

Scripps Heritage Planner

An Income, Estate and Gift Tax Newsletter for Professionals
from the Office of Gift Planning at Scripps Health Foundation

SPRING 2010

Valuation and Substantiation of Charitable Contributions: An Overview

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www.scrippsheritage.org



Scripps Health Foundation

Our Services

The Office of Gift Planning at Scripps Health Foundation is available as a resource to estate planning professionals. Our office will provide these services at no cost or obligation:

**Immediate Telephone Consultations • Charitable Deduction Calculations
Summary of Benefits • Flow Charts and Graphs • Private Client Meetings
Presentations at Your Office • Seminars for Clients**

Our Website: Resources for Estate Professionals

Please visit us online at www.scrippsheritage.org to find many helpful tools, calculators and links to tax laws and articles. You may also sign up easily for our weekly eNewsletter on our web site.

Upcoming Gift Planning Luncheon Seminars

Roth IRA Conversions: What Are They and Why Should I Care?	May 5, 2010
Top Tips for Avoiding Financial Elder Abuse	June 2, 2010
Fundamentals of Charitable Gift Planning	July 7, 2010

All presentations will take place from noon to 1:30 pm
at the Founder's Room, Schaezel Center for Health Education

Scripps Memorial Hospital La Jolla
9888 Genesee Avenue
La Jolla, CA 92037

See back cover for further information about these educational opportunities.



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"Through philanthropy, we help to heal, enhance and save lives."

Introduction

IRC Sec. 170(a) permits a donor to deduct the value of property given to a qualified charity. However, there are specific rules concerning what amount the donor can deduct. It is the donor's responsibility to adhere to these rules and keep records to show compliance.

There are two basic requirements that all donors must meet in order to claim a deduction for a charitable contribution: One, the donor must determine the fair market value of the donated property; and, two, the donor must retain documentation to substantiate the donation. In this booklet, we cover these requirements in greater detail.

I. What is Fair Market Value?

Fair market value (FMV) is the starting point to determine the value of any charitable gift of property. FMV 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 [Reg. Sec. 1.170A-1(c)(2)].

FMV is relatively easy to determine when there is a prescribed valuation methodology or an organized exchange or market for the particular type of property involved (e.g., listed stocks). But, valuation can become more problematic when there is no organized market and the valuation is based on more subjective factors.

One important indicator of FMV is the cost or selling price of the donated property. There are specific criteria for judging the relevance of its cost or selling price:

- The purchase or sale took place close to the valuation date in an open market
- The purchase or sale was at arm's length
- The buyer and seller knew all relevant facts
- The buyer and seller did not have to act
- The market did not change between the date of purchase or sale and the valuation date
- Any terms of the purchase or sale that might have affected the price (e.g., covenants limiting use or disposition of the property)

Another useful gauge of FMV is the sale of comparable properties:

- How similar is the property sold to the property donated?
- How close is the date of sale to the valuation date?
- Was the sale at arm's length?
- What was the market's condition at the time of sale?

However, there can be many factors that create problems for determining FMV:

- Unusual market conditions
- A lack of information on comparable sales
- An inability to predict future events
- Too great a reliance on past events

The preferred method (and, most likely, the legally required method) to establish FMV for purposes of claiming a charitable deduction is by a qualified appraisal.

II. Valuation of Different Types of Property

Household Goods and Used Clothing

Household goods (furniture, appliances, linens, etc.) and used clothing are items usually valued much lower than the price paid when new. Besides the issue of wear and tear, the goods may be out of style or no longer useful (e.g., a dot matrix printer). In the case of used clothing, the price that buyers of used items actually pay in used clothing stores, such as consignment or thrift shops, is an indication of the value.

Furthermore, any donated goods must be in good condition or better in order to deduct the FMV [Prop. Reg. Sec. 1.170A-18(a)]. Note there is one exception to this general rule: the donor can deduct an item not in good condition if the item is valued for more than \$500 and the donor attaches a qualified appraisal and a completed Form 8283 [Reg. Sec. 1.170A-18(b)].

