SUBSTANTIATING (SUBSTANTIAL) CONTRIBUTIONS—OH, WHAT A RELIEF IT IS!

(AKA: "Charitable Contributions Can Be Valuable, But Qualified Appraisals Can Be Priceless!)

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These materials outline what the IRS and the courts are focusing on when looking at appraisals being submitted to substantiate valuations claimed for transfer tax or income tax reporting purposes. The subjects addressed include:

I. Substantiation Needed;
II. Applicable Penalties; and
III. Penalty Avoidance/Defenses

I. SUBSTANTIATION NEEDED

A. Estate and Gift Tax Returns.

1. Gift Tax. According to IRC §6501(c)(9), the statute of limitation for gifts does not toll as to an item reported on a gift tax return unless the item is disclosed in a manner adequate to apprise the IRS of the "nature of the gift and the basis for the value so reported."

In addition to other items, the "adequate disclosure" Regs (Regs. §301.6501(c)-1(f)) require the following valuation-related items in order to constitute "adequate disclosure":

- a detailed description of the method used to determine the fair market value of property;
- any financial data utilized in determining the value;
- any restrictions on the transferred property that were considered in determining the fair market value of the property; and
- a description of any discounts claimed by valuing the property (e.g., blockage, minority or fractional interests, and lack of marketability).

An appraisal report can be submitted in satisfaction of the materials stated above if the appraisal meets the following requirements (Regs. §301.6501(c)-1(f)(3)):

a. The appraisal is prepared by an appraiser who:

i. Holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis.

ii. Because of his or her qualifications, is qualified to make appraisals of the type of property being valued.

iii. Is not the donor or donee of the property or a member of the family of the donor or donee (as defined in IRC §2032A(e)(2), or any person employed by the donor, the donee, or a member of the family of either; and

b. The appraisal contains:

i. The date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal.

ii. A description of the property.

iii. A description of the appraisal process employed.

iv. A description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analyses, opinions, and conclusions.

v. The information considered in determining the appraised value, including in the case of an ownership interest in a business, all financial data that was used in determining the value of the interest.

vi. The appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions.

vii. The valuation method utilized, the rationale for the valuation method, and the procedure used in determining the fair market value of the asset transferred.

viii. The specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transactions, etc.

2. Estate Tax. Although the gift tax "qualified appraisal" rules of Regs. §301.6501(c)-1(f)(3) do not apply to the estate tax return, they can serve as a guide.

B. Income Tax Returns/Charitable Contributions. According to IRC §170(f) and Regs §1.170A-13, taxpayers must maintain the following records to claim deductions for charitable contributions:

1. Charitable Contributions of *Money*. The taxpayer shall maintain: (i) A cancelled check; (ii) A receipt from the done; and (iii) other reliable written records showing the name of the donee, the date of the contribution, and the amount of the contribution.

a. *Durden v. Commissioner*, T.C. Memo 2012-140 (2012). Petitioners must strictly or substantially comply with the substantiation requirements or their charitable contribution deductions will be disallowed.

In *Durden*, over $20,000 worth of contributions made by check to a 501(c)(3) church were disallowed because the church's "first acknowledgement" lacked a statement that no goods or services were provided (even though that statement was provided (albeit late)).

A written acknowledgment is *contemporaneous* if it is obtained by the taxpayer on or before the earlier of: (1) the date the taxpayer files the original return for the taxable year of the contribution; or (2) the due date (including extensions) for filing the original return for the year. (IRC §170(f)(8)(C); Regs. §1.170A-13(f)(3)).

b. *Villareale v. Commissioner*, T.C. Memo 2013-74 (2013). In *Villareale*, the taxpayer, president and cofounder of a 501(c)(3) organization, made about $10,000 in contributions to that organization in 2006. The transfers were electronically made and the amounts and dates of withdrawal and deposits corresponded on the taxpayer's and organization's respective bank accounts and statements. The taxpayer claimed the total as a charitable contribution deduction for 2006 and the IRS issued a deficiency notice disallowing the deduction. Conceding that the contributions were made to a valid 501(c)(3) organization, the IRS' sole ground for objection at trial was that the taxpayer's bank statements documenting the contributions did not satisfy the contemporaneous writing requirements of IRC §170(f)(8).

The Tax Court held that the taxpayer failed to satisfy the writing requirement because the bank statements did not state whether the taxpayer received any goods or services in exchange for her contributions. The taxpayer argued that it would be futile to issue such writing because she was on both sides of the transaction. Citing *Durden*, the Court rejected that argument and stated that the purpose of this requirement is not only to assist the taxpayer in determining the amount of their contribution, but also to assist the IRS in determining whether the taxpayer is entitled to such a contribution.

The Court also rejected the taxpayer's substantial compliance argument by stating that substantial compliance is inapplicable for purposes of excusing compliance with the necessary content of the contemporaneous writing required under IRC §170(f)(8).

2. Charitable Contributions of *Property*.

a. Substantiation Requirements. For claimed deductions of $250 or more see IRC §170(f)(8). For claimed deductions of more than $500, more than $5,000, or more than $500,000 see IRC §170(f)(11).

b. Applying the Dollar Thresholds Under IRC §170(f)(8) and (11).

i. Under IRC §170(f)(8), each contribution is treated separately in determining whether a gift of $250 or more was made. In contrast,

ii. Under IRC §170(f) (11), *similar items* of property are lumped together to determine whether property with a claimed deduction of more than $500, $5,000, or $500,000 was made.

- *Similar items* of property are items of the same generic category or type, such as coin collections, paintings, books, clothing, jewelry, nonpublicly traded stock, land, or buildings.

c. A receipt must show:[1]

i. The name of the donee;
ii. The date and location of the contribution; and
iii. A description of the property.
iv. If the contribution is worth more than $250, it must be supported by a *contemporaneous written acknowledgement* including:

(a) The amount of cash contributed and a description of any property other than cash contributed;

[1] IRC §170(f)(8)

(b) Whether the donee organization provided any goods or services in consideration for the contribution; and

(c) If the donee organization provided any goods or services (other than intangible religious benefits), a description of the goods or services and a good-faith estimate of the value thereof.

d. <u>Contributions with Claimed Deduction Greater than $500 But Not More than $5,000</u>.

i. <u>Contributions on or Before June 3, 2004</u>. In addition to obtaining a *contemporaneous written acknowledgement* and maintaining the additional written records required for contributions of at least $250, Regs. §1.170A-13(b)(3)(i) states that written records must show:

(a) the manner and approximate date of acquisition of the property; and

(b) the adjusted basis of the property.

Further, if required by an income tax return form or instructions, a taxpayer must state on the return the information required to be maintained in the taxpayer's written records. (Regs. §1.170A-13(b)(3)(i).)

<u>*Reasonable Cause* ***Exception***</u>**:** If a taxpayer has reasonable cause for being unable to provide either the acquisition date or cost basis of the property donated, the taxpayer may attach a statement to the return that explains why the information is not available. If the IRS finds that the taxpayer has *reasonable cause* for failing to provide the acquisition date or cost basis, the taxpayer's charitable contributions deduction will not be disallowed for failure to provide the required information. (Regs. §1.170A-13(b)(3)(ii).)

ii. <u>Contributions After June 3, 2004</u>. In the absence of any contrary guidance from the IRS, it is assumed that the rules for substantiating contributions made before June 4, 2004, with a claimed deduction of more than $500 and not more than $5,000, continue to apply for such contributions made after June 3, 2004.

<u>***Exception***</u>***:*** Pursuant to Regs. §1.170(f)(11)(A)(ii)(II), a deduction is not disallowed if a taxpayer can show that the failure to satisfy the requirements is due to *reasonable cause* and not willful neglect.

e. <u>Deductions in Excess of $5,000</u>. If the amount claimed exceeds $5,000, no deduction shall be allowed unless the donor:

i. Obtains a qualified appraisal;

ii. Attaches a fully completed appraisal summary [Form 8283]to the tax return on which the deduction for the contribution is first claimed; and

iii. *Maintains records* for so long as they may be relevant.

f. Deductions in Excess of $500,000. If the amount claimed exceeds $500,000, no deduction shall be allowed unless the donor attaches a *qualified appraisal* to the tax return on which the deduction is first claimed.

C. *Qualified Appraisal* (IRC §170(f)(11)(E)(i)). With respect to returns filed on or before August 17, 2006, a "*qualified appraisal*" means an appraisal which:

1. Is made not earlier than 60 days prior to the date of contribution nor later than the due date of the return on which the deduction is claimed;

2. Is prepared by a *qualified appraiser;*

3. Does not involve a prohibited appraisal fee; and

4. Includes:

a. A description of the property and its physical condition;
b. The date (or expected date) of its contribution;
c. The terms of any agreement that relates to the use, sale, or other disposition of the property;
d. The name, address, and identifying number of the appraiser and the person who employs or engages the appraiser;
e. The appraiser's qualifications;
f. A statement that the appraisal was prepared for income tax purposes;
g. The date (or dates) on which the property was appraised;
h. The appraised fair market value of the property on the date (or expected date) of contribution;
i. The method of valuation used; and
j. The specific basis for the valuation.

