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subject: Purported Transfer of LLC Units to Tax-Exempt Entity and Related Transactions

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

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LEGEND

Advisor1	=
Appraiser	=
LLC1	=
Organization1	=
Taxpayer-Husband	=
Taxpayers	=
OA1	=
OA2	=

OA3	=
Percentage1	=
Percentage2	=
Percentage3	=
Percentage4	=
Strategy	=
Brokerage Firm	=
Date1	=
Date2	=
Date3	=
Date4	=
Date5	=
Date6	=
Date7	=
Date8	=
Date9	=
Amount1	=
Amount2	=
Amount3	=
Amount4	=
Amount5	=
Amount6	=
Amount7	=
Amount8	=
Year1	=
Year2	=
Year3	=
Year4	=
State	=
Charity1	=

TAX YEARS

Form 1040 –
Form 1065 -

ISSUES

A. Whether Taxpayer-Husband's transfer of nonvoting interests in LLC1 to Organization1, pursuant to Strategy, should be respected for federal income tax purposes.

B. Whether Organization1 has sufficient economic or membership interests in LLC1 to be treated as a bona fide partner.

C. Whether the partnership income allocated to the nonvoting interests in LLC1 transferred to Organization1 is taxable to Taxpayers pursuant to the assignment of income doctrine.
D. Whether Taxpayers may claim charitable contribution deductions for their transfers of nonvoting interests in LLC1 to Organization1.

CONCLUSIONS

A. No. Taxpayer-Husband's transfer of nonvoting interests in LLC1 to Organization1, pursuant to Strategy, should not be respected for federal income tax purposes. Taxpayer-Husband's transfer of interest in LLC1 is disregarded because it lacks economic substance.

B. Organization1 did not have sufficient economic or membership interests in LLC1 to be treated as a bona fide partner.

C. The partnership income allocated to the nonvoting interests in LLC1 transferred to Organization1 is taxable to Taxpayers pursuant to the assignment of income doctrine.

D. Taxpayers may not claim charitable contribution deductions for their transfers of nonvoting interests in LLC1 to Organization1.

INTRODUCTION

Taxpayers formed, and made capital contributions to, LLC1 in exchange for LLC1 voting and nonvoting interests. LLC1 earned investment income. Taxpayers controlled LLC1's investment accounts and managed and controlled its operations. During the tax years at issue, LLC1 made one distribution to its members and Taxpayers took loans from LLC1's assets.

Taxpayers transferred the nonvoting interests, to which they allocated Percentage1 of LLC1's partnership items -- the income, gain, loss, deductions, and credits ("partnership items"), to a section 501(c)(3) organization. Taxpayers claimed a charitable contribution deduction equal to the asserted appraised fair market value of the nonvoting interests transferred. Taxpayers retained the voting interests in LLC1 to which they allocated the remaining Percentage2 of the partnership items.

We have been asked to consider whether to (1) treat LLC1's investment income allocated to the section 501(c)(3) organization as taxable to Taxpayers; (2) treat the capital accounts of Organization1 as belonging to Taxpayers; and (3) disallow Taxpayers' charitable contribution deductions.

FACTS

We have relied only on the facts set out in this memorandum for our opinion in this case. If you believe that we should consider any other facts not contained in this memorandum, please notify us as this could change our opinion.

I. Strategy

Advisor1 devised Strategy pursuant to which Taxpayers could earn investment income "in a tax-free environment" and claim charitable contribution deductions.

The steps in the Strategy were as follows:

1. In Year2, pursuant to OA1 and OA2, Taxpayer-Husband set up LLC1. On the same day, Taxpayer-Husband transferred the nonvoting interest in LLC1 to Organization1 to fund a purported donor advised fund ("DAF").

2. In Year2, Taxpayers opened a brokerage account for LLC1 at Brokerage Firm. They opened the brokerage account in their names, as members of LLC1, giving them signatory authority to manage the investment and business activities of LLC1. Taxpayer-Husband transferred Amount1 in assets, including marketable securities to the LLC1 brokerage account.

3. By early Year3, an additional Amount2 was deposited into the LLC1 account by Taxpayer-Husband from his personal retirement account[1]. In Year3, Taxpayer- Husband deposited Amount3 into the LLC1 brokerage account and transferred Amount4 into the LLC1 brokerage account.

4. In accordance with OA1, OA2, and OA3, Taxpayer-Husband, as the Manager of LLC1 and the owner of all the voting interests in LLC1, allocated Percentage1 of LLC1's partnership items to Organization1 and Percentage2 of LLC1's partnership items to Taxpayers. LLC1 reflected this allocation on its Year3 Form 1065, Schedule K-1.

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1. [redacted]

5. In Year3, Taxpayers claimed a charitable deduction for the donation of the LLC1 units to Organization1.

6. In an appraisal dated Date1, Appraiser determined that, as of Date2, the fair market value of the Percentage1 non-voting non-managing membership interest Taxpayer- Husband transferred to Organization1 as a charitable contribution in Year3 was Amount5.

