



Documents for October 28, 2005 Podcast
Charitable Deductions of Noncash Items
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Two recent cases illustrate the issues regarding “optimistic” valuations and charitable contributions, as well as the importance the courts put on actual sales to determine the validity of appraisals.

Charitable Contribution Valuations

For contributions other than cash, fair market value, subject to certain limitations that serve to exclude generally amounts that would be ordinary income, is normally the key measurement. Fair market value for purposes of charitable contributions is defined by Regulation §1.170A-1(c)(1) as follows:

(2) The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. If the contribution is made in property of a type which the taxpayer sells in the course of his business, the fair market value is the price which the taxpayer would have received if he had sold the contributed property in the usual market in which he customarily sells, at the time and place of the contribution and, in the case of a contribution of goods in quantity, in the quantity contributed. The usual market of a manufacturer or other producer consists of the wholesalers or other

distributors to or through whom he customarily sells, but if he sells only at retail the usual market consists of his retail customers.

Basically, you have the standard “willing buyer/willing seller” standard for valuing the contribution.

Generally, the best evidence of that willing buyer/willing seller amount is an actual sale between such a willing buyer and willing seller. However, since in a charitable contribution situation the property moves from the donor to the charity without a sale, another method most often has to be used. In many cases, an appraisal is required in order to claim the charitable contribution.

However, an appraisal is an attempt to come up with that price at which the property would transfer between the willing buyer and willing seller, and by its nature involves some judgment and discretion. In fact, given recent restrictions added to the deduction for the donation of vehicles, it appears Congress believed some taxpayers and/or promoter are tempted by the nature of appraisals to overstate the value to maximize the charitable deductions

Sales Near Donation Date

If a valuation is challenged by the IRS, the courts have to evaluate the reasonableness of what will often be competing valuations, once provided by the taxpayer and one provided by the IRS. While a number of methods are used to evaluate the appraisal, if there is a sale of the property reasonably close to the valuation date, that tends to have a significant influence on the value the court chooses to apply, absent a clear explanation to account for a change in value.

In two recent cases, *NHUSS Trust* (TC Memo 2005-236) and *Wortmann* (TC Memo 2005-227), sales between willing parties near enough to the donation date caused the court to substantially reduce the charitable contribution deduction allowed to the taxpayer, even though each taxpayer produced their own appraisal. In neither case did the taxpayer offer an explanation for the change in value that the court deemed plausible—rather, the court decided the taxpayer’s appraisal was demonstrated to be flawed by the actual sale.

Donation of a Car

As noted, Congress last year imposed additional restrictions on the donation of vehicles, specifically tying the deduction to the later sale. Part of the reason for that change involved what were widespread reports of a fact pattern very similar to that which was found in *NHUSS Trust*.

The taxpayers in this case donated a van to charity in 2000. The court summarized the basic facts surrounding this donation in this way:

In October of 1996, petitioners purchased a 1996 Ford E150 conversion

van. On October 30, 2000, petitioners donated the van to the Cancer Fund. At the time of the donation, the van had been used in petitioners' furniture business and had approximately 220,000 miles on it,³ and the van had, among other things, a cracked windshield and a broken fender.

At the time of the donation, the Kelley Bluebook indicated generally a wholesale value of \$14,750 and a retail value of \$20,425 for a van of the same year, make, and model.

On November 10, 2000, Mr. Monte Sobrero appraised the van at \$19,750.

At this point, I think most of us might be concerned that this appraisal seems a bit high. The Kelley Blue Book value would have been for a vehicle in average condition—but the court noted that this particular van had noticeable damage (cracked windshield and a broken fender) as well as relatively high mileage (220,000 miles). Most buyers would demand a discount from the “normal” price when buying such a vehicle.

However, the taxpayers did have an appraiser who gave the valuation in question. The court indicated the following about the taxpayer’s appraiser and the nature of his appraisal:

The record does not reflect who hired Mr. Sobrero, how much Mr. Sobrero was paid, or who paid Mr. Sobrero for his appraisal. The record is also unclear as to whether the van was still in petitioners' possession at the time of its appraisal by Mr. Sobrero.

Mr. Sobrero's stated appraisal qualifications include 40 years as a craftsman in metal finishing and paint restoration, 30 years as a licensed automotive dealer in California, 15 years as owner-operator of an automotive shop, 10 years as owner-manager of an automotive leasing and rental business, and certification in the International Automotive Appraisers Association.

Mr. Sobrero's appraisal of petitioners' van consisted of a visual inspection. Mr. Sobrero, however, did not take into account in his appraisal the mileage of the van.

One more fact was deemed important enough for the court to mention—and the reason for this presentation.

On December 16, 2000, 6 weeks after receiving the donated van from petitioners, the van was sold at auction by the Vehicle Donation Processing Center, Inc., for \$6,900.

