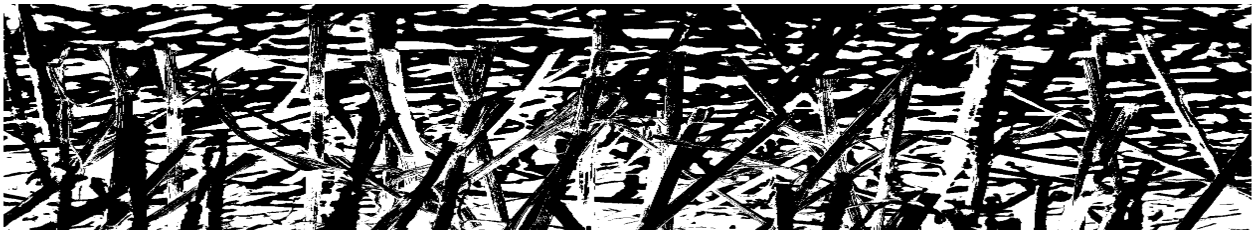

Jack Straw Fortnightly*

Half a loaf

Let's take a break from these three thousand word essays and just talk for a minute or two about a pair of letter rulings IRS released a couple of weeks ago -- reasonably straightforward analyses of the tax consequences of the misreporting, years ago, of split gifts to some trusts with skip potential, and some 9100 relief. The kind of stuff I used to write up almost daily behind a paywall.

The rulings are not identical, but they do arise from the same circumstances, involving the same couple. In "year 1," sometime after August 5, 1997 but before January 1, 2001,[fn. 1] the husband made transfers to four separate irrevocable trusts, one for the benefit of each of his daughters. Each trust was to distribute income to the daughter, with apparently no discretionary distributions of principal, and the remainder after her death was to be distributed to her children as each attained age 35. [fn. 2]

The husband and wife each filed gift tax returns, with the wife consenting to split the gifts. But the return preparer, referred to in the text of the letter rulings as an "accounting firm," split the gifts unequally, reporting three-quarters of the amounts transferred on the husband's return and one-quarter on the wife's return. And the preparer allocated no generation-skipping transfer tax exemption to these transfers on either return.[fn. 3]

Converting the spare

Some years later, in "year 2," the couple made further reportable gifts,[fn. 4] and in preparing those gift tax returns, the same accounting firm belatedly "realized" that no GST tax exemption had been allocated to the earlier transfers. The firm advised the husband that he could make late allocations, using then-current values.

But then the firm prepared the husband's year 2 return allocating amounts equivalent to the entire corpus of the four trusts, despite the fact that the gifts had been reported in year 1 as split. The wife's year 2 return made no allocations of exemption to her portion of the split gifts.

Apparently the problem came to a head after the wife died, and her executor was faced with the problem of how to report this tangle on an estate tax return, with a view to securing a zero inclusion ratio for the trusts.

The husband sought a ruling that because the limitations period had run on the year 1 returns reporting the split gifts, he would be treated as the transferor -- both for gift tax and GST tax purposes -- of three-quarters of the amounts in which the trusts had been funded. The wife's executor sought rulings (a) that she would be treated as transferor of only one-quarter, and (b) granting her an extension to allocate GST tax exemption to those transfers using year 1 values.

IRS took a somewhat more nuanced view.

Disconnecting the dots

In PLR 201811002, IRS agreed that for gift tax purposes, because his year 1 return was closed, the husband would be treated as having transferred three-quarters of the reported amounts. However, for GST tax purposes, he would be treated as the transferor only as to half.

The ruling cited reg. section 26.2652-1(a)(4), which says that where a couple splits gifts, each is treated for purposes of the GST tax as having transferred one-half, regardless of the amount each is deemed to have transferred under section 2513.

But wait a second, says Jack. What is the logic of that rule? Apart from some egregious misreporting, under what circumstances might a spouse who consents to split a gift be deemed to have transferred something other than half?

The text of the reg. itself suggests an answer, making cross-reference to an example under reg. section 26.2632-1(c)(5), where the split gift is subject to an estate tax inclusion period. Not our facts here.

A quick detour

What is now paragraph (a)(4) of the reg. was added at the last minute when the initial batch of chapter 13 regs, proposed in December 1992, were finalized in December 1995. The question had come up in comments to the notice of proposed rulemaking: if a spouse consents to split a gift to a trust in which the transferor has retained a qualified interest for purposes of section 2702(b), that is, an annuity or unitrust payout, with the remainder to a skip person, should she treated as the transferor only as to half the present value of the remainder? or half the amount transferred?

For gift tax purposes, the answer is half the present value of the remainder. But for generation-skipping transfer tax purposes, it makes sense for the spouse to be treated as the transferor of half the amount transferred -- keeping in mind that in the case of a grantor retained annuity or unitrust, an allocation of available exemption does not take effect until the close of the ETIP.

Not to get distracted

The scenario sketched in these two rulings does not implicate the concerns the reg. was intended to address -- a mismatch between the amount of the transfer and the present value of the reportable gift. Still, the language of the reg. is broad enough to cover this scenario. In his pedantic mode, Jack would prefer that this all be at least briefly acknowledged in the text of the letter rulings.

