

MLI
#8

Charitable Deductions Under IRC § 170

SUMMARY

Subject to certain limitations, taxpayers can take deductions from their adjusted gross incomes (AGIs) for contributions of cash or other property to or for the use of charitable organizations.¹ To take a charitable deduction, taxpayers must contribute to a qualifying organization² and substantiate contributions of \$250 or more.³ Litigation generally occurred in this reporting cycle in the following three areas:

- Substantiation of the charitable contribution;
- Valuation of the charitable contribution; and
- Requirements for a qualified conservation easement.

TAS reviewed 26 cases decided between June 1, 2015, and May 31, 2016, with charitable deductions as a contested issue. The IRS prevailed in 19 cases, taxpayers prevailed in three cases, and the remaining four cases resulted in split decisions. Taxpayers represented themselves (appearing *pro se*) in ten of the 26 cases (about 38 percent), with one taxpayer prevailing in full, the IRS in seven cases, and the remaining two resulted in split decisions.

TAXPAYER RIGHTS IMPACTED⁴

- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Appeal the IRS Decision in an Independent Forum*
- *The Right to a Fair and Just Tax System*

PRESENT LAW

Charitable contributions made within the taxable year are generally deductible by taxpayers, but in the case of individual taxpayers, a taxpayer must itemize deductions from income on his or her income tax return in order to deduct the contribution.⁵ Transfers to charitable organizations are deductible only if they are contributions or gifts,⁶ not payments for goods or services.⁷ 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.⁸

1 Internal Revenue Code (IRC) § 170.

2 To claim a charitable contribution deduction, a taxpayer must establish that he or she made a gift 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 § 170(f)(8)(A).

4 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).

5 IRC §§ 63(d) and (e), 161, and 170(a).

6 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).

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

8 IRC § 170(c).

For individuals, charitable contribution deductions are generally limited to 50 percent of the taxpayer's contribution base (AGI computed without regard to any net operating loss carryback to the taxable year under IRC § 172).⁹ However, subject to certain limitations, individual taxpayers can carry forward unused charitable contributions in excess of the 50 percent contribution base for up to five years.¹⁰ Corporate charitable deductions are generally limited to ten percent of the taxpayer's taxable income and are also available for carryforward for up to five years, subject to limitation.¹¹ 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.¹²

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.¹³ Deductions for single charitable contributions of \$250 or more are disallowed in the absence of a contemporaneous written acknowledgement from the charitable organization.¹⁴

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 organization;
- The amount of cash contribution;
- A description (but not the value) of 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.¹⁵

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.¹⁶ When taxpayers contribute property other than money, the amount of the allowable deduction is the fair market value of the property at the time of the contribution.¹⁷ This general rule is subject to certain exceptions that in some cases limit the deduction to the taxpayer's cost basis in the property.¹⁸ For

9 IRC §§ 170(b)(1)(A) and (G).

10 IRC § 170(d)(1).

11 IRC §§ 170(b)(2) and (d)(2).

12 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).

13 Treas. Reg. § 1.170A-13(a)(1).

14 IRC § 170(f)(8). See also Treas. Reg. § 1.170A-13(f).

15 IRS Pub. 1771, *Charitable Contributions Substantiation and Disclosure Requirements* (Rev. 3-2016).

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

17 Treas. Reg. § 1.170A-1(c)(1).

18 Treas. Reg. § 1.170A-1(c)(1). Note that the deduction is reduced for certain contributions of ordinary income and capital gain property. See IRC § 170(e).

claimed contributions exceeding \$5,000, the taxpayer must obtain a qualified appraisal prepared by a qualified appraiser.¹⁹

ANALYSIS OF LITIGATED CASES

TAS reviewed 26 decisions entered between June 1, 2015, and May 31, 2016, involving charitable contribution deductions claimed by taxpayers. Table 8 in Appendix 3 contains a detailed list of those cases. Of the 26 cases, the most common issues were: substantiation (or lack thereof) of the claimed contribution (12 cases), value of the property contributed (five cases), and contribution of an easement (nine cases).²⁰

Qualified Conservation 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.²¹ Taxpayers generally are not permitted to deduct gifts of property consisting of less than the taxpayer's entire interest in that property.²² Nevertheless, taxpayers may deduct the value of a contribution of a partial interest in property that constitutes a "qualified conservation contribution,"²³ also known 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."²⁴ All three conditions must be satisfied for the donation to be deemed a "qualified conservation contribution."

