Jack Straw Fortnightly*

not yesterday anymore

As part of an effort to start adhering more closely to a fortnightly schedule for this newsletter, your correspondent has begun posting short articles to LinkedIn and participating in comment threads there and on Twitter as events arise.

Some of these can then serve as rough drafts for the Jack Straw. For example.

not entirely wasted

On May 07, the Treasury issued proposed regulations that would allow distributees to itemize excess deductions on termination of a decedent's estate or nongrantor trust, rather than treating these as miscellaneous itemized deductions, which have been suspended through 2025.

The notice of proposed rulemaking was published in the Federal Register on May 11, opening a comment period of only forty-five days, through June 25. So get out your pencils.

The proposed regs also clarify that expenses of administration deductible under section 67(e) are not miscellaneous itemized deductions, and are thus still deductible by the estate or trust.

Which would actually have been noncontroversial were it not for the implementing reg. section 1.67-4(a), which frames section 67(e) as an exception to the rule that miscellaneous itemized deductions generally are (or were, when they were allowable at all) subject to a floor of two pct. of adjusted gross income.

Why that framing is flawed we explored at some length in Jack Straw volume one, number nine[1] back in August 2018, a few weeks after IRS released Notice 2018-61, offering the same clarification.

At the time, they were asking for comments on the question how to treat excess deductions on termination under section 642(h)(2). The present regulatory project is the result.

And they did get some comments. Including one pointing out that until this difficulty is resolved fiduciaries will be under pressure to hold administration open until 2026 or to realize gains at the entity level to absorb deductions that would otherwise be wasted.

In the end they settled on a scheme that was already being hinted at in the notice. Excess deductions on termination will retain their character in the hands of the distributees, using the same principles we are already using under reg. section 1.652(b)-3(a) in allocating deductions on an ongoing basis.

And since section 67(e) expenses are by definition an adjustment to gross income, that means these should somehow also be "above-the-line" deductions in the hands of the distributees. The literal text of proposed reg. section 1.642(h)-2(b)(1) reads:

> Each deduction comprising the excess deductions under section 642(h)(2) retains, in the hands of the beneficiary, its character (specifically, **as allowable in arriving at adjusted gross income**, as a non-miscellaneous itemized deduction, or as a miscellaneous itemized deduction) while in the estate or trust.

(emphasis supplied).

This is almost as far as you can get from disallowing the deduction in the hands of the distributees, or subjecting them to a two pct. floor.

The regs will be effective for reporting years beginning after the date final regs are published, but taxpayers are permitted to rely on the proposed regs with respect to tax years beginning after 2017.

After some struggle, you correspondent has accepted that this means a fiduciary may rely on the proposed regs in reporting excess deductions on termination attributable to section 67(e) expenses as an "above-the-line" income adjustment in the hands of the distributees in any tax year beginning after 2017, without waiting for the regs to be finalized.

Until IRS revises the form, this would probably be a matter of making an entry in box 14 of the K-1, coded "I," with a written explanation.

However, it remains the case that this ought always to have been the rule. So it ought to be possible to amend any open returns to take this reporting position. Not just 2018 and later.

The only reason we are seeing a reference here to "tax years beginning after 2017" is that that is the effective date of the suspension of "miscellaneous" itemized deductions. Which has nothing directly to do with reporting an income adjustment item on a K-1 to a distributee.

The proposed revision to reg. section 1.642(h)-2 corrects a longstanding error, and should apply retroactively to any open year.

Your correspondent is likely to submit comments to this effect.

gee six sub two

IRS has won yet another skirmish in its permanent war against ~~perceived~~ abuses of the ~~already excessively generous~~ tax incentives for conservation and facade easements.

Whether they can hold this turf on appeal remains to be seen, but this case is likely not the vehicle.

