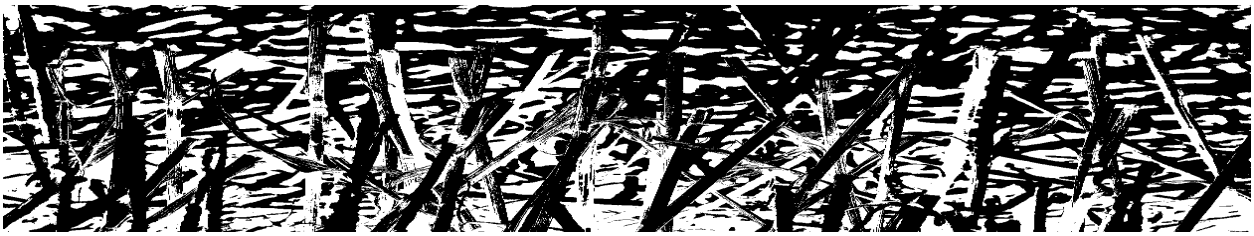

Jack Straw Fortnightly*

storm warning

. . . and we are back, after a hiatus of a hundred twenty-something days, almost nineteen weeks.

In the interim, we did get the PG 103 project launched. And we got each of the seven sessions listed with CFRE for education credit, both certification and recertification.

Working now to edit and update the supporting text, something over 25k words, which should print up to something under a hundred pages.

Anyway. We have some catching up to do, but we are mostly going to just skim the surfaces. Some of the dozens of items that have accumulated since mid-July we will simply discard. Others we may get to in coming weeks.

Palmer plus or minus

One item of particular interest to gift planners would be the Tax Court memorandum decision in *Dickinson v. Commissioner*, T.C.Memo. 2020-128 (09/03/20). A taxpayer victory, yes, but also possibly a hint of trouble to come.

At least superficially this case would seem to be your typical situation in which the taxpayer contributes highly appreciated stock in a closely held corporation to a donor advised fund, which the fund sponsor -- here, Fidelity Charitable -- then almost immediately tenders for redemption.[1]

Similar in some ways to the scenario in *Palmer*, 62 T.C. 684 (1974), the question again being whether the steps of the transaction should be collapsed, so that the taxpayer would be treated as having first sold the stock, recognizing the gain, and having then contributed the proceeds.

Actually, the facts in *Palmer* might appear to be much stronger on the question of prearrangement, as the taxpayer there also controlled the foundation, to which he had contributed enough stock that the foundation was in a position to force the redemption.

Or, as the court noted, to prevent it.

IRS lost that case, the court having given perhaps too much credence to the idea that the taxpayer in his role as foundation manager was limited by his fiduciary responsibilities.

And then voluntarily dismissed its cross-appeal[2] to the 8th Circuit, ultimately acquiescing in the result in Rev. Rul. 78-197.

The revenue ruling cited several federal appeals court decisions[3] in which, again, the taxpayer as a practical matter had controlled both ends of the transaction, but the courts had chosen to respect the form of the transaction over what IRS had argued was its substance.

But the ruling gave more ground than was perhaps strictly necessary, announcing a bright line rule that

> "under facts similar to those in *Palmer*" IRS would treat the proceeds of a redemption as income to the taxpayer "only if" the recipient org was "legally bound" to sell or if it "[could] be compelled by the [issuing] corporation to surrender the shares for redemption[,]"

in effect conceding the question of prearrangement altogether, but also shifting the focus from whether the taxpayer was assigning an existing, enforceable right to proceeds to whether the recipient org would be obligated to sell.

Though grounded in *Palmer*, the ruling is widely understood to apply to ostensibly unenforceable prearrangements well outside the immediate context of stock redemptions. It is only a slight exaggeration to say that an entire industry has been built on this one revenue ruling.

One federal appeals court, the 2d Circuit in *Blake*, 697 F.2d 473 (2d Cir. 1982), did express the view that the revenue ruling "reads too much into" the cited decisions. But this was dictum, *i.e.*, not necessary to the result in the case at hand.

