O. DONOR CONTROL

by
Ron Shoemaker, Debra Kawecki, Sadie Copeland and David Jones

Part I – Gift Funds: A New Direction in Charity?

by Ron Shoemaker and David Jones

1. Introduction

The tax issues associated with the use of donor directed funds sponsored by commercial investment companies were described in the 1996 EO CPE Text, Topic M, p 328, titled "Donor Directed Funds." While not focusing exclusively on the issues associated with the promotion and operation of gift funds of mutual fund companies, the purpose of this segment of this article is to update the 1996 EO CPE Text, Topic M, with the latest authority in the area.

The legal issues raised in the gift fund cases are being debated in a particular political context. A useful discussion of some of the controversies in this area appeared in a lead article in the Wall Street Journal dated February 12, 1998. This article explains some of the complex issues involved. Beyond the concerns of the Service about potential tax abuse, the article describes the rivalry between the gift funds and "traditional" community trusts. Among the community trusts' concerns are that commercially sponsored gift funds (1) may be "siphoning off" charitable gifts away from the traditional charities or (2) may fail to justify a clearly defined charitable mission (unlike the community trusts).

The Service is not the arbiter between these two groups. Rather, its mission is to even-handedly administer the tax law. The 1996 article discusses commercially-sponsored donor directed funds and whether they offered potential for tax abuse. It should be clearly understood, however, that both groups are subject to the same rules and both raise many similar issues.

2. Court Cases

The Service first challenged the donor-directed fund technique in court in the case of National Foundation, Inc. v. United States, 13 Cl. Ct. 486 (1987). The court held for the organization, finding that it qualified for exemption under IRC 501(c)(3). It held that the organization furthered a charitable purpose by distributing funds to charity in a manner similar to the United Way. The court rejected the Service contention that the organization was a commercial enterprise. The court also rejected arguments that the organization was a mere conduit as well as rejecting inurement, private benefit, and private foundation arguments. For a more complete discussion and analysis of the case, see the 1996 CPE Text, Topic M, page 343.

The Service did have success in a more recent case, The Fund for Anonymous Gifts v. Internal Revenue Service, 97-2 U.S. Tax Cases (CCH) P50,710 (1997). In a memorandum opinion, the Court held that the organization (the "fund") is not charitable within the meaning of IRC 501(c)(3). Although the Fund was not sponsored by or related to a commercial investment or financial company, its main features included separate donor sub-accounts generating income for disposition by the donor.

Under the facts found by the court, the agreement between the parties provided that the donor would take a charitable deduction at the time funds were transferred to the Fund. The Fund credits the donor's sub-account. Although the fund ostensibly possesses the contribution, the Fund's trustee is bound by the donor's enforceable conditions as to disposition of the funds to the ultimate charity. The court found that the trustee of the fund would comply with the donor's conditions as long as they did not require the trustee to violate IRS regulations or cause the Fund to lose its IRC 501(c)(3) exemption. If the Fund would face a loss of exemption by virtue of the nature of a gift, the trustee would either invite the donor to redirect the gift, return the gift to the donor, or redirect the donation itself.

The Fund agreement required the trustee to invest the funds in the donor's account as instructed by the donor. The Cout discussed both control over charitable disposition and control over investment decisions, as follows:

> "The manner in which the Fund's investment activity would be conducted makes clear that one of the purposes of the Fund is to allow persons to take a charitable deduction for a donation to the Fund while retaining investment control over the donation. This is so because the Trustee is bound by the conditions attached the donations as to the 'terms or conditions for retaining such transfers,' to the 'use or disposition of the transferred property,' and to the 'acts required of the Trustee in the management of such property, or the disposition of income from assets attributable to such transfers,' unless any of these conditions require that the Trustee make a donation to a non-exempt organization or to an individual for a non charitable use. Therefore, other than this exception, the Trustee is fully bound by the investment instructions attached to the donation."

The court distinguished National Foundation because funds donated to NFI were given without restriction. The Court then stated in the memorandum opinion that because of its holding that the Fund is not entitled to IRC 501(c)(3) status, it was not necessary to determine whether the fund should be classified as a publicly-supported charity rather than a private foundation. Despite this pronouncement, the court offered the opinion that it is unlikely that the plaintiff has shown that it can reasonably be expected to be supported by the general public.

The court also compares the Fund with Fidelity Investments Charitable Gift Fund, a fund that is, presumably, an example of a commercial donor-directed fund. The Fidelity discussion is dicta; it may not reliably predict how the court would rule with respect to a generic commercial donor-directed fund based on all the relevant facts.

