# Jack Straw Fortnightly*

## Letterboxing

By way of introducing a piece I wrote for Tax Analysts last year, I confessed to a quirk. On Friday mornings, I said, "I like to fire up the French press and sit down to browse the week's release of private letter rulings."

Truth is I broke the beaker awhile back, and these days I am using a tea ball to similar effect. But as to the letter rulings, yes, every Friday. One of my little rituals.

In a typical week there will be a couple dozen, which I will sift down to a handful that are what I call "within scope" -- that is, within the range of concerns that inform my consulting practice and this newsletter.

Usually these are simply requests for 9100 relief from blown elections, or "comfort rulings" on transactions for which the tax treatment is reasonably clear, but which for one reason or another are not covered by existing formal guidance.

But every once in awhile, you will find a letter ruling in which "maybe a key fact is left unstated," as I put it in the Tax Analysts piece, "or maybe the facts as presented raise issues that are not addressed."

Or maybe the taxpayer gets something less than she asked for, or even an unfavorable ruling, and you are left to puzzle through why she did not withdraw the request.

This past week there were three rulings that drew my attention. An exceptional week in that regard. Typical would be zero or maybe one. But you never know.

Excuse me a moment while I brew up a second cup.

**The incompleteness theorem**

It is week 25 already? Where has the time gone? Summer solstice already past, third quarter waxing to the hay moon.

Let's get to work. First up, PLR 201825003 involved a gift of artwork to two museums.

Wait, I know this one, some of you are saying. The income tax deduction for a gift of a fractional interest in tangible personal property is subject to recapture unless you complete the entire gift within ten years, and the museum has to take possession and put it on display for at some significant interval during those ten years, and, and --

-- oh yeah, and you don't get the benefit of appreciation in value after the date of the initial gift. Section 170(o), added in 2006, when Chuck Grassley was chairing the Finance Committee. Those were the days.

Very good, but not what this ruling was about. This was a gift of a remainder after a reserved life estate.

Okay, then, no deduction at all for a gift of a partial interest unless it is in a remainder annuity or unitrust. Section 170(f)(3). That goes back to 1969.

Again good, but again, not what the ruling was about. The remainder was to two museums in a foreign country -- which country we don't know, because this is redacted from the text as released. So, no income tax deduction under any circumstance, and no gift tax deduction because of the way the transfer is structured.

We are looking for something else. What, then? Yes, you in the next to last row, by the exit. Say again?

If there is no deduction then maybe we are seeking a ruling that there is not a completed gift. Excellent.

The taxpayer and her late husband had entered into a "deed of transfer" with these two museums, under which they conveyed "legal title, naked ownership[,] and remainder interest in and to the artwork," while reserving to themselves a "life interest and usufruct."

Some of the wording is maybe a little odd, but it does kinda sound like a completed gift of the remainder. But wait.

The deed itself recited that the transferors did not intend a completed gift for federal tax law purposes, and that the entire "deed of transfer" would take effect only upon issuance by IRS of a "favorable" ruling on this point.

So the text we have in front of us responds to the taxpayer's request for a ruling that the transfer of a vested remainder subject only to a reserved life estate is somehow not a completed gift.

And the agency's response is, well, no, that would be a completed gift. The only contingencies that might still intervene are beyond the transferor's control. She cannot sell or otherwise dispose of the artwork.

Some pretty interesting contingencies here, by the way. These are described as "conditions subsequent" that would defeat the vested remainder gift.

One, the museums have to take particular care of artwork the taxpayer and her late husband had already given them. Two, the museums must not become "privately owned" -- which seems to imply that this might be a plausible scenario.

Three, the tax laws of the country in which the museums are located must not be changed to treat these transfers as taxable to the transferors.

And four, "the X law principles currently governing in [that country] must not be replaced by Y law."

What can it mean? Ecclesiastical? Sharia? This is the closest we are going to get to a clue what country we are talking about here.

Anyway. In a roundabout way, the taxpayer did actually get the ruling she was looking for. If all we were looking at were the conditions subsequent, this would be a completed gift. Not what she wanted. But there is also a condition precedent: a "favorable" ruling from IRS that the gift is not complete. And instead, we have a ruling that the gift is otherwise complete. But this result itself fails the condition precedent. Therefore the gift is not complete. Sort of a moebius strip.

A perhaps unexpected consequence is that because the "deed of transfer" is itself also subject to the same condition precedent -- as paraphrased in the text of the ruling, if the taxpayer "does not obtain a favorable ruling," the deed "does not come into force" --, the "unfavorable" ruling could arguably make the deed a nullity, leaving the museums with an unenforceable pledge.

The ruling does not indicate whether the taxpayer was required by the terms of the deed to seek the ruling, presumably not. The kick-out clause would have been for her own protection.

**Throwing in the towel**

Next, PLR 201825004. A non-functionally integrated Type 3 supporting org making a formal transition to private foundation status.

