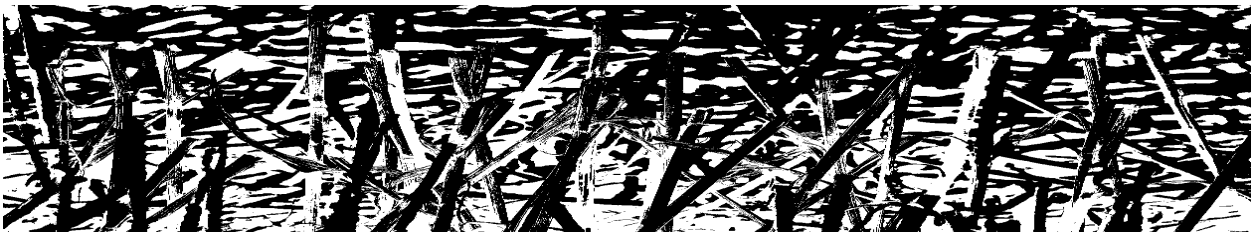

Jack Straw Fortnightly*

thematic

Briefing is underway in the appeal from an order of a federal district court in California dismissing the complaint of a contributor to a donor advised fund at Schwab Charitable, seeking declaratory and injunctive relief on behalf of a putative class.

The complaint alleges that the fund sponsor has been investing these accounts in mutual funds with higher administrative fees and lower returns than they might have, with the "parent" brokerage reaping profits.

We discussed the *Pinkert* case briefly in Jack Straw four comma six, by way of posting the briefs to the Jack Straw landing page, alongside a copy of the district's court order. [1] The central issue is whether the plaintiff has standing to pursue these claims.

Lurking behind that question, as we discussed in Jack Straw three comma three in connection with *Fairbairn*, is the question whether the continuing donor control standing would imply might make the gift incomplete, so that the contribution deduction might be disallowed.

The appellant's opening brief was filed October 12, and the respondent's brief was extended to December 13. The appellant's reply brief has been extended to February 02. Oral argument has not yet been scheduled.

back to school

IRS has nonacquiesced in the recent decision of the 8th Circuit federal appeals court in *Mayo Clinic*, 997 F.3d 789 (8th Cir. 2021), invalidating that portion of reg. section 1.170A-9(c)(1) that excludes from the definition of "educational organization" an entity that also engages in noneducational activities unless these are "merely incidental" to the "primary" activity of "present[ing] formal instruction," etc.

Why this mattered was that in addition to operating its graduate research university, the Clinic also manages investments for its various subsidiaries, which generate very large amounts of debt-financed income. As in, over the eight years in question, amounts on which the tax would be $11.5 million.

This would be unrelated business taxable income per section 514(c) unless the Clinic falls within an

exception at (c)(9)(C)(i) for "an organization described in section 170(b)(1)(A)(ii)," *i.e.*, an "educational organization" which

> normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.

The Clinic obviously does meet that definition, but as noted, the controverted reg requires further that any "noneducational" activities be "merely incidental," etc.

The Clinic paid the tax under protest and brought a refund claim in federal district court in Minnesota. The trial court granted the Clinic summary judgment invalidating that portion of the reg.

The appeals court did also rule that the reg was invalid, but for a rather different reason, and it ended up reversing the trial court and remanding for further proceedings.

The appeals court accepted the idea of trying to strike a balance between "primary" and "merely incidental" functions, but said the requirement that the org focus its activity primarily on presenting "formal instruction" is an unreasonable gloss on the statute.

In fact, the court said, the requirement is directly contrary to a reviewed decision of the Tax Court back in 1970, invalidating the identical requirement in another reg -- in which decision IRS had acquiesced, albeit "in the result only," rather than pursuing an appeal. Not a good look, the court said.[2]

But then the appeals court said it was not possible "on this record," which had been developed on cross motions for summary judgment on issues somewhat differently framed, to determine the relative weight of the Clinic's educational and noneducational activities -- which, the court said, were "inextricably intertwined."

So the case was remanded. Trial has been set for late April.

Apparently we can expect the government to argue that the Clinic must show but cannot show that all of its patient care and research activities directly serve its educational function, while the Clinic will be arguing that any of its activities that may be said to be "exclusively" noneducational are merely "incidental" to its educational activities.

After all which we can expect to go back to the appeals court.

logic and proportion

We have had oral argument in both pending appeals from decisions of the Tax Court disallowing claimed deductions for conservation easements on the ground that the extinguishment clause improperly allocated a portion of gross proceeds to post-contribution "improvements" to the subject property.