The decision of the District Court is now on appeal before the U.S. Court of Appeals, District of Columbia Circuit. Oral arguments were heard in March, 1998.

3. Donor Control I

Donor control was an important issue in both National Foundation and The Fund for Anonymous Gifts, and arises in many gift fund and community trust cases. As the degree of donor advice or control varies, particularly with donor-advised gift funds, each case should be tested against the factors set out in Reg. 1.507-2(a)(8)(iv)(A)(2). Those factors are:

> (2) The presence of some or all of the following factors will indicate that the reservation of such a right does not exist (emphasis added):
>
> (i) There has been an independent investigation by the staff of the public charity evaluating whether the donor's advice is consistent with specific charitable needs most deserving of support by the public charity (as determined by the public charity);
>
> (ii) The public charity has promulgated guidelines enumerating specific charitable needs consistent with the charitable purposes of the public charity and the donor's advice is consistent with such guidelines;
>
> (iii) The public charity has instituted an educational program publicizing to donors and other persons the guidelines enumerating specific charitable needs consistent with the charitable purposes of the public charity;
>
> (iv) The public charity distributes funds in excess of amounts distributed from the donor's fund to the same or similar types of organizations or charitable needs as those recommended by the donor; and
>
> (v) The public charity's solicitations (written or oral) for funds specifically state that such public charity will not be bound by advice offered by the donor.

> (3) The presence of some or all of the following factors will indicate the reservation of such a right does exist (emphasis added):
>
> (i) The solicitations (written or oral) of funds by the public charity state or imply, or a pattern of conduct on the part of the public charity creates an expectation, that the donor's advice will be followed;
>
> (ii) The advice of a donor (whether or not restricted to a distribution of income or principal from the donor's trust or fund) is limited to distributions of amounts from the donor's fund, and the factors described in paragraph (a)(8)(iv)(A)(2) or (i) or (ii) of this section are not present;
>
> (iii) Only the advice of the donor as to distributions of such donor's fund is solicited by the public charity and no procedure is provided for considering advice from persons other than the donor with respect to such fund; and
>
> (iv) For the taxable year and all prior taxable years the public charity follows the advice of all donors with respect to their funds substantially all of the time.

4. Donor Control II

Although public charities are not subject to a minimum distribution requirement, as are private foundations, a public charity's failure to distribute the minimum that it would be required to distribute if it were a private foundation may indicate a degree of donor control inconsistent with achieving charitable purposes. Reg. 1.507-2(a)(8)(B) provides:

> (B) Other action or withholding of action. The terms of the transfer agreement, or any expressed or implied understanding, required the public charity to take or withhold action with respect to the transferred assets which is not designed to further one or more of the exempt purposes of the public charity, and such action or withholding of action would, if performed by the transferor private foundation with respect to such assets, have subjected the transferor to tax under chapter 42 (other than with respect to the minimum investment return requirement of section 4942(e)).

As long as a community trust or a gift fund distributes an amount equal to the minimum investment return (calculated as if the public charity were a foundation) gifts that delay the distribution of contributions will not affect the fund's exempt status.

5. Life Insurance Benefit Sharing Arrangements

A recent development has been use of life insurance arrangements with a donor-directed feature. A donor owning life insurance may enter into a benefit-sharing arrangement with an IRC 501(c)(3) charity. The charity purchases a share of the policy with funds contributed by the donor and continues annually to use donor contributed funds to pay for its share of the annual policy premium. The charity is entitled to receive a proportional share of the death benefit or cash surrender value. When the donor's account is funded then the donor or designated successor may exercise donor advisory rights established under the contract with the charity. The insurance aspect of this arrangement raises concerns that the interests of charity are sacrificed to the private interests of the donor, and, thus may be operated for the substantial private benefit of donors.

To date, the tax problems associated with the insurance portion of these arrangements have resolved cases without a need to challenge the donor directed feature.

6. Conclusion

The Service will carefully evaluate both commercial gift funds and community trusts as to operations and purposes. Each case is highly factual and outcomes may vary depending on the facts in each case. The Service is likely to view more favorably those organizations that live up to a well defined exempt purpose, provide for a minimum 5 percent payout amount (where appropriate), and monitor and police donor abuse.

An article appearing in the Wall Street Journal, titled "Charities Decry Invasion of For-Profit Concerns", April 1, 1998, indicates that influential community trusts and other traditional charities are willing to lobby Congress for a change in the law to put restrictions on commercially related charities. Whatever may happen in the legislative arena regarding this matter, the Service continues to work through the difficult concerns associated with the donor directed fund.

