Deconstructing the Tax Code: A Cautionary Tale for Canada on Charitable Contributions and Appraisal Pitfalls

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Introduction:

As Canada begins to implement tax credits for donations of deconstructed building materials, the country enters uncharted territory that the United States has been navigating for over two decades. While the U.S. has offered tax deductions for these types of donations, the results have been mixed—ranging from legitimate tax savings to abusive valuation practices that led to costly audits, penalties, and legislative crackdowns.

This is a **cautionary tale** for Canada to learn from the U.S. experience. By emphasizing the importance of using **sound valuation methodology** and ensuring that **qualified appraisers** produce **qualified appraisals**, Canada can avoid the pitfalls that have plagued the U.S. system. The Deficit Reduction Act of 1984 (DEFRA) in the U.S. introduced stringent substantiation requirements, but even with regulations, issues such as inflated valuations and conflicts of interest have persisted. As the Canadian government steps into this space, understanding the complexities of tax shelters, appraisal requirements, and the roles of all parties involved is critical to protecting both the tax system and donors.

This article will delve into the challenges faced in the U.S. and offer recommendations for Canada to navigate this tax incentive with greater integrity and transparency, ensuring that deconstruction donations fulfill their intended benefits without falling prey to misuse.

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The Canadian Revenue Agency's (CRA) Tax Code on Charitable Contributions

The CRA provides tax incentives for gifts to qualified donees, which include **registered charities**, **registered journalism organizations (RJO)**, **Canadian amateur athletic associations**, **national arts service organizations**, **housing corporations** for low-cost housing for the aged, **municipalities**, **government bodies**, the **United Nations and its agencies**, **universities outside Canada** that regularly accept Canadian students, and **registered foreign charities** to which the Canadian government has made contributions. Qualified donees must be publicly listed, except for the United Nations and Canadian government bodies, which qualify automatically.[1]

Eligible Amount of the Gift

The eligible amount for tax credits is typically the **fair market value (FMV)** of the gift, minus any advantage (benefits or compensation) received by the donor. The advantage could include contingent future benefits, use, or debt forgiveness. The **eligible amount** must exclude the value of any benefits the donor or their related party may receive.

In some cases, the **eligible amount is deemed to be nil** if the donor fails to provide necessary information to the donee, or the FMV is reduced in cases where there is a **deemed FMV** lower than the original FMV, such as property acquired within three years before donation or as part of a **tax shelter gifting arrangement**.

Types of Donations

1. **Monetary Gifts**: Monetary donations to registered charities or other qualified donees can claim up to **75% of net income** in the year. The unused amount can be carried forward for up to **5 years** (or 10 years for ecologically sensitive land).
2. **Non-monetary Gifts (Gifts-in-kind)**: Gifts of property, such as securities, real estate, cultural property, and ecologically sensitive land, can also be claimed. **Capital gains** arising from the donation of **publicly traded securities** may benefit from a **zero-inclusion rate**, meaning no capital gains tax is owed.
3. **Capital Property**: Donations of capital property, such as land, securities, or other appreciated assets, are generally considered **dispositions** for tax purposes, and the capital gain must be reported. However, donors can **designate** an amount lower than the FMV to reduce the capital gains tax, provided it is not lower than the property's **adjusted cost base (ACB)**.
4. **Ecologically Sensitive Land**: Gifts of ecologically sensitive land to approved bodies are eligible for special tax benefits, such as not being subject to the 75% of net income limit and the ability to carry forward unused credits for **10 years.**

[1] CRA Publication 113 Gifts and Income Tax 20233

5. **Cultural Property**: Donations of certified cultural property to designated institutions are also eligible for enhanced tax incentives, and donors avoid realizing any **capital gains**.
6. **Non-qualifying Securities**: Special rules apply to gifts of non-qualifying securities, such as shares or obligations from a company controlled by the donor. These gifts may not be eligible for tax credit unless certain conditions are met.
7. **Gifts to U.S. Charities**: Donations to U.S. charities can be claimed if the donor has **U.S.-source income**, and the charity meets the CRA's conditions for recognition. These gifts are eligible up to **75% of the donor's U.S.-source income** reported on the Canadian tax return.

Documentation and Reporting

Donors must keep official donation receipts and relevant documentation, such as appraisals for gifts in kind, for tax filing purposes. **Official receipts** must detail the FMV and eligible amount of the gift. For non-cash gifts, the donee must obtain a **professional appraisal** to determine the FMV. If the FMV exceeds $1,000, it is recommended to obtain multiple appraisals.

In cases of **estate donations**, the estate can claim gifts made by the deceased within five years before death, and certain gifts can be allocated to earlier tax years. Estate donations are eligible for the **graduated rate estate (GRE)** treatment, allowing tax benefits across multiple tax years.

When completing **Schedule 9** for non-cash charitable contributions in Canada, there are several critical steps and guidelines to follow to ensure compliance with the Canada Revenue Agency (CRA).[2] Based on the detailed guidance in the Canadian tax publication P113 and other relevant sections of the Canadian tax code, the process includes:

1. **Enter the Eligible Amount of Gifts**: Taxpayers must include the eligible amount of the gift, which refers to the fair market value (FMV) of the donated property, minus any advantages received from the donation. The FMV is determined at the time the donation is made, and in many cases, an independent appraisal is required, especially for property like art, antiques, or real estate. For gifts of cultural property or ecologically sensitive land, specific certifications from governing bodies like the Canadian Cultural Property Export Review Board (CCPERB) or the Minister of Environment are needed to determine the value.
2. **Tax Credit Calculation**: The eligible amount calculated is used to determine the federal and provincial non-refundable tax credits. You are entitled to claim up to 75% of your net income as donations. However, donations of capital property (such as shares, real estate, or art) may allow for an increased donation limit. Donations of certified cultural property or ecologically sensitive land often have more favorable capital gains treatment, including a potential 0% capital gain inclusion rate.

