THE
CATHOLIC
FOUNDATION

The Business Lunch: Uncommon Facts About Charitable Deductions

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"Let's do lunch."

This short, seemingly innocuous invitation can carry a multitude of hidden meanings: Let's talk about my upcoming project. Let me tell you about the changes in my company. Let's work together soon. I really don't want to talk to you right now but want to appear polite. Is it a brush-off, an opportunity, or simply an invitation to dine? Parsing these subtleties can leave us wishing for a written explanation of the speaker's intent.

On the surface, charitable income tax deductions seem similarly straightforward. Many donors believe it is common knowledge that when a person makes a contribution to a school, house of worship, or any qualified charitable organization, the donor can take a charitable income tax deduction if they itemize on their federal income tax return. However, here too, there are subtleties. In particular, potential donors must keep in mind the rules for substantiating and valuing charitable gifts if they intend to deduct their charitable contribution.

Charitable Deduction Substantiation: Do's and Don'ts of Business Lunches

As with most other aspects of business (and life), there is no shortage of articles, books, podcasts, and videos explaining what a business person should and should not do during a business lunch. Despite conflicting advice, some tips are common sense:

- Do be polite and on time
- Don't overindulge in either food or drink
- Do keep the conversation going and focused on the other person
- Don't try to establish a personal connection by venting about personal problems
- Do pick up the check

Luckily, when considering the deductibility of a charitable donation, we don't need to wade through online sources and conflicting opinions—we can simply turn to the Internal Revenue Code (IRC) to find a definitive source of "do's and don'ts." IRC §170 states the general rule: "There shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year."[1] In other words, a taxpayer who makes a contribution to a qualified charity can deduct the gift in the year in which it is made—after meeting two basic requirements:

- Determine the fair market value of the property donated to the charity.
- Retain documentation to substantiate the donation (as prescribed in the Treasury regulations as maintaining adequate records to substantiate the gift).[2]

We will begin by looking at the second requirement—substantiation. It is common knowledge that taxpayers must maintain records related to their taxes, so it shouldn't surprise donors that a gift to charity must be substantiated with a record of the contribution.[3] This record can be:

- a cancelled check
- an electronic fund transfer receipt from a financial institution
- a receipt or written letter from the charitable organization showing the donee name, the date, and the amount of the contribution
- some other reliable written record showing the same information[4]

If a receipt from the charity is impractical (such as for a donation made at a charity drop-box), the taxpayer must keep a reliable written record (including all information required in the regulations) of each item donated.[5]

A Gift of $250 or More

If the donation is $250 or more, the Code requires a "contemporaneous written acknowledgment" (CWA).[6] The Ninth Circuit Court of Appeals noted that this requirement is placed directly on the taxpayer seeking the deduction, not on the charity.[7] A CWA is considered contemporaneous if the donor obtains it before the earlier of (1) the filing of the donor's tax return, or (2) the due date of the donor's tax return in the year in which the charitable donation was made.[8] If the taxpayer files an extension, extensions are included.[9]

A Gift of $500 to $5,000

As charitable donations increase in value, the IRS requires additional information in order to allow the taxpayer to deduct the donation. For gifts of property

over $500 but not more than $5,000, the taxpayer must use IRS Form 8283 to include a description of the donated property with the federal income tax return.[10]

A Gift of $5,000 or More

For a gift of property worth $5,000 or more (other than cash or publicly traded securities, which never require a qualified appraisal), the taxpayer must obtain a qualified appraisal and include the appraisal summary with the tax return.[11] If the donation is non-publicly traded stock, certain publicly traded securities, or a contribution by a C corporation, the donor must maintain additional records.[12] Non-publicly traded stock with a value less than $10,000 does not need a qualified appraisal, but if the value is over $5,000 but less than $10,000, the non-publicly traded stock requires an appraisal summary.[13]

The taxpayer making a gift over $5,000 must also maintain the general substantiation records required by Treas. Reg. §1.170A-13(b)(2)(ii):