In *Blake*, the Tax Court had determined, and the appeals court agreed, that the recipient org was in fact obligated, under equitable principles of promissory estoppel, to tender the contributed stock for redemption, and to use the proceeds to purchase a yacht from the taxpayer at a price well in excess of its fair market value.

If the org had not made this commitment, the taxpayer would not have made the contribution in the first instance.

back to the future

My first impression on reading *Dickinson*, almost twelve weeks ago now, was that IRS might be retreating from the position it had articulated in the 1978 revenue ruling and trying to make a case on prearrangement that fell somewhat short of enforceability. The problem being of course that the ruling is still out there.

They did actually try this years ago in *Rauenhorst*, 119 T.C. No. 9 (2002), yet another stock redemption case. But the Tax Court was having none of it, and treated the revenue ruling as a "concession" by IRS that the dispositive question was not whether the anticipated merger was a "practical certainty" at the time of the transfer, as IRS was arguing, but whether at the time the stock warrants were transferred the recipient orgs were in fact **already legally obligated** to tender the underlying shares for redemption.

The agency had "neither revoked nor modified Rev. Rul. 78-197 in response to the comments in *Blake*," the court noted, and had in fact cited the ruling in several private letter rulings since.

Taxpayers "should be entitled to rely on revenue rulings in structuring their transactions," the court concluded, "and they should not be faced with the daunting prospect of the Commissioner's disavowing his rulings in subsequent litigation." And worse, asserting penalties. Fair enough.

It bears noting that the Tax Court in *Rauenhorst* took pains to say it was not itself "adopting" the "bright line" test stated in the revenue ruling, and but for the "concession" would instead have focused on whether at the time of the transfer the taxpayer **already had an enforceable right** to the proceeds of the redemption.

An assignment of income analysis, in other words, flipping the equation as to where enforceability lies.

what is the what

In the intervening years IRS has still not revoked or modified the 1978 revenue ruling.

And as it turns out, they were actually arguing in *Dickinson* that the revenue ruling did apply here, that is, that Fidelity had received the stock subject to an enforceable obligation to tender it for redemption.

You might not quite gather that from the text of Judge Greaves' opinion. At page 10 he says, quote,

> Regardless of whether the donee's obligation to redeem the stock may suggest the donor had a fixed right to redemption income at the time of the donation, [citation to *Rauenhorst*], respondent does not allege that petitioner had any such right in this case. Accordingly, respondent's resort to Rev. Rul. 78-197, *supra*, is unavailing[,]

end quote.

Which sounds somehow wrong, because again, the revenue ruling is focused on whether the org is receiving the stock **subject to an existing obligation** to redeem, not whether the taxpayer transferor had **an existing enforceable right** to proceeds of a pending redemption.

But what actually was the argument IRS was making from the revenue ruling we are not told. For this we need to read the briefs, which the court has a policy not to post to its website, and which your correspondent has retrieved at a cost of twelve American dollars and posted to the landing page for his newsletter.

There were cross motions for summary judgment. And what we find in the IRS brief in support of its motion is an argument

> (a) that the shareholders' agreement restricted ownership of stock to a handful of select, full-time employees,[4]
>
> (b) that therefore a transfer of stock to Fidelity would require consent of the board of directors, which might be conditional on a prompt redemption,

(c) that the board had also reserved a unilateral right to call the stock of any shareholder, and crucially

(d) that the transaction at issue was one of a series of similar transactions engaged in by several shareholders under blanket consents given by the board **on the express understanding** that Fidelity would implement its own policy "to immediately liquidate the donated stock [by] promptly tender[ing it] to the issuer for cash,"

which understanding enabled the board to consider the arrangement "consistent with the prompt repurchase of shares following a transfer by the shareholder, consistent with [the shareholders' agreement]."

Arguably a condition, in other words, somewhat analogous to the situation in *Blake*. That is to say, the board might not have approved the transfers had it not been assured that Fidelity would immediately tender the stock for redemption.

And if the court had adopted the logic of the revenue ruling, we would be looking at the fact that the corporation did have an enforceable right to call in the stock.

For whatever reason, Judge Greaves does not address this argument directly. Instead, at page 8 of the opinion, he says "the assignment of income doctrine applies only if the redemption was practically certain to occur at the time of the gift, **and would have occurred** whether the shareholder made the gift or not" (emphasis supplied).

