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IRS Curbs Tax Abuse by Charity Support Groups

In 2004, the IRS began investigating supporting organizations that obscure philanthropies created to support specific charities. Arising from this investigation, the IRS has recently revoked the tax-exempt status of 72 of these groups. The revocations were disclosed this month in a meeting with tax advisors to non-profit groups in Baltimore.

Back in 2005, the then IRS Commissioner, Mark W. Everson put such entities on a list known as the Dirty Dozen of the worst tax swindlers. A former staff lawyer for the Senate Finance Committee, Dean A. Zerbe, now a tax consultant wrote legislation in 2006 to make supporting organizations more accountable.

Congress ordered that regulations governing supporting organizations in the 2006 Pension Protection Act be revised. This effectively brought in the rules that govern private foundations to prevent private benefit. A major provision of the Pension Protection Act requires the Treasury Department to establish a mandatory payout rate to ensure they are giving money to charity.

One of the tax abuse methods used was to create supporting organizations as tools in dubious financial planning programs where donors would receive tax deductions for their charitable giving, only to be reimbursed by the support organizations in the forms of interest-free loans or offshore investments.

Besides the 72 support groups, another 30 supporting groups examined by the IRS agreed to end their business in audits. 59 more groups were reclassified as charities or private foundations, which brought them under more stringent reporting and granting requirements.

Although it is not the policy of the IRS to discuss details of specific organizations, the agency does release a list of non-profit organizations that have lost their tax exempt status because of revocation.

According to Lois G. Lerner, the director of the exempt organizations division of the IRS, the supporting groups that were investigated were by and large those who were linked to promoters that were identified by other IRS divisions.

For example, some of the supporting groups that have lost their tax exempt status of late were those linked with Merrill Scott & Associates Ltd. The Utah-based company is under receivership after a Securities and Exchange Commission investigation claimed that it was operating an illegal pyramid scheme. One of such supporting groups was HFZ Charitable Supporting Organization of Santa Barbara, California.

Lerner said the most common abuse were cases where promoters set up supporting organizations on behalf of their clients who made charitable donations. The client would claim a tax deduction for the money they donated to the organization. Then, through a series of promoter-controlled transactions — some involving offshore activity — the "donation" would be returned to the client or a relative, often in the form of a no-interest loan.