I am actually a little surprised we have not seen more of these. The legislation effectively killing non-functionally integrated Type 3s has been in place since August 2006 -- Grassley again --, an advanced notice of proposed rulemaking in August 2007 was followed by proposed regs in 2009, and these were finalized in December 2012.

So any Type 3 that was not ready to become functionally integrated or to restructure as Type 1 or Type 2 has in effect been operating informally as a private foundation for several years. In the sense that it has had to distribute the greater of 85 pct. of adjusted net income or 3.5 pct. of the net fair market value of non-exempt use assets.

No matter. In this case, the supporting org -- for convenience and clarity, we will just start calling it "the foundation" -- had been created some years back by a husband and wife for the benefit of nine designated orgs. One spouse had since died, leaving a trust for the benefit of the survivor, with the remainder at least in part to the foundation.

The trust also provided for current distributions from income [fn. 1] during the survivor's life to the nine supported orgs, and it permitted the survivor to assign trust assets to the foundation. These, and the trust remainder, were to be held separately in a restricted fund. The nature of the restrictions is not indicated in the text of the ruling, but apparently they had at least in part to do with limiting the amounts to be distributed to some of the supported orgs.

The foundation had nine directors, three of whom were appointed by the supported orgs, three of whom were individuals who would not be "disqualified persons" under section

4946(b)(1), and three of whom were "members of the family," within the meaning of section 4946(d), of the couple who had created the foundation.[fn. 2]

After the final regs were published in December 2012, the board decided the supporting org could operate "more efficiently" if it did not have to comply with the notice requirements imposed by the regs and could instead be classed as a private foundation.

Specifically, reg. section 1.509(a)-4(i) requires a Type 3 supporting org to provide to each of its supported orgs annually a written report of the "amount and type" of support provided during the preceding tax year to that org, a copy of the supporting org's most recently filed 990, and updated copies of the supporting org's governing documents.

Does not seem all that burdensome in the particular case, but as we read on through the letter ruling we maybe get a clearer picture what was actually going on.

To formalize the transition to private foundation status, the foundation had petitioned the state court to modify the terms of the deceased spouse's trust to remove the restrictions, but at the same time to cash out the supported orgs for which smaller percentage payouts had been specified to allow the foundation to focus future grantmaking on the remaining orgs.

Some but not all of the smaller orgs agreed to the buyout. The state attorney general was joined but took no position. Ultimately, the court approved a settlement agreement under which shares of the remaining orgs in distributions from the restricted fund were recalculated, and were to be recalculated again at the death of the surviving spouse. The judgment was to take effect upon issuance of this letter ruling.

The foundation sought rulings on eight questions. IRS granted only seven, mostly "comfort" rulings. Payments under the settlement agreement would not be treated as "excess benefit" transactions, or as acts of self-dealing, or as taxable expenditures, or as triggering a termination tax, but would instead be treated as qualified distributions.

The foundation should file a final 990 for the short year ending on the date the judgment took effect, and a 990-PF for the short year starting on that date, and would owe excise tax only on net investment income received after that date, with distributable income calculated with reference to the short year.

IRS declined to rule on the question whether the conversion or the transfers would affect the foundation's exempt status or its classification, as these are items on the perennial "no rule" list. The appropriate mechanism for seeking a change in classification is to file an 8490 seeking a "miscellaneous" determination.

So pretty much the only real question does not get a response.

**Soft mod**

And finally, PLR 201825007. On the surface, your typical request for confirmation that a slight modification to the distribution

mechanisms of a pre-1985 multi-generational trust will not affect its grandfathered status as exempt from the generation-skipping transfer tax. But here with a wrinkle that Jack says gets not enough attention.

The decedent's will had provided for distribution of "net income," half to the decedent's daughter and half among the daughter's three children or the descendants of a deceased grandchild. At the death of the survivor of these four, the trust was to be divided into separate trusts for each line of descent, with "net income" distributed among descendants until the expiration of the perpetuities period, when the remainder of each trust was to be distributed to whoever was left standing, otherwise to the decedent's heirs.

At the time of the ruling request, the daughter and two grandchildren had died -- one survived by three great-grandchildren, the other by zero -- and the surviving grandchild had no children.

The trustees had previously obtained a judicial modification amending the definition of "net income" to mean the greater of net fiduciary accounting income or a stated unitrust amount, and had secured a favorable letter ruling on that modification.[fn. 3] Now they were back, but with a somewhat different request.

The trustees were proposing another modification, again amending the definition of "net income," but this time to a flat unitrust amount, apparently at a different stated percentage -- let's say higher, though this is not made clear.

More to the point, they were proposing to implement an ordering rule, which would treat distributions as coming first from net fiduciary accounting income, next from other "ordinary" income not otherwise allocated to net fiduciary accounting income, then from realized capital gains -- first short-term, then long-term --, and finally from corpus.[fn. 4]

IRS determined that neither of these changes would affect the trust's grandfathered exempt status, because they would not have the effect of shifting a beneficial interest to a lower generation, or extend the time for vesting of any beneficial interest.