Jewelry and Gems

Items of jewelry and gems have a specialized nature that most often requires an appraisal. The value ascribed to jewelry and gems should account for the potential value of the item beyond its current state and fashion – i.e. whether the item could be recut, reset, or redesigned. The coloring, weight, cut, clarity and flaws should be reported in the appraisal.

Motor Vehicles

There are several publications that provide guidance on the valuation of automobiles, boats, or aircraft based on the dealer sale prices or average prices recorded based on make, model, and year. The price listed for a private party sale is usually an acceptable measure for estimating FMV. Of course, if there are conditions that would reduce the value of the vehicle such as engine trouble or excessive mileage, the valuation must reflect this.

In the case of a contribution of a qualified vehicle valued for more than \$500, if a charity sells the vehicle instead of utilizes or materially improves the vehicle, the amount of the deduction is limited to the gross sale proceeds [IRC Sec. 170(f)(12)(A)(ii)].

Inventory

Inventory is defined as assets held by a taxpayer for sale to customers in the ordinary course of a business [Reg. Sec. 1.170A-1(c)(2)]. The fair market valuation of inventory relies on the usual market for the goods – if the manufacturer or producer sells to wholesalers, the property is valued at that wholesale price. If the distributor sells the property to retail customers, the property is valued at its retail price.

However, a donor is subject to the reduction rules when deducting charitable contributions of inventory property. Because this is property that would create ordinary income if sold, the donor's deduction generally must be reduced by the amount that would be ordinary income [IRC Sec. 170(e)]. Thus, for gifts of inventory, the appropriate deduction is the donor's cost basis or the fair market value of the asset, whichever is lower. Note there have been exceptions to this reduced deduction depending on the type of property and/or the status of the taxpayer [IRC Sec. 170(e)(3)].

Note that there is no available deduction in the case where an individual or business has already deducted the cost basis for inventory property contributed to a charity – the taxpayer cannot first deduct the expense under IRC Sec. 162, and then deduct the value of the property under IRC Sec. 170 [Reg. Sec. 1.170A-1(c)(4)].

Stocks and Bonds

The existence of a public exchange makes it relatively simple to determine the FMV of a stock or bond. The value of a listed security is the mean between the high and low quoted sale prices for the stock on the day it is given to charity. In the rare case that there were no sales on the day of the gift, Reg. Sec. 25.2512-2(b)(1) and Reg. Sec. 20.2031-2(b)(1) provide guidance.

Closely Held Stock

Closely held stock is often an attractive option for a donor choosing an asset to give to charity because these assets usually have a very low cost basis and there lies an opportunity to avoid the capital gain tax.

The usual factors in valuing stock in a closely held corporation are:

- The nature of the company's business
- The economic outlook for the economy generally and for the specific industry
- The company's book value
- The company's earning history and dividend paying ability
- Intangible assets
- Prior sales of the same stock
- The value of comparable stocks
- The size of the block of stock to be valued

[See Rev. Rul. 59-60, 1959-1 CB 237]

Real Estate

The fair market value of real estate generally is its appraised FMV based on the property's highest and best use, regardless of how the property had been used or how the charity expects to use the property. The appraisal may include comparable sales, replacement cost, or capitalization of income. If the donated property is mortgaged, the gift value is the property's fair market value in excess of the mortgage.

All inventory property held in the course of a donor's trade or business is also ordinary income property so the deduction would be limited to the cost basis. Land lots or homes owned by a real estate developer in the course of business are considered inventory property.

Remainder Interest in a Personal Residence or Farm

A donor may contribute a remainder interest in certain real estate to charity, retaining a life estate. To obtain a charitable deduction, the remainder interest must be in a personal residence or farm. The donor receives an income tax charitable deduction for the discounted present value of charity's future interest.

