Report on Tax Deductibility of Contributions to Disregarded Entities Owned by Charities

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Report No. 1254

Report on Tax Deductibility of Contributions to Disregarded Entities Owned by Charities

I. Introduction

This report[1] discusses the tax deductibility under Section 170 and related sections of the Internal Revenue Code[2] of contributions made to a disregarded entity ("DRE") subsidiary of a tax-exempt organization eligible to receive tax deductible contributions (hereinafter a "charity").[3] In Announcement 99-102[4], the Internal Revenue Service ("IRS" or "Service") announced that, in light of the entity classification regulations' treatment of DREs, if a tax-exempt organization owns a DRE, the DRE's operations are treated as a branch or division of its owner and its owner "must include, as its own, information pertaining to the finance and operations of a disregarded entity in its annual information return." In 2001, the IRS announced that it intended to publish guidance on "charitable contributions to disregarded entities."[5] To date, no such guidance has been issued.

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[1] The principal drafter of this report was Richard R. Upton, with substantial assistance and contributions from Carl Merino, Matthew Kohley, Marina Vishnepolskaya and Dahlia Doumar**.** Helpful comments were received from Kimberly Blanchard, Peter Connors, Michael Farber, Albert Feuer, Edward Hein, Elizabeth Kessenides, David Miller, Andrew Needham, Richard Reinhold, Michael Schler, Jodi Schwartz, Philip Wagman and Kirk Wallace. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or its House of Delegates.

[2] Except as otherwise noted, all "Section" references in this Report are to the Internal Revenue Code of 1986, as amended (the "Code"), references to "Regulations" or "Reg." are to the Treasury Regulations promulgated thereunder. References to a "PLR" are to a private letter ruling.

[3] Under Section 170(c)(2), a charity qualifies as an eligible donee only if it (1) is a "corporation, trust, or community chest, fund, or foundation" organized under U.S. law; (2) is organized and operated exclusively for any of several specified purposes (charitable, religious, scientific, literary, or educational purposes, fostering national or international amateur sports competition, or preventing cruelty to animals or children); and (3) otherwise meets the requirements of Section 501(c)(3) with respect to the limitations on inurement, lobbying, and political activity. In addition, subject to various limitations, Section 170(c) provides that tax-deductible contributions also may be made to (1) governmental bodies, (2) war veterans organizations, (3) domestic fraternal lodges, and (4) cemetery organizations.

[4] 1999-43 I.R.B. 545.

[5] Department of Treasury, *2001 Priorities for Tax Regulations and Other Administrative Guidance (April 26, 2001). See also* R.A. McCray and W.L. Thomas, *Limited Liability Companies as Exempt Organizations*, *Continuing Professional Education, Exempt Organizations – Technical Instruction Program for FY 2000 (1999),* at

Reg. § 301.7701-1(a)(1) provides that the entity classification regulations apply "for federal tax purposes." The Section 7701 entity classification regulations (also referred to as the "check-the-box regulations") provide that an eligible entity may either default to be, or elect to be, a DRE. Based on the plain language of these regulations, a contribution to a DRE owned by a charity is the same as a contribution to the charity.

As discussed below, the IRS has held in private letter rulings and other guidance that assets transferred to and held by a single member disregarded entity owned by a charity are treated as assets of the charity itself for purposes of Sections 170(b)(1), 501(c)(3) and 507-509 and Chapter 42 and for public reporting and disclosure purposes. However, to date, the IRS has not taken a public position on the question of whether a donor is entitled to claim a charitable contribution deduction under Section 170(a) if the donor makes a contribution to a DRE whose sole member is a charitable organization described in Section 170(c)(2) and recognized as exempt from tax under Section 501(c)(3).[6] There is no case law directly addressing the deductibility of charitable contributions to a disregarded entity owned by a charity.

This is an important question that affects numerous charities and their donors. In light of the IRS's statements from over a decade ago that it was going to issue guidance on this subject and the absence of such guidance, some taxpayers and their advisors may be reluctant to rely on the clear implications of the Section 7701 regulations.

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http://www.irs.gov/pub/irs-utl/topich00.pdf. (hereinafter, "McCray and Thomas"), stating that guidance on this issue "will be forthcoming in the near future."

[6] For example, the IRS declined to rule on the deductibility of charitable contributions to the DRE discussed in PLR 200150027.

The IRS has informally expressed concerns about the deductibility of gifts to DRE subsidiaries of charities. Is the gift "to or for the use of"[7] the charity when it is made to a DRE subsidiary that itself is not exempt? In the case of foreign DREs, is the gift "to or for the use of" a domestic charity?

This report first summarizes our conclusions and recommendations in this area. The report then discusses the entity classification regulations and their applicability to DREs owned by charities. This report next provides an overview of the general requirements for deductibility of gifts to or for the use of charities and then discusses some of the policy issues implicated in considering whether the IRS should limit or change the current law treatment of contributions to DREs owned by charities. Finally, the report discusses possible guidance the IRS could issue addressing the deductibility of donations to DREs owned by charities.

II. Summary Conclusions and Recommendations

A. Gifts to DREs Should be Deductible

The check-the-box regulations became final in 1997. The regulations are clear: a 100% owned eligible entity that is not classified (by election or default) as a corporation is "disregarded as an entity separate from its owner." The IRS confirmed this treatment applies to DREs owned by charities in Announcement 99-102. Taxpayers are entitled to rely on final regulations. Accordingly, in our view, under current law, a contribution to a DRE owned and controlled by a charity is treated as a gift to the charity and is deductible under Section 170(a) to the same extent and subject to the same conditions and limitations as a gift to a branch of the

[7] As discussed below, Section 170(c) generally defines a charitable contribution to mean a gift "to or for the use of" a domestic charity.

parent charity. We think the same conclusion applies in determining whether a deduction is allowed for estate and gift tax purposes for gifts to DREs owned and controlled by charities.

Arriving at these conclusions involves a two-step analysis. Is there anything about the way the DRE is organized or operated that is inconsistent with the parent's tax-exempt status (*e.g.*, on liquidation, the DRE's assets go to a named individual)? If no, would the gift have been deductible if made to a branch of the charity (rather than to a DRE), assuming the gift is subject to the same express or implied restrictions imposed on the gift to the DRE? If the DRE is organized and operated consistently with the parent's tax-exempt status and a gift to a DRE would have been deductible if it had been made to a branch of the charity, our view is that such a gift should be deductible when made to a charity's DRE. We do not think the DRE should have to independently be able to qualify as a charity for gifts to the DRE to be deductible. For example, a gift to a DRE that has solely investment purposes should be deductible even though investment purposes standing alone are not charitable.

The IRS should issue a ruling or other guidance confirming these conclusions. Such a ruling or guidance could give several fact patterns. Deductibility should be premised on the DRE being controlled by the charity (to eliminate some potential abuse, which we have not seen, where the entity's governing law or documentation allows control to be divested from ownership and the charity does not control the entity). Deductibility also should be premised on the DRE's governing documents not providing that the DRE be operated for purposes that are contrary to the tax-exempt purposes of the charity owner. Finally, deductibility could require the acknowledgment required under Section 170(f)(8) to give the parent charity's name and address and to contain a statement confirming the DRE status of the recipient of the gift.

Such guidance should provide at least one example involving a foreign DRE owned by a domestic charity. Here, the IRS should confirm that under current law, the check-the-box regulations do apply and a contribution to such a foreign entity is deductible to the same extent as a contribution to a charity's domestic DRE.

B. The IRS Should not Limit the Deductibility of Gifts to DREs

As discussed in this report, but for the check-the-box regulations' treatment of DREs, contributions to a charity's subsidiary generally would not be deductible unless the subsidiary itself is qualified as a charity or the subsidiary is the agent of the parent charity. Only contributions "to or for the use of" a domestic charity are deductible under Section 170(a). Treatment of eligible entities as disregarded is purely a regulatory concept and is not expressly required by the Code or case law. We acknowledge that, as for employment taxes and several other specific purposes, the IRS has the power to change the check-the-box regulations prospectively to provide that, for purposes of deductibility under Section 170(a), otherwise disregarded entities are regarded.[8]

Deductibility of charitable contributions is a question of federal tax law and is not dependent on state law rights or principles that must be interpreted to apply federal tax law (in contrast to estate and gift tax valuation principles). We have found no compelling reason why the IRS must or should regard otherwise disregarded entities for purposes of Section 170.

Well over a decade of experience with the check-the-box regulations as applied to DREs owned by charities has not brought to light any real abuses or problems of tax

[8] We believe it would be bad policy for the IRS to attempt to retroactively narrow or disavow the application of the check-the-box regulations to DREs owned by charities. Presumably, any attempt by the IRS to retroactively change the check-the-box regulations for Section 170 purposes would be based on the premise that the regulations are "manifestly incompatible" with the Section 170 language limiting charitable deductions to contributions "to or for the use of" a "domestic" charity. Any such attempt at a retroactive change in the regulations likely would be challenged and, in our view, not upheld in court.

administration. The IRS can and does receive information about such DREs on Form 990. If the IRS desires or needs more information, it can revise Form 990 to require such information. In this regard, the IRS should consider revising Form 990 PF to request additional information from private foundations on DREs. Further, the IRS has the power to revoke the exempt status of any charity that is not operated exclusively for charitable purposes. If a DRE (which is treated as part of the charity) engages in activities that are incompatible with being tax exempt, the IRS can revoke the parent's exempt status.

In sum, we recommend that the IRS treat otherwise disregarded entities as disregarded for purposes of Section 170 and related estate and gift tax provisions of the Code and treat contributions to a DRE owned and controlled by a charity as contributions to the parent charity.

III. Background

A. Overview of Deductibility of Charitable Donations

1. Income Tax

Section 170(a)(1) provides generally for the allowance of a deduction for any charitable contribution made within the taxable year.[9] Section 170(c) defines a charitable contribution to mean a contribution or gift "to or for the use of" a charity.[10]

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[9] *See generally,* Joint Comm. On Taxation, *Present Law and Background Relating to the Federal Tax Treatment of Charitable Contributions*, JCX-55-11 (October 14, 2011). Deductions are subject to the generally applicable limitations on the deductibility of charitable contributions (*e.g.*, percentage limitations applicable to charitable gifts under Section 170, limitations on itemized deductions, and any applicable requirements for obtaining a contemporaneous written acknowledgement of the gift from the DRE or the charity pursuant to Section 170(f)(8)).

[10] Reg. § 1.170A-8(a)(2) defines the terms "to" or "for the use of" with respect to certain transfers of income interests and trust remainder interests. The Act of 1913 excluded from income tax "any corporation or association organized and operated exclusively for religious, charitable, scientific, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual." Act of 1913, Pub. L. No. 63-16. Under the War Revenue Act of 1917, Congress for the first time allowed a deduction in computing net income for

The Code and regulations do not address how Section 170 and the check-the-box regulations interface. Although, as discussed below, the IRS has issued guidance on certain tax aspects of the relationship between charities and their disregarded subsidiaries, most such guidance is nonprecedential and none of the guidance addresses the specific question of the deductibility under Section 170 of contributions to a charity's DRE. It is interesting to note that the Section 170 regulations have long provided that certain funds associated with a community trust (whether such a fund is a trust, not-for-profit corporation or unincorporated association) are treated as component parts of the parent entity (that is, disregarded) for purposes of Section 170 and other related Sections of the Code.[11]

2. Estate and Gift Taxes

For purposes of the estate tax imposed by Section 2001, the value of the taxable estate is determined, in part, by deducting from the value of the gross estate the amount of all bequests, legacies and transfers to or for the use of any charity.[12] For purposes of the estate tax imposed by Section 2101 on nonresidents who are not citizens, the value of the taxable estate of nonresidents who are not citizens is determined, in part, by deducting from the value of that part of his or her gross estate, which at the time of his or her death is situated in the United States, the amount of all bequests, legacies and transfers made to or for the use of a domestic charity.[13]

"contributions or gifts actually made within the year to corporations or associations organized and operated exclusively for religious, charitable, scientific, or educational purposes . . . no part of the net income of which inures to the benefit of any private stockholder or individual." War Revenue Act of 1917, Pub. L. No. 65-50. The Revenue Act of 1935 made the charitable deduction available to corporations. Revenue Act of 1935, Pub. L. No. 74-407.