7. On its Year3 Form 990, Organization1 reports a grant of Amount6 to Charity1.

8. Pursuant to the terms of OA1, OA2, and OA3, Organization1 should have received an economic interest in LLC1.

In Year3, Taxpayer reported its Percentage2 distributive share of LLC1's investment loss. In Year4, Taxpayer reported its distributive 'share of LLC1's investment income. As a section 501(c)(3) organization, Organization1's Percentage1 distributive share of LLC1's investment income escaped taxation in Year3 and Year4.

II. Operation and Management of LLC1

Taxpayer-Husband formed LLC1 as a State Limited Liability Company. Taxpayer- Husband was the only named member of LLC1. Taxpayer-Husband was also named Manager of LLC1. (OA1 sec. 7.01) In general, the Manager may make all decisions concerning any matter affecting or arising out of LLC1's business conduct. (OA1, OA2, OA3 sec. 6.01) The Manager of LLC1 must distribute a specified amount of LLC1's total assets on a yearly basis. (OA1, sec. 5.05(b) and OA3, sec. 5.05(b)). However, as Manager and the only voting member of LLC1, Taxpayer-Husband never authorized a distribution to Organization1. In addition, Organization1 had no independent right to receive any investment income from LLC1 without Taxpayer- Husband's consent (OA1 and OA3 – sec. 4.07, sec. 6.03, sec. 8.04, and sec. 8.05); had no right to participate in management (OA1 and OA3 sec. 8.03); and had no control over its interest in LLC1 (OA1 and OA3 – sec. 7.01). Organization1 acknowledges that the transferability of its nonvoting interest in LLC1 is severely limited. (OA1, OA2, and OA3 Member Acknowledgment - Transferability Restrictions and OA1, OA2, OA3 Article 12). Except under certain circumstances, Organization1 could not transfer its nonvoting interest in LLC1 without the Manager's consent. (OA1, OA2, and OA3 sec. 12.07)

Between Date3 and Date4, Taxpayer-Husband withdrew funds from the LLC1 Brokerage Firm brokerage account, hereinafter referred to as the Brokerage

Firm brokerage account. However, it was not until after Date5, after Taxpayer-Husband withdrew the funds, that OA3 authorized LLC's Manager to make secured loans of LLC1 assets to qualified borrowers. Furthermore, Taxpayer-Husband and LLC1 did not enter into a loan agreement for any of the funds he withdrew from the brokerage account until Date6. The Date6 loan agreement, signed by Taxpayer-Husband as the Manager of LLC1 as lender, and signed by Taxpayers in their individual capacity as borrowers, imposes Percentage4 interest, requires quarterly payments beginning on December 10, 2020, and requires a final lump sum payment of the balance on Date8. Taxpayer-Husband made deposits to the LLC1 brokerage account as repayment on the loans. At the end of Year4, Taxpayer-Husband had an outstanding balance on the loans.[2]

III. Organization1

Organization1 was recognized by the Service in Year1 as an organization described in section 501(c)(3) and classified as a public charity described in section 170(b)(1)(A)(vi) as of its date of formation. On Date9, Organization1 was issued a Letter 3618 proposing to revoke Organization1's tax-exempt status as an organization described in section 501(c)(3), for failure to operate exclusively in furtherance of section 501(c)(3) purposes, due to Organization1's participation in the Strategy with Taxpayers and LLC1, along with dozens of other similar transactions. Specifically, the Service determined that more than an insubstantial part of Organization1's activities were not in furtherance of an exempt purpose. These activities include:

1. Participating in a tax shelter scheme, and
2. Operating as a vehicle to assist the promoter of the scheme (Advisor1) in carrying out his abusive charitable scheme

IV. Tax Reporting – Charitable Contribution Deductions

In Year3, Taxpayers claimed a charitable contribution deduction of Amount5 for the transfer of the nonvoting interests in LLC1 to Organization1. An officer of Organization1 signed the Donee Acknowledgment, Part V of the Form 8283, on Date1. However, Taxpayers did not attach a qualified appraisal for the value of the property transferred, nor a Contemporaneous Written Acknowledgment of the contribution, to their Year3 return.

2. [redacted]

LAW AND ANALYSIS

I. The transfer of LLC interests of LLC1 to Organization1 must be disregarded under the economic substance doctrine of section 7701(o) and all income and capital gain LLC1 realized in Year4, as well as capital accounts of Organization1, belong to Taxpayers.

As discussed below, the transfer of nonvoting units to Organization1 lacks substance and must be disregarded under the economic substance doctrine of section 7701(o). Because the transfer of nonvoting interests to Organization1 lacks economic substance, Organization1 is not a member of LLC1, and all income or gains of LLC1 must be allocated to Taxpayers.

Pursuant to the Strategy, Taxpayers (1) controlled the LLC1 assets and the related investment income, but paid tax on only Percentage2 of the investment income; (2) transferred taxation on the remaining Percentage1 to a section 501(c)(3) organization; and (3) claimed a charitable contribution deduction for their transfer of the nonvoting interests in LLC1 to a section 501(c)(3) organization.

