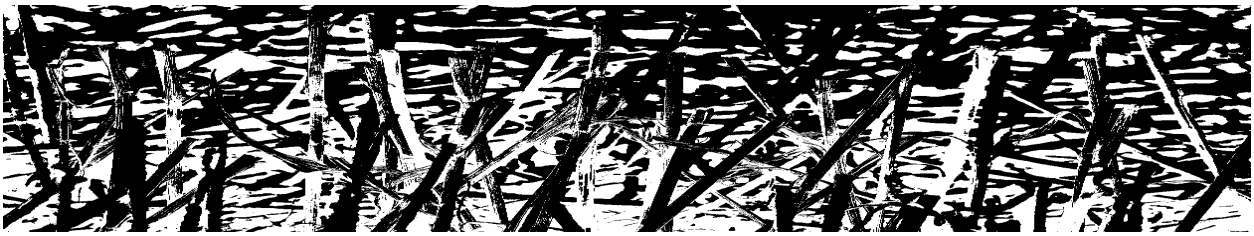

Jack Straw Fortnightly*

waning crescent

Just to keep things interesting, let's actually hit the two-week mark for a change. Three brief items, sort of like what you might expect from a fortnightly newsletter.

August 27

On cross-motions for partial summary judgment in Harbor Lofts Associates v. Commissioner, the Tax Court determined that the long-term lessee of two historic buildings would not be allowed a charitable contribution deduction for joining with its lessor in subjecting the properties to a facade easement.

The buildings were owned by the Economic Development and Industrial Corporation of Lynn, a nonprofit corporation created by the Massachusetts legislature in the 1970s for the purpose of redeveloping -- or shall we say "gentrifying" -- downtown Lynn, in Essex County just north of Boston.

In 1979, EDIC leased the buildings to Harbor Lofts for a term of sixty-something years. The lessee was responsible for all expenses of developing and maintaining the properties as rent subsidized apartment buildings. It had a right of first refusal to purchase the buildings and would share in the proceeds if the property were taken in condemnation.

In 2009, the parties extended the lease for another sixteen years. The facade easement at issue was part of that transaction. The rent schedule going forward was "revised," presumably downward, and Harbor Lofts paid EDIC $4.5 million.[fn. 1]

Harbor Lofts then claimed a charitable contribution deduction for the facade easement in the amount of not quite $4.5 million. On a final partnership administrative adjustment, IRS disallowed the deduction and assessed a 40 pct. gross valuation misstatement penalty, or in the alternative a 20 pct. negligence penalty.[fn. 2]

The court's analysis, briefly, was (a) that a lease is not an interest in real property at all, but merely a contract for services, and (b) that in any event the holder of a term of years is not in a position to grant a perpetual easement.

Jack acknowledges that the second point, perpetuity, might be a lock, but he takes issue with the idea that

a long-term lease -- in particular a ground lease -- is not, or cannot be, an interest in real property.[fn. 3]

The state law authority cited by the court here to characterize the lessee's rights under the lease as personal property had to do with what the court itself characterized as a "commercial" lease, which "usually contemplates a continuing flow of necessary services from landlord to tenant," etc. What we are looking at here is quite different.

Let us suppose, says Jack, that the lessor was not an exempt org, and that it was the lessor who wanted to create the facade easement. As a practical matter the lessee under a long-term ground lease would have to participate in that transaction.

Or to take the analogy further, suppose the holder of a legal life estate and the holder of a vested remainder in fee had joined in granting a facade easement.[fn. 4] Clearly in that case the life tenant does have an interest in real property, and while again the life tenant acting alone cannot create an easement in perpetuity, she would be a necessary party to the transaction.

In other words, as the court itself acknowledged, the lessee here did give up rights it held under the lease, and these rights had economic value. But in the court's analysis, the lessee ceded these rights not to the grantee of the facade easement, but to the lessor.

If this case eventually goes up on appeal, and we can see some of the underlying documentation in the record on appeal, we may learn who was the moving party here. Was the facade easement something Harbor Lofts threw into the mix to make the numbers work on what was essentially a buyout of the remaining term on the initial lease? or was it something EDIC wanted?

August 31

Two items from last week's release of letter rulings.

1. CCA 201835005

This was a memo from a lawyer in probably the PSI office to a lawyer in probably the P&A office,[fn. 4] suggesting that the recipient might want to hold off processing a refund claim on an estate tax return, apparently based on application of a predeceased spouse's unused exclusion amount, until the sender has had an opportunity to rule on a separate request for 9100 relief allowing a late QTIP election for a portion of a trust.