[2] Canadian Schedule 9

3. **Appraisals and Documentation**: For larger gifts, especially those valued over $1,000, an official appraisal may be required to substantiate the FMV. This appraisal must follow recognized standards, such as the *Uniform Standards of Professional Appraisal Practice (USPAP)*[3], and should be carried out by a qualified, independent appraiser. The appraiser should not be affiliated with either the donor or the donee. It is important to maintain all documents and receipts related to the appraisal and donation for future reference in case of a CRA review.
4. **Special Treatment for Certain Gifts**: Gifts of securities, real property, or other capital assets are subject to special rules. The CRA provides specific relief for capital gains realized on donations of publicly traded securities or ecologically sensitive lands, as detailed in the CRA's Guide T4037 (Capital Gains). Additionally, taxpayers may elect to reduce the value of the gift to reduce the capital gain triggered by the donation.
5. **Use of Carryforward**: If the entire amount of the donation cannot be claimed in the current year (due to the 75% income limitation), the unused portion can be carried forward and claimed in any of the next five years. In the case of donations of ecologically sensitive land, the carryforward period extends to 10 years.

For more detailed guidelines on completing Schedule 9, donors are encouraged to review CRA publications and consult professionals to ensure all aspects of the donation process comply with CRA requirements(p113-23e).

Considering these details, it is essential for donors to properly document their donations and ensure that any appraisals are conducted by qualified professionals. Taxpayers should also ensure they understand the implications of donating different types of property, especially in complex situations involving capital gains or specialized assets.

Special Rules for Tax Shelters

Gifts made as part of **tax shelter arrangements** may have their eligible amount reduced or deemed to be nil, depending on the nature of the arrangement. The CRA has strict reassessment and audit rules for such arrangements, and donors may face extended reassessment periods. We outline the details of these tax shelters in the subsequent section.

[3] Uniform Standards of Professional Appraisal Practice

Tax Shelters in Canadian Tax Law

A **tax shelter** in Canadian tax law is a type of arrangement that provides participants with significant tax benefits, usually in the form of **deductions** or **credits** that are disproportionate to the amount of investment. These schemes can involve various forms of investment, donations, or property transactions. The Canada Revenue Agency (CRA) defines and regulates tax shelters under the **Income Tax Act (ITA)**, and it requires promoters of such shelters to register them with the CRA.[4]

Key Features of a Tax Shelter

1. **Excessive Deductions or Credits**: A tax shelter provides the investor or donor with deductions or credits that exceed their original contribution, typically in a short period. For example, a common arrangement might promise deductions or credits greater than 100% of the amount invested within a few years.
2. **Limited Risk for Participants**: Many tax shelters involve situations where the participant faces little or no financial risk, often through non-recourse or limited-recourse financing arrangements, meaning the investor isn't personally liable for the full amount of the loan or investment.
3. **Gifting Arrangements**: Some tax shelters involve **gifting arrangements**, where a taxpayer donates property or cash to a qualified donee and receives tax credits based on inflated appraised values of the donated items.

Tax Shelter Registration

Promoters of tax shelters are required to register them with the CRA before offering them to the public. The CRA assigns a **tax shelter identification number**, which must be included in all related documentation and on tax filings. However, receiving a registration number does not mean the CRA endorses the tax shelter or guarantees its benefits. It merely tracks the shelter for audit purposes.

Examples of Tax Shelters in Canada

1. **Gifting Tax Shelters**: These are arrangements where participants make donations (often involving art, land, or other property) to a registered charity or qualified donee and receive a donation receipt for an inflated amount. This allows the taxpayer to claim a larger charitable donation tax credit than the actual value of the gift.

[4] Canadian Tax Shelters

    - **Example**: A taxpayer donates a piece of artwork that was purchased for $1,000 but receives a donation receipt valuing the artwork at $5,000, allowing the taxpayer to claim tax credits on the inflated value.
2. **Tax Shelter Investments**: These involve arrangements where taxpayers invest in schemes promising tax deductions or credits that are significantly greater than the amount of money invested. These often involve limited partnerships or ventures where investors are told they will receive deductions exceeding their capital outlay.
    - **Example**: An investor contributes $10,000 to a limited partnership and is promised $15,000 in tax deductions over the course of a few years.

Limited-Recourse Financing in Tax Shelters

A common feature in many tax shelters is the use of **limited-recourse financing**, where the loan used to finance the investment is structured in such a way that the taxpayer isn't at full risk for repayment. This often results in inflated tax benefits. Limited-recourse debt is debt for which the borrower has limited risk of repaying.

- **Non-recourse debt**: The lender has no claim against the borrower's other assets if the loan isn't repaid.
- **Limited-recourse debt**: The borrower's liability is capped, typically below the amount of the loan.

In the case of a tax shelter, if the taxpayer isn't genuinely at risk for repaying a loan, the CRA considers this when determining the true amount of the tax deduction or credit that can be claimed. The **eligible amount of the tax benefit** will exclude the portion of the financing that is non-recourse or limited-recourse.

These provisions should be considered as Canadians move towards claiming tax credits for donations of deconstructed building materials to avoid an intentional or unintentional illegal tax shelter.

CRA Rules on Deemed Fair Market Value and Gifting Tax Shelters

The CRA enforces strict **deemed fair market value (FMV)** rules in situations where gifts or investments are part of tax shelter schemes. For property donations or gifts involved in tax shelter schemes, the CRA typically limits the amount that can be claimed for tax purposes to the **lower** of the following:

1. The **fair market value** (FMV) of the property at the time it was gifted, or
2. The **cost** or **adjusted cost base (ACB)** of the property to the donor.

This rule is designed to prevent taxpayers from inflating the value of donated property to claim an outsized tax benefit. The deemed FMV applies particularly to property acquired less than three years before the donation, or less than 10 years if the primary purpose of acquiring the property was to make a donation.

Audit and Reassessment

Taxpayers who participate in tax shelters are at a high risk of being audited by the CRA. The CRA has the authority to **reassess** taxpayers who claim tax deductions or credits associated with tax shelters.