Section 1409 of the Health Care and Education Reconciliation Act of 2010 added section 7701(o) to the Code to provide clarification of the economic substance doctrine. That section applies to transactions entered into on or after March 31, 2010. Codified economic substance under section 7701(o) applies here because Taxpayers completed their purported contribution to Organization1 after March 31, 2010.

When a transaction falls within the scope of section 7701(o), the first inquiry is whether the economic substance doctrine is relevant to the transaction. section 7701(o)(1). If the doctrine is relevant, the second inquiry is whether the transaction is treated as having economic substance under section 7701(o). *Id.* Relevance of the economic substance doctrine is determined in the same manner as if section 7701(o) had never been enacted. I.R.C. § 7701(o)(5)(C). A transaction shall be treated as having economic substance if "(A) the transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position, and (B) the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into such transaction." I.R.C. § 7701(o)(1).

Under the economic substance doctrine, a transaction is disregarded for federal tax purposes if the taxpayer did not enter into the transaction for a valid business purpose but rather sought to claim tax benefits not contemplated by a reasonable application of the language and purpose of the Internal Revenue Code or its regulations. See *e.g.*, *Horn v. Commissioner*, 968 F.2d 1229, 1236 (D.C. Cir. 1992). The doctrine originated in *Gregory v. Helvering*, 293 U.S. 465 (1935). In *Gregory*, the Court recognized the taxpayer's right to minimize taxes through legal means but stated that "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." 293 U.S. at 469.

The steps of the Strategy, as detailed above, lack economic substance. Taxpayers took those measures for no purpose other than tax savings. By transferring LLC1 membership interests to Organization1, Taxpayers obtained a charitable deduction, and avoided income tax during the life of the LLC, while maintaining complete control over the assets, and unbridled use of the assets, as evidenced by three withdrawals totaling Amount7 from LLC1, which were later characterized as loans. A closer examination of the Strategy, as a whole, reveals that it had no economic substance beyond tax benefits.

A. Subjective Inquiry

The subjective factors focus on the taxpayer's expectations and motives to determine whether it engaged in the transaction for business purposes other than tax avoidance. *Bail Bonds v. Commissioner*, 820 F.2d 1543, 1549 (9th Cir. 1987); see *Kirchman v. Commissioner*, 862 F.2d 1486, 1492 (11th Cir. 1989). Evidence of corporate form alone, however, is insufficient to demonstrate an economic purpose as it may just as likely reflect an intent to disguise a transaction's true purpose. *Gregory*, 293 U.S. at 469. “[A] transaction with no economic effects, in which the underlying documents are a device to conceal its true purpose, does not control the incidence of taxes.” *Sacks v. Commissioner*, 69 F.3d 982, 986 (9th Cir. 1995). In any event, proper corporate form indicates nothing about the likelihood of producing economic benefits. *Shasta Strategic Inv. Fund, LLC v. United States*, 2014 WL 3852416, at *8 (N.D. Cal. July 31, 2014). To meet its burden, the taxpayer must articulate a legitimate business purpose for placing its assets at risk. *Dow Chemical Co. v. United States*., 250 F. Supp.2d 748, 799 (E.D. Mich. 2003). As discussed herein, the Strategy at issue in this case lacked economic substance because: (a) the structure did not support the Taxpayer’s stated reasons for engaging in the Strategy; (b) Taxpayers did not follow the agreements; and (c) Taxpayers’ intention for undertaking the Strategy was solely to obtain tax benefits.

1. The transaction did not support Taxpayers’ stated reasons for engaging in the Strategy.

Taxpayers’ stated purpose for engaging in the Strategy was to grow the investments in LLC1 “in a tax-free environment” and thus maximize the impact of their intended charitable giving.

That Taxpayers continued to maintain control and utilization of the value underlying the nonvoting LLC1 interests that Taxpayer-Husband donated to Organization1 belies Taxpayers’ stated intent. For the same reason, the nonvoting LLC1 interests have little to no value. Any potential distribution paid to the nonvoting interest holder was within the discretion of Taxpayer-Husband. (OA1 and OA3, secs. 1.04, 5.05 6.03, 8.04, 8.05) (Although the agreements required yearly distributions to Organization1, Taxpayer-Husband retained the sole discretion to dissolve LLC1 at any time or to exhaust the LLC's investments and Organization1 had no right to demand any distributions). Although the agreement called for mandatory yearly distributions, no member could force a distribution. (OA3, sec. 5.05(b) and flush language)

Organization1 was also unable to realize any value from the transfer or sale of the nonvoting LLC1 units. Organization1 was limited in its ability to divest itself of the LLC units. (OA1 and OA3 sec. 8.04) Organization1 could not sell the interests to obtain value, because the interests had no value (*i.e.*, the operating agreements were statements of intention to make a gift in the future) and the ability to sell any interests was subject to a very detailed right of first refusal. (OA1 and OA3 secs. 12.01-12.03)

Taxpayer-Husband had unfettered control over the assets of LLC1, as evidenced by the withdrawals from LLC1 during the years at issue. These withdrawals were later papered as loans to Taxpayers to take advantage of an amendment made to the operating agreement, which allowed for secured loans to "qualified borrowers." This is evidence that Taxpayer-Husband not only had the ability to drain value out of the entity at any time, he, in fact, acted on this ability. Taxpayers, through these withdrawals had the immediate benefit of the investment income. Although LLC1's loans were subsequently papered to be limited to "qualified borrowers" and were to be secured by collateral, "qualified borrower" is not defined and there is no evidence that the Taxpayers' loans were secured in any way.

