

## Why House Burning Cases Are Still Smoldering

By Robert W. Wood



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not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

Charitable contributions of homes used in fire department training exercises achieve safety goals and generate tax benefits. Yet like contributions that achieve conservation goals, they have proven controversial in practice. Wood reviews the latest fire department training exercise case and offers comments on the future of those deductions.

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It seems like such a win-win situation. You don't really want your house and plan to tear it down and build something better. The local fire department needs to conduct training exercises for their firefighters. The department rarely gets a chance to practice on a real structure, to set it up in advance in a controlled environment, and then destroy it without repercussions.

Your builder says he can haul away the burnt rubble afterward far cheaper than if he had to dismantle an unburnt house. In fact, the fire department is so solicitous about getting the gig that it may even haul away the burnt remains for you. You are doing a good civic deed and could help save the lives of fellow citizens, not to mention firefighters. The fire department might even put up a plaque in your honor in the station house.

Professionals appraise the value of donating your pristine if undesired house to the department, which could be sizable. All the paperwork is in

order, so it's perfectly legit to claim it on your taxes. Or is it? The answer depends on a daunting bevy of details and may vary from state to state.

To some extent, it may even depend on whether you seem mostly motivated by altruism or by a desire to get rid of an eyesore by whatever means seems cheapest post-taxes. It also varies based on how aggressive or timid you are about valuation. The tax cases are mixed, making it is hard to advise homeowners, municipalities, fire departments, appraisers, and professionals, many of whom seem enthralled by this idea. Much depends on nuanced details, and that can spell trouble.

A recent Tax Court case could have either set the field of unwanted buildings burning bright or extinguish it once and for all. Instead, I'm afraid this will be with us for a time longer. In *Patel v. Commissioner*,<sup>1</sup> the Tax Court held that a couple who donated the use of their house — including burning it down as a training exercise — could not deduct it even though a local fire department unquestionably benefited from their donation.

This is not the first case involving deductions for fire department training. But it may be the most important one. Unlike most Tax Court cases that are decided by a single judge, this case was reviewed by the entire court.

Thus, all judges had a chance to weigh in with their votes. Judge Howard A. Dawson Jr. wrote the opinion denying the deduction, and judges John O. Colvin, Mary Ann Cohen, Juan F. Vasquez, Michael B. Thornton, L. Paige Marvel, David Gustafson, and Richard T. Morrison agreed. Judge Elizabeth Crewson Paris concurred only in result. Then there were the dissenters, with Judge Joseph H. Gale penning the dissenting opinion and the following judges agreeing: James S. Halpern, Maurice B. Foley, Joseph Robert Goeke, Robert A. Wherry Jr., Diane L. Kroupa, and Mark V. Holmes.<sup>2</sup>

The granddaddy fire department donation case is *Scharf v. Commissioner*,<sup>3</sup> in which the Tax Court allowed a charitable contribution deduction. In *Scharf*, the building had been partially burned and was about to be condemned. The owner donated

<sup>1</sup>138 T.C. No. 23 (2012), *Doc 2012-13744*, 2012 TNT 125-9.

<sup>2</sup>Judge Kathleen Kerrigan also dissented to the majority's holding but did not join Gale's dissenting opinion or author her own.

<sup>3</sup>T.C. Memo. 1973-265.

the building to the fire department so it could finish the job and train at the same time. The Tax Court acknowledged that Scharf got his land cleared and thus received a benefit.

Of course, the public got a benefit from fire-fighter training. Comparing the value of the two benefits, the public benefit substantially exceeded Scharf's private benefit. To the court, that made the deduction allowable. To value it, the court used the established insurance loss figure for the building.

In *Rolfs v. Commissioner*,<sup>4</sup> however, the Tax Court and Seventh Circuit denied the deduction. Part of the reason was an intervening Supreme Court case, *United States v. American Bar Endowment*.<sup>5</sup> The latter was not a fire case but rather more broadly addressed whether a charitable contribution deduction is disallowed any time the donor receives any consideration in return for a donation.

The Supreme Court held there was no automatic disallowance (whew!), but valuation was a big issue. The fair market value of any substantial returned benefit must be subtracted from the FMV of the donation, the Court announced. If the charity gives you something in return, you can deduct only the amount by which your contribution exceeds the FMV of the benefit you receive.<sup>6</sup> Thus, if you pay \$500 for a charity dinner, the ticket may say your dinner costs \$100, so your donation is \$400.

That makes perfect sense, but what if the economics aren't so clear? Sometimes something you receive in return is hard to identify or value. The Tax Court in *Scharf* held that the public benefit of the fire department donation exceeded the land-clearing return benefit. *Rolfs* (in the Tax Court and Seventh Circuit) adhered to the new quid pro quo standard of *American Bar Endowment*.

