MLI #7 Charitable Deductions Under IRC §170

SUMMARY

Subject to certain limitations, taxpayers can take deductions from their adjusted gross incomes for contributions of cash or other property to or for the use of charitable organizations.[1] In order to take a charitable deduction, taxpayers must contribute to a qualifying organization[2] and must substantiate contributions of $250 or more. Litigation generally arises over one or more of these four issues:

- Whether the organization to which a donation is made is charitable;
- Whether contributed property qualifies as a charitable contribution;
- Whether the amount taken as a charitable deduction equals the fair market value of the property contributed; and
- Whether the taxpayer has substantiated the contribution.

We reviewed 40 cases decided between June 1, 2012, and May 31, 2013, with charitable deductions as a contested issue. The IRS prevailed in 32 cases, with taxpayers prevailing in five cases and with the remaining three cases resulting in split decisions. Taxpayers represented themselves (appearing *pro se*) in 18 of the 40 cases (45 percent), with one of these *pro se* cases resulting in a split decision and the IRS prevailing in the remaining 17 cases.

PRESENT LAW

Taxpayers must itemize in order to claim any charitable contribution deduction[3] and generally are able to take a deduction for charitable contributions made within the taxable year. Transfers to charitable organizations are deductible only if they are contributions or gifts[4] and not if they are payments for goods or services.[5] A contribution or gift will be allowed as a deduction under IRC § 170 only if it is made "to" or "for the use of" a qualifying organization.[6]

For individuals, charitable contribution deductions are generally limited to 50 percent of the taxpayer's contribution base (adjusted gross income computed without regard to any net operating loss carryback to the taxable year under IRC § 172).[7] However, subject to certain limitations, individual taxpayers can carry forward unused charitable contributions in excess of the 50 percent contribution base for up to

1 Internal Revenue Code (IRC) § 170.

2 To claim a charitable contribution deduction, a taxpayer must establish that a gift was made to a qualified entity organized and operated exclusively for an exempt purpose, no part of the net earnings of which inures to the benefit of any private shareholder or individual. IRC § 170(c)(2).

3 IRC §§ 63(d) and (e); 161; 170(a).

4 The Supreme Court of the United States has defined "gift" as a transfer proceeding from a "detached and disinterested generosity." *Comm'r v. Duberstein*, 363 U.S. 278, 285 (1960).

5 Treas. Reg. § 1.170A-1(g) (no deduction for contribution of services).

6 IRC § 170(c).

7 IRC §§ 170(b)(1)(A), (G).

five years.[8] Corporate charitable deductions are generally limited to ten percent of the taxpayer's taxable income.[9] Taxpayers cannot deduct services that they offer to charitable organizations; however, incidental expenditures incurred while serving a charitable organization and not reimbursed may constitute a deductible contribution.[10]

Substantiation

For cash contributions, taxpayers must maintain receipts from the charitable organization, copies of cancelled checks, or other reliable records showing the name of the organization, the date, and the amount contributed.[11] Deductions for single charitable contributions of $250 or more are disallowed in the absence of a contemporaneous written acknowledgement from the charitable organization.[12] The donor is generally required to obtain the contemporaneous written acknowledgment no later than the date he or she files the return for the year in which the contribution is made, and it must include:

- The name of the charitable organization;
- The amount of the cash contribution;
- A description (but not the value) of any non-cash contribution;
- A statement that no goods or services were provided by the organization in return for the contribution, if that was the case;
- A description and good faith estimate of the value of goods or services, if any, that an organization provided in return for the contribution; and
- A statement that goods or services, if any, that an organization provided in return for the contribution consisted entirely of intangible religious benefits, if that was the case.[13]

For each contribution of property other than money, taxpayers generally must maintain a receipt showing the name of the recipient, the date and location of the contribution, and a description of the property.[14] When property other than money is contributed, the amount of the allowable deduction is the fair market value of the property at the time of the contribution.[15] This general rule is subject to certain exceptions that in some cases limit the deduction to the taxpayer's cost basis in the property.[16] Moreover, for claimed contributions exceeding $5,000, a qualified appraisal prepared by a qualified appraiser is required.[17]

8 IRC § 170(d)(1).

9 IRC § 170(b)(2).

10 Treas. Reg. § 1.170A-1(g). Meal expenditures in conjunction with offering services to qualifying organizations are not deductible unless the expenditures are away from the taxpayer's home. *Id*. Likewise, travel expenses associated with contributions are not deductible if there is a significant element of personal pleasure involved with the travel. IRC § 170(j).