This remainder value is determined using the value of the land and improvements, but must be reduced by the value of the life use of the property by the donor. To determine the remainder value, the donor must incorporate several factors including:

- The property's FMV
- The depreciable property FMV (the value of the improvements to the property divorced from the land)
- The useful life of the improvements
- The salvage value (if any) of the improvements
- The term of the agreement or the donor's life expectancy
- The available 7520 Rate (the mid-term applicable federal rate)

[Reg. Sec. 1.170A-12]

Conservation Easement

A qualified conservation contribution is the contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes, protected in perpetuity [IRC Sec. 170(h)(1)]. Usually, historical sales data will help determine the fair market value of a donated easement, but, for lack thereof, the fair market value of an easement is equal to the difference between the fair market value of the encumbered property before the donation and its value after the donation.

Fractional Interest

A fractional interest is a gift of an undivided part of the entire interest in a property that consists of a part of each and every substantial interest or right derived from the property [IRC Sec. 170(o)(1)]. An example is the gift of a 25% undivided interest in a parcel of real estate.

However, the formula for determining the FMV of such a contribution is not so simple as to determine the FMV for the entire interest and apply the fraction.

There are a number of factors that would tend to discount the value of a fractional interest:

- The disadvantage of co-tenancy
- The expense of partitioning the property
- The difficulty of selling such an interest

Life Insurance Policies

If the policy is paid-up (i.e., no premium remains to be paid), the policy's fair market value is its replacement cost. This is the amount an insurance company would charge to issue an identical policy at the time the policy is transferred.

If premiums remain to be paid, the policy's FMV is equal to its "interpolated terminal reserve value" (approximately the policy's cash value) plus the part of the last premium payment that covers the policy period following the date of the gift.

Life insurance is ordinary income property. So, even if the policy's FMV exceeds the donor's cost basis for the policy, the charitable deduction will be limited to the policy's cost basis.

III. Appraisal and Appraiser Requirements

When is an Appraisal Necessary?

If the FMV of the property the donor intends to deduct as a charitable contribution is greater than \$5,000, the donor must obtain a qualified appraisal [Reg. Sec. 1.170A-13(c)(1)(i)].

However, a type of property often given to charities that is excluded from the appraisal requirement is publicly traded securities. And non-publicly traded securities have a less strict appraisal requirement: a qualified appraisal is not required if the amount claimed as a deduction is greater than \$5,000 but does not exceed \$10,000. Instead, only a partially completed appraisal summary form is required as attached to the income tax return.

Appraiser Requirements

To be "qualified," an appraisal must be made by a qualified, independent appraiser, meaning a person who meets the following criteria [Prop. Reg. Sec. 1.170A-17(b)(1) and (2)]:

- Has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements as determined by the IRS in its regulations
- Regularly performs appraisals for which he or she receives compensation
- Can demonstrate verifiable education and experience in valuing the type of property for which the appraisal is being performed
- Has not been prohibited from practicing before the IRS at any time during the three years preceding the conduct of the appraisal
- Is not excluded from being a qualified appraiser under applicable Treasury regulations

An appraiser might be "qualified" to make the appraisal, but not sufficiently independent. The appraiser cannot be someone whose objectivity regarding the appraisal might be suspect; the appraiser may not be any of the following [Prop. Reg. Sec. 1.170A-17(b)(5)]:

- The donor
- The recipient charity or an employee thereof
- The person from whom the donor acquired the property (with certain exceptions)
- Any person employed by or related to any of the above
- An appraiser who is otherwise qualified, but who has some incentive to overstate the value

The appraiser must sign and date the appraisal, and also must sign a declaration that he or she understands that a false appraisal may subject the appraiser (as well as the donor) to penalties.

