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IRS ISSUES

Charitable Deduction Rules: Beware "Sharp Corners"

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In federal tax law, sometimes forgetting to dot an "i" or cross a "t" isn't a fatal error.

But, for the substantiation of charitable deductions, "almost good enough" is *not* enough.

In two recent court cases, donors learned that lesson the hard way: *Albrecht v. Commissioner,* United States Tax Court, Memorandum Decision 2022-53 (May 25, 2022) and *Kevin M. Keefer et. al. v. United States* (July 6, 2022) United States District Court, Northern District of Texas.

The 2012 Durden Case

This is such an important point – for *both* donors and the donee organizations – that it was the topic of one of our first blog posts eight years ago. See *We Received Your Generous Donation. Nevertheless, . . .* (June 6, 2014).

It's the cautionary tale about David and Veronda Durden. They were "faithful members of the flock at Nevertheless Community Church in Texas." For the tax year 2007, they happily donated over $22,000 in cash in periodic contributions almost all of which were over $250.

Just as happily, Nevertheless Community Church provided the Durdens a letter confirming these donations. The Durdens also had their canceled checks. Confident that this was enough to substantiate the deduction, the Durdens filed their 2007 tax return.

When the IRS audited that 2007 tax return in April 2009, the agent told these donors the bad news: The Church's letter did *not* include all the language required by the federal tax statute and regulations. In particular, it omitted certain magic words: namely, that it "did not provide any goods or services to the Durdens in connection or exchange for the contributions."

And, still, after the Church issued a second letter with that required wording, the agent denied the entire claimed deduction. Why? The correction letter was offered way past the "contemporaneous" time frame specified in the statute and regulations.

The IRS denied the entire deduction, and the Durdens took their case all the way to the United States Tax Court. The judge ruled for the government. Mr. and Mrs. Durden lost the entire claimed deduction – over $7,000. See *Durden v. Commissioner*, T.C. Memo 2012-140.

Simply put, as we explained in that early post: "Congress really meant what it wrote. And the regulations were entirely consistent with this rigid proof requirement. There was no exception for 'substantial compliance.' The Judge's hands were tied."

Substantiation Requirements

The substantiation rules for charitable contributions over $250 were designed to combat widespread abuses. "People didn't actually give what they said they gave, or they donated property they said was worth much more than it was actually worth."

So Congress imposed duties on the donors as well as on the section 501(c)(3) recipient-organizations to prove that deductions were actually made in the amounts claimed, and also that the taxpayers are entitled to the full amount of the claimed deductions. Internal Revenue Code section 170(f)(8) is rigorous and precise. And the tax agency's regulations implementing that statute are equally tough. See Treas. Reg. 1.170A-13(f).

The all-cash situation, like the one in the Durdens' lawsuit, is the simplest. The recipient-organization must provide a "contemporaneous written acknowledgment. "

In order to pass muster, the writing has to include certain recitals including these two:

- The contribution amount; and
- Whether the organization provided any goods or services in exchange for the contributions. If the organization provided any goods or services (like a meal at a fundraiser), there must also be a description and estimate of the value of the goods or services, or a statement that such goods or services consisted of only "intangible religious benefits."

And the writing must be "contemporaneous," meaning before the earlier of: (a) the date the taxpayer filed the tax return or (b) the due date, including extension, for filing the original return for the year.

For non-cash donations, there are additional substantiation requirements including appraisals.

For the 2022 cases we're discussing for the first time in this post, it's that "contemporaneous written acknowledgment" that is tripping them up, sometimes resulting in deductions losses in the millions of dollars.

The 2016 Tax Partners Case

A few years later after our June 2014 post, we wrote about another lawsuit in *Charitable Deductions of $250 or More: Know the Rules* (February 15, 2017). That was another "… cautionary tale for

everyone out there who wants to take a $65-million charitable deduction. Or a $250 deduction. Or whatever."

Just three days before Christmas, the United States Tax Court issued its decision in *15 West 17th Street LLC, Isaac Mishan, Tax Matters Partner v. Commissioner*, 147 T.C. 19 (Dec. 22, 2016), handing these high-powered petitioners the largest lump of coal ever recorded in holiday-season gift-giving history.