In *Carroll v. Commissioner*, the taxpayers, a married couple who filed a joint return, attempted to donate a conservation easement on the property on which they resided, and would continue to reside, to the Maryland Environmental Trust and the Land Preservation Trust, Inc. as joint easement holders.²⁵ In tax years 2005, 2006, 2007, and 2008, the taxpayers claimed a charitable contribution deduction for 2005 and carryover deductions for the subsequent years. The IRS disallowed the non-cash charitable contributions and issued a notice of deficiency. The easement agreement contained language addressing the valuation of the share of the donee organizations in the event of the extinguishment of the easement.²⁶

Treasury Regulation § 1.170A-14(g)(6) specifically addresses the valuation of a conservation easement in the event of extinguishment in order to satisfy the "in perpetuity" requirement of IRC § 170 for a qualified conservation easement.²⁷ The regulations require that a donee receive a vested property interest of the fair market value of the proportionate value of the conservation easement at the time

19 IRC § 170(f)(11)(C). "Qualified appraisal" and "qualified appraiser" are defined in IRC §§ 170(f)(11)(E)(i) and (ii), respectively.

20 Cases addressing more than one described issue are counted for each issue. For example, cases addressing the valuation of easements are counted once as a valuation issue case and again as a conservation easement issue case. As a result, the breakdown of case issues above will not add up to the total number of cases reviewed by TAS.

21 IRC § 170(f)(3).

22 IRC § 170(f)(3).

23 IRC § 170(b)(1)(E).

24 IRC § 170(h)(1)(A)-(C). IRC § 170(h)(4)(B)(i) provides that, in the case of a contribution that consists of a restriction with respect to the exterior of a certified historic structure, the contribution must satisfy two requirements to be considered "exclusively for conservation purposes": 1) the interest must include a restriction which preserves the entire exterior of the building, and 2) the interest must prohibit any change to the exterior of the building that is inconsistent with the historic character of the exterior.

25 *Carroll v. Comm'r*, 146 T.C. No. 13 (2016).

26 *Id.*

27 See Treas. Reg. § 1.170A-14(g)(6) and IRC § 170(h)(5)(A).

of the donation for purposes of determining the proceeds awarded to the donee in the event of an extinguishment of the easement and the sale of the property.²⁸ For example, if the fair market value of an entire property on the date of the donation was two million dollars and the value of the conservation easement was one million dollars, the donee organization is entitled to a 50 percent interest in the proceeds of the sale of the entire property should the easement be extinguished. In the easement agreement between taxpayers and the donee organizations, taxpayers set the value of the easement, for purposes of extinguishment, at the value of the deduction allowed for federal income tax purposes and subject to change due to any disallowance by the IRS or subsequent court proceedings.²⁹ The Tax Court held that this language failed to satisfy the in perpetuity aspect of a qualified conservation easement since the value was fixed to the allowed charitable deduction amount and not the fair market value, and a disallowance of the deduction with an extinguishment of the easement would result in a windfall for the taxpayers, or their heirs, since the value of the deduction would then be zero, leaving the donee organizations with no entitlement to the extinguishment proceeds.³⁰

A conservation easement must be protected in perpetuity for it to qualify as a “qualified conservation contribution” pursuant to the IRC and Treasury regulations.³¹ In last year’s Most Litigated Issue on IRC § 170, we discussed the *Mitchell*³² case for the premise that a mortgage must be subordinated to the easement at the time of the donation, which has now been cited in other circuits.³³

Conservation Easement Valuation

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.³⁴ In *Palmer Ranch Holdings LTD v. Commissioner*, the corporate taxpayer owned an 89 acre parcel of land in Sarasota County, Florida, which was home to a bald eagle’s frequent route from a nest to waterways.³⁵ The corporation donated a conservation easement to the county and took a deduction for over \$25 million.³⁶ The IRS disallowed the deduction on the basis that the taxpayer had overvalued the worth of the easement.³⁷ The Tax Court agreed with the taxpayer’s characterization of the highest and best use of the property; however, it still rejected the valuation provided by the taxpayer.³⁸ Both the taxpayer and the IRS appealed the Tax Court’s decision to the Eleventh Circuit.³⁹

In determining the fair market value of a conservation easement, the “before and after” valuation, which compares the values of the property with and without the easement, is generally accepted.⁴⁰ The valuation also takes into consideration “any effect from zoning, conservation, or historic preservation

28 Treas. Reg. § 1.170A-14(g)(6)(ii).

29 *Carroll v. Comm’r*, 146 T.C. No. 13 (2016).

30 *Id.*

31 IRC § 170(h)(1); Treas. Reg. § 1.170A-14(g).

32 775 F.3d 1243 (10th Cir. 2015), *aff’g* 138 T.C. 324 (2012).

33 National Taxpayer Advocate 2015 Annual Report to Congress 515-22 (Most Litigated Issue: *Charitable Deductions Under IRC § 170*). See *Minnick v. Comm’r*, 796 F.3d 1156 (9th Cir. 2015), *aff’g* T.C. Memo. 2012-345.

34 IRC § 170(f)(11)(C).

35 812 F.3d 982 at 985 (11th Cir. 2016), *aff’g in part, rev’g in part, and remanding for further proceedings* T.C. Memo. 2014-79.

36 *Id.*

37 *Id.*

38 *Id.* at 992-93.

39 *Id.* at 993.