The emphasized phrase is a fair summary of the ruling in *Palmer* only if you limit the rationale of that case to its particular facts. But not every transfer to an exempt org with the exit strategy clearly in view arises in the context of a pending merger or redemption.

What happened here might almost be seen as some kind of incentivized stock buyback. On a more fully developed record, it might even have emerged that the buyback was leveraged.

Jack suggests that summary judgment for the taxpayer was premature here, and that an appeals court might remand to allow further discovery. But the taxpayer has already been arguing that the Commissioner was slow in launching discovery and has only himself to blame.

It remains to be seen whether the Commissioner will take an appeal, but Jack is asking whether we might be seeing omens and portents of an emerging policy at IRS to challenge more of these transactions under theories of prearrangement.

sleight of hand

Another item of some interest that came up while we were on hiatus is PLR 202037009, released on nine eleven. The linked subhead is to a post I made to LinkedIn at the time, reading pretty much as follows.

Over here we have an inter vivos charitable lead unitrust (CLUT), term of years not yet expired at the settlor's death. Over there, a sale by the settlor to an irrevocable nongrantor trust (IDGT) of nonvoting stock in a corporation (closely held?

we are not told), in exchange for a promissory note, interest only (secured? unsecured? at what rate? we are not told), with a balloon payment at maturity (how many years? we are not told).

Settlor dies, unpaid balance of the note held by her revocable trust to be distributed with the residue, of which x pct. goes to the CLUT, and the balance to three named individuals who are members of the decedent's family within the meaning of section 4946(d).

Those three are also the co-trustees of the CLUT, and they are the remainder beneficiaries at the expiration of its term. More than 35 pct. of the beneficial interests in the IDGT are held by family members, presumably the same three, let's say the settlor's children.[5]

In short, if the note were distributed to the CLUT, this would be an act of self-dealing. And the note comprises a sufficiently large share of the trust remainder (how large? we are not told) that this result could not be avoided.

the ask

The trustees of the lead trust propose [to persuade the trustees of the revocable trust][6] to instead create a limited liability company, funded entirely with the promissory note, and distribute nonvoting interests in the LLC to the CLUT, rather than direct interests in the note itself.

The voting interests in the LLC would be distributed to the other remainder beneficiaries of the revocable trust, *i.e.*, those three kids again. They would control the distribution of proceeds of the note to the members.

The nonvoting interests would be required to participate in a unanimous vote to liquidate the LLC, but this would not constitute a veto power over any action "relevant to any potential acts of self-dealing," per reg. section 53.4941(d)-1(b)(5).

So we are good. The lead trust is effectively separated from control of the promissory note.

Incidentally, this is by no means the first time IRS has ruled favorably on similar facts. Both PLR 201723005 and PLR 201407023 come readily to mind, and there may be others.

while we are here

The trustees also sought an advance determination that the nonvoting interests held by the CLUT would not be "excess business holdings" within the meaning of section 4943(c).

The rule here (greatly oversimplifying) is that a split-interest trust subject to the private foundation excise tax regime is permitted to hold -- in combination with the holdings of all disqualified persons -- no more than 20 pct. of the voting interests in a "business enterprise."[7]

Here, of course, the lead trust would hold no voting interests at all, but disqualified persons would hold 100 pct. However. The LLC is not a "business enterprise," because more than 95 pct. of its gross income is derived from passive sources, *i.e.*, payments on the note.[8]

the state pushes back

Someone on twitter posted a link to draft legislation that is under discussion at the franchise tax board in California that would treat an incomplete nongrantor trust (ING) created by a resident as a "grantor" trust for state law purposes, thereby in theory defeating the strategy to remove the trust situs to a state that has no income tax.[9]

The draft is expressly based on a statute enacted in New York in 2013, codified at section 612(b)(41) of that state's tax law, and effective January 01, 2014.