D. **Notice 2006 – 96**. (IRC §170(f)(11)(E)(i)). With respect to returns filed after August 17, 2006, a "*qualified appraisal*" means an appraisal which is: (i) treated as a *qualified appraisal* under regulations or other guidance prescribed; and (ii) conducted by a *qualified appraiser* in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed.

1. Report Format and Standards.

a. There is limited statutory or regulatory guidance as to what constitutes an acceptable appraisal report. Given that lack of guidance, combined with increased scrutiny of appraisal reports by the IRS, it has become common practice in transfer tax matters to have appraisers prepare reports that conform to the Uniform Standards of Professional Appraisal Practice ("USPAP"). (This is particularly true since the IRS explicitly cited USPAP as an example of acceptable standards in IRS Notice 2006-96.)

b. It is important to note that USPAP contains provisions for an abbreviated form of report called a "Restricted Use Appraisal Report." This form of report is restricted to the use of knowledgeable insiders only and is not to be relied upon by third parties (like the IRS). This form of report is tempting because it is generally less costly to the client. However, it is not appropriate to attach to an estate or gift tax return. Ironically, an abbreviated report could satisfy IRS requirements in a given case. But in that case it could not also be represented to conform to USPAP.

E. *Qualified Appraiser*

1. Regs §1.170A-13(c)(5) *Qualified Appraiser*. With respect to returns filed on or before August 17, 2006, a "*qualified appraiser*" means an individual (other than an excluded person) who includes on the appraisal summary a declaration that:

a. The individual either holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis;

b. Because of his or her qualifications, he or she is qualified to make appraisals of the type of property being valued;

c. The appraiser is not an excluded person; and

d. The appraiser understands that an intentionally false or fraudulent overstatement of the value of the property may subject the appraiser to a civil penalty under §6701 for aiding and abetting an understatement of tax liability.

2. **Exception**. An individual is not a *qualified appraiser* if the donor had knowledge of facts that would cause a reasonable person to expect the appraiser falsely to overstate the value of the donated property.

3. *Qualified Appraiser* **Exclusions**. The following persons cannot be *qualified appraisers*:

a. The donor or the taxpayer who claims a deduction for the contribution;

b. A party to the transaction in which the donor acquired the property being appraised unless the property is donated within two months of the date of acquisition and its appraised value does not exceed its acquisition price;

c. The donee of the property;

d. Any person employed by any of the foregoing persons;

e. Any person related to any of the foregoing persons under §267(b), or married to a person who is in a relationship described in §267(b) with any of the foregoing persons;

f. An appraiser who is regularly used by any person described above who does not perform a majority of his or her appraisals for other persons.

4. Fees. In general, no part of the fee arrangement can be based on a percentage of the appraised value of the property. [There is an exception.]

5. **Notice 2006 – 96**. (IRC §170(f)(11)(E)(ii)). With respect to returns filed after August 17, 2006, a "*qualified appraiser*" means an individual who (i) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations; (ii) regularly performs

appraisals for which the individual receives compensation; and (iii) meets such other requirements as may be prescribed in regulations or other guidance.

a. An appraiser will be treated as having earned an appraisal designation from a recognized professional appraiser organization if the appraisal designation is awarded on the basis of demonstrated competency in valuing the type of property for which the appraisal is performed.

b. An appraiser will be treated as having demonstrated verifiable education and experience in valuing the type of property subject to the appraisal within the meaning of IRC §170(f)(11)(E)(iii)(1) if the appraiser makes a declaration in the appraisal that, because of the appraiser's background, experience, education, and membership in professional associations, the appraiser is qualified to make appraisals of the type of property being valued.

c. An appraiser will be treated as having met minimum education and experience requirements if:

i. For <u>real property</u>:

(a) For returns filed on or before October 19, 2006, the appraiser is qualified as a "*qualified appraiser*" within the meaning of Regs §1.170A-13(c)(5) to make appraisals of the type of property being valued.

(b) For returns filed after October 19, 2006, the appraiser is licensed or certified for the type of property being appraised in the state in which the real property is located.

ii. For property <u>other than real property</u>:

(a) For returns filed on or before February 16, 2007, the appraiser is qualified as a "*qualified appraiser*" within the meaning of Regs §1.170A-13(c)(5) to make appraisals of the type of property being valued.

(b) For returns filed after February 16, 2007, the appraiser has (i) successfully completed college or professional-level coursework relevant to the property being valued; (ii) obtained at least two years of experience in the trade or business of buying, selling, or valuing the type of property being valued; and (iii) fully described in the appraisal the education and experience which qualify the appraiser to value the type of property being valued.

d. <u>For returns filed after February 16, 2007</u>, the declaration required under Regs §170A-13(c)(5)(i) must include an additional statement that the appraiser understands that a substantial or gross valuation misstatement resulting from an appraisal which the appraiser knows, or reasonably should have known, would be used in connection with a return may subject the appraiser to a civil penalty under IRC §6695A.

6. An individual will <u>not</u> be treated as a *qualified appraiser* unless that individual (i) demonstrates verifiable education and experience in valuing the type of property subject to the appraisal; and (ii) has not been prohibited from practicing before the IRS under 31 USC §330(c) at any time during the 3-year period ending on the date of the appraisal.

7. <u>Transitional Guidance</u>. Until regulations are effective under IRC §170(f)(11), an appraisal that meets the requirements of Notice 2006-96 shall be treated as a *qualified appraisal*. The determination of whether an appraiser is qualified under Notice 2006-96 must be based on the appraiser's qualifications as of the date the appraisal is made.

a. An appraisal will be treated as a *qualified appraisal* if the appraisal complies with all of the requirements of Regs §1.170A-13(c) (except to the extent inconsistent with IRC §170(f)(11)), and is conducted by a *qualified appraiser* in accordance with generally accepted appraisal standards

b. *Generally accepted appraisal standards*. An appraisal will be treated as having been conducted in accordance with *generally accepted appraisal standards* if the appraisal is consistent with the principles of the Uniform Standards of Professional Appraisal Practice ("USPAP"), as developed by the Appraisal Standards Board of the Appraisal Foundation.

c. The requirements of Regs §1.170A-13(c) concerning *qualified appraisals* and *qualified appraisers* continue to apply, except to the extent they are inconsistent with the provisions of IRC §170(f)(11

F. The Appraiser's Perspective.

1. Appraiser Qualifications.

a. Neither the "Adequate Disclosure" regulations nor any other statutory source provides a definitive test for what constitutes a *qualified appraiser* in a transfer tax context. Unlike real estate appraisers, business appraisers are not licensed by the state, so that "bright-line" distinction is unavailable.

b. The regulations require that appraisers be independent, that they hold themselves out as appraisers on a regular basis, and that they have the appropriate training, experience, and professional credentials to appraise the subject real or personal property. No reference is made to any specific credentials. However, it seems prudent to use an appraiser who holds a professional credential from a widely recognized appraisal organization.

c. Professional associations that confer professional designations include:

i. The American Society of Appraisers, which offers the Accredited Senior Appraiser ("ASA") designation.

ii. The National Association of Certified Valuation Analysts ("NACVA"), which offers the Certified Valuation Analyst ("CVA") and Accredited Valuation Analyst ("AVA") designations.

iii. The Institute of Business Appraisers ("IBA"), which offers the Certified Business Appraiser ("CBA") designation.

iv. The American Institute of CPAs ("AICPA"), which offers the Accredited in Business Valuation ("ABV") designation.

d. Each of these associations have websites that offer the ability to search for appraisers according to a variety of criteria, including geographic location and appraisal specialty. The websites for each organization are as follows:

i. ASA: www.appraisers.org.
ii. NACVA: eee.nacva.com.
iii. IBA: www.go-iba.org.

iv. AICPA: www.aicpa.org.

2. How to Find a Qualified Appraiser.

a. Unlike real estate appraisers, business appraisers are not licensed by the state. No minimum standards are mandated by any government agency.

b. Look for stability and longevity. Your appraiser may have to support his or her work years after the initial assignment is completed.

c. Look for relevant experience, particularly if the business or valuation context is unusual.

d. Look for an appropriate educational background, including undergraduate and/or graduate degrees in areas such as finance, economics, and business administration.

e. Make sure business valuation is the person's *primary* vocation. (For example, some accountants "dabble" in business valuation.)

f. As with the selection of any professional, referrals from trusted sources increase confidence.

g. Obtain a detailed, specific engagement letter.

h. Appraisers charge either a fixed fee or on the basis of an hourly rate. It is a violation of professional ethics and appraisal standards to charge a fee that is contingent on a specific outcome or tied to the opinion of value.

i. An *Appraiser Retention Checklist* is included as Appendix B to this material.