- **Extended Reassessment Period**: For participants in tax shelters, the normal reassessment period is extended by three years beyond the typical reassessment period. If the tax shelter was not properly registered or if required documentation was not submitted, the reassessment period may be extended further.
- **Penalties**: If a taxpayer is found to have improperly claimed tax benefits from a tax shelter, they may be required to repay any benefits they received, along with interest and potentially **penalties**.

Warnings and Risks

The CRA has issued warnings to taxpayers about the risks of participating in tax shelters, particularly gifting arrangements that are **too good to be true**. Despite registration requirements, many tax shelters are flagged for audit, and taxpayers are advised to obtain **independent professional advice** before participating in any such arrangement.

In cases where the CRA determines that a tax shelter is abusive or fraudulent, the tax benefits claimed can be **disallowed** entirely. The CRA frequently audits and reassesses taxpayers who have participated in tax shelters, especially those involving large deductions or credits in a short period.

Tax Shelter Identification Numbers

When a taxpayer claims a tax benefit from a registered tax shelter, they must include the **tax shelter identification number** on their tax return. The CRA monitors these tax shelter numbers closely to ensure compliance.

Key Takeaways on Canadian Tax Shelters

- Tax shelters provide deductions or credits greater than the invested amount or involve inflated valuations.
- Promoters must register tax shelters, but registration doesn’t guarantee CRA approval or protection from audit.
- Limited-recourse financing or gifting arrangements often characterize tax shelters.
- The CRA applies strict rules on fair market value, and taxpayers may face audits or reassessment if benefits are improperly claimed.

By comparison to the U.S., Canada's approach to tax shelters is similarly stringent, focusing heavily on preventing abuses through inflated deductions or credits, though the structure of tax benefits and limitations can differ based on the type of arrangement (e.g., charitable donations, gifting of property, or investments). Both countries emphasize transparency, compliance, and strict audit enforcement.

Overview of the U.S. System for Charitable Contributions (Non-Cash Donations)

Under the U.S. Internal Revenue Code (IRC) Section 170, individuals and businesses may deduct charitable contributions of non-cash property made to qualified organizations, provided they meet specific criteria. These rules are further outlined in IRS Publication 526. Key highlights include:

Qualified Organizations

Charitable deductions are only allowed if the donation is made to a qualified organization, which includes:

- U.S. federal, state, or local governments for public purposes
- Religious, charitable, educational, and scientific organizations
- War veterans' organizations, nonprofit volunteer fire companies, and certain nonprofit cemetery companies
- Fraternal societies, if the contribution is used for charitable purposes
- Certain foreign organizations, like Canadian charities, under tax treaties (if the donor has Canadian source income)

Types of Deductible Contributions

- **Fair Market Value (FMV) of Property:** For non-cash donations, the general rule is to deduct the FMV of the property at the time of donation. Adjustments may be required if the property has appreciated.
- **Limitations on Deductions:** Donations are generally deductible up to 50% of Adjusted Gross Income (AGI) for most charities and 30% for private foundations. Special limitations apply for donations of long-term capital gain property and certain high-value items, such as art. The deduction must be fully taken against Adjusted Gross Income in the first year with an additional five-year carry forward on a use it or lose it basis.
- **Substantiation Requirements:** Contributions over $500 require additional forms (e.g., Form 8283) and for amounts exceeding $5,000, a qualified appraisal may be necessary.

Timing of Contributions

Non-cash donations must be made by the close of the tax year to be deductible in that year, and there are special rules governing the deduction of future interests in property.

DEFRA Compliance

The Deficit Reduction Act of 1984 (DEFRA) sought to address the abuse of inflated valuations for non-cash charitable contributions in the U.S., which were exploited by tax shelter promoters. Congress recognized the limitations of relying on audits alone to detect overvaluations and enacted stricter substantiation requirements and penalties for overvaluation to deter excessive charitable deductions.

In response, the IRS implemented regulations under §170(a)(1), with §1.170A-16 outlining substantiation requirements for non-cash donations over $5,000. These include obtaining a contemporaneous written acknowledgment from the charity, securing a qualified appraisal by a qualified appraiser, and filing Form 8283 with the tax return.

Several court cases illustrate the importance of compliance with these substantiation requirements. In *Estate of Harvey Evenchik v. Commissioner*, the taxpayer incorrectly appraised the wrong asset and failed to meet several requirements, resulting in the denial of the deduction. In *RERI Holdings I, LLC v. Commissioner*, the omission of key information on Form 8283 led to a complete disallowance of a $33 million deduction. Similarly, in *Mark R. Ohde v. Commissioner*, deductions were denied due to the lack of required appraisals and signatures.

These cases emphasize the importance of adhering to the DEFRA-mandated substantiation and reporting rules, underscoring the need for proper documentation, accurate appraisals, and complete tax forms to avoid penalties and denied deductions for non-cash charitable contributions.

If a single component of the appraisal is deemed unqualified, if the appraiser is deemed unqualified, if the nonprofit does not produce a compliant Contemporaneous Written Acknowledgement (CWA) and/or if a single portion of Form 8283 is noncompliant, the taxpayer can lose the value of the entire deduction on a technicality. This position has been bolstered by recent Tax Court cases.

Taxpayer Penalties for Erroneous Appraisal Valuations

The IRS imposes penalties for the **underpayment of taxes** to ensure taxpayer compliance and discourage inaccurate reporting on tax returns. One key penalty is the **substantial understatement of income tax penalty**, which applies directly to the taxpayer and **not** the appraiser. The taxpayer is fully responsible for all aspects of the appraisal, including the values claimed, and any inaccuracies can result in significant penalties.

Key Criteria for the Penalty:

- For **individuals**, the penalty applies if you **understate** your tax liability by either:
    - **10%** of the total tax required to be shown on the return, or
    - **$5,000**, whichever is greater.
- If you claim a **Section 199A Qualified Business Income Deduction**, the penalty applies if you understate your tax by either:
    - **5%** of the total tax required to be shown on the return, or
    - **$5,000**, whichever is greater.

