Valuation Observations

Some practical observations from a practicing business appraiser.

VLC

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Interesting Changes with the IRS

The new valuation penalties are quite stiff. When a charitable donation is grossly overvalued, the fine is 40% of the additional tax attributable to the overvaluation. One case that landed before the Tax Court was a group of doctors whose corporate practice was acquired by a tax-exempt hospital. Just before the acquisition, they donated their stock to the hospital and claimed a value of $400 a share, even though their corporation was going out of business. The Court decided the true value was $37 per share and imposed the maximum penalty on the doctors (*Berguist, 131 TC No. 1*). Ouch!

Speaking of charitable donations, tightening the rules on deductions of car donations paid off for Uncle Sam. Deductions dropped by 80% in 2005, the first year under the tighter rules. Taxpayers only claimed $470 million on 300,000 returns that year. This compares to $2.4 billion on 900,000 returns in the previous year. That is almost as dramatic a drop as the disappearance of 7 million dependents in 1987 after Congress required filers to put tax ID numbers of dependents on their returns. Remember the days when people would claim Pooch as a dependent?

Under the car donation curb, if the claimed value for a vehicle exceeds $500 and the charitable group sells it, the donor can only deduct the amount of the proceeds. But the market value (blue book) is deductible if the charity gives the auto to a needy person for free or at a discount, or the organization uses the vehicle for operating the charitable organization.

All you litigators out there may be interested to know that lawsuit winners may also be able to recover the extra taxes due on the lump sum damages. In a District Court case, a paramedic successfully sued for sex discrimination, winning taxable back pay of $460,000 for the years when discrimination occurred. She complained that she was disadvantaged taxwise by the lump sum payment because it pushed her into the 35% tax bracket in the year she got it. Her tax bill would have been less had she been taxed separately on each year's share of the back pay. So the Court boosted her damages to cover the extra tax (*Loesch v. Phila., D.D., PA*)

For you creative thinkers out there, there is a way to defer the tax on lump sum damage awards – assign the award to a third party and take an annuity. In a Private Ruling, a worker who sued a past employer over a hostile work environment got IRS' ok to take part of her damage award that way. She couldn't accelerate any of the payments or assign her rights to the payments, so the IRS will respect the annuity for tax purposes. She will be taxed as the payments are made to her. There is a potential drawback however. The annuity issuer cannot set aside funds to secure the future payments to her. So, if there is a default, her only recourse is as a creditor against the annuity issuer.

Now, how about those mortgage payments? If you recall, taxpayers were not allowed to deduct mortgage interest or property taxes if the taxpayer didn't own the home. The IRS has changed its outlook on this. In *Njenge, TC Summ. Op. 2008-24*, a son took out a mortgage to buy a home for his parents who had filed for bankruptcy and couldn't get a mortgage themselves. The son held title to the house and was liable for the mortgage. The parents made all the mortgage payments, paid the taxes and the upkeep, and were the only occupants. The Tax Court determined that the parents were the home's equitable owners, bearing all benefits and burdens of ownership, and ok'd their deduction on the mortgage interest, even though the parents weren't liable to repay the mortgage.

And, non-itemizers can deduct property taxes for 2008 in addition to their standard deduction. This is an excellent break for those divorced or retired individuals with lower taxable income and no mortgage. The caveat here is that this tax break is only for 2008 and is capped at $1,000 for married couples and $500 for singles.

If you would like additional information, or have a question, please do not hesitate to call.

Very truly yours,

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Terri Lastovka is the founder of Valuation & Litigation Consulting, LLC. Her practice focuses on business valuations and litigation consulting in the areas of domestic relations, gift and estate tax, probate, shareholder disputes, economic damages, and forensic accounting. She draws from a wide range of experiences, including public accounting, law, banking, and CFO. She has received extensive training from the American Society of Appraisers in the area of business valuation and works closely with members of the bar to effectuate practical settlements. Terri also serves as the Director of Legal & Finance for Journey of Hope, a grass roots non-profit organization providing financial support to cancer survivors.