40 See *Hilborn v. Comm’r*, 85 T.C. 677, 688 (1985); Treas. Reg. § 1.170A-14(h)(3)(i).

laws that already restrict the property's potential highest and best use."⁴¹ Both the taxpayer and the IRS relied heavily on expert opinion testimony as to the pre- and post-contribution values of the property. Ultimately, however, the Tax Court agreed with the taxpayer's experts' view that the highest and best use of the property was moderate density residential zoning. The court characterized the argument from the IRS as being based on hearsay evidence from minutes taken at a board meeting years prior, where a zoning board had speculated on the use of the parcel at hand when deciding a zoning issue related to a contiguous property.⁴² Although the Tax Court accepted the highest and best use of the property as presented by the taxpayer's experts, it nonetheless reduced the value of the easement from the proposed \$25,200,000 to \$21,005,278.⁴³ The Eleventh Circuit affirmed the Tax Court's finding of the highest and best use of the property, but rejected the Tax Court's proposed reduction of the value of the property.⁴⁴ The Eleventh Circuit found error in the Tax Court's failure to explain its departure from the comparable sales method of valuation, which was proposed by both the taxpayer and the IRS, and found error in the Tax Court using evidence outside the record to value the property.⁴⁵ As a result, the Eleventh Circuit remanded the case to the Tax Court to either use the comparable sales method or explain the departure method, and to stick to only that evidence which was on record for the purposes of making a valuation determination.⁴⁶

Substantiation

Twelve cases involved the substantiation of deductions for charitable contributions. When determining whether a claimed charitable contribution deduction is adequately substantiated, courts tend to follow a strict interpretation of IRC § 170. Treasury Regulation § 1.170A-13(a)(1) requires the taxpayer to maintain a canceled check or a receipt from the donee organization to substantiate a cash contribution.⁴⁷ In the absence of a canceled check or a receipt from the donee organization, the taxpayer must maintain other reliable written records showing the name of the donee and the date and the amount of the contribution.⁴⁸

In *Gracia v. Commissioner*, the married taxpayers filed a timely tax return and claimed \$2,415 in donations which the IRS accepted, and additional contributions of \$390 for travel expenses incurred in performing services for their church, \$3,560 for clothing donations, \$5,350 for cash and property donations.⁴⁹ The IRS selected the return for examination. The taxpayers were able to produce one receipt for a \$400 cash donation during the trial. The court found no substantiation for any of the other disputed claimed charitable contributions and disallowed all of them, despite the taxpayers attempting

41 Treas. Reg. § 1.170A-14(h)(3)(ii).

42 812 F.3d 982 at 992 (11th Cir. 2016), *aff'g in part, rev'g in part, and remanding for further proceedings* T.C. Memo. 2014-79.

43 *Id.* at 993.

44 *Id.* at 1002.

45 *Id.* at 1003.

46 *Id.*

47 The IRS issued a Notice of Proposed Rulemaking on Sept. 17, 2015, that would implement the exception to the "contemporaneous written acknowledgment" requirement for substantiating charitable contribution deductions of \$250 or more and would provide rules concerning the time and manner for donee organizations to file information returns that report the requirement information about contributions. See Prop. Treas. Reg. § 1.170A-13(f)(18)-(19), 80 Fed. Reg. 55,802 (Sept. 17, 2015). On Jan. 8, 2016 the IRS withdrew the proposed regulations after receiving numerous comments concerned about the potential for identity theft when providing a donee organization donors' taxpayer identification numbers and requiring the donee to maintain that information for several years. IRS, *Withdrawal of Notice of Proposed Rulemaking*, FR Doc. 2016-189 (Jan. 8, 2016).

48 Treas. Reg. § 1.107A-13(a)(1)(iii).

49 T.C. Memo. 2016-21.

to create a log of items donated and securing a letter purporting to detail donations to an unattended clothing bin, as neither document was a contemporaneous writing.⁵⁰

CONCLUSION

IRC § 170 and the accompanying Treasury Regulations provide detailed requirements with which taxpayers must strictly comply. The statutory and regulatory requirements to qualify for a deduction become more stringent as deductions increase in size. Most of the charitable contribution cases reviewed this year addressed issues regarding substantiation of contributions or the complex rules governing the donation of a conservation easement.

Due to the complex nature of the rules and regulations surrounding charitable contributions, it is likely that litigation will continue in this area of the law. Taxpayers must carefully follow all aspects of the relevant laws and regulations when attempting to make a charitable contribution. Particularly, taxpayers must pay attention to the requirements for substantiation of a charitable contribution and to the elements of donating a qualified conservation easement.

50 T.C. Memo. 2016-21. The IRS initially allowed \$2,415 in cash charitable contributions claimed on the taxpayers' tax return. At issue in the trial were additional contributions of \$400 in cash, which the taxpayers substantiated at trial: \$390 for travel expenses related to charitable activities, \$3,560 of donated clothing and \$5,350 of additional cash and gifts. The taxpayers were unable to substantiate the latter three items.