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Laura H. Peebles

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Defective paperwork is often a client's downfall

Over the past few years, there's been an uptick in Internal Revenue Service audit activity related to substantiating both cash and non-cash charitable contributions. Of late, several audits have been nothing more than a letter asking taxpayers to fax to the IRS a copy of all charitable acknowledgement letters and appraisals used to determine the value of a donation. As support for our anecdotal evidence of the IRS' increased scrutiny over charitable contributions, since the beginning of 2012, there have been nearly 50 court decisions issued on cases related to charitable contributions.

If there's one lesson to be learned from the plethora of charitable income tax deduction cases over the past few years, it's that taxpayers are losing their charitable deductions due to defective paperwork more often than they are from valuation issues. Although very few tax audits, probably less than one in 100, make their way to tax court, taxpayers and their advisors can learn from those cases. When the IRS questions a charitable deduction in an audit situation, it's often too late to correct any errors or omissions, as both an acknowledgment letter and a qualified appraisal must be obtained before the return is filed.[1] So, taxpayers should have the paperwork in order at the time of the donation, or at the latest, when the tax return is prepared.

The Rules

As is the case with most tax related queries, the answer to the question, "What documentation do I need to support my charitable donation?" is, "It depends." It depends not only on what was donated, but also on the value of the donation.

Cash contributions. These are made up of those contributions that are made via cash, check or charge, as well as payroll deductions.[2] There are two thresholds that apply to cash contributions:

(1) donations of less than $250, and (2) donations of $250 or more.

For cash donations of less than $250, the taxpayer must maintain one of the following three pieces of information: (1) a cancelled check, (2) a receipt from the donee organization showing the name of the organization, the date the donation was given and the amount of the donation, or (3) any other reliable written records showing the name of the organization, the date the donation was given and the amount of the donation.[3] A credit card statement is generally able to meet the "other reliable written records" prong.

For cash donations of $250 or more, a mere canceled check or credit card statement won't substantiate the donation;[4] instead, taxpayers must receive a contemporaneous written acknowledgement from the donee to sustain their charitable deduction. The written acknowledgement must include: (1) the amount of cash contributed, (2) a statement indicating whether any goods or services were given to the donor in connection to the gifts, (3) if any goods or services were received, a description of them and their estimated value, and (4) a statement of any intangible religious benefits provided if applicable.[5] For the written acknowledgement to be considered contemporaneous, the taxpayer must have the acknowledgement by the earlier of the date the taxpayer files the original tax return or the due date (including extensions) of the original tax return.[6]

The above requirements have been in place since 1996. Surprisingly, they're still occasionally overlooked. Sometimes, the receipt only says "thank you for your donation, which is deductible to the full extent of the law" instead of "thank you for your donation: you received no goods or services in return for your donation."Additionally, a written acknowledgment may only list some of the goods or services received by the taxpayer. In this case, the acknowledgement letter wouldn't meet the requirements.[7]

Unfortunately, if a taxpayer is in possession of a defective acknowledgement letter, the courts have made it very clear that an updated, corrected statement can't be obtained once an IRS agent is involved; the deduction will be completely disallowed because the updated letter wouldn't be contemporaneous.[8] Additionally, a taxpayer shouldn't think about forging a contemporaneous written acknowledgement letter and having one of her children sign it, as a 20 percent negligence penalty under Internal Revenue Code Section 6662 could potentially be applied.[9] The good news is that separate contributions of less than $250 aren't subject to these requirements regardless of whether the total contributions to one organization are equal to or more than $250.[10] As result, the taxpayer won't get the benefit of larger donations, but she'll get the cumulative benefit of the smaller ones.[11]

Sometimes, clients forget that they need to issue receipts from their private foundation (PF) or public charities that they manage. Thus, even when a taxpayer keeps meticulous records detailing the contributions she made to a ferret rescue and sanctuary that she founded, all deductions for contributions of $250 or more will be lost without written acknowledgement.[12] Taxpayers who find themselves on both sides of the transaction and have forgotten to send themselves an acknowledgement letter can easily fulfill the requirements at the last minute by emailing themselves (and printing) an "acknowledgment letter" prior to filing their tax return (assuming the return is being timely filed).

