or the most basic principles of real estate valuation.

1. The Tax Court Erroneously Adopted the Discount Rate in Cragg's Report, which Is Riddled with Errors

The Tax Court's discount rate was derived almost entirely from the report of the government's expert, Dr. Cragg. Cragg, an economist whose areas of expertise does not include valuation of real estate (Ex. 275-R at A-2, A. __), was offered as an expert primarily on the question of whether RERI's acquisition of the Remainder Interest in 2002 had a profit motive independent of taxes. The Tax Court correctly held that that question was irrelevant in the context of a charitable contribution, (Doc. 162 at 22, A. __), and consequently ordered that Cragg's report was inadmissible in part, (Doc. 280 at 525:16-530:8, A. __).

In the surviving portions of his report, Cragg does not take the direct approach of reviewing market data from the relevant valuation date to determine the appropriate discount rate. Instead, Cragg solves for the discount rate by putting assumed amounts into an algebraic formula. Consequently, Cragg's discount rate is reverse engineered. He described his methodology as "a very different approach." (Doc. 283 at 710:7-711:4, A. __.)

In determining a discount rate, Cragg used the following formula:

(A) Present value of initial lease term cash flows (2002-2016)

\+ (B) Present value of post initial lease term cash flows (2016-2021)

= (C) Fair market value of undivided interest as of February 2002

(Ex. 275-R ¶¶ 35-38, A. __.)

Simply stated, Cragg's formula is A + B = C. The discount rate in dispute in this appeal is the "r" embedded in determining the present value of the post initial lease term cash flows ("B" in the formula).[11] Cragg reverse engineers the "r" used to determine "B" by making unsupported assumptions about every other input necessary in the formula.

As described below, Cragg's method derives the value of "B" by subtracting "A" from "C". For "C", he used the $42.35 million sales price for the Property in February 2002 (18 months before the correct valuation date). (Ex. 275-R ¶ 36, A. __.) To derive the present value of the cash flows for the initial lease term ("A" in the formula), Cragg used the initial lease term cash flows (which were known under the terms of the lease) discounted by a highly liquid bond rate, arriving at a value of $39.06 million. (Ex. 275-R ¶¶ 38.a., 40, 41, A. __; Doc. 282 at 682:12-17,

[11] Three inputs are used to determine the present value of the cash flows ("A" and "B" in the formula): (1) the future cash flow amount, (2) the number of months (or years) to discount, and (3) the discount rate. The formula for determining the present value of the cash flows is:

$$\text{PV of cash flows} = \text{Future cash flow amount} \times (1 \div (1 + r)^{\text{Time}})$$

A. __.) He derived "B", the present value of the post initial lease term cash flows, by subtracting A from C ($42,350,000 - $39,060,000) to arrive at $3,290,000.[12] (Ex. 275-R ¶ 38.a, 42, A. __.)

After concluding by subtraction that the present value of the post initial lease term cash flows was $3.29 million, Cragg attempted to divide that figure into two components of present value: (1) future cash flows (*i.e.*, the lease payments) and (2) a discount rate. Cragg did not independently determine the fair market value of the lease payments following the initial lease term (*i.e.*, the future cash flows). Instead, he assumed, without any analysis or justification, that the lease amount at the end of the initial 15.5-year term would be a fair market value amount. (Ex. 275-R ¶ 45, A. __.) Cragg then applied a growth rate (later rejected by the Tax Court) to determine how much the monthly post initial lease term cash flows would grow. (Ex. 275-R ¶ 45, A. __.) Cragg then algebraically solved for the discount rate that would result in a present value as of April 2002 (the wrong date) of $3.29 million. (Ex. 275-R ¶¶ 43, 47, A. __.) It is this mathematically derived discount rate that drives the Tax Court's value conclusion.

There are three commonly recognized methods for valuing real property: income, replacement cost, and comparable sales. *Whitehouse Hotel Ltd. P'ship v. Comm'r*, 615 F.3d 321, 333 (5th Cir. 2010). "The income approach to valuing real

[12] For purposes of this discussion, the numbers are rounded.

property involves discounting to present value the expected cash flows from the property." *Whitehouse Hotel Ltd. P'ship v. Comm'r*, 131 T.C. 112, 137-138 (2008), *vacated*, 615 F.3d 321 (5th Cir. 2010). Cragg's method, which he characterized as a "very different method", involved, in his own words:

> [L]ooking at the price of the property when it was sold for 42.3 million and saying, Well, what is the implied discount rate embedded in that sale price, given that there's a lease in place. So that's a very different way of approaching this as opposed to, you know, assuming some cash flows and, you know, coming up with a discount rate and then discounting them back to our present value.