[11] Reg. §1.170A-9(f)(11).

[12] Specifically, any corporation described in Section 2055(a)(2) or trust described in Section 2055(a)(3). In this regard, there is no requirement for this purpose that the charity be domestic.

[13] Specifically, any domestic corporation described in Section 2106(a)(2)(A)(ii) or trust described in Section 2106(a)(2)(A)(iii).

Section 2501 imposes a gift tax on the transfer of property by gift by any individual. Deductions for gift tax purposes are allowed for gifts to or for the use of any charity made by a citizen or resident of the United States.[14] In the case of a nonresident not a citizen of the United States, a deduction is allowed for gifts made to or for the use of a domestic charity.[15]

As noted, we believe that the same conclusions concerning deductibility of gifts to DREs owned by charities for income tax purposes under Section 170(a) generally should apply to deductibility for estate and gift tax purposes. Although this report focuses on income tax deductibility under Section 170(a), except as expressly noted, the same analysis and conclusions apply to estate and gift tax deductibility.

B. Overview of the Check-the-Box Regulations

Section 7701, the underpinning of the check-the-box regulations, defines entities for purposes of the Code "where not otherwise distinctly expressed or manifestly incompatible with the intent thereof." Reg. § 301.7701-1(b) provides that Reg. §§ 301.7701-2, - 3 and - 4 determine the classification of organizations, unless a provision of the Code specifically provides for special treatment. Reg. § 301.7701-4 provides for the classification of organizations as trusts. That section provides that trusts generally do not have associates or an objective to carry on business for profit. Reg. § 301.7701-1(b) provides that Reg. §§ 301.7701-2 ("Business entities; definitions") and -3 ("Classification of certain business entities") provide rules for classifying organizations that are not classified as trusts. Reg. § 301.7701-2 divides the world of business entities into corporations, partnerships and disregarded entities.

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[14] Specifically, any corporation described in Section 2522(a)(2) or a trust described in Section 2522(b)(3). As with the estate tax deduction, the recipient charity need not be domestic.

[15] Specifically, any domestic corporation described in Section 2522(b)(2) or trust described in Section 2522(b)(3).

The check-the-box regulations, which became effective on January 1, 1997, allow certain organizations (so-called "eligible entities") to choose treatment as a corporation or, depending upon whether the entity has one or more owners, as a partnership or disregarded entity for federal tax purposes. Reg. § 301.7701-1(a)(1) provides:

> The Internal Revenue Code prescribes the classification of various organizations for federal tax purposes. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.

Reg. § 301.7701-3(a) provides:

> Classification of certain business entities. (a) In general. A business entity that is not classified as a corporation under [Reg. § 301.7701-2] (an *eligible entity)* can elect its classification for federal tax purposes as provided in this section. An eligible entity . . . with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner. . . .

C. Application of the Entity Classification Regulations to Charities and their Subsidiaries

1. Trusts vs. Business Entities

The entity classification regulations are not a perfect fit for charities. Under state law, domestic charities generally are created either as trusts or as nonprofit corporations.[16] A similar pattern is followed by foreign charities.

The entity classification regulations retain the distinction between trusts and other organizations (business entities). A business entity is not a trust and vice versa. A business entity that is not a *per se* corporation is an eligible entity subject to the "check the box" entity classification rules.

[16] *See generally*, Hill & Mancino, *Taxation of Exempt Organizations*, WG&L (2009) at ¶ 2.05.

The application of the entity classification rules to charitable organizations is somewhat strained and not the subject of this report. Arguments could be made that a charity should never be classified as a business entity and accordingly, all charities should be classified as trusts and never as corporations. However, the Code and entity classification regulations clearly contemplate that some charities will be formed and classified as business entities.[17] In this regard, Reg. § 301.7701-3(c)(v) (discussed below) provides that an eligible entity that has been determined to be, or claims to be, exempt from taxation under Section 501(a) is treated as having made an election to be classified as an association (treated as a corporation).

For purposes of this report, it is not relevant whether the parent charity is a trust or corporation (including an eligible entity treated as an association). At issue is the treatment of the parent charity's disregarded entity subsidiary.[18]

2. <u>DREs</u>

As noted, Reg. § 301.7701-2 provides generally that the world of business entities is divided into corporations, partnerships and DREs. Reg. § 301.7701-2(b) provides that certain entities are *per se* corporations,[19] and are not eligible to choose their status.

Other unincorporated business entities are "eligible entities." For example, a limited liability company (an "LLC") is an eligible entity. An eligible entity with a single owner

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[17] The Code clearly provides that charities may be classified either as trusts or corporations. *See* for example Section 512(b)(10) (providing for a 10% charitable contribution deduction in calculating net unrelated business taxable income ("UBTI") subject to unrelated business income tax ("UBIT") in the case of charities classified as corporations) and Section 512(b)(11) (providing for a 50% charitable calculation deduction against UBTI for charitable trusts).

[18] We are not aware of situations involving the deductibility of gifts to a trust that has been established as a non-exempt subsidiary of a charity.

[19] *Per se* corporations include entities described as corporations under federal or state law, joint-stock companies, insurance companies, certain banks, government-owned business entities that are not integral parts of the state, organizations treated as corporations under special Code provisions and certain business entities formed in certain foreign countries and U.S. possessions. The check-the-box regulations list foreign entities that are *per se* corporations not eligible to choose their status.

may elect to be treated as an association or to be disregarded as an entity separate from its owner (a DRE).[20] Reg. § 301.7701-3(a). A business entity which is owned solely by a charity and is not classified as a *per se* corporation under the Regulations would default to (or be eligible to elect to) be disregarded as an entity separate from the charity, absent a special exception.

For purposes of this report, we understand and assume (except as expressly stated otherwise) that any DRE owned by a charity also is controlled by the charity. As discussed elsewhere in this report, other issues would be raised if the charity that purportedly owned the eligible entity did not control the entity, including by having unfettered rights to appoint and dismiss its management.

3. The Deemed Election Regulation

a. In General

Although the entity classification regulations generally apply "for federal tax purposes," the regulations carve out certain exceptions to DRE treatment of eligible entities. Of particular relevance to eligible entities owned by charities is Reg. § 301.7701-3(c)(1)(v)(A) (the "Deemed Election Regulation") which provides: "[a]n eligible entity that has been determined to be, or claims to be, exempt from taxation under Section 501(a) is treated as having made an election under this section to be classified as an association." As discussed below, the IRS has provided guidance that, under the Deemed Election Regulation, an eligible entity 100% owned by a charity generally defaults into (or may elect) DRE status unless the entity expressly applies to the IRS for tax-exempt status.

The Preamble to the proposed 1996 check-the-box regulations explains:

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[20] Default rules apply if an election is not made. In general, by default, a domestic eligible entity with two or more members is a partnership, and a domestic eligible entity with a single owner is disregarded as a separate entity. Reg. § 301.7701-3(b)(1). A foreign eligible entity with limited liability for all of its members defaults to corporate status.

> *Special rule for exempt organizations.* A special rule is provided for eligible entities that have been determined to be, or claim to be, exempt from taxation under section 501(a). A substantial majority of exempt organizations (including those employee plans that qualify under section 401(a)) will not be eligible entities, either because they are properly classified as trusts for federal tax purposes or because they are not-for-profit corporations. However, for those exempt organizations that are eligible entities, the business entity classification that is consistent with the claim for exemption is association (taxable as a corporation). Accordingly, the proposed regulations provide that a claim or determination of exempt status by an eligible entity is treated as an election to be classified as an association. Such elections will take effect on the first day for which exemption is claimed or determined to apply, regardless of when the claim or determination is made, and will remain in effect unless an election is made to change that classification after the date that either the claim is withdrawn or rejected or the determination is revoked.[21]

In general, Section 508 provides that an organization will not be treated as exempt under Section 501(c)(3) unless it applies for exempt status. This could be read to suggest that an eligible entity subsidiary of a charity could not be viewed as exempt without applying for exempt status and, accordingly, being treated as an association, not a DRE. However, when an entity's sole member is tax-exempt and such entity does not apply for or claim exemption separate from its sole member, the IRS has acknowledged that the Deemed Election Regulation does not apply[22] In IRS Announcement 99-102, as well as a series of private letter rulings and through various other publications, the IRS has acknowledged that a single-member entity, whose sole member is tax-exempt, is not subject to the Deemed Election Regulation and can default or elect

[21] 61 Fed. Reg. 21989 (May 13, 1996).

[22] *See, e.g.*, PLR 200150027. *See also* PLRs 200134025, 200124022, 200249014, 200304036, 200538027, 200551023 and 200637041. The IRS has not fully resolved the conflict between the general election rule and the Deemed Election Regulation: *see* McCray and Thomas, *supra*, footnote 5.

to be a disregarded entity under the general entity classification rules so long as the entity does not separately apply for tax-exempt status.[23]

IRS Announcement 99-102, discussing the check-the-box regulations, establishes that an entity wholly owned by a single organization exempt under Section 501(a) may be disregarded as an entity separate from its owner.[24] It follows that when an entity is disregarded as separate from its owner, its operations are treated as a branch or division of its owner. Therefore, an owner that is exempt under Section 501(a) must include, as its own, information pertaining to the finances and operations of a disregarded entity in its annual information return. IRS Form 990, Return of Organization Exempt From Income Tax, requires the assets and activities of DRE subsidiaries to be reflected as assets and activities of the parent charity. Form 990 Schedule R solicits information specifically relating to disregarded entities.

The IRS has confirmed that Announcement 99-102 provides that a single-member entity of which a tax-exempt entity is the sole member is recognized as tax-exempt as part of its owner, and recognizing the single-member entity as exempt does not trigger the Deemed Election Regulation.[25] If an eligible entity subsidiary of a charity chooses to make its own

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[23] IRS Instructions to Form 8832 "Entity Classification Election" refer to the Deemed Election Regulation in providing that Form 8832 cannot be filed by an eligible entity "that is tax-exempt under Section 501(a)." An entity "shall be exempt from taxation" only if it is "described" in Section 501(c) or (d) or Section 401(a). *See* Section 501(a). An entity is "not treated as an organization described in Section 501(c)(3) unless it has given notice" to the IRS (i.e., filed a Form 1023) in accordance with Section 508. It follows that an entity cannot be tax-exempt under Section 501(a) for purposes of the Deemed Election Regulation unless it has filed a Form 1023 for recognition of exemption in a manner prescribed by Section 508.

[24] The Announcement states: "[o]n January 13, 1997, final regulations under section 7701 of the Internal Revenue Code pertaining to the classification of certain business organizations under an elective regime were published in the Federal Register. *See* 26 C.F.R. 301.7701-1 *et seq.* These regulations provide that an entity wholly owned by a single owner may be disregarded as an entity separate from the owner. When an entity is disregarded as separate from its owner its operations are treated as a branch or division of the owner. Therefore, an owner that is exempt from taxation under section 501(a) of the Internal Revenue Code must include, as its own, information pertaining to the finances and operations of a disregarded entity in its annual information return." 1999-43 I.R.B. 545.

