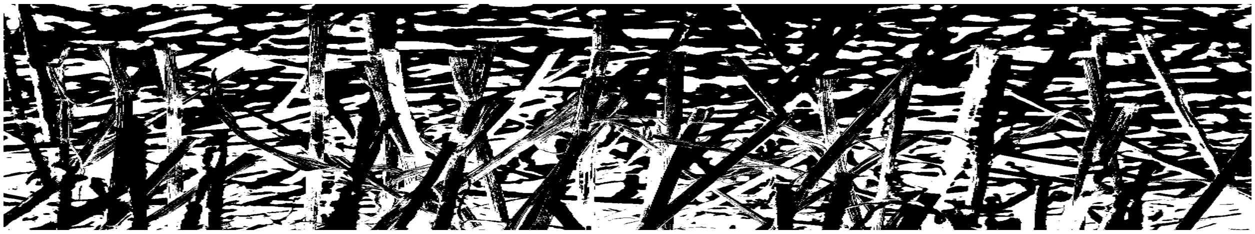

Jack Straw Fortnightly*

broken

[More than once, Jack has promised an extended rant on the incomplete nongrantor trust (ING). This may or may not be the occasion.]

The start of another calendar year brings a fresh batch of "administrative" revenue procedures, including an update of the list of issues on which IRS will no longer give advance determinations, Rev. Proc. 2020-03.

These fall into three categories: section 3, the "no rule" list itself, issues they simply will not rule on at all, section 4, stuff on which they will "not ordinarily" rule, and section 5, areas in which they are "temporarily" not giving advance determinations "because those matters are under study."

Lots of fun for the tax law ~~geek~~ journalist.

This time around there are two or three items of particular interest to the trusts and estates crew, that is to say, y'know, us.

whither the ING

At section 3.01(93) of the rev. proc., IRS says it will no longer give advance determinations on the question whether an incomplete nongrantor trust (ING) should in fact be treated in whole or in part as a disregarded entity for income tax purposes --

-- or at least, they will not rule on trusts that fall within a narrow range of specified circumstances having to do with who exactly holds the power to direct distributions during the settlor's life.

Specifically, IRS will no longer rule either

(a) where there is a distributions committee, but (1) a majority or unanimous agreement is not required, or (2) there are not at least two others on the committee besides the settlor and her spouse,

-- here Jack interrupts to say that nearly every[1] ING ruling to date has featured a committee of permitted distributees who can direct distributions unilaterally by unanimous action, or by majority with the consent of the settlor,

so items (a)(1) and (a)(2) are almost superfluous --

and typically the settlor has also reserved a right to act alone in directing distributions of corpus,[2] albeit nominally subject to an "ascertainable" standard, but albeit again, to be exercised in a "nonfiduciary" capacity,[3]

as well as a limited testamentary power to appoint the remainder at her death, to make the gift incomplete.

In other words, the settlor has accepted the risk that the value of the trust might grow, increasing her potential estate tax liability, but through the ING she can manage that risk by making and/or allowing interim taxable gifts to be completed by way of distributions.

Where were we. Oh yes: IRS will no longer rule, (a)(3),

> where not everyone on the committee is a permissible distributee during the settlor's life.

And that was just condition (a), which defines by negative inference what can be seen as a safe harbor in structuring distributions committees.

where to begin

Jack has a problem already with this item (a)(3), but we will postpone discussion until we have recited condition (b), thus:

> (b) where there is no committee, or the committee structure is within the safe harbor, IRS will no longer rule where distributions require the consent of one or more "adverse" parties, "whether named or unnamed under the trust document."

This latter condition is somewhere between odd and incoherent.

Whether the interests represented on the distributions committee are "adverse" to the exercise of the committee's limited power to appoint trust income or corpus during the settlor's life within the meaning of section 672(a) is itself the very question ~~promoters~~ taxpayers have been asking in these ruling requests.

It is a legal conclusion, in other words, not an objective fact --

-- and it is a legal conclusion Jack would argue IRS has been getting wrong in the hundred-odd "favorable" ING rulings to date.[4] And item (a)(3) confirms that they still do not get it.

Take for example the most recent batch, PLRs 201925005 through 010, released last June. Distributions committee comprised entirely of permissible distributees. Plain vanilla as far as item (a)(3) is concerned.

