

Beware the Charitable LLC

Take-Away: The IRS is now getting wise to, and successfully attacking, a tax planning strategy known as the charitable LLC.

Background: Some aggressive promoters in recent years have pushed the strategy to create substantial income tax deductions using what is called a 'charitable LLC.' This charitable LLC 'tax planning' strategy is on the IRS's radar. Back in 2024 the IRS issued press release on charitable LLCs in which it noted: *"The IRS is currently using a variety of compliance tools to combat abusive donations, including thorough audits of tax returns and civil penalty investigations. The IRS has seen hundreds of tax returns filed using this abusive charitable contribution scheme."*

Charitable LLC: The IRS has described a charitable LLC as follows. *"In the 'Charitable LLCs' scheme, promoters create documents establishing the LLC for a fee. They then assist in the transfer of the taxpayer's assets to the LLC and create documents that purport to transfer membership units in the LLC to a charity. The promoter might supply an appraisal supporting the value of the claimed gift and might even provide a list of charities willing to accept membership units or identify a single charity that will accept the donation."* To induce the donor to adopt the charitable LLC strategy, the promoter will then promise that the donor can retain control and legally access the assets transferred to the LLC for his or her own personal use after their donation.

Example: Lucy and Charlie have a profitable business run as an LLC, which is taxed as a partnership. Each member owns 50% of the LLC units. The LLC owns life insurance policies on the lives of Lucy and Charlie. Lucy and Charlie agree to transfer 30% of the LLC's units to a 501(c)(3) charity that they formed, called Schroder Conservancy, or simply the Conservancy. Lucy and Charlie each transfer 15% of their respective LLC units to the Conservancy. Lucy and Charlie claim an immediate income tax deduction for the 30% value of their LLC. The Conservancy pays no income tax on 30% of the profits generated by the LLC. Lucy and Charlie, as controlling LLC members, decide that a portion of the LLC's profit that is allocated to the Conservancy should be used to purchase the life insurance policies that the LLC owns on their respective lives. Accordingly, the profit that is allocated to the Conservancy which was never taxed will now be used by the Conservancy to purchase the two life insurance policies. In short, the insurance premiums will be paid,

going forward, with pretax dollars. At a later date, when Lucy and Charlie near retirement, they exercise their right to buy-back the LLC units owned by the Conservancy, at a substantial valuation discount for the minority interest owned by the Conservancy, and when the LLC is dissolved Lucy and Charlie will each own a substantial cash surrender value life insurance policy on his/her own life, paid for over the years using pretax dollars.

Chief Counsel Advice: Last month the IRS released Chief Counsel Advice Memorandum 20260401F that addressed a charitable LLC strategy, and in it explained why the donor's claimed charitable income and gift tax deduction to a donor advised fund was disallowed. [<https://www.irs-lafa/20260401f.pdf>.] Basically, the donor set up an LLC and on the same day he also transferred nonvoting interests in the LLC to a donor advised fund. The following calendar year the donor opened a brokerage account in the name of the LLC, over which he retained authority to manage its investments and control other LLC activities. The donor then transferred marketable securities to that brokerage account and made additional transfers to that account in the next year. After each of those transfers to the LLC the donor claimed charitable income tax deductions. Because the donor advised fund only held nonvoting LLC interests, the IRS found the donor remained in control of the LLC, and therefore his gift to the donor advised fund lacked economic substance and consequently the donor's charitable deductions were denied.

Conclusion: Promoted tax planning 'strategies' often fall into the 'too good to be true' category. With the IRS on the lookout for the use of Charitable LLCs, it would be wise to stay clear of them.

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