

## **TAX COURT CASE UPDATE**

### **FCG Valuation Case E-Flash**

Authored by Fawntel Romero, AM, and Chris D. Treharne, ASA, MCBA, BVAL of Gibraltar Business Appraisals, Inc. a member firm of FCG

### **Citation:**

*James Hendrix v. United States*, Case No. 2:09-cv-132, United States District Court, Southern District of Ohio Eastern Division, July 21, 2010.

### **Comments:**

The U.S. District Court considered whether an income tax charitable deduction for real property should be allowed. Ultimately, The Court denied the deduction because the taxpayer failed to submit a qualified appraisal and failed to obtain a contemporaneous acknowledgement of the donation from the donee.

While this case is centered on a real estate appraisal, it suggests that business appraisals are exposed to similar risks. More specifically, “discount letters” (which often are substituted for appraisals of family limited partnership interests) and “calculation” reports may subject taxpayers to unnecessary sanctions. As stated in *Hendrix*, the purpose of a qualified appraisal is to eliminate unnecessary guessing. The Court found that taxpayers’ appraisal lacked content in critical areas required by the qualified appraisal regulations. As a result, The Court ruled that the taxpayers were not entitled to the claimed deduction.

### **House Donated to City and Demolished:**

James and Lori Hendrix intended to demolish a house and rebuild a larger house in its place. Two estimates for conducting the demolition indicated the cost would be approximately \$10,000. Rather than paying for the property to be demolished, Mr. and Mrs. Hendrix donated it to the city. On June 29, 2004, the taxpayers entered into a contract with the city’s Upper Arlington Fire Division, which required the house be burned and/or demolished as part of a training exercise. A real estate appraisal of the property was prepared. The report was signed on June 11, 2004, and indicated a value of \$520,000. The appraisal stated “[t]he intended use of this appraisal is to assist the owner in estimating the fair market value of the subject property.” The appraiser failed to include her qualifications in the report and included only her license number. Additionally, she failed to provide the terms of the agreement between the taxpayers and the city, as well as the expected date of the donation. Mr. and Mrs. Hendrix claimed a charitable deduction for the property in the amount of \$287,400 on their 2004 tax return. The IRS disallowed the deduction and asserted a tax deficiency.

### **Submitted Appraisal was Not Qualified Appraisal:**

The IRS asserted that the taxpayers were required to obtain a qualified appraisal and attach it to their tax return by §170(f)(11)(C). The regulations provide that the appraisal must include the following in order to constitute a qualified appraisal:

- The expected date of contribution.
- The terms of agreement between the taxpayers and the city.
- The appraiser's qualifications (background, experience, education, and any membership in professional associations).
- The required statement that the appraisal was prepared for income tax purposes.

Because the appraisal failed to meet these requirements, The Court concluded that it failed to constitute a qualified appraisal.

The taxpayers contested and argued that they substantially complied with the regulations. The Court concluded that the substantial compliance doctrine applies to statutory language that specifically provides for substantial compliance, but the doctrine did not apply to the taxpayers' deductions.

The Court indicated that the substantial compliance doctrine "is at most a means of accepting a nearly complete effort that has simply fallen short in regards to minor procedural errors or relatively unimportant oversights." Even if the doctrine could apply to the taxpayers' deductions, The Court pointed out that the appraisal failed to comply with numerous statutory and regulation mandates. For example, The Court ruled inclusion of only the appraiser's license number as a substitute for the appraiser's qualifications did not constitute substantial compliance. Furthermore, whether the appraiser was qualified as an appraiser is not the issue. The issue is what the taxpayers were required to do, not what they could have done.

### **Appraisal Analysis was Incomplete:**

No explanation was given for the claimed deduction of \$287,400. The taxpayer later explained the value of the charitable contribution was determined by subtracting the value of the land from the value determined in the appraisal. The Court indicated that a qualified appraisal will "show the work" and eliminate guessing. The appraisal failed to do so.

### **Contribution Acknowledgement Not Obtained:**

In addition to obtaining a qualified appraisal, the taxpayers were required by §170(f)(8)(B) to file a contemporaneous acknowledgement of the contribution by the donee organization. The Court found that the taxpayers failed to produce such documents.

### **Court Rules In Favor of IRS:**

Because the preceding two issues required by §170 proved dispositive, The Court did not address whether a deduction would have been available for this type of transaction or whether the taxpayers established that they were entitled to the deduction.