(Doc. 283 at 710:7-711:4, A. __.) The determination of the correct valuation method is a question of law. *Powers v. Comm'r*, 312 U.S. 259, 260 (1941). The Tax Court was wrong as a matter of law to adopt Cragg's novel and untested method rather than the commonly recognized income approach used by appellant's expert, Myers. The Tax Court's error is compounded by the fact that Cragg used the wrong valuation date.

Even if the Tax Court's use of Cragg's "very different" method was not wrong as a matter of law, the court's acceptance of several factual premises in Cragg's conclusions was clear error.

a. Cragg's Calculation of the Present Value of Initial Lease Term Cash Flows Is Wrong Because it Uses a Corporate Bond Rate to Value a Real Estate Interest

As noted above, Cragg computed the present value of the initial lease term cash flows ("A" in the formula A + B = C) using a highly liquid bond rate, to arrive at a value of $39 million for "A". (Ex. 275-R ¶ 38.a, A. __.) Cragg determined that the AT&T corporate bond rate as of March 2002 for a 14-year bond was approximately 7.92 percent and applied that rate as the discount rate for the initial lease term. (Ex. 275-R ¶ 41-42, A. __.)

Cragg's own report and his trial testimony show why it was wrong to use the rate of a highly liquid AT&T corporate bond to value an illiquid asset – here a 288,000 square foot data center (Ex. 271-P at III, A. __; Ex. 8-J at RERI-041053, A. __). Cragg stated in his report that "the appropriate discount rate to apply is what an investor would require in order to invest in a transaction of equivalent risk." (Ex. 275-R at 18, n. 45, A. __.) Thus, in choosing to apply the AT&T corporate bond rate, he concluded that an investor would view ownership of an AT&T corporate bond as having the same risks as ownership of the Property while subject to a long-term lease to AT&T. (Doc. 283 at 729:24-730:3, A. __.)

Cragg admitted at trial, however, that corporate bonds are significantly more liquid than an interest in real estate, and he admitted that his opinion did not account for that difference in liquidity. (Doc. 283 at 689:7-21, A. __.) He also admitted that he did not account for the fact that a seller of the Property would incur transaction costs. (Doc. 283 at 688:23-689:2, A. __.) On questioning by the court, Cragg admitted that the discount rate for real estate should reflect a higher liquidity risk than for a corporate bond. (Doc. 283 at 730:16-732:5, A. __.)

Cragg further admitted that a stream of payments that can be turned into cash immediately is worth more than a stream of payments that can be turned into cash after 5 days. (Doc. 283 at 732:24-732:25, A. __.) While Cragg admitted that an AT&T corporate bond could be sold quickly, possibly even the same day, Myers and the Bonz/REA appraisal recognize that marketing and selling the Property could take 12 months. (Ex. 271-P at 61, A.__; Ex. 24-J at RERI-017958, A.__.) Cragg does not address that issue in his report. Indeed, Cragg provided absolutely no market data to support his bald assertion that an investor in the Property (or any commercial real estate) would apply the corporate bond rate to discount cash flows. Thus, the Tax Court's acceptance of the corporate bond rate was clear error. *See, e.g.*, *Trans-Orient Marine Corp. v. Start Trading & Marine, Inc.*, 925 F.2d 566, 571 (2d Cir. 1991) (setting aside district court's findings where they were not supported by affirmative evidence in the record).

The record was clear that an AT&T corporate bond rate did not capture the liquidity risks associated with an investment in the initial lease term cash flows. By using the AT&T bond rate, Cragg vastly overstated the value of those cash flows. Under Cragg's method, overstating the value of the initial lease term cash flows understates the value of the later cash flows, leading in turn to the inflated discount rate used by the Tax Court. The Tax Court gave two flawed reasons for adopting

Cragg's use of a corporate bond rate, further demonstrating that its conclusion was clear error.