Two interesting exceptions apply to the cash donations rules. First, cash contributions that are made via withholding from a taxpayer's paycheck can be substantiated with a pay stub, a W-2 or another document supplied by the taxpayer's employer.[13] Second, unreimbursed out-of-pocket expenses are considered to be cash contributions.[14] This rule will apply as long as the expense was incurred to further the charitable goal of the organization. The expense could be the cost of an airline ticket to attend a board meeting or the cost of cat litter for an animal rescue. For unreimbursed expenses of less than $250, a cancelled check, credit card statement or receipt for the expense will suffice. For unreimbursed expenses of at least $250, the taxpayer will also need to obtain a contemporaneous written acknowledgement letter from the donee.[15] In lieu of listing the amount of the donation, the acknowledgment letter should state that the taxpayer incurred expenses on behalf of the organization; the acknowledgement letter needn't list the exact amount of unreimbursed expenses. The letter should also contain the other three requirements for acknowledgement letters for donations of $250 or more.

Non-cash contributions. There are four thresholds of non-cash contributions in which different substantiation requirements apply: (1) donations of less than $250, (2) donations of $250 to $500, (3) donations of $500.01 to $5,000, and (4) donations of more than $5,000. The requirements of each threshold include the requirements of the lower thresholds.

A non-cash contribution of less than $250 requires the taxpayer to obtain a receipt with the following information:[16]

1. The name of the charitable organization;
2. The date and location of the contributions;
3. A detailed description of the property;
4. The fair market value (FMV) at the time of the contributions and the method used to determine the value;
5. The cost or other basis in the property;
6. If less than an entire interest in the property is donated, the amount donated in the current year; and

7. The terms of any conditions related to the donation of the property.

A non-cash contribution of $250 or more must be substantiated with contemporaneous written acknowledgement similar to that required for cash contributions of $250 or more. The only difference is that the acknowledgment must contain a description of the property donated rather than the amount donated.[17]

For non-cash contributions of more than $500,taxpayers are also required to report the following two pieces of information on Part 1 of Form 8283:(1) the manner in which the property was acquired, and(2) the cost or other adjusted basis of the property.[18] If the taxpayer is unable to provide either of those two pieces of information on her return, she must provide a statement of reasonable cause as to why that information isn't available.[19]

For non-cash contributions of more than $5,000, a taxpayer is required to obtain a qualified appraisal.[20] (The requirements for qualified appraisals are discussed below.) Taxpayers should also be aware that all similar items of property donated to one or more donees should be aggregated to determine whether non-cash contributions are over the $5,000 threshold.[21] Donations of publicly traded securities[22] don't require a qualified appraisal regardless of the amount donated.[23]

Taxpayers are also required to attach a fully completed appraisal summary to their tax return.[24] The regulations require 15 specific items to be included on the appraisal summary, including a signature by the donee and the appraiser, as well as a catchall of "other information as may be specified by the form [prescribed by the IRS]."[25] Currently, Section B of Form 8283 is the form prescribed by the IRS, which functions as the "appraisal summary."

In many cases, due to time constraints, the donee and appraiser have to sign separate Forms 8283. The IRS has previously argued that all the required information must appear on the same Form 8283; otherwise, the entire deduction would be lost. The courts have ruled against the IRS' position, noting that the IRS was advancing an argument that was "the most technical of deficiencies."[26] These rulings are some of the few taxpayer victories in the area of charitable substantiation. Seeing an issue this small before the court indicates the level of IRS scrutiny of contribution paperwork.

The taxpayer must be cognizant that the courts have allowed defects to the appraisal summary only under the strict legal doctrines of "reasonable cause" and "substantial compliance." In *Mohamed v. Commissioner,*[27] the Mohameds found out that not reading the instructions doesn't fit into the criteria for either legal doctrine. The IRS thought the Mohameds overstated the values of the properties, and these types of cases seemed set to become valuation battles. But then, the Commissioner realized that the Mohameds made several mistakes in filing their Forms 8283 for

2003 and 2004 and amended his answer to assert that these mistakes compelled denying the Mohameds any charitable deductions for their charitable remainder unitrust at all. According to the taxpayer's testimony, Mr. Mohamed completed the Forms 8283 himself, without reading the instructions. The court upheld the IRS' position and denied the Mohameds' deduction for $18.5 million in real estate donated to a trust.