Part II – If It's Too Good to be True, It's Too Good to be True!

by Debbie Kawecki and David Jones

The title to this article sums up the message the Service would like to communicate to thousands of people who spend money on trust packages often sold by seminar and the Internet. These trust kits are sold to both the naive and the sophisticated taxpayer as devices, which will reduce tax liability to almost zero. These schemes have been around for almost as long as the income tax system. The Service has been successful in hundreds of cases, yet the sales continue.

Currently, the Service is making a concentrated effort to identify and prosecute abusive trust schemes. This effort, the National Compliance Strategy, Fiduciary and Special Projects, is a joint undertaking of Assistant Commissioner (Examination, Assistant Commissioner (Criminal Investigation, and the Office of the Chief Counsel. Currently, the Assistant Commissioner (Employee Plans and Exempt Organizations) is participating on the Task Force. One early result of the Task Force's effort is the publication of Notice 97-24. This notice is intended to alert taxpayers about certain trust arrangements that purport to reduce or eliminate federal taxes in ways that are not permitted by federal tax law.

EP/EO has become involved with the Task Force because of the use of charitable trusts as part of these abusive trust packages. The taxpayer may transfer assets to an alleged charitable trust and claim that the payment to the trust is a charitable contribution or that the payments from the trust are charitable distributions. Payments made to actual charitable beneficiaries are rare. What is more common are payments for the benefit of the taxpayer and family in the form of tuition and other personal expenses.

When the income tax was introduced after the Sixteenth Amendment in 1913, people immediately began to look for ways to avoid or to mitigate its effects on their income. Due to the graduated structure of the income tax, the tax on an individual earning $10,000 was more than twice the tax on an individual earning $5000. The earliest method of tax avoidance relied upon income splitting by assigning a portion of one's income to someone else. The split income would be taxed at a lower rate so that the total tax bill would be reduced. The fundamental case of Lucas v. Earl, 281 U.S. 111 (1930) held that a person could not avoid taxation on income which was assigned to someone else.

Rather than move the income, the next method involved shifting the underlying income producing property from the taxpayer to someone else. For example, Taxpayer owns 10,000 shares of stock. On the day before dividends were to be paid he gives this stock to his spouse. On the day after dividends were to be paid, the spouse gives the stock back. Congress plugged this particular loophole, but there always seems to be some one willing to try it again with a slightly different twist.

Ten years after Lucas v. Earl, supra., the Supreme Court made another fundamental ruling. In Helvering v. Clifford, 309 U.S. 331 (1940), the Court held that income should be taxed to the original owner even though the owner had made a "formal" transfer of income-producing property to his wife, since he had retained economic control over the property. The issue of what is and is not economic control was frequently the subject of litigation. The rules evolving from these cases were codified in IRC 671-679, the grantor-trust rules.

In the 1970's the abusive trust became a mainstay of the tax protestor movement. Even though the principles of Lucas and Helvering should have made it clear that these devices could not be successfully employed to legitimately lower tax liability, they proliferated. The most common form was the "family trust" in which individuals would attempt to transfer their assets and assign their income to a trust. The claim was that the income was no longer taxable to the individual and the assets were shielded from creditors. The Service was successful in litigating a large number of these cases. The concept should have died, but it did not.

The 1980's saw a rise in the tax on self-employment income. This led to a tax avoidance device using subchapter S corporations. A vigorous enforcement program curtailed this attempt but set the stage for the abusive trust devices of the 1990's which are aggressively marketed to middle income taxpayers looking for ways to avoid paying self-employment tax.

The abusive trust devices of the 1990's are a package of trusts, each supposedly performing a unique service for the purchaser and each trust intertwined with the others to produce amazing tax savings with no change or inconvenience to the life style of the purchaser.

While surfing the WEB, Dr. Gullible chances upon the following:

Why Pay Tax?

America is the Land of the Free

Let the Pure Trust Set You Free

After reading of the tax advantages (i.e. no tax owed) and the impressive legality (two ancient cases that have been repudiated countless times) of this approach, Dr. Gullible charges $5000 on his credit card to receive his trust kit. When he receives his package, he finds a number of different trust documents. He is instructed to fill in the name of each trust and to sign the documents, along with his spouse and an independent trustee of his choosing.

Two suggestions are made by the promoters. He is advised that it is always wise to choose a trustee who owes him a favor. He is also advised not to discuss the trust arrangements with a lawyer, as lawyers are not trained to understand the fine complexities of this type of sophisticated arrangement.

Having no great love for lawyers, Dr. Gullible executes the trust documents even though he can make no sense out of them. In that regard, Dr. Gullible is not alone. The United States Bankruptcy Court for the District of Minnesota, In re: Constitutional Trust #2-562, was perplexed by similar trust documents. The Court quoted "the immortal words of Lewis Carroll, in his poem "Jabberwocky" and went on to make the following observation.