But *Rolfs* was an easy case. The Rolfs claimed a \$76,000 deduction for donating their lake house (but not the land under it) to the local fire department for training and demolition. That was its FMV, they claimed. With considerable audacity, they later increased their deduction to a whopping \$235,350, the claimed cost of rebuilding the house.

The IRS countered that there should be no deduction whatsoever. All the couple wanted was to have the house knocked down, the IRS argued. In the Tax Court, the question was the amount by which the value of the lake house exceeded the demolition costs. The Rolfs didn't have good evidence of the \$76,000 value, yet they didn't want to give an inch.

In fact, they argued that demolition costs were irrelevant, even though the IRS estimated the cost of demolition at \$10,000 to \$12,000. Plainly, the Rolfs should have had a good appraisal. They also should have happily agreed to subtract \$12,000 for demolition.

The Tax Court held that the Rolfs failed to prove their lake house had *any* value beyond the demolition costs, which meant no deduction. The Seventh Circuit agreed. Similarly, in *Hendrix v. United States*,<sup>7</sup> the court denied any deduction because appraisal requirements weren't met. One sees a trend here: aggressive positions and poor documentation, always a dangerous combination.

In *Patel*, there were also at least some bad facts that may have made a deduction not feel right. First, the taxpayers bought the house with the intention of demolishing it. They never lived in the house and started plans to demolish and build anew immediately.

Moreover, the donation was prepackaged in a kind of fraternity rush way that smacked a little of tax shelters. Although surely well-meaning, the Patels participated in the Fairfax County Fire and Rescue Department Acquired Structures Program (ASP). Like vehicle donation and other charitable incentive programs, ASP was designed to do precisely what occurred here: stimulate interest in people donating the use of a building to burn during training. The Patels learned about ASP from their real estate agent when they were buying their house. They complied with the fire department's requirements for participating, including removing asbestos, obtaining a demolition permit, and certifying they were the property's true owners.

Of course, charitable contributions are often made in kind, and not all charitable contributions are to section 501(c)(3) organizations. Taxpayers can claim charitable contribution deductions for donations to political subdivisions of a state if made exclusively for public purposes.<sup>8</sup> But whatever entity receives property, with only limited exceptions, the donation must be the taxpayer's entire interest in that property.<sup>9</sup>

Thus, an additional ground of IRS attack in these cases is the rule that you normally must donate your entire interest in property to claim a deduction. There is a difference between donating the house itself and merely giving the fire department the right to use it for training. The code says that "a contribution by a taxpayer of the right to use

<sup>4</sup>135 T.C. 471, 483 (2010), *Doc* 2010-23824, 2010 TNT 214-6, *aff'd*, 668 F.3d 888 (7th Cir. 2012), *Doc* 2012-2557, 2012 TNT 27-12.

<sup>5</sup>477 U.S. 105 (1986).

<sup>6</sup>Reg. section 1.170A-1(h).

<sup>7</sup>No. 2:09-cv-132 (D. Ohio 2010), *Doc* 2010-16278, 2010 TNT 141-19.

<sup>8</sup>Section 170(c)(1).

<sup>9</sup>See section 170(f)(3).

property shall be treated as a contribution of less than the taxpayer's entire interest in such property."<sup>10</sup>

Because virtually no one wants to give the fire department the land too, there's a debate even among practitioners and academics. Some believe you should not get a deduction unless you donate the land. However, most seem to disagree, and some taxpayers have been successful if they dot their i's and cross their t's.

The Patels claimed a noncash charitable contribution of \$339,504, using \$92,865 of it that year and carrying forward the remainder. Arguing that the donation was a mere right to use the property, not a property interest at all, the IRS disallowed it and asserted penalties. The IRS alternatively argued that the donation was of a partial interest in the property and therefore was prohibited by statute.

Of course, it was clear the Patels had not conveyed the land. Still, they argued that they conveyed all of their right, title, and interest in the house, not merely the right to use it. There was no requirement in the tax law that they transfer the land along with the house, they asserted. The Tax Court denied the deduction but hardly in a way that means no other fire department donation case will come along.

In fact, the court classified the critical partial interest issue as a question of federal law, but one that depended in part on state law. Was the house a part of the land under applicable Virginia law, the court asked? State law said the house was part of the land, the court noted, and that meant that in Virginia on these facts, there could be no deduction.

Because the Patels retained the land, their purported contribution was of a partial interest. The few exceptions to the partial interest rule under section 170(f)(3) were no help, either. The contribution was not of an undivided portion of the property. The fire department was not given a remainder interest in the house, and the contribution was not a qualified conservation contribution. Besides, this wasn't a donation of the house itself, even if it could be considered a separate piece of property from the land under it.