Qualified Appraisals

As noted above, any non-cash contribution of more than $5,000 must be substantiated by a qualified appraisal. The regulations provide 15 points that must be present for an appraisal to be considered "qualified:"[28]

1. The appraisal isn't made earlier than 60 days prior to the date of contribution but not later than the due date (including extensions) of the return on which the deduction is first claimed. In the case of an amended return, the appraisal must be received by the date it's filed.[29]
2. The appraisal should be signed by a qualified appraiser.[30]
3. The taxpayer should maintain the records required for non-cash contributions of less than $250.
4. The appraisal fee can't be based on a percentage of the appraised value of the property.[31]
5. A detailed description of the property.
6. The physical condition of any tangible property.
7. The date or expected date of the contribution.
8. The terms of any agreement entered into by or on behalf of the donor or donee related to the use, sale or other disposition of the property.[32]
9. The name, address and taxpayer identification number of the qualified appraiser.
10. The qualifications of the appraiser, including background, experience, education, and membership, if any, in professional appraisal associations.
11. A statement that the appraisal was prepared for income tax purposes.
12. The date on which the property was appraised.
13. The FMV of the property.
14. The method of valuation used to determine the FMV.
15. The specific basis of the valuation, such as comparable sales or statistical sampling employed.

As discussed in *Mohamed*, the IRS will first challenge the qualified appraisal based on technical deficiencies rather than on valuation. This logic is sound because if the IRS is successful in showing that the appraisal doesn't meet the standard of a qualified appraisal, the entire deduction will be lost. Most commonly, the IRS has challenged the method used in these appraisals as not being proper valuations methods. The U.S. Court of Appeals for the Second Circuit threw cold water on this argument in *Scheidelman v. Commissioner*:

> For the purpose of gauging compliance with the reporting requirement, it is irrelevant that the IRS believes the method employed was sloppy or inaccurate, or haphazardly applied—it remains a method, and [the appraiser] described it. The regulation requires only that the appraiser identify the valuation method "used"; it does not require that the method adopted be reliable.[33]

Even though the IRS' argument on valid methodology didn't succeed in that case, it won't stop the Tax Court from rejecting an appraisal as qualified because it fails eight of the 15 requirements.[34] As discussed with the appraisal summary, the courts have ruled that, in certain circumstances, taxpayers can substantiate charitable deductions because they've substantially complied with the regulations. The Tax Court came to this conclusion because "the reporting requirements do not relate to the substance or the essence of whether or not a charitable contribution was actually made."[35] The Tax Court, therefore, concluded that the reporting requirements are directory and not mandatory. The courts have allowed substantial compliance when the appraisal: (1) didn't include the appraiser's qualification, but they were presented on request,[36] (2) didn't include a statement that the appraisal was for income tax purposes,[37] or (3) was performed more than 60 days before the donation.[38] However, it's better to address the requirements before the return is filed rather than have to argue "substantial compliance" before the courts to save the deduction.

Valuation Disputes

If a taxpayer's appraisal meets the standard of a qualified appraisal, a dispute over valuation could arise. The IRS might challenge the assumptions of the taxpayer's appraisal and recalculate with the new assumption, perform its own valuation or a combination of both. The IRS, on several occasions, has made successful challenges on valuation by pointing out that restricted stock owned by a company's founder isn't the same as the publicly traded stock of the company.[39] Additionally, the taxpayer and the taxpayer's advisors must confirm that the assets that were donated were, in fact, the assets that were appraised. If a taxpayer donates shares of a holding company, the appraiser should appraise the value of the shares of the holding company and not the value of the underlying property owned by the holding company.[40]

Conservation easements. Given the number of conservation easement cases in the Tax Court over the last two years, it's obvious that this particular form of charitable donation[41] continues to be popular with donors and continues to draw intense IRS scrutiny. Indeed, at the beginning of the year, there were over 200 easement cases docketed in Tax Court.

While several cases have focused on the specific rules and requirements related to substantiating the deduction,[42] more frequently, disputes over the value of the easement are found. To calculate the charitable deduction allowed, the appraiser values the property before the easement is placed and then again with the easement in place. The difference is allowed as a charitable income tax deduction. Assuming the dispute is limited only to valuation, the Tax Court considers the factors raised by the taxpayer's appraiser and the IRS' appraiser and determines a value for the easement.

