Before the Committee on Finance
United States Senate
Hon. Charles E. Grassley, Chairman

22 June 2004

Tax Abuse of Charitable Organizations

Statement of:

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Mr. Chairman and members of the Committee, I thank you for the opportunity to appear to discuss the growing problem of tax schemes and shelters involving charitable organizations. I am Jay D. Adkisson,[1] the Director of Private Client Services for Select Portfolio Management, a registered investment advisory that advises several of the largest charities in the nation. I am also the creator and editor of Quatloos.com, an internet website that warns the public about various sophisticated tax frauds and financial frauds.

Charities are meant to serve the common good. To encourage such entities, Congress has honored charities, foundations, and other public service entities with perhaps the greatest benefit that Congress is capable of bestowing: Exemption from the tax laws. And by far, the greatest number of public charities live up to the high level of societal responsibility which they exist to fulfill. Public charities facilitate critically important funding for such things as cancer research, disaster relief, infrastructure development in third-world countries, and preservation of the arts.

Yet, as moths to the flame, those whose livelihoods consist of torturing the tax code for the economic benefit of their clients and themselves are drawn to charities not because of any philanthropic reasons, but solely, only, and exclusively because of the technical tax exemption for such organizations. This tax exemption is simply too tempting for the purveyors of tax schemes and shelters to ignore, and so they have devised and will continue to devise strategies to take advantage of the exemption in ways both never contemplated by Congress and which provide the associated charities with relatively nominal benefits, if any benefits at all.

Indeed, as the Treasury Department and Internal Revenue Service continue their laudable campaign against the recent proliferation of tax shelters marketed to corporations and affluent individuals, so will the tax planners who create those schemes look to hide their strategies within the exempt ambit of charities.

CORPORATION SOLE

Tax scams are cyclical in nature. An abusive strategy that is discovered and then prohibited by a change in the law will eventually resurface after a few years in a slightly modified form. One such scam that has survived in various forms since the inception of the Internal Revenue Code has been that of converting yourself, your business, and your family into a "church" that thereafter lives, according to promoters, a perpetually tax-free existence.

The most recent incarnation of the church scam is the so-called "corporation sole". There are, actually, statutes on the books of many states that authorize a form of corporation called the "corporation sole", and it is meant to provide a limited liability form of organization for a true church organization. However, tax scam promoters are marketing the corporation sole as the ticket for the average American to make him and his business tax free. According the website of one corporation sole promoter: "Once you declare your pauper status, your income is tax-free to you and your assets cannot be encumbered with a property tax. Your earnings are also tax-free and are considered the Income of the religious organization."[2]

While the Internal Revenue Service has attempted to warn the public about the corporation sole scam,[3] it continues to proliferate, largely as the successor-in-scam to the so-called "Pure Trust". Although the IRS also put out warnings about Pure Trusts, the aggressive marketing of those entities continued well beyond the time that the IRS notified the public of the illegality of their use as tax avoidance vehicles. Only after the

Department of Justice began aggressively prosecuting the promoters of pure trusts did the fad of the pure trust scam begin to subside. The IRS should heed the lessons learned from the boom in pure trusts and request the aggressive prosecution of corporation sole promoters now before sales of the latter scam gain further momentum.

PRIVATE FOUNDATIONS

The corporation sole scam is primarily marketed to small business owners and others who typically will not spend the money for qualified tax professionals to advise them as the validity of the scheme. Yet, not far removed from the corporation sole is a form of entity that is actively marketed by highly qualified and respected tax professionals, yet which is susceptible to abuse, which is the Private Foundation.

Foundations serve an important role in America, disbursing over $27 billion in contributions, gifts and grants last year,[4] and by far the vast majority of foundations fulfill the important public purposes for which they were formed. Unfortunately, however, a seemingly increasing number of foundations are being created not to serve any public purposes, but merely as thinly-disguised tools to further the lifestyles of the wealthy persons who create them and to pass assets between generations with minimal, if any, tax consequences.

During the course of my professional practice I have run across private foundations whose activities to benefit the public were little more than annually paying for the expenses of the donors to review the reefs off the coast of Cozumel to make sure that they were still there. To the extent that these foundations made *bona fide* charitable contribution, there was often a significant *quid pro quo* that was received, such as the option to purchase choice seats at college football games. There also seems a perception among some wealth planners that private foundations are not regularly audited, and that there are only slight penalties for a client who uses a private foundation as essentially a form of family trust.