3. Appraiser's Role.

a. *Boltar, L.L.C. v. Commissioner*, 136 T.C. No. 14 (*Daubert* Challenge). Clearly irritated by the blind insistence of the valuation expert that, despite numerous factual, logic and reason errors, the concluded value was largely correct and should be accepted by the Court, the Tax Court granted the government's motion to strike the taxpayer's appraisal because it was "unreliable and irrelevant."[2] The government's notice of deficiency was upheld - only $42,400 out of the $3,245,000 claimed was allowed.

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[2] The IRS filed a motion in limine to exclude petitioner's expert report and testimony as neither reliable nor relevant under the Federal Rules of Evidence and *Daubert v. Merrell Dow Pharm., Inc.*, 509 U.S. 579 (1993).

G. Cases (what the courts want).

1. Cases Addressing the Regs.

a. *Mayo Foundation for Medical Education & Research v. U. S.*, 131 S.Ct. 704, 178 L.Ed. 2d 588 (2011);

b. *Home Concrete & Supply LLC v. U.S.*, 132 S.Ct 1836, aff'g 634 F.3d 249 (4th Cir. 2011));

2. Qualified Appraisal/Substantial Compliance.

a. *Bond v. Commissioner*, 100 T.C. No. 4 (1993) (Substantial Compliance). Taxpayer donated two airships (blimps) in 1986. An experienced appraiser, knowledgeable in airships, inspected the airships, computed the value of the component parts and determined the airships' FMV. The appraiser completed parts of the 8283 and signed it. The 8283 was attached to a timely filed tax return. During the audit, the appraiser provided information on his background and experience and the manner in which he derived the value of the blimps.

The Tax Court analyzed IRC §155 of the Deficit Reduction Act of 1984, attempting to determine whether the taxpayer should be entitled to a deduction even though they had not literally complied with all of the substantiation requirements. In opting to apply a *substantial compliance* test, the *Bond* Court stated the critical question to be answered is whether the requirements relate "to the substance or essence of the statute." If so, strict adherence to all statutory and regulatory requirements is a precondition to an effective election.

The essence of §170 is to allow certain taxpayers a charitable deduction. The *reporting requirements* of Regs. §1.170A-13 facilitate the processing and auditing of returns. They do not relate to the substance or essence of whether a charitable contribution was actually made. Therefore, the *reporting requirements* are directory and not mandatory, and strict compliance is not required.

b. *Hewitt v. Commissioner*, 166 F.3d 332 (1998) (Substantial Compliance). Taxpayer donated non-publically traded stock valued at the average per share trading price of the stock as trade in contemporaneous arm's-length transactions, but did not obtain a *qualified appraisal*.

Deductions in excess of basis were denied for lack of *qualified appraisals*. Taxpayer argued *substantial compliance* under *Bond*. Noting language in the Senate Finance Committee reports on the 1984 Act[3] that the principal objective of IRC §155 was to provide a mechanism whereby respondent would obtain sufficient return information in support of the claimed valuation of charitable contributions of property to enable respondent to deal more effectively with the prevalent use of overvaluations.

[3] Deficit Reduction Act of 1984.

The Court denied the deduction for any amounts in excess of the taxpayer's basis (the "old school" approach), because the taxpayer's furnished practically none of the information required by either the statute or the regulations.

c. *Consolidated Investors Group v. Commissioner*, T.C. Memo 2009-290 (2009) (Bargain Sale/Substantiation)). Taxpayer made a bargain sale to Ohio Turnpike Commission (OTC) of property for the right-of-way for a state highway interchange. Because the fair market value of the property transferred exceeded the amount the partnership received, the partnership had donative intent when it transferred the property. The partnership substantially complied with the substantiation requirements of Regs. §1.170A-13(c)(2).

A portion of a payment is deductible as a charitable contribution under §170 if the following two conditions are met: "First, the payment is deductible only if and to the extent it exceeds the market value of the benefit received. Second, the excess payment must be made with the intention of making a gift." *Id.*

In response to IRS arguments that the partnership failed to substantiate its claimed charitable contribution deduction with a "qualified appraisal" because the appraisals it submitted were untimely (obtained more than 60 days before the date of contribution) and lacked some of the info required by the regulations (the date the partnership contributed the property, a statement that the appraisal was prepared for income tax purposes, and the fair market value of the appraised property as of the date of contribution), the Court found that, similar to the taxpayer in *Bond*, the partnership timely provided respondent with nearly all of the info required in the Regs. Respondent was provided with the date of the contribution and the fair market value of the property on the date of contribution on the partnership's completed Form 8283. The appraisal did lack a statement that it was prepared for income tax purposes; but the Court found that omission to be insubstantial -- The info provided to respondent was sufficient to permit respondent to evaluate the partnership's reported contribution and monitor and address concerns about overvaluation and other aspects of the reported charitable contribution.

d. *Todd v. Commissioner*, 118 T.C. No. 19 (2002) (Qualified Appreciated Stock). On December 20, 1994, taxpayer formed the Todd Family Foundation (the "Foundation"), a Colorado nonprofit. On December 27, 1994, they transferred 6,350 shares of stock in Union Colony Bancorp (the "Shares") to the Foundation (the "Transfer"), with respect to which they claimed a charitable contribution deduction. Attached to their return was a Form 8283, which included their basis in the Shares, their determination of the fair market value of the Shares, and a statement of the method used to determine that fair market value: "Sales of other shares at same time." (This statement was based on the Foundation's sale of the Shares one week later to First National of Nebraska, Inc., pursuant to an agreement of merger.) The portion of the Form 8283 that provides for the certification of an appraiser was without entries. No appraisal summary was attached.

Finding that the stock was not "publically traded securities," the Court denied the deduction because the Taxpayer could not prove compliance with the three substantiation requirements: (i) There was no evidence that they met the requirements for a qualified appraisal; (ii) No appraisal summary was attached to the Form 8283, and (iii) There was no evidence that they maintained records containing the information required by the Regs.

e. *Mohammed v. Commissioner*, T.C. Memo 2012-152 (2012) (Substantial Compliance). Taxpayers donated property to a CRT. They attached a summary appraisal. The value claimed on the contribution was $18.5 million. Stating that the appraisal did not provide much of the information required under the Regs., the Tax Court refused to apply the *substantial compliance doctrine*.

f. *Bruzewicz,* 604 F.Supp.2d 1197 (2009) (N.D. Ill.)

g. *Herman v. US*, 73 F.Supp.2d 912 (1999) (E.D. Tenn.)

h. *Jorgenson v. Commissioner*, T.C. Memo. 2000-38 (2000)

i. *O'Connor v. Commissioner*, T.C. Memo. 2001-90 (2001)

j. *Evans v. Commissioner*, T.C. Memo. 2010-207 (2010)

k. *Friedberg v. Commissioner*, T.C. Memo. 2013-224 (2013) reconsidering *Friedberg v. Commissioner*, T.C. Memo. 2011-238 (2011). The taxpayer donated an architectural façade easement and the development rights of a townhouse he owned to a qualified charitable organization and took a charitable contribution deduction. The IRS issued a notice of deficiency, contesting, among other things, whether the appraisals submitted by the taxpayer constituted qualified appraisals. The taxpayer moved for partial summary judgment that the appraisal was a qualified appraisal and the IRS moved for summary judgment that the taxpayer was not entitled to the charitable contribution deductions for the façade easement and the development rights because the appraisal by the qualified appraiser failed to include the method of valuation and the specific basis for valuation (i.e., it was not a qualified appraisal).

The Tax Court initially granted partial summary judgment to the IRS and held that the taxpayer was not entitled to the façade easement contribution deduction because the appraisal was not qualified. Relying on *Scheidelman I*, the Tax Court stated that the valuation method used by the appraiser was not an acceptable method under the requirements of Reg. § 1.170A-13(c)(3)(ii)(J) because the method used for the valuation and the basis for the valuation were unreliable. See *Friedberg v. Commissioner*, T.C. Memo. 2011-238 (2011).

After the Tax Court entered their decision in *Friedberg I*, *Scheidelman I* was reversed and remanded by the Second Circuit in *Scheidelman II*. The Second Circuit stated that Reg. § 1.170A-13(c)(3)(ii)(J) only requires the appraiser identify the method used so as to enable the Commissioner to evaluate the appraiser's methodology, not that the method adopted be reliable. The Second Circuit further stated that the requirement under Reg. § 1.170A-13(c)(3)(ii)(K) for the appraisal to include the specific basis is fulfilled if the appraiser's analysis is present, even if the Commissioner deems it unconvincing.