11 Treas. Reg. § 1.170A-13(a)(1).

12 IRC § 170(f)(8); *see also* Treas. Reg. § 1.170A-13(f).

13 IRS Pub. 1771, *Charitable Contributions Substantiation and Disclosure Requirements* (Rev. 7-2013).

14 Treas. Reg. § 1.170A-13(b)(1)(i)-(iii).

15 Treas. Reg. § 1.170A-1(c)(1).

16 *Id*. Note that the deduction is reduced for certain contributions of ordinary income and capital gain property. *See* IRC § 170(e).

17 IRC § 170(f)(11)(C). A qualified appraisal is defined in IRC § 170(f)(11)(E)(i), and a qualified appraiser is defined in IRC § 170(f)(11)(E)(ii).

ANALYSIS OF LITIGATED CASES

We reviewed 40 decisions entered between June 1, 2012, and May 31, 2013, involving charitable contribution deductions claimed by taxpayers. Table 7 in Appendix III contains a detailed list of those cases. Of the 40 cases, 25 cases involved the taxpayers' substantiation (or lack thereof) of the claimed contribution, 14 cases involved a dispute over the valuation of property contributed, and four cases involved the issue of whether the recipient was a qualified charitable organization. Various other challenges were raised by the IRS primarily involving claimed qualified conservation contribution deductions.

Qualifying Charitable Organization

A gift will qualify as a deductible contribution under IRC § 170 only if it is made "to" or "for the use of" a qualifying organization.[18] Courts rejected claimed charitable deductions in four cases for taxpayer failure to establish that the donee organization qualified as a charitable organization under IRC § 170(c). In *Gunkle v. Commissioner*,[19] the taxpayers deducted amounts for claimed charitable contributions to a church that they had operated. The taxpayer husband dissolved the church three years prior to the year for which the charitable deduction was claimed, and the IRS issued notification to the taxpayers at the time of dissolution that the church's charitable status had been terminated.[20] The court noted that for a church to be characterized as a qualifying organization under IRC § 170(c), it must meet organizational and operational tests in IRC § 501(c)(3).[21] The court held that the deductions were inappropriate because the taxpayers did not provide evidence that the organization qualified as a charitable organization under IRC § 501(c)(3).[22]

Qualified Contribution

For a gift to constitute a qualified contribution under IRC § 170, the donor-taxpayer must possess a transferrable interest in the property and intend to irrevocably relinquish all rights, title, and interest to the property without any expectation of some benefit in return.[23] For example, in *Patel v. Commissioner*,[24] the taxpayers claimed a charitable deduction contribution for donating their existing house to the local fire department but maintained possession of the real property on which the house stood. The fire department subsequently burned the house down in a training exercise. The IRS disallowed the deduction, believing that the taxpayers donated merely a right for the fire department to use the property, and therefore the taxpayers only contributed a partial interest in the property. The court noted that "[w]here a taxpayer contributes to a charity an interest in a building that is part of the land under State law but retains all title to and interest in the remaining land, the taxpayer has donated less than his entire interest

18 IRC § 170(c).

19 T.C. Memo. 2012-305, *appeal filed* (5th Cir. Apr. 5, 2013).

20 *Id*.

21 *Id*.

22 *Id*.

23 IRC § 170(f)(3)(A) generally requires that taxpayers relinquish all rights, title, and interest in property contributed.

