



Jack Straw Fortnightly*

unforced

It took a very long while, but IRS has finally woken up to the idea that they really ought not to be giving cover to an arrangement in which a private foundation is given a nonvoting interest in a limited liability company that holds a promissory note from a disqualified person.

The agency made this announcement a few weeks ago in [Rev. Proc. 2021-40](#), saying they had determined "it is in the interest of sound tax administration not to issue rulings on such transactions while it reviews their proper tax treatment." [1]

Sounds almost like section 5 of [the annual "no rule" rev. proc.](#), which lists "areas in which the Service is temporarily not issuing rulings or determination letters because those matters are under study."

But for the most part those are questions on which there is a formal guidance project under way or at least contemplated. Not the case here, apparently.

The present rev. proc. says it is instead **amplifying section 3**, "areas in which rulings or determination letters will not be issued," period.

At least until IRS has completed its "review."

Any ruling request pending on September 03, the date the rev. proc. was released, will be closed and the user fee returned. Jack suggests it is an open question whether any letter rulings that have already been issued might be withdrawn, or what the consequence to the affected taxpayers might be.

but why now

Jack is always curious to know what was the final straw, but we may never learn.

There have been at least nine letter rulings approving this arrangement, sometimes in pairs, dating back to at least 2006. [2] The most recent was PLR 202101002, issued almost a year ago and released in January of this year.

The scenario was typical. Mom and dad sell something or other to an intentionally defective grantor trust in exchange for a promissory note. Your generic estate "freeze," in other words. The ultimate beneficiaries of the IDGT are the transferors' descendants.

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What exactly they are selling and what are the terms of the note are not disclosed in this particular ruling. Typically we are talking about equity in a closely held business, and often the note pays interest only, at or slightly over the applicable federal rate, with a balloon payment at the close of a stated term.

At the death of the surviving spouse, unless some other planning is undertaken, the promissory note is to be distributed to a private foundation. Since more than thirty-five pct. of the beneficial interests in the IDGT would be held by her descendants, this extension of credit and any payments on the note would be self-dealing transactions, on which the IDGT would incur first tier excise taxes of ten pct. of the "amount involved," and possibly second tier taxes of two hundred pct. if the transactions were not immediately unwound.

Also first tier excise taxes of five pct. on foundation managers who knowingly participated in the transactions, escalating to fifty pct. second tier, capped at \$20k. The text of the ruling does not indicate who are the foundation managers, but these would often be the same descendants who are beneficiaries of the IDGT.

sleight of hand

The workaround proposed is to create a limited liability company to hold the note, and to distribute only nonvoting interests in the LLC to the foundation, either during the transferors' lives or at the death of the survivor. Who would end up holding the voting interests is not

stated, but presumably again the transferors' descendants, who are beneficiaries of the IDGT which is the obligor on the note.

And the requested ruling is that this arrangement would not constitute even "indirect" self dealing between the foundation and disqualified persons.

There is a certain amount of handwaving in the recitation of facts about how the managers of the LLC would have fiduciary responsibilities to enforce the note, but the key point for purposes of this letter ruling, and the eight or so other rulings IRS is apparently now coming to regret, is that the foundation itself would have **no ability to compel enforcement.**

Jack wants the reader to understand that this is supposed to be a feature, not a bug. The fact that the foundation would not "control" the LLC, at least not under a literal reading of the applicable reg, [3] means that it is not engaging even indirectly in extending credit to disqualified persons.

Technically. It is merely the holder of a nonvoting interest in what we might call a **"blocker" entity**
--

in each of these rulings, an entity managed by disqualified persons, some or all of whom are themselves, directly or indirectly, obligors on the note,

in each of these rulings, an entity that holds no other assets and engages in no active business, income entirely passive,

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-- which again is supposed to be a feature, not a bug, because it means we do not have an [excess business holdings](#) problem.

We need not evoke Jack to say, obviously there is no economic substance to the LLC.

All of these ruling requests should have been denied under the standing principle, section 3.02(1) of the annual "no rule" rev. proc., that IRS will not give an advance determination on the question "whether the economic substance doctrine is relevant to any transaction or whether any transaction complies with the requirements of [section 7701\(o\)](#)." [4]

and another thing

Each of these rulings includes the standard disclaimer that it is issued only to the taxpayer who requested it, and that per [section 6110\(k\)\(3\)](#) others may not rely on it.

So you might suppose each was requested by an obligor on the promissory note and/or by a foundation manager. Someone in other words who would be liable for an excise tax if the transaction were characterized as self-dealing. The trustees of the IDGT for example.

