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'Hunt Now on the Pay-Never Plan'

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"Hunt Now on the Pay-Never Plan" was the title of a newspaper article in the April 18, 2005, Arizona Republic by Michael Markarian, executive vice president of the Humane Society of the U.S. His point: "A big-game hunter can shoot an exotic animal in Asia, in Africa or even at a drive-through 'canned hunt' here in the United States and write off his vacation at the expense of American taxpayers." Part of Markarian's concern was the tax incentive he saw the U.S. providing for the slaughter of animals. "In an ironic twist of so-called conservation," he said, "the more animals that are hunted, the more rare the species and thus the higher 'value' of the animal and tax break to the hunter."[1] Our concern is with what can be done about exaggerated valuations of donated property short of simply banning fair market value as the measure of tax deductions for property donations. Related to that is our concern over the responsibility of tax practitioners when advising a taxpayer regarding those donations or preparing his tax return.

The Senate Finance Committee

Certainly, Congress seems interested in doing something. On March 1, 2005, the Panel on the Nonprofit Sector set up by the Senate Finance Committee made its interim report to the committee. Doc 2005-4171, 2005 TNT 40-61. It said that it had:

> deep reservations concerning the Joint Committee on Taxation recommendation in its January 27, 2005, report on "Options to Improve Tax Compliance and Reform Tax Expenditures" to limit deductions for contributions of property (other than publicly traded securities) to the donor's basis in the property or, if less, the fair market value of the property. The effect of this proposal could be to eliminate a significant source of contributions for charities.

The April 5 hearings of the Senate Finance Committee on reform proposals for charities and charitable giving brought forth more concerns about abuses, as well as concerns about eliminating the ability to take a contribution deduction for the fair market value of property donations. We share both those concerns. One divide in the discussion separates those who seek a single uniform rule that can be applied across-the-board from those who believe different rules may have to apply to different situations, for example, the rule on vehicle donations that was adopted in last year's tax legislation.[2]

Finance Committee Chair Chuck Grassley, R-Iowa, said that the tax administration problem regarding hunting trophy donations was similar to what had been discovered with automobile donations:

> There's mounting evidence that some taxpayers are using these gifts to play big-money games for personal enrichment. . . . With car donations, someone cheated on his taxes to the tune of hundreds of dollars and the charity got $50 out of it. With taxidermy donations, the museum gets a pittance for a dusty boar's head that sits in a railway car until it sells, while the donor gets big tax breaks. Doc 2005-6994, 2005 TNT 65-25.

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[1] *See also* "Humane Society Asks Congress to Stop Tax Breaks for Hunters," *Doc 2005-7044, 2005 TNT 65-37*, summarizing the results of the Society's two-year investigation of hunter donation abuses.

[2] If the claimed value exceeds $500, the deduction cannot exceed the amount of gross proceeds realized by the charitable donee -– and reporting requirements are imposed on donees to help implement that determination.

The railway car comment referred to a specific situation mentioned in the Humane Society report in which more than 800 big-game and exotic animal mounts were piled into an old railroad car behind the Wyobraska Wildlife Museum, a modest and lightly visited facility in Gering, Neb., far from any large city. The museum's main societal value seems to have been to provide $5 million of tax contribution deductions in 2004 to the hunters who donated trophies. While the Finance Committee professes to have been surprised that such flagrant tax abuses exist, the fact is that tax cases disclosing identical abuses were decided years ago. We will discuss two of those and then turn to the role of the practitioner in property donation situations.

Dr. Engel, Appraiser Duncan, and the N.C. Museum

George H. Engel et ux. v. Commissioner, T.C. Memo. 1993-362, Doc 93-8875, 93 TNT 173-4, involved medical doctors (two dermatologists married to each other) and appraisals made by Robert Bruce Duncan. George Engel was, Tax Court Judge Edna G. Parker noted, "ranked in the top 25 of world game hunters." In 1985 he had literally hundreds of wild animal trophy mounts on the walls of his home, in a gallery, and in a guest house. He hired Duncan, whom he believed a reputable and well-known appraiser, to value 18 of the animal mounts and rugs in Engel's collection. Duncan appraised them at $126,500. Judge Parker said that "Duncan's appraisal is brief and lacking in detail and explanation of any of the figures contained therein." Based on that appraisal, Dr. Engel donated the 18 items and took a $126,500 charitable contribution deduction.

