

Evaluating the Charitable Contribution Substantiation Rules

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Key Points

- Two Tax Court decisions from May 2012 demonstrate the equitable concerns that arise when the substantiation rules are strictly applied.
- Current substantiation rules depend on the nature and amount of property donated but generally require the taxpayer to have the value of larger contributions certified by a credentialed appraiser before they are donated, to receive a contemporaneous acknowledgment from the donee, and to fill out and attach the Form 8283 to the taxpayer's tax return.
- Congress has addressed the charitable substantiation rules five times in the past 30 years. Each time, Congress has strengthened the rules to try to prevent overvaluation.
- Current and proposed regulations do allow narrow exceptions from strict compliance with some substantiation requirements.
- The Tax Court, at least until recently, has sometimes applied the substantial compliance doctrine to the substantiation requirements.
- Several reforms to these rules are possible, including providing equitable relief for certain gifts, expanding use of advisory councils, making greater use of technology, expanding regulatory exceptions to the rules, permitting deduction only above a floor, and limiting or forbidding deductions for certain property donations.

Introduction

In May 2012, the Tax Court issued two decisions denying taxpayers income tax deductions for contributions to charitable organizations. In *Mohammed, Sr. v. Commissioner*, the taxpayer had donated real property unquestionably worth more than \$15 million to his charitable remainder unitrust in 2003 and 2004. Among other failures, the taxpayer had failed to obtain a qualified appraisal; he, as an experienced real property appraiser, had prepared the appraisal himself, even though he was both donor and recipient of the property. The opinion concluded with this regret:

We recognize that this result is harsh... But the problems of misvalued property are so great that Congress was quite specific about what the charitably inclined have to do to defend their deduction, and we cannot in a single sympathetic case undermine those rules.

Less than two weeks earlier, in *Durden v. Commissioner*, the Tax Court had denied a charitable contribution deduction claimed in 2007 for cash contributions of more than \$25,000 given primarily to the taxpayers' church. The taxpayers had failed to obtain a contemporaneous acknowledgment from the church stating whether any goods or services had been provided in consideration for the contribution, as required by section 170(f)(8)(B) and Treas. Reg. sec. 1.170A-13(f)(2) for any contribution of \$250 or more.

Both these cases sparked outrage. They highlight some of the issues raised by the current substantiation regime.

The Substantiation Rules

Elaborate and complicated statutory provisions require substantiation of charitable contributions for them to be eligible for deduction from the income tax. Requirements vary with the nature and amount of property donated. The statutory provisions explicitly state that no deduction will be allowed if a taxpayer fails to meet the substantiation and recordkeeping requirements provided; these include receiving a contemporary acknowledgment, undergoing a qualified appraisal before contribution, attaching summary appraisal (Form 8283), and using a qualified appraiser with credentials.

Over the past 30 years, Congress has repeatedly returned to the charitable contribution substantiation rules, each time strengthening them in an attempt to prevent abuse, particularly overvaluation. The first effort took place in connection with the Economic Recovery Tax Act of 1981 (ERTA). New legislative rules regarding substantiation were introduced in 1984 as part of the Deficit Reduction Act (DEFRA), in 1993 as part of the Omnibus Budget Reconciliation Act (OBRA), in 2004 as part of the American Jobs Creation Act (AJCA), and most recently in 2006 as part of the Pension Protection Act (PPA).

This legislative history carries several implications. On one hand, Congress considers substantiation necessary and important. On the other, the frequent changing and strengthening of these rules seem to indicate that Congress is not yet satisfied that substantiation efforts have achieved their purpose.

Two aspects of the many pages of regulations merit highlighting. Current regulations provide an opportunity for the donor to submit the appraisal summary within 90 days of a request from the IRS if the donor has failed to attach an appraisal summary to his or her tax return as required, as long as the failure to include the summary is a good-faith omission.

Regulations proposed in 2008 for both AJCA and PPA changes revise this provision in light of a new reasonable-cause exception enacted in 2004. The proposed regulations require the donor to submit with the return a detailed explanation of why failure to comply was due to reasonable cause and not to willful neglect. Moreover, the taxpayer must have timely obtained a contemporaneous written acknowledgment and a qualified appraisal, if applicable.

The failure of the IRS and Treasury to finalize regulations proposed in 2008 suggests that the IRS and Treasury find keeping up with congressional requirements challenging. At the same time, two circuit courts—in *Kaufman v. Commissioner* (1st Cir.) and *Scheidelman v. Commissioner* (2nd Cir.)—have recently urged the IRS and Treasury to promulgate yet further regulations.

All this suggests that the current regime is not working satisfactorily. Moreover, judicial invocation of the substantial compliance doctrine in some situations but not others further complicates enforcement and raises additional questions about the current scheme.

Judicial Gloss

Long-standing section 170(a)(1) provides that a charitable contribution “shall be allowable as a deduction only if verified under regulations prescribed by the Secretary.” Despite this language, at some times (but not others), courts, particularly the Tax Court, have permitted substantial compliance with the substantiation and recordkeeping requirements.

The Tax Court cases applying the substantial compliance doctrine to the charitable contribution substantiation requirements rely primarily on *Bond v. Commissioner*, a case that seems internally inconsistent. *Bond* and other substantial compliance cases claim to distinguish between directory or procedural requirements and essential ones. As Judge Posner of the Court of Appeals for the Seventh Circuit has written, “Reading the Tax Court’s decisions on the subject of substantial compliance is enough to make one’s head swim.”