But in almost every case the ruling was instead requested by the holder of the note, who proposed to transfer it, either *inter vivos* or at death, to a lead trust or to a private foundation, albeit wrapped in a shell. And/or by the lead trust or foundation itself, not by foundations managers individually.

So none of these rulings actually

protects anyone who would require protection.

further context

The [Holland & Knight blog post](#) mentioned in footnote 1 situates this discussion in the context of the so-called "estate administration" exception, [reg. section 53.4941\(d\)-1\(b\)\(3\)](#), which allows a disqualified person to purchase assets from a decedent's probate estate or revocable trust that would otherwise be distributed to a private foundation, provided

(i) the executor or trustee has a power of sale or discretion to make non-pro rata allocations, **or is required to sell** to the holder of an option, [5]

(ii) the transaction is **approved by the probate court** or another court that has jurisdiction over the subject matter and the parties,

(iii) the transaction is completed **before the estate is closed**, or before the trust becomes subject to [section 4947](#),

(iv) the foundation receives **at least fair market value** for the property, "taking into account the terms of any option," **and** (conjunctive)

(v) the interest or expectancy the foundation receives is **"at least as liquid"** as what it gives up.

The authors of the blog post point out that this mechanism can be cumbersome, particularly the requirement to determine fair market value. [6]

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But it also bears noting that since at least January 2015 IRS [has refused to give](#) letter rulings on whether a transaction meets the "estate administration" exception "in cases in cases in which a disqualified person issues a promissory note in exchange for property of an estate or trust." [7]

This despite the fact that [reg. section 53.4941\(d\)-2\(c\)\(1\)](#) expressly exempts from the characterization of a lending transaction as self-dealing a transaction that meets the requirements of the "estate administration" exception. [8]

You can do it, in other words, but you are on your own. Facts and circumstances, etc. best determined after the fact, on examination.

only by aggregating

We also want to just mention briefly [Rev. Rul. 76-158](#), which is cited to no particular effect in one pair of these letter rulings, [9] though clearly it has no direct application where the foundation is holding only nonvoting interests.

But the ruling is instructive on the question what constitutes "control" under [reg. section 53.4941\(d\)-1\(b\)\(5\)](#). As the garbled letter ruling cited in footnote 3 indicates, the definition can be, or at least can seem, confusing.

The revenue ruling proposes a scenario in which a private foundation holds 35 pct. of the voting stock of a corporation, and a foundation manager happens to hold the other 65 pct., **not because** she is a foundation manager, but just because. [10]

In this scenario, says the ruling, the foundation does not "control" the corporation, within the meaning of the reg, because

(a) on the one hand, although it could, by aggregating its votes with those of the foundation manager, compel the corporation to engage in a transaction that would be self-dealing transaction, those votes are not held by the foundation manager **in her capacity as such**, while

(b) on the other hand, the 65 pct. holder **need not aggregate** her votes with those held by the foundation in order to compel the corporation, etc. [11]

Jack suggests that while IRS is reviewing whether a foundation holding units in an LLC that holds a promissory note from a disqualified person is self-dealing, they might also review the revenue ruling and the reg itself, which seem not to have anticipated these maneuvers.

gee six sub two

Oral argument has been set in each of two appeals we have been tracking from Tax Court decisions upholding the validity of [reg. section 1.170A-14\(g\)\(6\)\(ii\)](#), which requires

that the donee of a conservation or facade easement be entitled to receive, in the event the easement is later extinguished, proceeds at least equal to the "proportionate value" of the restriction as a component of the value of the entire property, without reduction for the value of any post-contribution "improvements."

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The appeal in [Oakbrook Land Holdings](#) is set for argument before the 6th Circuit federal appeals court on October 27, and the appeal in [Hewitt](#) is set for argument before the 11th Circuit on November 16.

We posted copies of the briefing in both these cases to [the Jack Straw](#)

[landing page](#) back in July, alongside [issue four comma five](#), including amicus briefs filed by a couple of regional land trusts who have been using "improvements" clauses in their specimen deeds for years.

Watch this space.

crumbs

[1]

Alert readers may already have read [an excellent analysis](#) posted by lawyers at Holland & Knight to the firm's blog page a few days after the rev. proc. was issued.