[25] *See* the IRS letter of October 27, 1999 from Marvin Friedlander (Chief, Exempt Organizations) to Catherine E. Livingston, a private practitioner at the time, in which the IRS clarified that an entity wholly owned by an exempt

application for tax-exempt status, however, the IRS concludes that such a single-member entity would be electing to be recognized as an association for tax purposes under the Deemed Election Regulation.[26]

The IRS publication "Instructions for Limited Liability Company: Reference Guide Sheet" provides further support that a disregarded entity may be encompassed within the owner's exempt status without triggering the Deemed Election Regulation: "The disregarded entity receives the benefit of its owner's tax-exempt status, including exemption from federal income tax, federal unemployment tax, and other federal taxes where applicable."[27]

The IRS has indicated that the governing documents of a disregarded entity are not required to independently satisfy the organizational test: "because the entity is treated as an activity of the owner, it is the owner's articles that matter."[28] However, "nothing in the disregarded entity's articles should prohibit the entity from operating exclusively for exempt purposes."[29] In addition, the disregarded entity should not carry out activities that would adversely affect the 501(c)(3) status of its owner.[30]

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organization may be disregarded and does not have to file a separate exemption application. Tax Analysts Electronic Citation: 1999 TNT 212-16.

[26] *Id*. *See also* McCray and Thomas, *supra* footnote 5. These training materials produced by the IRS conclude that the governing documents of a disregarded entity need not independently satisfy the operational and organizational tests required for tax-exempt treatment under 501(c)(3) because the entity is treated as an activity of its owner, further evidence that the Deemed Election Regulation is not an issue.

[27] *See* http://www.ins.gov/pub/irs-tege/llc_guide_sheet_instructions.pdf. Furthermore, a series of private letter rulings confirms that a single-member LLC can be a disregarded entity that is part of a tax-exempt owner but not subject to the deemed election under the Deemed Election Regulation. *See*, *e.g*., PLRs 200150027, 200134025, 200124022, 200249014, 200304036, 200538027, 200551023 and 200637041. For example, in PLR 200150027, the IRS ruled that: (1) the single-member LLC at issue will be disregarded as separate from its tax-exempt owner for purposes of Sections 170(b)(1)(A)(v), 501(c)(3), and 507-509, (2) the LLC is not required to submit an application for recognition under Section 508, and (3) the LLC will be encompassed within the owner's income tax status, and therefore will be "part of a public charity described in Sections 509(a)(1) and 170(b)(1)(A)(vi)."

[28] *See* McCray and Thomas, *supra*, footnote 5. *See also* PLR 200150027.

[29] McCray and Thomas, *id*.

[30] *See* Information Letter 2010-0052 (March 15, 2010).

Based upon the foregoing, an eligible entity owned by a charity should be treated for federal tax purposes as disregarded as an entity separate from its sole member under Regs. § 301.7701-2 and 3 unless the eligible entity makes a separate application for recognition of exemption under Section 508.[31]

4. Other Exceptions to the Check-the-Box Regulations

Over the years since the check-the-box regulations became effective, the IRS has selectively made several changes to disregarded status for one or another "federal tax purposes." On August 16, 2007, amendments to the check-the-box regulations were finalized pursuant to which, for employment tax purposes, DREs with employees are treated separately from their owners. Regs. § 301.7701-2(c)(2)(iv) and (v). These rules were applied prospectively beginning on and after January 1, 2009.[32] On January 1, 2008, Reg. § 301.7701-2(c)(2)(v) became effective (prospectively) requiring an entity that otherwise is a DRE to be regarded for certain excise tax purposes. In effect, beginning on those dates, every DRE is taxed as a corporation for purposes of employment taxes and various federal excise taxes.[33]

The IRS has treated DREs as separate entities in other limited areas. For example, Reg. § 1.752-2(k) provides,[34] in determining whether an owner of a DRE partner has basis from the recourse debts of a partnership, that for liability allocation purposes, the DRE

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[31] Treatment as a DRE would occur by default with a domestic eligible entity (unless it elected to be treated as a corporation) or by election with most foreign eligible entities (if the entity has limited liability to its owner).

[32] In further tinkering with the check-the-box regulations, on October 31, 2011, the IRS promulgated proposed, final and temporary regulations that make an exception to the employment tax exception to the check-the-box regulations. The new rules treat an otherwise disregarded entity as disregarded in applying employment tax exceptions for relatives and members of religious faiths. REG-136565-09, T.D. 9554.

[33] For dates prior to the effective date of these amendments, courts agreed with the IRS that entities that otherwise were DREs were disregarded for employment tax purposes. *See* discussion at IV.F.2 below.

[34] This regulatory carve out from the check-the-box regulation applied prospectively to partnership liabilities incurred or assumed on or after the regulations' October 11, 2006 effective date.

partner is regarded and its owner only gets basis to the extent of the value of the DRE partner in excess of the value of the DRE's partnership interest.[35]

In *Pierre v. Comm.*, 133 T.C. 24 (2009), discussed at length below, the Tax Court respected the state law status of a single member LLC as a separate entity for gift tax valuation purposes.

No stated exceptions to disregarded entity treatment apply to DREs owned by charities. Accordingly, under current law, an eligible entity owned by a charity, when the entity has not sought tax exemption and has not elected to be a corporation, is disregarded for "federal tax purposes." Thus, a contribution to such a DRE presumptively is treated as a contribution to the charity that owns the DRE and the deductibility of such a contribution is governed by the same rules that govern a contribution directly to the charity.

5. <u>A Recent Example of Nonprecedential IRS Guidance</u>

During the years since Announcement 99-102, the IRS has issued numerous rulings concerning charities with DRE subsidiaries.[36] Although none of the rulings or IRS guidance directly rule or otherwise give a conclusion on the issue of deductibility of

[35] Another carve out from the check-the-box rule applies to the purported gift rules (which treat gifts to a U.S. person from a foreign partnership or corporation as income to the donee). These rules cannot be avoided by electing pass-through treatment for a single member entity. A single member entity that elects to be taxed as a sole proprietorship under the check-the-box regulations will be treated as a corporation for purposes of Reg. § 1.672(f)-4. Reg. § 1.672(f)-5(b).

[36] PLR 200150027 (Aug. 7, 2001); PLR 200134025 (May 22, 2001) (single-member LLC is not required to file Form 1023); PLR 200216036 (Jan. 24, 2002) (reorganization involving a single-member LLC does not impact tax-exempt status); PLR 200124022 (Mar. 13, 2001) (separate legal existence of single-member LLC disregarded for "federal income tax purposes"; activities do not affect exemption of parent); PLR 200551023 (Sept. 28, 2005) (multiple single-member LLCs formed by parent charity are disregarded for federal income tax purposes, and their activities are treated as activities of the parent charity; formation does not change the nature of activities of the charity or their purposes with respect to Section 501(c)(3)); PLR 200723030 (Mar. 14, 2007) (merger of wholly owned for-profit corporation into a single-member LLC does not affect Section 501(c)(3) status of parent charity).

contributions to a charity's DRE, none contain qualifications[37] backing off from full disregard of the eligible entity.[38]

A recent example of IRS guidance that has come close to concluding that a contribution to a charity's DRE is a good Section 170(a) deduction is Information Letter 2010-0052 (the "Information Letter").[39] At issue was whether a grant by a private foundation to a DRE LLC owned by a charity would be treated as a grant to the public charity. A grant to a public charity by a private foundation is a qualifying distribution under Section 4942(g) and not a taxable expenditure under Section 4945(d). The Information Letter concludes that a grant:

> to a limited liability company that is treated as a disregarded entity for federal tax purposes to accomplish one or more exempt purposes described in section 170(c)(2)(B), where the sole member of the disregarded limited liability company is a public charity (which is described in section 509(a)(1) and is not controlled by the distributing private foundation), generally will be treated as a qualifying distribution to the public charity for purposes of section 4942.

The Information Letter then notes that under Section 4945(d), a "taxable expenditure" includes a grant to any organization, except certain pubic charities, unless the foundation making the grant exercises "expenditure responsibility." On this issue, the Information Letter concludes that a grant to the charity's DRE does not require the exercise of expenditure responsibility.

In arriving at these conclusions, the Information Letter reviews the entity classification regulations as applied to an LLC owned by an exempt organization, stating:

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[37] However, some of the PLRs and other guidance indicate, among other things, the DRE's purposes should not preclude charitability.

[38] Other than in situations involving employment taxes, etc., where the check-the-box regulations expressly regard an otherwise disregarded entity. *See* Information Letter 2010-0052 (March 15, 2010).

[39] As noted in the Information Letter, an information letter is defined in Rev. Proc. 2010-4 to mean a statement issued by the Director, Exempt Organizations Rulings that "calls attention to a well-established interpretation or principle of tax law."

> If the sole owner of a disregarded limited liability company is a tax-exempt organization described in section 501(a) of the Code, then the limited liability company is treated as a component part of the exempt organization. In such a situation, the exempt owner of the disregarded limited liability company generally must treat the operations of the limited liability company as a branch or division of the owner and include, as the owner's own, information pertaining to the finances and operations of the limited liability company in filing an annual information return as required under section 6033 of the Code.
>
> . . . The disregarded entity generally receives the benefit of its owner's tax-exempt status, including exemption from federal income tax, federal unemployment tax, and other federal taxes where applicable.
>
> . . . .
>
> A tax-exempt organization that is the sole owner of a disregarded limited liability company will not jeopardize its exempt status merely because the organizational documents of the limited liability company do not contain specific language limiting the limited liability company's purposes to one or more exempt purposes. However, the exempt status of the owner may be adversely affected if the disregarded limited liability company's organizational documents provide that the limited liability company will be operated for purposes that are contrary to the tax-exempt purposes of the owner.

In effect, the Information Letter treats a grant from a private foundation to a public charity's DRE as a grant to the charity.[40] In our view, for purposes of deductibility under Section 170 and related estate and gift tax provisions of the Code, there is no real distinction between a grant by a private foundation to a charity and a contribution by a taxpayer to a charity.

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[40] The Information Letter qualifies its conclusion in two ways. First, as required by Sections 4942 and 4945, it requires that the purpose of the grant must be "to accomplish one or more exempt purposes." Second, the conclusions are qualified by the word "generally." This second qualifier seems inherent in an information letter which does not address a specific set of facts.

IV. Policy Concerns and Issues

A. Why Charities Use DREs

Charities use 100%-owned eligible entities for many appropriate reasons, including limiting liability for a specific charitable project, limiting liability for specified assets or activities, having a local company in a foreign jurisdiction in order to establish local bank accounts, and other legitimate purposes. For example, a charity may prefer that real estate or other assets be donated directly to a single-member LLC in order to avoid the presence of the parent tax-exempt entity in the chain of title and to shield the charity from potential liability.[41] Some charities create DRE subsidiaries to accommodate the tax planning needs of donors, particularly where U.S. taxpayers live and work abroad. For example, a domestic charity may have a DRE in a foreign country to allow U.S. taxpayers who live abroad to be able to treat donations as deductible both for U.S. and for local tax purposes.

B. Overview of Policy Issues and Concerns

In general, to be deductible, a contribution must be "to or for the use of" a domestic charity. The regulations, case law and the position taken by the IRS in various private letter rulings support the conclusion that donors can deduct the donations they make to the

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[41] *See* Catherine E. Livingston, *The Tax Consequences of Accepting Charitable Contributions Through a Single Member LLC*, 13 Tax'n of Exempts 107, 107 (2001) ("Livingston"). Moreover, an "LLC can serve as an alternative to the title-holding company [organized under I.R.C. sections 501(c)(2) or (c)(25)]. For example, it may be more efficient for a tax-exempt organization to acquire the property using a single-member LLC that is treated as a disregarded entity. One advantage is that no separate filing is required for the LLC. Among the other advantages of the LLC option, the LLC may be able to hold certain interests not permitted under Sections 501(c)(2) or 501(c)(25), and may provide for greater flexibility with respect to distributions of income from the property." Robert W. Fritz, *The Evolving Use of Limited Liability Companies by Tax-Exempt Organizations*, 13 Tax'n of Exempts 112, 115 (2001). *See also* Khrista M. McCarden, *The Deductibility of Contributions to Single Member LLCs Owned By Tax-Exempt Organizations*, 49 Exempt Org'n Tax Rev. 233, 234 (2005), a paper presented to IRS officials by a delegation from the California State Bar and Los Angeles County Bar Association Tax Sections during their annual visit to Washington, D.C., May 14-15, 2005 ("McCarden").