The citation was to reg. section 26.2601-1(b)(4)(i)(E), example 11, which however does not deal with an ordering rule.

Jack gonna split a hair here.

In January 2004, in TD 9102, the Treasury did revise reg. section 1.643(a)-3 to allow a trustee to allocate realized gains to distributable net income in a "total return" trust, where this is authorized or required by state law itself, or by the terms of the trust instrument not inconsistent with state law.

If "income" is defined as a unitrust amount, realized gains may -- not must, but may -- be allocated to income to the extent the unitrust amount exceeds ordinary income, even if state law and the trust instrument are silent on the question, where the trustee intends to adhere to this as a regular practice.

Example 11 under paragraph (e) of that reg. expressly countenances a statutory ordering rule such as we see here.

TD 9102 also added reg. section 1.643(b)-1, which among other things says says that a "switch between methods" of determining trust "income" will not be a recognition event per section 1001 and will not be treated as a taxable gift, if it is "specifically authorized" by state statute, whereas otherwise it might, depending on "facts and circumstances."

And TD 9102 added language to reg. section 26.2601-1(b)(4), including the example 11 cited in the present ruling, saying that if state law provides for a "reasonable apportionment" of "total return" between income and remainder beneficiaries -- if it meets the requirements of reg. section 1.643(b)-1 --, then the administration of a trust in conformance with that law "will not be considered to shift a beneficial interest" to a lower generation.

And here is the split hair. Or maybe an apple and an orange.

The language just quoted from reg. section 26.2602-1(b)(4) does not reference reg. section 1.643(a)-3, which is where you find the example including an ordering rule. It references only reg. section 1.643(b)-1, where you find a more abstract statement that a unitrust payout between three and five pct. is a presumptively "reasonable" apportionment of total return.

An apple. Nothing about who should shoulder the tax burden of realized gains. We accept that a redefinition of what comprises trust "income" for fiduciary accounting purposes does not shift a benefit to a lower generation.

Versus an orange at example 11 in reg. section 1.643(a)-3(e), which not only contemplates pushing at least a portion of realized gains out to the beneficiaries, but appears to countenance apportioning the taxable components of the distribution under a "worst in, first out" rule.

And here Jack notes that while the statement "this treatment of the capital gains is a reasonable exercise of [the] trustee's discretion" appears repeatedly in the examples, not only in example 11, in each case it is offered as a "fact and circumstance" on which the tax result is premised -- *i.e.*, because the exercise happens to be reasonable in this instance, therefore --, not as a *per se* determination that any such exercise would necessarily be "reasonable."

To return to the issue at hand.

The trustees have made a decision to invest for total return. This will have a tendency to depress current receipts in favor of capital appreciation. To treat the income beneficiaries fairly we will redefine "income" as a unitrust amount. Because this is expressly authorized by state statute, we get the benefit of reg. section 1.643(a)-3, which allows us to allocate realized gains to the unitrust payout, shifting tax burden to the "income" beneficiary to that extent.

Hit pause. Absent an ordering rule, section 661(b) would allocate the

distributions deduction across "income" classes pro rata. Not "worst in, first out." Because we do have an ordering rule, the trust pays less income tax than it otherwise might -- not just because it is apportioning realized gains to the unitrust payout, but because those gains are treated as being distributed only after ordinary income classes are exhausted.

To be sure, if state law did not permit us to define "income" as a unitrust amount, we would have been distributing net ordinary income anyway. But not realized gains, unless we could rationalize it as a regular practice. Bottom line, we are enhancing the remainder by shifting the tax burden on amounts that would otherwise have been taxed to the trust.

This does shift a benefit to a lower generation, not because reg. section 1.643(b)-1 says it is okay to adjust between income and principal for fiduciary accounting purposes, but because reg. section 1.643(a)-3 says it is okay to shift the tax incidence of the components of the "income" distribution, and because an example under that reg. appears to countenance making a non-pro rata apportionment of those components.

The present ruling quietly breaks new ground on the question whether the 2004 revision of the fiduciary income tax regs implies the requested result, and it does so with only the most cursory analysis, dismissing the ordering rule as "administrative in nature."

## Marginalia

[fn. 1]

Literally, the provision for current distributions was "limited to" the greater of income or five pct. of trust corpus. The proportions in which these distributions were to be allocated among the surviving spouse and the nine supported orgs is not indicated in the text of the ruling, but as we shall see they were unequal.

[fn. 2]

Given this structure, the supporting org was clearly Type 3, and because its only engagement with the supported orgs was grantmaking, it was by definition non-functionally integrated.

[fn. 3]

I have not been able to track down the particular ruling, but these are not uncommon. The logic of these rulings is articulated in the present ruling using what has become stock language.

[fn. 4]

The trustees had changed the situs of the trust for a second time, to a state that had this ordering rule in its statute.