There are two paragraphs near the bottom of page 6 of these six rulings that you will see cut and pasted verbatim into pretty much every ING ruling.

First paragraph,

"[b]ased solely on the facts submitted and representations made," we don't see anything here that would cause the settlor to be treated as the income tax owner of the trust -- setting aside for the moment section 675, "administrative powers." And none of the distributions committee has a unilateral power to appoint to herself that would trigger section 678(a)(1).

Second paragraph,

we don't see anything in the trust document itself that would trigger section 675, but this is a matter of facts and circumstances that would more appropriately be addressed on audit of someone's return.[5]

So as a practical matter, while pretending to withhold ruling on the question whether the trust is a disregarded entity as to the settlor, IRS has in fact been giving at least half a loaf here, by conceding that the composition of the distributions committee is at least in theory sufficient to take the trust out of subpart E.

thriving in adversity

But it is not, even in theory. All these hundred-odd "favorable" letter rulings have been premised on a mistaken reading of section 672(a). That section defines "adverse party" as someone who has a "substantial beneficial interest" in the trust that would be "adversely affected" by the exercise or nonexercise of a power she has been given -- in this case, to participate in directing distributions of income or principal.

The regulation interpreting this section is not a model of clarity, but it does say (a) that a "substantial beneficial interest" gotta be "not insignificant," and (b) that although "ordinarily" a beneficiary will be an adverse party, if her share in income or corpus is "limited to only a part," she may be adverse "only as to that part."

So what about these six rulings from last year. Distributions committee comprised entirely of permissible distributees during the settlor's life, check. But at the settlor's death, these folks are contingent remaindermen in default of the exercise of her reserved limited testamentary power to appoint only to the extent of a pro rata share of ten pct.[6]

There are four of them, each in for two point five pct., maybe. And at least two, the settlor's parents, are perhaps unlikely to survive the settlor.

An argument might be made that these interests are "insignificant." But none of these rulings even mentions the reg. Instead, the focus has been on the status of the distributions committee members as permissible distributees during the settlor's life.

Jack says these latter are not "adverse" interests for purposes of section 672(a) -- in fact, he says, these folks do not have "beneficial interests" during the settlor's lifetime at all. They are permissible distributees, at the whim of the committee, not subject to any enforceable standard.[7]

And that was just (a)(3). This business in condition (b) about "named or unnamed" seems to imply that IRS has been seeing cases in which the "adverse" party was a member of a contingent class. For example. Or something. Jack suggests there may have been some ruling requests withdrawn. But no doubt the proponents are still sharpening their knives.

an alternate reality

This is how the folks who dream up these schemes think:

If we wanted the trust to be a disregarded entity for income tax purposes, we would reserve to the settlor a tax sensitive power she does not intend to exercise. But if instead we want the trust be treated as a separate entity, while reserving to the settlor an otherwise tax sensitive power she actually does intend to exercise, we burden the power with imaginary restraints --

-- in this instance, tracking the language of section 674(b)(5), a power to distribute corpus "limited by a reasonably definite standard set forth in the trust instrument." Though it should be fairly obvious that section is intended to refer to a power exerciseable by a trustee.

Probably the settlor does intend to exercise this power, to manage the tradeoff between gift taxation of amounts distributed during her life versus estate tax inclusion of the remainder. But literally no one has a sufficiently enforceable interest in the trust to challenge an abuse of the "reasonably definite standard." See footnote 3 above.

Jack says IRS should refuse to rule in these circumstances altogether. Or they should offer an adverse determination and in effect force the taxpayer to withdraw the request. And then open an examination.[8]

but wait, there is more

At section 3.01(125) of the rev. proc., IRS says it will no longer give advance determinations on whether a split-interest trust is subject to the private foundation excise tax regime if the querent says the trust is not holding amounts for which income or transfer tax charitable deductions have been allowed.

Paraphrasing here. What item (125) actually says is IRS will not rule whether such a trust "is described in" section 4947(a)(2), which clearly it is not.

Relatedly, at section 4.01(62), the rev. proc. says IRS will "not ordinarily" rule whether a split-interest trust "is described in" section 4947(a)(2) "because it has" -- or more grammatically, despite the fact that it has -- "no amounts in trust for which a deduction was allowed," etc.