DRE.[42] If a donor makes a gift to a branch or division of a charity, the donor would be treated as making a gift to the charity itself and would be allowed a deduction under Section 170 because a branch or division is not viewed as a separate entity for federal tax purposes.

In the area of employment taxes and certain excise taxes, the IRS exercised its regulatory authority to cause eligible entities that otherwise are DREs to be regarded for such purposes.[43] We assume (as discussed in greater detail below) that the IRS has the power to amend the entity classification regulations to provide that an eligible entity that otherwise is a DRE as regarded for purposes of Section 170.

The IRS's concerns in this area focus on whether a gift to a DRE subsidiary is a gift "to or for the use of" the parent charity and, in the foreign context, whether a gift to a foreign DRE is a gift to a domestic charity. That is, the IRS is concerned over whether DRE treatment for Section 170 is "manifestly incompatible" with the Code. Even if allowing deductions for donations to a charity's DRE is not manifestly incompatible with the Code, are there policy reasons or considerations in administering the tax law that point to the conclusion that allowing Section 170 deductibility for contributions to DREs owned by charities is incompatible with, or contrary to, good tax policy. Control seems critical; does the parent charity have sufficient control over its DRE subsidiary to ensure use of the contribution consistent with the parent's charitable purposes? Would allowing deductions for contributions to DREs lead to abuses or weaken the ability of the IRS to enforce charitability requirements? In particular, will allowing

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[42] This position is supported by other practitioners. *See*, e.g., Livingston and McCarden, *supra*, note 41, and the IRS letter of October 27, 1999 from Marvin Friedlander (Chief, Exempt Organizations) to Ms. Livingston on the same issue, *supra*, note 25.

[43] *See* 32, *supra*.

Section 170 deductions for contributions to a foreign DRE owned by a U.S. charity lead to situations where the IRS is unable to obtain needed information concerning the DRE?

In this regard, the tax transparency afforded disregarded entities ensures DRE subsidiaries could not be used to avoid, for example, UBTI subject to UBIT, the feeder organization rules of Section 502[44] or other issues that would be disclosed on Form 990. The DRE is treated as part of the charity for federal tax purposes, including the Form 990 information return, requiring disclosure of transactions and activities that possibly could be masked by a partnership or corporate subsidiary.

It is noted that allowing a Section 170 deduction for gifts to DREs inherently involves a policy decision to treat DREs owned by charities the same as branches of the charity, in line with the check-the-box regulations. There clearly are local law differences between branches and entities. This is particularly true with foreign DREs. Allowing tax deductible gifts to a foreign DRE but not to a foreign regarded subsidiary could be viewed as an arbitrary policy decision.[45]

C. Are Contributions to a DRE "to or for the use of" the Charity?

1. In General

As discussed above, under the current check-the-box regulations, a DRE owned by a charity is disregarded "for federal tax purposes" and, accordingly, a donation to such a DRE

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[44] Section 502 generally provides that an organization operated for the primary purpose of carrying on a trade or business for profit is not exempt on the grounds that all of its profits are payable to one or more exempt organizations.

[45] In addition, in some circumstances, allowing a Section 170 deduction for gifts to a foreign DRE could be viewed as implicating U.S. treaty policy. Certain U.S. treaties, such as the treaty with Canada, allow a deduction for gifts to treaty country charities limited to a portion of the donor's income sourced in the treaty country.

should be treated as a contribution to the parent charity. This conclusion should apply unless it is "manifestly incompatible" with the Code.[46]

On the one hand, a DRE clearly is a separate entity under state law. Thus, a contribution to a charity's DRE is just that, a contribution to the DRE, not a contribution to the charity. There is no question that a contribution to the subsidiary of a charity is not deductible if the subsidiary is not a DRE, tax-exempt itself or the charity's agent.[47]

On the other hand, a DRE is disregarded "for tax purposes." Is there a reason why a charity's DRE should not be treated as a branch? Should the IRS carve out from the entity classification regulations DREs owned by charities for Section 170 purposes in a manner similar to the way the IRS affirmatively decided to carve out employment taxes, certain excise taxes, etc.?

The critical policy questions are whether a gift to a charity's DRE should be treated as a gift "to or for the use of" the charity and whether the charity has sufficient control over the DRE and the donation.

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[46] It is unclear whether a single-member LLC would have been deemed an association prior to the promulgation of the current entity classification regulations in 1996. Single-member LLCs became widely used only recently. See Jimmy G. McLaughlin, *The Limited Liability Company*: *A Prime Choice for Professionals*, 45 Ala. L. Rev. 231, 253–254 (1993). As of 1993, only Arkansas and Texas permitted a single-member LLC. *See id*. at 253. In the same year, the Service announced that guidance was forthcoming on LLC classification and opened a project to address the one-owner LLC issue. Catherine Hubbard & Lee A. Sheppard, *Guidance Forthcoming on LLC Classification, Practitioners Told*, 55 Tax Notes Today 824, 825 (1993). The IRS did not issue guidance on the classification of a single-owner LLC prior to the promulgation of the current Section 7701 regulations. See Francis J. Wirth & Kenneth L. Harris, *Tax Classification of the One-Member Limited Liability Company*, 93 TNT 140-53 (June 28, 1993). Some practitioners argued that a single-member LLC lacked characteristics for partnership status, but also did not qualify as an association. *See id*. Rather, it would be appropriate to treat the LLC as a sole proprietorship and a pass-through entity under the Code. The IRS agreed, and in 1996, issued final regulations stating that a single-member LLC was a disregarded entity by default, but could elect to be treated as a corporation. See 61 Fed. Regs. 21,989, 21,991 (May 13, 1996).

[47] A gift to a charity's exempt subsidiary (such as a Section 501(c)(2) title holding corporation) would not be deductible if the exempt subsidiary is not an eligible donee listed in Section 170(c). Similarly, a gift to a charity's for-profit subsidiary corporation generally would not be deductible.

2. **Contributions "for the use of" Charity**

In some senses, contributions to a subsidiary of a charity could be viewed as a gift "for the use of" the charity because of the control the charity has over its subsidiary. However, the words "for the use of" have been interpreted, administratively and judicially, as being synonymous with "in trust for" a qualified organization.[48] In *Davis v. U.S.*, 495 U.S. 472 (1990) the Supreme Court was called on to interpret the phrase "for the use of." In *Davis*, parents of Mormon missionaries put money into their sons' bank accounts to pay their expenses as full time missionaries. The Mormon Church required the payments, set the amount and instructed that the funds only be used for missionary work. The parents deducted the funds transferred, claiming the funds were "for the use of" the Church.[49] They argued that "for the use of" should be given a broad reading, describing "the entire array of fiduciary relationships in which one person conveys money or property to someone else to hold or employ in some manner for the benefit of a third person."[50] Under this reading, no legally enforceable relationship need exist between the recipient of the donated funds and the qualified donee; in effect, any intermediary may handle the funds in any way that would arguably benefit a charitable organization. The taxpayers also advanced a second, narrower interpretation, that a contribution is "for the use of" a charity so long as the donee has "a reasonable ability to ensure that the contribution primarily serves the organization's charitable purposes."[51] The Court rejected these interpretations of "for the use of"

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[48] *Rockefeller v. Comm.*, 676 F.2d 35 (2d Cir. 1982).

[49] The taxpayers also argued that the amounts at issue were deductible under Reg. § 1.170A-1(g) as "unreimbursed expenditures made incident to the rendition of services to an organization contributions to which are deductible." The Court rejected this argument on the grounds that the regulation only applies to a taxpayer's own rendition of services and not for expenses made incident to a third party's (their sons') rendition of services.

[50] *Davis*, 495 U.S. at 479.

[51] *Davis*, 495 U.S. at 479.

and held for the Commissioner.[52] The Court held, based on the legislative history and consistent administrative interpretations of the phrase, that "for the use of" means "held in a legally enforceable trust for the qualified organization or in a similar legal arrangement."[53]

A DRE is not a trust. Assets of a DRE owned by a charity are not held "for the use of" the charity in that such assets are not held in trust for the organization. Accordingly, a contribution to a charity's DRE is not deductible as a gift "for the use" of the DRE's owner.[54]

3. Contributions "to" Charity

Is a donation to a charity's DRE a contribution "to" the charity? The seminal case interpreting the meaning of the word "to" a charity is *Rockefeller v. Comm.*[55] At issue in *Rockefeller* was whether unreimbursed expenses incurred by John D. Rockefeller, 3rd and his wife, Blanchette, in rendering services to a charity were deductible as contributions "to" the charity rather than as contributions "for the use of" the charity. In the years at issue, there were limitations on the deductibility of gifts "for the use of" a charity but no limitations on deductions for gifts "to" a charity. The Second Circuit first observes that the words "for the use of" mean "in trust for."[56] The court concluded that unreimbursed expenses incurred in rendering services to charities are contributions qualifying as gifts "to" charities. The Second Circuit noted that

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[52] By contrast, in Rev. Rul. 62-113, 1962-2 C.B. 10, sufficient control by the charity of the contributions was established for purposes of Section 170. In the ruling, the taxpayer made the payments to the church fund established for the purpose of reimbursing the living expenses of missionaries, rather than to his son, a church missionary. The test for deducting the amounts under Section 170 was "whether the organization has full control of the donated funds, and discretion as to their use, so as to insure that they will be used to carry out its functions and purposes." The Service concluded that, "unless the taxpayer's contributions to the fund are distinctly marked by him so that they may be used only for his son or are received by the fund pursuant to a commitment or understanding that they will be so used, they may be deducted . . . under section 170 of the Code."

[53] *Davis*, 495 U.S. at 485.

[54] However, a gift in trust "for the use of" a DRE owned by a charity should be deductible (or not) based on the same considerations that apply to gifts "to" a DRE owned by a charity.

[55] 676 F.2d 35 (2nd Cir. 1982).

[56] *Rockefeller*, at 40.

"[c]ourts have consistently reaffirmed that public policy demands a broad and flexible interpretation of statutes governing charitable deductions."[57]

The case law and rulings concerning gifts "to" a charity are not helpful in answering the question of whether gifts to a charity's DRE should be deductible. Under the check-the-box regulations, the local law entity is disregarded and, as such, a gift to a DRE is to the DRE's owner. The issue is whether there is a compelling reason to carve out an exception to the entity classification regulations for this purpose.

4. <u>Control</u>

a. <u>In General</u>

A critical issue in analyzing the deductibility of donations to DREs is the question of control. In the Ninth Circuit's opinion in *Davis* (which the Supreme Court affirmed) the Ninth Circuit held that contributions are deductible only when the recipient charity exercises control over the donated funds.[58] The Ninth Circuit concluded in *Davis* that the Church lacked actual control over the disposition of the funds and thus they were not deductible.