- The name and address of the donee organization
- The date and location of the contribution
- A description of the property in reasonable detail (descriptions of securities must include the name of the issuer, the type of security, whether the stock is publicly traded, and where it is traded)
- The fair market value (FMV) of the property at the time of the contribution and how this FMV was determined
- The basis of the property, if the contribution involved certain ordinary income and capital gain property (see IRC 170(e))

A Gift of $500,000 or More

For a non-cash charitable donation of $500,000 or more, the taxpayer must attach a copy of a qualified appraisal (not just an appraisal summary) to the income tax return for that year.[14]

NOTE: Certain charitable gifts are not usually deductible, including:

- Volunteer time (work not done as a professional service)
- Donations to foreign charitable organizations
- Donations made specifically for the benefit of an individual or small group of friends
- Donations made in a *quid pro quo* manner, where the donor receives something of value in return from the charity

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Qualified Appraisals

The IRC only requires appraisals for gifts above $5,000. According to Treasury Regulations, a "qualified appraisal" is an appraisal document that is not more than 60 days old, done by a qualified appraiser, includes the required information, and does not involve a prohibited fee.[15] It must be conducted in accordance with generally accepted appraisal standards and should assess value as of the proposed date of the gift.[16] The required appraisal information includes:[17]

- A sufficiently detailed description of the property
- The physical condition of any tangible property
- The contribution date (or expected date)
- The terms of any agreement or understanding that restricts or reserves rights to or use of the property
- The name, address, and other identifying information and/or the identifying number of the qualified appraiser
- The appraiser's qualifications, including background, experience, education, and professional association membership (if any)
- A statement that the appraisal was prepared for income tax purposes
- The date(s) on which the property was appraised
- The appraised fair market value (see Treas. Reg. §1.170A-1(c)(2)) of the property on the date (or expected date) of contribution
- The method of valuation used to determine the FMV
- The specific basis for the valuation

Qualified Appraisers

The IRC defines a qualified appraiser as someone who:[18]

1. Has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and

experience requirements

2. Regularly performs appraisals for which the individual receives compensation
3. Meets any other requirements prescribed by the Secretary in regulations or other guidance
4. Demonstrates verifiable education and experience in valuing the type of property subject to appraisal
5. Has not been prohibited from practicing before the IRS by the Secretary at any time during the three-year period ending on the date of the appraisal

Specifically excluded from this list are the donor or taxpayer who wants to claim the deduction, as well as any relative or employee of the donor,[19] any person party to the transaction in which the donor acquired the property (unless the property is donated within two months of acquisition for an amount that does not exceed the acquisition price),[20] or anyone who regularly performs appraisals for one of these excluded parties and who does not perform a majority of their appraisals for other people.[21]

Appraisal Summaries

While the taxpayer must attach the actual appraisal when deducting a gift over $500,000, for gifts from $5,000 to $500,000, only an appraisal summary is required. This summary is an IRS form signed and dated by both the donee and the appraiser that includes:

- The donor's name and taxpayer identification number (Social Security number for individuals, employer identification number for partnerships or corporations)
- The donee's name, address, and taxpayer identification number
- The date the donee received the property
- A description of the property (detail must be such that a person who is not generally familiar with the type of property can ascertain that the appraised property is the contributed property)
- A brief summary of the overall physical condition of the tangible property at the time of the contribution
- The manner of acquisition (e.g., purchase, exchange, gift, or bequest)
- The date the donor acquired the property (or the date the property was created, produced or manufactured by or for the donor)
- The cost or other basis of the property, adjusted as provided by IRC §1016
- A statement explaining whether or not the charitable contribution was made by means of a bargain sale and the amount of any consideration received from the donee for the contribution
- The name, address, and identifying number (if a taxpayer identification number is otherwise required by IRC §6109 and the regulations thereunder) of the qualified appraiser who signs the appraisal summary and of other persons as required
- The appraised fair market value of the property on the date of contribution
- Any other required information[22]