> Assuming the debtor spent any time reviewing the trust document, it could not help but feel much as Alice did upon reading "Jabberwocky":
>
> > ***'It seems very pretty', she said when she had finished it, 'but it's rather hard to understand'...'Somehow it seems to fill my head with ideas--only I don't exactly know what they are.'***
> > Carroll, Through the Looking Glass (1872)

Not wanting to delay the start of the tax savings, Dr.Gullible, his wife, and his nurse executed documents to establish the following trusts.

1) Dr. Gullible transferred all of his business assets into a business trust in exchange for units or certificates of beneficial ownership. The business trust will pay him only a small salary. Thus, in theory he has canceled his self-employment tax liability because he is no longer self-employed.

2) All of his personal assets and real property are transferred to an asset preservation trust. The business trust will contract with the asset preservation trust to lease the assets of the asset preservation trust. The lease payment is set at an inflated price, which draws all of the income out of the business trust into the asset preservation trust. The assets preservation trust contracts with the doctor and his family requiring them to live in the former family residence in order to preserve the assets of the trust. All of the family's prior personal expenses are treated as deductible expenses of the trust. This zeros out the trust's income so that any taxable distributions to the certificate holders are minimal.

3) Dr. Gullible elects to donate income from the asset preservation trust to an exempt organization raising funds through this trust promotion. He is directed to set up an account with Charity Begins at Home, Inc., an organization exempt under IRC 501(c)(3), which is currently under examination. Dr. Gullible is concerned that he will loose control of the funds deposited with CBH. A call to the promoter allays his concerns. He is told that CBH will follow his investment advice and he can freely grant money to himself for any project he may choose, such as the education of his children.

Many of the abusive trusts the Service is currently aware of follow the pattern laid out above. The basic scheme can be played out with endless variety. Some of the trusts can be created offshore; there can be more layers of trusts, and combinations offshore and domestic trusts. The litigation record of the Service in its continuing battle with abusive trusts is highly successful. The judicial system may be losing patience with taxpayers that resort to this patently illegal method of reducing tax liability.

In Victor J. Soloniuk v. Commissioner, 44 T.C.M. 1982-339, the Court seems to have had just about enough.

> Aside from the fact that we read the Trust provisions as precluding charitable contributions, we find that petitioners further disregarded the Trust by using it to make their own charitable contributions. When asked what purpose of the Trust was furthered by paying $6,258.00 to a church, Victor responded as follows: 'Simply because being deeply religious, we feel that 10 per cent of our income -- or the income of which we have control *** belongs to God and we figure 10 per cent ***' It is commendable that petitioners are willing to render unto their church what is due their church; we wish they were as willing to render unto their government what is due their government.
>
> Since petitioners are deeply religious people we remind them of the statement in Matthew 22:21 (King James Version): 'Render therefore unto Caesar the things which are Caesar's; and unto God the things that are God's.
>
> Petitioner's attempt to build an ESP [name of the trust] paper palace to avoid taxation results in a house of cards, which collapses of its own weight when scrutinized. Our review of the record compels us to conclude that the Trust lacks economic substance, was a sham, and a nullity for Federal income tax purposes...

The economic substance argument and the sham transaction argument are only two of a number of legal theories that have been argued by the Service and adopted by the Courts to support adverse opinions for taxpayers that utilized abusive trusts.

When the Service audits such trusts, it generally finds that the individual who set up the trust previously filed a Form 1040 with a Schedule C on which had been reported the income and expenses from a business. Upon examination, the Service typically collapses the trust with the income flowing back to the individual's Form 1040. The personal expenses that where taken by the trusts as deductions are disallowed.

There are generally three legal theories on which the Service relies to collapse the income back to the individuals Form 1040.

1) the trust income is taxable to the individual because the trust is a sham, with no economic reality;

2) the trust income is taxable to the individual because of the grantor trust provisions of the IRC.

3) the trust income is taxable to the individual, since the transfer of income to the trust was merely an assignment of income earned by the individual.

An argument can be made that these trusts are shams because neither title nor economic control of the taxpayer's business left the hands of the taxpayer. Patterson v. Commissioner, 48 T.C.M. 418 (1984) is a good example of the use of the sham argument to collapse a series of trusts.