The taxpayer petitioned the Court for reconsideration based on the change of law and argued that, even if the appraiser's valuation method was improperly applied and unreliable, reliability is not a factor for determining whether a qualified appraisal exists and thus, the appraisals were qualified.

The Tax Court granted the taxpayer's motion for reconsideration and agreed that any evaluation of accuracy is irrelevant for purposes of determining whether the appraisal is qualified. On that note, the Tax Court stated that the appraiser's appraisal was sufficient because it allowed the Commissioner and the Tax Court to evaluate the appraiser's method. The Tax Court further stated that even if the specific basis for the valuation is unreasonable and unconvincing, for purposes of determining whether a qualified appraisal exists, it only matters that the specific basis be there. On these grounds, the Court concluded that the taxpayer's appraisal for the façade easement was a qualified appraisal.

The Tax Court next addressed the issue of whether the appraisal for the development rights was qualified. The Tax Court originally permitted this issue to go to trial because they construed the reliability of the appraisal to be an issue of fact necessary to determine whether the appraisal was qualified. In light of *Scheidelman II*, the Court held that the appraisal for the development rights was qualified because the appraisal listed the method of appraisal and specific basis for valuation.

The IRS further argued that the appraisal for the development rights was not a qualified appraisal because the appraiser admitted (at a deposition after the summary judgment hearing) that he had never appraised development rights before and that the taxpayer knew that. The Court said that whether the appraiser is in fact qualified, as he certifies on the Form, is irrelevant and so long as the certification is signed by someone not excluded from appraising the property, this is enough for purposes of holding a qualified appraisal exists. The Court noted that the IRS did not argue that the appraiser was not a qualified appraiser pursuant to Reg. § 1.170A-13(c)(5)(iv) and thus, did not address this point.

l. *Smith v. Commissioner,* T.C. Memo. 2007-368 (2007)

i. *Smith v. Commissioner*, T.C. Memo. 2007-368 (2007) <u>aff'd,</u> 364 Fed. Appx. 317 (**9th Cir.** 2009)

m. *Hendrix v. US*, 106 A.F.T.R.2d 5373; 2010-2 USTC ¶50,541 (2010)

n. *Ramirez v. Commissioner*, T.C. Memo 2010-108 (Substantiation; Penalties) Married taxpayers were denied various deductions for failing to keep records proving that they were entitled to those deductions.

o. *Farber v. Commissioner*, T.C. Memo 2010-37 (Substantiation). Charitable contribution deductions claimed by an individual were allowed only to the extent she provided substantiation.

p. *Cohan v. Commissioner,* T.C. Memo 2012-8 (2012) (Substantial Compliance).

q. *Gaerttner v. Commissioner*, T.C. Memo. 2012-43 (2012) (Substantiation).

r. *Bilyeu v. Commissioner,* T.C. Memo. 2012-161 (2012) (Substantiation).

3. Facade/Conservation Easement.

a. *Simmons v. Commissioner*, T.C. Memo. 2009-208 (2009).

i. *Commissioner v. Simmons*, 646 F.3d 6 (D.C. Cir. 2011) (Façade; Qualified Appraisals). On appeal, IRS argued that the easement was not "exclusively for conservation purposes." The IRS argued that the clause in the deed that stated, "Nothing . . . shall be construed to limit the grantee's rights to . . . consent to, for example, changes in the façade or to abandon all of its right hereunder," meant that the easement was not protected in perpetuity. Additionally, they argued there was no language in the easements that provided for continuity of the easements if the trust ceased to exist.

The appellate court held that allowing some change to the easements may be necessary to accommodate change, and noted that the trust had been holding easements since 1978 and had never failed to enforce its rights.

The appellate court went on to point out that Regs §1.170A-14(g)(3) states that: "A deduction shall not be disallowed merely because the interest that has transferred to the donee organization may be defeated by the performance of some act or the happening of some event, if on the date of the gift it appears that the possibility that such act or event will occur is so remote as to be negligible. Thus, the appellate court concluded that the taxpayer's deductions could not be disallowed based on a remote possibility that the trust will abandon the easements. (Citing *Stotler v. Commissioner*, 53 T.C. Memo (1987)).

Addressing the issue of *qualified appraisals*, the IRS argued that the taxpayer's appraiser did not explain the methodology; pointing out that the percentages relied on by the appraiser were from an article published by the IRS. The taxpayer replied that the appraiser used the "before and after" methodology because there were no comparable easement transactions. The appellate court held that the Tax Court did not err in finding that the taxpayer's appraisal was a *"qualified appraisal,"* although they noted that the appraiser could have elaborated further on the valuation methodology to avoid the litigation.

b. *Mitchell v. Commissioner* – 138 T.C. No. 16 (April 3, 2012) (Conservation Easement). The Mitchells donated a conservation easement on 180 acres of their 456-acre property and took a $504,000 charitable contribution deduction. However, they had purchased a portion of the property only two years earlier and still owed the seller for that purchase. Two years after the donation, the Mitchells entered into an agreement with the seller which subordinated the seller's right to receive future payments from the Mitchells to the rights of the donee organization. Notwithstanding the subsequent subordination, the Court ruled, "the mortgagee's rights in the property must be subordinate to the conservation easement on the date the conservation easement is granted." Moreover, "Petitioners cannot avoid the strict requirement . . . [the] Regs. simply by showing that they would most likely be able to satisfy both their mortgage and their obligation to ... [the charity]."

The grant of the conservation easement failed to qualify for a charitable deduction because it was not enforceable in perpetuity because, at the time interest was conveyed, the deed of trust securing a mortgage on the property was not subordinated to the donee organization. The "so-remote-as-to-be-negligible" standard, with respect to the probability of the donor defaulting on the mortgage on the property prior to the subordination of the deed of trust to the donee organization, did not apply in determining whether the subordination requirement was met. An oral agreement with the mortgagee that the property would not be subdivided or developed did not protect the conservation easement purpose in perpetuity because the mortgagee still could have foreclosed on the property.

i. *Mitchell v. Commissioner* – T.C. Memo 2013-204 (2013) The taxpayer filed a motion for reconsideration, arguing that there was a pertinent change of law in *Kaufman III*. The Tax Court denied the motion because the change of law was not on point. The issue in *Kaufman* was whether the subordination requirement was complied with since the mortgagee was entitled to conversion insurance proceeds. Here, the mortgagee failed to subordinate his rights to the conservation easement holder altogether. Citing their recent decision in *Carpenter*, the Tax Court stated that, like the judicial extinguishment requirement, the subordination requirement was mandatory.

c. *Kaufman v. Commissioner*, 134 T.C. No. 182 (2010), 136 TC 294 (Façade Easement Denied). A married couple who contributed a façade easement and cash to a qualified donee organization was not entitled to a deduction for the façade easement contribution since the interest in the property conveyed by the façade easement was not protected in perpetuity and the contribution did not constitute a qualified conservation contribution. The property had a mortgage and the lender retained a prior claim to all proceeds of condemnation and all insurance proceeds as a result of any casualty, hazard, or accident until the mortgage was satisfied and discharged. Thus, the donee organization's right to its proportionate share of future proceeds was not guaranteed.

i. *Kaufman v. Shulman*, 687 F.3d 21 (1st Cir. 2012), 110 A.F.T.R.2d 2012-5278, 2012-2 USTC ¶ 50,472 (2012). On appeal, **the First Circuit reversed, holding that**:

[1] Claimed deductions could not be disallowed based upon the remote possibility that donee organizations would abandon easements since governing law did not deprive donee organization of flexibility to deal with remote contingencies.

[2] Defects in an appraisal summary with regard to a deduction for a contribution of a façade easement that were not prejudicial to IRS did <u>not</u> doom the summary. The procedural regulations for charitable contributions requiring an appraisal report and summary are designed to provide information sufficient to permit the IRS to evaluate the taxpayer's reported contribution and monitor and address concerns about overvaluations. However, whether a charitable contribution or gift valuation was overstated, grossly or otherwise, is a factual question different from whether the formal procedural requirements were met, either strictly or under the "substantial compliance" doctrine.

[3] The substantial compliance doctrine allows taxpayers to overcome technical noncompliance if they make a showing that a regulatory requirement is unimportant, unclear or confusingly stated.

d. *Scheidelman v. Commissioner*, T.C. Memo. 2010-151 (2010). (Façade Easement; Substantiation; Penalties). The taxpayer donated a façade easement. To determine the value of the easement, the appraiser reviewed other court cases and determined that the IRS had found façade easement values of 10-15% of the total property value were appropriate. Based upon other façade easements for similar properties in New York, the appraisal set the easement value at 11.33% of the value of the property as a whole.

As part of the donation process, the easement holder, Natural Architectural Trust ("NAT"), required donors to pay a deposit with their application and make an additional payment (10% of the easement value) when the easement was accepted. NAT characterized the payment as an "agreed upon cash donation" even though it was mandatory. *Scheidelman* did not originally claim a deduction for her cash payments, but the parties agreed to submit the issue of their deductibility to the Court.