Penalty Amount for Understatement or Negligence:

- The **accuracy-related penalty** for substantial understatement or negligence is **20%** of the portion of the underpaid tax.
- Negligence refers to failing to make a reasonable attempt to comply with tax laws or disregarding IRS rules or regulations.

Penalty for Gross Negligence:

The gross valuation misstatement penalty is a serious consequence for taxpayers who overstate the value of a charitable donation, particularly when the donation is deemed to be a sham. This penalty comes into play under Section 6662(h) of the U.S. tax code, imposing a **40% penalty** on the portion of the underpayment of tax attributable to the misstatement.

A gross valuation misstatement occurs when the claimed value of the donated property exceeds 200% of its actual value. In cases where a donation is found to have no legitimate value, such as in Fakiris v. Commissioner, where restrictions placed on the donated property (a theater) rendered the gift incomplete, the Tax Court held that the value of the donated property was zero. This resulted in the automatic application of the 40% penalty.

The Supreme Court's ruling in United States v. Woods reinforced that the valuation misstatement penalty applies even when an entire transaction is disregarded for lacking economic substance. This case established that if the "correct value" of the property is zero, the misstatement penalty applies.

In the Fakiris case, the IRS sought a reconsideration, arguing that the gross valuation penalty should be based on the difference between the value of the theater without restrictions and the value of the property with restrictions. However, the court held that because no actual gift was transferred, the correct value of the property was zero, thus affirming the application of the penalty.

Responsibility of the Taxpayer:

- The penalty is **entirely the taxpayer's responsibility**. Even though the appraisal may be prepared by a qualified appraiser, the taxpayer is accountable for the accuracy of every detail within the appraisal, including the values claimed. Any errors or overvaluations can lead to the taxpayer being penalized.
- A negligence 20% penalty or the gross negligence 40% penalty could result in tens of thousands in fines and penalties and could easily reach the six figures depending upon the claimed deduction and legal fees. Again, ***these penalties are entirely on the taxpayer and not the appraiser.***

Appraiser Penalties for Valuation Misstatements

Under 26 U.S. Code § 6695A, penalties are imposed on appraisers who provide incorrect valuations for property used in connection with tax returns or refund claims. The penalties are specifically aimed at preventing substantial or gross valuation misstatements that result in incorrect tax filings. Here is an overview of the key provisions of the law:

(a) Imposition of Penalty:

A penalty is imposed if:

1. An appraiser prepares an appraisal knowing, or reasonably should have known, that the appraisal would be used for a tax return or refund claim.
2. The claimed value of the property on the return, based on the appraisal, results in:
    - A substantial valuation misstatement under Chapter 1 (as defined by §6662(e)),
    - A substantial estate or gift tax valuation understatement (as defined by §6662(g)), or
    - A gross valuation misstatement (as defined by §6662(h)).

If these conditions are met, the appraiser is liable for a penalty.

(b) Amount of the Penalty:

The penalty for an incorrect appraisal is the lesser of the following:

1. The greater of:

    - 10% of the amount of the underpayment of tax attributable to the misstatement, or
    - $1,000, or
2. 125% of the gross income received by the appraiser for preparing the incorrect appraisal.

(c) Exception:

No penalty will be imposed if the appraiser can demonstrate to the satisfaction of the Secretary of the Treasury that the value established in the appraisal was more likely than not the proper value.

Key Points:

- This section of the code places direct responsibility on the appraiser for ensuring the accuracy of their valuations when they know or should know that the appraisal will be used for tax purposes.
- The penalty is designed to address situations where the appraisal leads to substantial or gross valuation misstatements, which could result in significant underreporting of taxes.
- The penalty on the appraiser is **minimal** compared to the substantial underpayment penalties imposed on the **taxpayer.**

This provision was added by Pub. L. 109–280, title XII, § 1219(b)(1) on August 17, 2006, and further amended by Pub. L. 110–172 on December 29, 2007. It reinforces the importance of accuracy and compliance with IRS guidelines for appraisers involved in property valuations used for tax deductions or refunds.

U.S. Tax Shelters Related to Charitable Giving

A **tax shelter** in the U.S. refers to any arrangement or scheme where the primary purpose is to reduce taxable income or to generate tax benefits, such as deductions, credits, or deferrals, often in a way that significantly reduces tax liability in an accelerated or disproportionate manner. In the context of **charitable giving**, tax shelters can take various forms, and the **Internal Revenue Code (IRC) Section 170** provides the framework for the deductibility of charitable contributions. While charitable deductions are legitimate, **abusive tax shelters** related to charitable donations, particularly involving non-cash gifts, have been a concern for the IRS.

The IRS has established rules and limitations to prevent misuse of charitable contributions for tax shelters, particularly in cases where taxpayers donate **non-cash assets** such as **real estate, art, securities, or intellectual property**. Below is an in-depth look at the various aspects of charitable giving tax shelters in the U.S., including how they are structured, the risks involved, and IRS rules designed to curtail abusive tax shelter practices.

Key Features of Charitable Tax Shelters

1. **Non-Cash Donations of Overvalued Property** One common type of charitable tax shelter involves the donation of **non-cash assets—**such as art, securities, or real estate**—**where the **fair market value (FMV)** of the donated property is artificially inflated to generate larger-than-justified tax deductions. In these cases, the donor claims a charitable deduction based on an overestimated value of the property, often through the use of questionable or biased appraisals.
    - **Example**: A taxpayer donates artwork valued at $10,000 to a charity, but the actual market value is only $2,000. The inflated deduction of $10,000 significantly reduces the taxpayer's tax liability.
2. **Limited Recourse or Non-Recourse Loans** In many tax shelter schemes, donors use **limited-recourse loans** to finance the purchase of assets that will later be donated to charity. Because the taxpayer has limited liability for the repayment of the loan, the true economic risk is reduced, but the taxpayer still claims a deduction for the full value of the donation.
    - **Non-recourse debt**: A loan where the lender's only recourse in case of default is to seize the collateral, with no claim on the borrower's other assets.
    - **Limited-recourse debt**: A loan where the borrower’s liability is capped at a certain amount, typically less than the total loan balance, thereby reducing the taxpayer's actual financial exposure.
3. **Gifting Arrangements** Tax shelters often involve complex **gifting arrangements** where the donor contributes property to a charity but retains some control or benefit over the donated asset. This may include retained rights to income from the

property or future benefits from the donation, such as a right to repurchase the asset at a reduced value.