Furthermore, the appraiser must declare that he or she is qualified, is not prohibited from performing the appraisal, understands the civil penalties for overstating the valuation,[23] did not charge a prohibited type of fee, and is not currently having his or her appraisals disregarded pursuant to 31 U.S.C. 330(c) on the date he or she signed the appraisal summary.[24]

Gift Valuation: Determining Fair Market Value

A business lunch with the right person at the right time may close a deal, result in a new job, or lead to a big sale—but could a simple business lunch be worth millions of dollars? For the last 20 years, Warren Buffett, the billionaire investor CEO of Berkshire Hathaway, has offered the opportunity to have lunch with him as part of a charitable fundraising auction.[25] In 2019, the winning bid was $4,567,888—an amount that bought the bidder a unique opportunity while providing the charity with a tremendous gift.

No matter how big or small a charitable contribution is, the donor must determine the fair market value (FMV) of the gift—a simple matter for gifts of cash, but more complicated with gifts 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.[26] However, if the charitable gift is property that the donor normally sells in the course of business, then the property's FMV is the price the donor would have received from a sale of the contributed property in the lowest usual market in which the donor customarily sells, at the time and place of contribution.[27]

FMV is relatively easy to determine when there is an established method of valuing the property—for example, a stock listed on an exchange or an over-the-counter market is valued at the mean between the highest and lowest quoted selling prices on the date of the gift.[28] (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.)

When there is no organized market for the asset, valuation becomes slightly more subjective. The IRS has indicated that the selling price of the property is a good indication of the FMV if:

- 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) are fully considered[29]

When the selling price is not certain, there are four common ways to determine value:

1. **Sales of similar assets.** A sale of comparable properties is often used for property, equipment, or art. Consideration must be given to the similarity of the properties, how close the sale date is to the valuation date, whether the sale was at arm's length, along with relevant market conditions. Problems can arise when there are unusual market conditions, little or no information on comparable sales, an inability to predict future events, or too great a reliance on past events. The IRS noted that "(c)omparable property sales may be used only after the sales prices have been adjusted for differences between the properties. In making adjustments, the appraiser should adjust to the property being appraised."[30] Of course, these adjustments are a "judgment conclusion of the appraiser."[31]
2. **Capitalization of earnings.** Income-producing property (such as commercial real estate, intellectual property, restaurant or other retail franchises, or certain other real estate interests) is sometimes valued using the capitalization-of-earnings method, which takes the property's estimated future income stream and discounts it to a present cash value.
3. **Replacement value.** Assets without comparable properties or an income stream may have to rely on replacement cost to determine the FMV—in other words, the amount that it would take to replace the item donated on the date of the charitable donation. Such items are subject to economic pressures of supply and demand, so scarcity will increase the value. Of course, there must be a reasonable relationship between the replacement cost and the FMV.[32]
4. **Expert appraisal.** For some assets, an expert appraisal may be the best option. As we noted earlier, gifts over $5,000 will require an appraisal.

Guidance for Particular Assets

While the IRS leaves the valuation method to the taxpayer (subject to applicable laws and guidance), it does provide specific rules for a number of particular types of property.

Motor vehicles, boats, and airplanes. The American Jobs Creation Act of 2004 provided new requirements for the charitable donation of qualified motor vehicles, boats, and airplanes, particularly applying to deduction substantiation.[33] The IRS notes that some trade organizations and commercial operations publish dealer sales prices or average prices, and while these guides are not official valuations—nor do they qualify as an appraisal—they do provide relative prices for comparable sales in the donor's area.[34]

Inventory. Occasionally, a business owner will donate inventory—items normally sold to customers.[35] Here, FMV relies on the usual market for the goods. If the owner normally sells to wholesalers, the property is valued at that wholesale price. If the owner sells directly to retail customers, the property is valued at its retail price.