Several commentators indicate that, although the Supreme Court's holding in *Davis* is limited to defining when a gift is made "for the use of" a Section 501(c)(3) charity, the reasoning in the decision provides a basis for concluding that a gift to a disregarded entity, of which a Section 501(c)(3) charity is the sole member, is a gift to the charity.[59] Specifically, the Court stated that a "contribution made in trust for a charity does not give the charity immediate possession and control, as does a donation directly to a charity," because a trustee has discretion or must follow instructions set forth in the trust instrument. In contrast, where the charity is the

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[57] *Rockefeller*, at 42.

[58] 861 F.2d 558 (1988) at 562.

[59] *See* Livingston and McCarden, *supra*, footnote 41.

single owner of a disregarded entity, the charity, as owner of the DRE, has real (albeit indirect) control over assets held in the disregarded entity. The control is similar to the control a charity has over one of its branches or divisions. As the owner of the DRE, the charity has the power to cause the liquidation of the DRE and the distribution of its net assets to itself. Thus, based on the reasoning in *Davis*, a gift received by the DRE could be viewed as a gift to the charity.

In this report, we understand and assume that in order for a gift to an eligible entity subsidiary of a charity to be deductible, the parent charity must have control over the subsidiary. Control includes unfettered rights to appoint and dismiss management. If the parent does not control the subsidiary, various additional issues are raised.[60] For example, assets controlled solely by a non-exempt person could be held for private benefit.

Two key IRS rulings on control are the "friends of" rulings from the 1960s, Rev. Rul. 63-252 and Rev. Rul. 66-79.[61] These rulings involve the issue of whether contributions to a charity are deductible if the charity thereafter transmits some or all of the funds to a foreign charitable organization.[62] In overview, the rulings hold that if the contributions are earmarked to

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[60] Various situations could arise where a purported 100% owner of a subsidiary does not control the subsidiary. An LLC could have a non-member manager where the LLC operating agreement prevents the member from removing the manager without the manager's consent. For example, assume the management of an LLC has sole authority to dispose of the assets of the LLC and that management is not subject to removal by the charity. The only power of the charity is to liquidate the LLC and receive any assets that have not previously been sold by management (or transferred to themselves). Such an LLC may in fact not be a DRE of the charity; management may have an ownership interest in the LLC. In other contexts, we have seen limited partnerships with a 100% limited partner and a 0% general partner.

[61] 1963-2 C.B. 101 and 1966-1 C.B. 48.

[62] For a gift to a charity to be deductible under Section 170, the recipient organization must be validly created or organized in the United States. We note that Section 170(c)(2) imposes a domestic-use requirement upon contributions or gifts made by a corporation to an unincorporated domestic entity (such as a trust, chest, fund, or foundation). However, this provision applies only to corporate contributions to unincorporated entities; corporate contributions to incorporated exempt organizations are not subject to the domestic-use requirement. *See* Rev. Rul. 69-80, 1969-1 C.B. 65 (domestic corporation is entitled to a charitable contribution deduction for an unrestricted contribution to a domestic charitable corporation even though the contribution is used in a foreign country. *See generally* Kirschten & Freitag, 521-3rd T.M., *Charitable Contributions: Income Tax Aspects* at A-20. This report does not further discuss this "domestic use" requirement for certain corporation contributions to charities.

go to the foreign organization, or the domestic organization otherwise is merely a conduit through which the funds flow to the foreign organization, the contributions are not deductible because the recipient domestic charity does not control the funds.

Rev. Rul. 63-252 notes that to be deductible under Section 170, it first must be determined that the recipient organization is domestic. Further, the recipient must be organized and operated exclusively for one of the purposes stated in Section 170(c)(2)(B).[63] The ruling provides five examples. In the first three, the domestic charity was required, under its governing documents or by agreement with donors, to transmit the funds donated to a foreign charity. The ruling holds these contributions are not deductible.

The fourth example involves a domestic charity that conducts charitable activities in a foreign country. In some situations, it makes grants to charities organized in that country. The domestic charity makes the grants from its general funds and reviews and approves each grant. In soliciting funds from the public, no special funds are raised on behalf of a particular foreign charity. The ruling holds that contributions in the fourth example are deductible because they are not earmarked in any manner and "use of such contributions will be subject to control by the domestic organization."

The fifth example is a domestic organization which does charitable work in a foreign country. The organization formed a foreign subsidiary for administrative convenience. The domestic organization controls every facet of its foreign subsidiary's operations. The domestic charity solicits funds for its foreign charitable activities and "will transmit" such funds to the foreign subsidiary.

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[63] Namely religious, charitable, scientific, literary or educational purposes or for the prevention of cruelty to children or animals, and that it meets the remaining requirements of Section 170(c)(2).

Interestingly, the ruling also concludes that the contributions in the fifth example are deductible even though the domestic recipient "will transmit" such funds to its foreign subsidiary. The ruling says that "[s]ince the foreign organization is merely an administrative arm of the domestic organization, the fact that contributions are ultimately paid over to the foreign organization does not require a conclusion that the domestic organization is not the real recipient of those contributions."

Rev. Rul. 66-79 follows logic similar to Rev. Rul. 63-252. In Rev. Rul. 66-79, contributions to a domestic organization whose name suggests a purpose to assist a named foreign organization (friends of foreign charity X) were found to be deductible. The bylaws gave the board the power to decide how contributions were used, the board could make grants to any charitable organization and had to approve each grant and the domestic organization had the power to use contributions for purposes other than those for which the contribution was solicited. The organization refused to accept contributions earmarked so that they must go to the foreign organization.

Rev. Rul. 66-79 holds that contributions to a "friends of" organization may be deductible. The test is "whether the organization has full control of the donated funds, and discretion as to their use, so as to insure that they will be used to carry out its functions and purposes."

It is not entirely clear how to apply the principles of these rulings to contributions to a charity's DRE. In general, ownership imparts control.[64] The DRE situation is closest to example five of Rev. Rul 63-252. That situation involved a foreign subsidiary to which the

[64] In most "friends of" situations, the U.S. charity does not control the foreign organization. In fact, in some situations, the foreign organization could be viewed as controlling the U.S. charity.

domestic charity "will transmit funds it receives for its foreign charitable activities." Under an earmarking or conduit theory, the funds really are going to the foreign entity. However, because of the control the domestic organization has over its subsidiary (which was formed "for administrative convenience"), the funds are treated as contributed to the domestic organization. This is not easily distinguishable from a direct gift by the donors to the foreign organization.[65] This holding strongly suggests a conclusion that at least in some circumstances, gifts to a charity's DRE are deductible if the domestic charity forms the DRE "for purposes of administrative convenience" and where the domestic organization "controls every facet of its operations."

b. Earmarking

A gift to a charity's DRE could be viewed as "earmarked" for the DRE and not for the general charitable purposes of the parent charity. In general, we do not see the issue of earmarking as an impediment to deductibility of gifts to DREs except where the gifts are earmarked for a named individual or a foreign organization. Many gifts to charity are restricted gifts that only can be used for specified charitable purposes.[66] The creation of an endowment fund or otherwise putting restrictions on the use of a contribution (*e.g.*, only for the purpose of cancer research, building a library, funding a grant to a named foreign charity, etc.) does not affect deductibility. As with other aspects of the analysis of deductibility of gifts to DREs, DREs do not create or solve new problems in this area; nondeductibility because of earmarking could

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[65] Under the check-the-box regulations, if the foreign organization were a DRE, a gift to the foreign organization would be tantamount to a gift to the domestic charity.

[66] Richard L. Fox, *Charitable Giving: Taxation, Planning, and Strategies*, WG&L 2nd Ed. (2009) at ¶ 3.02[5] ("Fox").

occur for gifts to charities (or branches of charities) as well as to their DRE subsidiaries. Once again, the critical issue is control.

Nondeductibility because of earmarking principally arises in two areas: gifts earmarked for individuals and gifts earmarked for foreign organizations. As discussed above, the "friends of" rulings require that to be deductible, the gift to the domestic charity must not be earmarked to go to a foreign organization.[67] Similarly, a charitable contribution deduction is not allowed if a charity is used as a conduit and the payment is "earmarked" or designated for the benefit of a particular individual, even if the individual is a member of the class the charity is intended to benefit.[68]

Situations where a gift is made in support of a stated charitable purpose are to be distinguished from earmarking which results in a loss of deductibility. For example, if a charity determines to make a grant to a named foreign organization or to hire a named professor, it can fund raise to accomplish its goals and donors may deduct gifts intended to be so directed.[69] Donations to a DRE subsidiary established for a specified purpose could be viewed as gifts in support of a need specifically identified by the DRE's parent.

In sum, where the parent charity controls the DRE subsidiary and where the gifts to the DRE are not inappropriately required (earmarked) to be used for a foreign organization or

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[67] Rev. Rul. 63-252.

[68] S.E. Thomason v. Commissioner, 2 T.C. 441 (1943). The organization must have control and discretion over the contribution, unfettered by a commitment or understanding that the contribution would benefit a designated individual. Rev. Rul. 62 113, 1962 2 C.B. 10. The donor's intent must be to benefit the organization and not the individual recipient. Rev. Rul. 68 484, 1968 2 C.B. 105. In PLR 8420003 the Service ruled that donations to a foundation for use by its for-profit subsidiary will not qualify for a Section 170 deduction because the foundation will have no control over the use of those funds.

[69] So long as any restriction does not prevent the charity from using the assets for its exempt purposes. Fox, *supra*, note 66 at 3.02[5].

for the benefit of a specific individual, the fact that a contribution is made to a DRE rather than the parent charity should not preclude deductibility.

5. Agency

A gift qualifies as a charitable contribution if the gift is made to the agent of a charity.[70] The principal-agent relationship generally requires an agency relationship formed under State law.[71]

A subsidiary is not generally the agent of its parent, absent an express state law agency relationship.[72] Accordingly, a gift to a charity's DRE is not a gift to the parent under general agency principles. This report addresses the deductibility of contributions to DREs in situations where there is not an express agency relationship.

D. Issues for Foreign DREs

Assume a domestic charity owns a foreign DRE. In addition to all of the policy considerations applicable to determining whether a contribution to a domestic DRE of a domestic charity is deductible, additional considerations arise in the case of a foreign DRE. Section 170(c)(2)(A) provides that a contribution is deductible only if it is made to or for the use of a domestic charity. As stated in Rev. Rul. 63-252, "it must first be determined that the recipient organization was validly created or organized in the United States." Another consideration with foreign DREs is enforceability. The IRS has indicated it relies to a certain

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[70] *See* Rev. Rul. 85-184, 1985-2 C.B. 84. For example, in PLR 200230005 (April 11, 2002), a charity entered into an agency agreement with an unrelated for-profit company, under which the company, as an authorized agent of the charity, accepted certain donations, among other activities. The charity remained the sole equitable owner of the donated property but the agent issued the "official receipts" to the donors as records of their contributions under Reg. § 1.170A-13(b)(1). The Service ruled, *inter alia*, that the donations were made "to the charity" through the company within the meaning of Section 170(c)(2).

[71] *See*, *Comm. v. Bollinger*, 485 US 340 (1988).

[72] *National Carbide Corp. v. Comm.* 336 US 422 (1949).

degree on state attorneys general to enforce charitability requirements.[73] As a practical matter, what controls exist over foreign entities and will the IRS be able to audit and enforce charitability requirements for foreign DREs?[74]

The key policy issue is whether there are reasons a foreign DRE should not be viewed as a branch of the domestic charity. In our view, the same two-step analysis we propose generally for analyzing the deductibility of gifts to DREs should apply to foreign DREs. First, is there something in the foreign DREs governing documents or operations that is inconsistent with the parent's tax-exempt status? For example, do the foreign DRE's organizational documents provide that, on dissolution, the DRE's assets go to a named individual rather than to charity? Second, would a gift to a similarly situated foreign branch be deductible if it were subject to the same express or implied limitations on use as a gift to the foreign DRE?