On May 12, a divided Tax Court issued a reviewed opinion in *Oakbrook Land Holdings, LLC v. Commissioner*, upholding not only

(a) the validity of reg. section 1.170A-14(g)(6)(ii), which requires that the donee be entitled to receive, in the event the easement is later extinguished, proceeds at least equal to the "proportionate value" of the restriction as a component of the value of the entire property, but also

(b) the agency's interpretation of that regulation, which would allow no compensation to the holder of the servient estate for any improvements it may have made to the property in the interim.

Eleven judges concurred in a majority opinion authored by Judge Lauber. They acknowledged that this is a "legislative" regulation, *i.e.*, not merely "interpretive," for which notice and public comment were required, but found that in finalizing this reg the Treasury had adequately addressed concerns that were raised in the notice and comment period.

Judge Toro, concurring in the result only, *i.e.*, that the taxpayer should be denied a deduction, disagreed with that finding. He argued at length that in finalizing the regs the Treasury had in fact ignored comments questioning the proposed rule that would not allow the holder of the servient estate to recover its investment in improvements.[2]

However, Judge Toro said the court should not even have reached this question, because even without the "improvements" clause the agreement here froze the donee's share at its value on the date of the initial transfer. This, he said, failed the requirement of section 170(h)(2) that the easement be an interest in the real property itself, which of course would participate in any appreciation in its value.

Judge Holmes, who had actually heard the case, dissented, echoing several of Judge Toro's arguments. It was in fact his memorandum decision denying the claimed deduction, issued the same day, that had necessitated a reviewed decision on the validity of the reg.

"particularly in the southeast"

Back in 2008, IRS released a letter ruling, PLR 200836014, that seemed to countenance an "improvements" clause in a conservation easement, but

(a) of course a letter ruling is not precedent, and
(b) the clause was not itself at issue in the ruling request.

And in the particular case, the agreement did provide that the donee would participate in any appreciation, albeit net of the adjustment for improvements.

Still, the taxpayer in *Oakbrook* was able to cite this letter ruling as "substantial authority" to support the "reasonableness" of its reporting position and escape negligence and understatement penalties.

And as Judge Holmes noted in his memorandum decision, apparently the "improvements" clause was then already a fairly widespread practice, "particularly in the southeast."[3]

In other words, there are quite number of these cases in the pipeline, and eventually someone will get the question of the validity of this reg, and more specifically the agency's interpretation of the reg, in front of an appeals court.[4]

But apparently not just yet.

The taxpayer did try to raise the issue to the Fifth Circuit in *PBBM-Rose Hill Ltd. v. Commissioner*, but that court declined to take it up as it had not been argued below.

here it comes

What promises to be an avalanche of decisions denying very large claimed deductions for conservation or facade easements involving "improvements" clauses was launched last October in *Coal Property Holdings, LLC v. Commissioner*, a reviewed opinion, also authored by Judge Lauber, which we mentioned briefly in Jack Straw volume two, number fourteen.

As in *PBBM-Rose Hill*, however, the taxpayer did not challenge the validity of the regulation, not even in its motion for reconsideration.

Thus, while it appears likely that case will be appealed to the 6th Circuit after the question of penalties has been resolved, the appeals court probably will decline to take up the validity of (g)(6)(ii) or the agency's reading of that reg.

Judge Toro makes a good argument in his concurrence in *Oakbrook*, which is well worth reading. The heart of the matter is at pages 52 and following: assuming the "proportionality" requirement of (g)(6)(ii) is valid, is IRS reading of that reg to forbid an "improvements" clause reasonable.

Though technically this is *Auer deference*, not *Chevron step two*.[5]

forcing the election

In our April 08 issue, we talked about the "unlimited" itemized deduction for cash contributions to 170(b)(1)(A) charities made during calendar 2020, enacted as part of the third round of federal legislation responding to the COVID-19 crisis.

In particular we talked about how the "unlimited" deduction operates differently from the temporary increase in the percentage limit for cash gifts to (b)(1)(A) charities to sixty pct. through 2026, enacted as part of the 2017 tax bill.