> Dr. Patterson would have us believe that in creating the trust he stripped himself of all control over all of his property which he valued at $1 million-his home, his medical office, his office equipment, his home furniture and furnishings, other real and personal property, and even his razor, toothbrush and tennis racket. Yet he continued to live in the same location, use the same medical equipment, and enjoy the services of the same office staff. There was 'no separation of legal title from beneficial enjoyment', Markosian v. Commissioner, 73 T.C. 1245 (1980)...The principle changes effected by the trust were changes in claimed tax consequences. Before the trust was created, Dr. Patterson paid his personal and living expenses from his own bank account and reported as taxable his substantial medical practice income less business deductions. After the trust was created, it reported as its income a sum equal to about two-thirds of Dr. Patterson's medical practice receipts and took deductions for most of the related expenses. In addition, the trust paid and deducted amounts which has been previously treated as personal expenditures, such as expenses for residential upkeep, utilities, and telephone service, homeowners insurance, charitable contributions, and Mrs. Patterson's medical bills. Also, the trust deducted each year depreciation on the trust 'headquarters,' i.e. petitioners' personal residence...We conclude that the trust was a transparent tax avoidance scheme, designed to reduce the income tax on Dr. Patterson's medical practice income and to create tax deductions for personal expenses. Its continued existence and income depended entirely upon Dr. Pattersons, who, together with Mrs. Patterson, provided the purported capital contributions and generated virtually all of its income. An entity whose existence, everyday functioning, and ultimate demise are controlled by its creators and which produces no material changes in the status quo, except to reduce income taxes, can only be characterized as a sham, devoid of economic reality.

The courts have repeatedly held that these trust arrangements are merely illusions, conjured up for taxpayers in an attempt to avoid federal income tax. They are shams. The legal principles involving them are so well settled that the only purpose of litigation is to delay the payment of tax because the cases can not be won by the petitioners.

The Service also successfully attacks these trusts under the grantor trust provisions of IRC 671-679. Rev. Rul. 75-257, 1975-2 C.B.251, is one of four companion revenue rulings issued in 1975, which deal with the taxation of family trusts. Rev. Rul. 75-257 deals with the grantor trust rules and the assignment of income theory. The taxpayer/grantor assigned all of his property, including income-producing property to a 'pure equity/constitutional/family estate trust,' of which the taxpayer owned all of the units of beneficial interest. The trustees included the taxpayer, his wife, and a third party. The ruling concluded that the grantor trust rules applies so that the taxpayer was taxed on the income rather than the trust.

Under IRC 674(a) a grantor is treated as owner of any portion of a trust in which the beneficial enjoyment of the corpus or this income is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both without approval of any adverse party. The adverse party requirement is often the key element in these cases. The taxpayer's spouse is not considered an adverse party. Usually there are three trustees, the taxpayer, the spouse, and a third party. Thus, in the unlikely event that the third party was truly adverse, the taxpayer and spouse would control the distributions from the trust.

If one assumed for purposes of discussion that the trusts were not shams, the income from the trusts would still be attributed to the individuals under the grantor trust rules.

Taxpayers typically claim that they transferred their business into a business trust, with the net distributable income to be distributed to another trust/and/or to the ultimate beneficiaries. Both before and after the establishment of the trusts, the taxpayers will continue to run the business as usual, in the same location and under the same business name. This is a classic anticipatory assignment of income scheme, and the income is taxable to the individual. In Rev. Rul. 75-257, supra, the grantor assigned his "lifetime services" to the trust, which included all of the remuneration earned by him regardless of its source. This assignment was ineffective and the income was taxed to the individual. The anticipatory assignment of income doctrine is based on the famous case of Lucas v. Earl, 281 U.S. 111 (1930). The Court compared the taxpayer's situation to a tree (the taxpayer) and the fruit (the income). The fruit, the Court stated, can not fall far from the tree. In other words, income will be taxed to the person who has actual control and tax will not be avoided by diverting the income to other entities.

As part of the National Compliance Strategy, Fiduciary and Special Projects, the Service seeks to encourage voluntary compliance with the tax laws. Accordingly, taxpayers that have participated in abusive trust arrangements are encouraged to file correct tax returns and to amend tax return for prior years. While voluntary compliance is the goal, the Service has a number of civil and criminal penalties it has used successfully.

There are a number of civil penalties that apply to the individual taxpayer. For example, IRC 6662 provides a 20 percent accuracy related penalty on any portion of an underpayment attributable to one or more of the following:

1) negligence or disregard of the rules and regulations;

2) any substantial understatement of income tax;

3) any substantial valuation misstatement;

4) any substantial overstatement of pension liabilities; and

5) any substantial estate or gift tax valuation understatement.

There are a number of other penalties, including significant fraud penalties that also apply to the individual. Courts seem more and more willing to approve of these penalties because of the repetitive nature of these abusive cases. The Court, in Brown v. Commissioner, 43 T.C.M. 1322 (1982), summed up the feelings of many courts grappling with these tax abuses.

