COMMITTEE ON FINANCE
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MEMORANDUM

To: Reporters and Editors
From: Carol Guthrie for Finance Committee Chairman Max Baucus (D-Mont.)
Jill Gerber for Finance Committee Ranking Republican Member Chuck Grassley (R-Iowa)
Re: abusive tax transactions involving contribution of non-cash property

Finance Chairman Baucus and Ranking Republican Chuck Grassley wrote to Treasury Secretary Henry Paulson today regarding a type of abusive tax transaction involving the contribution of non-cash property to tax-exempt organizations. Baucus first wrote the Treasury Secretary regarding the transaction in April of this year. The IRS has indicated knowledge of the abusive tax tactic, but has not yet determined whether to make it a listed tax shelter transaction. Today, Baucus and Grassley are seeking information on the entities employing this abusive tax shelter and clarification of the response of the Internal Revenue Service (IRS).

"The IRS is clearly aware of this shell game involving contributions of property to tax-exempt entities, but I'm not satisfied that enough is being done quickly enough to stop this abusive transaction," said Baucus. **"We want to know how widespread the problem is and who's playing fast and loose with the tax code in this way. The IRS needs to take timely action to stop deals like this from proliferating."**

Grassley said, **"The IRS must send a clear signal that charities cannot engage in these types of transactions and expect to continue to receive the benefits of tax-exempt status. The agency needs to use all of the tools it has to police the charities – big and small -- that engage in these transactions."**

The text of the Senators' letter is below, followed by Baucus's original query to the IRS. The May 3 response of Acting Commissioner Kevin Brown is attached in PDF.

June 18, 2007

The Honorable Henry Paulson, Jr.
Secretary
U. S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Mr. Secretary:

We are writing in response to Acting Commissioner Kevin Brown's letter of May 3, 2007 regarding abusive transactions involving the contribution of non-cash property to a charity and the claiming of a charitable deduction in an amount that substantially exceeds the true fair market value of the property.

The purpose of this letter is twofold: 1) to focus on the charities that are involved in this activity and the Internal Revenue Service's (IRS) response to these charities; and, 2) to understand better the difficulties that the IRS faces in discovering and auditing these types of transactions.

Organizations receive significant tax benefits when they are granted status as a charity under section 501(c)(3) of the tax code. We are troubled by organizations that benefit from tax-exempt status taking advantage of this privilege by aiding and abetting abusive tax transactions that allow others to avoid paying tax. We believe that the IRS needs to give serious consideration to imposing Section 4965 penalties on these charities as well as revoking the exempt status of those charities that knew or had reason to know about their participation in these transactions.

The May 3, 2007 letter states that the IRS has identified 48 entities participating in this transaction claiming approximately $271 million dollars. Please inform us of the number of charities that are involved in this abusive transaction and please describe the type of charities involved and the size of the entities. Please describe their role and involvement with this transaction.

In considering the involvement of charities in this transaction, three issues are raised: 1) Section 4965; 2) Private Benefit; and, 3) Public Policy.

Section 4965

This transaction appears to be a prime example of what Congress sought to address with the passing of Section 4965 in the Tax Increase Prevention and Reconciliation Act of 2005. This law was passed, in part, in response to the Commissioner of the IRS' testimony that charities and other tax-exempts were serving as accommodating parties for tax shelters and tax abusive transactions. In general, the penalties and taxes of Section 4965 are triggered when a tax-exempt entity is a party to a prohibited tax shelter transaction – which is defined as either a listed transaction or a prohibited transaction (a prohibited transaction being a reportable transaction due to being either: a) a confidential transaction; or b) a transaction with contractual protection).

We note in the May 3, 2007 letter that IRS is considering a listing notice under existing reportable transaction regulations, or a "transaction of interest" notice under proposed regulations. Listing would send a strong signal to charities; listing also would trigger disclosures by the LLC members and make it easier for the IRS to identify these transactions. Please thoroughly explain the IRS's decision whether or not to list the transaction and the rationale for making the decision, including to what extent disclosure requirements and Section 4965 penalties influenced the IRS's position.

Given that this transaction was identified in August 2006 – nearly a year ago – we want to know why it has taken the IRS so long to make this determination. The Finance Committee has worked diligently to enact Section 4965 and other legislation to give the IRS the "tools to do the job" of fighting abusive tax transactions. We are concerned that frequently the instinct of IRS appears to be a lack of will or imprimatur to use these tools. This frustrates the will of Congress.