First, the Tax Court noted that although Cragg's discount rate (7.92 percent) did not include a liquidity premium, it was higher than the rate (7.5 percent) for a "bondable lease structure"[13] that appellant's expert, Myers, included in his expert report. (Doc. 293 at 54, A. __.) This misstates Myers' conclusions. Myers concluded that the appropriate discount rate for the initial lease term cash flows was 9 percent. (Ex. 271-P at 48, A. __.) In his discussion of why a 9 percent rate was appropriate, one of the factors considered by Myers was that an appropriate rate for a "bondable lease structure" was 7.5 percent, derived as the sum of two numbers: a 6 percent bond rate plus a 1.5 percent liquidity premium. (Ex. 271-P at 47, 48, A. __.) Thus, if the Tax Court viewed Myers's "bondable lease structure" as guidance, it should have added a 1.5 percent liquidity premium to Cragg's 7.92 percent bond rate to produce a discount rate of 9.42 percent for the initial lease term period. To do otherwise was clear error.

[13] Myers describes the difference between a "bondable" lease and a "typical" triple net lease.

> A "Bondable Lease" is a variation of a triple net ("NNN") lease in which the tenant carries all real estate risks related to the property. This structure, assuming a credit tenant lease of sufficient term is in place (which is the case with the Hawthorne Property), is perceived as creating an investment which is more similar to a "bond" than to a real estate transaction.

(Ex. 271-P at 37, A. __.)

Second, the Tax Court analogized the AT&T lease payments to an annuity and therefore "distinct in nature from those interests to which a marketability discount is typically applied." (Doc. 293 at 54, A. __) (citing *Estate of Gribauskas v. Comm'r*, 116 T.C. 142, 164 (2001), *rev'd*, 342 F.3d 85 (2d Cir. 2003)). The Tax Court's reliance on *Gribauskas* is misplaced. That case involved the right to receive lottery payments, not lease payments, and whether the lottery payments were an "annuity" for purposes of 26 U.S.C. § 7520. *Estate of Gribauskas*, 116 T.C. 142. The case is, therefore, inapposite on the question whether marketability restrictions affect the value of real estate with a fixed stream of rental payments. *Gribauskas* itself states it is inapposite, since it concluded that lease payments are distinguishable from an annuity. *Id.* at 157 ("As regards leasehold, patent, and royalty payments, each of these assets, unlike an annuity, derives from the use of an underlying item of tangible property or intangible property that exists separate and apart from the agreement to make a series of remittances."). Thus, by its own terms, *Gribauskas*' statements about annuities do not apply to lease payments.

In light of the obvious flaws in the Tax Court's explanations combined with Cragg's admissions that he did not account for differences in liquidity risk, it was clear error for the Tax Court to apply Cragg's corporate bond rate to the initial lease term cash flows without adding a liquidity premium to the rate. Appellee submitted no evidence as to what the appropriate liquidity premium should be. Appellant, through his expert, submitted evidence that the liquidity premium should be 1.5 percent. (Ex. 271-P at 47, A. __.) Accordingly, if Cragg's methodology is to be used, the case should be remanded with instructions to apply a discount rate of 9.42 percent to the initial lease term cash flows.

b. Cragg's $42.35 Million Fair Market Value Is Wrong Because It Is 18 Months Out of Date and Inconsistent with Other Assumptions in His Report

Cragg used the $42.35 million sales price for the Property in February 2002 (18 months before the correct valuation date) as the fair market value of the undivided interest ("C" in the formula). Since the value of the undivided fee interest is the starting point of Cragg's calculation, it has a direct impact on the ultimate conclusion of the value of the Remainder Interest.

Cragg offers no explanation as to why he relies on an outdated valuation.[14] Cragg's own report suggests it is likely that the value of the Property increased significantly during the interval between February 2002 and August 2003. His report shows that between March 2002 and September 2003 the Industrial Commercial Property Sub-Index changed from 139.27 to 160.71, a 15.4 percent increase. (Ex. 275-R at Workpapers, MIT Commercial Real Estate-Based Indices

[14] The most plausible explanation is that the purpose of Cragg's report was not to value the Remainder Interest on the date of donation (the relevant question for tax purposes), but rather was an attempt to argue the irrelevant point that RERI did not purchase the Remainder Interest for a non-tax business purpose.

at 3, A. __.) By ignoring the data in his own report and assuming that the February 2002 sales price constituted a reliable indicator of the fair market value of the Property, Cragg's report is internally inconsistent, implausible, and unreliable.

