Allen v. Commissioner, 92 T. C. 1 (1989)

A charitable contribution deduction is not allowed for borrowed funds that are part of a circular flow of money among related entities, as the charity does not receive a genuine benefit.

Summary

In Allen v. Commissioner, the Tax Court ruled that a taxpayer could not deduct the borrowed portion of a charitable contribution where the funds originated from the charity itself and were part of a circular flow among related entities. The taxpayer, Kenneth Allen, contributed $25,000 to the National Institute for Business Achievement (NIBA), with $2,500 from his own funds and $22,500 borrowed from a related for-profit entity, National Diversified Funding Corporation (NDFC). The court held that only the $2,500 was deductible, as the borrowed portion did not constitute a genuine contribution to NIBA. The decision underscores the importance of examining the substance of charitable contribution transactions, particularly when involving complex financing arrangements.

Facts

Kenneth Allen contributed $25,000 to NIBA, a tax-exempt organization under section 501(c)(3). The contribution comprised $2,500 of his own funds and $22,500 borrowed from NDFC. NDFC was a for-profit entity related to NIBA, and the loan was unsecured with a 3% interest rate, significantly below market rates. Unbeknownst to Allen, the funds he borrowed were part of a circular flow originating from NIBA, passing through related entities, and returning to NIBA as contributions. Allen intended to donate the funds to further NIBA's charitable goals and was current on his interest payments to NDFC.

Procedural History

The Commissioner of Internal Revenue issued a statutory notice of deficiency to Allen, disallowing the $22,500 borrowed portion of the contribution and asserting a negligence addition. Allen petitioned the Tax Court, which heard the case and ruled that only the $2,500 from Allen's own funds was deductible as a charitable contribution.

Issue(s)

1. Whether the $22,500 borrowed from NDFC and contributed to NIBA is deductible as a charitable contribution under section 170.
2. Whether Allen is liable for the negligence addition under section 6653(a).

Holding

1. No, because the borrowed portion of the contribution was part of a circular flow

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of funds among related entities, and NIBA did not receive a genuine benefit from the transaction.
2. Yes, because the circumstances of the contribution should have put Allen on notice that the deduction could be disallowed, warranting the negligence addition.

Court's Reasoning

The court applied the substance-over-form doctrine, as articulated in Gregory v. Helvering, to determine that the borrowed portion of the contribution did not constitute a genuine payment to NIBA. The court noted that the funds were recycled through a "money circle" involving NIBA, International Business Network (IBN), and NDFC, with no new infusion of cash. The court emphasized that NIBA was not enriched by the contribution program, as it relied on IBN's repayment of loans funded by membership dues. The court also considered the below-market interest rate and the lack of security for the loan as factors indicating the transaction's lack of economic substance. The court concluded that the $2,500 from Allen's own funds was deductible, as it was an unconditional donation to a qualified donee. The court further held that the negligence addition was warranted, as the circumstances of the transaction should have alerted Allen to potential issues with the deduction.

Practical Implications

This decision has significant implications for taxpayers and tax professionals involved in charitable contribution planning, particularly when using borrowed funds. It highlights the need to examine the substance of such transactions, especially when involving related entities and below-market financing. Practitioners should advise clients to be cautious of complex contribution arrangements that may be subject to scrutiny under the substance-over-form doctrine. The decision may also impact the structuring of charitable contribution programs by organizations, as they must ensure that contributions provide a genuine benefit to the charity. Subsequent cases have cited Allen v. Commissioner when addressing the deductibility of borrowed funds in charitable contributions, reinforcing the principle that the charity must receive a real economic benefit for a deduction to be allowed.

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