24 138 T.C. 395 (2012).

in the land."[25] The court disallowed the deduction concluding that the taxpayers donated only a partial interest in their property, namely the right to use the existing house for training purposes.[26]

As exemplified in the *Patel* holding, taxpayers generally are not permitted to deduct gifts of property consisting of less than the taxpayers' entire interest in that property.[27] Nevertheless, taxpayers may deduct the value of a contribution of a partial interest in property that constitutes a "qualified conservation contribution,"[28] known more colloquially as a conservation easement. A contribution will constitute a qualified conservation contribution only if it is of a "qualified real property interest" made to a "qualified organization" "exclusively for conservation purposes."[29]

In *Belk v. Commissioner*,[30] the Tax Court addressed for the first time what constitutes a "qualified real property interest."[31] In that case, the taxpayers (a husband and wife) executed a conservation easement in favor of a qualifying organization prohibiting the taxpayers' entire golf course from being used for "residential, commercial, institutional, industrial, or agricultural purposes."[32] The conservation easement agreement, however, permitted the taxpayers and donee to change what property would be subject to the easement, presumably to allow the taxpayers to reconfigure the golf course.[33] As a result, the court determined that the contribution comprised neither the entire interest of the donor nor a remainder interest. The court then examined whether the contribution qualified as a use restriction granted in perpetuity, which is a permitted type of qualified real property interest described in IRC § 170(h)(2)(C).[34] Nevertheless, the court concluded that there was no agreement that the golf course would not be developed in the future because the taxpayers had the ability to remove portions of the golf course and replace them with property currently not subject to the conservation easement.[35] Accordingly, the substitution provision disqualified the conservation easement from characterization as a qualified real property interest and by extension as a qualified conservation contribution.[36]

A conservation easement subject to a mortgage will not qualify as a qualified conservation contribution unless the taxpayer obtains consent from the mortgagee to subordinate its interest in the property to the easement.[37] In *Minnick v. Commissioner*,[38] the taxpayer donated a conservation easement to a qualified

25 138 T.C. 406 (2012).

26 As support for its holding, the Tax Court looked to similar cases, explaining "As with this case, taxpayers usually grant a fire department license to destroy a building on their land because they wish to have it removed from the land, either to increase the value of the land (*Scharf*) or so that they may construct a new building on the land (*Rolfs*)." *Patel*, 138 T.C. at 415 (citing *Scharf v. Comm'r*, T.C. Memo. 1973-265, and *Rolfs v. Comm'r*, 135 T.C. 471 (2010)). For a further discussion of *Rolfs*, see also National Taxpayer Advocate 2011 Annual Report to Congress 673-674.

27 IRC § 170(f)(3).

28 IRC § 170(b)(1)(E).

29 IRC § 170(h)(1)(A)-(C).

30 140 T.C. 1 (2013), *reconsideration denied*, T.C. Memo. 2013-154.

31 A "qualified real property interest" is defined as any of the following interests in real property: (A) the entire interest of the donor other than a qualified mineral interest, (B) a remainder interest, and (C) a restriction (granted in perpetuity) on the use which may be made of the real property. IRC § 170(h)(2)(A)-(C).

32 *Belk*, 140 T.C. at 3.

33 *Id*.

34 *See also* Treas. Reg. § 1.170A-14(b)(2).

35 *Belk*, 140 T.C. at 10-11.

36 *Id*. at 14-15.

37 Treas. Reg. § 1.170A-14(g)(2).

38 T.C. Memo. 2012-345.

donee but did not execute an agreement under which the mortgagee of the subject property subordinated its interest in the property to the easement until after the conservation easement was granted. The court held that the taxpayer was not entitled to a charitable contribution deduction for the conservation easement donation because a subordination agreement was not in place at the time that the conservation easement was granted. Consequently, during the period when no subordination agreement existed, the mortgagee had the ability to seize the easement in the event of default on the mortgage, thus owning the land free of the conservation easement.[39] The court also noted that the intent of the taxpayer to seek subordination of the mortgagee's interest in the property at the time the conservation easement was granted was irrelevant.[40]

Valuation

In order to receive a deduction for most contributions of property in excess of $5,000, taxpayers must provide a qualified appraisal of the property that is donated.[41] In *Estate of Evenchik v. Commissioner*,[42] the taxpayers donated shares in a corporation to a charity and reported a charitable contribution deduction exceeding $5,000. The taxpayers provided a qualified appraisal of the corporation's two assets for which the stock was issued, rather than a valuation of the donated stock itself.[43] In addition to other shortcomings in the qualified appraisal,[44] the court concluded that not valuing the property actually donated is a defect that "goes to the essence of the information required" because without knowing the specific property contributed, the Commissioner is unable to determine whether the contributed property interest was overvalued by the taxpayers.[45] Thus, the court denied the deductions claimed with respect to the charitable contributions of stock.