2. Taxpayers arranged the Strategy to shield themselves from taxation on substantial short-term capital gains.

The Strategy allowed Taxpayers to shield tax on a net of approximately Amount8 of investment income without ever relinquishing control over the underlying assets. Taxpayer-Husband still controlled the funds in LLC1, and he disregarded the provision that required a mandatory distribution of at least Percentage2 of the assets for the Year3 tax year and Percentage3 of the assets for the Year4 tax year. When questioned regarding their motives in this case, Taxpayer-Husband indicated that one of the intents of this arrangement was for their assets to grow in a "tax free environment." They understood that by participating in this Strategy that their investments would grow without taxation. They further stated that they were guaranteed the investments would grow tax free.

3. Taxpayers did not follow agreements.

Not only did tax advisers draft agreements, with the motivation of avoiding taxes, Taxpayer-Husband did not follow those agreements. Specifically, the agreements provide for mandatory distributions each year that were not made.

Further, the agreements require the approval of Organization1 for all “financial decisions,” a provision that neither party attempted to follow. (OA3 sec. 6.01) There is no evidence that Organization1 was ever contacted regarding what would constitute “financial matters.” Taking all the circumstances into account, Taxpayers’ intention for engaging in the Strategy was solely to obtain tax benefits.

All of the reasons that Taxpayers or their representatives put forth as to why they entered into the transaction of creating a “charitable LLC,” transferring assets to it and transferring nonvoting interests to a charitable organization created by Advisor1, do not stand under scrutiny. In affecting the transaction, many agreements were drafted and signed between related parties, but few of the significant provisions in those agreements were followed.

Taxpayer-Husband engaged in the Strategy with the help of Advisor1 in order to shield their investment income and accumulate wealth in a “tax free environment.” The transactions were structured so Taxpayers could avoid paying income tax by transferring Percentage1 of their investment income (on paper) to Organization1 while retaining the assets under their control for their unfettered use and taking charitable deductions. The ultimate goal of the transaction Taxpayers engaged in was to avoid paying taxes as required by the code and therefore lacks economic substance.

B. Objective Inquiry

In analyzing the objective factors, the Ninth Circuit focuses on whether a "reasonable investor would enter" into the transaction. *Reddam v. Commissioner*, 755 F.3d 1051, 1060-1 (9th Cir. 2014). The courts look to the "overall structure” of the transactions. *Id*. at 1061 (internal citations omitted). Theoretical outcomes of the transaction do not control; the execution of the transaction and its actual outcomes are what matter. *Keane v. Commissioner*, 865 F.2d 1088, 1091-2 (9th Cir. 1989). The "practical" economic effects are what controls. *Sacks v. Commissioner*, 69 F.3d 982, 987 (9th Cir. 1995).

This test is also known as the business purpose test and provides that the "transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of taxpayer’s economic situation and intentions." *ACM Partnership v. Commissioner*, T.C. Memo. 1997-115. In other words, "[r]ealistic potential for profit is found … when the transaction is carefully conceived and planned in accordance with standards applicable to the particular industry, so that judged by those standards, the hypothetical reasonable businessman would make the investment." *Cherin v. Commissioner*, 89 T.C. 986, 993-4 (1987). As set out below, the transaction also does not satisfy the objective inquiry because (a) LLC1 was not organized for a nontax business purpose, and (b) the parties’ economic position did not change as a result of the transaction.

1. Taxpayers did not have a nontax business purpose for organizing LLC1.

As set out in connection with the analysis of the subjective prong, LLC1 was organized primarily to permit Taxpayers to avoid tax on their personal investments and to receive a charitable contribution deduction for those investments. See Section I.A., above.

2. The parties' economic position did not change as a result of the transaction.

Taxpayers treated the assets held by LLC1 (*i.e*., the Brokerage Firm account) as if they were the Taxpayer's personal assets. As previously outlined, after the purported transfer of nonvoting units to Organization1, Taxpayer-Husband remained in control of all assets held by LLC1. Economically, Taxpayer-Husband was in the same position as to the assets after the purported charitable contribution to Organization1, as he was before. As the transaction was structured, Taxpayer-Husband was able to withdraw the cash and then later created documents to treat the withdrawals as loans. Further, Organization1 was in the same position as to the assets before and after the purported contribution to Organization1, as it held no enforceable right to those assets.

As set out above, the transaction lacks economic substance, both subjectively and objectively, and must be disregarded for federal income tax purposes. The transaction did not meaningfully change Taxpayers' economic position (aside from tax consequences) nor did they have a substantial purpose in participating in the transaction (aside from tax consequences).