The only evidence in the record of the value of the Property on the correct valuation date – August 27, 2003 – is the Myers Report. (Ex. 271-P at 60, A. __.) That report valued the property at $52 million based on substantial market data. In view of Cragg's unreliable conclusions, Myers' opinion as to the value of the Remainder Interest should prevail. In the alternative, the Court should remand the case and instruct the Tax Court to value the Remainder Interest using Myers' $52 million value for "C," and the AT&T corporate bond rate as of August 2003 with a 1.5 percent liquidity premium.

c. Cragg's "Conclusion" as to the Present Value of the Post Initial Lease Term Cash Flows Is Arithmetically Derived and Compounds His Other Errors

Cragg derived the present value of the post initial lease term cash flows ("B" in the formula described above) by subtracting "A" from "C" ($42,350,000 - $39,060,000) to arrive at $3,290,000.[15] (Ex. 275-R ¶ 42, A. __.) Cragg then used a present value formula to solve for the discount rate that would result in a present value of $3,290,000. (Ex. 275-R ¶¶ 43-47, A. __.) In other words, he backed into a

[15] As noted above, the numbers are rounded for purposes of this discussion.

discount rate of 18.99 percent for the post initial lease term cash flows using algebra. (Ex. 275-R ¶ 45, A. __.)

For purposes of his formula, Cragg made no attempt to use valuation principles to determine the starting point for the post initial lease term cash flows. Instead, he merely "assumed that rental income in periods after the termination of the initial lease term would equal the scheduled rent as of the end of the initial term increased by an assumed grown rate of 3.29 percent, which he derived from an index of U.S. commercial real estate prices." (Doc. 293 at 16, A. __; Ex. 275-R at A-33, ¶ 96, A. __.) Cragg attempts to justify his 3.29 percent growth rate by stating that it was consistent with the 3 percent growth rate used in the Bonz/REA appraisal. (Ex. 275-R at A-33, ¶ 96, A. __.) Conveniently, however, Cragg ignores other parts of the Bonz/REA appraisal, such as the $47 million fair market value determination for the Property, in reaching his conclusions.

Cragg's discount rate determination for the post initial lease term cash flows (18.99 percent) differs drastically from the AT&T bond rate used for the initial lease term cash flows (7.92 percent). Cragg rationalized his 11.07 percent spread as being attributable to the increased "uncertainty about future real estate values and therefore uncertainty about the future lease payments." (Ex. 275-R ¶ 45, A.__.)

Uncertainty about future values is a ubiquitous feature in valuing commercial real estate. Yet Cragg did not provide any market data to support his conclusion that at the relevant period investors would have applied a discount rate of 18.99 percent to expected cash flows from commercial real estate. Even if Cragg's conclusion that the discount rate for the post initial lease term cash flows as of April 2002 was 18.99 percent were supported by substantial evidence, it was against the clear weight of the evidence. A finding is clearly erroneous "if there is substantial evidence, but the reviewing court concludes that the finding is, nevertheless, against the clear weight of the evidence." 9-52 MOORE'S FEDERAL PRACTICE – CIVIL § 52.31 (2015) (collecting cases).

Unlike Cragg's opinion, which was almost entirely devoid of market data and was based on the wrong valuation date, Myers supplied more than 60 pages of analysis of market conditions as of the correct valuation date, August 2003. For example, on the key question of the expected rental value of the Property, Myers provided detailed and substantial evidence regarding the data center industry (Ex. 271-P at 11-14, A. __), the market conditions in the area around the Property (Ex. 271-P at 8-10, A. __), the condition of the Property (Ex. 271-P at 15-20, A. __), zoning (Ex. 271-P at 22-24, A. __), and market rent for powered shell data centers, including lease comparables (Ex. 271-P at 39-44, A. __). Myers found a market rent rate of $1.50 per square foot as of August 2003. (Ex. 271-P at 44, A. __.) Cragg, in contrast, assumed but did not opine that the scheduled rental payments in the AT&T

lease would have been the fair market rent as of the end of the initial lease term. (Ex. 275-R ¶ 45, A. __.)

On the key question of rates of investor returns, Myers provided contemporary data from the August 2003 period. (Ex. 271-P at 46-48, A. __.) That data included investor return rates for comparable commercial properties, including properties in the Los Angeles area. To analyze the effects of the 17-year period for the Remainder Interest, Myers incorporated increased yields for uncertainty due to the length of the period, including a citation to data on the increased yields on U.S. Treasuries for longer duration. (Ex. 271-P at 62-63, A. __.) Using that data, Myers concluded that an 11 percent discount rate for the post initial lease term cash flows was appropriate. (Ex. 271-P at 63, A. __.)

In contrast, Cragg did not rely on any data on investor return rates for real estate. His 18.99 percent discount rate is simply the arithmetic result of a limited set of assumptions applied to an outdated transaction price. Cragg's conclusions about expected cash flows and investor returns were against the clear weight of evidence. Thus, the Tax Court erred in relying on those conclusions.

