Jack Straw Fortnightly*

Gotta serve somebody

On January 12, the 10th Circuit federal appeals court issued its decision in *Green v. United States*, No. 16-6371 (10th Cir. 01/12/18), reversing an Oklahoma district court that had allowed a trust an income tax charitable deduction at fair market value for a contribution of appreciated properties that had been purchased, it was said, from prior years' income.

At least for the moment -- the time for filing a motion for rehearing has not yet elapsed, and of course this is only one circuit --, the government has prevailed in its argument that the deduction should be limited to adjusted basis.

Which seems intuitively correct -- one might almost say obvious --, but it has been surprising to see the extent to which the argument is not solidly grounded in the statute, the interpretive regulations, or prior caselaw.

Very, very briefly

The trust in this case had filed an amended return adjusting the amount of its claimed charitable deduction upward and requesting a refund of $3.2 million. The explanation for the adjustment had to do with a recalculation of the limitation under section 681(a) where some of the trust's income would be unrelated business taxable income if the trust were an exempt entity.

Not a change in claimed values, in other words, and not a change in the underlying assertion that the trust should be allowed a deduction for unrealized appreciation.

An examiner asked the Chief Counsel for advice, and in CCA 201042023 a lawyer in that office whose name was redacted from the memo as released said the deduction should be limited to adjusted basis, pretty much for the reasons you would expect: section 642(c) says distributions must be sourced to "gross income" to be deductible, and of course unrealized appreciation has not been taken into "gross income."

This would have been water under the bridge had the trustee not filed a refund claim.

The portion of the memo dealing with litigation hazards acknowledged there was very little authority out there, apart from *W. K. Frank Trust of 1931 v. Commissioner*, 145 F.2d 411 (3d Cir. 1944), which denied a deduction for unrealized appreciation

in property that had been derived through like-kind exchanges from property contributed to the trust at its inception, *i.e.*, not purchased from prior years' income, and *Crestar Bank v. IRS*, 47 F.Supp.2d 679 (E.D.Va. 1999), which denied an income tax deduction to a decedent's estate for a bequest of stock, as this could not be "traced" to gross income.[fn. 1]

IRS rejected the refund claim, and the trustee filed suit in federal district court, where he did succeed in securing a partial summary judgment on the legal question and a jury verdict on the disputed valuation of one of the contributed properties. But the appeals court reversed, citing both the *Frank* and *Crestar* decisions.

In coming weeks, you can expect to see any number of articles analyzing the *Green* decision and its precursors. Some of these may go into considerable detail on the section 681 limitations, which as it turned out were actually just a distraction.[fn. 2]

For our present purposes it is enough to note that we do finally have a precedent directly on point. What I want to talk about here is the way the trustee and his tax advisor went about setting this up.

And how, in effect, they mostly got away with it.

Middle game combinations

On the return as initially filed, the trust had reported total income of $58.8 mil., net of $2.9 mil. in capital loss carryforwards and $977k in ordinary losses from a disregarded entity. The largest single source of income was a passthrough of $62.6 mil. from a limited partnership in which the trust held the 99 pct. limited interest. In other words, almost all of the total income figure was unrelated business income.

The gross amount of contributions reported was $36.9 mil. Noncash contributions aggregated $30.3 mil., including a single property valued at $29.5 mil., which the trust had acquired just over a year earlier at $10.4 mil. The amount actually claimed as a charitable deduction on the return as initially filed was $20.5 mil., reflecting a reduction for the UBTI limitation.

The amended return, filed three years to the day after the initial return had been filed on extension, increased the claimed deduction by $9.1 mil., with a four-page explanation about how the section 681 limitation had been calculated incorrectly and showing a "corrected" calculation.

At that moment, the deductibility of unrealized gains to the extent of the amount claimed on the return as initially filed was a closed question, as the statute of limitations had expired.

The amended return requested a refund of $3.2 mil. After securing the Chief Counsel memo mentioned above, the examiner denied the refund claim, noting that if the deduction had been limited to basis on the return as initially filed, now closed, only $17.2 mil. would be been allowed, which would have yielded an additional $1.8 mil. in tax.

The examiner's report mentioned that the trustee had claimed a deduction for unrealized appreciation in a later tax year as well, which had been disallowed on audit. In that particular case, the amount allowable under the section 681 limitation was actually less than the adjusted basis in the contributed property, so the matter was settled in appeals.

A speculative fiction

If I were writing this as fiction, it might go something like this.