The 18 items went to the North Carolina State Museum of Natural History, a museum set up to portray and extol North Carolina natural and agricultural history. However, the museum's director, Dr. Funderburg, had what Judge Parker described as some rather "grandiose schemes." She explained:

> Dr. Funderburg wanted to build a world-class collection of wild game mounts. He wanted as many game mounts as possible to flow into his museum with the idea that he would then cull out the finest and the best for the Museum's collection. Under the program devised by Dr. Funderburg and Duncan, thousands of game mounts flowed into this small State Museum, coming in by the sixteen-wheeler truckload toward the end of each year. . . .
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> North Carolina state officials, particularly the State legislators, did not seem to share Dr. Funderburg's dreams of grandeur. Rather than encouraging and supporting Dr. Funderburg's grand plan, the State of North Carolina did not fund space to house the game mounts that were coming in regularly from Duncan's clients, with shipments almost every day toward the end of 1985. Some 2,000 game mounts were shipped to the museum by contributors. Duncan prepared the appraisals for about 95 percent of those game mounts. . . .
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> After donation, many of the game mounts that came into the front door of the Museum, without a proper paper trail and probably in explanation of why there was not a proper paper trail, somehow went out the back door, again without a proper paper trail. Many of those game mounts, as many as 400, went to one individual; some ended up at a local furrier; some were given to local State legislators by Dr. Funderburg; other simply cannot be accounted for. The paper trail fell into even more disarray after the U.S. Fish and Wildlife Service raided the Museum and seized Dr. Funderburg's records. Dr. Funderburg and Duncan were ultimately charged and pleaded guilty to a conspiracy to import endangered species.

By the time of the Tax Court proceeding, it did not seem appropriate to use Mr. Duncan as an expert witness,[3] so Dr. Engel hired Jack Perry, who was then president and curator of the World Wildlife Museum in California (and the same Jack Perry who testified for the taxpayers in the Robson case some years later, as discussed below). Judge Parker said that “Perry advocates the replacement method as the only method for appraising game mounts because he views such specimens as unique.” Judge Parker did not reject replacement cost as a concept but she did find serious problems with the way it was being applied. “The recreational big game hunter receives a quid pro quo, the pleasure of pursuing his hobby, so all of the costs of the hunting trip cannot be attributed to the animal that is killed,” she said. Also, she rejected the idea of the use of current replacement costs for donations of old game mounts, pointing out that if a museum financed a current hunting trip, “it would have newly killed animals to mount and could mount them for its purposes (natural history displays) rather than as trophy mounts.” Finally, she concluded, “we would apply a volume discount, which represents the discount that a purchaser of the entire collection would expect, or alternatively, the increased costs that would be involved in selling the items individually.”

That replacement cost valuation is difficult both to make and to judge. The government expert came up with $21,500 and Perry’s figure was $113,000. Judge Parker concluded that the fair market value of the donated animal mounts and rugs was $75,000. She did not consider any possible mistreatment of the animal mounts by the museum postdonation. Her view was that the donee’s lack of care should not be imputed to the donor. She also set aside the negligence penalties that the IRS had proposed. Dr. Engel relied on Duncan’s appraisal, said Judge Parker, and “there was no reason for petitioner in 1985 to question Duncan’s valuation method or the values he determined for petitioner’s donations.”

Replacement Cost Rejected

Mr. Duncan’s valuation of donated wild animal trophies was also the issue in Benjamin H. Robson et ux. et al. v. Commissioner, 172 F.3d 876, Doc 1999-12594, 1999 TNT 75-7 (9th Cir. 1999), an unpublished decision affirming Benjamin H. Robson et ux. et al. v. Commissioner, T.C. Memo. 1997-176, Doc 97-10086, 97 TNT 70-11. The taxpayers, Drs. Robson and Trnavsky -- Dr. Trnavsky being the “et al.” -– were orthodontists as well as accomplished hunters. They both had animal mounts in trophy rooms in their homes, representing the fruit of numerous hunting trips to locations around the world. During the tax years at issue, both donated animal specimens to various charitable organizations. They claimed deductions totaling $297,050 over a three-

