

IRS APPLIES ECONOMIC SUBSTANCE DOCTRINE TO DISALLOW CHARITABLE LLC TAX BENEFITS

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In the recently released Field Service Advice 20260401F, the Internal Revenue Service concluded that the transfer of a non-voting interest in an investment limited liability company to a tax-exempt public charity should be disregarded for federal income tax purposes because it lacked economic substance. As a result, the IRS further concluded that taxpayer should be taxed on the LLC income allocated to the charity under the assignment of income doctrine and disallowed the taxpayer's charitable contribution deduction due to lack of donative intent and substantiation failures.

Factual Background

In the FSA, the taxpayer capitalized an investment LLC in exchange for voting and non-voting interests. The taxpayer managed and controlled the LLC's investment accounts and operations. The taxpayer transferred the nonvoting interest to an Internal Revenue Code Section 501(c)(3) public charity (the Charity) and claimed a charitable contribution deduction equal to the appraised fair market value of the non-voting, non-managing interest.

The LLC operating agreement allocated a high percentage of items of income, gain and loss to the Charity, allowing a significant portion of the investment income to pass through to the Charity tax-free. Despite the requirement to make annual distributions, the taxpayer never authorized a distribution to the Charity. Furthermore, the Charity had no independent right to receive any LLC investment income without the taxpayer's consent, had no right to participate in management and couldn't transfer its non-voting interest without the taxpayer's consent except in limited circumstances.

In addition, the taxpayer withdrew funds from the LLC brokerage account for personal use. Subsequently, the LLC operating agreement was amended to authorize the manager (that is, the taxpayer) to make secured loans to qualified borrowers. The withdrawals were then "papered as loans" with a loan agreement despite no evidence that the loans were secured in any way.

The taxpayer and his wife claimed a charitable contribution deduction for the transfer of the non-voting interest. The officer of Charity signed a Donee Acknowledgement, but the taxpayer didn't attach a qualified appraisal for the value of the transferred interest or a contemporaneous written acknowledgement of the contribution to their joint tax return.

Economic Substance Doctrine

Under IRC Section 7701, a transaction is treated as having economic substance if: (1) the transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position (objective test); and (2) the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction (subjective test).

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The IRS determined that the transaction failed the objective test because the taxpayer retained control of all of the LLC assets and remained in the same economic position with respect to the LLC assets after the purported charitable contribution. In addition, the Charity was in the same position as to the LLC assets before and after the purported contribution because it held no enforceable right to them.

With regard to the subjective test, the IRS concluded that the transaction had no purpose other than tax savings. It noted that the taxpayer obtained a charitable contribution deduction and avoided federal income tax during the life of the LLC while maintaining complete control over the LLC assets and unfettered use of the LLC assets through personal withdrawals.

Bona Fide Partner Status Rejected

The U.S. Supreme Court held in *Culbertson v. Commissioner*, 337 U.S. 733 (1949), that whether a partnership interest in form should be respected as a partnership interest in substance depends on whether the parties, in good faith and acting with business purpose, intended to join together in the present conduct of the enterprise. Citing this holding, the FSA states that the key inquiry is whether the purported partner had a meaningful stake in the success or failure of the enterprise.

Applying *Culbertson* to facts of the FSA, the IRS concluded that the Charity was a partner in name only because it:

- Didn't share in the upside potential of the LLC because the taxpayer failed to make mandatory distributions as required by the LLC operating agreement.
- Didn't share in the downside risk of the LLC because it didn't pay for its LLC interest, nor did it or was it obligated to make any cash outlays to fund the LLC.
- Couldn't realize any value associated with its LLC interest because: (1) it couldn't realistically sell its interest due to strict transfer restrictions and complete lack of control of the LLC operations or assets attributable to the interest; and (2) the taxpayer possessed absolute discretion in all decisions, including how to calculate distributions and how LLC assets should be used.

Further, the FSA noted that the Treasury regulations under IRC Section 704(e) provide that if the donor of a partnership interest has retained control of the interest that the donor has purported to transfer to the donee, then the donor should be treated as remaining the substantial owner of the interest. On the basis of *Culbertson* and the Treasury regulations, the FSA concluded that the Charity wasn't a partner in the LLC and that all income, loss, deductions, capital accounts and credits from the LLC should be allocated to the taxpayer.

Assignment of Income Doctrine

The assignment of income doctrine states that income should be taxed to the person who earns it and that a person anticipating the receipt of income "cannot avoid taxation by entering into a contractual arrangement whereby that income is diverted to some other person." Because the taxpayer never parted with dominion and control over the LLC assets and only assigned the LLC income for purposes of Form 1065, the IRS concluded that the income from the LLC assets should be treated as 100% taxable to the taxpayer under this doctrine.

Charitable Contribution Deduction Disallowed

Based on the facts of the FSA, the IRS disallowed the taxpayer's charitable contribution deduction for two reasons: (1) there was no charitable intent (it wasn't a transfer "made with no expectation of a financial return"); and (2) the taxpayer failed to attach a contemporaneous written acknowledgement of the contribution and qualified appraisal to his joint tax return.