Now we have the van being sold six weeks after the donation for \$6,900, far less than the \$19,750 appraised value.

The court points out the importance of this fact in its opinion:

Generally, the best evidence of fair market value is an actual sale of the property in an arm's-length transaction within a reasonable time before or after the valuation date. *Berry Petroleum Co. v. Commissioner*, 104 T.C. 584, 637 (1995), affd. 142 F.3d 442 (9th Cir. 1998).

Six weeks after petitioners donated the van, petitioners' van was sold for an amount almost \$13,000 less than Mr. Sobrero's appraisal. In his appraisal, Mr. Sobrero failed to account for the mileage of the van, which mileage, based on petitioner's testimony, would have been approximately 220,000 miles.

On the evidence before us, we conclude that the fair market value of petitioners' van on the date of its donation, for purposes of the claimed charitable contribution deduction, was its \$6,900 sale price in December of 2000.

But the taxpayer had an appraisal from someone who appeared qualified, so certainly no penalty must have applied due to the taxpayer having reasonable cause. Well, that wasn't the case in the court's view. The court indicated that the taxpayer was not allowed to rely on the appraisal when it had such obvious flaws and was so different from the price received in an actual sale a few weeks later. As the court noted in evaluating the applicability of the negligence penalty under §6662(a):

Petitioners unreasonably relied ... on an appraisal that was not credible with regard to the value of the van.

The importance here is to let clients know that the mere fact they have an appraisal does not guarantee either that the charitable deduction will be sustained or, if the appraisal is one that should appear unreasonable to a reasonable person, that it will even be able to shield the taxpayer from penalties in addition to a tax assessment. Similarly, tax professionals have a responsibility to give any appraisal they are given by a client the "smell test" in order to serve the client, rather than simply ceding over the whole issue of the value of the donation to any appraisal that might slide across the preparer's desk.

Importance of Explaining A Change in Value

A slightly different issue arose in the *Wortmann* case. In this case, the taxpayer had acquired a piece of property that had previously been used as a monastery—an unsuccessful one as it turned, which was the main reason the property was for sale.

The taxpayers bought the monastery property for \$75,000 in 1997. They then leased the property to a nonprofit organization for 17 months for \$1, after which they donated the property to the same organization. The donors claimed a value of \$475,000 for the donated property, based on an appraisal the taxpayers obtained. Unlike in the *NHUSS* case, in this case the property in question was not sold by the charity—rather, the problem would become the donor's own purchase of the property 17 months earlier.

In this case, the court looked at not only the taxpayer's appraisals, but also at two other appraisals. Two of the appraisals the court looked at had values that came close to the \$75,000 purchase price, while only the taxpayer's appraisal was out at the \$475,000 level.

The taxpayers attempted to explain away their low price by claiming it wasn't truly a willing seller situation, but rather was a forced sale where the price was depressed because the seller wanted the property to remain used for religious purposes and the monastery itself was losing money. The story, if accepted, could explain the increase in value—but the court didn't accept it. The court stated:

Petitioners argue that the \$75,000 purchase price is not persuasive because it was a "forced sale". We disagree. Although Father Stevens testified that he wanted the property to sell at a price to pay the debts plus a little seed money, there is no evidence of any foreclosure activity or that any creditor had begun any collection action. In fact, although the Monks Nonprofit was experiencing difficulty paying bills and needed to liquidate its assets, the Monks Nonprofit was continuing to make payments on the debt when due in the ordinary course of business. Further, we are mindful that Father Stevens expressed that the subject property must retain its religious purpose. In fact, Father Stevens testified that he would have preferred that the Monks Nonprofit not have sold the subject property at all if there was a risk the subject property would be used for nonreligious purposes. In that case, Father Stevens testified that he would have found another way for the Monks Nonprofit to pay its liabilities.

The evidence in this case shows that Father Stevens, through the Monks Nonprofit, was a willing seller. The Monks Nonprofit would sell at the right price, provided that the purchaser would use the subject property for religious purposes. If no purchaser came along who would use it for religious purposes, Father Stevens was prepared to have the Monks Nonprofit keep the subject property. It turned out, however, that TRY, an unrelated party, did come along and was willing to meet the Monks Nonprofit's conditions and offered a price that the Monks Nonprofit was willing to accept. The Monks Nonprofit was not an entity forced to sell at a depressed value because aggressive creditors were closing in. It found a purchaser who was willing to accept the conditions and who offered to pay a price that the Monks Nonprofit was willing to accept. Hence, we find that the May 1997 sale was between a willing buyer and seller.

Having made this conclusion that the original sale was between a willing buyer and willing seller, the court then turned to the "outlier" appraisal that the taxpayer used to value the contribution.

The court then looked at the IRS's expert in this case. The court was impressed with this appraiser's methods and the report given. As well the court noted that this appraisal came

out relatively close to the purchase price.