As we explained in that February 2017 post, "a development group bought a piece of real estate in Manhattan with the intention of constructing expensive office condos. The building, though, had historic value, and some Greenwich Village busybody butted in and started the process to have it named an historic landmark. Seeing their cash cow disappearing, the developers arranged to donate a historic preservation deed of easement to the Trust for Architectural Easements, a 501(c)(3) 'qualified organization.'"

So what happened? "The LLC's contribution of the easement to the Trust was completed for federal tax purposes in 2007. On May 14, 2008, the Trust sent the LLC a letter acknowledging receipt of the easement. This letter did not state whether the Trust had provided any goods or services to the LLC, or whether the Trust had otherwise given the LLC anything of value, in exchange for the easement."

Of course, the petitioners' expensive lawyers did not simply throw in the towel when the IRS denied the entire claimed $65-million deduction. "A few years after this colossal mistake," they presented a "highly creative and untested … argument" about what the substantiation rules really mean. In the eventual 68-page opinion, nine Tax Court judges joined the majority opinion smacking down this "Hail Mary" attempt.

A day after Christmas 2016, noted tax expert, Peter C. Reilly, CPA, wrote in *Forbes* that the substantiation rules – and the "contemporaneous written acknowledgment" requirement, in particular – are "…not exactly rocket science."

Mr. Reilly's professional advice for all 501(c)(3) organizations: "When there's a straightforward 'hoop' to jump through to make sure that your donors have the right paperwork to substantiate their charitable deductions of $250 and more to the IRS, just do it. Do it within the generous time frame allowed; not a day late. Make sure you parrot the required magic language – exactly."

Albrecht – May 2022

On May 25, 2022, the Tax Court issued a ruling in *Martha Albrecht v. Commissioner*, T.C. Memo 2022-53 "which shows why a well written thank you letter, even from a public charity, is so important." *Why It Is Important To Write A Good Thank You Letter* (June 21, 2022) Matthew Erskine, *Forbes*.

In late 2014, Martha L. Albrecht donated "a large collection of Native American jewelry and artifacts to the Wheelwright Museum of the American Indian."

In this transaction, the "… Museum and Mrs. Albrecht executed a Deed of Gift which recited the terms of donation and the items being donated and referred to a 'Gift Agreement,' but no such

agreement was provided by the Museum." More problematic, though, is that this Deed of Gift "failed to indicate … that 'no goods or services were provided by the Museum to Albrecht in exchange for the donation.'" So "the deed, by its terms, provided Albrecht the ability—or possibility—to retain an interest in the donation." *Charitable Contributions and Contemporaneous Written Acknowledgements* (June 8, 2022) Jason Freeman, Esq., *Tax Court in Brief.*

According to Tax Court Judge Travis A. Greaves: "Although the deed in this case provides that the donation was 'unconditional and irrevocable,' it continues that 'all rights, titles and interests held by the donor in the property are included in the donation, unless otherwise stated in the Gift Agreement' …. Thus, the terms of the deed were subject to a separate agreement, but the Wheelwright Museum did not provide petitioner with this document before the return was filed….[Internal Revenue Code section 170(f)(8)(A)]."

He adds that a "CWA [… Contemporaneous Written Agreement…] is not required to take any particular form but the requirement that a CWA be obtained 'is a strict one.' *15 W. 17th St. LLC v. Commissioner*, 147 T.C. 557, 563 (2016); Treas. Reg. § 1.170A-13(f)(2).

The bottom line: "We appreciate what appears to have been a good faith attempt by petitioner to substantially comply with the Code by executing the deed with the Wheelwright Museum. Substantial compliance, unfortunately for petitioner, does not satisfy the strict requirements of section 170(f)(8)(B). See 15 W. 17th St. LLC, 147 T.C. at 562."

See also *Lesson From The Tax Court: The Sharp Corners Of The §170 Substantiation Requirements* (May 31, 2022) Professor Bryan Camp, *taxprof.typepad.com*. Professor Camp quotes the "sainted Justice Holmes" who "once wrote: '"Men must turn square corners when they deal with the Government."