[3]Even though Duncan was not an expert witness, he did testify in the case as a fact witness regarding the appraisal that had been the basis for the deductions claimed on the return. Judge Parker commented that:

> we are disturbed by the focus of Duncan’s advertising of his services, which emphasizes tax savings through donations and “offsetting today’s terrible hunting costs.” Duncan has prepared research papers and articles touting a hunter’s ability to take advantage of “today’s astronomical hunt costs” by donating animals at their current replacement value, although the hunter may have collected the animals inexpensively years ago. Although Congress has chosen to allow charitable contribution deductions for such donations, Congress certainly did not intend for the valuations of such donations of game mounts to encompass a write-off of a recreational big game hunter’s vacation.

year period. The IRS disallowed the entire amount of those charitable contributions on the grounds that neither orthodontist had demonstrated the fair market value of the donated animals. The Tax Court allowed a total of $45,700 based on a "comparable sales" appraisal. No penalties were proposed or imposed.

Replacement Cost vs. Transactional Approach

In Robson, as in Engel, the taxpayers based their original tax deductions on a replacement cost appraisal by Robert Bruce Duncan. However, before the IRS finished its tax examination, Duncan had ceased to be a desirable expert witness because of his involvement with the North Carolina State Museum of Natural History and Dr. Funderburg. Instead of relying on Duncan, therefore, the Robson taxpayers, like the Engels, obtained the testimony of Jack Perry for the Tax Court to consider. Like Duncan, Perry based his appraisals on the replacement cost of the donated trophies, representing the total cost a hunter would incur in going on the hunt plus related costs such as trophy fees, taxidermy costs, and travel expenses.

Tax Court Senior Judge William M. Fay admitted replacement costs would be "a relevant measure of value where the property is unique, the market is limited, and there is no evidence of comparable sales." The taxpayers argued there could be no evidence of comparable sales because there could be no sales at all –- at least no legal sales. They were residents of California. That state's law made it illegal to sell any mounted animal specimens similar to theirs that had been taken under a hunting license. Further, they pointed out, a violation of California law would constitute a federal offense.

Even though the court did not dispute that there was a California law, it rejected the implication that, as a result, there could be no comparable sales. The IRS's expert witness had testified, without challenge or rebuttal, that many of the states near California -– such as Arizona, Montana, New Mexico, and Washington -– had relatively few restrictions on the sale of mounted game trophies. As a result, the IRS expert testified, game mounts were, regardless of the law, bought and sold in California at prices similar to those in states imposing no restrictions. "We therefore cannot accept Mr. Perry's valuations," concluded the court, "as petitioners have not demonstrated that their replacement cost analysis has a correlation to fair market value in this case." Instead, the court accepted the IRS's appraisals based on comparable sales and allowed a deduction of 15 percent of the amount originally claimed.

Judge Fay was affirmed on appeal, in a decision "not for publication" (172 F.3d 876). In their appeal, the taxpayers argued that it was wrong for Judge Fay to have looked solely to comparable sales in other jurisdictions in arriving at fair market value. Especially in light of the illegality of those sales in California, he should not have disregarded the replacement cost evidence that they had proffered. The appeals court panel pointed out that fair market value posits hypothetical buyers and sellers and that "the test is objective; there is no requirement that the taxpayers themselves actually be able to sell the donated goods." The judges quoted from Bank of California, N.A. v. Commissioner, 133 F.2d 428 (9th Cir. 1943), that "in applying this definition, we are required to assume the existence of a willing buyer and a willing seller, regardless of whether they actually existed or not, and to assume that the property could and would change hands, even though such a change could not in fact occur." Certainly, concluded the appeals court, "there was no basis for adopting a valuation based on replacement cost as taxpayers did not demonstrate that their analysis has any correlation to FMV in this case."

The Valuation Problem

At the legislative level, there are trade-offs involved no matter what is done with an issue such as the valuation of donated property. For a conceptually simple tax law to work, the IRS must deal with abuses by investing the resources necessary to identify them, propose deficiencies, and win the bulk of the cases that go to court. At the same time, the taxpayer must have the right to appeal unreasonable interpretations. That has been the structure the United States has had for dealing with charitable contributions, although the simple law has been modified many, many times to eliminate what were regarded as opportunities for abuse. Those modifications have included limiting to tax basis the deduction for donations of ordinary income property generally and of untraded securities to private foundations, in addition to last year's vehicle donation change. Documentation and reporting requirements have also been tightened. Those were all policy decisions, just as their implementation was a tax administration issue.