Anyway. Because he had already made a late allocation on his year 2 return at then-current values, the husband was not in a position to ask for an extension to make a "timely" allocation at date of contribution values. To the extent his late allocation exceeded half the trust corpus in year 2, it would be disregarded, per reg. section 26.2632-1(b)(4)(i).

Similarly, in PLR 201811003, IRS reasoned that because her year 1 return was closed, the wife would be treated for gift tax purposes as having transferred only one-quarter of the reported amounts, but for GST tax purposes she would be treated as the transferor as to half. The executor was granted an extension to file a supplemental gift tax return for year 1, allocating the wife's available exemption to the extent of half the amounts transferred to the trusts.

Bottom line, the taxpayers were able to secure the zero inclusion ratio for the four trusts, albeit with some slippage in the allocation of the husband's exemption and at a cost of something like 30k in user fees for the two letter rulings, plus whatever fees they might have had to pay a lawyer to submit the ruling requests.

Jack observes

State statutes of limitation for professional malpractice -- which can be rather short -- often run from the later of the date the client knew or should with reasonable diligence have known of the mistake or the date the client suffers an actual economic injury. The statute may be suspended while the client still has an ongoing relationship with the professional concerning the matter at issue.

Much detail hidden within that brief summary.

In this case, although the reporting of the year 1 gifts was almost astonishingly inept, the husband arguably did not suffer an economic injury until he was persuaded to make an allocation on the year 2 return using then-current values, and the wife may not have suffered an economic injury until her executor paid to secure the letter ruling itself.

Again with the notes

[fn. 1]

The references are to the effective dates of two amendments to the tax Code. Pub. L. 105-34, enacted August 5, 1997, amended section 2504(c) to provide that a reported gift for which the statute of limitations for assessment has expired cannot be revalued for purposes of determining the transfer tax rate bracket or the available unified credit. Pub. L. 107-16, enacted June 7, 2001, amended section

2632 by adding subsection (c), which automatically allocates generation-skipping transfer tax exemption to an "indirect skip" unless the transferor elects out. An indirect skip is a transfer to a trust that does have skip potential, but from which distributions may also be made to nonskip persons, in this case the daughters.

[fn. 2]

It may be that the trust documents literally said nothing about distributions to a grandchild who had not yet turned 35 at the time of her mother's death, or about per stirpital shares for descendants of a deceased grandchild, etc. Or it may be that the author of these two letters simply gave an incomplete description of the dispositive terms, as these details were not germane to the requested rulings.

[fn. 3]

Because these transfers occurred prior to the enactment of section 2632(c), the allocation of available exemption to the indirect skips was not automatic.

[fn. 4]

The two rulings differ slightly in their recitation of the underlying facts on this point. PLR 201811002, issued to the husband, does not mention the specific context in which the preparer discovered its error, *i.e.*, in reporting the later gifts. Neither ruling expressly mentions that the wife had since died, though PLR 201811003 does say it was issued to her executor.

Throwing in the towel

It appears the taxpayer will not be taking an appeal from the decision in *Salt Point Timber, LLC v. Commissioner*, T.C.Memo. 2017-245.

The Tax Court sustained a notice of final partnership administrative adjustment disallowing a claimed deduction of $2.13 million for the contribution of a conservation easement over a thousand acre parcel in Berkeley County, South Carolina. The ninety-day period for filing a notice of appeal has passed.

This is one of those cases in which IRS challenged a conservation easement on what some might argue were nonsubstantive, technical grounds.

The deed of easement included a paragraph 6.22 saying that if at some point the "protected property," *i.e.*, the servient estate, were transferred to the owner of an adjacent property that was also encumbered by a "comparable" conservation easement, and if the owner of that property and the grantee of that easement agreed to extend it to also cover the transferred property, then the parties to the present deed agreed to "release" the easement to allow that to occur.

It almost sounds like the parties already anticipated that such a transfer would likely occur. And some of the facts developed at trial would appear to bear this out.

The partnership had initially agreed to convey an easement to the Trust for Public Land, a much larger, national organization. TPL had applied for a federal grant to fund the acquisition, saying it expected the contribution of this particular easement would "encourage neighboring landowners to commit their properties to conservation in a domino-effect fashion."[slip opinion at 21]

But that agreement was "supplanted by subsequent agreements"[slip opinion at 3] under which the easement was instead conveyed to the Lord Berekeley Conservation Trust, a smaller, locally-based organization.

While it may have been pretty clear what the parties intended, this paragraph 6.22 was deficient in a couple of particulars.

One, it did not expressly require that the holder of a "comparable" easement on the adjacent property itself be a "qualified organization" within the meaning of section 170(h)(3) -- basically, a publicly supported charity or a governmental entity --, though one might argue this was implied.