- **Example**: A donor contributes property to a charitable trust but retains the right to income from the property. The taxpayer deducts the full FMV of the property while still receiving financial benefits.

4. **Charitable Remainder Trusts (CRTs) and Charitable Lead Trusts (CLTs)** While **CRTs** and **CLTs** can be legitimate estate planning tools, they are sometimes structured in ways that allow donors to claim large deductions for contributions of illiquid or hard-to-value assets, such as privately held stock or real estate, without truly relinquishing control over the assets.
   - **CRTs**: The donor places assets into a trust that pays income to the donor or another beneficiary for a period, with the remainder going to charity. If the initial valuation of the contribution is inflated, the donor can claim an excessive deduction.
   - **CLTs**: These involve placing assets into a trust that pays income to a charity for a set term, after which the remaining assets revert to the donor or their heirs. Tax shelters involving CLTs often overestimate the value of the charitable interest.

IRS Rules Governing Charitable Tax Shelters

To prevent the abuse of charitable deductions and address concerns about tax shelters, the IRS enforces strict regulations under **IRC Section 170** and related sections, particularly for non-cash donations and complex charitable giving arrangements. Here are some key IRS provisions aimed at curbing abusive tax shelters:

1. **Fair Market Value (FMV) Rules** The IRS requires that taxpayers use the **true FMV** of donated property when claiming charitable deductions. Fair market value is defined as "the price that property would sell for on the open market between a willing buyer and a willing seller, both having reasonable knowledge of the relevant facts." For certain types of property—like artwork, intellectual property, and real estate—the IRS requires taxpayers to obtain **qualified appraisals** to substantiate the claimed FMV.
   - **Publication 561**: This IRS publication outlines how to determine the value of donated property and provides guidance on acceptable methods for appraisals.
   - **Qualified Appraisal Requirement**: For non-cash donations valued at more than $5,000, the IRS requires a **qualified appraisal** from a qualified appraiser. The appraisal must be attached to the taxpayer's return for donations above certain thresholds.
2. **Substantiation Requirements (Form 8283)** For non-cash contributions, the IRS requires taxpayers to file **Form 8283** with their tax return. This form includes details about the property donated, its appraised value, and the receiving organization. For donations valued at over $500, this form is required to claim the deduction.

- **Form 8283, Section B**: For contributions valued over $5,000, the donor must attach a signed qualified appraisal and provide specific information about the donated asset. This includes details on how the donor acquired the property and the appraised FMV.

If the IRS determines that the claimed value of the property is overstated, it can disallow the deduction entirely or limit it to the actual FMV.

3. **Appraisal Penalties** As outlined in the prior section appraisers who provide inflated valuations to assist in tax shelters can face penalties under **IRC Section 6695A** as detailed in an earlier section. Taxpayers relying on fraudulent or grossly overstated appraisals can also face penalties and interest charges for underreporting their tax liability.
4. **Limitations on Charitable Deductions** The IRS limits the amount a taxpayer can deduct for charitable contributions, which prevents excessive deductions often seen in tax shelters:
   - **50% of AGI Limit**: In general, deductions for charitable contributions cannot exceed 50% of the taxpayer's adjusted gross income (AGI) for the year. Contributions to public charities, churches, and private operating foundations fall under this limit.
   - **30% of AGI Limit**: Contributions to private foundations, veterans' organizations, and certain other entities are limited to 30% of the taxpayer's AGI.
   - **Special Limitations for Long-Term Capital Gain Property**: If a taxpayer donates appreciated property, such as stock or real estate held for more than a year, they can deduct the FMV of the property but may be subject to a lower limitation (30% of AGI).
5. **Split-Interest Trusts** In cases of **split-interest trusts** (e.g., charitable remainder trusts, charitable lead trusts), the IRS imposes strict rules on the valuation of the charitable and non-charitable interests. Taxpayers cannot deduct the entire value of the donated property; instead, they can only deduct the portion that represents the present value of the future charitable gift.
   - **Charitable Deduction Rules**: Taxpayers are only allowed to deduct the **present value** of the charitable portion of the gift, which is often much less than the total FMV of the donated property. The IRS uses discount rates and actuarial tables to calculate the present value of the charitable remainder or lead interest.
6. **Increased Scrutiny on Syndicated Conservation Easements** Syndicated conservation easement arrangements, where multiple investors purchase interests in a piece of real estate and then donate a conservation easement, have come under intense IRS scrutiny. These schemes often involve **overstated valuations** of the easement and exaggerated deductions.
   - **Conservation Easements**: These allow property owners to donate rights to develop their property to conservation organizations in exchange for a tax deduction. The deduction is based on the reduction in the property's FMV

due to the easement, but many syndicated easement arrangements inflate the valuation to generate larger tax deductions.

Tax Shelter Penalties and IRS Actions

Taxpayers and promoters involved in abusive tax shelters related to charitable donations face significant risks:

- **Civil Penalties**: The IRS can impose civil penalties, including disallowing the entire deduction, imposing fines, and requiring the taxpayer to pay back taxes, interest, and penalties.
- **Criminal Penalties**: In severe cases involving fraud, taxpayers and promoters may face criminal charges.
- **Promoter Penalties**: Promoters of abusive tax shelters may be fined or barred from continuing such practices under IRS regulations.

United States Abuses of Deconstruction Non-Cash Charitable Contributions

The Abuses of Deconstruction Tax Deductions in the U.S.: An Overview

The use of **deconstruction tax deductions** has grown significantly in recent years, offering both environmental and financial incentives. Deconstruction, the careful dismantling of a building with the intent of salvaging and donating materials, allows taxpayers to claim charitable deductions based on the **fair market value (FMV)** of donated materials. This practice, when properly executed, reduces waste in landfills and provides affordable building materials for nonprofit organizations. However, **abuses and missteps in the appraisal process** have led to tax deductions being inflated or disallowed, placing taxpayers at risk of penalties and fines.