Whether by accident or design, the temporary sixty pct. limit is structured in such a way as to potentially force carryforwards of gifts subject to lower percentage limits. The Joint Committee says this was an accident, but we have seen no technical corrections.

But here the legislative text says contributions qualifying for the "unlimited" deduction are to be "disregarded" in applying the ordering rule for deductions subject to lower limitations. Same as with other temporary suspensions of deduction limits for disaster relief in the past.

"So," we concluded,

> if a taxpayer also makes contributions and/or has carryforwards subject to lower percentage limitations, she can still take advantage of the

temporary "unlimited" deduction for cash gifts without "wasting" a carryforward year for those items. Excess cash gifts will simply be carried forward.

What we did not talk about is the fact that the "unlimited" deduction is elective.

And of course as you get closer to zeroing out your adjusted gross income, the deduction is offsetting income in lower and lower brackets.

So you might want to elect to deduct only a portion of the amounts in excess of the temporary sixty pct. limit and carry the balance forward to a later year in which it can offset income in higher brackets.

But here we run into another difficulty.

With a tip of the fedora here to Sheila Hard at the University of the Pacific, who challenged your correspondent on a CGPLink thread -- what some of us old timers still call "gift-PL" -- on the question whether you can carry forward the portion of the excess cash contributions you do not elect to deduct for 2020.

"I was under the impression," Sheila said, "that one cannot carry forward a deduction to future years unless one had claimed the full amount available in the current tax year. Do I have that wrong," she continued, "or are the rules different under the CARES Act?"

Direct and to the point.

And after some struggle, your correspondent framed the following response. Attaching a copy of section 2205 of the bill to facilitate the discussion.

"Literally what clause (ii), top of the second page, says," he argued, "is that you can carry forward amounts in excess of the limitation in clause (i), which is a hundred pct. of your contribution base.

"Which might sound like if you elect to deduct less than the entire excess contribution, you lose the carryforward.

"But note," he said, "that here they are talking only about 'qualified' contributions, which is to say, paragraph (3), amounts as to which you have made an election.

"So if you make cash contributions to (b)(1)(A) charities in excess of fifty pct. of your contribution base, but you do not elect to treat the entire excess as 'qualified,' then you fall into the default carryforward rules at 170(d), which reference the fifty pct. limitation.

"So then the question is," he continued, "what about the margin between fifty and sixty pct. Keeping in mind that the temporary sixty pct. limit, standing alone, has the effect of forcing the carryforward of items subject to lower limitations (if any), which the one-year 'unlimited' deduction does not."

Your correspondent then went on to suggest that to avoid that result you might elect to treat anything over fifty pct. as "qualified," up to the amount where your tax benefit breaks even, so as to prevent anything being treated as subject to the temporary sixty pct. limit."

It would be helpful if IRS gave some formal guidance on this, but the foregoing is what your correspondent would expect such guidance to say.

In the CGPLink thread, your correspondent acknowledged he "would not be astonished if IRS took a different view," but he said he did not see "how they would square this with the policy objective to incentivize cash gifts in calendar 2020. Forcing folks to 'elect' as to amounts that are deductible against lower marginal rate brackets or lose the deduction entirely," he said, "would instead incentivize delaying some portion of these contributions into January of next year."

touching bottom

On May 08, the ACGA announced another cut to its recommended maximum gift annuity rates, effective July 01. And while the new tables are not yet published, we are looking at an assumed rate of return of only 3.75 pct., which seems to be a record low.

Meanwhile, the 7520 rate for June will be an astonishing zero point six pct., yet another twenty basis points down from the May rate, and a hundred forty from the January rate.

We did touch one point zero three times in 2012 and again in January 2013, but until this month we have never been below that threshold.

There are opportunities here for charitable lead annuity trusts, both "grantor" and non, and for GRATs and intrafamily loans.