II. Organization1 should not be treated as a bona fide partner of LLC1.

A. Organization1 was not a partner in LLC1 under *Culbertson*

The Supreme Court in *Culbertson v. Commissioner* laid the foundation for determining, under federal tax laws, whether a partnership interest in form should be respected as a partnership interest in substance:

> [C]onsidering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

337 U.S. 733, 742 (1949). The determination is based on a realistic appraisal of the totality of the circumstances. *TIFD III-E, Inc. v. United States*, 459 F.3d 220, 231 (2d Cir. 2006). The key inquiry is whether the purported partner had a meaningful stake in the success or failure of the enterprise. *Id.* Here, Organization1 was a partner in name only as established by the totality of the circumstances. As set out below, Organization1 was not a partner in LLC1 and did not participate in any of the upside or downside from LLC1.

1. Organization1 did not share in the upside potential of LLC1.

The OA1 and the OA3 provide that Organization1, as a holder of the nonvoting interests, would receive mandatory distributions of Percentage2 of the assets in Year3 and Percentage3 of the assets in Year4. However, Taxpayer-Husband as Manager disregarded those terms and failed to the required mandatory distributions from LLC1. As previously mentioned, Taxpayers were also able to drain value out of LLC1 through purported loans, receiving the immediate benefit of a distribution. (OA3, sec. 1.04)

Both the OA1 and the OA3 allow an amendment to the agreement by a vote of voting members of which Taxpayer-Husband was the only voting member. Because Taxpayer-Husband controlled the distributions and disregarded the terms of the agreement requiring mandatory distributions, Organization1 could not, and did not expect to share in the upside potential of LLC1. Based on the facts set out here, under the Strategy, Organization1 would not have any upside potential in the assets, or investment income, of LLC1. Also, it seems evident that Organization1 never expected to have any upside potential, as it never expressed any concern about not receiving a distribution, despite the terms of the agreements. Further, Organization1 was set up by Advisor1 to allow individuals, such as the Taxpayers, to accumulate wealth “tax free.”

2. Organization1 did not share in the downside risk of LLC1.

Organization1 did not pay for its membership interest in LLC1, nor did it or was it obligated, to make any cash outlays to fund LLC1. Regardless of what happened to LLC1 economically, Organization1 remained in the same position: receiving distributions at Taxpayer-Husband’s sole discretion. Organization1 paid nothing for its interest in LLC1 and it never made, nor was it required to make, any capital contributions. While Organization1 was allowed to share in the losses per the operating agreements and was allocated a net loss on the Schedule K-1 for Year2, the fact is that Organization1 never had any interest in LLC1 to lose. It could never lose anything more than the nominal value it had.

3. Organization1 was not able to and did not realize the value allegedly associated with its interest in LLC1.

As set out above, Organization1 was not able to realize any value through the sale of its interest. The Operating Agreements set out the process of selling membership interests. (OA1 and OA3, sec. 12) It provides for a right of first refusal to purchase an interest if a member finds a willing third-party buyer. It is highly unlikely that Organization1 would be able to find a buyer for its nonvoting interests because, as further explained below, Organization1 exercises no control of LLC1, LLC1 did not conduct an operating business, and LLC1 only holds assets tied to the managing partner. Furthermore, because the nonvoting member has no upside potential and any transfer of interests has to be approved by Taxpayer-Husband, it is unlikely that an outside buyer would have any interest in purchasing the nonvoting units.

Organization1, as a holder of a nonvoting interest, did not have any power to enforce the alleged donation or to prevent the misappropriation of the value associated with its interest. As previously set out, Taxpayer-Husband, as owner of the voting interests and Manager of LLC1, maintained absolute discretion in all decisions, including how to calculate the distributions, and how LLC1's assets should be used.

4. As described above, Organization1 was created as a vehicle for individuals, like Taxpayers, to avoid income tax on the earnings from the assets of LLC1, while still having access to the assets to use for their own personal purposes.

During the audit, the revenue agent requested all correspondence between Taxpayers and Organization1. A review of the few documents provided indicated that Organization1 did not perform any due diligence prior to accepting the nonvoting interests. It did not inquire into the type of assets being put into LLC1, the type of income it would generate, the timing of any potential distributions, the possible expenses, etc. However, considering the way the Strategy was structured, it is unlikely that Organization1 would have conducted any due diligence because Advisor1 set Organization1 up as a vehicle for Taxpayers to accumulate wealth tax free and obtain a donation for charitable contributions which are of marginal benefit to any charity, with Advisor1 reaping associated fees. Had Organization1 performed due diligence prior to accepting the LLC1 interests, it would have required that numerous provisions of the Operating Agreements be clarified or changed. The facts show that Organization1 did not perform the due diligence that an entity in a bona fide transaction would have done.

5. LLC1 did not engage in any business activity.

LLC1 did not engage in any business activity beyond purportedly holding the cash in the Brokerage Firm account. Taxpayer's Brokerage Firm account undercuts any claim that Taxpayers gave Organization1 anything of value when they transferred the LLC1 units to Organization1 and objectively helps establish the structure has no economic substance. LLC1 did not engage in any business or investment activity, beyond the investment in the LLC1 Brokerage Firm account, the income of which Taxpayers never relinquished control. LLC1 was also used as a vehicle to avoid paying income tax on the appreciation in that account and to obtain a tax deduction. See *Ford v. Commissioner*, T.C. Memo. 1983-556 (determining that use of an intermediary corporation that "did not conduct business and its incorporation served no business purpose" and was used "to avoid the strictures of section 170(e)").