Private Benefit

The known facts of these transactions – where individuals claim highly inflated valuations for purposes of claiming a charitable deduction and then repurchase the LLC interest from the charity for a fraction of the original claimed value – raise concerns of private benefit being conferred by the charity to the individuals involved. If any of these deals are insider transactions, please provide details. These concerns of private benefit are particularly heightened in those cases that are cited in the May 3, 2007 letter where "the donor may have reacquired the donated interest from the charity two years [and a day] later at a significantly lower cost."

On the face of it, private benefit is implicated because it appears that either or both of the following occurred: 1) the charity allowed itself to be used for the substantial pecuniary benefit of private persons; and, 2) the charity sold property at well below its reported and booked value.

Given the amount of deductions involved that you cite in your letter – $271 million – this is not an insignificant amount.

Please inform us of your views on whether these charities have met or failed to meet the private benefit test. Please inform us of what actions you will be taking in response to those charities that have failed the private benefit test.

Public Policy

Congress has repeatedly stated that tax shelters and tax evasion are against public policy and has enacted legislation addressing tax shelters over a significant period of years. This is especially the case when an entity receives the benefits of tax-exempt status and uses that special status to improperly assist others in avoiding tax. Congress did not create the exemption from the tax laws so that a charity could sell or rent the benefits of its tax-exemption to others.

In addition, it appears that the charities involved may have violated civil or criminal laws. The courts and the IRS have consistently made it clear that illegal activities are not permissible activities for a tax-exempt organization.

Please inform us of your policy on these matters and what actions could be taken against those charities that engaged in these transactions – transactions that were against public policy because they were either tax shelters or violated the law.

Valuation Questions and IRS Resources

As stated above, in addition to actions taken against the charities, we are also concerned about the difficulties the IRS faces in trying to bring actions against those who took the inflated charitable tax deductions. We are disappointed by the answer to the Finance Committee letter dated April 13, 2007, regarding the valuation issues raised by this transaction. The Finance Committee's letter discusses at length possible responses to the valuation problems raised by this transaction and similar transactions. The response from the IRS to this detailed commentary and questions is one sentence: "We share your concern about the valuation problem this transaction presents and welcome your support as we explore ways to improve compliance in this area." This answer is not helpful and we seek a more complete answer.

Please discuss in detail the hurdles that the IRS faces in developing during audit – and sustaining through appeals – the resources required to contest this and similar transactions. Please discuss the number of employees (including outside contractors involved); the number of hours; the seniority of the staff; and valuations or other related issues. This discussion should also include what problems are faced by the IRS in identifying these types of transactions in the first place. So that the Finance Committee can have a point of reference, please compare this effort to that needed to raise non-valuation issues of a similar dollar value. Please discuss what would be the impact of the basis rule discussed in the April 13, 2007 letter, based on a Joint Committee on Taxation proposal, in terms of IRS resources and also addressing the tax gap. In that discussion, it would be useful for you to highlight what has been the impact of Congress changing the rules regarding intellectual property and car donations – in terms of both allocation of IRS resources and addressing the tax gap.

Related to this investigation, describe the IRS's policy and practice to employ technology that uses taxpayer identification numbers and other identifying information to link flow-through entities and their partners, shareholders and members, in order to detect tax shelters, abusive tax avoidance transactions (ATATs), and patterns or indicators of noncompliance. As part of your response, please include the number of returns to which this linking technology was applied during each of the last 4 years compared to the number of flow-through returns and individual returns with K-1s that were filed during each of the last 4 years to which it potentially could be

applied. To what extent could additional abusive transactions be identified through broader use of linking technology? Explain the IRS's rationale for when this technology is applied.

To what extent does the amount of tax return information that is transcribed limit the IRS's ability to detect noncompliance? Describe and explain the IRS's policy and practice on transcribing tax return data. Compare and contrast the IRS's policy on transcribing data from paper tax returns and from electronic tax returns. To what extent would the IRS's ability to detect tax shelters, ATATs and patterns or indicators of noncompliance be improved if all line items on Forms K-1 were transcribed? Does the IRS have alternatives to obtain nontranscribed K-1 information?

Please provide in a separate letter the names, addresses and EIN for each charity and other tax-exempt entities, including governments, that were involved in these abusive transactions. Please provide what actions the IRS has taken, or plans to take, in regard to each entity. The May 3, 2007 letter also states that the IRS first became aware of the transaction in August, 2006 and that later that year the State of New York provided additional information. Please describe what information the IRS received in August, 2006 and what actions the IRS took at that time, as well as what information the IRS received from the State of New York and what actions have been taken after that period. Please detail what ongoing efforts the IRS is taking to identify and take action against all participants in this transaction – promoters, advisers, charities and those individuals taking the charitable tax deductions.