Sometimes, the dispute is over the valuation before the easement is placed. This conflict is most common in easements over undeveloped land, farms or open spaces. If the appraiser is valuing the land before the easement based on the possibility of subdivision for home sites, conversion to a vineyard or mineral development, the IRS may challenge the development plan as being economically infeasible.[43] This notion of a possibility not only accounts for the physical possibility, but also for the legal possibility. If the assertion is being made that the highest and best use is a vineyard, it should first be proven that there's ample water supply available to grow grapes.[44] Secondly, all local, state and federal laws must allow for the alternate use. It will be up to the taxpayer's appraiser to establish that there was more than a mere a possibility of an alternate "highest and best use." The appraiser will need to supply credible evidence that there's either "unfilled demand" or an "unmet market" for an alternate use.[45] If the appraiser can't show this currently, he'll need to demonstrate that a market opportunity would present itself "in the reasonably foreseeable future."[46]

For developed property, including single-family, multi-family and commercial real estate, the valuation disputes are rarely over the "before easement" value. For these properties, the disputes tend to be about the reduction in value caused by the restrictions in the easement.[47] The IRS may assert that the restrictions in the deed are only marginally more restrictive than those in the pre-existing zoning or historic district restrictions, and, therefore, the incremental reduction in value is very small or non-existent.[48]

One other point is often overlooked when determining the after value of a conservation easement. The increase in value related to the easement of any adjacent land that the donor owns must also be taken into consideration. This increase in value would be added to the after value, which reduces the decrease in value associated with the easement, thereby reducing the value of the donation.[49] This increase in value will likely be generated because the easement provides that the donor's home or other unrestricted, undeveloped land will have an unobstructed view of the ocean or the 18th fairway.

Donations of PTP Units

Another situation in which donors need advice is for donations of publicly traded partnership (PTP) units. Some donors give PTP units, thinking that they're just like shares of stock. Unfortunately, they're not: Because many PTPs use debt, the donation triggers gain under the bargain sale rules.[50] Additionally, because most PTPs are in the natural resources industry, they're often subject to ordinary income recapture[51] related to depreciation and depletion if the units are sold. While this ordinary (versus capital) gain isn't recognized on the donation of the PTP units, the charitable deduction is reduced by the recapture amount, as it wouldn't have been long-term capital gain if the PTP units had been sold.[52] For donations to PFs, PTPs aren't "publicly traded stock," so the deduction is generally limited to the lesser of basis or value[53]—and the deemed bargain sale could expose the donor to penalties.[54]

Another more obscure issue for PTPs: Although they're publicly traded on many exchanges, they're technically not "securities" within the definition of the regulations that exclude publicly traded securities from the requirement to obtain a qualified appraisal.[55] Although the qualified appraisal will likely be short and only reference the public market data, it's still required, and not having the appraisal will place the full amount of the deduction in jeopardy.

Review Forms and Regs

In the interest of preserving the income tax benefit of the donors' charitable donations, taxpayers and their advisors should first review the filing instructions for Schedule A and Form 8283 before completing a return that includes a cash contribution of at least $250 and/ora non-cash charitable donation in excess of $500. Although the IRS forms and instructions aren't law,[56] they're still a good place to start. The next stop is the regulations, which list all the required items for acknowledgment letters, qualified appraisals and appraisalsummaries. By our count, the regulations list at least 26 items that must be included in a qualifiedappraisal and appraisal summary. Although overlooking one of the minor ones may not preclude thededuction, because the courts have been lenient on a few of them under the doctrine of substantialcompliance, it's worth re-checking the appraisal, the acknowledgment letter and the completedForm 8283 one more time before filing, to avoid as many potential disputes as possible. It's better to avoid an IRS controversy rather than have to resolve it.

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Endnotes

1. Treasury Regulations Section 1.170A-13(c)(3)(iv)(B) for the appraisal; Treas. Regs. Section

1.170A-13(f)(3) for the acknowledgment letter.