For completists, a recording of the October 27 argument to the 6th Circuit federal appeals court in *Oakbrook Land Holdings* is posted here, and a recording of the November

16 argument to the 11th Circuit in *Hewitt* is posted here.[3]

We had discussed *Oakbrook* at some length in Jack Straw three comma five, back in May 2020. And we mentioned *Hewitt* briefly in four comma five.

At issue are the validity of the regulation requiring that the donee of a conservation easement participate "proportionately" in the proceeds of an extinguishment, and also IRS' interpretation of that reg, allowing the transferor no compensation for subsequent "improvements."

There are legitimate questions about the Treasury's process in finalizing this reg,[4] but *Oakbrook* in particular is not a good vehicle for getting into these, as the easement deed in that case simply froze the donee's share at its value at the date of contribution. The reg had been in place more than twenty years when the deed was written, no real excuse.

But the question of compensating the transferor for "improvements" is not expressly addressed in the reg, despite the fact that some commenters on the proposed reg had raised the issue. This is merely the agency's informal interpretation of its own regulatory text.

And it is only in the past few years that IRS has made an issue of this, as part of its permanent war on syndicated easements.

Indeed, as the taxpayer in *Hewitt* pointed out, there is a 2008 letter ruling, which IRS has not yet withdrawn, that expressly contemplates compensating the transferor for post-contribution improvements from proceeds of a possible extinguishment.[5]

So there is some possibility we will see a taxpayer-friendly result in *Hewitt*.

rule thirty-six

Attentive readers may recall that we devoted almost an entire issue two years ago in Jack Straw two comma fourteen to dissecting an abusive tax strategy involving the transfer of nonvoting interests in a limited liability company to a donor advised fund.

One promoter of that scheme, a guy by the name of Meyer, had already stipulated to a consent judgment with the Department of Justice, enjoining him from giving tax advice on charitable contributions, preparing returns, assisting with tax appraisals, etc. -- pretty much requiring him to seek another livelihood. Details in the issue already cited.

Meyer now has an appeal pending in the 11th Circuit federal appeals court from a trial court order denying his motion for a protective order to prevent IRS from using admissions he had made in the course of discovery in the injunction action to support the assessment of a little over $7 million in penalties for promoting an abusive tax shelter.[6]

The government had argued that the trial court had no further jurisdiction as the case was already closed, and that in any event the requested relief was contrary to the anti-injunction act, which provides,

with a handful of exceptions not relevant here, that

> no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person[.]

The trial court accepted the second leg of this argument, rejecting Meyer's argument that the recent decision of the Supreme Court in *CIC Services* required a different result.

Not to get too far into the weeds, the plaintiff in *CIC Services* is the promoter of a micro-captive insurance strategy, seeking to enjoin enforcement of Notice 2016-66 pending a declaratory judgment that it is invalid.

The Notice identifies the strategy as a "transaction of interest," requiring material advisors to file Form 8918 disclosing their involvement and to disclose to IRS on request lists of taxpayers whom they have advised.

There are penalties, including possible criminal sanctions, for noncompliance.

The government had persuaded both the trial court and the 6th Circuit federal appeals court that the petition for injunctive relief was barred by the anti-injunction act.

The Supreme Court reversed, holding that the immediate object of the petition was not to enjoin assessment of a penalty for failure to comply with the reporting requirement, but to enjoin the imposition of the reporting requirement itself.

On remand, the trial court immediately granted a preliminary injunction. The deadline for filing the 8918 would have been several years ago.

The plaintiff has since amended its complaint, so it will be awhile before we see a substantive result.

Jack says there is a bit of a chicken and egg problem here.

The plaintiff's argument is that the Notice is a "legislative" rather than an "interpretive" rule, which would require an opportunity for public comment.

But the Notice does not in itself, technically, characterize the micro-captive transaction as a "shelter." It identifies the agency's concern that in some cases it may be, it requires material advisors to report various data points that might enable the agency to launch a regulatory project, and it actually does invite public comment on "how the transaction might be addressed in published guidance."

With the enactment of section 6707A(c)(1) in 2004, Congress expressly empowered IRS to make these inquiries. Jack finds it curious that the plaintiff has not alleged that this may have been an improper delegation of legislative authority. Not that they could prevail on that argument.

In the end, Jack expects the Notice to stand. Presumably other promoters have been filing the 8918s, and IRS should be ready to launch a regulatory project soon.[7]

redistribution

We have data from estate tax returns filed during calendar 2020, many of which of course would be for decedents who died in 2019, pre-pandemic.

There were something like thirty-four hundred federal estate tax returns filed, representing about

one-eighth of one percent of the two point eight million Americans who had died the preceding year.