We recognize that some of the material requested in this separate letter is protected by Section 6103 of the Internal Revenue Code. Pursuant to Section 6103(f)(4), the Chairman designates [staff] to have access to all Section 6103 material and tax return information on individuals, entities and charities pertaining to the transaction, and similar transactions, discussed in this letter as well as the letter of April 13, 2007 and May 3, 2007.

Thank you for your time and assistance. We ask for your response within 30 days.

Cordially yours,

Max Baucus
Chairman

Charles Grassley
Ranking Member

cc: Mr. Kevin Brown, Acting Commissioner
Internal Revenue Service
The Honorable Donald Korb, Chief Counsel
Internal Revenue Service
Dr. Thomas Barthold, Acting Chief of Staff
Joint Committee on Taxation

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April 13, 2007

The Honorable Henry M. Paulson, Jr.
Secretary
Department of the Treasury
1500 Pennsylvania Avenue, N.W.

Washington, DC 20220

Dear Mr. Secretary:

The Finance Committee has learned of an abusive transaction involving the contribution of non-cash property to charity and the claiming of a charitable deduction in an amount that substantially exceeds the true fair market value of the property. The transaction not only appears to violate established tax law, but also appears to be carefully crafted to conceal key portions of the transaction from the Internal Revenue Service. I would like to learn what Treasury knows about the transaction and what actions you intend to take to combat it.

As we understand one form of the transaction, a tax shelter promoter arranges the purchase of real property that is encumbered by a long-term lease, sometimes with a lease term as long as 60 years. The so-called remainder interest in the real property (following the expiration of the lease) is owned by a single-member limited liability company (LLC 1). It appears that the sole membership interest in LLC 1 is owned by a separate LLC – LLC 2 – in which various investors in the transaction hold membership interests. LLC 2 contributes the sole membership interest in LLC 1 to a section 501(c)(3) charity, such as a tax-exempt college or university. For purposes of claiming a charitable deduction, LLC 2 claims a value that is several multiples of the price originally paid for the remainder interest. The valuation is based on an appraisal that purports to support the claimed value. The various member-investors in LLC 2 are provided with Forms K-1 showing their respective shares of the apparently inflated charitable deduction.

We further understand that the section 501(c)(3) organizations involved in such transactions typically enter into an agreement not to dispose of the interest in LLC 1 for a period of at least two years and one day following the contribution. This requirement appears to be designed to avoid the legal requirement that certain dispositions of donated property by a charitable organization within two years of the donation be reported to the Internal Revenue Service on Form 8282. Following expiration of this time period, we understand that the donee charity may sell its interest in LLC 1 to an entity owned or controlled by the promoter for a price substantially below the claimed value of the charitable contribution, after which the promoter may use the same property in another, similar transaction. It is unclear whether, at the time of the purported charitable contribution, the donee organizations agree to resell the property to the promoters at the expiration of the minimum holding period.

In one such transaction, we understand that the promoter originally purchased a remainder interest in property for less than $200,000, and arranged for the remainder interest to be owned indirectly by a single-member LLC. Shortly thereafter, the sole membership interest in the LLC was contributed to a university for a claimed value as much as seven times the purchase price. After the donee organization had held the property for the two-year-and-one-day minimum holding period to avoid reporting, an entity owned or controlled by the promoter repurchased the LLC interest for less than the original purchase price of the remainder interest.

The above-described transaction may raise a number of issues under present law. For example, if the donor in such a transaction receives or expects to receive a substantial return benefit in exchange for the contribution of the LLC interest, the contribution would be nondeductible in its entirety. Similarly, as discussed above, if the transaction were to involve a contribution of a partial interest in property as described in section 170(f)(3) of the Code, the contribution would be nondeductible. Even assuming the contribution is not entirely nondeductible, the transactions appear to involve significantly inflated valuations, raising serious questions about the claimed value of the resulting charitable deductions. The apparently inflated valuations also could result in penalties for a substantial or gross valuation overstatement. An appraiser who prepares an appraisal to support such a contribution may also be liable for penalties or become subject to disciplinary action by the Internal Revenue Service.

Furthermore, if, in connection with the transaction, the donee charity uses charitable assets for the benefit of private individuals, the donee's tax-exempt status could be at risk. For example, if the charity re-sold an LLC interest to the promoter for less than the fair value of the interest as of the time of the sale, the sale may result in impermissible private benefit in violation of section 501(c)(3). In addition, depending on the facts, certain participants in the transaction could be found to have engaged in fraud or to have aided and abetted the understatement of tax liability.