The Tax Court found that Scheidelman did not substantiate the donation of the façade easement with a "*qualified appraisal*" and the entire deduction was disallowed. The Court ruled that Scheidelman's appraisal lacked a meaningful analysis of the specific, qualitative attributes of the property to support the determination of the easement value. Instead the appraisal "applied mechanically a percentage with no demonstrated support as to its derivation, other than acceptance of similar percentages in prior controversies." The Court also found the appraisal to be deficient for lack of certain information required by the Regulations, including a description of the property, the terms of the deed of easement, and a statement that it was prepared for tax purposes.

The taxpayer argued that she had *substantially complied* with the reporting requirements, but the Court ruled that "the lack of a recognized methodology or specific basis for the calculated after-donation value is too significant for us to ignore under the guise of substantial compliance."

With respect to the taxpayer's cash payment to NAT, the Tax Court found that the taxpayer failed to prove that she received nothing of substantial value in return, or that the payment greatly exceeded the value of the benefits received. Therefore, the deduction was not allowed.

i. *Scheidelman*, the **Second Round—**On June 15, 2012, the **Second Circuit Court reversed** the Tax Court and found the appraisal qualified. They held that the appraisal sufficiently detailed the method and basis of valuation. They also held that there was no quid pro quo on the contribution/payment as the taxpayer received nothing of value.

ii. *Scheidelman v. Commissioner,* the **Third Round—** (January 16, 2013) T.C. Memo. 2013-18. **Supplemental Memorandum Opinion**. The Court of Appeals held that the appraisal petitioners relied on at the time their 2004 tax return was filed (Drazner report) was a "qualified appraisal" for purposes of IRC §170(f)(11) and that the disputed cash contribution was deductible. However, the Court of Appeals stated: "Our conclusion that Drazner's appraisal meets the minimal requirements of a qualified appraisal mandates neither that the Tax Court find it persuasive nor that Scheidelman be entitled to any deduction for the donated easement." *Scheidelman v. Commissioner*, 682 F.3d at 199.

(a) The Drazner Report. Drazner determined the value of the easement by applying an 11.33% discount to the value of the property. His derivation of that percentage was not based on reliable market data or specific attributes of petitioner's property, but on his analysis of what the courts and the IRS had allowed in prior cases. That conclusion was not based on qualitative factors for the Vanderbilt property or the specific attributes of that property but was based on mechanical application of a percentage with no demonstrated support as to its derivation, other than acceptance of similar percentages in prior controversies. *Thus the report was not based on sufficient facts or data and was not the product of a reliable methodology, and Drazner's methodology was not reliably applied to the facts of the case. For those reasons, it was not credible.*

(b) Petitioners' Trial Expert. Petitioners' trial expert (Ehrmann) prepared a market study that was attached to his report. The information he relied on came from NAT through its counsel. He incorporated material recommended by NAT's counsel. He admitted that his report did not accurately describe the easement. He relied on outdated information rather than contemporaneous inspection. He used alleged comparables from outside the geographical area of petitioner's property, and applied an unsupported and unrealistic adjustment to petitioner's townhouse as compared to a detached house in Evanston, Illinois. He ignored studies suggesting a contrary result and adopted those supporting his client's desired value. His testimony had all of the earmarks of overzealous advocacy in support of NAT's marketing program and, indirectly, petitioner's tax reporting.

Expert opinions that disregard relevant facts affecting valuation or exaggerate value to incredible levels are rejected. See *Boltar, L.L.C. v. Commissioner*, 136 T.C. 326, 335 (2011) (and cases cited therein, among others).

An expert loses usefulness to the Court and loses credibility when giving testimony tainted by overzealous advocacy. *Boltar, L.L.C. v. Commissioner*, 136 T.C. at 335-336.

(c) Respondent's Expert. Respondent's first valuation expert (Barnes) analyzed the terms of the easement, zoning laws, and regulations of the LPC and concluded: "in highly desirable, sophisticated home markets like historic brownstone Brooklyn, the imposition of an easement, such as the one granted on June 23, 2004, is not a deterrent to the free trade of such properties at fully competitive prices and does not materially affect the value of the subject property."

Barnes researched the geographic area of petitioner's property, contacting real estate brokers and valuation professionals in the Brooklyn market to determine whether the imposition of a facade easement affected the marketability of or ability to finance a townhouse within the Fort Greene Historic District. The "uniform response" was that such easements did not negatively affect buyer interest, marketing time, or financing.

Respondent also presented expert testimony by Stephen D. Dinklage, an engineer employed by the IRS, who used an alternative approach based on condemnation techniques and determined that the grant of the easement did not have a material effect on fair market value. Dinklage used market data to divide the value of the land from that of the building and then used a modified cost approach to isolate that portion of petitioner's townhouse affected by the facade easement. He concluded that because only the facade was affected by the easement and the loss of utility was only to the facade, the restrictions would not have a material effect on the market value of the whole property. Dinklage reasoned that a hypothetical buyer would not pay less for the Vanderbilt property because it was already restricted by the LPC regulations and the easement did not make a difference.

(d) Other Evidence. A logical inference from the testimony of the chairman of the Fort Greene Association (which has as its mission preservation within the Fort Greene boundaries) is that preservation of historic facades is a benefit, not a detriment, to the value of Fort Greene property, and the conclusion that the easement did not materially diminish the value of petitioner's property is also supported by petitioner's own testimony.

Held: We do not believe that petitioner would have granted the easement if she had anticipated a substantial drop in the market value of her property as a result. The preponderance of the evidence supports respondent's position that the easement had no value for charitable contribution purposes.

e. *Irby v. Commissioner*, 139 T.C. No. 14 (Oct. 25, 2012) (Conservation Easement). Petitioners were members of an LLC which conveyed conservation easements encumbering two parcels of land (one conveyance in 2003 and the other in 2004) to COL, a qualified organization as defined in IRC §170(h)(3), in bargain sale transactions. The purchase portion of the transactions was funded with grants from governmental agencies which were established to assist in the conservation of open land. The LLC reported gain with respect to the sale portion and a charitable contribution with respect to the remaining portion (the bargain portion) of the transactions. Petitioners reported their respective shares of the gain and deducted their respective share of the charitable contributions on their respective individual tax returns. In disallowing the charitable contribution deductions, Respondent determined that: (1) the conservation purpose for the easements was not protected in perpetuity because COL was required to reimburse the government agencies in the event it received proceeds should the land be condemned and the easements extinguished; (2) the appraisal was not a "qualified appraisal" because the report did not include statements that the appraisal was prepared for income tax purposes; and (3) Taxpayers did not obtain contemporaneous written acknowledgements indicating the amount of goods or services received for the contributions.

Held: The conservation purpose of the easements was protected in perpetuity; Taxpayers' appraisal met the requirements of a qualified appraisal and Taxpayers obtained the required contemporaneous written acknowledgement of the transactions.

f. *Rothman v. Commissioner*, T.C. Memo. 2012-163 (2012), in reconsideration. (Qualified Appraisal; Facade Easement). The taxpayer filed a motion for reconsideration after *Scheidelman III* was decided and argued that they submitted a qualified appraisal. The appraisal was substantially the same as the one in *Scheidelman* except that it had additional errors. The Tax Court granted the motion for reconsideration in part and stated that to the extent the appraisal was originally defective like the *Scheidelman* appraisal those requirements were satisfied. However, the additional missing provisions in the appraisal led the Court to deny the charitable contribution deductions for lack of a qualified appraisal. The major issue with the appraisal was that it wrongly appraised a right that was not even contributed and thus, failed to describe the easement accurately or sufficiently enough for the Commissioner to ascertain whether the appraised property and the contributed property were one and the same. The Tax Court stated that although the taxpayer failed to provide a qualified appraisal, this was not fatal to his charitable contribution deduction if the taxpayer could prove at trial that he had reasonable cause for the omissions.

g. *Schrimsher v. Commissioner*, T.C. Memo. 2011-71 (March 27, 2011) (Façade Easement; Substantiation; Penalties). The Taxpayer had made a charitable contribution of a façade easement valued at $705,000. The primary issue concerned language within the Easement Agreement which stated, "for and in consideration of the sum of TEN DOLLARS, plus other good and valuable consideration ...." According to the Taxpayer, this language was "typical boilerplate" which should be disregarded.

The Court recognized that in some situations an exception may apply, but noted that the Taxpayer did not raise "any issue as to the applicability of any exception to the contemporaneous written acknowledgment of IRC §170(f)(8).