As indicated by the "friends of" rulings discussed above, it is clear that deductibility of gifts to domestic charities is not limited merely because the charity intends to use the funds abroad. The general requirement that to be deductible, a contribution must be made to a domestic charity, came into the law in 1938.[75] The legislative history indicates Congress permitted funds received by a domestic organization to be used abroad.[76] Indeed, the regulations

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[73] Although in our experience states are primarily concerned with enforcing state law requirements, including state not-for-profit laws, self-dealing considerations, and other non-tax requirements.

[74] Note that in addition to the information on the foreign DRE reportable on Form 990, the charity would have to file Form 8858, Information Return of U.S. Persons with Respect to Foreign Disregarded Entities.

[75] The Revenue Act of 1938, Pub. L. 554, 52 Stat. 447.

[76] The House Ways and Means Committee report accompanying the legislation provides: "that the deduction . . . be also restricted to contributions made to domestic institutions. The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare. The United States derives no such benefit from gifts to foreign institutions, and the proposed limitation is consistent with the above theory. If the recipient, however, is a domestic organization, the fact that some portion of its funds is used in other countries for

permit all of a domestic charity's funds to be used abroad.[77] We have often seen this with U.S. charities that operate schools abroad.[78]

In our view, if a deduction would be allowed for giving to the foreign branch of a U.S. charity, a deduction should be allowed for giving to the foreign DRE of that charity. The parent clearly must control the foreign DRE in a meaningful sense to ensure that the DRE's governing documents are not inconsistent with U.S. requirements (*e.g.*, if the foreign DRE is a charity locally, even if the local law requirements for charitable expenditures are broader or different from U.S. law requirements, that U.S. law limitations apply to the extent the broader requirements would adversely impact the parent charity's tax exemption) and its operations are consistent with the parent charity's exempt purposes (*i.e.*, no private benefit or inurement; no forbidden discrimination, etc.).

It may be helpful to consider a situation where a foreign DRE is useful in tax planning. Assume a U.S. citizen resides and pays taxes in foreign country X, which has a tax system similar to ours. The individual has 100 of X country source income and makes a charitable contribution of 10. If the contribution is made to a U.S. charity, the individual will be taxed on 100 in country X and 90 in the U.S. The individual will owe tax on 100 in country X (say 35) and owe tax on 90 in the U.S. (31.50 which, after foreign tax credits, results in no U.S. tax and total tax of 35). Similarly, if the individual makes the contribution of 10 to a country X charity, the taxpayer will owe tax on 90 in country X and 100 in the U.S. (losing the charitable contribution deduction because the gift was not made to a domestic charity). Thus the individual

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charitable and other purposes (such as missionary and educational purposes) will not affect the deductibility of the gift." H. Rept. 1860, 75th Cong. 3d Sess. (1938). 1939 1 C.B. (Part 2) 728, 742.

[77] Reg. § 1.170A-8(a)(1).

[78] *See, Bilingual Montessori School of Paris v. Comm.,* 75 T.C. 480 (1980) (contributions to Delaware tax-exempt corporation allowed under Section 170 even though 100% of the organization's assets and operations were in France).

will pay tax of 31.50 in country X and owe tax of 35 in the U.S. which, after a foreign tax credit of 31.50, results in U.S. tax of 3.5 and a total tax of 35.

If a U.S. charity has a country X DRE that qualifies as a country X charity, the individual can give 10 to the DRE. If the foreign charity is disregarded, the taxpayer receives a deduction of 10 both in country X and in the U.S. The individual has taxable income of 90 in both country X and the U.S., pays tax of 31.50 to country X and has tax of 31.50 in the U.S. offset by foreign tax credits.

We have seen foreign charity DREs structured similarly to the above example. We have not seen abuses of this structure. Rather, we have seen the structure used to eliminate the tax inefficiencies that otherwise would arise in this situation. Further, the situation of the foreign DRE is very similar to example 5 in Rev. Rul. 63-252, in which the IRS found a gift destined for the charity's foreign subsidiary to be deductible.

E. Possible Compliance Issues and Abuses

The IRS is vigilant to find and stop abuses involving charities. Would allowing tax deductible contributions to DREs lead to increased opportunities for abuse? Does the possibility of abuse outweigh the benefits of allowing deductions for such gifts? As noted above, the tax-transparent nature of DREs serves to eliminate the possibility of certain abuses by requiring that all of the assets and activities of the DRE subsidiary be shown on the charity's Form 990.[79]

The issue of abuse ties into the issue of control. In theory, lack of control can occur within a charity that has internal branches, divisions or departments that are

[79] In the case of a foreign DRE, the IRS would receive additional information on Form 8858.

semi-autonomous. Similarly, a 100%-owned subsidiary could be managed by persons the charity does not control.

In PLR 200833022 (May 21, 2008), the IRS determined that an organization formed to assist various colleges and universities in developing student housing was not exempt. The organization's primary activity would be to own and operate student housing for colleges and universities through DRE LLCs. The IRS concludes that the organization's primary role is as a real estate developer, a substantial nonexempt purpose. In this regard, the use of DRE LLCs was helpful to the structure but not essential. The housing could have been provided by separate branches or divisions of the organization with the same result. Also, the use of DRE LLCs did not impede or thwart the IRS's ability to get information or analyze the structure. On balance, the use of DRE LLCs was not abusive, but merely part of the background facts.

PLR 201052022 was a final adverse determination of exempt status for a purported supporting organization.[80] The facts show extensive use of disregarded LLCs that were owned by the organization and its founders to move money and assets from the organization to disqualified persons. The founders were the managers of the LLCs. Cash flowed in circles; cash the founders donated ended up in the founders' pockets. The IRS determined that the organization was operated for the private benefit of individuals and that the organization's net earnings inured to the benefit of its founder trustees. Clearly, from the IRS's point of view, substantial abuses were present and the DREs were used to assist in such abuses. The ruling does not involve donations to DREs.

[80] The ruling is difficult to read because it is heavily redacted; the numerous organizations, individuals and LLCs discussed in the ruling all are referred to as "XX."

The IRS was able to obtain the needed information to ascertain that the organization should not be exempt. The DREs were not the cause of the abuse; rather, they were a means to facilitate the abuse.

These rulings merely show fact patterns involving DREs. Of course people can use DREs to try to obfuscate and hide bad transactions. But the IRS has the ability to get sufficient information to ascertain whether the public trust is being abused.

Oversight of charities is a challenge. However, on the question of whether donations to DREs should be deductible, we find the potential for abuse to be neutral. Abuse can occur with or without DREs.

F. Judicial Interpretations and Other Applications of the Check-the-Box Regulations

1. The *Pierre* Case

a. Overview

A recent Tax Court case, *Pierre v. Commissioner*,[81] analyzes and ultimately rejects the application of the check-the-box regulations to the federal gift tax valuation regime. As discussed below, the majority opinion in *Pierre* does not have any direct bearing on the application of the check-the-box regulations to Section 170 (or related estate and gift tax provisions), as the case addresses a very different tax regime with different considerations and the holding is quite specific to the question of valuation under that regime. However, because the majority, concurring and dissenting opinions include lengthy discussions of the scope of the check-the-box regulations – particularly, the breadth of the term "for federal tax purposes" – and the interplay between the check-the-box regulations and various other tax regimes, *Pierre* is

[81] *Pierre v. Commissioner*, 133 T.C. 24 (2009).

instructive in considering the application of the check-the-box regulations to the deductibility of contributions to DREs owned by a charity.

Pierre addresses the question of "whether the check-the-box regulations require us to disregard a single-member LLC, validly formed under State law, in deciding how to value and tax a donor's transfer of an ownership interest in the LLC under the Federal gift tax regime." In *Pierre*, the petitioner formed a New York limited liability company, Pierre Family, LLC ("Pierre LLC") and two irrevocable, grantor trusts for the benefit of her son and grandson. The LLC defaulted to DRE status for federal tax purposes under the check-the-box regulations. Mrs. Pierre transferred cash and marketable securities to the LLC and then transferred her entire interest in the LLC to the two trusts in a two-part transaction by gifts and sales. She applied a 36.55% discount (for lack of control, marketability, etc. at the entity level) to the gifts and related sales. The IRS disallowed the discounts in their entirety (treating the LLC as disregarded so that no entity level discounts applied) and assessed additional gift taxes and penalties.

The petitioner and the IRS agreed that the LLC was disregarded "for federal tax purposes" under the check-the-box regulations, but disagreed whether the check-the-box regulations required that the state law entity and the restrictions in the LLC's governing documents be ignored for federal gift tax valuation purposes. The IRS took the position that the LLC should be disregarded for all purposes, including valuing the interests transferred. Accordingly, both the gifts and the "subsequent" (same day) sales would be treated as transfers of the underlying cash and securities without any discounts. The Tax Court held against the IRS, upholding the overall application of entity-level discounts and concluding that the check-the-box

regulations should not be applied to disregard a single-member LLC for purposes of valuing a transferred interest for gift tax purposes.[82]

b. Federal Tax Purposes v. State Law Property Rights

The crux of the majority opinion was the "fundamental premise of transfer taxation . . . that State law creates property rights and interests, and Federal tax law then defines the tax treatment of those property rights" (citing *Morgan v. Commissioner*, 309 U.S. 78 (1940)). Drawing on *Morgan* and its progeny,[83] the *Pierre* court concluded that because federal law could not create a property right in the underlying assets, the transferred interests had to be valued at the entity level rather than as a "hypothetical transfer of the underlying assets of Pierre LLC."[84]

The court's key concerns were that reading the tax classification of a disregarded entity under the check-the-box regulations into the gift tax valuation rules would "require that Federal law, not State law, apply to define the property rights and interest transferred by a donor for valuation purposes under the Federal gift tax regime" in contravention of *Morgan*. The court

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[82] The Tax Court reduced the discounts in a separate opinion. T.C. Memo 2010-106.

[83] *See, e.g.*, *Knight v. Commissioner*, 115 T.C. 506 (2000) (applying *Morgan* in taking into account the actual partnership interests transferred for valuation purposes, rather than simply the underlying assets).

[84] The court notes (*Pierre* at 35):

> While we accept that the check-the-box regulations govern how a single-member LLC will be taxed for Federal tax purposes…we do not agree that the check-the-box regulations apply to disregard the LLC in determining how a donor must be taxed under the Federal gift tax provisions on a transfer of an ownership interest in the LLC. If the check-the-box regulations are interpreted and applied as respondent contends, they go far beyond classifying the LLC for tax purposes. The regulations would require that Federal law, not State law, apply to define the property rights and interests transferred by a donor for valuation purposes under the Federal gift tax regime.

concluded that such a reading would be "manifestly incompatible"[85] with the federal estate and gift tax statutes, as interpreted by the Supreme Court.[86] The court concluded:

> In the absence of such explicit congressional action and in the light of the prohibition in section 7701, the Commissioner cannot by regulation overrule the historical Federal gift tax valuation regime contained in the Internal Revenue Code and substantial and well-established precedent in the Supreme Court, the Courts of Appeals, and this Court, and we reject respondent's position in the instant case advocating an interpretation that would do so. Accordingly, we hold that petitioner's transfers to the trusts should be valued for Federal gift tax purposes as transfers of interests in Pierre LLC and not as transfers of a proportionate share of the underlying assets of Pierre LLC.[87]

c. **Implications of *Pierre* for the Treatment of Charitable Gifts to DREs owned by Charities**

For a number of reasons outlined below, the majority's key concerns in *Pierre* are unique to the gift tax valuation regime and thus do not weigh against treating a charitable gift to a charity's DRE as a gift to the charity itself. In fact, some points arguably lend weight to ignoring the DRE for purposes of the donor's charitable deduction. Moreover, as discussed in this report, the addition of a number of specific carve-outs to the general tax treatment of an eligible entity (*e.g.*, employment taxes, the Deemed Election Regulation, etc.) shows that the tax classification of an entity does, in fact, generally dictate its tax treatment. In addition, the IRS's litigating position in *Pierre* that DREs are disregarded for all federal tax purposes (except as expressly carved out) is consistent with a conclusion that gifts to a charity's DRE are deductible.