B. Organization1 is not recognized as a member of LLC1 for income tax purposes under section 704(e), given the facts of the circumstances.

With respect to partnerships in which capital is a material income-producing factor, section 704(e)(1) provides that a person shall be recognized as a partner for income tax purposes if he owns a capital interest in such a partnership whether or not such interest is derived by purchase or gift from any other person. Treas. Reg. § 1.704- 1(e)(1)(ii).

> Whether an alleged partner who is a donee of a capital interest in a partnership is the real owner of such capital interest, and *whether the donee has dominion and control over such interest*, must be ascertained from all the facts and circumstances of the particular case. The reality of the transfer and of the donee's ownership of the property attributed to Whim are to be ascertained from the conduct of the parties with respect to the alleged gift and not by any mechanical or formal test.

Treas. Reg. § 1.704-1(e)(2) (emphasis added).

If the donor has retained control of the partnership interest that he has purported to transfer to the donee, then the donor should be treated as remaining the substantial owner of the interest. Treas. Reg. § 1.704-1(e)(2)(ii). Controls of significance include: (1) retention of control of the distribution of amount of income or restrictions on the distributions of amounts of income (other than amounts retained in the partnership annually with the consent of the partners, including the donee partner, for the reasonable needs of the business); (2) limitation of the right of the donee to liquidate or sell his interest in the partnership at his discretion without financial detriment; (3) retention of control of assets essential to the business (for example, through retention of assets leased to the alleged partnership); (4) retention of management powers inconsistent with normal relationships among partners. *Id.* If controls by the donor are exercised indirectly (such as through a separate business organization, trust, or partnership), then the reality of the donee's interest will be determined if such controls were exercisable directly. Treas. Reg. § 1.704-1(e)(2)(iii).

On the other hand, substantial participation in the control and management of the business (including participation in major policy decisions affecting the business) is strong evidence of a donee partner's exercise of dominion and control over his interest. Treas. Reg. § 1.704-1(e)(2)(iv). Actual distribution to a donee partner of the entire amount or a major portion of his distributive share of the business income is evidence of the reality of the donee's interest. Treas. Reg. § 1.704-1(e)(2)(v). In determining if a donee ownership interest exists, consideration will be taken into whether the donee partner is included in the operation of the partnership business. Treas. Reg. § 1.704-1(e)(2)(vi).

A donee partner may be a limited partner who does not participate in the management of the partnership if the donee partner's right to transfer his interest is not subject to substantial restriction. Treas. Reg. § 1.704-1(e)(2)(ix).

If the reality of the transfer of interest is satisfactorily established, the motives are generally immaterial, but the presence of a tax avoidance motive is one factor to consider in determining the reality of the ownership of a donee's partnership interest. Treas. Reg. § 1.704-1(e)(2)(x).

In the present case, the nonvoting interests, which Taxpayers claim to have donated to Organization1, are similar to limited partnership interests as described in Treas. Reg. § 1.704-1(e)(2)(ix), in that they did not confer any voting rights or any right to a say in the management or operation of LLC1. While Taxpayer-Husband, LLC1's Manager and the voting interest holder, retained all control of LLC1, because the nonvoting interests could be seen as akin to limited partnership interests, Organization1's lack of voting rights or control of LLC1 would not be dispositive of the issue in this case. Accordingly, it is important to note, that aside from the lack of voting interests, Organization1 also had no ability to realize the value allegedly associated with the nonvoting interests and Taxpayer-Husband was able to, and did, drain value from the assets that were to provide the value allegedly donated to Organization1.

A consideration of other factors indicates that Organization1 is not a bona fide partner in LLC1. The OA1 and the OA3 set out the amount of distributions to the nonvoting partners, but that amount does not bear any relation to the income of LLC1. Instead, Organization1 only receives distributions when Taxpayer-Husband decides that he wants Organization1 to receive it, as evidenced by the fact that Taxpayer-Husband ignored the mandatory distribution provisions of Percentage2 and Percentage3 of the assets for Year3 and Year4. The Year3 distribution that was reported on the Form 1065 was not paid. Taxpayer-Husband's consent is required to approve all transfers of interests to anyone other than a family trust or a charity.

Taxpayers provided some explanation as to the purpose behind the transactions. The purported donation to Organization1 was part of Taxpayers' charitable legacy plan. Making Organization1 a nonvoting member of LLC1 did not accomplish this stated objective. In reality, notwithstanding the asserted appraisal of the nonvoting interests in LLC1, Taxpayers never gave anything of value to Organization1 by transferring the LLC1 units and while LLC1 transferred a minimal amount, a total of Amount6, that ultimately went to charities other than Organization1, the donation of the LLC1 units was solely to benefit Taxpayers.