That private foundations are marketed as wealth accumulation and estate planning tools emphasizes that many, if not the majority of, donors consider the assets of the foundation to continue to be family assets even after the donation is made. Thus, private foundations are sometimes marketed as a "get your donation now, and let your children live off the management fees forever after" sort of arrangement. Yet, as Congress and the IRS continue to restrict the inurement of personal benefits for those managing private foundations, so will such persons look for creative ways to transfer wealth out of the foundation, or as wealth planners sometimes say, "rescue" the wealth from the purposes for which it was intended. As great wealth continues to accumulate in private foundations, it should be anticipated that "rescue" strategies will begin to appear whereby strategies are developed to repatriate significant portions of certain foundation's wealth back into the family unit. Thus, it can be anticipated that the future abuses of private foundations will not be as much with the original donation, as it will be with sophisticated transactions designed to repatriate the wealth held and grown with the private foundation back to direct family ownership and control.

FOREIGN FOUNDATIONS

Such "rescue" strategies have historically being implemented through the use of foreign foundations and charities. Various offshore tax promoters have been shameless in their marketing of foreign foundations as tax shelters. In 1997, at the Shorex Exhibition held in London, I had the occasion to see a presentation by Mr. Marc Harris, a former

CPA and American expatriate whose firm, the Harris Organization, was promoting to U.S. persons the uses of Panamanian Foundations as the centerpiece of blatant offshore tax evasion schemes. A year later, I attended a seminar in Nassau where Mr. Harris made the pitch to approximately 200 affluent Americans. Although Mr. Harris was recently extradited to the United States and is serving a fourteen year sentence for his participation in a freon smuggling scheme, to the best of my knowledge none of Mr. Harris' clients have ever been prosecuted for the use of his structure. Indeed, even today numerous offshore promoters pitch the use of foreign foundations to U.S. persons as vehicle for tax evasion, with such foundations being funded by contribution of the participating U.S. person's domestic foundation.

Of significant concern must be the interplay between domestic private foundations and foreign foundations and charities, and their potential to act as money laundering conduits. Once money has passed outside the U.S. banking system, it is difficult to track especially if the foreign foundation or charity is domiciled in an offshore jurisdiction or one with weak regulatory controls. Over the years, I have personally seen schemes where payments ostensibly made to a foreign charity were quickly funneled back into the control of the original donor for investment purposes. It is not difficult to image schemes where the payments are funneled not back to the original donor, but instead to those with more malicious purposes than mere evasion of the tax laws.

It is therefore suggested that gifts, contributions, and grants made by a domestic private foundation in the U.S. be limited either to purposes and organizations within the U.S., thus allowing the U.S. public which has helped to shoulder the burden of the original deduction to share in the benefits, or to such foreign charities which have established their bona fides by registering here.

<u>PARKING TAX-PRODUCING ASSETS</u>

Further up the hierarchy of abusive charitable schemes are those which generate artificial losses, absorb income, or effectively "park" assets for a period of time in anticipation that the assets will be repurchased at a later time. With such schemes the charitable benefits are nominal compared to the taxes saved by the donors, and, it is with such schemes that the recent abuses have been the greatest.

Among the first of these schemes were Charitable Family Limited Partnerships, which was marketed by a variety of tax law firms in the late 1990s. This involves the contribution of an illiquid asset is made to a charity, giving the donor a large deduction for the gift, then after a number of years the charity re-sells the asset back to either the original donor, or better yet a trust formed for the donor's children, at a substantial discount. That the charity would resell the asset back to the original donor, or the original owner's designee, was a foregone conclusion since only that was the only way that the charity could realize significant cash for the assets. From the donor's viewpoint, the effect of the arrangement was that basically the donor had a call option on the asset and could directly or indirectly redeem it at any time.

The concept of donating an asset to a charity in anticipation of the donor purchasing the same asset from the charity at a substantial discount some years later proved to be too tempting for giant accounting firm KPMG, which by the late 1990s had shamelessly sold its ethical soul in exchange for the quick bucks to be made selling complex tax shelters. But the arrangement that KPMG devised would not be limited to merely taking a large donation up front and getting the same asset back at fraction of its value later. Indeed, KPMG often told the targets of its promotion that they might be better not taking the initial charitable gift deduction at all, for that might increase the odds of the transaction being audited and the real prize discovered: The avoidance of potentially tens of millions of dollars of income taxes which otherwise would have been paid to the owners of S-Corporations.

Broken down into its basic components, the KPMG shelter was relatively simple. The owners of the S-Corporation would issue a second series of stock to the owners, which would then be donated by the owners to a cooperative charity. The S-Corporation would then attribute a significant portion of the income taxes it was generating to the stock held by the charity. The shelter was designed so that the charity would receive little if any cash distributions while it held the S-Corporation stock. After a few years, the owners of the S-Corporation would repurchase the S-Corporation stock back from the charity, either at the then fair market value or at a discount. Only at that time would the charity receive any significant cash benefits, although these benefits were substantially outweighed by the income taxes saved by the S-corporation owners.

