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IRS Crackdown on Tax Deductions Puts Focus on Gift Records

By Debra E. Blum

Charities are facing new pressure to make sure they say thank you to donors exactly the way the IRS says. And donors must be fastidious about the steps they take to prove they made a gift if they expect to get a charitable deduction.

That new reality is the lesson from two Tax Court rulings saying the Internal Revenue Service was right to deny tax deductions to donors who didn't have the right paperwork.

The court has denied charity write-offs plenty of times over the years, but legal observers say these recent cases signal an alarming willingness by the IRS to penalize taxpayers for what amounts to a foot fault.

"The IRS is following the letter of the law, but it's a very tunneled approach, form over substance," says Steven Fromm, a Philadelphia tax lawyer. "It's pretty scary, but it reminds us all that we need to be really careful dotting our I's and crossing the T's and be more accountable to the IRS."

An IRS spokesman says the agency provides ample guidance to taxpayers and charities on record keeping. He declined to comment on the specific cases.

Detailed Rules

Under a federal law that went into effect in 1994, donors cannot claim write-offs for gifts of $250 or more unless they have received written acknowledgments of such gifts from the charities by the time they file their income-tax returns.

The acknowledgments must state the amount of cash donated or describe noncash gifts. They must also say whether the charity provided goods or services in exchange for the gift.

The rules for proving the value of charitable gifts, which have been amended and updated over the past eight years, also include detailed regulations about the steps donors must take to claim income-tax deductions for donated property (except publicly traded securities) valued at more than $5,000. Chief among them: Donors must have a qualified appraisal.

In one of the court cases, a judge ruled in May that a California couple, Joseph and Shirley Mohamed, could not claim tax breaks for donating millions of dollars worth of property because they didn't include proper appraisals with their returns.

Mr. Mohamed, a real-estate broker and appraiser, did the couple's own taxes and listed a self-assessed value of the donations of $18.5-million on their tax forms for 2003 and 2004.

Independent appraisals conducted after the start of the audit found that Mr. Mohamed had undervalued the properties in his filings, prompting the judge to state in a note at the end of his opinion that he recognized denying the write-off claim was “harsh.”

“But,” wrote Judge Mark Holmes, “the problems of misvalued property are so great that Congress was quite specific about what the charitably inclined have to do to defend their deductions, and we cannot in a single sympathetic case undermine those rules.”

Well-Meaning Donors

The other tax-court case also centers on donors who appear well meaning but were tripped up by inflexible IRS rules.

The court, also in May, disallowed a Texas couple, David and Veronda Durden, from taking a 2007 charitable deduction for more than $25,000 worth of cash gifts to their church, plus it assessed the donors an “accuracy-related penalty” of more than $1,500.

The court’s opinion said the Durdens failed to provide suitable and timely written acknowledgments of their gifts, even though it noted the couple had twice tried to satisfy the IRS by getting letters from the church.

In the first instance, the letter did not include all the stipulated language. In the second, the letter came too late, the opinion said.

The Durden case has attracted interest in part because it was a surprise that the IRS bothered to challenge the deductions in the first place.

Usually when the IRS challenges deductions under the proof-of-value law, it has been over issues like donations of real estate, transactions that prompt donors to take big write-offs.

“This is a rare time that we see the IRS and the court come down on ordinary taxpayers making small cash contributions to charity with no other issues but some paperwork problems,” says Ira Shepard, professor emeritus at the University of Houston Law Center.

He and other tax experts see the Durden and Mohamed cases as part of a wider crackdown on charitable deductions over the past few years, prompted in part by Congressional pressure on the IRS to close the tax gap—the difference between taxes owed and taxes collected.

And since fighting over valuations can be costly, the IRS, they say, has started focusing on highly technical violations of the law.

Lessons for Charities

Tax advisers see the Durden and Mohamed cases as their warning. Many say they will take greater pains to ensure clients understand that they, as donors, must get properly worded gift acknowledgments from charities before tax time. And they will continue to advise donors seeking write-offs for more complicated gifts, like real estate, to comprehend the appraisal and valuation rules and secure professional help.

The Durden case also carries lessons for nonprofit organizations, as the Texas church in that case failed to help its donors get the documents they required in a timely fashion.

Insufficient gift acknowledgments could aggravate donors, observers say, or worse, put them in a position, like the Durdens, in which their gifts are challenged years after they are made.

“There’s so much focus with thank-you notes on how to be clever and get donors’ attention and cultivate donors that we might forget the legal issues that our donors face,” says Jennifer Chandler, a vice president at the National Council of Nonprofits, a group that represents state nonprofit associations.

“We don’t want to be dry and we don’t want to look like we’re giving legal advice, but letters sent soon after a gift is made with all the language the IRS requires will go a long way to help.”