Not only was the Taxpayer's deduction disallowed, but it appears that the Taxpayer was also subject to a 20-percent accuracy related penalty under IRC §6662(a) for "negligence or disregard of rules or regulations."

h. *Carpenter v. Commissioner*, T.C. Memo. 2012-1 (2012) (Conservation Easement). Motion for summary judgment. As in *Kaufman*, the Tax Court determined that the conservation easement at issue failed to comply with the "enforceability in perpetuity" requirements under the Regs.

The conservation easement deeds were virtually identical to the deeds in <u>*Kaufman*</u>, <u>*Lord*</u> and <u>*Friedburg*</u>, and contained the following clause regarding extinguishment:

> Extinguishment - If circumstances arise in the future . . . that render the purpose of this Conservation Easement impossible to accomplish, this Conservation Easement can be terminated or extinguished, . . . in whole or in part, by judicial proceedings, <u>or by mutual written agreement of both parties</u>, provided no other parties will be impacted and no laws or regulations are violated by such termination. * * * [Emphasis added by the Court.]

The IRS convinced the Tax Court that the Easements were not protected in perpetuity because the deeds allowed the parties to extinguish the conservation easements by "mutual agreement." Hence, *Carpenter* suggests that the language in the contract is critical in the structuring of an easement donation that will pass the scrutiny of the IRS and hold up in court. While the Carpenter Taxpayers' donation was a qualified easement in use, and donated to a qualified organization, the “protection in perpetuity” test was not met and that caused its failure.

i. *Carpenter v. Commissioner,* T.C. Memo. 2013-172 (2013) The taxpayer filed a motion for reconsideration arguing that there was a pertinent change of law in *Kaufman III*. The Tax Court denied the motion for reconsideration because the change of law was not on point for the issues. The issue in *Kaufman* was whether the subordination requirement was complied with since the mortgagee was entitled to conversion insurance proceeds whereas in *Carpenter*, the entire easement was subject to extinguishment at the discretion of the parties. Specifically, the Tax Court made clear that a charitable deduction for a conservation easement will be allowed only if the perpetuity requirement is strictly complied with and the only method allowed by the conservation deed for extinguishment is by judicial proceeding. The Tax Court stated that, regardless of the fact that the proceeds would ultimately go to the charitable organization, extinguishment without judicial proceeding is unacceptable for purposes of satisfying the regulation.

i. *Averyt et al, v. Commissioner,* T.C. Memo 2012-198 (Conservation Easement). Taxpayers donated a conservation easement. Upon receipt of the conservation easement, the donee organization sent a letter acknowledging receipt of the easement and stated that they would be sending a “pen and pendant.” The letter failed to provide a “good faith estimate” of the value of the pen and pendant, neither of which was ever sent.

The Tax Court rejected the taxpayer’s contention the requirements of §170 should be disregarded because the pen and pendant was of nominal value. However, after reviewing the deed of conveyance, the Court concluded that (1) the “pen and pendant” was an unconditional gift, because no consideration was received in exchange for it; and (2) because the conservation deed constituted the entire agreement between the parties, the conservation deed satisfied the substantiation requirements of §170(f)(8).

j. *Lord v. Commissioner*, T.C. Memo. 2010-196 (2010) (Qualified Appraisals; Conservation Easements). A qualified appraisal must include the date (or expected date) of [the] contribution, the date on which the property was appraised, and the appraised fair market value of the property on the date (or expected date) of the contribution. In addition, the appraisal must be made not earlier than 60 days before the contribution date of the appraised property nor later than the due date of the tax return on which a deduction is first claimed.

k. *Evans v. Commissioner*, T.C. Memo 2010-207 (Façade Easement; Substantiation). The Court upheld a denial of easement façade donations where Petitioner failed to provide sufficient credible evidence of their fair market value to meet his burden of proof.

l. *Trout Ranch, LLC*, 493 Fed. Appx. 944, 110 A.F.T.R. 2d 2012-5621 (2012) (Conservation Easement). The Tax Court rejected both parties’ valuations. The **Tenth Circuit** held that the Tax Court was free to adopt its own model for valuation.

m. *Dunlap v. Commissioner*, T.C. Memo. 2012-126 (May 1, 2012) (Conservation Easement). Taxpayers made gifts of a condominium’s façade. Their appraiser valued the façade easement at 12% of the “before” value. At trial, the taxpayers introduced another expert who determined the easement to be 10% of the "before" value. The IRS's two experts each determined a zero value for the easement. The Court ruled that the taxpayers' experts' opinions "lack[ed] credibility and found that petitioners failed to provide credible evidence with respect to the fair market values of the easements…."

n. *Butler et al. v. Commissioner* – T.C. Memo. 2012-72 (March 19, 2012) (Conservation Easement). Taxpayers donated a conservation easement on separate properties which were in the path of development. The Court determined that the taxpayers had overvalued their charitable donations. The Court spent considerable time in assessing the many experts' reports and, in the end, selectively used information from several reports to fashion its own conclusions.

o. *DiDonato v. Commissioner* – T.C. Memo. 2011-153 (June 29, 2011) (Conservation Easement). Taxpayer contributed a land conservation easement claiming a charitable deduction on his 2004 tax return. The charitable contribution arose from a settlement of a lawsuit initiated by Taxpayer against the Donee. While the Memorandum of Settlement was entered into in 2004, the actual conveyance of the property required receipt of the statutory and regulatory approvals required by the State of New Jersey. Those final approvals were not granted until 2007. The Court held that Mr. DiDonato's "obligation to transfer those rights had not yet matured [as of 2004] and were not certain to do so." Accordingly, "the settlement agreement does not qualify as a contemporaneous written acknowledgement within the meaning of section 170(f)(8)(A)."

p. *Whitehouse Hotel Limited Partnership et al. v. Commissioner*, 139 T.C. 304 (2012), on rehearing from 615 F.3d 321 (5th Cir. 2010) (Conservation Easement). The investors in Whitehouse made a façade easement donation on a hotel property that was immediately adjacent to another hotel held in the partnership. The Taxpayers' appraisal recognized that by providing an easement on one hotel property the investors were forgoing opportunities to combine the hotels in a manner that would result in the "highest and best use" of the combined properties. Accordingly, the appraiser based his easement valuation on the reduction in value of the combined properties despite the fact that only one property's easement was donated. The Taxpayers lost in Tax Court. However, the **Fifth Circuit reversed and remanded the Tax Court's** decision because "the amount of the deduction in the case of a charitable contribution of a perpetual conservation restriction covering a portion of the contiguous property owned by a donor . . . is the difference between the fair market value of the entire contiguous parcel of property before and after the granting of the restriction."

On rehearing, the Tax Court still found that the comparable sales approach was still the most reliable method of valuation and applied it in reaching their determination that the easement was overvalued on the taxpayers' Form 8283. The Tax Court also imposed the accuracy related penalty on the taxpayers because it found that the taxpayers failed to satisfy the reasonable cause exception by failing to show that it made a good faith investigation of the value.

q. *Wall v. Commissioner*, T.C. Memo 2012-169 (2012) (Façade Easement Denied).

r. *RP Golf LLC v. Commissioner*, T.C. Memo. 2012-282 (2012) (Conservation Easement Denied).

s. *Foster v. Commissioner*, T.C. Summ. Op. 2012-90 (Façade Easement Denied; Valuation).

t. Chief Counsel's Advice 201014056; 4/9/2010 (Summary of Façade Easement Rules).

4. Other.

a. *Crimi v. Commissioner*, T.C. Memo. 2013-51 (2013)

In 2000, Taxpayers hired a qualified appraiser to value the property for the purposes of transferring the property to Morris County, New Jersey ("County"). County could not arrode the $3,000,000 value, so this transaction did not close until 2004 when taxpayers transferred to a partnership including the County, more than 65 acres of undeveloped land for $1,550,000 in a bargain sale (part-sale, part-gift) transaction. When Mr. Crimi asked his accountant how to properly report the transaction on his tax return he was told by his 24-year CPA that the 2000 appraisal sufficed to support the contribution. The CPA gave this advice after the appraisal was reviewed by his firm's tax department.

Petitioners reported the value of the land at $2,950,000 and claimed a $1,400,000 charitable contribution. Respondent disallowed the deductions on the grounds that petitioners did not meet the requirements of IRC §170.

Respondent argues the 2000 appraisal was not a qualified appraisal because it (1) did not value the subject property as of the contribution date; (2) was prepared four years before the contribution date; (3) did not include the date or expected date of contribution; (4) did not contain a statement that the appraisal was prepared for income tax purposes; (5) incorrectly described the subject property as having more acreage than what was actually transferred; and (6) used market value instead of fair market value as its valuation standard. Respondent also claimed petitioners failed to obtain from the county a contemporaneous written acknowledgment as required by IRC §170(f)(8).

First, taxpayer argued that the appraisal substantially complied with the requirements for a qualified appraisal. Second, the taxpayer argues that any noncompliance should be excused for reasonable cause pursuant to IRC §170(f)(11)(A)(ii)(II).