We present and examine the potential abuses in deconstruction tax deductions, the **role of appraisers**, the **IRS rules** governing these deductions, and the key issues that have emerged based on prior articles published by The Green Mission Inc.

The Role of Appraisals in Deconstruction Tax Deductions

A **deconstruction appraisal** is central to claiming tax deductions for donated materials. As detailed above, the IRS requires that donations of non-cash property with a value greater than $5,000 be substantiated by a **Qualified Appraisal**, produced by a **Qualified Appraiser**. This ensures that the claimed FMV is accurate, the appraisal is compliant, and the taxpayer is entitled to the deduction.

However, **inaccurate appraisals** and **unqualified appraisers** have led to cases where tax deductions were disallowed. As noted in our article "Appraising Your Appraiser," taxpayers often face problems when their appraiser does not meet IRS standards.[5] The most common issues include:

- **False Information in CVs**: Some appraisers falsely claim qualifications or experience they do not possess, leading to invalid appraisals.
- **Circular 230 Violations**: Appraisers who have violated IRS rules under Circular 230 are precluded from practice, yet some continue to produce appraisals.

  Key restrictions include:

  - **Individuals with Felony Convictions**: Felons, especially those convicted of tax-related or financial crimes, are generally prohibited from preparing tax returns or

[5] https://www.thegreenmissioninc.com/article/appraising-your-appraiser

representing taxpayers before the IRS. This restriction ensures that individuals involved in criminal misconduct, particularly fraud or dishonesty, are not entrusted with tax compliance responsibilities.
- **Disqualified Appraisers or Professionals**: Individuals who have been disbarred, suspended, or sanctioned under IRS disciplinary actions are also barred from preparing tax returns or representing taxpayers. This includes appraisers who have been found guilty of gross valuation misstatements or other misconduct.
- **Persons Engaged in Dishonest Conduct**: Circular 230 also excludes individuals who have engaged in dishonest, fraudulent, or disreputable conduct. This includes people who have provided false or misleading information to the IRS or who have been involved in tax shelter promotion schemes.
- **Non-Licensed Individuals**: Only specific licensed professionals, such as attorneys, certified public accountants (CPAs), and enrolled agents (EAs), can legally prepare tax documents and represent taxpayers. Individuals without these credentials may not do so unless specifically authorized under limited exceptions.

There is no easy way to determine if a taxpayer is in violation of Circular 230 but simple background check software coupled with a perusal of their CV to ensure proper college and graduate school education can often answer these questions expeditiously.

- **Insufficient Descriptions and Comparable Sales**: Appraisals that lack adequate descriptions, sales comparisons, and photographs often fail to meet IRS standards.
- **Incorrect Valuation Methodology**: Some appraisers misapply valuation methods, leading to inflated or incorrect property values.

Deconstruction Tax Shelter Abuses

Deconstruction tax shelters have arisen where inflated appraisals are used to claim **excessive charitable deductions**. In these cases, the appraised value of the donated materials is significantly higher than their actual market value, resulting in larger tax deductions than the taxpayer is entitled to. These schemes are attractive to property owners and developers looking to offset significant portions of their income with large tax deductions.

Some specific examples of abuse include:

1. **Overvaluation of Donated Materials**: Appraisers may inflate the FMV of salvaged materials, such as reclaimed wood or fixtures, without proper documentation or sales comparisons. This leads to tax deductions that exceed the true value of the donation. The IRS frequently disallows such deductions upon audit.
2. **Appraisers Lacking Qualifications**: As highlighted above, many appraisers who claim to specialize in deconstruction have insufficient qualifications, often using outdated or incorrect valuation methods. Without the appropriate knowledge or training, college education, and accreditation in one of the three personal property organizations sponsoring the Congressional created **The Appraisal Foundation**

(American Society of Appraisers, Appraisers Association of America, and International Society of Appraisers) these appraisers produce reports that fail to meet IRS standards, leaving taxpayers exposed to disallowed deductions and penalties.

3. **Collusion Between Nonprofits and Appraisers**: In some cases, nonprofits have improperly recommended or required taxpayers to use specific appraisers, which blurs the lines of independence between the parties involved. Nonprofits may encourage inflated appraisals to maximize donations, but this jeopardizes the taxpayer's compliance. As noted in our article, "the nonprofit cannot mandate the taxpayer to work with any single appraiser." See the following section for an example of one specific instance of many witnessed during tax year 2023.
4. **Form 8283 Compliance Failures**: IRS **Form 8283** is required when claiming non-cash charitable deductions exceeding $5,000. In some abusive schemes, appraisers and nonprofits sign Form 8283 without providing a proper appraisal to the taxpayer. This practice misleads the taxpayer into believing that a proper appraisal is not necessary, and deductions are often disallowed during an IRS audit.
5. **Tax Shelter Promoters Offering Insurance Guarantees**: Some promoters of deconstruction tax shelters claim that they offer **insurance policies** to protect clients from the adverse effects of an audit. As Marschall explains, these policies are often misleading, and they do not cover taxpayers' financial losses unless the taxpayer sues the appraiser. The cost of litigation is prohibitive, and such policies rarely offer genuine protection to the taxpayer.

Safeguarding Canadian Donations from Unethical Nonprofits and Appraisers

Our article written in May 2023 ***Nonprofit ~ Taxpayer ~ Appraiser: Understanding Each Role*** details an example of prominent US-based nonprofit and details what is happening consistently in the US deconstruction appraisal industry. A nonprofit created a captive appraiser and dictated the valuation conclusion. Similar nonprofits often insist that appraisers and deconstruction contractors pay a compulsory fee to the nonprofit for each appraisal or job referred and will only allow clients to work with their approved appraisers and deconstruction contractors.