Appraisal Requirements

An appraisal must be made not earlier than sixty (60) days before the date of contribution of the appraised property, nor later than the due date (including extensions) of the return on which a deduction for the contribution is first claimed [Reg. Sec. 1.170A-13(c)(3)(i)(A); Reg. Sec. 1.170A-17(c)(4)].

A qualified appraisal must be signed and dated by the appraiser and should include all of the following [Prop. Reg. Sec. 1.170A-17(a)(3)].

- A detailed description of the property
- The date of the gift
- The physical condition of the tangible personal property
- Any restrictions relating to the charity's use or disposition of the property
- The appraiser's name, address, and taxpayer identification number
- The appraiser's qualifications, especially education, experience and certification
- A declaration that the appraisal was performed for tax purposes
- The date of the appraisal
- The fair market value of the gift property on the date of the gift
- The method of determining the fair market value
- The informational basis used by the appraiser in determining value
- The fees paid by the donor for the appraisal
- The appraiser's dated signature
- A declaration that the appraiser is aware of the penalties for substantial or gross valuation
- An admission if the appraiser is acting as a partner in a partnership, an employee of any person, or an independent contractor engaged by a person other than the donor, with such person's name, address and taxpayer identification number

Appraisal Fees

The appraiser's fee cannot be based on a percentage of the value of the appraised property, nor can the fee be based on the amount allowed as a charitable deduction [Reg. Sec. 1.170A-13(c)(6)].

Appraisal fees may not be lumped in with the charitable contribution, but they are an expense paid in determining income tax liability [IRC Sec. 212(3)]. As such, they are deductible as a miscellaneous itemized deduction, subject to the two-percent-of-AGI floor [IRC Sec. 67(a)].

Appraisal Summary

If the donor must obtain a qualified appraisal, the donor must attach an appraisal summary to the income tax return [Reg. Sec. 1.170A-13(c)(2)(i)(B)]. The donor can satisfy the appraisal summary requirement by completing Part B of IRS Form 8323 (see below).

IV. Substantiation Requirements

Cash Gifts in General

A donor must have a bank record (such as a cancelled check) or written communication from a charity (usually a letter) for any monetary contribution in order to claim a charitable contribution. The written communication from the charity should list the name of the charity, the date of the contribution, and the amount of the contribution.

Cash Gifts of \$250 or More

In addition to the general requirements, the donor must also have a written acknowledgment from a charity for any single contribution of \$250 or more in order to claim a charitable contribution. The written acknowledgment must contain the following information:

- Name of the organization
- Amount of the cash contribution
- A statement that no goods or services were provided by the organization in return for the contribution, if that was the case - or
- A description and good faith estimate of the value of goods or services that an organization provided in return for the contribution - or
- A statement that goods or services that an organization provided in return for the contribution consisted entirely of intangible religious benefits

Note that the charity does not need to include the donor's social security number or tax identification number on the written acknowledgment. Nor does the donor need to attach the acknowledgment to the tax return; the donor only needs to retain the acknowledgment. The charity can provide a separate acknowledgment for each single contribution of \$250 or more, or one acknowledgment (such as an annual summary) to substantiate several single contributions of \$250 or more. The charity can send the acknowledgment as a paper copy or as an electronic mail message. The acknowledgment must be contemporary; the donor must receive acknowledgment by the date the donor actually files the income tax return, or on the due date (including extensions) of the return (whichever event is earlier).

Property Gifts in General

For non-cash gifts, the donor must have a receipt from the charity that contains the following information [Prop. Reg. Sec. 1.170A-16(a)(1)]:

- The name and address of the charity
- The date of the contribution
- A description of the property in detail
- If the property is securities, the name of the issuer, type of security and whether the security is publicly traded

The donor must keep a letter or other written communication from the charity that acknowledges the receipt of the contribution, shows the date of the contribution, and lists the required description of the property. This letter must be contemporaneous.

Property Gifts of More than \$500

A donor who gives property (other than cash, publicly traded securities or qualified vehicles) to charity and claims a deduction of more than \$500 must attach to the income tax return a description of the property and other information the IRS may require [Prop. Reg. Sec. 1.170A-16(c)].