Although the hard dollar benefits received by the complicit charities are almost trivial compared to the taxes saved by the donors involved in the schemes, the charities have almost no incentive not to participate since they historically have little risk of realizing any adverse tax consequences. If the donor in these schemes is able to attribute, for example, $10 million of phantom income to the charity, and the charity receives $100,000 in cash, from the charity's viewpoint it is only concerned with the $100,000 in cash, since of course the tax exempt status of the charity means that it will not be paying taxes on the $10 million of phantom income anyway. There is thus little more downside for the involved charities than the reputational risk of being caught in a tax shelter. Yet, the promoters of these schemes mitigate the reputational risk as well, by providing lengthy, detailed, and convoluted letters that opine that these arrangements are "more likely than not" to pass tax court muster.

THE PROBLEM OF OPINION LETTERS

With mention of the opinion letters of the promoters, we have thus arrived at one of the common denominators for tax shelters. It is said that a tax shelter can be defined as a transaction that no financially savvy person would enter into but for the tax benefits. But it can also be defined as transaction that no client would participate in if he or she was not protected from penalties by the opinion letter arranged by the promoter. Indeed, the role of the opinion letter is central to the transaction. The existence of the opinion letter suggests to the client that the transaction, while offhand the transaction sounds bogus, may actually have substance within the convoluted and often indecipherable mess that is the tax code. The existence of the opinion letter allays the fears and concerns of otherwise skeptical outside advisors. And in the end, the opinion letter allows the client to gamble the non-payment of tax consequences against today's historically low audit rates.

While the investigations of promoters and the acquisition of their client lists by subpoena helps to rebalance this equation back in favor of common sense and compliance, such is only a temporary fix insofar as new and less visible promoters will pick up the cudgel and hope that the limited manpower of the federal and state taxing agencies will concentrate on the bigger fish.

The solution is to attack one at the roots of the sources of the tax shelter problem, by requiring the contemporaneous filing of tax opinion letters as a prerequisite to penalty avoidance. Whether or not the tax authorities ever review the letters, the mere filing of the letters tells potential customers that they will be alerting the authorities to the shelter at the outset, just as the laws requiring the registration of shelters now require. If the opinion letters are filed in electronic format, allowing them to be searched *en masse* by reviewers looking for key phrases, there would be tremendous concern on behalf of promoters and their customers that if a new shelter was discovered that all the opinion letters referencing that transaction would be immediately tagged for review. Also, the cost of requiring the contemporaneous filing of opinion letters would be nominal, especially in regard to the potential benefits of chilling tax shelter sales.

VALUATIONAL GAMES AND CHARITIES

The filing of opinion letters will not, however, address another significant area of abuse in regard to charities, which is the contribution of intellectual property and complex financial derivative products. Although as to intellectual property these issues were significantly addressed in Revenue Ruling 58-260, the temptation to play valuation games will simply be too great for tax planners to ignore. Yet, it is easy to envision a scheme where intellectual property or complex financial derivative products are temporarily "parked" with a cooperating charity, giving the original donor a large initial deduction, perhaps allowing the charity to absorb some income or capital gains taxes while parked, and then after the limitations period has run on the original donation the charity will re-sell the soft asset either back to the original donor or as directed by the original donor to a trust so as to avoid estate taxes, etc.

A restriction should be imposed that limits the overall tax benefits received by the donors to the true hard-dollar value received by the charity. Thus, if a scheme or shelter arrangement were to give the donor $10 million in tax benefits while the charity itself benefits only to the extent of $1 million, the donor would not be able to take advantage of the tax benefits of the transaction beyond the $1 million benefit actually received by the charity.

CONCLUSION

In conclusion, the favorable tax benefits given to charitable organizations and foundations will continue to be abused by those economically motivated to press the legal envelope of the tax code in the hopes of creating phantom deductions and avoiding taxes in amount far exceeding the value of the benefits received by the involved charity. Congress must maintain its vigil for abuses that are particular to these entities, such as those involving private inurement, and take action now against practices common to all tax shelters, such as requiring the filing of opinion letters, so that the reputation of charitable organizations and foundations as organizations which serve the public good and nothing more, remains unstained.

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[1] The author thanks Carin Amaradio, Tony Amaradio and Ed Stone for their assistance in preparing this submission.

[2] http://www.the7thfire.com/debt_elimination/corporation_sole_FAQ.htm

[3] IR-2004-42, March 29, 2004.

[4] IR-2004-9, January 14, 2004.