> We agree with the statement in Harris v. Commissioner, T.C. Memo 1981-66: 'To anyone (and we would include petitioners) not incorrigibly addicted to the 'free lunch' philosophy of life, the entire scheme had to have been seen as a wholly transparent sham.' It is not clear from the record whether an attorney or a CPA ever advised petitioners to engage in this wholly transparent sham. The record is clear that petitioners accepted the blandishment of the ESP [promoter] representatives and bought the 'pie in the sky' peddled by ESP.

While the individual is subject to serious penalties, a case by case approach is not enough to curtail the use of these devices. Congress has provided a number of penalties on the promoters of abusive tax shelters and promoters have been convicted of criminal conspiracies.

The Court of Appeals for the Fifth Circuit, in Buttorff v. United States, 761 F.2d 1056 (1985) approved the use of abusive tax shelter promoter penalties under IRC 6700 and an injunction under the procedures of IRC 7408 for promoters of abusive trust packages.

> Prior to the enactment of section 6700, the Internal Revenue Code contained no penalty provisions specifically directed toward promoters of abusive tax shelters and other abusive tax avoidance schemes...The legislative purpose in enacting these statutes was to allow the IRS to attack the growing phenomenon of abusive tax shelters at their source---the organizer and salesman---in the 'most effective way'--by injunction.

IRC 6700 penalizes any person who makes statements regarding the tax benefits of an arrangement organized or sold by him which he knows or has reason to know are false or fraudulent as to any material matter. IRC 7408 is a very effective tool for the enforcement program. In any case where IRC 6700 penalties can be applied, the Service can seek an injunction to prevent the recurrence of the conduct giving rise to the IRC 6700 violation. The trust promoter will be enjoined from rendering the incorrect tax advice. When the promoter continues in rendering the incorrect advice, promoters have been jailed. The following are two counts in an injunction that was approved by the Court of Appeals in Buttorf v. U.S., supra.,

> Defendant and others described above are prohibited, pending the final hearing and determination of this action, from selling and promoting either directly or indirectly the "Constitutional Pure Equity Trust,' or any similar scheme or device.
>
> Defendant and others described above are prohibited, pending final determination, from performing services for others such as counseling, tax return preparation, or preparation of deeds, resolutions, minutes, or other legal documents in connection with such trust, scheme or device, including the trust sold or formed prior to the entry of this Order.

The injunctions do not run afoul of the Constitution because they are only limiting commercial speech. The individual is free to do anything other than provide incorrect tax advice.

Also available to litigators is 18 U.S.C. 371, conspiracy to commit offense or to defraud the United States. If two or more persons conspire either to commit any offense against the United States, or any agency and one or more of such persons does any act to effect the object of the conspiracy, the fine is $10,000 and/or up to five years in jail. Section 371 has been effectively employed in a number of cases involving abusive trust scams. In United States v. Scott, 37 F. 3d 1564 (1964) the Tenth Circuit affirmed the convictions of eight defendants tried for conspiracy to defraud the United States. The charge of conspiracy arose from defendant's involvement with an unincorporated organization, which created, promoted, and sold trusts through marketing seminars held around the country and through sales representatives.

EP/EO has recently become involved with the Task Force because some promoters are using an alleged organization exempt under section 501(c)(3) of the Code, to funnel tax savings from the business trusts and the asset preservation trusts. The Form 1023 for the applicant states that the applicant will receive donations and make contributions to charitable organizations. It many indicate that donor's contributions will be kept in a separate account and that donors will be able to provide investment advice.

Applications with this fact pattern should be scrutinized carefully. All promotional material to prospective donors should be solicited. The key to these cases, is who has control over the donations-the donors or the applicant. In some few instances, the issue of control may be close (see the discussion of donor advised funds elsewhere in this article). Any instance where the determination specialist is concerned that the applicant may be part of an abusive trust device can be discussed with Headquarter. Contact Debra Kawecki at 202-622-8493 or, with respect to the question of donor advised funds, Ron Shoemaker at 202-622-8438.

Part III - Deputized Fundraising

by Sadie Copeland and David Jones

1. Introduction

Many religious, charitable, and other organizations that qualify for tax deductible contributions use a practice known as "deputized fundraising" to support their activities. Deputized fundraising consists of paid staff, and/or volunteers conducting grass roots fundraising to support the organization. This practice has occasionally been controversial because of the tendency on the part of some fundraisers to represent that contributions will only be used to support the work of the individual doing the fundraising. In such cases, the nature of the transaction has become blurred and donors are led to believe that the organization is a mere conduit and that contributions will eventually be automatically allocated to the fundraiser. Although private giving to an individual designated to be the recipient is not deductible, contributions are deductible to a religious, charitable or other qualified organization for use in its charitable program.