The court was not so impressed with the taxpayer's appraiser. First, the court had a problem with this appraiser dismissing the prior sale:

Under the sales comparison approach, Mr. White valued the land only, not the land and improvements. Mr. White identified three sales of property to use as comparable sales, all of vacant land located in or around Neligh or Oakdale, Nebraska, and all purchased for special uses. These special uses included a transformer site, fertilizer plant and storage, and commercial sales and inventory storage. None of Mr. White's comparable sales involved agricultural land or pasture, even though approximately half of the subject property was agricultural land or pasture. Mr. White also did not include the May 1997 sale of the subject property to petitioners through TRY, nor the sale of the 210 acres of the retreat center property sold for \$63,000 in 1996. Mr. White did not include the 1997 sale because he considered the subject property sold for less than what it was worth. Mr. White failed to explain, however, why he considered the subject property sold for less than what it was worth in May 1997. We question this omission.

We are also concerned by Mr. White's reasoning that the prior sale of the subject property should not be included as an indication of value. Mr. White's subjective determination that the property sold for less than it was worth is not sufficient to disregard a prior sale of the exact property to be valued that occurred only 17 months earlier. While property valuation is admittedly inexact, Mr. White's subjective determination to exclude this particular comparable sale, that of the subject property itself, with no further explanation or analysis, causes us considerable concern.

The court was also concerned that when the appraiser used a cost approach, he did not adjust for physical or economic obsolescence:

Under the cost approach, Mr. White, like Mr. Fischer, used the Marshall-Swift method to find the value of the buildings new and then adjusted the value of each structure to account for physical depreciation. Unlike Mr. Fischer, however, Mr. White did not adjust the building value for physical or economic obsolescence. We question why Mr. White did not discount the value for economic and functional obsolescence. Mr. White admitted at trial that economic obsolescence included the inability to operate the property economically, and Mr. White knew that the subject property could not be operated as a monastery on a cost effective basis based on the experiences of the Monks Nonprofit. Yet, faced with these circumstances, Mr. White did not adjust his values for economic obsolescence. Similarly, Mr. White was aware that the subject property was designed as a

monastery and knew the subject property was sold because it was not self-supporting as a monastery. Despite this overwhelming evidence, Mr. White did not adjust his values for functional obsolescence. We believe Mr. White's valuation under the cost approach does not appropriately account for these essential elements.

Finally, the court considered the county assessor's valuation of the property, though a footnote indicated the taxpayer objected that this was wrongly influenced by the prior sale—a reason the court dismissed:

Petitioners contend that the value the Antelope County assessor determined is somehow biased and the assessor was simply attempting to hit a mark of the purchase price. We find this contention unfounded. To the extent the Antelope County assessor considered the prior sale of the subject property when performing the valuation, we find the assessor simply considered it, much as we do, relevant to determine the fair market value. We do not find that the 1997 sale of the subject property improperly controlled the assessor's valuation in any way.

The assessor's valuation was much closer to the IRS's appraisers' report and the purchase price. Given this record, the court came to the following conclusion:

We further find that the record does not support petitioners' position that the subject property was worth \$475,000 at the time of contribution. As explained previously, we found the sale by Father Stevens through the Monks Nonprofit to petitioners was between a willing buyer and seller, not a "distressed" sale. We also place no weight on petitioners' accusation that the Antelope County assessor was somehow inappropriately affected by the actual sale price and correlated the assessed value with the sale price, rather than making an independent determination. Finally, we cannot disregard the conclusions of respondent's expert, an MAI certified appraiser with significant experience appraising property similar to the subject property.

Instead, we have relied on three evidentiary bases showing the determinations of value of the subject property, all of which we find to be credible. The actual sale price, respondent's expert's valuation, and the Antelope County assessment are reasonably close in their ultimate conclusions of value. Petitioners' valuation is the only outlier and is based upon an expert opinion we find dubious and not well supported by valuation methodology. We find that Mr. Fischer's report provides a better indication of the fair market value. It is well reasoned and thorough. In addition, it is consistent with the previous purchase of the subject property 17 months before the valuation date, and the assessed value of the subject

property corroborates this value.

What Does It Mean?

Most of us have heard the old saying in tax matters that “pigs get fatter, hogs get slaughtered” and that saying may very well be seen to apply to these cases. In both cases, the taxpayers claimed a value that was at odds with actual sales. In neither case did the taxpayer give an explanation the court accepted for the difference in value.

A preparer needs to be aware if there is a valuation of a contribution that appears “too good to be true” that the taxpayer wants to use. This is especially true given the IRS’s settlement initiative announced Thursday regarding certain overvaluations in qualified conservation easements described in Notice 2004-41 (<http://www.irs.gov/pub/irs-drop/n-04-41.pdf>) and intellectual property described in Notice 2004-7 (<http://www.irs.gov/pub/irs-drop/n-04-7.pdf>).