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Steve Leimberg's Charitable Planning
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Subject: Ken Jefferson and Linda Kotis on *Mann Up!* Accept that Your Gift of a Deconstructed House is Less than the Sum of Its Parts

"While donations of cash or tangible personal property to a charitable organization and realization of an income tax deduction is generally a simple and straightforward process, the same cannot always be said with respect to charitable donations of real property. State law requirements may add complexity to the transaction, the value of the property transferred tends to be much larger, and the potential for scrutiny by the IRS more likely. The recent decision in Mann v. United States, denying a charitable deduction for the donation of a deconstructed residence, could not make this message clearer.

Submitting an initial appraisal treating components of the demolished structure as equivalent to an intact residence and failing to record a deed transferring the property to the charity are just a few of the missteps made by the Maryland couple in this case. Therefore, when donating real estate, it is always necessary to follow local law applicable to real property transfers, provide a qualified appraisal to substantiate the deduction that conforms with the intended use and condition of the property, and confirm the charity's characterization of the gift with the donee and one's attorney or accountant.

Ken Jefferson and **Linda Kotis** provide members with commentary on *Mann v. United States*, which examines the potential foot-faults in charitable contributions of interests in real property.

Ken Jefferson is an associate in the Washington, DC office of **Ivins, Phillips & Barker,** a firm ranked by Chambers in its 2020 *High-Net Worth Guide*. Ken was recently named by *Best Lawyers in America's* inaugural listing of "*Ones to Watch*" in 2021. He joined the firm in the fall of 2018 having previously worked for the Internal Revenue Service (IRS) as an Estate and Gift Tax Attorney. He is a member of the District of Columbia and California Bars. During his time with the IRS, he examined numerous estate, gift and fiduciary income tax returns. Now, Ken utilizes the knowledge and experience gained at the IRS to advise clients on their estate plans as well as to analyze and advise on income and transfer tax obligations. Ken's practice also includes advising on and implementation of trust modification techniques, the handling of probate matters and administration of high-net-worth estates, and business planning and entity formation. Ken is a former collegiate football player and scholarship member of the Virginia Tech Hokies, an NCAA Division I program. He was also a member of the Hokies' Champions club and earned the privilege to serve as a captain during his senior year. For **LISI**, Ken has written *Look, Up in the Sky. It's a Transfer Tax on Your Plane* (March 19, 2020) with co-author Linda Kotis of Ivins, Phillips & Barker. Ken's most recent presentations on estate planning are *Wrapping Your 2020 Gift Tax Returns with a Tidy Bow - A Refresher of Best Practices & How to Avoid IRS Audit in 2021 Filings* (March 17, 2021) with Chelsea McGrath of Venable at the Business Planning Group of the Real Property, Trust and Estate Section of the American Bar Association's Monthly Conference Call Series and *An Overview of IRS Estate and Gift Audit Procedures and Practice Tips* (June 25, 2020) also with Chelsea McGrath at the DC Bar Communities Estate Planning Series. Ken is currently serving as a Fellow for the Real Property, Trusts and Estates Section of the American Bar Association, and he is a member of the D.C. Estate Planning Council.

Linda Kotis is Of Counsel in the Washington, DC office of **Ivins, Phillips & Barker**. She is a member of the District of Columbia, California, Indiana, and Maryland Bars. Linda advises clients on forming and revising their estate plans and analyzes estate, income, generation-skipping transfer, and gift taxation matters for high-net-worth individuals and families. Linda's significant experience includes analysis of complex state trust administration and non-tax issues, the administration of high-net-worth estates, formation of private foundations, marital agreements, complex guardianships, post-mortem planning, probate matters and court pleadings regarding fiduciary administration issues. For **LISI**, Linda has written *Navigating the Waters of Maryland's New Elective Share Law: How Not to Be Up The Creek without A Paddle* (October 2, 2020) with co-authors Andrea Dykes and Carolyn Rogers of Howard Insurance, *Look, Up in the Sky. It's a Transfer Tax on Your Plane* (March 19, 2020) with co-author Ken Jefferson, *Modification Mania: Avoid Trust Code Trip-Ups and Draft Documents to Facilitate Change* (October 31, 2019), *Reset of the District of*