Because Organization1 had no interest in LLC1, as discussed above, Organization1 was not a partner of LLC1 under section 704(e), which means all income, loss, deductions, capital accounts, and credits from LLC1 reported on the 2019 Form 1065 should be allocated to Taxpayer-Husband.

III. The income from the Percentage1 nonvoting interests purportedly transferred to Organization1 should be treated as taxable to Taxpayers, pursuant to the assignment of income doctrine.

A longstanding principle of tax law is that income is taxed to the person who earns it. *United States v. Basye*, 410 U.S. 441, 450 (1973) ("[H]e who earns income may not avoid taxation through anticipatory arrangements no matter how clever or subtle[.]"). Thus, a person anticipating receipt of income "cannot avoid taxation by entering into a contractual arrangement whereby that income is diverted to some other person." *Id*. at 449 (citing *Lucas v. Earl*, 281 U.S. 111, 115 (1930)). "More than expectation or anticipation of income is required before the assignment of income doctrine applies." *Greene v. United States*, 13 F.3d 577, 582 (2d Cir. 1994).

In order for a valid transfer of property to occur, there must be a significant change in the economic relationship of the taxpayer to the property. *Zmuda v. Commissioner*, 731 F.2d 1417 (9th Cir. 1984). The assignment of income doctrine will apply if the taxpayer retains rights in and control over the transferred assets. *Chase v. Commissioner*, T.C. Memo. 1990-164, aff'd, 926 F.2d 737 (8th Cir. 1991).

As previously analyzed, Taxpayer-Husband never parted with dominion and control over the assets of LLC1. There was no change in the economic relationship of Taxpayer-Husband and the property of LLC1. Taxpayers created the illusion that they parted with an interest in LLC1, but in reality, Taxpayers only assigned the income for purposes of the Form 1065, as Organization1 had no right to this income or any distributions from the partnership. The nonvoting interests in LLC1 had no value and were created in form to give the illusion that Taxpayer-Husband had parted with an interest in the securities that represent the value of LLC1. Thus, the income from the assets of LLC1 should be treated as 100% taxable to Taxpayers, pursuant to the assignment of income doctrine.

We are aware that some may reference the decision in *Palmer v. Commissioner*, 62

T.C. 684 (1974), affirmed on other grounds 523 F.2d 1308 (8th Cir. 1975), and the acquiescence to *Palmer* contained in Rev. Rul. 78-197, 1978-1 C.B. 83, to argue that assignment of income is not appropriate in this prearranged structure with a charitable entity. The acquiescence to the *Palmer* case contained in Rev. Rul. 78-197 established the rule that "when a charitable gift is followed by a 'prearranged redemption' or 'pursuant to a prearranged plan,' the IRS will 'treat the proceeds as income to the donor under facts similar to those in the *Palmer* decision only if the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption." Rev. Rul. 78-197. However, the opinion in *Palmer* and the Revenue Ruling are clearly distinguishable from the structure discussed in this memorandum, since both the decision in *Palmer* and Rev. Rul. 78-197 are premised on a structure with a charity that receives a donation of an interest from the donor that had value. Here, the nonvoting interests in LLC1 have no value. The structure in the present case was created solely to give the illusion that the charity received something of value so that Taxpayers could have their assets grow in a "tax free environment," with the income being shifted to a tax-exempt entity for tax purposes only. Organization1 had no right to receive anything of value from LLC1. Accordingly, neither *Palmer* nor Rev. Rul. 78-197 have any application to the present case.

IV. Disallowance of Taxpayer's Section 170 Charitable Contribution Deduction.

In general, section 170(a)(1) allows a deduction for any charitable contribution made during the taxable year. The deduction is allowed whether the contribution is in cash or in other property. Treas. Reg. § 1.170A-1.

Deductions are a matter of legislative grace and are strictly construed. *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934). As such, a taxpayer has the burden to establish that a claimed charitable contribution occurred and meets the requirements for a deduction.

Failure to meet any of the charitable contribution deduction requirements under section 170, and the related regulations, will result in the disallowance of Taxpayers' charitable contribution deductions.

A. Lack of Charitable Intent

Under section 170(c), "the term 'charitable contribution' means a contribution or gift to or for the use of [a qualifying organization]". Section 170(c) does not define "contribution or gift."

The legislative history to section 170 says that a "contribution or gift" is a transfer "made with no expectation of a financial return commensurate with the amount of the gift.” S. Rep. No. 1622, 83d Cong. 2d Sess. 196 (1954).

In Rev. Rul. 67-246, 1967-2 C.B. 104, the Service provided guidance regarding the extent to which taxpayers may claim a charitable contribution deduction for their participation in charitable fund-raising events, such as charity balls and banquets. The Service set out a two-part test to determine whether the taxpayer is entitled to a charitable contribution deduction under these circumstances. First, the taxpayer must prove that its payment to the charity exceeds the market value of the privileges or other benefits received. Second, the taxpayer must show that it paid the excess with the intention of making a gift.