Only a handful of these were filed with respect to estates under ten million dollars. Somewhat over half of the aggregate reported values were from estates of over fifty million, though these comprised only about ten percent of filers.

Among estates in this latter subgroup that actually paid any tax, *i.e.*, in which marital and charitable deductions did not completely zero out the tax, the average gross estate was close to a quarter billion. On average those folks paid a little over thirty million in tax. An effective rate of about thirteen and a half percent.

What Jack is trying to say is that the estate tax meaningfully affects only a tiny handful of extremely wealthy people.

but wait, there is more

Among all taxable estates, the largest single component of the gross was "lifetime transfers," at thirty-eight percent. Among estates grossing between twenty and fifty million, this figure climbed to forty-six percent.

Think GRATs and QPRTs, etc., but also think intentionally nonqualified forms of these transfers, with the transferor's retained interest valued at zero.

Some of these folks are the target of an incipient guidance project that turned up in the current year's priority guidance plan, which was released in early September.

The idea, as eloquently explained in the last two pages of comments on the proposed anti-clawback regs submitted by the tax section of the New York state bar back in February 2019, is that the anti-clawback regs as finalized in November of that year would protect a nonqualified inter vivos transfer consuming some portion or all of the temporarily increased exclusion amount, despite the fact that the transferred property is still includible the transferor's estate.

The computational mechanics are explained by Ron Aucutt in item 3 of his October 2021 "capital letter" for ACTEC.

Once the Treasury is ready to launch this project, Jack says you can expect pushback from the planning "community."

scraps

item: The section 7520 rate for January will hold for a second month at one point six, up a full point from January 2021 and the highest rate since just before the pandemic. And up a hundred twenty basis points from a trough at an historic low zero point four from August through November of 2020.

item: IRS has announced inflation adjustments for 2022 to various bracket floors, phaseouts, etc. The basic exclusion amount for estate and gift taxes will be $12.06 million, and the annual gift tax exclusion will be $16k.

item: After carrying the issue for three years dormant on its list of guidance priorities, IRS has made a

soft launch of a project to set criteria a limited liability company must meet to secure exempt status under section 501(c)(3).

The problem of course is that under most state statutes, an LLC would have equity "members," which is contrary to the requirement of (c)(3) that the org not have "private shareholders."

In Notice 2021-56, the agency recites the criteria it currently applies in determining the exempt status of an applicant that is organized as an LLC -- basically, that each member be itself an exempt org or a governmental unit -- and invites comments on about a dozen issues that might arise under various state statutes, notably including the question whether under some circumstances it might be permissible to have nonexempt entities as members.

The comment period closes February 06.

leftovers

[1]

At the time, these materials were behind a paywall at the grotesquely misnamed "public access to court electronic records" (PACER) site.

Portions of the dockets for this and other federal district court cases have since been made available by RECAP (an anagram of "pacer," but not obviously an acronym), a project of something called free.law, a (c)(3) org that also operates courtlistener.com.

Your correspondent is a participant in this project, which basically means that any document he pays ten cents a page to download from PACER gets added to the RECAP archive at courtlistener.

Several of the links in our discussion of *Mayo Clinic*, text accompanying footnote [2], and of *Meyer*, text accompanying footnote [6], were generated in this way.

Jack encourages readers to support this effort.

[2]

Directly quoting from page 15 of the slip opinion:

> Applying this language to a more recent statute enacted to provide limited relief from the UBIT has the earmarks of an agency interpretation intended to nullify a statutory benefit the Treasury Department [had] unsuccessfully opposed.

[3]

The same lawyer argued for the taxpayers in both cases, working from a nearly identical script.

[4]

These are explored in detail in Judge Toro's concurring opinion in the reviewed decision in *Oakbrook*, and in Judge Holmes' dissent.

[5]

And although letter rulings are not precedent, at least one taxpayer has successfully argued that it would have been reasonable, for purposes of escaping the twenty percent negligence penalty, to have relied on this ruling.

The link here is to a copy of the decision posted to Lew Taishoff's blog. As we may have observed previously, and as regular readers of Mr. Taishoff's blog will have heard repeatedly, the recent overhaul of the Tax Court's website has resulted in a situation where, at least for now, there are no permanent links to published decisions.

[6]

Meyer might actually have the better substantive argument here, on the question whether admissions he made in the course of discovery in the civil action can be used in assessing penalties, but unless the appeals court reverses, which seems unlikely, he will have to pay the $7 million and pursue a refund action.

[7]

Again, we are not going to go into the weeds on micro-captives, which is outside the scope of the Straw.

For the curious, the 2017 reviewed decision in *Avrahami* is a good introduction to the subject.

Jack says, forget about your house of cards