Columbia's Estate Tax Exemption (January 9, 2019) with co-authors Andrea Dykes and Carolyn Rogers, *Minding the Gap: The Mismatch Between Maryland's 2019 Estate Tax Exemption and the New Federal Estate Tax Exemption* (June 25, 2018), and *Reform School: Lessons on Rescuing an Undesirable Tax Plan after Death* (April 27, 2017). She is a co-author with Andrea Dykes and Carolyn Rogers of *Maryland Enacts New Elective Share Law: Increased life insurance planning opportunities for states that have adopted the augmented estate concept,* Wealth Management's Trusts & Estates (August 11, 2020) and *The 2020 Election in Maryland*: *It's Not About Politics*, Probate & Property magazine (July/August 2020), and the author of *Nonjudicial Settlement Agreements: Your Irrevocable Trust is Not Set in Stone*, Probate & Property magazine (March/April 2017), and other articles in *Washington Lawyer, Bloomberg BNA Daily Tax Report,* and *Wealth Strategies Journal*. Linda's most recent presentation on estate planning was with co-presenter Kasey Place of Ivins Phillips & Barker at the 2020-2021 DC Bar Communities Guardianship and Probate Program Series on *The Blessings and Burdens of Drafting for and Administering Estates with Charitable Beneficiaries* (February 25, 2021). Other recent presentations were with co-presenter Judith Barnhard of Councilor Buchanan & Mitchell at the Greater Washington Society of CPAs' 2020 Nonprofit Symposium (December 14, 2020) on *Planning to SECURE Charitable Gifts: How the SECURE Act Supports Donations of Retirement Assets*, with co-presenter Kasey A. Place on *Lemons to Lemonade: Making Use of the Delaware Tax Trap* (November 13, 2018) at the DC Bar Communities, Estates, Trusts, and Probate Lunch Series, and as a panelist with Robin Solomon of Ivins, Phillips & Barker at the *Women, Influence & Power in Law* conference (October 4, 2018). Past presentations include meetings of the American Bar Association and the District of Columbia Bar, as well as law firm briefings. Linda is an active member of the Estate Planning Council of Montgomery County, Maryland.

Here is their commentary:

EXECUTIVE SUMMARY:

In *Mann v. United States*, 984 F.3d 317 (4th Cir. 2021), the Circuit Court of Appeals upheld the district court's affirmation of a disallowed deduction for a charitable donation. The plaintiffs had entered into an agreement to donate their residence to a 501(c)(3) organization and took a charitable deduction for $675,000, representing the appraised value of the house as if it were moved intact to another lot. In fact, the charitable organization deconstructed some of the house, salvaging some components, and leaving the remainder for demolition by the couple's contractor. The IRS disallowed the deduction because the Manns did not convey their entire interest in the house to the charity and the appraisal provided did not accurately reflect the nature of their donation. The IRS also rejected the couple's attempt to amend the deduction to $313,353 as supported by a subsequent appraisal representing the aggregate value of donating all of the house's components. The Circuit Court affirmed the district court's ruling that this appraisal did not constitute a qualified appraisal since "a valuation of over $300,000 based on the extraction and resale of all building materials does not properly value the donation in light of the conditions placed on the conveyance."[1]

FACTS:

***Overview*:** In April 2011, Linda and Lawrence Mann downsized to a smaller home in the same Bethesda, Maryland neighborhood in which they had recently sold their previous home of 20 years. The new home, an existing single family residential dwelling, was purchased in Mrs. Mann's sole name in an effort to divide assets between the couple. While the new house was in good condition, the Manns had intended to perform renovations to the existing structure from the outset. During the renovation planning process, however, the couple discovered issues that led them to decide to demolish the existing home and build a new one. Upon suggestion by builders known to the Manns, the couple was referred to Second Chance, Inc. ("Second Chance"), to address the removal of the existing home and a possible donation.