Although charitable contribution deductions are generally disallowed when the taxpayer receives a benefit for a donation, a taxpayer who receives goods or services in exchange for a contribution of property may still be entitled to a charitable contribution deduction if he or she makes a contribution that exceeds the fair market value of the benefit received and makes the excess payment with the intention of making a gift.[46] In *Boone Operations Co., L.L.C. v. Commissioner*,[47] the taxpayer sold fill dirt to the City of Tucson at what the taxpayer claimed to be a price below fair market value. After finding that the taxpayer did not provide a contemporaneous written acknowledgement from the city as required by IRC § 170(f)(8), the court noted that the taxpayer failed to prove that the fair market value of the fill dirt exceeded the amount received by the taxpayer.[48] The court focused particularly on defects in the taxpayer's expert's appraisals of the fill dirt including, *inter alia*, inconsistent valuation methodologies applied to different orders of dirt delivered to the city, the inclusion of labor and delivery costs in the valuation calculation, and failure

39 T.C. Memo. 2012-345.

40 *Id*.

41 IRC § 170(f)(11)(C).

42 T.C. Memo. 2013-34.

43 *Id*.

44 Treas. Reg. § 1.170A-13(c)(3)(ii) contains a detailed set of requirements that a qualified appraisal must contain. The two appraisals that the taxpayers provided failed to meet all of those requirements.

45 *Estate of Evenchik*, T.C. Memo. 2013-34.

46 Treas. Reg. § 1.170A-1(h).

47 T.C. Memo. 2013-101.

48 *Id*.

to introduce evidence of the claimed highest and best use of the fill dirt.[49] Consequently, the Tax Court sustained the IRS's determination to disallow the claimed charitable contribution deductions.

Substantiation

Twenty-five cases involved the substantiation of deductions for charitable contributions. When determining whether or not a claimed charitable contribution deduction is adequately substantiated, courts tend to follow a strict interpretation of IRC § 170. For example, in *Longino v. Commissioner*,[50] the taxpayer alleged that he made a cash contribution of $25,000 to a qualifying organization and claimed a deduction for the donation. The court denied the deduction because the taxpayer failed to provide a contemporaneous written acknowledgement from the donee indicating whether or not it furnished any goods or services in exchange for the cash as required under IRC § 170(f)(8)(B)(ii).[51]

Further, in *Riether v. United States*,[52] the taxpayers donated Chevrolet vans to religious organizations and claimed charitable contribution deductions for the donations. The court denied the deductions because the taxpayers did not submit a "qualified appraisal" meeting each of the requirements as described in Treasury Regulation § 1.170A-13(c)(3)(ii).[53]

Although gifts of charitable contributions of $250 or more must be substantiated by a contemporaneous written acknowledgement from the donee organization, that acknowledgement need not take any particular form. For example, in *Averyt v. Commissioner*,[54] the court addressed the question of whether a conservation easement deed can function as a contemporaneous written acknowledgment. In that case, the taxpayers conveyed a conservation easement to a charitable organization so as to protect the land as a wildlife habitat.[55] The IRS challenged the taxpayers' charitable contribution deduction, arguing that the taxpayers' contemporaneous written acknowledgment did not comply with the requirements under IRC § 170(f)(8).[56] Among other things, the taxpayers contended that the conservation deed constituted a satisfactory contemporaneous acknowledgment. The court observed that the conservation deed contained a signature from a representative of the qualifying donee, provided a detailed description of the donated property, and was executed contemporaneously with the contribution.[57] Moreover, the court observed that the conservation deed stated the property was an unconditional gift for which no consideration was received. The court held that, taken as a whole, the conservation deed met all requirements under IRC § 170(f)(8) and served as a satisfactory contemporaneous written acknowledgement to support the charitable contribution deduction.[58]

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49 T.C. Memo. 2013-101.