2. The Tax Court's Attempt to Fix a Fatal Error in the Cragg Report Was Flawed

The Tax Court adopted Cragg's conclusion on the discount rate, except the court reduced Cragg's rate by 1.24 percent to reflect Cragg's use of the wrong valuation date. (Doc. 293 at 57-58, A. __.) Because April 2002 was the wrong valuation date, the Tax Court tried to correct Cragg's error by adjusting Cragg's discount rate – 18.99 percent – down to 17.75 percent to account for the decline in interest rates in the interval between Cragg's valuation date and the correct date. (Doc. 293 at 58, A. __.) The Tax Court's downward adjustment accounted only for changes in interest rates, however. That adjustment is inadequate to correct Cragg's mistake, as interest rates are only one consideration in determining the correct discount rate.

As noted by the Tax Court in *Gribauskas*, with respect to leasehold payments, the "anticipated payment stream can be affected by a wide variety of external market forces that operate on and impact the worth of the underlying asset. This injects into the valuation of these payment streams risks and considerations beyond simply the time value of money." *Estate of Gribauskas*, 116 T.C. at 27. As Cragg himself noted, "[t]he discount rate compensates investors for both their risk bearing and the time value of money." (Ex. 275-R at 18, n. 45, A. __.)

The undisputed facts establish that there were significant changes in the "external market forces that operate[d] on and impact[ed] the worth of" the Property during the 18 months between Cragg's valuation date and the correct valuation date. Cragg's key assumptions about the numerical relationships of overall value, initial lease term cash flows value, and post initial lease term cash flows value no longer held true as of the correct valuation date.

For example, Cragg's methodology relied on assumptions about the amount of the cash flows. But, as the Tax Court found, post initial lease term rental values as of August 2003 were significantly higher than Cragg assumed. This is reflected in the fact that Cragg's expected 2021 cash flows were $6,665,522 but the court concluded that the expected 2021 cash flows were $8,669,276. Similar disparities in annual cash flows would be present for all post initial lease term years (2017-2020). Thus, the gross amount of expected total post initial lease term cash flows was millions of dollars higher than Cragg assumed.

In addition, Cragg's own report shows that between March 2002 and September 2003 the Industrial Commercial Property Sub-Index changed from 139.27 to 160.71, a 15.4 percent increase. (Ex. 275-R at Workpapers, MIT Commercial Real Estate-Based Indices at 3, A. __.) By ignoring this data in his own report and assuming that market conditions remained the same from April 2002 to August 2003, Cragg's report is internally inconsistent. *See Anderson v. City of Bessemer City, N.C*, 470 U.S. at 575 (explaining that a court may find clear error when a witness' statement is so internally inconsistent or implausible on its face that a reasonable factfinder would not credit it). Neither Cragg's report nor the Tax Court's adjustment to the interest rate accounts for these changes in market conditions.

Because he used an April 2002 valuation date, Cragg's report did not reflect an investor's "risk bearing" as of the correct valuation date. Thus, under Cragg's own description of the components of a discount rate, his 18.99 percent discount rate was contradicted by the evidence of altered market conditions as of August 2003. For that reason, it was clear error for the court to adopt Cragg's conclusions with adjustments only for changes in interest rates. Accordingly, appellant respectfully requests that the Tax Court's determination of value be reversed and remanded with instructions that the Tax Court compute value without regard to Cragg's determination of value.

IV. RERI HAD REASONABLE CAUSE FOR ITS TAX POSITION; THUS, THE TAX COURT'S APPLICATION OF A VALUATION PENALTY WAS WRONG AS A MATTER OF LAW

As discussed above, the Commissioner failed to satisfy his burden of production with respect to the gross valuation misstatement penalty. However, even if the Commissioner had satisfied his burden, a penalty still should not be imposed because, contrary to the Tax Court's holding, the reasonable cause exception to the imposition of a valuation misstatement penalty applies.

A gross valuation misstatement penalty may not be imposed on an underpayment of tax where the taxpayer can show reasonable cause. 26 U.S.C. § 6664(c). To satisfy the reasonable cause exception for a valuation misstatement penalty, the taxpayer must have obtained a qualified appraisal of the donated property before filing its tax return and made a good-faith investigation of the value of the donated property. 26 U.S.C. § 6664(c)(2).