The two-part test of Rev. Rul. 67-246 was subsequently applied by the courts. In *United States v. Am. Bar Endowment*, 477 U.S. 105 (1986), the Supreme Court noted that the essential condition of a charitable contribution is the transfer of money (or property) without expectation of adequate consideration. Moreover, the Supreme Court stated in *Hernandez v. Comm’r*, 490 U.S. 680 (1989), that when payments are made in return for an identifiable benefit, the payments do “not qualify as ‘contributions or gifts’”. Thus, examining the “external features of the transaction in question” is enough to show the lack of charitable intent of the individual taxpayers.

Additionally, *Singer Co. v. United States*, 449 F.2d 413 (Ct. Cl. 1970) demonstrates that adequate consideration does not need to be specifically quantifiable at the time of the transfer. In *Singer Co. v. United States*, a sewing machine manufacturer encouraged schools to teach students to sew by offering the sewing machines at a discounted price. The court found that the predominant purpose of the discount was to enlarge the potential market for Singer sewing machines. Because the predominant reason for the discounts was “other than charitable”, the court held there was no contribution or gift within the meaning of section 170.

Taxpayer-Husband managed and controlled LLC1 and, therefore, had the authority to allocate Percentage1 of its partnership items to the nonvoting membership interest he transferred to Organization1 and retain the remaining Percentage2. Taxpayers’ predominant purpose in transferring the nonvoting interests in LLC1 to Organization1 was to engage in the Strategy for which they received substantial, identifiable financial benefits in return. Taxpayers had signatory authority over the brokerage accounts and chose LLC1’s investment strategy thereby earning investment income on investments of their choosing on which they paid only 1% of the tax, escaping tax on the rest. The lack of distributions made by LLC1 to Taxpayers is immaterial because Taxpayers received partnership income from LLC1 through tax-free low-interest loans. In addition, Taxpayers claimed charitable contribution deductions. Because Taxpayers lacked the charitable intent to make a contribution or gift of the nonvoting interest in LLC1 to Organization1, their claim for a charitable contribution deduction under section 170 is disallowed.

Taxpayers may argue that Organization1's charitable contribution to Charity1 in Year3 supports their charitable intent. This argument is not persuasive because Taxpayers' financial benefits from Strategy significantly outweighed any charitable benefit Charity1 received from the de minimis amount of Organization1's distribution. Therefore, as in *Singer Co.*, Taxpayers' predominant reason for entering into the Strategy was "other than charitable."

B. Failure to Comply with Substantiation Requirements.

1. Contemporaneous Written Acknowledgment

Section 170(f)(8)(A) provides that no deduction under section 170(a) will be allowed for any contribution of $250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgment (CWA) of the contribution by the donee organization. See also § 1.170A-13(f).

Section 170(f)(8)(B) requires that a CWA (1) include a description of the property donated, (2) state whether the donee organization provided any goods or services for the donation, and (3) provide a description and good faith estimate of the value of any goods or services provided, or a statement that only an intangible religious benefit was provided. Under section 170(f)(8)(C), Taxpayers must obtain a CWA on or before the earlier of the date the taxpayer files their original Federal tax return for the year in which the contribution was made or the due date (with extensions) for filing the return, whichever comes first.

The Tax Court has held that a deed of easement may constitute a CWA. See *310 Retail, LLC v. Comm'r*, T.C. Memo. 2017-164, 114 T.C.M. (CCH) 228; *RP Golf, LLC v. Comm'r,* T.C. Memo. 2012-282, 104 T.C.M. (CCH) 413; *Averyt v. Comm'r*, T.C. Memo. 2012-198, 104 T.C.M. (CCH) 65. In *French v. Commissioner*, the Tax Court noted that a letter from a representative of the donee to the donors may satisfy the requirements of section 170(f)(8)(B) but the CWA the donee provided did not satisfy the substantiation requirement because it was dated after the taxpayers filed their amended return. T.C. Memo. 2016-53, 111 T.C.M. (CCH) 1241.

Taxpayers did not attach a CWA to their Year3 tax return, and they cannot avail themselves of the Tax Court's comment in *French* because there is no documentation from Organization1 to Taxpayers that complies with the substantiation requirements of section 170(f)(8)(B).

Furthermore, for a charitable contribution to a DAF, section 170(f)(18)(B) provides that the CWA must meet rules similar to those of section 170(f)(8) and state that the sponsoring organization of the DAF has exclusive legal control over the assets contributed. Organization1, a purported sponsoring organization, could not make this statement because it had no legal control over the assets contributed.

Taxpayers' failure to comply with the CWA requirements of section 170(f)(8) and section 170(f)(18) is sufficient to deny their section 170(a) deduction for Year3.

2. Qualified Appraisal

Section 170(f)(11)(D) denies a deduction under section 170(a) for any contribution of property for which a deduction of more than $500,000 is claimed unless the taxpayer attaches to the return for the taxable year a qualified appraisal of the property.

Taxpayers did not attach a qualified appraisal to their Year3 tax return. Therefore, under section 170(f)(11)(D), Taxpayers' claim for charitable contribution deduction in Year3 is denied.

<u>CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS</u>

[redacted]

[redacted]

[redacted]