Second Chance is a Baltimore-based § 501(c)(3) non-profit organization with a mission to provide "workforce development and job training opportunities to disadvantaged members of the community." In furtherance of its mission, it offers building deconstruction services to prevent salvageable fixtures and other building materials from ending up in a landfill. Second Chance markets itself by distinguishing its services as deconstruction as opposed to demolition services offered by other similar organizations. That is, Second Chance acknowledges its work involves the dismantling of a structure to preserve, salvage, and remove certain components while others are destroyed and left behind for further demolition and/or disposal. Second Chance stresses this latter point and recommends its property donors also engage a demolition contractor. Finally, to cover the wages and training of the program participants performing the salvage labor, Second Chance encourages donors to make cash contributions.[2]

After learning about Second Chance, the Manns decided to proceed with donating the residence in a deconstructed condition. The Manns engaged Novastar Appraisals ("Novastar") in mid-October 2011 to establish the value of the donation for tax purposes. A Novastar appraiser valued both the house and the personal property in the residence. Contrary to the Manns' intention to donate the home to Second Chance for deconstruction,

> the appraiser concluded, as stated in the appraisal, that the 'Highest and Best use' of the house was 'not disassembly, but rather physically moving the structure to another lot' to function as a residence. The appraisal added that 'disassembly destroys part of the structure during the process, such as: drywall, tile and roofing materials. Deconstruction therefore is not considered Highest and Best use.' The appraiser accordingly assessed the value of the house 'without disassembly.'[3]

The appraiser determined that the land and house as purchased were worth $1,875,000. Subtracting the value of the land at $1,200,000, the structure was then valued at $675,000.

Deconstruction Process**:** In December 2011, Mrs. Mann entered into a property donation agreement with Second Chance. In the two-page "Agreement for Charitable Contribution," Mrs. Mann conveyed all of her "right, title and interest in the improvements, building and fixtures" of the existing single-family residential dwelling as described in the Novastar Appraisal to Second Chance. In exchange, Second Chance agreed to: (i) remove the building in accordance with its customary procedures, (ii) provide labor, materials, and tools necessary to do so, and (iii) cooperate with Mrs. Mann to provide documentation to evidence the charitable contribution for the purposes of the Manns' federal and state income tax returns.

Before deconstruction began in December 2011, a Deconstruction Sales

Manager explained the tax deduction to Mr. Mann:

> You should of course discuss this with your CPA, but I can confidently say that a 'contents' donation is as solid as it gets. Although no nonprofit can offer a guarantee, I'm sure your CPA will agree that an inventoried materials donation is equivalent to donating and deducting the value of your front door, or couch (as with your personal property donation). *The approach we're discussing only considers the value of what crosses the threshold of our warehouse, based on a manifest that we sign to verify receipt.* [Emphasis added]. [I]f the donor follows the IRS code for deducting the fair market value based on a qualified appraisal done by a qualified appraiser, there is no reason a donor should not receive the deduction.
>
> You and your CPA have a couple [of] options to arrive at that manifest based deduction. Either way we will provide a manifest list of what we actually take away from the site. We fully expect this manifest list will carry a value north of 200k, but a conservative minimum would be 150k — creating tax savings of at least 45k, of which 20k you would pledge to Second Chance, leaving at least 25–30k in your pocket at the end of the process.[4]

Based upon the estimated tax savings generated by the donation, Second Chance asked the Manns to donate $20,000 in cash to offset the charity's cost of paying its trainees. Though Mr. Mann initially wanted to condition this payment on the IRS' allowance of the charitable contribution deduction, he sent a check on December 31, 2011 for $10,000, and then another check in 2012, as payment on the second installment of the proposed donation.

Second Chance deconstructed the house in two phases. After completion of the process in July 2012, Second Chance informed the Manns that it was not able to recover as much of the materials as expected. In contrast to its representation that it would keep and provide records of all extracted components, Second Chance retained complete records only of the components extracted from the first phase of deconstruction.