The memo says the portability election was made on a timely filed return, which would seem to imply that the refund request is against an estimated payment made in connection with an automatic extension. And unless we are looking at a second marriage, this would in turn seem to imply that the late severance and QTIP election would be with respect to the predeceased spouse's estate. [fn. 5]

Allowing a belated QTIP election in the estate of the predeceased spouse would if anything increase the DSUEA for the survivor.

If it is a second marriage, maybe we are looking at a timely filed return for the second decedent

spouse, who was in turn survived by another spouse, and the amount of a potential refund would be affected by qualifying a portion of a trust for the second survivor as QTIP.

Certainly a puzzle.

2. PLR 201835014

Somewhere around a half dozen rulings issued in a given year respond to requests from private foundations to treat amounts set aside for distribution over periods extending up to five years as though they had been distributed currently, thereby avoiding an excise tax on "undistributed income" under section 4942.

This was a fairly unusual instance in which IRS denied the request.

The math is a bit more complicated, but the rule of thumb is that a nonoperating private foundation should distribute about five pct. of its "nonexempt use assets" on a current basis.

Section 4942(g)(2) allows IRS to approve a set-aside where either (a) the funded project is one "which can better be accomplished by such set-aside than by immediate payment of funds" or (b) the project will not be completed before the end of the tax year and the foundation is otherwise current with its obligation to make "qualifying distributions," according to a couple of metrics we need not go into here.

In construing these requirements, IRS has taken the position at reg. section 53.4942(a)-3(b)(9) that a foundation that is involved in litigation may seek and obtain a "contingent set-aside" with respect to assets or income that are subject to a court order forbidding distribution.

The foundation requesting the present ruling was a testamentary trust, apparently a nonexempt charitable trust under section 4947(a)(1). The decedent's will required the trust to make distributions to a designated charity, to support a specified activity.

At some point the trustees determined that the designated charity was no longer performing the specified activity, and it "sought to replace" that charity with another. [fn. 6] The designated charity sued, and eventually the matter was settled on the basis of a formal "expenditure responsibility" agreement.

Unfortunately, neither party had secured an order from the state court precluding distribution pending the litigation. Absent a court order, IRS said it could not grant the requested set-aside.

September 4

Today was the deadline for submitting final drafts of papers to be presented at the NACGP conference in October. Your correspondent submitted his paper yesterday, when he might instead have been remembering Joe Hill.

A copy is posted here for your perusal.

Asides

[fn. 1]

The text of the court's opinion does not make entirely clear what each party was seeking in renegotiating the lease -- what exactly the $4.5 million payment was for --, or the extent to which the anticipated benefit of the facade easement deduction may have been a factor in their calculations. Obviously EDIC itself, as an exempt org, could not directly benefit from the deduction.

[fn. 2]

The Tax Court website does not carry copies of the parties' pleadings or briefs, so it is unclear what other issues may still be open in this case. At the very least, the assessed penalties, which would involve questions of valuation and of possible defenses.

If and when this case is appealed, we will have online access to the record on appeal, which would likely include exhibits and transcripts of testimony.

[fn. 3]

For example, reg. section 1.1031(a)-1(c) treats a leasehold of thirty or more years as "like kind" to real property for purposes of a tax-deferred exchange. At common law, a leasehold is an estate for a term of years.

[fn. 4]

In its arguments to the court, Harbor Lofts drew an analogy to a tenancy in common. As the court noted, this analogy is not apt, as tenants in common each hold a fee in their undivided interests.

[fn. 4]

Redactions. Gotta love 'em.

[fn. 5]

Also the word "sever" might seem to imply a "reverse" QTIP allowing the surviving spouse to be treated as a transferor for generation-skipping transfer tax purposes.

None of this speculation is helped by the fact that the uniform issue list code under which this ruling was released is 2010.04-00, which is the code under which rulings allowing late portability elections are gathered. The memo here says right up front that the portability election was timely made, so apparently that is not an issue.

If we were looking at a simple late QTIP election, we would expect to see a code of 2056.07-01. If we were looking at a late "reverse" QTIP election, the code would be 2652.01-02.

[fn. 6]

The text of the ruling does not indicate whether the trustees petitioned a state court for modification of the trust, whether under common law or statutory principles of *cy pres* or otherwise.

Jack says, an injury to one is an injury to all.