This section will focus on the interpretation by the courts and the Service in determining whether a donor makes contributions "to" a charity or to the charity earmarked for an individual. This section will conclude with the Service's current recommendations regarding this issue.

2. Development of the Deputized Fundraising Issue Under IRC 170

IRC 170(a) provides that a deduction shall be allowed, subject to certain limitations, for any charitable contribution defined under IRC 170(c) and which is paid to the organization within the taxable year. IRC 170(c) provides, in part, that a charitable contribution includes a contribution to or gift to or for the use of a corporation organized and operated exclusively for religious, educational or other charitable purposes and which has no net earnings that inure to the benefit of any private shareholder or individual.

The rulings and cases have laid down two general tests for determining whether a contribution was made to or for the use of a charitable organization, rather than to a particular individual who ultimately benefited from the contribution.

In Rev. Rul. 62-113, C.B. 1962-2, 10, it was stated that "The test in each case is whether the organization has full control of the donated funds, and discretion as their use, so as to insure that they will be used to carry out its functions and purposes." The taxpayer there had made donations to a fund established by his local church for supporting its overseas missionaries, one of who was the taxpayer's son. The ruling considered whether the donations were contributions to the church, or were nondeductible personal expenses for the support of the taxpayer's son. It was held that so long as there was no understanding that the funds would be used only for the taxpayer's son, the donations were deductible under section 170 as contributions to the church. See also, S.E. Thomason, 2 T.C. 441 (1943), (payments

to a charitable organization to reimburse it for the expenses of maintaining a particular child were not deductible because the organization did not have the exclusive right of appropriation of the funds donated, but had to use them only for the designated child.

The second test which has been used for determining whether contributions are to an organization, rather than to a particular individual who ultimately benefits from them, is whether the contributor's intent is making the payment was to benefit the organization itself or the individual. In George E. Peace, 43 T.C. 1 (1964)(Acq. C.B. 1965-2, 6), the court held that the taxpayer's contributions to a missionary society were deductible, despite the Commissioner's contention that the contributions were designated for the support of particular missionaries, upon finding as a fact that the taxpayer intended that his contributions go into a common pool to be administered and distributed by the organization as it desired. See also, Tripp v. Commissioner, 337 F.2d 432 (7th Cir. 1964), (payments made to an educational institution and earmarked for the educational expenses of a particular individual were not deductible because they were neither made to the college for its general use nor made for the benefit of an indefinite number of persons); Archibald W. McMillan, 31 T.C. 1143 (1959) (charitable deduction disallowed because taxpayer's primary intent was not to benefit the adoption agency but was to satisfy his personal desire to adopt a child).

The "intended benefit test" was likewise employed in G.C.M. 32045, (July 27, 1961), where under a proposed arrangement, a fund would collect contributions from fraternity alumni to assist one of the fraternity's chapter to construct a new fraternity house and turn the contributions over to the university. The university would agree to lend them with interest to the fraternity chapter in return for a second mortgage on the building to be constructed. The university would be entitled to use the interest to award scholarships to students of its choice. While recognizing that benefits would accrue to the university under the proposed arrangement, the Service nevertheless held that the university was "merely a conduit for the cash contributions to and for the benefit of the fraternity," and that the contributions to the proposed fund would not be deductible as gifts or contributions to or for the use of the university under section 170.

The Service further enunciated this position in Rev. Rul. 68-484, 1968-2 C.B. 105. Rev. Rul. 68-484, supra, provides that for purposes of determining that a contribution is made to or for the use of an organization described in section 170 of the Code rather than to a particular individual, the organization must have full control of the use of the donated funds; and the contributor's intent in making the payment must have been to benefit the charitable organization itself and not the individual recipient.

Control and intent to benefit were also issues in Rev. Rul. 79-81, 1979-1 C.B. 107. The Service applied the reasoning of Rev. Ruls. 62-113 and 68-484, supra, and concluded that contributions solicited by members of a religious organization for participation in a leadership training program were not deductible because the facts evidenced the contributor's intent to benefit the individual recipient and the organization did not have control over the donated funds.

3. Davis v. United States and its Impact on Deductibility Under IRC 170

In Davis v. United States, 495 U.S. 472 (1990), the Supreme Court provided guidance for the first time on the issue of whether payments made "to or for the use of" a qualified organization were deductible as charitable contributions under IRC 170(c). The taxpayers, who are members of the Church of Jesus Christ of Latter-day Saints (Church) claimed such deductions for funds transferred to their sons while they were serving as full-time, unpaid missionaries for the Church. The Church requested payments, set their amounts, and, through written guidelines, instructed that they be used exclusively for missionary work. In accordance with the guidelines, their sons used the money primarily to pay for rent, food, transportation, and personal needs while on their missions.