Because inventory would create ordinary income if sold, the donor's deduction for such a gift (at a time when the donor could expect to receive the usual selling price) generally must be reduced by the amount that would be ordinary income, making the deduction the lower of the FMV or the donor's cost basis.[36] If the donor has already deducted the cost basis for inventory property under IRC §162, a second charitable deduction under IRC §170 is not allowed.[37]

Closely held stock. This often-attractive gift option provides an opportunity to avoid capital gains tax, but with no organized market, valuation can be challenging. In Revenue Ruling 1959-60, the IRS acknowledged that valuation is not an exact science and there can be no general formula—however, it did provide a number of factors to consider in determining FMV. In addition to all available financial and market data, an appraiser should consider the following:

- 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

Household goods and used clothing. These items are usually valued much lower than the price paid when new.[38] While the items must be in good condition to claim a deduction, there is still the issue of wear and tear, or goods that are no longer useful or in style.

Real estate. The fair market value of real estate is generally based on the appraisal required under the IRC.[39] The IRS looks at the property's highest and best use, regardless of how the property had been used or how the charity expects to use the property.[40] 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 FMV in excess of the mortgage.

Real property held in the course of a donor's trade or business (for example, a home or lot owned by a real estate developer for a business purpose) is considered inventory property and also ordinary income property, and the donor's deduction would be limited to the cost basis.

Learning from Mistakes: Lessons from a Court Case

A bad business lunch is hard to forget. Consider this meal that went horribly wrong:

> … the saleswoman invited her very sophisticated client and his wife to dinner to celebrate the signing of a large construction contract. The saleswoman's boss, the owner of the Kansas City construction company, insisted on going to the dinner with her. The saleswoman watched her commission dissipate while her boss picked his teeth with fish bones and impressed the party by using a commonly used expletive as five different parts of speech. Instead of using his dinner napkin to wipe his mouth, the boss wiped out the deal when he used it to blow his nose. The following day the contract was rescinded.[41]

Mistakes present an opportunity to learn and to hopefully not make the same mistake again—but it's always easier to learn from the mistakes of others. Therefore, let's take a quick look at a legal decision so we can learn lessons from both the taxpayer and the IRS.

Christopher John Totten v. Commissioner U.S. Tax Court, T.C. Summary Opinion 2019-1, (Jan. 29, 2019)

In his Tax Court case, Christopher Totten, a medical sales representative, disputed a number of items for tax years 2009 and 2010, including several charitable contribution disputes. He had issues with both valuation and substantiation.

In 2009, Totten made a number of charitable contributions and took a deduction of $18,414 for non-cash contributions. The Tax Court described Totten's return:

> On his 2009 Form 8283, petitioner reported that on March 10, 2009, he donated clothes, computers,

> and furniture to the donation center with an aggregate fair market value of $2,164; that the date acquired was "various"; that the contributed items were acquired by purchase; that he had a cost or adjusted basis in the contributed items of $10,478; and that "consignment shop" was the method used to determine the fair market value. On the 2009 Form 8283, petitioner also reported that he donated to the foundation new and unopened toys, household items, and money with an appraised fair market value of $16,250 and with December 2009 as the date acquired; that the contributed items were acquired by purchase; that he had a cost or adjusted basis in the contributed items of $16,250; and that their overall physical condition was "brand new items unopened." At trial, petitioner argued that a portion of his non-cash contributions also included the value of a vehicle—a 1998 Mercedes C280W (1998 Mercedes)—he had donated in 2009.

Unfortunately for Totten, the IRS stated that he only substantiated $3,709 of non-cash charitable contributions and $135 of cash charitable contributions for 2009. As a result, the IRS disallowed the $14,570 in non-cash contributions, as well as any amount for the Mercedes. Totten testified that the value assigned to his donations was assigned by the donation center, and that the costs were based on the actual costs of the items. Totten said he had kept the original receipts, but he attached them to the items when he donated them to the charity. Further, Totten testified that he had kept an itemized list of each item he donated with the assigned value, but he no longer had it.

