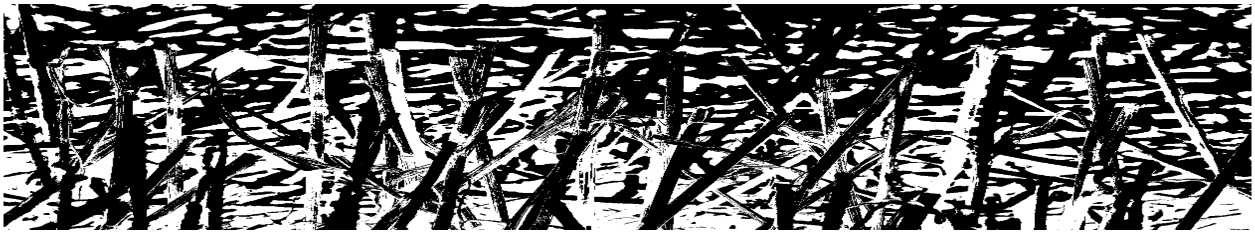

Jack Straw Fortnightly*

Reboot

[*] In the first issue I explained the asterisk by saying the newsletter would be fortnightly "or occasional."

It has been seven weeks. Forty-nine days. The bardo.

A couple of things did happen in the interval. In no particular order:

April 13

IRS released Notice 2018-37, announcing its intention to issue regulations clarifying the effective date of the repeal of section 682 and inviting the public to comment on some potential consequences of that repeal the drafters may not have anticipated.

The tax overhaul enacted in late December has repealed Code section 215, which allows a deduction for alimony paid, as well as section 71, which taxes alimony as income in the hands of the recipient former spouse. The same section of the bill also repeals section 682.

These changes do not take effect until 2019, and unlike most of the other changes to the income tax rules for individuals, they do not sunset at the end of 2025. This will become the permanent new reality, at least until the next regime change. The economics of divorce are about to change.

Until the repeal takes effect, section 682 overrides any provision elsewhere in subtitle A of the Code that would otherwise tax income in what is sometimes called an "alimony trust"[fn. 1] to the settlor, and instead treats distributions to the recipient former spouse as though these were made from a "complex" trust. Some interesting planning opportunities here, which are probably underutilized.

The Notice says IRS intends to propose regulations that would say this treatment continues to apply to trust income payable to a former spouse who was divorced or legally separated under a decree entered on or before December 31 unless the decree is later modified "and the modification provides that the changes made by [section] 11051 of the Act apply to the modification," which pretty much tracks the text of the legislation.

Jack says, a window of opportunity for "strategic" divorce, and further opportunities for manipulation going forward.

The repeal of section 682 is treated in the legislation as an incidental, "conforming amendment" to the repeal of section 215, and it is not even mentioned in either the Ways and Means majority tax staff report or the Conference Report. Nothing to see here, citizen.

The staff report characterized the income shifting effect of the alimony deduction as a "divorce subsidy."

The Joint Committee on Taxation estimated the revenue effect of the repeal at $8.3 billion over ten years. With the one-year delay in implementation coming out of conference, this estimate was lowered to $6.9 billion. Some portion of this is attributable to a gap between taxpayers claiming a deduction and recipients not reporting the income.

The predecessor to section 682 was first enacted in 1942, simultaneously with what are now -- for a few more months -- section 71(a), taxing alimony payments to the recipient former spouse, and portions of section 215, allowing a deduction to the payor.

Prior to 1942, there was nothing in the Code specific to the taxation of alimony. The controlling authority was the 1917 decision of the Supreme Court in *Gould v. Gould*, which held that alimony was neither taxable to the recipient nor deductible by the payor, on the theory that

> "permanent alimony is [to be] regarded rather as a portion of the husband's estate to which the wife is equitably entitled than as strictly a debt"

[citation to a pre-1913 case holding that alimony is not dischargeable in bankruptcy].

The stated rationale for the 1942 legislation was that the top marginal rates were being increased significantly, and this would "intensify the hardship of payment of alimony out of after-tax income." Section 71 was revised substantially in 1984 to prevent "frontloading" of alimony to accomplish what amounted to property settlements.[fn. 2]

Anyway.