The Tax Court stated "[w]e have previously held that an appraisal substantially complied with the qualified appraisal requirements when the appraisal was almost five months premature, did not have the contribution date, failed to include a statement that the appraisal was prepared for income tax purposes, and failed to provide the fair market value of the appraised property as of the contribution date." While Judge Laro indicated he was "doubtful" that the appraisal could meet the substantial compliance test, he went on to say that the Court did not need to rule on that issue, since it would deal with the matter on the reasonable cause exception instead--Even if the appraisal did not substantially or actually comply with the requirements for a qualified appraisal, the taxpayer had reasonably relied on the advice of his CPA that the appraisal was adequate.

The Court noted that reasonable cause generally requires the taxpayer to exercise ordinary business care and prudence with regard to the matter in question; have a reasonable belief the professional was competent and experienced; the taxpayer has provided the professional with necessary and accurate information; and the taxpayer relied on the advice in good faith.

Here, the CPA in question had been advising the taxpayer for over 20 years; the taxpayer had not been made aware of errors in any prior advice he had received from the CPA; the CPA was part of an established accounting firm; the CPA had experience filing returns that claimed charitable contributions; and the taxpayer had provided access to all relevant information to the CPA.

The Court further noted that the appraisal that was undertaken prior to trial actually found that the property was more valuable than it had been at the 2000 appraisal date and thus it was reasonable for Mr. Crimi to believe that the amount he was claiming as a deduction was not being overstated by using an appraisal prepared at a time when the property was worth significantly less than it was worth at the contribution date (the 2007 appraisal valued the property at $5,200,000).

There was no reason why Mr. Crimi should second-guess the CPA's advice or believe he was claiming an overstated value. He had sought advice from an adviser whose qualifications Mr. Crimi was aware of and which appeared sufficient to justify reliance. In sum, the taxpayers were entitled to the deduction for the charitable contribution of the subject property even though they did not attach a qualified appraisal as required under the IRC and the regulations, because any failure to comply with the requirement was excused on the ground of reasonable cause.

b. *Theodore R. Rolfs, et ux. v. Commissioner*, 668 F.3d 888 (7th Cir. 2012), *aff'g* 135 T.C. No. 24 (November 4, 2010) (No Deduction When Value of Benefits Exceed the Value of the Donation). The Tax Court denied a charitable contribution deduction for donation of a house to the local fire department where the value of the demolition services that the taxpayer received exceeded the value of the donated property. The Seventh Circuit affirmed the Tax Court decision.

c. *Berquist / Kendrick v. Commissioner* – 131 T.C. No. 2 (July 22, 2008). The Court was unimpressed with the Estate's valuation expert, and applied accuracy related penalties despite having a "qualified appraisal."

The Court allowed the IRS to use the Pre-IPO Approach to determine the appropriate discount for lack of marketability. In 2003 (*Estate of McCord*), in an en banc decision, the entire Tax Court determined the Pre-IPO Approach to be unredeemedly flawed. Now, the Tax Court has allowed its use by the IRS. **<u>Query</u>:** Can the IRS now claim the Pre-IPO Approach to be faulty?

II. PENALTIES

A. <u>*IRC §6662. Imposition Of Accuracy-Related Penalty On Underpayments*</u>. A 20% penalty shall apply to that portion of any underpayment which is attributable to:

- *Negligence* or disregard of rules or regulations.
- Any *substantial understatement* of income tax.
- Any *substantial valuation misstatement* under chapter 1.
- Any substantial estate or gift tax valuation understatement.

1. <u>Substantial Valuation Misstatement Under Chapter 1</u>. There is a *substantial valuation misstatement* under chapter 1 if the value or the adjusted basis of any property claimed on any return of tax imposed by chapter 1 is 150% or more of the amount determined to be the correct amount.

2. <u>Substantial Estate Or Gift Tax Valuation Understatement</u>. There is a *substantial estate or gift tax valuation understatement* if the value of any property claimed on any return is 65% or less of the amount determined to be the correct amount.

3. <u>Gross Valuation Misstatements</u>. To the extent that the underpayment is attributable to one or more gross valuation misstatements, the penalty shall be increased to "40%."

a. The term "*gross valuation misstatements*" means (i) any substantial valuation overstatement determined by substituting *200%* for 150%; or (ii) any substantial estate or gift tax valuation understatement as determined by substituting *40%* for 65%.

B. <u>*IRC §6694. Understatement of Taxpayer's Liability by Tax Return Preparer*</u>.

1. <u>With Respect to Unreasonable Positions</u>. The penalty shall be equal to the greater of $1,000 or 50% of the income derived by the preparer with respect to the return.

2. <u>With Respect to Willful or Reckless Conduct</u>. The penalty shall be equal to the greater of $5,000, or 50% of the income derived by the preparer with respect to the return.

3. <u>Abatement Where Taxpayer's Liability Not Understated</u>. If there is a final determination that there was no understatement, the penalty shall be abated.

4. <u>Definition</u>: for the definition of a "tax return preparer," see IRC §7701(a)(36).

C. <u>*IRC §6701. Penalties for Aiding and Abetting Understatement of Tax Liability*</u>. Any person who aids or assists in the preparation of a return who knows that a position would result in an understatement shall pay a $1,000 penalty (unless the return relates to the tax liability of a corporation, in which case the penalty shall be $10,000).

D. <u>"New" §6695A</u>. If the claimed value of property based on an appraisal results in a substantial or gross valuation misstatement under IRC §6662, a penalty is imposed under §6695A on any person who prepared the appraisal and who knew, or reasonably should have known, the appraisal would be used in connection with a return or claim for refund.

III. PENALTY AVOIDANCE/DEFENSES

A. *Regs §1.6662-3(b)(3) Reasonable Basis*. See Regs §1.6664-4 if a return position does not satisfy the *reasonable basis* standard.

B. *Regs §1.6662-3(c) Exception For Adequate Disclosure*. No penalty may be imposed if the position is disclosed in accordance with the rules.

C. *Regs §1.6662-4(d) Substantial Authority*. If there is *substantial authority* for the tax treatment of an item, the item is treated as if it were shown properly on the return.

1. There is *substantial authority* for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment.

D. *Regs §1.6662-4(e) Disclosure of Certain Information*. Items for which there is adequate disclosure are treated as if such items were shown properly on the return.

1. Disclosure will not have an effect where the item or position (i) does not have a *reasonable basis*; (ii) is attributable to a tax shelter; or (iii) is not *properly substantiated*.

E. *Regs §1.6662-4(f) Method of Making Adequate Disclosure*. Disclosure must be made on Form 8275 or, in the case of a position contrary to a regulation, on Form 8275-R.

1. The Commissioner may prescribe the circumstances under which disclosure of information on a return is adequate by annual revenue procedure. If the revenue procedure does not include an item, disclosure is adequate only if made on a properly completed Form 8275 or 8275-R.

F. *Regs §1.6664-4 Reasonable Cause and Good Faith Exception to §6662 Penalties*. No penalty may be imposed under IRC §6662 with respect to any portion of an underpayment upon a showing that there was *reasonable cause* for, and the taxpayer acted in *good faith* with respect to, such portion.

1. The determination of whether a taxpayer acted with reasonable cause and in *good faith* is made on a case-by-case basis, taking into account all pertinent facts and circumstances. *Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability*. Reliance on an information return or on the advice of a professional tax advisor or an appraiser does not necessarily demonstrate reasonable cause and good faith. Reasonable cause and good faith ordinarily is not indicated by the mere fact that there is an appraisal of the value of property.

2. <u>Reliance on Opinion or Advice</u>.

a. All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice. Reliance may not be reasonable or in good faith if the taxpayer knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.

i. The requirements of this paragraph are not satisfied if the taxpayer fails to disclose a fact that it knows, or reasonably should know, to be relevant to the proper tax treatment of an item.

ii. The advice must not be based on unreasonable factual or legal assumptions and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person.

iii. A taxpayer may not rely on an opinion or advice that a regulation is invalid to establish that the taxpayer acted with reasonable cause and good faith unless the taxpayer adequately discloses the position that the regulation in question is invalid.

3. <u>Valuation Misstatements of Charitable Deduction Property</u>.

a. There may be reasonable cause and good faith with respect to an underpayment attributable to a substantial (or gross) valuation misstatement of charitable deduction property only if (i) the claimed value of the property was based on a *qualified appraisal* by a *qualified appraiser*; and (ii) the taxpayer made a good faith investigation of the value of the contributed property. But **<u>NOTE</u>:**

i. These requirements ((i) & (ii), above) apply regardless of whether Regs §1.170A-13 permits a taxpayer to claim a charitable contribution deduction for the property without obtaining a *qualified appraisal*. and

ii. The rules requiring a *qualified appraisal* by a *qualified appraiser* to show reasonable cause and good faith with respect to an underpayment attributable to a substantial (or gross) valuation misstatement of charitable deduction property apply <u>in addition</u> to the generally applicable rules concerning *reasonable cause* and *good faith*.