Qualified Appraisal Required for Contributions of More than \$5,000

As noted above, in the case of contributions of property for which a deduction of more than \$5,000 is claimed, the donor must obtain a qualified appraisal of the property. In certain situations, the donor must attach the appraisal to the return for the taxable year [Prop. Reg. Sec. 1.170A-16(d)].

Substantiation for Contributions of More than \$500,000

In the case of contributions of property for which a deduction of more than \$500,000 is claimed, the donor must attach the appraisal to the return for the taxable year [Prop. Reg. Sec. 1.170A-16(e)].

Aggregation of Contributions

In applying the \$500, \$5,000 and \$500,000 thresholds, the donor must combine all gifts of "similar items of property" for the year, even if made to different organizations. If the total of such similar gifts exceeds the pertinent threshold, the statutory requirements apply [IRC Sec. 170(f)(11)(F)]. This raises the question of when gifts are similar. Suppose a donor has donated collectible postage stamps. Later he donates various items related to his collection, as well as books on stamp collecting. Are these "similar" items that must be aggregated? The IRS stated in PLR 8604025 that was the case. In other words, stamps and books were determined to be similar for purposes of applying the aggregation rule. Likewise, art books and display frames donated in the same year as works of art might be subject to aggregation.

Donor's Form 8283

The donor must file Form 8283 if the amount of the deduction claimed for all noncash gifts is more than \$500 for the year, determined after any required reductions in fair market value for the particular gift, but without regard to the percentage-of-AGI limitations on the charitable deduction. For property gifts of more than \$500 but not more than \$5,000, a donor must complete Section A of Form 8283. If one item, or a group of similar items, exceeds \$5,000 in value, a donor must also complete Section B (unless the property is publicly traded securities).

V. Disclosure Requirements for the Charity

Quid Pro Quo

The charity must inform the donors of the value of any quid pro quo in exchange for the donor's contribution. The written statement from the charity must state the following:

- The amount deductible as a charitable contribution is limited to the excess of the amount of any money and the value of any property contributed over the value of the goods, or services furnished in return by the charity; and
- The amount that is a good faith estimate of the value of the quid pro quo.

The donor need not reduce the amount of the contribution if the goods or services are considered token benefits valued at \$75 or less that are offered as part of a membership (free or reduced admission, tickets to events, etc.)

Tattletale Form

Charitable organizations must file Form 8282 (the so-called "tattletale" form) to report to the IRS any sale or other disposition of donated property (other than publicly traded securities) within three years after the contribution if the property was valued at \$5,000 or more. When required, Form 8282 must be filed with the IRS within 125 days of the disposition, and there are penalties on charities who fail to comply (up to an annual maximum of \$250,000). Charities also must provide a copy of Form 8282 to donors, and additional penalties apply to charities who fail to do so.

No reporting by the charity is required if the property is gratuitously transferred by the charity or consumed by the charity, provided these are done in pursuit of the charity's exempt purpose. Thus, the consumption of a donated vaccine would not have to be reported by a charitable organization as it administered inoculations.

The information that must be reported by the charity includes:

- Name, address, and TIN of the charity
- Name, address, and TIN of the original donor
- A description of the property
- Amount received by charity upon disposition
- Date of the contribution

- Date of the disposition
- A description of the charity's use of the property
- A statement indicating whether the use of the property was related to the purpose or function constituting the basis for the charity's exemption under IRC Sec. 501

VI. Penalties and Fines

Valuation Misstatements

Overvalued charitable gifts that result in underpayments of tax are potentially subject to the accuracy-related (or negligence) penalty [IRC Sec. 6662] and the anti-fraud penalty [IRC Sec. 6663].