50 T.C. Memo. 2013-80.

51 *Id*.

52 *Riether v. Comm'r*, 919 F. Supp. 2d 1140 (D.N.M. 2012).

53 A "qualified appraisal" requires the following: a detailed description of the property, the physical condition of the property, the date of contribution, the terms of any agreement by the donor or donee relating to the use, sale, or disposition of the property, the name, address, and identification number of the appraiser, the appraiser's qualifications, a statement that the appraiser prepared the appraisal for income tax purposes, the date on which the appraiser appraised the property, the appraised fair market value of the property, the method of valuation used, and the specific basis for the valuation. Treas. Reg. § 1.170A-13(c).

54 T.C. Memo. 2012-198.

55 *Id*.

56 *Id*.

57 *Id*.

58 T.C. Memo. 2012-198.

Charitable Contribution Deduction Limitations: Fair Market Value v. Cost Basis

The manner in which a taxpayer holds his or her donated property prior to donation may limit a charitable contribution to the donated property's cost basis.[59] In *Flood v. Commissioner*,[60] the taxpayers operated a real estate business, which included purchasing and selling vacant lots. The taxpayers donated 11 of the lots to charity and claimed charitable contributions consistent with the fair market value of the lots.[61] The court, however, determined that the charitable contributions were inappropriate because the donated lots had been purchased as part of the taxpayers' business venture and only a cost-basis deduction is allowable when property held primarily for sale to customers in the ordinary course of business is later donated.[62]

A charitable deduction is also allowable for the appreciated portion of long-term capital gain[63] property. Nevertheless, if the property is not held as a capital asset for more than one year, the deduction is limited to the taxpayer's basis in the property at the time of the property's contribution.[64] In *Williams v. Commissioner*,[65] the court was required to determine whether execution by the taxpayer of an Art Purchase Agreement triggered the holding period required for long-term capital gain. In that case, the taxpayer signed an agreement to purchase unidentified artwork that was to be donated to charitable organizations.[66] Upon execution of the agreement, the taxpayer did not obtain title to the unidentified artwork, paid only five percent of the purchase price with the remainder being due when the taxpayer took physical possession of the artwork, had no obligation to honor the contract, and bore none of the expenses and risk in the transaction.[67] The court held that the Art Purchase Agreement was not a contract for sale but rather an option contract and that the date on which the taxpayer actually paid for and acquired a present interest in the art was the date that must be used to calculate the holding period for purposes of determining if the property was long-term capital gain property.[68] The holding period when measured from this date was less than one year; consequently, the taxpayer's charitable contribution deduction for donating the art was limited to his basis in the property.[69]

59 IRC § 170(e).

60 T.C. Memo. 2012-243.

61 *Id*.

62 *Id*.

63 "Long-term capital gain" means "gain from the sale or exchange of a capital asset held for more than one year, if and to the extent such gain is taken into account in computing gross income." IRC § 1222(3).

64 IRC § 170(e)(1)(A).

65 498 F. App'x 284 (4th Cir. 2012), *aff'g* T.C. Memo. 2011-89.

66 *Id.*

67 *Id*.

68 *Id*.

69 *Id*.

CONCLUSION

IRC § 170 and the accompanying Treasury Regulations provide detailed requirements which must be complied with strictly and become more stringent as deductions increase in size. As one court has observed, the "hoops become longer and tighter as the value of donated property rises."[70] Taxpayers must be careful to include every statutorily required item of information in any mandated agreement and ensure the integrity of any necessary valuations of donated property. Taxpayers donating conservation easements would be advised to pay particular attention to the technicalities of qualified conservation contributions, especially where mortgages are attached to the donated easement and where easement deeds may be ambiguous as to whether use restrictions are truly granted in perpetuity to the donee.

70 *Estate of Evenchik v. Comm'r*, T.C. Memo. 2013-34.