Scott v. Commissioner, 61 T. C. 654 (1974); 1974 U. S. Tax Ct. LEXIS 152; 61 T. C. No. 69

A charitable contribution deduction for encumbered property is disallowed when the encumbrances exceed the property's fair market value.

Summary

Martin Scott purchased a vineyard, the Rancho de Santa Fe, using purchase-money notes with a bonus discount for early payment. He then donated the property, subject to these encumbrances, to a charity which immediately sold it to a limited partnership. Scott claimed a charitable contribution deduction for the difference between the property's fair market value and the encumbrances. The Tax Court disallowed the deduction because the encumbrances, including the bonus discount, exceeded the property's fair market value of $1,229,000. The court also declined to impose a negligence penalty, finding a bona fide dispute over the deduction's validity.

Facts

Martin Scott, employed by the Firestone Group, purchased the 348-acre Rancho de Santa Fe vineyard from Lewis Guerrieri in 1967 for $1,053,000, using three purchase-money notes totaling $1,253,000 if paid in full after 10 years, but ranging from $1,164,605 if paid earlier. The notes included a bonus discount for early payment. Scott then donated the property to the American Physical Fitness Research Institute, which sold it to the Rancho Santa Fe Co. , a limited partnership syndicated by the Firestone Group, for $1,229,000. Scott claimed a charitable contribution deduction based on the difference between this sale price and the encumbrances.

Procedural History

The Commissioner disallowed Scott's charitable contribution deduction, resulting in a tax deficiency and a proposed negligence penalty. Scott petitioned the Tax Court for review. The court heard the case and issued its opinion on February 14, 1974, denying the deduction but also declining to impose the negligence penalty.

Issue(s)

1. Whether the petitioners are entitled to a charitable contribution deduction for the conveyance of the encumbered Rancho de Santa Fe to the American Physical Fitness Research Institute.
2. Whether the petitioners are subject to an addition to tax under section 6653(a) for the understatement of tax resulting from the claimed charitable contribution deduction.

Holding

1. No, because the encumbrances on the property, including the bonus discount for early payment, exceeded the property's fair market value at the time of the transfer.
2. No, because there was a bona fide dispute over the deduction's validity and the amount deducted was less than the amount the court deemed non-negligently claimed.

Court's Reasoning

The court applied the rule that a charitable contribution of encumbered property is deductible only to the extent of the donor's equity in the property's fair market value. The court included the bonus discount in calculating the encumbrance amount, relying on *Manuel D. Mayerson*, which held that a similar discount should be included in property's basis for depreciation purposes. The court also noted that Scott failed to prove the charity had more than a remote chance of benefiting from the donation. On the negligence issue, the court found a bona fide dispute over the deduction's validity and declined to impose a penalty, especially since the amount deducted ($7,667) was less than the amount the court deemed non-negligently claimed ($64,395).

Practical Implications

This decision clarifies that when calculating a charitable contribution deduction for encumbered property, the full amount of any encumbrances, including bonus discounts for early payment, must be considered. Taxpayers attempting to claim such deductions should ensure the property's fair market value exceeds all encumbrances. The case also illustrates that the IRS may not impose negligence penalties where there is a bona fide dispute over a deduction's validity. Subsequent cases have followed this reasoning in determining charitable contribution deductions for encumbered property.

