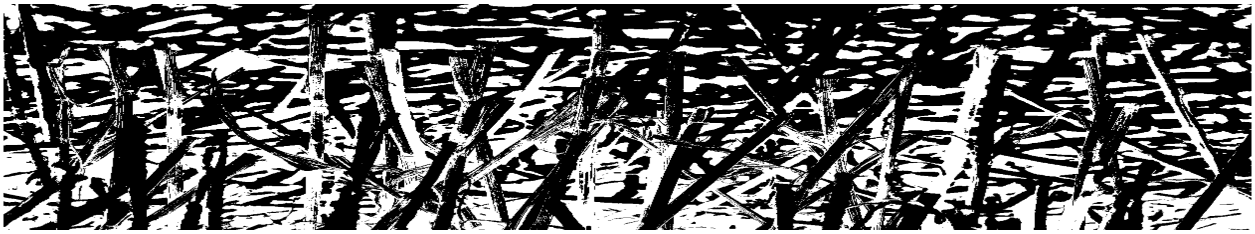

Jack Straw Fortnightly*

the double, double negative

Late again. Six weeks since the previous issue.

But even now I am taking time away from a few projects that are under deadline. A webinar later this week on section 1031 like-kind exchanges, a paper for the NACGP conference in Las Vegas in October, a "viewpoint" article for Tax Notes on PLR 201825007, which we discussed in issue seven. And some consulting work we cannot discuss here in any detail.

So let's just look at a few items that have come in over the transom in recent weeks. And again, we will take these chronologically.

July 16

There has been some uncertainty whether the suspension of miscellaneous itemized deductions through 2025, section 11045 of the 2017 tax bill, might somehow also preclude decedents' estates and nongrantor trusts from deducting expenses of administration under section 67(e)(1).

Notice 2018-61 says no, and gives a reasonably sensible argument why not.

The problem arises in part because reg. section 1.67-4(a) frames section 67(e) as an exception to the rule that miscellaneous itemized deductions generally are (or were, when they were allowable) subject to a floor of two pct. of adjusted gross income.

This is inexact. What section 67(e) says is that expenses of administration that "would not have been incurred" if the property were not held in a trust or estate are not miscellaneous itemized deductions, period. Not an "exception." Only those expenses that might "commonly or customarily" have been incurred by an individual holding the same property -- here quoting reg. section 1.67-4(b) -- are subject to the two pct. floor. Or were. Now they are disallowed altogether.

The Notice does not expressly acknowledge this inaccuracy, but in fairness the matter was not raised in public comments on the proposed reg back in 2014 in the aftermath of the *Knight/Rudkin* decision. The focus then was on the question of "bundled" fees.

Oh, but wait a minute, Jack. Section 67(e) does use the word "except."

Yes, but what it says is that an estate or trust calculates its "adjusted gross income" -- which, incidentally, is not a phrase that is used anywhere in subchapter J itself, [fn. 1] -- "in the same manner as" an individual, "except" that in effect expenses of administration are treated as an "above the line" deduction, as though they were listed in section 67(b). Unless they might "customarily" have been incurred by an individual.

An exception to an exception to an exception to an exception. Wrapped in an enigma.

Interestingly, the Notice invites comments on the question whether excess deductions on termination of an estate or trust should still be deductible by the distributees as though they were not miscellaneous itemized deductions, and thus suspended through 2025.

This is another instance in which the regulation does not quite track the statute. What section 642(h) says is that excess deductions on termination are passed through to the distributees, who may in turn claim them "as a deduction" on their own returns. Sort of like negative distributable net income. But where do you report it?

Nothing about "itemized" or "miscellaneous" in the statute itself. It is only when you get to reg. section 1.642(h)-2(a) that we see these characterized as "miscellaneous itemized" deductions. The predecessor to the current reg. goes all the way back to implementation of the 1954 Code. The most recent revision was in 1978, and dealt with other issues. Any comments that might have been submitted to the proposed regs. are lost in the mists of time.

But it is not obvious from the text of section 642(h) that excess deductions on termination "should" be treated as miscellaneous itemized deductions in the hands of the distributees, or why. On the other hand, section 67(b) gives what appears to be intended as an exhaustive list of itemized deductions that are not "miscellaneous," and the 642(h) passthrough is not on the list.

So I do not see a clear path here. I don't think you can go "above the line," because the technical term there is not "deduction," but "adjustment to gross income." And I don't think you can really characterize these as expenses incurred by the distributee in the production of income.

But we will see. This will likely be a priority guidance project for the coming fiscal year.

July 17

In Rev. Proc. 2018-38, IRS announced it would no longer require exempt entities other than (c)(3) orgs to submit schedule B with their 990s, identifying their "substantial contributors."

I have not much to say about that, substantively. Dark money, etc.

But there may be some question whether the procedural mechanism is appropriate. It might be better to propose a change to the reg. and issue a notice protecting orgs from withholding schedule B in anticipation of the change being finalized.

The reporting requirement at section 6033(b)(5) does literally apply only to (c)(3)s. The implementing reg. extends the requirement to all 501(a) orgs. Under what authority is not stated.

