CHARITABLE DEDUCTIONS: APPRAISALS, THE IRS AND SUBSTANTIAL COMPLIANCE

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Section 170 of the Internal Revenue Code provides a tax deduction for any charitable donation. Cash donations are relatively straight-forward, but donations of property are not. If the value of the donated property exceeds $5,000, there are qualified appraisal rules that apply under the Treasury Regulations. *See* Treas. Reg. § 1.170A-13(c)(3). The requirements are technical, and they give rise to a fair volume of litigation.

On September 20, 2016, the Tax Court issued a taxpayer-friendly ruling in a case that illustrates both how technical the qualified appraisal rules are and how hard the IRS will fight to enforce them. *Cave Buttes, LLC v. Comm'r*, 147 T.C. No. 10, 2016 U.S. Tax Ct. LEXIS 27 (Sept. 20, 2016).

The case involved a limited liability company that owned eleven acres of raw land overlooking downtown Phoenix. The property, however, was close to a dam owned by the Maricopa County Flood Control District, which created some complications in developing it. *Cave Buttes*, 2016 U.S. Tax Ct. LEXIS 27 at *1. To resolve the situation, the LLC's owners negotiated a land swap with the flood control district; this arrangement became complicated when the flood control district, which required an appraisal for its own purposes, valued the property at $735,000 because of errors by its appraiser. *Id.* at *11-*13.

This problem was resolved by an agreement that the LLC would receive cash of $735,000, and that the balance of the value of the property would be treated as a donation in an amount to be determined by two appraisals to be commissioned by the LLC. *Id.* at *13. When the two appraisals were provided, one valued the property at $1.5 million, and the second placed the value at $2 million. *Id.* at *14.

The LLC elected to rely upon the lower appraisal of $1.5 million (prepared by Lyons Valuation Group) for tax purposes; this appraisal was signed by both Mr. Lyons and one of his colleagues. *Id.* at *14-*15. The LLC attached both appraisals to its tax return, but it relied upon the Lyons report for the Form 8283 it provided with the return to provide background on the donated property in accordance with the qualified appraisal rules. *Id.* at *15.

Although the LLC had elected to rely upon the lower of the two appraisals, the IRS balked and disallowed any deduction. *Id.* at *15-*16. The members of the LLC elected to challenge the IRS in Tax Court, and they hired another appraiser as an expert, who valued the property at $2.167 million at trial. *Id.* at *16.

After trial, the Tax Court commenced its analysis by observing that a bargain sale to a charity gives rise to a deduction to the extent that the taxpayer received less that the fair market value of the property. *Id.* at *18 (citations omitted). Claiming this deduction, however, requires a taxpayer to comply with the requirements of the qualified appraisal rules. The Tax Court then noted that only substantial compliance with the qualified appraisal rules was required. *Id.* at *20 (citing *Bond v. Comm'r*, 100 T.C. 32, 41 (1993)). The court then turned to each of the technical arguments raised by the government concerning the sufficiency of the Lyons appraisal.

Initially, the IRS argued that the LLC had not utilized a qualified appraiser because the Lyons appraisal report was signed by two authors, David Lyons and Jeffrey Clifford, but only Lyons signed the IRS Form 8283, and only his resume was provided. *Id.* at *25-*26. The Tax Court recognized that the regulations required that each appraiser who contributed to a report should comply with the regulatory requirements by signing the declaration and supplying a resume, but it nonetheless concluded that the LLC had substantially complied, noting that the instructions for Form 8283 in place in the relevant tax year did not explain who should sign the form if multiple appraisers contributed to a valuation, an omission that the IRS later changed. *Id.* at *26-*27. The court's decision was also influenced by the fact that the IRS never questioned the second appraiser's qualifications until *after* the trial concluded. *Id.* at *27.

Next, the IRS challenged the accuracy of the description of the property, which must supply "sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was (or will be) contributed." Treas. Reg. § 1.170A-13(c)(3)(ii)(A). The IRS argued that the property description was inaccurate because it identified the property as three separate lots to reflect a prior split of the property, but that split technically did not become effective for property tax purposes for a few months after the relevant transfer. 2016 U.S. Tax Ct. LEXIS 27 at *28. The court dismissed this argument as a "Gotcha" with little bearing on the property's value. *Id*. at *28-*29. It also dismissed similar quibbles concerning the accuracy of information about the proximity of utilities and the extent of access as has having little to do with establishing the identity of the property in light of the appraisal's inclusion of a general description, an address, dimensions and maps. *Id*. at *30.

The qualified appraisal regulations require that the appraisal report include a statement that "the appraisal was prepared for income tax purposes." Treas. Reg. § 1.170A-13(c)(3)(ii)(G). The IRS argued that the Lyons report was fatally defective because it said it was providing a valuation "for filing with the IRS;" the Tax Court rejected the government's argument, refusing to endorse a requirement for "magic words." 2016 U.S. Tax Ct. LEXIS 27 at *31.

The Tax Court also rejected an effort by the government to argue that the appraisal was not a qualified appraisal because it did not speak to valuation specifically as of the date the property was technically transferred, concluding that a gap of between eleven and twenty-one days between the transfer date and the valuation date was not dispositive, particularly since nothing occurred in the interim that would meaningfully alter the property's value. *Id*. at *31-*32.

The IRS also quarreled with the definition of fair market value included in the Lyons appraisal. Under Section 170, fair market value is defined as "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." Treas. Reg. § 1.170A-1(c)(2). The appraisal actually used the far more involved definition developed under FIRREA. The Tax Court concluded there was substantial compliance because the FIRREA definition embraced all of the concepts in the Treasury Regulation. And it probably didn't hurt that the government's own expert used the same definition of "fair market value." 2016 U.S. Tax Ct. LEXIS 27 at *32-*33.

Having rejected these arguments under the qualified appraisal rules, the Tax Court turned to the actual merits of the dispute, which turned on a variety of factors specific to the unique property. These included an issue concerning access to the property that required the court to determine whether a 1937 map that had been scanned onto a website maintained by the Arizona State Library was admissible as an ancient document (it was). Ultimately, the Tax Court rejected the government's valuation, and held that the fair market value was $2.167 million dollars, well in excess of the amount claimed by the LLC on its return.

The case offers two distinct lessons:

- *First*, a sharp focus on the technical requirements of the qualified appraisal rules can save a taxpayer significant time and money.
- *Second*, the Tax Court may be more reasonable about technical defects in an appraisal report than the IRS.

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