The accuracy-related penalty is 20 percent of the tax underpayment that results from, among other things, a "substantial valuation misstatement." Such a misstatement occurs if the value claimed on a tax return is 150 percent or more of the correct valuation. The penalty doubles to 40 percent if the claimed value exceeds the correct value by 200 percent or more. The penalty is not imposed unless the resulting underpayment exceeds \$5,000, or \$10,000 in the case of C corporations. The IRS can waive the penalty if it determines that the claimed value of the property was based on a qualified appraisal made by a qualified appraiser, and the taxpayer made his or her own good faith investigation of the value of the contributed property [IRC Sec. 6664(c)].

The anti-fraud penalty is 75 percent of any resulting underpayment of tax. The accuracy-related penalty does not apply to any portion of an underpayment to which the fraud penalty applies [IRC Sec. 6663(b)].

Lack of Documentation and Recordkeeping

If a donor does not have the proper documentation to substantiate a charitable contribution, the donor will likely not be able to deduct the contribution for income tax purposes. [*John F. Kyne v. Commissioner*, U.S. Tax Court, T.C. Summary Opinion 2009-98, (Jun. 25, 2009); *Stockwell v. Commissioner*, T.C. Memo. 2007-149]. And, for loss of a charitable deduction, the donor may be subject to fines and penalties for filing an incorrect income tax return.

In Closing

During the recent financial and economic downturn, generous donors have looked to different ways of giving in order to maintain a commitment to philanthropy. This includes giving property to a charity that might be difficult to value. It is important that your clients understand the particular rules about valuing and substantiating specific charitable contributions in order to preserve the helpful deduction.

Upcoming Gift Planning Luncheon Seminars

Complimentary lunch and self-parking are provided — MCLE credit is offered and available for those who qualify.

Reservation details & location are listed below

Roth IRA Conversions: What Are They and Why Should I Care?

Wednesday, May 5, 2010, noon to 1:30 pm

Presented by:

Lou Mezzullo, Partner, Luce Forward

Who can benefit from a Roth IRA conversion, and who might not? What are the factors and risks that should be considered in making a Roth conversion? Our speaker will review these timely issues and discuss the implications for your practice and charitable planning.

By Reservation Only – Deadline: Friday, April 30, 2010

Top Tips for Avoiding Financial Elder Abuse

Wednesday, June 2, 2010, noon to 1:30 pm

Presented by:

Paul Greenwood, Deputy District Attorney,
Head of Elder Abuse Prosecution

It is unfortunate but true, your elderly clients could become victims of financial elder abuse. At this presentation you will learn steps you can recommend your clients take to reduce the risk of becoming a victim. Our speaker will share his own stories of financial elder abuse cases that he has prosecuted, illustrating how ordinary estate plans—the type that are done routinely—have been abused, the consequences suffered, and how you can help to protect your clients.

By Reservation Only – Deadline: Friday, May 28, 2010

Fundamentals of Charitable Gift Planning

Wednesday, July 7, 2010, noon to 1:30 pm

Presented by:

David E. Williams, Senior Director of Gift
Planning, Scripps Health Foundation

Natalie Ganz, Director of Gift Planning,
Scripps Health Foundation

Your clients come to you with a variety of needs that require creative solutions. With options ranging from bequests to life-income gifts, charitable gift planning offers a number of tools for you to creatively meet their needs. Our speakers will review the fundamentals of gift planning and how it can offer opportunities for effective tax, estate, and legacy planning.

By Reservation Only – Deadline: Friday, July 2, 2010

PLEASE NOTE:

All presentations will take place at:

Founder's Room, Schaetzl Center for Health Education

Scripps Memorial Hospital La Jolla

9888 Genesee Avenue La Jolla, CA 92037

To make a reservation: email giftplanning@scrippshealth.org or call 858-678-7120



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Please visit us online at www.scrippsheritage.org where you will find many helpful tools and links to tax laws and articles. If you are not already receiving our weekly eNewsletter, you may sign up easily on our web site.