The Notice also requests comment on whether formal guidance is needed on the effect of the repeal of section 682 on various provisions of subpart E of subchapter J, the "grantor" trust rules -- specifically,

- section 672(e)(1)(A), which treats the settlor as holding any power or interest held by an individual who was the settlor's spouse at the time the power or interest was created,

- section 674(a), which treats the settlor as the "owner" of any portion of a trust as to which the settlor or a "nonadverse" party holds a power of disposition over income or corpus, exerciseable without the consent of an "adverse" party, and

- section 677(a), which treats the settlor as the "owner" of any portion of a trust the income of which may be distributed, in the discretion of the settlor or a "nonadverse" party, and without the consent of an "adverse" party, to the settlor or the settlor's spouse.

Suffice it to say, one or more of these are fairly common features of the "alimony trust," and the repeal of section 682 will require some serious rethinking of how these trusts are to be structured in order to shift taxable income to the recipient spouse.

Comments are due July 11.

April 26

The New Hampshire House did approve SB 311, but not without some effort. The bill "clarifies" that section 112 of the Uniform Trust Code as enacted in that state in 2004 was somehow not intended to import the pretermitted heir statute into the trust code.

This is of course absurd -- but I have already belabored the point in a previous issue of this newsletter.

The House Commerce committee sent the bill to the floor on a vote of 11 to 6, with a minority report expressing a "concern" that "a broad exemption for trusts" from the application of the pretermitted heir statute "would have unintended consequences." To say the least.

The split took the bill off the consent calendar, and when it came to a vote on the regular calendar, someone called for a "division" vote, which is something short of a roll call, but does require an actual count of the yeas and nays, rather than allowing the presiding officer to simply declare "the ayes have it" on a voice vote.

The tally was 188 to 134, a bit more than a four to three margin, with more than a dozen representatives apparently present but not voting.

The bill was enrolled on May 3, but at this writing, nearly three weeks later, the governor still has not signed it. And of course it remains to be seen what the state supreme court will make of it in deciding the *Craig Trust* litigation.

The case was argued and submitted on March 15. In oral argument, the lawyer for the trustee hedged the question whether the statute, if enacted, should apply retroactively to the trust at issue.

On the one hand, the purpose clause does say the legislation is intended to "clarify" what the legislature intended fourteen years ago, but on the other hand, the stated effective date is "upon passage," meaning the date the governor signs the legislation.

Typically, legislation affecting trusts will state the effective date in rather more specific terms.

For example, section 564-B:11.1104 of the New Hampshire statutes says the comprehensive 2004 revision to the trust code applies not only prospectively, but also to then-existing arrangements, and even to pending court proceedings, quote,

> "unless the court finds that application of a particular provision of this chapter would substantially interfere with the effective conduct of the judicial proceedings or prejudice the rights of the parties, in which case the particular provision of this chapter does not apply and the superseded law applies."

But here, ostensibly, we are not "superseding" anything.

Interestingly, paragraph (a)(4) of that same section -- all of this is drawn directly from the uniform code, incidentally -- says

> "any rule of construction or presumption provided in this chapter applies to trust instruments executed before the effective date of this chapter unless there is a clear indication of a contrary intent in the terms of the trust[.]"

But in *Craig*, the trustee is arguing the pretermitted heir statute is not a rule of construction. Whatever.

Louder, faster

I was in Seattle for the ACGA conference, eating a pretty nice vegetarian platter -- broccolini and polenta, etc. -- at the "rates luncheon" on Thursday, April 26, when they announced an increase in the recommended maximum gift annuity payout rates, to take effect July 1.

The complete schedule was not released until May 15, but in making the announcement they did say they were increasing the gross investment return expectation by fifty basis points, from 4.25 pct. to 4.75 pct., and that this would have the effect of increasing recommended maximum payouts by thirty to fifty basis points for the age ranges in which most annuity contracts are issued.

My jaw probably dropped, but I was surprised to see very little reaction of that kind from others. For the most part, folks seemed gratified to have a fresh marketing tool.

This is the first rate change in more than six years. When interest rates were at or near zero, the ACGA changed its recommended rates five times in three years. In January 2012 they implemented a new requirement that the present value of the residuum be at least twenty pct., rather than the ten pct. required by Code section 514(c)(5)(a).

According to Bill Laskin over at PGCalc, the new recommended rates will fail the twenty pct. requirement for some younger annuitants if the section 7520 drops below 2.8 pct., and will fail the ten pct. requirement if the rate drops below 1.8 pct.

Jack is not a doomsayer, but while it is true that the 7520 rate for June is up to 3.4 pct., and we have been averaging 3.03 pct. for the year, the last time we were at 3.4 pct. was May 2010, more than eight years ago. In between, we hit 1.0 pct. four times, most recently in January 2013. Last year the rate averaged 2.4167. We may not be out of the woods yet.