A **captive appraiser** refers to an appraiser who is not independent and may be influenced or controlled by one of the parties involved in a transaction, typically to inflate the value of property in a way that benefits the party controlling the appraisal. The term often implies a conflict of interest, where the appraiser's judgment is compromised, and they might provide valuations that are favorable to the party they are "captive" to, rather than adhering to objective and ethical standards.

In the context of tax deductions or charitable contributions, a captive appraiser might overvalue donated property to allow the taxpayer to claim an inflated tax deduction. The IRS and other regulatory bodies have strict guidelines and penalties in place to prevent such practices, as accurate and independent valuations are critical to ensuring compliance with tax laws.

A **qualified appraiser** should be independent, impartial, and not subject to influence from any party involved in the transaction, as stipulated in both U.S. and Canadian tax laws

From the article:

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*The three parties to an appraisal **MUST** remain independent to ensure accuracy and validity of the deconstruction tax donation. We recently experienced an issue where these lines were blurred, and the taxpayer could have found themselves without a compliant appraisal.*

*The **NONPROFIT** recommended (or in this case required) the taxpayer to use the nonprofit's referred appraiser. Nonprofits can recommend appraisers they know to produce high-quality, compliant work. However, they **CANNOT** require a taxpayer to use a certain appraiser.*

*The **APPRAISER** contracted with the **TAXPAYER** to produce an IRS Qualified Appraisal to substantiate their donation of deconstructed building materials.*

*The **TAXPAYER'S CPA** reviewed the **TAXPAYER'S** return and could not find the accompanying appraisal to substantiate the donation.*

*The **APPRAISER** then informed the client that an actual appraisal was not needed if the value was less than $500k and the signed Form 8283 would suffice. The **NONPROFIT** and the APPRAISER signed Form 8283 without providing an appraisal to the **TAXPAYER**. The client's CPA immediately knew this was not IRS compliant.*

Please note that the actual appraisal does not need to be ATTACHED to the return if the value is <$500,000 for property like building materials and <$20,000 for art. However, this does not negate the necessity the appraiser actually providing a copy of the appraisal to the client! The appraiser MUST provide a copy of the appraisal to a client.

*The **NONPROFIT** reached out to the **APPRAISER** who then produced a 5-page appraisal.*

Here is a link to what is required to be in a non-cash charitable donation appraisal, per American Society of Appraisers including sixteen distinct sections with substantiating information in each:

American Society of Appraisers Personal Property Appraisal Report Writing Checklist

*The **APPRAISER's** report was missing approximately 90% of the required components.*

*The **TAXPAYER** and **CPA** found our information and articles online and contracted with us to complete a retrospective replacement appraisal.*

Our appraisal was approximately 250 pages long. Additionally, the valuation was about 30% less than the original appraisal, basing value upon sales of comparable property in the correct secondary market. Our team completed the appraisal in six weeks and charged a similar fee to the client as the appraiser who completed a five-page boilerplate appraisal.

*The **NONPROFIT** then refused to sign IRS Form 8283 unless the **TAXPAYER** used the original appraisal, which had not even been given to the **TAXPAYER** until the **APPRAISER** had their feet held to the fire and was required to produce a report.*

*The **NONPROFIT** then offered unsolicited and risky tax advice advising the **TAXPAYER** to go with the higher donation value and let the IRS knock it down from there.*

*Our team notified the **NONPROFIT** that they are an independent entity and cannot mandate the **TAXPAYER** to work with any single appraiser. Additionally, we recommended they not dispense tax advice, especially if it is not sound tax advice and could guide a TAXPAYER to remit a potentially unqualified appraisal with a value that could not be substantiated with underlying market data.*

Case Studies of Deconstruction Donation Abuse

Two significant tax court cases, **Mann v. U.S. (2019)** and **Loube v. Commissioner (2021)**, illustrate the dangers of relying on inflated deconstruction appraisals. In both cases, the taxpayers claimed large charitable deductions for donated materials based on inflated appraisals. The IRS disallowed the deductions, and the court upheld the IRS's decision, citing the lack of a qualified appraisal and overstated valuations.

These cases serve as cautionary tales for taxpayers, appraisers, and nonprofits. As we point out, "These cases are presented by IRS Counsel at almost every personal property appraisal organization's events, demonstrating what **not to do** as an appraiser."

Canadian vs United States System for Charitable Contributions (Comparison)

In Canada, non-cash charitable donations also have specific tax rules, but there are some differences when compared to the U.S. system:

Qualified Organizations

In Canada, donations must be made to a "qualified donee," which generally includes:

- Registered Canadian charities
- Governmental bodies in Canada (federal, provincial, or municipal)
- Certain foreign organizations under tax treaties, such as U.S. charities under the Canada-U.S. tax treaty, provided the donor has U.S. source income
- Registered Canadian amateur athletic associations and some international organizations

Types of Deductible Contributions

- **Fair Market Value (FMV):** As in the U.S., non-cash donations can generally be deducted at their FMV. However, Canada places specific requirements on appraising property over a certain value and includes stricter scrutiny for gifts of cultural property.
- **Capital Gain Donations:** Canadian taxpayers who donate certain appreciated securities to charity can exclude the capital gain from tax, an incentive not available in the U.S.
- **Donation Limits:** Canada generally limits charitable donations to 75% of the taxpayer's net income (compared to the U.S.'s 50% of AGI). In the year of death and the year preceding death, this limit increases to 100% of net income, which is unique to Canada.

Substantiation and Reporting

Both countries have rigorous documentation requirements for large donations. In Canada, taxpayers must receive an official donation receipt from the charity, and the charity must be registered for tax purposes.