Needless to say, the Court did not find Totten's testimony convincing, as he had failed to satisfy the substantiation requirements, failed to provide a contemporaneous written acknowledgement, and failed to maintain written records of the acquisition of the donated items, their cost, and the calculation method for determining their FMV. Totten did not obtain an appraisal or attach an appraisal summary. As for the Mercedes, Totten said he donated it to a charity for which he could not remember the name, and he failed to obtain the required contemporaneous written acknowledgement.

Common Knowledge vs. Knowledge of Subtleties

People understand the advantages of the business lunch, but may have developed their own successful style that doesn't exactly match tips from the experts. Similarly, donors understand the advantages of taking a charitable income tax deduction. But to be successful, donors cannot develop "their own style" that ignores the substantiation and valuation requirements of the IRS—rather, success hinges on following every detail prescribed in federal tax law.

Knowledgeable financial professionals can provide an essential service by guiding donors to properly substantiate and value their gifts according to the law. Understanding and applying these subtleties will help donors achieve a successful, properly deductible charitable donation. And when that happens, you won't have to wonder about the underlying intention when the donor says, "Let's do lunch"—it will assuredly be a celebration of a successful, well-documented transaction.

ENDNOTES

1 IRC §170(a)(1).
2 Treas. Reg. §1.170A-13(a)(1).
3 *Id.*
4 *Id.*
5 Treas. Reg. 1.170A-13(b)(1)(iii) and (b)(2)(ii).
6 IRC 170(f)(8)(A).
7 *Addis v. Commissioner of Internal Revenue*, 374 F3d 881 (9th Cir. 2004).
8 IRC §170(f)(8)(C).
9 IRC §170(f)(8)(C)(ii).
10 IRC §170(f)(11)(B).
11 Treas. Reg. §1.170A-13(c)(2)(i)(B).
12 Treas. Reg. §1.170A-13(c)(2)(ii).
13 Treas. Reg. §1.170A-13(c)(2)(ii)(A).
14 IRC §170(f)(11)(D).
15 Treas. Reg. §1.170A-13(c)(3).
16 IRC §170(f)(11)(E) and Treas. Reg. §25.2512-3.
17 Treas. Reg. §1.170A-13(c)(3)(ii).
18 IRC §170(f)(11)(E)(ii).
19 Treas. Reg. §1.170A-13(c)(5)(iv).
20 Treas. Reg. §1.170A-13(c)(5)(iv)(B).
21 Treas. Reg. §1.170A-13(c)(5)(iv)(D).
22 Treas. Reg. §1.170A-13(c)(4)(i)(A)-(D).
23 Treas. Reg. §1.170A-13(c)(5)(i)(D).
24 Treas. Reg. §1.170A-13(c)(4).
25 Jonathan Stempel, "Warren Buffett charity lunch fetches record $4.57 million winning bid," Reuters, June 1, 2019. https://www.reuters.com/article/us-buffett-lunch/warren-buffett-charity-lunch-fetches-record-4-57-million-winning-bid-idUSKCN1T238Y
26 Treas. Reg. §1.170A-1(c)(2) and Reg. §25.2512-1 and 20.2031-1(b).
27 Treas. Reg. §1.170A-1(c).
28 Treas. Reg. §25.2512-2(b) and 20.2031-2(b).
29 IRS Publication 561: *Determining the Value of Donated Property*.
30 *Id*.
31 *Id*.
32 *Id*.
33 IRC §170(f)(12)(E).
34 IRS Publication 561: *Determining the Value of Donated Property*.
35 Treas. Reg. §1.170A-1(c)(2).
36 IRC §170(e).
37 Treas. Reg. §1.170A-1(c)(4).
38 IRS Publication 561: *Determining the Value of Donated Property*.
39 IRC §170(f)(11)(C) and Treas. Reg. §1.170A-13(c)(2).
40 IRS GCM 39380 (July 9, 1985) (citing *McGuire v. Comm'r*, 44 T.C. 801 (1975)).
41 Elizabeth Fountain, "Failing to observe good etiquette is bad manners, bad for business," *Kansas City Business Journal*, November 10, 1996. https://www.bizjournals.com/kansascity/stories/1996/11/11/smallb3.html

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