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[85] Section 7701.

[86] Further, the majority noted that Congress has specifically enacted provisions to disregard entity-level discounts in the transfer tax context (*e.g.*, Sections 2701-04), observing that "[b]y contrast, Congress has not acted to eliminate entity-related discounts in the case of LLCs or other entities generally or in the case of a single-member LLC specifically."

[87] *Pierre* at 36.

As noted above, the *Pierre* court found support in the language of Section 7701(a) for declining to apply the check-the-box regulations to disregard an otherwise disregarded entity for purposes of the gift tax valuation rules. As explained by Judge Cohen in her concurring opinion:

> [T]he regulation implements a statute that, by its terms applies *except* where "manifestly incompatible with the intent" of the Internal Revenue Code. Sec. 7701(a). The language of the regulation requires a determination of which "federal tax purposes" are implicated and whether a given purpose might be manifestly incompatible with the Internal Revenue code.[88]

The Tax Court's concerns in *Pierre* were specific to the gift tax valuation regime, which, under long-settled law, necessarily must look to the "rights and interests" conveyed under local law in determining the value of a gift. As discussed in the majority opinion, the starting point in the regulations and case law for determining the value of a gift for gift tax purposes is "the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of the relevant facts."[89] As Judge Cohen explained in her concurring opinion:

> Transfer tax disputes, including this one, more frequently involve differences over the fair market value of property, and fair market value is determined by applying the "willing buyer, willing seller" standard to the property transferred. See majority op. pp. 8-11. Where the property transferred is an interest in a single-member LLC that is validly created and recognized under State law, the willing buyer cannot be expected to disregard that LLC. See, e.g., *Knight v. Commissioner*, 115 T.C. 506, 514 (2000) ("We do not disregard…[a] partnership because we have no reason to conclude from this record that a hypothetical buyer or seller would disregard it.").[90]

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[88] *Pierre*, at 39.

[89] *Pierre*, at 28 (citing Reg. § 25.2512-1).

[90] *Pierre*, at 37.

Both the majority and concurring opinions cite the principle that "a regulation will be interpreted to avoid conflict with a statute" as further support for holding that the check-the-box regulations should not be read to ignore a disregarded entity for valuation purposes.[91]

In contrast, ignoring a disregarded entity for purposes of determining whether a gift to a disregarded entity owned by a charity is a gift to or for the use of the charity is not "manifestly incompatible" with Section 170. Over a decade of experience, IRS authorities (for example, Announcement 99-102 and other numerous letter rulings on LLCs owned by charities), combined with the control that a charitable organization presumably would retain over a wholly owned DRE, suggest that there is nothing manifestly incompatible with applying the check-the-box regulations for purposes of treating a gift to a disregarded entity owned by a charity as a gift to the charity itself.[92]

The check-the-box regulations were drafted specifically to avoid being "manifestly incompatible" with statutes governing exempt organizations. The Deemed Election Regulation was included because the IRS considered associations (taxable as corporations) to be the type of eligible entity most consistent with exempt status (for those types of exempt organizations that are not trusts and thus not eligible entities in the first place). For example,

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[91] The majority did not question the check-the-box regulations themselves, but rather the IRS's interpretation of them as reflected in its litigating position. There was some disagreement among the judges, with Judge Halpern arguing in his dissent that the majority opinion effectively invalidated the check-the-box regulations for federal gift tax purposes and "disregard[ed] the plain meaning of the phrase 'for federal tax purposes' in section 301.7701-3(a), Proced. & Admin. Regs." Judge Cohen, in the concurring opinion, took the view that "[n]othing in the check-the-box regulations or in the cases cited by respondent persuades us that those regulations require us to disregard a single-owner LLC where, as is the case here, to do so would be 'manifestly incompatible' with the intent of other provisions of the Internal Revenue Code." In any event, the majority opinion did not question the validity of the regulations themselves.

[92] Although not the subject of this report, the case for "regarding" a disregarded entity is stronger where, for example, one is trying to value an interest in a disregarded entity transferred to a charity for purposes of determining the amount of the contributor's charitable deduction, as this would raise some of the same issues presented by a valuation for gift tax purposes. However, in the case where a contributor gives 100% of a DRE to a charity, different valuation considerations apply than in the case where minority or noncontrolling interests in an entity are given away.

corporations (and associations) are the only type of business entity included in Section 501(c)(3) (as well as other provisions of Section 501(c)).[93] Thus, a disregarded entity or partnership claiming exempt status as a charity (as opposed to a disregarded entity claiming to be part of a charity) arguably would be inconsistent with the language of Section 501(c).[94] The existence of this specific carve-out (and the newer carve-outs added for employment taxes and certain excise taxes) suggest a broad reading of the term "for federal tax purposes" in the absence of an identifiable conflict with another statute.

2. Employment Tax Cases

Effective in 2009, entities that are otherwise disregarded are regarded as separate entities for employment tax purposes. These regulations were issued in 2007 and were applied prospectively. For years prior to the 2009 effective date, an eligible entity that was a DRE was disregarded for employment tax purposes. This meant owners of such DREs were personally liable for the entity's employment taxes. This spawned litigation where owners of such DREs claimed state law limited liability as a shield against such personal liability.

In a series of employment tax cases, courts upheld the imposition of withholding tax liability on the owners of single-member LLCs with respect to employees of the LLCs.[95] These cases are instructive on the application of the check-the-box regulations in a context where federal law, rather than state law, is at issue. The courts did not question whether "for federal tax purposes" included employment tax liability. In fact, the Second Circuit in *McNamee* noted: "If the LLC chooses not to be treated as a corporation, either by affirmative election or by default,

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[93] Trusts also are entities included in Section 501(c).

[94] Similarly, an eligible entity that makes an S election is deemed to have elected to be treated as an association for tax purposes. Reg. § 301.7701-3(c)(1)(v)(C).

[95] *See, e.g., McNameee v. Dep't of the Treasury*, 488 F.3d 100 (2d Cir. 2007); *Littriello v. U.S.*, 484 F.3d 372 (6th Cir. 2007).

its owner will be liable for debts incurred by the LLC, but there will be no more double taxation. The IRS check-the-box regulations, allowing the single-owner LLC to make the choice, are therefore eminently reasonable."[96]

The majority in *Pierre* distinguish the employment tax cases, without much discussion, more or less on the basis that they were concerned with employment tax liability rather than the valuation of transferred interests for gift tax purposes.[97] But Judge Halpern, in his dissenting opinion for *Pierre*, elaborated on the *McNamee* ruling, tying in the "manifestly incompatible" limitations of Section 7701(a):

> In other words, notwithstanding the protection from the liabilities of his LLC that Mr. McNamee enjoyed under local law, see *id. at 107*, nothing in the relevant section 7701(a) definitions deprived the Secretary of the authority to write a regulation permitting Mr. McNamee to waive that protection, at least as it pertained to the employment tax liabilities of the entity, in exchange for escaping the double taxation that would result if he failed to make that waiver, see *id. at 109, 111*. The Court of Appeals thus rejected Mr. McNamee's contention that the limited liability rights he enjoyed under local law protected him from the Commissioner's action to collect his LLC's unpaid payroll taxes. *Id. at 111*.[98]

Subsequent to the years at issue in *McNamee* and *Littriello*, the check-the-box regulations were amended to treat entities otherwise treated as DREs as corporations separately liable for employment tax purposes.[99] Indeed, the Preamble to these final regulations notes that

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[96] *McNameee*, 488 F.3d at 109. *See also Littriello v. U.S.*, 484 F.3d at 378-79.

[97] One could use the same basis to distinguish the *Pierre* holding from the question of deductibility of a charitable contribution to a disregarded entity wholly owned by a charity.

[98] *Pierre* at 47.

[99] *See* 70 Fed. Reg. 60475 (2005). Prior to the proposed regulations, owners of single-member LLCs could elect to withhold employment taxes either at the LLC level or at the owner level per IRS Notice 99-6, 1999-1 C.B. 321. As the dissent in Pierre noted, "the Court of Appeals [in *McNamee*] clearly stated that, at least for payroll tax purposes (under the preamendment version of the regulation), the limited liability that local law accorded the owner is ignored." *Pierre* at 48.

"a disregarded entity ***continues*** to be disregarded for other Federal tax purposes"[100] [emphasis added], presumably including Section 170.

3. Other Applications of the Check-the-Box Regulations

Judge Halpern notes in his *Pierre* dissent that the IRS's apparent litigating position (that "the wrapper be disregarded in determining the property the owner of a single-member disregarded entity transfers when she transfers an interest in the entity") is "consistent with the Commissioner's administrative position for at least 10 years." As discussed in this report, there is indeed a considerable administrative record in support of disregarding eligible entities owned by charities.[101] In addition, authorities in other areas support a broad application of the check-the-box regulations. Examples include the 1999 revenue rulings governing conversions of partnerships into disregarded entities and vice versa[102] and a ruling treating the exchange of a wholly owned (and disregarded) LLC that owns real property as an exchange of its underlying assets potentially eligible for Section 1031 exchange treatment.[103]

The language of the check-the-box regulations goes beyond simply determining how the entity and/or its owners are taxed, as implied by certain comments of the court in *Pierre* (although not in its holding).[104] For example, when an eligible entity treated as a corporation checks the box to be classified as a disregarded entity, "the following is deemed to occur: The association distributes all of its assets and liabilities to its single owner in liquidation of the

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[100] *Id.*

[101] *See* Announcement 99-102 and the numerous PLRs involving charities with DRE subsidiaries.

[102] Rev. Rul. 99-5, 1999-1 C.B. 8 and Rev. Rul. 99-6, 1999-1 C.B. 6.

[103] *See* PLR 200251008. An interest in an entity does not qualify for like-kind exchange treatment under Section 1031. For example, an exchange of a 100%-owned entity that holds an interest in real estate for other real estate would not be a nonrecognition transaction under Section 1031 unless the entity is a DRE.

[104] *See* note 82.

association."[105] Similarly, when a disregarded entity checks the box to be classified as a corporation, the owner of the eligible entity is deemed to contribute all of the assets and liabilities of the entity to the corporation in exchange for stock of the corporation.[106]

All of these deemed transactions carry tax consequences not just for the entity in question, but also for the members, shareholders and partners (as applicable). The Preamble to the final 1996 regulations provides:

> Taxpayers are reminded that a change in classification, no matter how achieved, will have certain tax consequences that must be reported. For example, if an organization classified as an association elects to be classified as a partnership, the organization *and its owners* must recognize gain, if any, under the rules applicable to liquidations of corporations. [emphasis added].[107]

The tax consequences of the above transactions that are deemed to occur on account of a change in an entity's classification extend far beyond the entities themselves. Accordingly, it does not seem a stretch to "disregard" a disregarded entity owned by a charitable organization for purposes of determining whether a contribution made to the disregarded entity should be treated as a contribution to the charitable organization itself for determining whether the contributor is entitled to a charitable contribution deduction.[108]

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[105] Reg. § 301.7701-3(g)(1)(iii).

[106] *See* Reg. § 301.7701-3(g)(1)(iv).

[107] *See* T.D. 8697 (Dec. 17, 1996).