Before filing its 2003 tax return, RERI engaged Howard Gelbtuch of Greenwich Realty Advisors, Inc., to perform an appraisal for purposes of RERI's charitable contribution deduction. (Ex. 132-J, A. __.) To determine the value of a remainder interest in the Property, Mr. Gelbtuch applied the tables under 26 U.S.C. § 7520 to the fair market value of the leased fee interest in the Property. (Ex. 1-J at RERI-002039, A. __.)

Mr. Gelbtuch's appraisal determined a fair market value of $55 million for the leased fee interest in the Property as of August 28, 2003, and a value of $32,935,000 under 26 U.S.C. § 7520 for the remainder interest. (Ex. 1-J at RERI-002039, A. __.) The value of the leased fee interest in the Property determined by Mr. Gelbtuch was in line with (1) the $42,350,000 purchase price paid by Hawthorne to acquire the Property in February 2002 and (2) the $47 million value determined by Bonz/REA for purposes of the financing of the property in August 2001, making it easy for RERI to conclude that Mr. Gelbtuch's valuation determination was reasonable.

Despite the foregoing, the Tax Court held that "[m]arshaling evidence of a property's value 18 months or more before a gift is simply not sufficient as a matter of law to qualify as a good-faith investigation into the value of the property at the time of the gift." (Doc. 293 at 67, A. __.) Consistent with this Court's *de novo* review of rulings on motions for judgment as a matter of law, *see U.S. ex. rel. Yesudian v. Howard Univ.*, 153 F.3d 731, 735 (D.C. Cir. 1998), the Tax Court's ruling should be subject to a *de novo* review.[16] The Tax Court's holding goes beyond the statutory language and imposes a significant burden on taxpayers claiming charitable contribution deductions. The law requires that a taxpayer obtain only ***one*** contemporaneous appraisal to establish reasonable cause. 26 U.S.C. § 6664(c)(2). The Tax Court's holding effectively requires a taxpayer to obtain ***two*** contemporaneous appraisals. The Supreme Court already has rejected that ill-conceived idea. *United States v. Boyle*, 469 U.S. 241, 251 (1985) (interpreting section 6664 in context of advice of counsel and concluding that "To require the taxpayer to challenge the attorney, to seek a 'second opinion,' or to try to monitor counsel on the provision of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place.").[17]

Here the taxpayer met the good-faith investigation requirement by comparing a contemporaneous appraisal valuing the Property at $55 million, with an appraisal of the Property that was completed two years earlier that valued the property at $47

[16] Even under the clearly erroneous standard, the Tax Court's holding should be reversed.

[17] In doing so, the Tax Court relied on its own opinion in *Whitehouse Hotel Ltd. Partnership v. Commissioner*, 139 T.C. 304 (2012). That decision as it related to the reasonable cause exception to the valuation penalty, however, was vacated by the U.S. Court of Appeals for the Fifth Circuit. *Whitehouse Hotel Ltd. P'ship v. Comm'r*, 755 F.3d 236 (5th Cir. 2014).

million, and a sale of the property completed 18 months earlier for more than $42 million. (Doc. 293 at 66, A.__.) The Tax Court, however, criticized the taxpayer, concluding that "the evidence of the Hawthorne property's value in February 2002, much less the August 2001 date of the Bonz/REA appraisal, is of limited worth in assessing the property's value in August 2003." (Doc. 293 at 67, A. __.)

The Tax Court's conclusion is contradicted by its own opinion on value. Although the Tax Court described the earlier evidence of value as of "limited worth in assessing the property's value in August 2003" when concluding the taxpayer did not make a good faith investigation of value, the court relies directly and indirectly on that very same evidence in determining the fair market value of the Remainder Interest. The Tax Court offers no explanation for the logical inconsistencies in its conclusions and there is no reason why the same evidence is reliable for one purpose, but not another.

Based on the foregoing, the Tax Court erred when it held that the Commissioner met his burden to prove that RERI did not meet the good-faith investigation requirement as a matter of law. Accordingly, the Tax Court's holding that a valuation misstatement penalty applies should be reversed.

CONCLUSION

For the foregoing reasons, appellant respectfully requests that the Court reverse the Tax Court's holdings below that no charitable contribution deduction is allowed and that a gross valuation misstatement penalty applies.

Dated: April 2, 2018

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that, on April 2, 2018, the foregoing Brief for Petitioner-Appellant was filed with the Clerk of the United States Court of Appeals for the District of Columbia Circuit, and served on Jacob Earl Christensen, counsel for Appellee, at jacob.e.christensen@usdoj.gov using the Court's electronic filing system (CM/ECF).

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