The advisor -- who does after all work for the parent company -- says to the trustee, we could pick up this light industrial property in rural Virginia for ten mil., as a possible site for one of our retail stores, but with some acreage we could split off and contribute to this grantmaking foundation at a much higher appraised value -- say, threefold[fn. 3] -- after holding the property for just over a year, so that any gain or loss would have been long term had the property been sold.

We could then claim a deduction for the unrealized appreciation and wait to see if we get audited. Probably we would extend the return to allow time to work up a defensible appraisal.[fn. 4]

I cannot put this in writing, [fn. 5] the advisor continues, but the audit rate on 1041s is only about one-tenth of one percent.[fn. 6]

On the other hand, we are a fairly high profile trust, so the real question is whether, assuming we do get audited, the examiner would identify this particular issue, and if so, whether we could make a settlement that avoids the assessment of penalties.

There is almost no authority on the question, the advisor says, and we could probably hold onto this reporting position to at least the appeals court level -- if we took it up as a refund case through the district court, rather than as a deficiency case in the Tax Court.

No doubt IRS will fight us on the, shall we say, implausible valuation, but again, if we were taking this up through the district court, we could get a jury of our neighbors here in the Oklahoma City area to decide the question of value. [fn. 7] We are something like the sixth largest employer in the area.

So, we want to generate a trigger for a refund request by initially claiming less than we might, maybe take a conservative reading of the reduction for income sourced to UBTI, and then come back at the three year mark to see if we can have a second bite.

Deep in the weeds

But it might not have happened that way at all.

You might think I am beating up on the advisor here, and certainly that would be consistent with the larger themes of this newsletter. But one reason I am focusing so much attention on the advisor here is that he did not sign the return, though it is reasonably clear he prepared it.

Reg. section 301.7701-15(f) lists a number of exceptions to the

general rule that if you are preparing a return for compensation you are a "tax return perparer" and you are required to sign the return, disclosing your role.

Either of two exceptions might arguably apply here. Subparagraph (f)(1)(ix), if you are preparing a return for an entity by which you are employed or in which you are a general partner, or more likely subparagraph (f)(1)(x), if you are preparing a return for a trust of which you are an employee of the fiduciary.

The preparer here did not sign the return. There is a deduction claimed on line 14 of the 1041 for about $19k in fees, which might include return preparation fees, but this figure is not broken down in any of the attached statements. The preparer did sign a form requesting additional time to file, beyond the initial automatic extension, identifying himself as "tax manager."

According to his testimony at trial, this identification would have described his then status as an employee of the parent company, which operates a chain of retail stores, apparently through a limited partnership of which it holds the one pct. general interest and the trust holds the 99 pct. limited interest.

The reader may determine for herself whether the 1041 was prepared for the parent company, by which the "tax manager" was employed, or whether the preparer was also an "employee" of the trustee.

I am going with neither, though the argument could be made this trust is itself just another arm of the parent company.

More stray notes

[fn. 1]

As noted in the memo, this tracing principle is articulated in Reg. section 1.642(c)-3(b), finalized in 1975 as part of a package of regulations interpreting and inplementing the Tax Reform Act of 1969.

The memo also noted *Old Colony Trust Co. v. Commissioner*, 301 U.S. 379 (1937), which said (a) cash contributions could be treated as sourced to prior years' gross income, and (b) the trustee could claim a deduction where the trust instrument permitted but did not require distributions to charity. The latter issue, incidentally, had not been raised by the parties, but *sua sponte* by the appeals court.

[fn. 2]

Probably few or none will note that section 170 itself allows a deduction for unrealized appreciation only by negative inference, and until the enactment in the early to mid sixties of the reduction rules at section 170(e) for unrealized short term gain and depreciation recapture, there was not even that.

But all of this is beyond the scope of the present discussion.

[fn. 3]

Oddly missing from any of the motions, briefs, or rulings throughout this case is any mention of the fact that while the Form 8283 attached to the return recites the $10.4 mil. purchase price and claims a $29.5 mil. value for the deduction, the acreage contributed to the grantmaking foundation was only two-thirds of the acreage purchased a little over a year earlier.

So only about $6.9 mil. of the trust's adjusted basis was actually allocable to the gift, meaning the multiplier was more like fourfold.

[fn. 4]

In an unexpected wrinkle, the appraiser died before the return was filed, and the Form 8283 was signed by his widow, who apparently was also a licensed appraiser. The government sought to exclude the appraisal report from evidence at trial on the ground of hearsay, but the district judge let it in, not for the truth of the assertion as to value, but to explain where the reported figure of $29.5 mil. came from.