For the next few days, it will still be possible to elect the April rate of one point two pct. in valuing a charitable gift.

With the gift annuity there is a tradeoff between maximizing the deduction and reducing the portion of each payment that is taxed as ordinary income.

Get out your calculators.

remnants

[1]

Tl;dr, what section 67(e) literally says is that expenses of administration that would not [ordinarily] have been incurred by an individual are not an itemized deduction at all, but an above-the-line income adjustment.

The confusion arises in part because "adjusted gross income" is not a "thing" in subchapter J, and in part because the Congress chose to codify this provision within section 67, rather than, say, somewhere in section 642.

And then the Treasury compounded the problem with reg. section 1.642(h)-2(a), asserting without any express statutory authority that excess deductions on termination are to be treated as itemized in the hands of the distributee.

[2]

If the taxpayer does take an appeal, and tries to argue the

invalidity of the reg to the 11th Circuit, we will see an administrative record showing the comments submitted.

This regulatory project predates the electronic posting of comments online at regulations.gov, so those are not otherwise readily available. Should be an interesting read.

[3]

A little over a year ago, we briefly mentioned a lawsuit the Justice Department had filed in December 2018 in federal district court in Atlanta, seeking to shut down a conservation easement syndication operation, to permanently enjoin the promoters from working in the industry, and to require them to disgorge every nickel they had made on these projects in the preceding ten years.

When last we looked in on this, the parties were just beginning to fight over the scope of discovery. Two weeks ago, with a fair amount of discovery in hand, the DOJ moved to amend its complaint to "amplify" the allegations with respect to the "breadth and extent" of the defendants' conduct.

And at the same time, the DOJ sought relief from limitations the trial judge had placed on its efforts to subpoena information from nonparties in other states.

Meanwhile, five individuals have filed a class action suit, also in Atlanta, against several of the same players, together with lawyers, accountants, financial advisors, and land trusts who allegedly worked together on a strategy to promote easement syndications to investors like the plaintiffs, who then found themselves paying lawyers to fight the disallowance of their claimed deductions, and ultimately paying back taxes with interest and penalties.

[4]

In *Woodland Property Holdings, LLC v. Commissioner*, in a memorandum decision issued the day after the two decisions in *Oakbrook*, Judge Lauber granted IRS a partial summary judgment in another case involving an "improvements" clause.

An appeal in that case would lie to the 11th Circuit, but as in *Oakbrook*, the easement agreement also froze the value of the donee's share at its value on the date of transfer, and again, the taxpayer did not challenge the validity of the reg.

So, also probably not a good vehicle for testing the validity of the reg on appeal. But eventually we will get there.

[5]

Jack does not want to try the patience of our readers with an extended discussion of judicial deference to an administrative agency in framing a regulation where the statute is silent or in interpreting an ambiguous regulation.

These subjects are treated with reasonable clarity in the majority opinion in *Oakbrook*, in Judge Toro's concurrence, and in Judge Holmes' memorandum decision.

Suffice it to say that under "*Chevron* step two," where the statute

is silent, a court will sustain an interpretation that is not "arbitrary, capricious, or manifestly contrary to the statute," and under "*Auer* deference" a court will accept the agency's reading of an ambiguous regulation unless it is "plainly erroneous or inconsistent with the regulation."

As Judge Holmes detailed in his memorandum decision in *Oakbrook*, the Supreme Court has recently elaborated the *Auer* formulation in *Kisor v. Wilkie*, 139 S.Ct. 2400 (2019), saying the agency's interpretation must be "reasonable," must not be *ad hoc*, must somehow implicate the agency's expertise, and must be the product of "fair and considered judgment."

If and when the validity of the "proportionality" rule of (g)(6)(ii) itself, and more particularly soundness of IRS' position that this rule precludes the use of an "improvements" clause, are properly presented to multiple federal appeals courts, it is possible all h*ll may break loose.

Jack says, my building has every convenience