IV. PENALTIES CASES

A. *D'Arcangelo v. Commissioner*, T.C. Memo. 1994-572 (1994)

The taxpayer was a CPA who befriended an artist and assisted the artist with substantial loans. When the artist was unable to maintain his shop, the taxpayer removed artwork, art supplies, and frames, donated the items to a high school and claimed a $40,000 charitable deduction.

The Tax Court held that the $40,000 deduction failed substantial compliance because the items were not valued by a qualified appraiser. Rather, they were appraised by the high school's principal who testified that: (i) He had no experience in the appraisal of printing equipment; (ii) He had only visited the shop 6 years before the contribution; (iii) In order to do a proper valuation, he would have to spend at least 2 weeks in the shop (but he only spent 1 hour there); (iv) He never examined the books of the business nor any comparable business; (v) He did not know if the items he saw in the shop were the items contributed; (vi) the items contributed in 1986 had the same value they did when he saw them in the late 70s; (vii) He knew that reusing the silkscreens would affect their value but had no idea how many times they might have been used; and (vii) Most of the silkscreens were discarded by the high school as useless.

Noting that Regulations expressly prohibited an employee of the donee from making the appraisal, the Tax Court found the taxpayer did not submit a fully completed appraisal summary, and the evidence that he put forth was insufficient because his "expert" did not even look at the items and never appraised the type of items before. Noting the taxpayer was a CPA, the Tax Court upheld the (old) penalties for negligence, substantial understatement and valuation overstatement.

B. *Esgar Corporation*, T.C. Memo. 2012-35, February 6, 2012 (Conservation Easement; Highest and Best Use; Penalties)

The Court did <u>not</u> apply a §6662(a) valuation understatement penalty because the taxpayers met the three requirements: (1) The adviser was a competent professional who had sufficient expertise to justify reliance; (2) the taxpayer provided necessary and accurate information to the adviser; and (3) the taxpayer actually relied in good faith on the adviser's judgment.

C. *Friedman v. Commissioner*, T.C. Memo 2010-45 (Qualified Appraisals; Penalties; Reliance)

A couple was denied noncash charitable contribution deductions because they neither obtained timely and complete qualified appraisals, nor maintained adequate records related to the donated property. Although they argued that they should be excused from penalties because they relied on the advice of their CPA, the Court noted that a taxpayer relying on professional advice must show: (1) the adviser was a competent professional; (2) the taxpayer provided necessary and accurate information to the adviser; and (3) the taxpayer relied in good faith on the adviser's judgment. Here, the Tax Court found the donors liable for the penalties -- because they did not provide full and accurate information to their CPA, they could not have relied *in good faith* on his advice.

D. *Estate of Thompson v. Commissioner*, 370 Fed. Appx. 141 (2010) (No Penalty for Under Valuation)

The IRS imposed an accuracy-related penalty against the estate because the estate's valuation of the asset was less than 25% of the correct valuation. At trial, the Tax Court found that the estate was not liable for the accuracy-related penalty because the valuation of the asset was particularly difficult. The appellate court affirmed.

E. *Patel v. Commissioner*, 138 T.C. No. 23, (June 27, 2012) (No Penalty for Over Valuation)

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APPENDIX A

IRS Website Publications Related to Valuation[4]

Note: References are subject to revision/replacement by updated versions. Links may not automatically redirect to updated versions.

IRS Publication 526 on Charitable Contributions
http://www.irs.gov/pub/irs-pdf/p526.pdf

IRS Publication 561 on Determining the Value of Donated Property
http://www.irs.gov/pub/irs-pdf/p561.pdf

IRS Notice 2006-96 on Guidance Regarding Appraisal Requirements for Noncash Charitable Contributions (including Qualified Appraisal and Qualified Appraiser)
http://www.irs.gov/pub/irs-tege/n2006_96.pdf

Note: Also see IRS Revenue Procedure 66-49 (on Westlaw or Lexis) for additional guidance on appraisals for Federal tax purposes.

Internal Revenue Manual: Penalties (incl. 6695A) Applicable to Incorrect Appraisals
http://www.irs.gov/irm/part20/irm_20-001-012.html

Internal Revenue Manual: Overview of Engineering Program
http://www.irs.gov/irm/part4/irm_04-048-001.html

Internal Revenue Manual: Real Property Valuation Guidelines
http://www.irs.gov/irm/part4/irm_04-048-006.html

Internal Revenue Manual: Business Valuation Guidelines
http://www.irs.gov/irm/part4/irm_04-048-004.html

Note: Also see IRS Revenue Ruling 59-60 (on Westlaw or Lexis) for additional guidance on appraisals of business interests, and IRS Revenue Ruling 93-12 (on Westlaw or Lexis) for additional guidance on transfers of business interests among family members with aggregate control.

Discount for Lack of Marketability Job Aid for IRS Valuation Professionals
http://www.irs.gov/pub/irs-utl/dlom.pdf

Internal Revenue Manual: Intangible Property Valuation Guidelines
http://www.irs.gov/irm/part4/irm_04-048-005.html

Note: Also see IRS Revenue Ruling 65-192 (on Westlaw or Lexis) for additional guidance on appraisals of intangible assets.

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Internal Revenue Manual: Tangible Personal Property Valuation Guidelines
http://www.irs.gov/irm/part4/irm_04-048-003.html

Internal Revenue Manual: Valuation Assistance for Cases Involving Works of Art
http://www.irs.gov/irm/part4/irm_04-048-002.html

APPENDIX B[5]

Appraiser Retention Checklist

- ☐ Do they have the requisite professional credentials and are they current?
- ☐ What is their educational background?
- ☐ How long have they been practicing?
- ☐ Have they ever been disciplined or disqualified by a professional organization, a court, the IRS?
- ☐ Is valuation their primary vocation?
- ☐ Who is actually going to do the bulk of the work on a given assignment?
- ☐ What is their experience supporting their opinions at audit, appeals, and trial?
- ☐ Have they valued the subject type of business before?
- ☐ Do they have professional liability insurance and in what amount?
- ☐ What is their record retention practice and policy?
- ☐ Do they plan to interview the client and/or conduct a site visit of the subject business?
- ☐ Have they dealt before with legal issues presented?
- ☐ Have you seen a sample of their reports?
- ☐ Does the engagement letter clearly identify:
  - The client
  - The entity to be appraised
  - The specific interest to the be appraised
  - The purpose of the appraisal
  - The appropriate standard of value, including the appropriate statutory reference
  - The form of report to be produced and if it will be USPAP compliant
  - The timing of report delivery and acknowledgement of specific deadlines (such as a Form 706 filing date)
  - In an estate tax matter, whether appraisals will be done as of both the date of death and alternate valuation date

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- The proposed fee structure (fixed or hourly)
- A checklist of information required to conduct the appraisal

APPENDIX C
Appraisal Report Checklist[6]

- ☐ Addressed to the right party
- ☐ Clear statement of assignment
- ☐ Intended user and use identified correctly
- ☐ Entity and specific interest appraised identified
- ☐ Valuation date(s)
- ☐ Appropriate standard of value identified
- ☐ Appraiser certification and signature(s)
- ☐ Identification of any assumptions or limiting conditions
- ☐ USPAP compliance statement
- ☐ Should be opinion of appraiser signing report - not someone else
- ☐ Report not drafted by attorney or other advisor
- ☐ Discussion of legal assumptions
- ☐ Contains all elements needed for its purpose
    - Substantiation of charitable deductions
    - Adequate disclosure
    - Other
- ☐ Description of business and all relevant facts
    - History
    - Type of entity
    - Nature of business
    - Capitalization and ownership
    - Management and directors
    - Products and services
    - Customers and markets served
    - Facilities

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- Competition

☐ Historical financial analysis

- Income statement history
- Balance sheet history
- Ratio analysis
- Comparison to industry averages

☐ Adjustments to reported earnings (as needed and appropriate)

☐ Relevant economic and industry analysis

☐ Overview of appraisal process employed

☐ Description of methods considered but not used and why

☐ Description of methods used and why

☐ Application of reasonable valuation methodology

☐ Detailed exhibits

☐ Explicit presentation of all calculations leading to stated opinions

☐ Presentation of basis for all underlying assumptions and valuation variables

☐ Application of valuation discounts

- Description of methodology
- Empirical evidence
- Nexus to specific fact pattern

☐ Sources of information used

☐ Studies or other data cited

☐ Summary of appraiser qualifications

☐ General

- Does it have a clear, unbiased tone?
- Does is disclose and deal with "bad facts" as well as "good facts"
- Is it free of grammatical, mathematical, and typographical errors?
- Should be clear and understandable

(These can compromise the "authority" of an otherwise sound opinion)