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RERI Holdings I, LLC and the Importance of Form 8283

A recent Tax Court case, **RERI Holdings I, LLC et al. v. Commissioner, 149 T.C. 1 (Jul. 3, 2017)**, should remind charities and their donors of the importance of full compliance with the substantiation rules and the potential costs of aggressive tax planning.

Facts of *RERI Holdings*

To over-simplify the complex facts in *RERI Holdings*:

- › A partnership owned an LLC that in turn owned real property.
- › The partnership effectively split that LLC interest into two pieces: (1) a term of years interest (i.e. ownership of the LLC until December 31, 2020) and (2) a remainder interest (i.e. ownership of the LLC beginning January 1, 2021).
- › The partnership sold the remainder interest to the donor (another partnership) for \$3 million.
- › The following year, the donor then gave the remainder interest to a university and claimed a \$33 million tax deduction.

It does not take a tax expert to understand the IRS's skepticism when a donor takes a deduction for \$30 million more than the donor just paid for the donated property. Perhaps that explains why, when the donor filled out Form 8283, it left blank the line for "donor's cost or adjusted basis." Typically, this line shows what the donor paid to acquire the property. Intentional or not, that omission became extremely costly.

Substantiating a Charitable Contribution Deduction and Form 8283

All charities and their donors need to be aware of the substantiation rules that impose certain procedural requirements before a donor can claim a charitable contribution deduction (for more information, see Publication **1771**). As part of these rules, if a donor claims a deduction in excess of \$500 for a noncash gift, the donor must file Form 8283. If the gift exceeds \$5,000 and is a noncash gift other than publicly traded securities, the donor, in addition to obtaining a qualified appraisal (with limited exceptions), must completely fill out Section B of Form 8283 and have the charity sign the Form 8283 acknowledging the gift.

In *RERI Holdings*, the donor satisfied all requirements except reporting the basis on Form 8283. For the IRS and the Tax Court, that omission alone was enough to cost the donor its entire \$33 million deduction. While the "substantial compliance" doctrine will sometimes save a taxpayer from such a harsh response to a minor procedural error, the

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Tax Court found that doctrine did not apply because the omission hid a critical “red flag” (i.e. that the donor had just purchased the property for 1/11th of what it claimed was the actual value).

Imposition of Penalty for Overvaluation

The IRS has often used a breach of the substantiation rules to deny a questionable deduction while avoiding an expensive fight over valuation. Here, however, the IRS still attacked the donor’s valuation in order to impose a Section 6662(h) “gross valuation misstatement” penalty. This penalty applies when a taxpayer claims that property is worth 400% or more of its actual value and is equal to 40% of the underpayment resulting from the overvaluation.

Here, the IRS suspected an inflated value because the underlying property had been previously valued at \$47 million while being subject to approximately \$43 million of debt. Although there were other factors to consider, these numbers alone suggest a net value for the entire property closer to \$4 million, while the taxpayer claimed that the remainder interest alone was worth \$33 million. The Tax Court settled on an actual value of approximately \$3.4 million for the remainder interest (meaning the taxpayer’s overstatement triggered the Section 6662(h) penalty), for several reasons, including:

- (1) The taxpayer used the “7520 tables” to value the remainder interest (these tables are used in the context of a remainder interest in a trust, but not when the person retaining a present interest has no fiduciary obligation to preserve the value of the property); and
- (2) The taxpayer used what the IRS’s experts and the Tax Court considered an exceedingly optimistic projection of cashflow.

Reasonable Cause Exception

Even after losing on the question of value, the taxpayer argued that the penalty should not apply due to “reasonable cause.” In this context, the reasonable cause exception requires both a qualified appraisal and the donor’s own “good-faith investigation” of the property’s value. Even accepting as true the donor’s representation of what it actually investigated, the Tax Court found that at most, the donor had reviewed an 18-month old appraisal, which was not sufficient to satisfy the good-faith investigation requirement.

Bottom Line: No Deduction and Harsh Penalties

So, the donor not only lost a \$33 million deduction but also had to pay millions of dollars in penalties for even trying to claim the deduction in the first place. *RERI Holdings* stands as a reminder to all to satisfy the substantiation requirements and that the IRS and courts may be unforgiving of a donor caught trying to get away with an unwarranted deduction.