This reg. was finalized in June 1971, with no mention of any comments -- and actually with no citation to any notice of proposed rulemaking. But here we are, and the question is, if we want to change the rule how do we go about doing it.

The reg. does ostensibly reserve to the Commissioner authority to "relieve any organization or class of organizations," other than supporting orgs, from filing part or all of the annual information return, where she has made a determination that "such returns are not necessary for the efficient administration of the internal revenue laws."

And the present rev. proc. does purport to make such a determination. The reporting requirement "increases compliance costs," it "consumes IRS resources in connection with the redaction" of information that should not be disclosed to the public, and it "poses a risk of inadvertent disclosure." Or shall we say leaks.

It might be noted the two instances cited in the rev. proc. in which IRS has previously exercised this authority both have to do with filing thresholds for smaller orgs, which I suppose no one would really question.

What the statute says, at section 6033(a)(3)(B), is that the Secretary "may relieve any organization," singular, of the filing requirement, if she has determined, etc. This does not sound like blanket authority to relieve "classes" of orgs.

But again, the reg. has been in place for close to fifty years.

August 3

A couple of letter rulings of some slight interest among the batch released in week 31.

In PLR 201831003, we have a disclaimer by an appointee under a limited testamentary power created in a pre-1977 trust. The disclaimant is a second cousin, possibly once removed -- if my math is correct here -- of the deceased power holder. A grandchild of the settlor's great uncle.

The genealogy is not made entirely clear in the text of the ruling, but it would appear the deceased beneficiary who held the limited power was a sibling of the settlor, not a child. There may have been other siblings. Certainly there were other cousins.

The disclaimant says he did not see a copy of the underlying trust document until after his cousin's death, though he kinda knew there might be something out there. His disclaimer would be timely under state law, nine months, but the question is whether it is timely not to be treated as a taxable gift.

The applicable rule here is not section 2518(b), which requires that a disclaimer be made within nine months of the date of the transfer creating the interest. That statute was enacted in October 1976, and applies only to disclaimers of property interests under transfers made after December 31 of that year.

Instead we are dealing with a transitional rule at reg. section 25.2511-1(c)(2), which allows for a disclaimer of an interest created under a pre-1977 transfer "within a reasonable time after [the disclaimant acquires] knowledge of the existence of the transfer."

The takeaway here is that the disclaimant's interest was created, not when his cousin died with a will exercising her limited power, but when the trust itself was created, decades ago. When I used to teach future interests, the students would sometimes ask "in what real world scenario would I ever have need to use this algebra." Well, here is one.

The trust document gave the decedent a limited testamentary power to appoint the remainder at her death among the descendants of the settlor's great-grandparents. In default of her exercise of the power, the remainder would go to her own descendants, of which there were none in this case, or in shares to existing trusts for trusts for great-grandchildren of the great-grandparents. By appointing outright only to descendants of the great uncle, the decedent apparently narrowed the class of distributees.

As a grandchild of the great uncle, the disclaimant was a member of both classes, permissible appointees and default takers. The text of the ruling characterizes his interest in the trust on day one as "contingent," which in its natural usage would refer to his status as a taker in default of the decedent's exercise of her limited power.

But the interest he was actually disclaiming was as an appointee. That interest did also exist on day one, but would be more correctly characterized as "executory" rather than "contingent."

In any case, the point to emphasize here is that the time limit for making a qualified disclaimer of a "contingent" interest runs from the date the interest is created, not from when it vests.

And then in PLR 201831009, we have a testamentary QTIP trust[fn. 2] with a remainder over to a private foundation with respect to which the both decedent and the surviving spouse are "disqualified persons."

No income or transfer tax charitable deductions yet allowable or claimed, but at the death of the surviving spouse the entire trust will be included in her estate under section 2044, and the entire remainder will be deductible under section 2055(a). Until the remainder is actually distributed to the foundation, the trust will be a nonexempt charitable trust under section 4947(a)(1).

The question is whether the trustee might find itself engaging in acts of self-dealing in the course of settling the trust after the spouse's death.[fn. 3] Apparently there was a specific transaction the trustee anticipated, the nature of which is not mentioned in the text of the ruling.

Per reg. section 53.4947-1(b)(2)(v), a trust that will ultimately be distributed entirely to charitable beneficiaries will not be treated as a nonexempt charitable trust under section 4947(a)(1) during a "reasonable period of settlement" after it becomes irrevocable.[fn 4]

So IRS graciously rules that during this window, the proposed transaction would not be an act of "direct" self-dealing. But they note that there is still the problem of "indirect" self-dealing, and they decline to speculate whether the transaction in question would meet the requirements of reg. section 53.4941(d)-1(b)(3), the so-called "estate administration" exception.

Because they did not ask? or because it depends on facts and circumstances that cannot be determined until the matter is under examination, after the fact? The text of the ruling does not say, but apparently the latter.

Stated simply,[fn. 5] the "estate administration" exception can apply where the trustee has a power of sale, the probate court approves the transaction, and the foundation gets at least fair market value in a form at least as liquid as what it is giving up.