Initial Returns and Tax Deductions: On their joint federal income tax returns for 2011 and 2012, the Manns claimed the following charitable deductions:

2011 -	$675,000	house
	$24,206	personal property
	$10,000	cash
2012 -	$1,500	cash

Both the Manns' 2011 and 2012 tax returns were selected for audit and the deductions for the donations of the house and personal property to Second Chance were disallowed. After denial of an administrative appeal, the Manns paid the outstanding tax liabilities of $191,638 for 2011 and $2,464 for 2012 and filed a refund suit in November 2015.[5]

Amended Return and Alternative Appraisal: In August 2016, the Manns filed an amended 2011 return "for settlement purposes," which adjusted the deduction claimed for the house from $675,000 to $313,353. Based on an alternative appraisal done by Novastar using a modified cost approach, the structure's used building components were valued as if they had been sold on a second-hand market. In justifying the methodology, Novastar likened the home's donation for purposes of Second Hand's use in its Workforce Development Program to a donation of a structure to a fire department for use in a fire training exercise. Because there is no established market for used home building materials, Novastar reasoned that "the cost approach to value" with proper adjustments for depreciation was appropriate.

As a starting point, all components were valued as new, for an aggregate value of $377,534. That value was then depreciated by 17% to arrive at $313,353, based on an effective age of 10 years with an estimated 60-year economic life for each component. The appraisal, however, did not identify or account for which components (i) were salvaged for resale by Second Chance, (ii) were destroyed in the deconstruction process, or (iii) would remain onsite for demolition and removal by the third-party contractor. As a result, the IRS once again disallowed the deduction.[6]

Refund Action*:* The Manns commenced yet another action in January 2017, seeking a refund and a determination finding the original claimed deductions valid. In an opinion dated January 31, 2019, the district court ruled for the IRS, granting its motion for summary judgment, and respecting the disallowance of the deduction on two grounds: (i) the Manns failed to make a valid transfer of an entire interest in real property as required by IRC § 170(f)(3). The house was not properly severed from the land as the transfer to Second Chance was never recorded in the land records as required under Maryland law; and (ii) even disregarding the severance issue, the deduction would not be available to the Manns because the appraisals provided to justify the deductions were not "qualified appraisals" which properly substantiated said deductions, pursuant to IRC §170(f)(11)(C). The court did, however, grant summary judgment to the Manns for the two cash donations to Second Chance, concluding that they were properly deductible.[7]

Appeal of Summary Judgment: Following the summary judgment, the Manns then challenged only the district court's affirmation of the government's disallowance of the amended deduction. In their appeal, the Manns contended: (i) the residence was constructively and effectively severed from the land by the execution of the donation agreement, (ii) the entire interest in the residential structure was donated to Second Chance, and (iii) the value of the donated property was properly appraised in the $313,353 appraisal.

In determining whether the Manns should have been permitted the charitable deduction, the Circuit Court considered whether the Manns (i) donated their entire interest in the house to Second Chance and (ii) supported the donation with a "qualified appraisal."[8]

The Circuit Court first reviewed the district court's conclusion that the Manns had not severed the house from the land due to the failure to record the transaction in the Maryland land records. The Circuit Court weighed this conclusion against the Manns' arguments that Maryland law (i) does not require recordation when an agreement constructively severs an improvement from the underlying land, (ii) only requires compliance with the statute of frauds, which was satisfied by the donation agreement executed by Mrs. Mann, and (iii) effectuates a conversion of the structure from real property to personalty based upon the provisions of the agreement.[9] Under common law, whatever is affixed or annexed to the soil or freehold becomes a part of such real property. Maryland's constructive severance doctrine alters this rule by allowing the express or implied agreement of the parties to change that result, with the agreement binding upon subsequent purchasers of the real property.[10]

The Circuit Court was unconvinced by their arguments and distinguished between the contractual ownership Second Chance may have obtained through execution of the donation agreement and the record ownership Mrs. Mann retained. The Court examined Maryland statutory and case law, defining real property as including both land and improvements to land where improvement generally refers to buildings but may also include any permanent structure or other development.[11]