[2]

Completists are referred to

a. [PLR 200635017](#), which involved a plan to fund several testamentary charitable lead annuity trusts with nonvoting interests in LLCs holding promissory notes from disqualified persons,

b. [PLRs 201407021 and 023](#), companion rulings issued to the transferor and to her existing private foundation, involving a plan to distribute from her estate at death to the foundation nonvoting interests in what was at the moment a single member LLC, holding a note from the transferor's daughter,

[Who would be the voting and/or managing members of the LLC after the transferor's death was not indicated. Both these rulings referenced [Rev. Rul. 76-158](#), discussed in the main text.]

c. [PLR 201446024](#), issued to a decedent's executor, who proposed to transfer a promissory note from an IDGT to a newly created LLC and to distribute nonvoting interests to a private foundation,

[This is the only instance among these rulings of post-mortem planning.]

d. [PLRs 201723005 and 006](#), companion rulings issued to the transferor and to her existing private foundation, involving a plan to distribute from her estate at death to the foundation nonvoting interests in what was at the moment a single member LLC owned by her revocable trust, albeit with her son as a nonmember manager, holding a note from an IDGT,

e. [PLR 201907004](#), which involved a plan to fund an inter vivos charitable lead annuity trust with nonvoting interests in an LLC holding promissory notes from several IDGTs,

f. [PLR 202037009](#), involving the distribution from a decedent's estate of nonvoting interests in an LLC holding a promissory note to

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what appears to be an inter vivos charitable lead unitrust trust, and

g. [PLR 202101002](#), discussed at length in the main text.

[3]

See [PLR 201510050](#), involving a rather different scenario, the details of which are sufficiently complicated that a recitation here would distract from our present focus. Notable here because (a) the analysis rather grievously misstates the provisions of [reg. section 53.4941\(d\)-1\(b\)\(5\)](#) concerning "control," and (b) there is a reference to [Rev. Rul. 76-158](#), see text accompanying footnote 7.

But the reader may object that there is nothing merely "literal" or "technical" about a reading of the reg that says a foundation holding only nonvoting interests cannot "control" the entity.

To which Jack would respond that even a nonvoting member has enforceable rights against a manager who fails to enforce the note. Or what is all the handwaving about the managing members having fiduciary responsibilities.

[4]

Prior to 2012, this criterion had been framed in terms of the transaction "lack[ing] a *bona fide* business purpose." It was not until 2010 that the economic substance doctrine was formalized in [section 7701\(o\)](#) in its "conjunctive" form as part of a [budget reconciliation measure](#) accompanying the enactment of Obamacare.

We will forgo a detailed discussion of the controversies surrounding that enactment. Suffice it to say that different courts, following the 1935 decision of the Supreme Court in [Gregory v. Helvering](#), had developed the doctrine in "conjunctive" and "disjunctive" forms, *i.e.*,

a meaningful change in the taxpayer's economic position "and" versus "or" a substantial nontax purpose, the latter prong being of course subjective, and there were proponents for each of these views, as well as for the view that the doctrine should not be legislated at all, but left to the courts.

[5]

The estate administration exception and an option in the hands of disqualified persons to purchase the notes and/or the nonvoting units were features in [PLR 200635017](#), item a. in footnote 1 above.

[6]

Or to actually pay fair market value, remarks Jack. noting that even with ostensible oversight by the probate court, there are [opportunities for abuse](#) here.

[7]

EO Technical [had already said](#) it would not issue rulings on this question back in 2011.

[8]

Jack suggests it might be difficult to meet the liquidity requirement with anything other than a demand note.

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[9]

PLRs [201407021](#) and [023](#), item b. in footnote 1 above.

[10]

The point maybe being to make her a disqualified person with respect to the foundation, though why not just say so. In the typical case she will be a disqualified person because she is, or is related to, a substantial contributor.

[11]

Where the author of [PLR 201510050](#), mentioned in footnote 3 above, goes wrong is in supposing that the reg applies only to situations in which the disqualified person is disqualified because of her status as a foundation manager.

Again without getting into the details, in the scenario presented in

that ruling, each of two private foundations held slightly less than half the voting interests in a partnership, in which the remaining votes were held by two disqualified persons.

Either foundation could have "controlled" the partnership by aggregating its votes with the other, but either could also have "controlled" the partnership by aggregating its votes with both disqualified persons.

The two disqualified persons acting together could have "controlled" the partnership only by aggregating their votes with those of one or the other foundation.

The text of the ruling mistakenly focuses on the fact that the two individuals did not hold their voting interests by virtue of their status as foundation managers.

Jack says, take what you have gathered from coincidence

<https://twitter.com/rawillis3/status/1444003210826432512>