In the recent *Mohamed* case, Judge Holmes asserts that, since *Bond*, “few taxpayers have succeeded in showing substantial compliance.” Judge Holmes, however, fails to discuss the cases, besides *Bond*, where the Tax Court has found substantial compliance; there are a number of such cases.

Still, the Tax Court seems to be moving away from substantial compliance. In a case called *Averyt*, and very recently in *RP Golf LLC v. Commissioner*, the Tax Court held that a deed when looked at as a whole satisfies the substantiation requirement that a contemporaneous acknowledgment include a statement whether any goods or services have been provided. As forgiving as the Tax Court has been regarding the contemporaneous acknowledgement in these cases, it has been unforgiving in other recent cases regarding including a valuation method and a specific basis for the determined value in submitting a qualified appraisal. In sum, in these very recent conservation easement cases, the Tax Court has asked only whether strict compliance has been met. It has found strict compliance regarding contemporaneous acknowledgment satisfied by language in deeds and found it lacking in valuation method and specific basis for valuation.

At the same time that the Tax Court claims to be moving away from substantial to strict compliance, two Courts of Appeals have embraced the reasoning underlying the doctrine. In *Scheidelman v. Commissioner*, the Second Circuit rejected the Tax Court’s position regarding

valuation method and specific basis for valuation. In reaching its conclusion, the court cited *Hewitt v. Commissioner*, a Tax Court case that discusses the substantial compliance doctrine, to assert that the appraisal at issue “provides the IRS with sufficient information to evaluate the claimed deduction and ‘deal more effectively with the prevalent use of overvaluations.’” The circuit court relies on the reasoning the Tax Court has adopted for applying the substantial compliance doctrine.

All these cases signal a seemingly irresistible urge by courts to permit the deduction for certain charitable contributions that fail to comply strictly with the applicable rules.

What Can Be Done?

Our system risks drowning under the weight of the charitable contribution substantiation requirements. The current state of affairs regarding substantiation cries out for reform. How to reform the regime in a way both practical and effective, however, is less clear. The next few paragraphs list a number of possibilities, some of them minor changes and others major ones.

One possible reform would give the Tax Court authority to provide equitable relief when there has been a legitimate charitable gift to a legitimate charity. The equitable relief now available to innocent spouses might offer a model.

Another model for such an approach would be the harmless error provision in the Uniform Probate Code, which, at the urging of Professor Langbein, is intended to replace the substantial compliance doctrine. Under the harmless error doctrine (also known as a dispensing power), a court can admit a document to probate even if it fails to follow the required formalities of execution, if clear and convincing evidence establishes that the decedent intended the document to be his or her will. An analogous provision for substantiation could permit a charitable contribution that failed to comply with substantiation requirements nonetheless to be deducted if clear and convincing evidence established that it was a legitimate gift. Perhaps any equitable forgiveness of substantiation failures could give rise to a partial, rather than a full, deduction in order to maintain an incentive for strict compliance.

Rethinking conservation easement contributions as a whole would seem a high priority, as others have proposed in more detail.

For at least some real estate donations, perhaps an advisory council similar to the IRS Art Advisory Panel would be helpful. Right now a taxpayer can request a statement of value for donations appraised above \$50,000. For certain donations, valuation by an advisory panel could be required.

Increased use of technology, such as matching Forms 8282 and 8283, could also aid enforcement for those charitable contributions disposed of by the donee charity within three years.

The IRS and Treasury, perhaps with congressional urging or direction, could revise the proposed regulations regarding “reasonable cause” for failure to follow the qualified appraisal and qualified appraiser rules. Rather than strictly construing the exception, the IRS and Treasury could provide some safe harbors that address common problems, such as failure to specify that an appraisal was done for income tax purposes. With legislative action, reasonable cause relief could be extended to the contemporaneous acknowledgment requirement, for taxpayers unable to obtain the required documentation from the charity.

Perhaps, however, it would be preferable to continue and expand the current rule of Treas. Reg. sec. 1.170A-13(c)(4)(H), which permits a donor who fails to file a Form 8283 appraisal summary with his or her return to do so within 90 days of a request from the IRS if the original failure is a good-faith omission. Such an approach gives the taxpayer an opportunity to correct an error upon notice, protecting both the taxpayer and the tax administrator. Expanding the 90-day provision to permit acknowledgment of a contribution from the donee charity after the fact under such a provision seems a worthwhile change.

Approaches endorsed in connection with basic reform of the charitable contribution deduction more generally would also affect substantiation. For example, some have suggested a floor that would permit deductions only for giving each year above a set percentage of adjusted gross income. Such a floor would relieve taxpayers of the need to keep records of charitable contributions unless they expected to exceed the floor.

More revolutionary departures from current law would also influence substantiation requirements. The IRS could eliminate the charitable contribution deduction for contributions of at least some tangible personal property. If such a path were pursued, the treatment of artwork would need careful thought because of concern for museums. Perhaps only contributions of depreciable personal property could be limited or prohibited. Another revolutionary departure would be to rely on direct grants to charities triggered by private donations, such as the British Gift Aid grants.

The enforcement problems and complexity that the charitable contribution deduction substantiation rules produce, however, suggest strongly that we reform this area.