The Circuit Court then examined a line of cases where transfers of improvements constructed by one party on land owned by another purportedly occurred, though without a recordation of the transfer. In 2011, the Maryland Court of Special Appeals held:

> [T]he 'owner of real property according to the land records' is also the 'record landowner' of 'the improvements built thereon' — and thus responsible for paying property taxes with respect to the improvements — unless there is 'a recorded deed or other instrument of record showing a transfer of the title to the improvements to another owner.' *Supervisor of Assessments of Balt. Cnty. v. Greater Balt. Med. Ctr. (GBMC)*, 32 A.3d 174, 180, 184 (Md. Ct. Spec. App. 2011).[12]

Based upon *GBMC*, the lack of a recorded transfer of the house to Second Chance meant that Mrs. Mann continued to retain record ownership of the house. Therefore, from the December 2011 execution of the property donation agreement through the July 2012 demolition of the house, Mrs. Mann was liable for property taxes on both the land and the house. As a result, the Circuit Court found the Manns had conveyed neither the entire interest (see IRC §170(f)(3)(A)) nor an undivided portion of the entire interest in the property (see IRC §170(f)(3)(B)(ii)) which would allow for a deduction under either provision.[13]

Donation Agreement: Irrespective of Mrs. Mann's continuing status as record owner of the property, the Circuit Court examined the donation agreement, and found that the Manns had not intended to transfer their entire interest in the house to Second Chance. The Circuit Court reached this conclusion, given the fact that the Manns understood even before executing the donation agreement that Second Chance engaged in deconstruction services which would only extract some components from the structure and destroy others in the process. The rest of the residence was to be demolished and removed by a third-party contractor already hired by the couple. This understanding was reiterated in the donation agreement and confirmed after Second Chance completed its two-phase process. Second Chance's deconstruction was entirely consistent with the scope of work discussed prior to execution of the donation agreement and consistent with the language contained in the agreement. Therefore, the Circuit Court found Mrs. Mann could not claim her entire interest in the property was donated under IRC § 170(f)(3).[14]

In response, the Manns argued a narrower reading of the donation agreement was appropriate, pointing to the language indicating conveyance of all of Mrs. Mann's right, title, and interest in the house. The Circuit Court countered that in tax matters "substance matters over form, [because] the taxability of a transaction is determined by its true nature rather than by the name which the parties may use in describing it."[15] Thus, while under the agreement, the parties clearly contemplated Second Chance was free to choose any building materials and fixtures for donation and that those left behind would be either destroyed or left for demolition by the Manns contractor, Mrs. Mann at all times remained the record owner of the property and retained all of the attendant benefits and burdens. Therefore, she did not donate the entire house as personal property and was not entitled to such value as a deduction.[16]

Review of Appraisal*:* Finally, the Court addressed the alternative appraisal providing a value of $313,353 for the claimed deduction. Under IRC § 170(f)(11)(C), a "qualified appraisal" is required for contributions of property for which a deduction of more than $5,000 is to be claimed. In addition to being conducted by a "qualified appraiser" who meets certain criteria for education and experience, the appraisal must provide the value of the property that is actually being contributed.

As discussed above, the alternative appraisal took a like-new cost approach of every component of the home's structure and then depreciated the aggregate value by 17% to arrive at the $313,353 value. In reviewing the district court's findings, the Circuit Court also noted that the methodology was flawed because the approach valued every component of the home, even though items destroyed in the construction process were not intended or available to be salvaged and removed by Second Chance. The Circuit Court noted that a "proper way" to account for the value of the donation would have been to account for the resale value of the items actually removed from the premises by Second Chance. Because the appraisal provided values for every component of the house as opposed to the components actually contributed, the appraisal was deficient and denial of the claimed deduction appropriate. The Circuit Court affirmed the judgment of the district court.[17]

COMMENT:

First, while there are several takeaways from this case, the importance of compliance with state law requirements for real property transfers cannot be stressed enough.