On its face, the above-described transaction raises a number of serious issues. Leaving aside the question of whether taxpayers are permitted any charitable contribution deduction, it seems clear that the catalyst for the transaction is the ability to derive a significant tax benefit through exploitation of valuation uncertainties. In other words, this appears to be yet another case of taxpayers (and established charities) taking advantage of the often subjective and hard-to-administer area of valuation.

The valuation of property for purposes of claiming a charitable contribution deduction was identified by the staff of the Joint Committee on Taxation in its January 2005 report on the tax gap, Options to Improve Tax Compliance and Reform Tax Expenditures, JSC-02-05, January 27, 2005. The JCT reported that every time an excess value of property is claimed for purposes of the charitable contribution deduction the tax gap is widened. The staff of the Joint Committee suggested eliminating the tax gap in this area by allowing taxpayers to claim no more than their basis in contributed property, with exceptions for easy-to-value property such as publicly traded securities, and property for use in charitable programs. In general, a deduction-not-to-exceed basis rule similar to this already applies for contributions of property to private foundations, and for contributions of tangible personal property not for an exempt use. If we were to apply a deduction-not-to-exceed basis rule to the above-described transactions, the opportunity for valuation abuse would be erased, as the taxpayers would be able to claim no more than what they paid for the contributed property interest, instead of claiming, as it appears they did, an amount well in excess of the purchase price.

Why should the Congress not adopt such a basis rule to close the tax gap in this area? Previously, the Congress has addressed valuation abuses on a property-by-property basis. For example, in 2004, we provided that, in general, the charitable contribution deduction for vehicles could not exceed the price for which the charity sold the vehicle. Also in 2004, we adopted a deduction-not-to-exceed basis rule for charitable contributions of intellectual property because taxpayers were claiming values greatly exceeding the property's true worth. Then, last year, we passed new rules for charitable contributions of easements, taxidermy property, and fractional giving, areas where valuation was a factor in abuse. Further, we tightened the deduction-not-to-exceed basis rule that applies for charitable contributions of tangible personal property by recapturing the fair market value-based deduction if the donee charity sells the contributed property within three years of the contribution date. In short, if valuation abuses such as those that appear to have occurred in the above-described transactions cannot easily and quickly be stopped by the IRS (for example, by listing the transaction, thus making an exempt organization that was party to it potentially subject to excise taxes under section 4965 of the Code), a legislative solution such as a deduction-not-to-exceed basis rule may well be appropriate.

I would appreciate the benefit of your thinking on this matter. To what extent is the IRS aware of the above-described transaction? How pervasive is this transaction? What steps has Treasury taken to curb this abusive transaction? With the 2003 tax year coming to a close, what is the IRS doing to protect the statute of limitations? Would Treasury support a general deduction-not-to-exceed basis rule for non-cash property? Does Treasury have any recommendations for improving compliance in this area?

Thank you for your prompt attention to this matter and I look forward to receiving your response.

Sincerely yours,

Max Baucus
Chairman

cc: The Honorable Eric Solomon, Assistant Secretary for Tax Policy
The Honorable Mark Everson, IRS Commissioner
The Honorable Don Korb, IRS Chief Counsel
Mr. Tom Barthold, Acting Chief of Staff, Joint Committee on Taxation

[1] In some cases, the remainder interest in the real property may be owned by another entity that, in turn, is owned by LLC 1. In other words, the ownership structure may involve several layers of ownership, possibly designed to conceal the identity of the beneficial owners or of the promoter.

[2] With few exceptions, a contribution of less than the donor's entire interest in property, such as a remainder interest, does not qualify for a charitable deduction. See sec. 170(f)(3). Furthermore, the ownership of property may not be divided for the purposes of avoiding this "partial interest" rule, e.g., by separating ownership of a remainder interest from ownership of a present interest to ensure that the donor's only interest at the time of a charitable contribution is the remainder interest. See Treas. Reg. 1.170A-7(a)(2)(i). In the transaction described in this letter, it is unclear how and at what point ownership of the remainder interest in the real property is separated from ownership of the other interests. If, however, ownership of the remainder interest is separated in order to effect the transaction, arguably the entire contribution of the sole membership interest in LLC 1 should be nondeductible.

[3] The Pension Protection Act of 2006 extended this time period to three years.

[4] Other penalties may apply if the promoter is an insider with respect to, or a disqualified person of, the donee charity. See secs. 501(c)(3) and 4958.