The Patels had granted the fire department the right to destroy the house while it conducted training exercises. Far from a conveyance of ownership, title, or possession of the house, this was a mere license to use it — a right to do an act that wouldn't be allowed without that authority. The court found that the fire department was a "mere licensee" that didn't actually receive any ownership interest in the property.

<sup>10</sup>Section 170(f)(3)(A).

Again referring to Virginia law, the Tax Court noted that the fire department acquired no exclusive right of possession. Moreover, the fire department acquired no interest in the land. The Patels retained the burdens of ownership. The Patels (not the fire department) were responsible for obtaining a demolition permit and cleaning up the debris.

Predictably, the Patels pointed to *Scharf*, which had seemed both clear and similar. Apart from the intervening *American Bar Endowment* case, the *Scharf* facts were virtually indistinguishable from the Patels', the court said. Although the Patels argued they in effect had conveyed a remainder interest in the house, the court concluded they had not. In any event, the Patels had never even resided in it.

The Tax Court's reliance on state law makes *Patel* not the conclusive tanker of flame retardant extinguishing all fire department donation cases the IRS might have hoped for. Yet the court did make broad statements suggesting that other taxpayers elsewhere are also unlikely to fare well. Like other taxpayers who grant a fire department license to destroy a building on their land, the court said, the Patels did so here *because* they wanted the house removed to increase the land's value or to make way for new construction.

As in *Rolfs*, there was simply no charitable contribution deduction. The only win for the Patels was that the Tax Court declined to impose accuracy-related penalties. The law was uncertain when the deduction was claimed, said the court. In the future, the IRS seems more likely to collect penalties.

### Burning Dissent

The dissent found the Patels' grant to the fire department of permission to destroy the house to be more than a license to use it. A license for use, the dissent said, necessarily implies that the property will be returned to the owner thereafter. In this case, however, the destruction of the house severed it from the land.

So severed, the house became personal property, and the Patels gave away every substantial interest in it they had. In fact, the dissent viewed the fire department grant as an undivided portion of the Patels' entire interest in the property. The Patels retained no substantial interest in the house after it was destroyed. How could it be otherwise when they got back a burned husk?

Because *Patel* was before the court on summary judgment, the dissent would have denied summary judgment pending a showing that the value of the house (taking into account the conditions on its donation) exceeded the value of the benefit the Patels received. That comparative analysis is what *Rolfs* requires.

**Next Time?**

Taxpayers hoping for a more *Scharf*-like result in a fire department donation case might consider these ideas. Some of these may merely be window dressing (but even that may help), some may seem preposterous, and clearly none should be viewed as foolproof:

1. Consider a document that actually deeds the house to the fire department. Of course, it would help if the deed to the house is enforceable under local law. Without conveying ownership of the underlying land, try to convey as much as you can.
2. Because state law property rights are paramount, consider hyperbole in your document of conveyance. Regardless of whether a person can own a house separate and apart from the land beneath it, consider language such as “any and all rights whatsoever,” or “including the legal right to exclude all others from the property.” If a bundle of sticks constitutes the ultimate, try to include as many rights as you can.
3. Consider deeding the entire property — the house and the land under it — to the fire department. That doesn’t mean the entire parcel, but rather the footprint of the house from the center of the earth up to the sky. The *Patel* court notes that if local law permits it, this should work. It doesn’t seem to violate the partial interest rule. After the fire department burns down the house — one hopes it would burn the building and not take up residence — the fire department could give back the land under the burned husk. Is that a quid pro quo?

Surely it is, but there arguably should be no disqualification of the donation as long as appropriate valuations are done.

4. Even if you are conveying only the right to use the house, consider conveying the *perpetual* right to use it. Also consider not specifying that the property *must* be destroyed. You might have an implicit understanding with the donee that the property will be used for training and will be destroyed. You might even have the understanding that it will occur soon, say within a month. But not making the donation quite so limited in scope and quite so explicit (if you can live with the uncertainty) might make the donation more likely to withstand scrutiny.
5. Consider being explicit that the fire department has the right to keep and use the building in its current condition with ingress and egress over the surrounding land, to sell the building with all the rights attached thereto, or to construct a new building on the site of the destroyed building. Clearly, this sounds extreme and is surely inadvisable — truly the tail wagging the dog.
6. Because transferring an interest in property is a necessary threshold and local law defines it, consider procuring a legal opinion that under state law the donation is of a property interest. Even if the transaction is audited, being able to provide a legal opinion to the IRS could forestall a proposed adjustment.
7. Just don’t do it, or if you do, don’t claim a charitable contribution deduction.