Recorded title in real property records is paramount. "Contractual ownership," without more, does not equal "record ownership." Linda Mann remained the record owner of the house because no deed was ever recorded in the land records transferring ownership of the residence to Second Chance, as required under MD Code, Real Prop. § 3-101(a). Simply recording the donation agreement may have been enough to sever the house from the land, so that it could be argued the entire interest in the dwelling structure had been contributed and allow for the charitable deduction for the contribution under IRC § 170(f)(3).

Second, the appraisal to substantiate the value of a charitable deduction with an appraisal must match the nature and description of the property being donated. While the property may have been accurately described in the donation agreement, its value, however, was not appropriately reflected in the appraisal submitted with the Manns' tax return. The district court described the proper way to value the donation of components from the house "would have been 'based on the resale value of the specific building materials and contents' that Second Chance removed from the premises."[18]

As a general rule, a party seeking a valuation of property for donation should confirm that the appraiser is aware of the nature and intended purposes of the valuation and conforms the appraisal to those purposes.

For example, just like the fair market value of an automobile is determined in a different manner based upon its intended continued usage as a passenger vehicle versus for its junk car value for scrap metal and parts, so should it be for valuing a dwelling structure intended for use as a private residence versus a building to be salvaged for its component parts.

Third, when a donee states it will provide specific documentation for a donation and fails to do so, the donor should contact the charity and attempt to obtain the promised records. In this case, because Second Chance did not retain complete records of the second phase of deconstruction, complete records were not available. The Manns, however, could have requested an explanation for Second Chance's failure to follow through on its promise, and having such information might have been helpful in creating a more effective argument to present to the IRS.

Fourth, it is a mistake to rely solely on the donee's characterization of the method for valuing the charitable donation. It is not clear whether the Manns based their actions solely on the representations of Second Chance's Sales Manager about the expected value of their gift, if they consulted a CPA or attorney, or followed some other person's advice. In any event, due to the atypical nature of the donation as deviating from the usual donations of cash, appreciated stock, or new or used home furnishings or similar items, the couple should have pressed the organization for more clarity about the meaning of an "inventoried materials" donation from the deconstructed house. The Manns could have asked the organization to provide a list of other donors willing to speak with them about how they handled their tax filings for similar donations.

Finally, it is essential to document in detail what is being donated. The Manns, in preparing and submitting their tax returns, should have included a final report with itemization of the components actually removed and retained by Second Chance for resale to support their position for a deduction. If such information had been provided along with either the original or alternate appraisal, the IRS may have been more inclined to find a middle ground instead of completely disallowing the deduction.

Concluding Observation

The Manns should be applauded for their philanthropic intent in giving away the components of their deconstructed house to Second Chance.

After all, their taking this action produced social goods: preventing salvageable items from ending up in landfills and supporting a non-profit that provides job training for members of the community. Unfortunately, a series of preventable missteps in the donation process resulted in the stress and financial burdens of multi-year litigation and a charitable deduction limited to their cash donations over two years totaling $11,500.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Ken Jefferson

Linda Kotis

CITE AS:

LISI Charitable Planning Newsletter #308 (March 23, 2021) at http://www.leimbergservices.com

CITATIONS:

[1] *Mann v. United States,* 984 F.3d 317, 328 (4th Cir. 2021).

[2] https://www.secondchanceinc.org.

[3] *Mann,* 984 F.3d at 321.

[4] *Id*.

[5] *Id*. at 322.

[6] *Id*. at 323.

[7] *Id*. at 323-324.

[8] *Id*. at 325.

[9] *Id*.

[10] *Id.* at 326.

[11] *Id.* at 325, citing Md. Code Ann. Tax—Prop. § 1-101(gg)(1); *Rose v. Fox Pool Corp*., 335 Md. 351, 643 A.2d 906, 918 (Md. 1994) (quoting Black's Law Dictionary 757 (6th ed. 1990)).

[12] *Id*.

[13] *Id*. at 326.

[14] *Id*. at 328.

[15] *Id*. at 327, citing *W. Va. N. R.R. Co.v. Comm'r*, 282 F.2d 63, 65 (4th Cir. 1960).

[16] *Id*. at 328.

[17] *Id*.

[18] *Id*.