Comparison of Key Differences

Category	Canada	United States
Type of Tax Relief	Tax credit	Tax deduction
Applicable to	Non-cash charitable donations (including capital property, land, etc.)	Non-cash charitable donations (including property, capital gains, etc.)
Limit on Charitable Contributions	Up to 75% of net income for most donations; higher limits for capital property donations	Up to 50% of Adjusted Gross Income (AGI) for most donations; special limits for certain donations (e.g., private foundations, capital property)
Carryforward of Unused Contributions	5-year carryforward for general donations, 10 years for ecologically sensitive land	5-year carryforward
Treatment of Capital Gains	Donations of publicly traded securities and ecologically sensitive land may benefit from a 0% capital gains inclusion rate	Long-term capital gains property subject to special deduction limitations (30% of AGI for certain gifts)
Qualified Appraiser Requirements	Must be a qualified appraiser as per CRA regulations. Must follow USPAP standards for appraisals.	Must be a qualified appraiser under IRS rules, also required to follow USPAP standards for appraisals.
Qualified Appraisal Requirements	Required for non-cash donations exceeding $1,000, particularly for property like art, real estate, or other valuable assets.	Required for non-cash donations exceeding $5,000, particularly for property, art, or collectibles.
Fair Market Value (FMV) Determination	FMV must be substantiated through a qualified appraisal. Special rules for deemed FMV apply in some cases (e.g., tax shelters).	FMV is determined through a qualified appraisal, subject to IRS verification. FMV for appreciated property may require adjustments.
Handling of Ecologically Sensitive Land	Donations may receive special treatment with a 10-year carryforward and no capital gains on the donation.	Special capital gains treatment not typically applied to land conservation donations, though deductions for conservation easements are allowed.
Deemed Fair Market Value	Certain property donations (e.g., acquired through tax shelters or within 3 years of donation) are subject to deemed FMV rules.	FMV is determined based on appraisal and subject to IRS scrutiny, with adjustments for property appreciation.

Category	Canada	United States
Eligible Donees	Registered charities, Canadian amateur athletic associations, national arts service organizations, housing corporations for the aged, and more.	Charitable organizations registered under Section 501(c)(3), U.S. states, political subdivisions, and certain foreign organizations via tax treaties.
Oversight and Scrutiny	CRA reviews appraisals and can reject those deemed non-compliant or improperly valued.	IRS audits charitable deductions, particularly scrutinizing high-value or inflated donations.
Treatment of Appraisal Errors	If the appraisal is found to be unqualified or incorrect, the deduction is disallowed, and penalties or reassessment may follow.	If the appraisal is incorrect, the IRS can disallow the deduction, impose fines, and assess penalties.
Standards for Appraisals	Must adhere to USPAP standards for appraisals. Appraiser qualifications and compliance with CRA regulations are critical.	Must follow USPAP standards for appraisals, with significant scrutiny of appraiser qualifications and compliance with IRS rules.

This comparison highlights the **key similarities** and **differences** between Canada and the U.S. regarding charitable contributions, including the use of **tax credits** versus **deductions**, appraisal requirements, and income limitations for contributions. Both countries emphasize the importance of qualified appraisers and proper valuation methods to prevent abuse of the system.

Both systems encourage non-cash charitable donations, but the Canadian system provides additional benefits for capital gains, while the U.S. system is more expansive in terms of its charitable deduction limits for a wider range of income levels.

Lessons from Two Decades of Deconstruction Tax Deductions in the United States: What Canada Can Learn

As Canada embarks on offering tax credits for donations of deconstructed building materials, there are valuable lessons to be learned from the U.S., where similar tax deductions have been in place for over two decades. The Green Mission Inc. is excited to work closely with Canadian deconstruction contractors and CRA-qualified appraisers to ensure this promising initiative in Canada avoids the pitfalls seen in the U.S. and thrives in a sustainable, ethical way.

The U.S. Experience: A Cautionary Tale

In the U.S., deconstruction and donation tax deductions have had mixed results. While the concept has helped divert materials from landfills and fostered sustainability, there have been significant abuses of the system, mainly due to inflated valuations and unqualified appraisers. The U.S. has seen instances of fraudulent appraisals that overstate the value of donated materials, leading to IRS audits and disallowed deductions. The involvement of unethical appraisers, nonprofits with captive appraisers and deconstruction contractors has put the entire deconstruction tax deduction model at risk, overshadowing the immense environmental benefits it offers.

Canada's Opportunity: Learning from the U.S. to Succeed

The Canadian model, offerfing tax credits instead of deductions, brings new hope for the future of deconstruction. By applying lessons from the U.S., Canada has a chance to implement more stringent oversight, ensuring that only qualified appraisers adhering to sound valuation methodologies are part of this growing industry. The Green Mission Inc. is committed to working with Canadian appraisers and contractors to ensure ethical practices are upheld from the start, fostering long-term success.

The Green Mission Inc.'s Involvement in Canada

As part of our commitment to supporting Canada's new tax credit system for deconstructed materials, The Green Mission Inc. is expanding our proprietary database to include Canadian data. Our database, which already tracks U.S.-based sales of deconstructed materials on a continual basis and over approximately 20,000 data points, provides invaluable insights into pricing trends, market analysis, and growth opportunities for the secondary retail market. By pulling in Canadian data, we will be able to offer even more accurate market feedback, helping both Canadian and U.S. industry members optimize their operations.

Protecting Canada from Unethical Practices

We will be working diligently to prevent the unethical practices that have plagued the U.S. deconstruction tax system from gaining a foothold in Canada. The Green Mission Inc. is determined to protect the integrity of this system, ensuring that the incredible environmental and economic benefits of deconstruction and donation are fully realized without falling prey to exploitation.

Growing the Secondary Retail Market for Deconstructed Materials

For deconstruction to thrive in Canada, the secondary retail market for deconstructed building materials must grow beyond its current infancy. The goal is to develop a larger, more efficient market model that can compete directly with the primary market. By offering a transparent, data-driven approach and working closely with qualified appraisers, The Green Mission Inc. aims to foster a sustainable and ethical secondary market that supports environmental goals and economic growth.

With the right steps and safeguards, Canada can avoid the missteps seen in the U.S. and create a thriving deconstruction and donation market. The Green Mission Inc. looks forward to contributing to this effort and helping build a robust secondary retail market for deconstructed materials.