"It is no accident," Professor Camp continues, "that Justice Holmes wrote that in a [1920] tax case …. Of all the corners in all the laws governing citizen interaction with government, tax laws contain some of the squarest. This is a lesson we've seen before …. But I think it's a lesson worth repeating: the substantiation rules in §170 contain some very sharp corners. The lesson is important for high-end donations such as the one in today's case. And it is not just a lesson for taxpayers, but also for charities."

Keefer – July 2022

A Texas couple were denied a $1.3 million deduction for a donation of a partnership interest to a nonprofit donor-advised fund. In *Keefer v. U.S*. (N.D. Texas, July 6, 2022), a federal district judge affirmed the denial by the government of the claimed deduction.

While there were additional alleged infirmities in the Keefers' charitable-deduction claim, the one that the judge discussed first (effectively disposing of the other, alternate, grounds for denial) was that pesky "contemporaneous written acknowledgment."

In *Charitable Acknowledgements For Tax Purposes Go Badly Wrong* (July 16, 2022) *Forbes,* once again Peter Reilly hits the nail on the head: "The rules for substantiation of charitable deductions are very strict with extra layers when a donor advised fund or property donations are involved. You can

get a pretty good feel for how things can go badly wrong from [the Keefer] opinion." He "imagine[s] this transaction being used in an exam for a Masters in Taxation."

Plaintiff husband, a non-practicing CPA working in the hospitality industry "… held indirectly a limited partnership interest in a hotel." There were interested buyers. "Prior to any sale being finalized Mr. Keefer converted part of his indirect interest into a direct 4% interest. He then donated that interest to the Utah based Pi Foundation which established a donor advised fund with the donation. An appraiser valued the interest at $1,257,000 largely on the basis of the pending sale, which ended up going through. The Keefers took that as a charitable contribution deduction."

The IRS agent disallowed the claimed charitable deduction for 2015 on two grounds. The first involved the appraisal and a few other issues which ended up being non-issues here.

"Then there is the problem with the acknowledgement required for contributions over $250. In the case of a donor advised fund the acknowledgement needs to include a statement that the funds are under the exclusive legal control of the sponsoring organization."

"On denial of the deduction Judge Boyle ruled that the failure of the acknowledgement by Pi to state that they had legal control was enough to deny the deduction. This was despite there being a separate package in which that was explained."

Mr. Reilly concludes his analysis with a suggestion to the "people running the" donor advised funds. They "might be wanting to check their acknowledgements."

See also, for example: *Innocent Mistakes Can Lead to Heavy Tax Losses* (July 20, 2022) Stefania Bartlett & Cara Howe Santoro, *wealthmanagement.com* ["A couple's charitable deduction was derailed due to assignment of income and minor paperwork errors."]

Conclusion

Shouldn't the tax law provide for a bit of wiggle room, you ask? Perhaps provide a soft landing for human error. After all, donating to charity should be encouraged. What's up with these unforgiving traps?

That's a long discussion for another day. Simply put, while there is a doctrine of "substantial compliance" regarding certain aspects of tax law, it doesn't apply to these charitable-deduction substantiation rules.

If you just can't wait to dive into that topic, start with: *When "Mostly" is Not Enough Part One: IRS Issues New Warning to Taxpayers of When Compliance is not "Substantial"* (August 22, 2017) Anthony P. Daddino, Esq., *Anthony P. Daddino P.C. Blog.* There, he cites an "Internal Revenue Service Concept Unit" titled The Meaning of "Substantially Complete" with Reference to Int'l Information Return Penalties (Date of Last Update 5/31/17) Document Control Number (DCN) IGA/C/17_03_01-02. Although it primarily relates to a different point, that document includes a long discussion concerning substantiation requirements for charitable deductions.

See also: *Using the Substantial Compliance Doctrine to Defeat the IRS* (August 31, 2020) Joel N. Crouch, Esq., *meadowscollier.com* [distinguishing a few situations in which substantial compliance

defenses worked].

Or there are some good movies on Netflix.

Your choice.

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