We have as yet seen no reported litigation on the New York statute, though clearly it would affect the Kaestner trust itself, see our discussion in Jack Straw two comma six, footnote 1.

the permanent war

The taxpayer has appealed to the 6th Circuit federal appeals court the decision in *Oakbrook Land Holdings*, presumably seeking to challenge the validity of the regulation requiring that the donee of a conservation or facade easement participate "proportionately" in the proceeds of an extinguishment, and the IRS' interpretation of that reg forbidding compensation to the transferor for "improvements" it might later make to the servient estate.

As we discussed at some length in Jack Straw three comma five, this case is not a promising vehicle for testing the reg, much less IRS' interpretation of the reg, because the "improvements" clause here froze the donee's share at its value on the date of the initial transfer, which fairly clearly fails the statutory requirement that the easement represent an interest in the real property itself, not merely a contractual right to proceeds.

IRS has cross-appealed, presumably from the court's having rejected its assessment of an accuracy-related penalty on the ground that the taxpayer had acted reasonably and in good faith, because, um

because there was this one letter ruling out there that appeared to countenance an "improvements" clause, though that was not one of the questions at issue in the letter ruling,

and because reasonable minds could differ on the validity of the reg, witness the divided Tax Court in the accompanying reviewed decision on the question.

But Jack says this does not explain the freeze.

We do not yet have a briefing schedule, but you may be assured your correspondent will track this appeal.

six forty-two aitch

The Treasury has quickly finalized without significant change the proposed regs treating excess deductions on termination as having the same character in the hands of the distributees as in the hands of the decedent's estate or irrevocable nongrantor trust. Details in Jack Straw three comma five.

They expressly rejected your correspondent's comment that the change ought to be made retroactive

to any open years, rather than only to the date of enactment of the suspension of miscellaneous itemized deductions -- probably a distinction without much difference, really --, on the theory that the existing reg had been in error all along.

And took a moment to say, hey, we are doing you a favor here, quitcher complaining.

pieces and parts

[1]

How this "sell immediately" policy plays out where the contribution is of a very large block of publicly traded stock is the subject of litigation in a federal district court in California in *Fairbairn*, mentioned briefly in Jack Straw three comma three.

There was a (virtual) bench trial over seven days in late October. The parties have each submitted proposed findings and conclusions. Closing arguments are December 04.

[2]

Not satisfied to have prevailed on prearrangement, the taxpayer in *Palmer* took an appeal on the question of valuation. For some reason IRS did not cross-appeal. The 7th Circuit affirmed at 523 F.2d 1308 (8th Cir. 1975).

[3]

Notably *Grove*, 490 F.2d 241 (2d Cir. 1973), and *Carrington*, 467 F.2c 704 (5th Cir. 1973). A third decision also mentioned in the revenue ruling was unpublished.

[4]

While the shareholder agreement did allow for the transfer of stock to a trust or other entity "for estate planning purposes," the individual shareholder would be required to retain the voting rights, which of course did not occur here and would have been a nonqualified partial interest if it had.

[5]

The lead trust and the IDGT are typically used to leverage gifts to lower generations, not to a surviving spouse, for which other vehicles balancing the marital deduction against portability are more suitable.

[6]

The ruling request was made by the trustees of the lead trust, and technically applies only to them, in that capacity.

In the corresponding footnote to the LinkedIn piece, we said it was possible we would see other related rulings requested by other parties to the transaction in the next week's release.

That did not happen, and Jack asks why not. The excise taxes on disqualified persons for participating in an act of self-dealing are a great deal steeper than those on foundation managers for allowing it to happen.

[7]

There is an interesting exception at section 4947(b)(3) for a lead trust for which allowed income and transfer tax deductions have not aggregated more than 60 pct. of the fair market value of trust assets. For reasons indicated in the main text, this exception was not discussed in the letter ruling.

[8]

Which at least in theory brings us back to the questions whether the note was secured by the nonvoting stock in the corporation and how closely the stock in the corporation was held. If the note went into default and the LLC ended up holding the stock, it might become relevant who held how much of the voting stock.

[9]

Longtime readers will be familiar with the fact that Jack has an agenda re INGs, the *Kaestner* decision, etc.

Those not already familiar with these ravings might survey the landing page for this newsletter with a text search. Jack would draw the reader's attention in particular to issue two comma nine re *Kaestner* and issue three comma one re INGs.

Jack says, they held the heavy sky on their open hands