[108] *Dover v. Comm.*, 122 TC 324 (2004) involved a check-the-box election; however, neither the IRS nor the taxpayer questioned the efficacy of the election or the breadth of the regulations. In *Dover*, a UK holding company owned by a Delaware corporation (and thus a controlled foreign corporation for purposes of the "subpart F" regime) sold its wholly owned UK corporate subsidiary to a German buyer. If the sale of the UK subsidiary had been treated as a stock sale for U.S. tax purposes, it would have given rise to capital gains which would be subpart F income under Sections 951(a) and 954(c). However, if the sale was treated as the sale of assets "used or held for use in the [UK parent's] trade or business," the gains would be excluded from subpart F income under Reg. § 1.954-2(e)(3). After the sale, the UK parent retroactively checked the box on the UK subsidiary to treat it as a disregarded entity effective prior to the date of sale. Thus, the assets of the UK subsidiary would be treated as having been sold (rather than the subsidiary's stock). The taxpayer argued the assets deemed sold should be considered to have been used or held for use in the UK parent's trade or business.

V. Possible IRS Guidance

A. Ruling or Other Guidance Confirming Deductibility

This report has examined the check-the-box regulations as applied to charities and their disregarded entity subsidiaries. We understand that many charities use DREs for legitimate and appropriate purposes, including limiting liability on specific charitable projects, limiting liability with respect to certain investment assets (particularly real property) and tax planning aimed at increasing contributions from specially situated donors (particularly U.S. citizens living abroad).

Deductibility under Section 170(a) and related estate and gift tax provisions is a federal tax question (and, unlike valuation issues, is not a question of state law property rights). We have not seen or identified any particular abuses that are created or facilitated by allowing deductibility of contributions to DRE subsidiaries of charities. Well over a decade of experience with the check-the-box regulations as applied to DREs owned by charities has not brought to light any real problems of tax administration. We have found no compelling reason why the IRS must or should regard otherwise disregarded entities for purposes of Section 170 and related estate and gift tax provisions.

The IRS acknowledged that for tax purposes, there was no difference between the deemed Section 332 liquidation triggered by the entity election and an "actual" Section 332 liquidation. In either case, the subsidiary would become a branch or division of the UK parent. Rather, the IRS argued that earlier Treasury guidance in Rev. Rul. 75-223, 1975-2 C.B. 109 and subsequent letter rulings to the effect that the transferee parent in a Section 332 liquidation succeeds to the business history of its liquidated subsidiary (with the result that the subsidiary's assets used in its trade or business constitute assets used in the parent's trade or business upon receipt of those assets) was limited to former Section 346. The court held for the taxpayer. Thus, although *Dover* is now considered a seminal case in giving real tax effect to a check-the-box election (at least in the "check and sell" context), the tax effect of the election itself, as compared with an "actual" liquidation, was not at issue.

The IRS can and does receive information about DREs on Form 990. If the IRS desires or needs more information, it can amend Form 990 to require such information.[109] In this regard, the IRS should consider revising Form 990 PF to request additional information from private foundations on DREs. Further, the IRS has the power to revoke the exempt status of any charity that is not operated exclusively for charitable purposes. If a DRE (which is treated as part of the charity) engages in activities that are incompatible with being tax exempt, the IRS can revoke the parent's exempt status.

The check-the-box regulations became final in 1997. The regulations are clear: a 100%-owned eligible entity that is not classified (by election or default) as a corporation is "disregarded as an entity separate from its owner." Taxpayers are entitled to rely on final regulations. The IRS confirmed this treatment applies to DREs owned by charities in Announcement 99-102.

As discussed in this report, we have concluded that under the check-the-box regulations, a contribution to a charity's disregarded entity subsidiary is the same as a gift to a branch or division of the charity. Accordingly, under current law, our view is that such a contribution is deductible under Section 170(a) to the same extent, and subject to the same limitations, as a contribution to the parent charity. In this regard, it is critical that the parent charity control the DRE. Further, we recommend a two-step analysis of the DRE. First, the DRE must be organized and operated in a way that is not inconsistent with the parent charity's tax-exempt purposes. Second, a gift to a DRE should be deductible only if a similar gift to a branch of the charity would be deductible if subject to the same express or implied limitations.

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[109] For foreign DREs, the IRS generally would receive additional information on Form 8858.

We also are of the view that the same analysis should apply for purposes of determining whether gifts to a charity's DRE are deductible for estate and gift tax purposes. For the reasons discussed in this report, bequests, legacies, devises, transfers or gifts received by a charity's DRE should be treated as bequests, legacies, devises, transfers or gifts "to" the charity owner, and therefore will be treated as made "to" an organization described in Sections 2055(a)(2), 2106(a)(2)(A)(ii), 2522(a)(2) and 2522(b)(2).

We encourage the IRS to issue guidance confirming the deductibility of contributions to DRE subsidiaries of charities. Such guidance could be in the form of a revenue ruling or announcement that gives several fact patterns. Deductibility should be premised on the DRE being controlled by the charity (to eliminate some potential abuse, which we have not seen, where the entity's governing law or documentation allows control to be divested from ownership and a person other than the charity controls the entity). Deductibility also should be premised on the DRE's governing documents not providing that the DRE be operated for purposes that are contrary to the tax-exempt purposes of the charity owner. Finally, deductibility could require the acknowledgment of the contribution required under Section 170(f)(8) to give the parent's name and address and to contain a statement confirming the DRE status of the recipient of the gift.[110]

Such guidance should provide at least one example involving a foreign DRE owned by a domestic charity. Here, the IRS should confirm that under current law, the check-the-box regulations do apply and a contribution to such a foreign entity is deductible to the same extent as a contribution to a charity's domestic DRE.

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[110] Some in the working group suggested that the IRS require that any solicitations by a DRE disclose the parent's name and address, so that potential donors could check to see if the parent is listed in IRS Publication 78.

In addition, the IRS should consider whether guidance is needed in related areas. For example, under Section 4958, sanctions are applied to certain excess benefit transactions between charities and disqualified persons. In general, we are of the view that the determination of who is a disqualified person should be determined by disregarding a DRE and viewing transactions in the context of the charity as a whole. However, we have not extensively reviewed this area and suggest that the IRS may want to give further consideration to the issues raised, including, for example, whether anti-abuse rules might be warranted to prevent the avoidance of the purposes of Section 4958 where a DRE's managers manage material or significant assets of the charity (including its DREs).

B. Possible Regulations Limiting Deductibility

1. Possible Reasons for Limiting Deductibility

As discussed in this report, but for the check-the-box regulations' treatment of DREs, contributions to a charity's subsidiary generally would not be deductible unless the subsidiary itself is qualified as a charity or the subsidiary is the agent of the parent charity. Only contributions "to or for the use of" a domestic charity are deductible under Section 170(a). Treatment of eligible entities as disregarded is purely a regulatory concept and is not expressly required by the Code or caselaw. The logic of permitting deductions for gifts to DREs owned by charities is somewhat circular. If the check-the-box regulations apply, the gift is deemed to be made to a branch or division of the charity. If the check-the-box regulations do not apply, the gift will be to a non-exempt subsidiary of the charity and generally not deductible.

The 100% owner of an entity presumptively has control over that entity. However, under *Moline*,[111] an entity is separate from its parent and, under *National Carbide*,[112] a subsidiary is not the agent of its parent absent more.[113] Further, if a gift to a charity's DRE is a gift "to" the charity, then a gift to a for-profit corporate subsidiary of a charity possibly could be viewed as a gift "to" the charity. This is not the law. And, given the breadth of the types of entities that are eligible entities, it does not seem that there are inherent differences between *per se* corporations and eligible entities that make 100% owned eligible entities more within the control of their parents than 100% owned *per se* corporations. Only a tax election distinguishes an eligible entity that is a DRE from an eligible entity that elects to be (or defaults to be) a corporation (including by applying for exemption and being treated as an association under the Deemed Election Regulation). For that matter, a contribution to a partnership in which a charity is a partner generally would not be deductible.

2. <u>Possible New Regulations</u>

As previously noted in this report, we acknowledge that, as for employment taxes and other specific purposes, the IRS has the power to change the check-the-box regulations prospectively to provide that, for purposes of deductibility under Section 170(a), otherwise disregarded entities are regarded. The IRS could amend the check-the-box regulations to treat DREs as separate entities for purposes of Section 170. Alternatively, the IRS could amend the check-the-box regulations to treat domestic DREs as disregarded but foreign DREs as not disregarded, possibly under the logic that only gifts to domestic organizations are deductible

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[111] *Moline Properties, Inc. v. Comm.*, 319 US 436 (1943).

[112] *National Carbide Corp. v. Comm.*, 336 US 422, 430 (1949).

[113] *See Comm. v. Bollinger*, 485 US 340 (1988).

under Section 170(a).[114] As discussed in this report, we do not recommend that any changes to the entity classification regulations be made in this area.

In particular, we urge the IRS not to attempt to issue regulations with retroactive effect limiting the deductibility of contributions to DREs owned by charities. Given the plain language of the current check-the-box regulations and the fact that two circuit courts have held those regulations to be "eminently reasonable,"[115] it seems unlikely a court would uphold the retroactive treatment of DREs as separate entities for purposes of Section 170.[116] First, the retroactive application of new regulations would disrupt the reasonable expectations of taxpayers. The language of the check-the-box regulations does not in any way indicate that DREs must be treated as separate entities for purposes of Section 170. Indeed, the regulations state that the entity classification rules are for "federal tax purposes," which includes Section 170. In addition, the IRS has not indicated in any published guidance that DREs should be treated as separate entities for purposes of Section 170. In fact, in private letter rulings and other

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[114] Query whether any such limitation should apply for estate and gift tax purposes where deductibility is not limited to domestic donees.

[115] *McNamee v. Department of the Treasury*, 488 F.3d 100 (2d Cir. 2007); *Littriello v. U.S.*, 484 F.3d 372 (6th Cir. 2007).

[116] As a result of the Supreme Court's recent decision in *Mayo Foundation for Medical Education and Research v. United States*, 131 S. Ct. 704 (2011), the standard of review to determine the validity of retroactive regulations is somewhat unsettled. The Supreme Court unanimously concluded in *Mayo* that the validity of all Treasury regulations (whether interpretative or legislative) should be determined under the test set forth in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.* 467 U.S. 837 (1984) and not under the multi-factor test set forth in *National Muffler Dealers Association, Inc. v. United States*, 440 U.S. 472 (1979). Under *Chevron* a court must first determine whether there is any ambiguity in the statute such that the IRS has any "room to interpret." *Salman Ranch, Ltd. v. Commissioner*, 107 AFTR2d 2011 2359, at 2011 2363, citing *Chevron*, 467 U.S. at 843. Specifically, the court must determine "whether the statute's plain terms 'directly addres[s] the precise question at issue.'" *National Cable & Telecommunications Ass'n v. Brand X Internet Services*, 545 U.S. 967, 986 (2005), quoting *Chevron*, 467 U.S. 837 (1984). If the statute is ambiguous on the point or silent, then the court must apply the second part of the Chevron test, which asks whether the regulation at issue is "reasonable." Courts will uphold the regulation as reasonable unless they consider it "arbitrary, capricious, or manifestly contrary to the statute." *Mayo*, 131 S. Ct. at 711 ("In the typical case, such an ambiguity would lead us inexorably to *Chevron* step two, under which we may not disturb an agency rule unless it is "'arbitrary or capricious in substance, or manifestly contrary to the statute.'") citing *Household Credit Services, Inc. v. Pfennig*, 541 U.S. 232, 242 (2004).

nonprecedential guidance, the IRS has suggested the opposite. Given the fact that the status of DREs for purposes of Section 170 is at best unclear, it seems that the retroactive application of a new regulation carving Section 170 out of the check-the-box regulations would lead to an inordinately harsh result for taxpayers and, accordingly, would be treated by a court as an abuse of IRS discretion.