In an airport concourse on the way up to the conference, waiting for a connecting flight, I was subjected to television -- probably MSNBC or CNN -- and I did hear that ten-year Treasuries had hit three pct. for the first time since January 2014. The low was 1.357 pct. in July 2016, not so very long ago.

And I do not know much or anything about how this stuff works. But the long-term trend is still down, kids. Also, of course, rising interest rates can bring their own problems.

April 27

As they do every spring, the Treasury and IRS have invited the public to identify tax issues requiring formal guidance to which they should give priority in coming months. Notice 2018-43.

At any given moment, the "priority guidance plan" is carrying a couple hundred open items. For the most part, these do not represent full-blown regulatory projects, but matters that might be covered by notices, revenue rulings, revenue procedures, and suchlike.

In selecting projects to include in the fiscal 2019 plan, the Treasury and IRS say they will consider a number of factors, including whether the proposed guidance would resolve "significant issues" affecting a large number of taxpayers, whether it would "promote sound tax administration," etc.

Starting last year, another item was added to these criteria: whether the proposed guidance "would be in accordance with" Executive Orders 13771 and 13777. The former order requires that an agency issuing a regulation that increases "incremental costs" -- including not only direct budgetary outlays and net transfers, but also compliance costs incurred by the private sector -- simultaneously eliminate the costs associated with "at least two prior regulations." The latter order describes an enforcement mechanism to be implemented by the Office of Management and Budget.

This year there is yet another caveat. We are going to be pretty busy with guidance implementing the tax overhaul enacted in December, the Notice says, and we do not expect to get to some of the items already identified in last year's plan until sometime next year. And of course some of those items have been carried for several years already.

The deadline for submissions is June 15. Typically, the AICPA will submit its comments just under deadline, while the ABA Section of Taxation will submit fashionably late.

May 15

The 9th Circuit federal appeals court heard oral argument in *Estate of Dieringer*, on appeal from a Tax Court decision sharply reducing the amount of a claimed estate tax charitable deduction for a residuary gift from the decedent's revocable trust to a private foundation.

The gift was to have been funded by the decedent's stock in a closely held corporation, but the corporation redeemed most of the stock from the trust at a fraction of its reported value and distributed unsecured notes.

I wrote about this case last year in an article for Tax Notes titled "Waiting for the other Shoe." In that piece, I argued that the government had pursued a mistaken strategy here -- that the case for disallowing a portion of the claimed charitable deduction was weak, and that IRS should instead have sought -- and might still, if the statute of limitations has not run -- to assess excise taxes under section 4941 for self-dealing -- on the executor in that capacity and in his capacity as sole director of the foundation, and on other disqualified persons who were parties to the transaction.

And sure enough, this was essentially the position the taxpayer took in oral argument -- IRS may have, or may have had, other recourse, but this is the wrong approach. And the lawyer for the government had not much to say.

Still, the appeals court panel did seem uncomfortable with allowing the taxpayer to benefit from this transaction. And it is possible they will affirm the Tax Court -- maybe on the theory that what happened here falls within the literal scope of reg. section 20.2055-2(b)(1), which limits the amount of the estate tax charitable deduction to only that portion of property that is transferred for a charitable purpose and is not subject to a power in a transferee or a trustee to divert the property to noncharitable uses.

Bad facts making bad law.

The Tax Court had stopped just short of relying on the reg. itself, because of course the executor did not formally have authority to divert assets from the foundation. He simply accomplished the same result through what was arguably a breach of his fiduciary responsibilities.

But no one has yet called him on it. Not IRS, by asserting an excise tax on self-dealing, and not the state attorney general. Yet.

Where are my notes

[fn. 1]

The phrase "alimony trust" is something of a misnomer, as reg. section 1.682(a)-1(a)(2) takes the position that section 682(a) applies, "for example, to a trust created before the divorce or separation and not in contemplation of it," while section 71 applies "only if the creation of the trust or payments by a previously created trust are in discharge of" a spousal support obligation "imposed upon or assumed by" the settlor under a decree of divorce or legal separation or under a written separation agreement.

[fn. 2]

There is an excellent writeup of the history of the taxation of alimony trusts in an unattributed student note in a 1969 issue of the Valparaiso University Law Review.

The law school, which first opened in 1879, will not be admitting a new cohort of students this year, and apparently will close after the current first year class graduates in 2020. Disclosure: my late father taught at the Valparaiso law school in the 1970s.

Jack says, we should do this more often.