As it happens, IRS has had a stated policy since 2011 of not giving an advance determination on whether the sale of an asset from a decedent's estate to a disqualified person in exchange for a promissory note meets the "estate administration" exception under the cited reg.

Although the "no rule" policy is not mentioned in the text of the letter, this might be a clue to what was going on here.

August 9

The NACGP has put out a call to action, asking its members to contact their representatives in Congress to support HR 1337, which would extend the charitable IRA "rollover" to permit a taxpayer as young as 59.5 to direct a "qualified distribution" of as much as $400k per year to fund a charitable remainder trust or a gift annuity paying at least five pct.[fn. 6]

The payouts from either "split interest entity" would be taxed entirely as ordinary income. Outright "rollovers" would still be available only to taxpayers aged 70.5 or older, and would still be limited to $100k per year.

The provision for "rollovers" to split interest entities would expire at the end of 2021, and we would find ourselves again fighting the extenders skirmishes every couple or three years.

One might ask, what is the size of this market. The most recent data available from IRS says that in 2015 there were about 50.7 million taxpayers aged 60 and over, and about 25.1 million, a little less than half, with nonzero balances in IRAs. The percentages trend up somewhat in higher age ranges.

Aggregate assets about $5.096 trillion -- there's your target --, which would divide out to a couple hundred thousand per. The folks over at the Employee Benefit Research Institute have a lot of data on IRAs, and among other things they note that only about 14.1 pct. of IRA account holders have balances of $250k or more. Which suggests that the upper end is pretty heavily skewed.

So yet another instance in which the sector is pursuing its self interest without any real thought for tax policy.

The particular vehicle, HR 1337, was introduced more than a year ago by Rep. Kevin Cramer (R-ND), and assigned to the Ways and Means committee, where it has languished. Rep. Cramer is in his third term in North Dakota's only Congressional district, and he is running for Senate this fall, challenging first term incumbent Sen. Heidi Heitkamp (D-ND) in what will apparently be a close race.

He does not sit on the Ways and Means committee, but the bill now has eleven co-sponsors, up from five when it was introduced, of whom nine are members of the committee, including Rep. Peter Roskam (R-IL), who at least until recently chaired the Tax Policy subcommittee, or Select Revenue Measures, what have you.

Interestingly, all of the co-sponsors are Republicans except Rep. Earl Blumenauer (D-OR), who also sits on that subcommittee. Rep. Blumenauer has in the past been a proponent of the enhanced incentives for conservation easements, which we can talk about another time.

The call to action suggests that this measure might be a natural fit with the thrust of Ways and Means chair Kevin Brady's plan to push a "tax reform 2.0" bill, which is supposed to include some kind of focus on retirement savings.

Not sure if I quite get how allowing people to drain tax deferred accounts into the nonprofit sector fits with creating additional incentives to save. But at this point almost nothing would surprise me.

August 16

Briefing is now complete in the taxpayer's appeal from the decision of the Tax Court in RERI Holdings, LLC v. Commissioner. I had mentioned this case briefly in issue five, and linked the opening brief, which was filed April 2.

At issue is a convoluted scheme involving a claimed deduction for $33 million on the contribution of what amounted to a future interest in a disregarded entity holding real property subject to a long-term lease, which the recipient university later sold for less than a tenth of the claimed value.

In the end, the Tax Court dodged the substantive issues and disallowed the claimed deduction altogether on a reporting technicality. But nonetheless imposed a 40 pct. gross valuation misstatement penalty.

The government's response brief was filed July 23, and the taxpayer's reply brief was filed August 16. We do not yet have a date for oral argument.

I want to give this case the attention it deserves, but not just yet.

Marginalia

[fn. 1]

Not quite true. Section 642(b)(2)(C) does use the phrase with reference to determining the personal exemption allowable to a qualified disability trust. Also, as part of the 2017 tax bill, a new subparagraph (E) was added to section 641(c)(2), changing the rules for charitable deductions claimed by electing small business trusts (ESBTs), and the phrase "adjusted gross income" does appear there. I am going to treat these as exceptions that tend to prove the rule.

[fn. 2]

Technically, a QTIP trust created after the settlor's death from the remainder of his revocable trust, but the same principles apply, and the text of the ruling does not draw the distinction.

[fn. 3]

The trustee also requested determinations that the private foundation excise tax regime generally, and the prohibitions against direct and indirect self-dealing in particular, would not apply during the lifetime of the surviving spouse, but these are "comfort" rulings.

[fn. 4]

In this case, of course, the trust is already irrevocable during the lifetime of the surviving spouse, so the reg. applies only by analogy. The trust here did permit discretionary distributions of principal to the spouse, so the remainder to the foundation might be seen as subject to defeasance.

[fn. 5]

Or to oversimplify somewhat.

[fn. 6]

An issuing charity using the ACGA recommended maximum rates that took effect July 1 would not pay an immediate gift annuity to an annuitant younger than age 64.

Jack says,
take this, brother, may it serve you well.