[fn. 5]

Section 10.37 of the regulations setting standards of "practice" before the IRS, commonly called "Circular 230," says a "practitioner" providing written advice to a client on a federal tax matter may not "take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit."

Apparently this means that an analysis of audit risk may not be included in the written advice itself. But it does not seem to forbid discussing audit risk orally.

Obviously the rule simply drives the behavior underground, but it may also shift the penalty risk to the taxpayer, who may have nothing in writing she can cite to support a reasonable cause defense.

There is some considerable uncertainty over whether the Treasury has authority to regulate the conduct of a practitioner who is offering written advice, but who is not at that moment engaged in representing a client in a live controversy. The Office of Professional Responsibility actually lost on this issue in *Sexton v. Hawkins*, No. 2:13-cv-00893 (D.Nev. 03/17/17). The government voluntarily dismissed its appeal to the 9th Circuit.

The preparer in this case was a certified public accountant -- clearly within the definition of "practitioner" at section 10.2 of the regs. Whether he provided written advice on this matter is not disclosed in the court record.

[fn. 6]

Source, IRS Data Book 2016, table 9a, page 23.

[fn. 7]

In the actual case, the jury determined the value of the disputed property was $28.5 mil., slicing only one mil. off the claimed value, but still leaving the trust ahead of the game. The appeals court finally had to step in and say, knock it off, you will wake the children.

Frayed ends

Our inaugural issue two weeks ago was given over to a lengthy discussion of a decision of the New Hampshire supreme court in *Hodges v. Johnson*, affirming the result, if not the rationale, of a probate court order setting aside a series of purported decantings from two irrevocable trusts and removing the co-trustees.

At the time there was still pending a motion for rehearing. That motion has since been denied, but not before yet another round of filings from both camps. These have been posted to the newsletter's landing page.

In the course of the discussion of *Hodges*, incidentally, I mentioned a 2013 decision of the Massachusetts supreme court holding that a facility of payments clause was functionally equivalent to a power to decant.

It turns out the link I initially provided to *Morse v. Kraft*, 466 Mass. 92 (2013), was getting snagged behind a Lexis paywall, though of course there is no actual charge for access to the report, it being, y'know, the official report.

So I have taken the liberty of posting a .pdf copy to my site and substituting a link to that .pdf in the newsletter. This despite the copyright notice you will see at the bottom of the last page.

Oddly enough, the seminal decision on whether a private publisher can claim exclusive rights to publication of a reported decision of a state court was itself a Massachusetts case, *Nash v. Lathrop*, 142 Mass 29 (1886), cited with approval by the United States Supreme Court in *Banks v. Manchester*, 128 U.S. 244 (1888).

Lexis might have a claim to any editorial content they provided, but I am not seeing any. And not to complain, but I think they could use a larger font.

Live free or drive

It is likely the folks who have been driving the effort to "modernize" the New Hampshire trust code will be back in the current session with a legislative "fix" to *Hodges*. So I have been monitoring the website for what they call the General Court, the state legislature.

And while I have not yet seen anything on decanting, I did see that a bill has been introduced to "clarify" that section 112 of the state's version of the uniform trust code, which purports to apply the rules of construction for wills to revocable trusts, does not import the state's pretermitted heir statute, as this is said not to be a "rule of construction."

The bill seems to anticipate an adverse result in a case that is now pending before the state supreme court, styled *In re Craig Trust*. Lawyers from both sides of that case showed up on January 9 to testify for and against the bill at a hearing before the senate commerce committee.

I do not intend this newsletter to become all New Hampshire, all the

time, but that is where some of the action is these days, and I will be tracking both the proposed legislation and the *Craig* litigation as each moves forward.

Briefing is not yet completed in *Craig*, and a date has not yet been set for oral argument.

I have my own issues with section 112 of the uniform code, which we can get into when the time comes. Also with the Restatement Third, which on this and some other issues seems to me to have moved from being descriptive of existing law to being prescriptive of what the law "should" be.

Meanwhile

Oral argument before the 9th Circuit federal appeals court in *Estate of Dieringer* has been postponed until at least May. The Tax Court disallowed an estate tax charitable deduction for a bequest of closely held stock to a private foundation, to the extent the value reported on the 706 exceeded the discounted price at which the corporation later redeemed the stock.

I wrote about this case for Tax Notes a few months back, just after all the briefs were in. A copy of that article is posted here.

Jack says, "knave spades courtier, queen clubs enabler."