And two, the mechanism it described, "releasing" the easement, looks a lot like "extinguishing" the easement outside the process required by reg. section 1.170A-14(g)(6)(i) -- a judicial determination that changed conditions had made continued use of the property for conservation purposes "impossible or impractical," with a "proportionate" share the proceeds of a subsequent sale of the property going to the donee land trust.

Apparently IRS had other arguments, but the first of these two was enough to persuade the Tax Court to disallow the claimed deduction. [fn. 5]

The court asked for supplemental briefing on the question whether the transaction contemplated by paragraph 6.22 might somehow be framed as a "transfer" of the easement to a "qualified organization," which would be permitted by reg. section 1.170A-14(c)(2). IRS held to its "extinguishment" argument, while the tax matters partner focused on an argument that the phrase "eligible donee," used elsewhere in the deed of easement to limit the class of permissible assignees, was also implicit in paragraph 6.22.

The court rejected this argument, and apparently the taxpayer saw no percentage in an appeal to the 4th Circuit.[fn. 6]

A couple of notes

[fn. 5]

The court also rejected the partnership's argument that the likelihood that the circumstances in which paragraph 6.22 would come into play might arise was "so remote as to be negligible" within the meaning of reg. section 1.170A-14(g)(3), as the parties had gone to the trouble to include the provision, with some purpose apparently in mind.

[fn. 8]

Discounting the possibility the parties may have settled on allowing a deduction at some lower figure. Nothing in the text of the Tax Court opinion suggests that valuation was an issue in this case. Also, where there is a possibility of settlement, the losing party will typically file a notice of appeal to keep the window open for negotiation.

Next up

There are a couple of items on the horizon.

RERI Holdings

The taxpayer filed its opening brief yesterday from the decision of the Tax Court in *RERI Holdings I, LLC v. Commissioner*. The government's brief is due May 2, and a reply brief will be due May 16.

The case involves the contribution of a "successor member interest" in a limited liability company, which IRS identified in Notice 2007-72 as a transaction of interest, just as it was getting ready to issue the notice of final partnership administrative adjustment. The taxpayer claimed a deduction of just over $33 million for the SMI, which the university sold two years later to a related party for only $1.94 million.

In the end, after almost ten years of litigation, the court disallowed the deduction entirely on a reporting technicality. The taxpayer had omitted to report its adjusted basis in the SMI on the Form 8283 substantiating the claimed deduction. Obviously the taxpayer is arguing substantial compliance. RERI had bought the SMI somewhat more than a year earlier for $2.95 million.

We will write this up after all the briefs are in.

Pretermitted heirs

Still awaiting word on what the House Commerce committee of the New Hampshire state legislature is going to do with SB 311, which was the subject of our issue three a few weeks back.

They had a public hearing on March 28, but neither the audio feed nor a written summary of the testimony has yet been posted. All six bills heard that day were assigned to a subcommittee that is having a work session today, April 3. No live feed, and of course no written report as yet.

Under House rules, the last day for sending the bill to the floor is April 26, and the last day for floor action is May 3.

Meanwhile the state supreme court heard oral argument on March 15 in the *Craig Trust* case, which SB 311 is intended to moot. It was not entirely clear from the questioning which way the justices might be leaning. The chief justice had recused herself, leaving a panel of four, which I suppose could result in a split decision, remanding the case to the trial court to try to decide the case on some footing that will lend itself to review on the legal question alone.

The chief justice retired from the bench over the weekend, six months before she hits the mandatory retirement age of 70. The governor has not yet nominated her replacement, so it is not yet possible to predict whether there would be a full bench when the case came back up.

Direct action

Stepping outside any pretended role as an "objective" journalist, on the eve of the House committee hearing last week, I sent a rather lengthy e-mail message to the entire committee, pushing back against the argument some lawyers involved with the *Craig Trust* litigation had offered at the Senate committee hearing in January, that "most" planning lawyers had simply assumed the enactment in 2004 of section 112 of the uniform code, importing the rules of construction for wills into the trust code, somehow did not apply to the pretermitted heir statute.

In the e-mail I proposed a series of questions the committee might ask these witnesses if they offered a similar argument again.

Until the audio feed or the written summary of the hearing is posted, of course I do not know whether this had any effect. When the bill came to the Senate floor on a consent calendar in February, I e-mailed the committee chair in that chamber to point out that he had mischaracterized the measure in his explanatory report in the Senate calendar. He acknowledged my message, but did not pull the bill from the consent calendar.

I have little doubt that as a nonresident my comments are of marginal interest to New Hampshire state legislators, but as I said in separate correspondence to one of the property law professors at the University of New Hampshire,

> "this process is unseemly -- not only legislating an outcome in a pending case, but with no real policy justification and no larger view of which rules of will construction 'should' and which 'should not' apply."

And finally

Once we get through our initial stumbles with this newsletter, I am hoping to put at least some content behind a paywall, maybe on Patreon. But that may be awhile.

In the meantime I may put up a "tip jar" on the Jack Straw landing page, which may require that I work all of this through the Greystocke Project, a (c)(4) org I created a year or so ago as a vehicle for this kind of advocacy.

Obviously still some details to work out. I will keep you posted as this moves forward.