The Supreme Court began its analysis by determining whether the payments at issued were "for the use of" the Church within the meaning of IRC 170. The Court looked at Congress's intent in 1921 in adding the phrase "for the use" to IRC 170. It found that representatives of charitable foundations requested the amendment making gifts to trust companies and similar donees deductible even though a trustee, rather than a charitable organization, held legal title to the funds. These organizations indicated that numerous communities had established charitable trusts, charitable foundations, or community chests so that individuals could donate money to a trustee who held, invested and reinvested the principal, and then turned the principal over to a committee that distributed the funds for charitable purposes. Responding to these concerns, Congress added the phrase "for the use of . . .any corporation, or community chest, fund, or foundation. . ." to the charitable deduction provision of the Revenue Act of 1921. The Court found that in choosing the phrase "for the use of" Congress was referring to donations made in trust or in a similar legal arrangement. The Court also gave considerable weight to the Service's interpretation of "for the use of." In several rulings the Service interpreted the phrase "for the use of" as "intended to convey a similar meaning as 'in trust for.'" An essential element of a trust, according to the Court, is that the beneficiary has the legal power to enforce the trustee's duty to comply with the terms of the trust. Since there was no evidence that the taxpayers created a trust or similar legally binding arrangement for the benefit of the Church, the Court concluded that the funds were not donated "for the use of" the Church for purposes of section 170.

The Court also rejected the Davis's alternative claim that their transfer of funds into their sons' account was a contribution "to" the Church under Reg. 1.170A-1(g), which allows the deduction of "unreimbursed expenditures made incident to the rendition of services to an organization contributions to which are deductible". The Court based its rejection on the ground that the taxpayers were not themselves performing donated services to a qualified organization. The Court noted that its interpretation is consistent with Rev. Rul. 55-4, 1955-1 C.B. 291, that was the precursor to section Reg. 1.170A-1(g). In Rev. Rul. 55-4, the Service held that a taxpayer who gave his services gratuitously to an organization, contributions to which were deductible under IRC 170, and who incurred unreimbursed travel expenses could deduct the amount of such unreimbursed expenses in computing his net income. For a more

detailed discussion of Davis, supra and a comparison analysis with Peace, supra, refer to the FY 1995 EO CPE article, Conduit Organizations - Charitable Deductibility and Exemption Issues, at 117, 139-142.

Although the outcome may vary depending on the facts and circumstances of each case, Davis, supra, and the other cases and revenue rulings provide clear guidance that under IRC 170, whether a contribution is made "to" the individual or "to or for the use of" the charitable organization depends on whether the organization has full control of funds and discretion as to their use; whether the contributor's intent in making the payment was to benefit the charitable organization itself and not the individual recipient; and whether the organization has a legally enforceable right to the funds.

4. TAM 94-05-003

More recently, the Service examined whether payments by a donor were contributions "to" a religious ministry for deductibility under IRC 170 in TAM 94-05-003 (Nov. 12, 1992). The ministry enables seminary students to receive support for the ministries in which they serve. Seminary students become self-employed contractors with the ministry. Their support comes from tax-deductible contributions by donors whom the seminary students contact. A donor usually gives a certain amount periodically for the ministry of a particular student minister. Contributions to the ministry are earmarked for the student by use of account numbers and envelopes with the student's name. The donations are directed to the organization, which maintains a separate account for each student.

The TAM found that the contributions were earmarked, indicating an intent to benefit an individual, rather than the ministry. Also, the TAM found that the ministry did not have control over the donated funds. Therefore, TAM 94-05-003 held that the taxpayers' payments were not contributions "to" the ministry and were not deductible under IRC 170. For a more detailed discussion of the facts and holding in TAM 94-005-003, see the FY 1995 EO CPE article, Conduit Organizations - Charitable Deductibility and Exemption Issues, at 117, 139-142.

5. Conclusion - Current State of the Art - Deputized Fundraising Language

Based on the above discussion, it appears that whether a gift is made "to" an organization for use in its charitable program rather than "to" an individual who is raising funds to support his activities will largely depend on the intent of the donor and the degree of control allowed to the donor to designate the charity.

To help clarify the record of the true intentions of a donor at the time of a contribution, the Service has suggested that the following language be used in a receipt for the contribution:

> "This contribution is made with the understanding that the donee organization has complete control and administration over the use of the donated funds."