2. Internal Revenue Code Section 170(f)(17).
3. Treas. Regs. Section 1.170A-13(a)(1).
4. IRC Section 170(f)(8).
5. Treas. Regs. Section 1.170A-13(f)((2).
6. Treas. Regs. Sections 1.170A-13(f)(3).
7. *Cohan et al. v. Commissioner*, T.C. Memo. 2012-8.
8. *Ofeoegbu v. Comm'r*, T.C. Summary Opinion 2013-79; *Durden v. Comm'r*, T.C. Memo. 2012-140.
9. *Payne v. Comm'r*, T.C. Summary Opinion 2013-64.
10. Treas. Regs. Section 1.170A-13(f)(1).
11. *Zavadil v. Comm'r,* T.C. Memo. 2013-222; *Humphrey v. Comm'r,* T.C.Memo. 2013-198.
12. *Villareale v. Comm'r,* T.C. Memo. 2013-74. The Tax Court, citing *Averyt v. Comm'r*, T.C. Memo. 2012-98 and *Durden, supra* note 8, went on to point out that the doctrine of substantial compliance didn't apply to excuse noncompliance with regards to Treas. Regs. Section 170(f)(8)(B)(ii) (the no goods or services statement).
13. Treas. Regs. Section 1.170A-13(f)(11)(i).
14. Treas. Regs. Section 1.170A-13(f)(10).
15. *Van Dusen v. Comm'r*, 136 T.C. No. 25 (2011).
16. Treas. Regs. Section 1.170A-13(b)(2).
17. IRC Section 170(f)(8)(A).
18. Treas. Regs. Section 1.170A-13(b)(3)(i).
19. Treas. Regs. Section 1.170A-13(b)(3)(ii).
20. IRC Section 170(f)(11)(C).
21. IRC Section 170(f)(11)(F); *Haskett v. Comm'r,* T.C. Summary Opinion 2013-76.
22. As defined by Treas. Regs. Section 1.170A-13(c)(7)(xi)(A).
23. Treas. Regs. Section 1.170A-13(c)(1)(i).
24. Treas. Regs. Section 1.170A-13(c)(2)(i)(B). Under IRC Section 170(f)(11)(D), a taxpayer isn't required to attach the complete qualified appraisal to the tax return until the donation is in excess of $500,000.
25. Treas. Regs. Section 1.170A-13(c)(4).
26. *Scheidelman v. Comm'r*, 682 F.3d 189 (2d Cir. 2012).
27. *Mohamed v. Comm'r,* T.C. Memo. 2012-152.
28. Treas. Regs. Section 1.170A-13(c)(3).
29. Treas. Regs. Section 1.170A-13(c)(3)(iv)(B).
30. *See* Treas. Regs. Section 1.170A-13(c)(5) for the requirements of a qualified appraiser.
31. *See* Treas. Regs. Section 1.170A-13(c)(6) for exceptions to prohibited fee arrangements.

32. *See* Treas. Regs. Section 1.170A-13(c)(ii)(D) for examples of agreement terms that should be noted in the appraisal.
33. *Scheidelman, supra* note 26.
34. *Rothman v. Comm'r*, T.C. Memo. 2012-218.
35. *Bond v Comm'r*, 100 T.C. 32 (1993).
36. *Ibid.*
37. *Simmons v. Comm'r*, T.C. Memo. 2009-208.
38. *Consolidated Investors Group v. Comm'r*, T.C. Memo. 2009-290. The Tax Court specifically pointed out that substantial compliance wouldn't have been granted had the appraisal been performed after the tax return claiming the deduction was filed.
39. *Hewitt v. Comm'r,* 166 F.3d 332 (4th Cir. 1998), affirming 109 T.C. 258 (T.C. 1997).
40. *Estate of Evenchik v. Comm'r,* T.C. Memo. 2013-24.
41. IRC Section 170(h).
42. *See Scheidelman, supra* note 26 and __ F.3d __ (2d Cir. 2014); *Freidberg v. Comm'r*, T.C. Memo. 2011-238; and *Rothman, supra* note 34.
43. *Esgar Corporation v. Comm'r*, T.C. Memo. 2012-35.
44. *Mountanos v. Comm'r*, T.C. Memo. 2013-138.
45. *Esgar Corporation, supra* note 43.
46. *United States v. Whitehurst*, 337 F.2d at 771-772.
47. *Whitehouse Hotel Ltd. Partnership, et al. v. Comm'r*, 139 T.C. No. 13; *Butler v. Comm'r*, T.C. Memo. 2012-72.
48. *Loren Dunlap, et ux., et al.*, T.C. Memo. 2012-126.
49. *Kiva Dunes Conservation LLC v. Comm'r,* T.C. Memo. 2009-145.
50. IRC Section 1011(b); *Goodman v. U.S.*, 1999 U.S. Dist. LEXIS 20650 (S.D. Fla. 1999).
51. IRC Section 1245.
52. Treas. Regs. Section 170(e)(1)(A).
53. Treas. Regs. Section 170(e)(1)(B)(ii).
54. IRC Section 4941(a) and Treas. Regs Section 53.4941(d)-2(a)(1).
55. Treas. Regs Sections 1.170A-13(c)(1)(i) and 1.170A-13(c)(7)(xi).
56. *Mohamed, supra* note 27.

person who relies on this publication.