There are many ways, in addition to the Joint Committee on Taxation's suggestion that all charitable contributions of property other than listed securities be valued at the lower of tax basis or fair market value, that legislation might approach the abuses regarding wild animal trophy donation. One way would be to change the law to require that fair market value for charitable contribution purposes be determined only by reference to comparable transactions and not to replacement cost. Another approach would be to broaden the scope of section 1221(a)(3)[4] to include "any property held by a taxpayer whose personal efforts, directly or through agents, resulted in the property becoming an art object, museum piece, or other form of collectible (as defined in section 408(m))." There also are administrative remedies available to the IRS, such as putting deductions for wild animal trophy donations on the roster of listed transactions.

The Tax Practitioner's Role

The tax practitioner has the persistent problem of helping put the client's best foot forward while also discharging her obligation to the system and staying within the shifting borders of acceptable tax practice. See our "Confidence Levels, Circular 230, and Practitioner Penalties," Tax Notes, Jan. 10, 2005, p. 187, and our "Tax Practitioner Standards and Professional Self-Discipline," Tax Notes, Oct. 7, 2002, p. 93, for further discussion of the current status of tax practice standards. What kind of advice does a tax practitioner give to a client who has such collectibles as wild trophy mounts and is contemplating a charitable contribution?

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[4]Under section 1221(a)(3), certain property owned by a taxpayer whose efforts created that property, or for whom that property was created, is treated as ordinary income property. The property so treated includes copyrights; literary, musical, or artistic compositions; letters; memoranda, or "similar property." Thus the question becomes whether the collectibles involved, such as the trophies a taxpayer has killed and had mounted, would be viewed as property that person either created or had created that is similar property to the categories specified in the statute. We would conclude that animal trophies would not be considered similar property. That conclusion is based primarily on the statutory language and the history of the provision, and the fact that there have been several Tax Court decisions involving donated animal trophy mounts in which the issue had not even been raised. Animal trophy mounts intuitively do not seem to be property similar to oil paintings or presidential letters. However, a collection of quilts might well be similar property in the hands of the person who created the quilts or someone deriving their tax basis from that person.

We think the practitioner may want to answer at least three related questions about the contribution before opining orally or in writing on the likely charitable contribution consequences of a donation:

(1) Will the proposed "use" of the collection by the charitable donee satisfy the requirements of section 170 for a deduction of the fair market value of a contribution of tangible personal property to a section 501(c)(3) organization as to some or all of the collectibles? Donations of art objects and similar items to a museum are deductible at the lesser of tax basis or fair market value unless the donated item is for current or future exhibition. Given the example of the North Carolina and Wyobraska museum debacles, it seems to us that due diligence requires some questions as to the donee and what will be done with the donated items.

(2) Is the principal purpose of the donation the charitable contribution deduction or is the donation being made for other reasons, with the charitable contribution deduction a "sweetener" but not the prime motivator? Can those other reasons be persuasively documented?

(3) Will the appraisal that has been or will be obtained be one that will likely stand up under challenge? If the appraisal takes a replacement cost approach of the sort used by Duncan and Perry in the Engel and Robson cases, what makes this appraiser's approach one that will be more acceptable to the IRS or the courts?

Conclusion

With the attention being currently focused on such situations as the Wyobraska Wildlife Museum, and with the example of Dr. Funderberg, the North Carolina State Museum of Natural History, and Robert Bruce Duncan a part of tax history, tax practitioners owe a duty to themselves and their affected clients to raise questions when similar charitable contribution situations arise. While tax practitioners are client advocates and are entitled to accept information from a client without "auditing" it, they are not justified in closing their eyes to situations that would call for further investigation on the part of a reasonably alert and well-informed tax practitioner. They need to ask questions and to follow up on those answers. That does not make them any less client advocates. Rather, it helps them to discharge their duties to their clients, one of which is to inform the client of the risk of penalties when controversial tax positions are being taken and another of which is to lay the groundwork at the transaction-planning and return-preparation stages for a successful outcome in the event of an IRS challenge.