This would appear to be an attempt to limit the damage from PLR 201713002, which really they ought to simply rescind as "not in the interest of sound tax administration," to quote section 3.02(10) of the same rev. proc., stock language repeated year after year.

In that ruling, IRS conceded that under a literal reading of the statute, you could have a split-interest trust that is not subject to the private foundation rules if you are willing to forgo the income and transfer tax deductions at the front end. So that horse is out of the barn.

Think net income unitrust, think excess business holdings and self-dealing. Lots of opportunities here. If the trust otherwise meets the requirements of section 664(d), it is exempt from income tax per section 664(c), regardless whether you claim a deduction.

Putting this on the "no rule" list accomplishes nothing except to deflect "comfort" rulings. The statute says what it says: if no deductions were allowed, a split-interest trust is not subject to the private foundation rules, period. A legislative fix may be needed here.

invariants of fields

The Tax Court in a memorandum decision in *Loube v. Commissioner*, T.C.Memo. 2020-3 (01/08/20), has ruled that a taxpayer cannot make a case that she has "substantially complied" with the reporting requirements for a noncash gift that includes unrealized gain to an exempt org --

-- in this case a nonprofit that deconstructs houses and sells the fixtures and other salvaged materials to support its mission to train folks "facing barriers to employment ranging from limited education to criminal records" to be employable in the building trades, while "reusing materials that would otherwise end up as landfill debris" --

unless she completes the fields on the 8283 that ask how long ago she acquired the property and what is her cost or adjusted basis or attaches an "explanation" of her claim that she has "reasonable cause" for the omission.

The decision solidifies in an appealable order a position the court struck in *Belair Woods, LLC v. Commissioner*, T.C.Memo. 2018-159 on cross motions for partial summary judgment. That case, which involved a syndicated conservation easement, is still working its way through pretrial motions.[9]

You know you are in trouble when the opinion begins by citing *RERI Holdings* for the general proposition that there is such a thing as substantial compliance. Another shoe is waiting to drop.

In that case, as you may recall, the Tax Court raised the issue *sua sponte* after more than nine years of pretrial skirmishing, and determined that the taxpayer's failure to disclose its basis in the contributed property did not "substantially comply" with the requirement of the substantiation reg., section 1.170A-13(c)(4)(ii), because in the particular case the very large spread between that figure and the value claimed as a charitable deduction "would have alerted [IRS] to a potential overvaluation" of the contributed property."[10] Neatly avoiding the substantive issues.

On appeal, the government argued for a *per se* rule, but the DC Circuit, affirming the result, found it unnecessary to go that far.

With *Belair Woods* and now *Loube* we seem to have closed the loop. The statute and the regs require you to disclose your basis, and failure to do so is simply noncompliance, period, no deduction.

The *Loube* decision is appealable to the 4th Circuit. *Belair Woods*, when it is finally decided on the merits, will be appealable to the 11th Circuit.

briefly noted

We are several weeks off schedule here, so we should take a moment to glance at a couple or three other items. We may return to some of these in future.

item: In CCA 202002011, released January 10, the Chief Counsel advised that a "constructive denial" clause in a conservation easement deed is not inconsistent with the statutory requirement that the use restriction be granted "in perpetuity."

The deed in question permitted certain uses only with the easement holder's express permission, upon written request of the holder of the servient estate. If permission was not granted within sixty days of the request, it was deemed denied. But because there was no formal decision on the merits of the request it could be resubmitted.

item: In PLR 202005020, released January 31, IRS issued adverse rulings on several requests concerning the operation of a political action committee by a for-profit subsidiary of an exempt org.

The request had been submitted by the (c)(3) parent of a healthcare "system" comprising multiple subsidiary (c)(3) orgs that operated hospitals, nursing homes, etc. -- as well as at least this one wholly-owned for-profit subsidiary that provided "real estate rental management services" to some of the exempt subsidiaries, as well as apparently to others.

The for-profit subsidiary proposed to create a section 527 political action committee, which would make expenditures to support or oppose candidates for public office. The PAC would solicit contributions from employees of the subsidiary itself, the parent org, and the exempt org "system" subsidiaries, working from mailing lists the parent org would provide at "fair market" prices.

Under a "resource sharing" agreement with the parent, the subsidiary would extend to the PAC the use of facilities, equipment, and employees of the parent at what were represented to be "arm's length" charges.

The parent sought rulings that this arrangement would not (a) constitute "participation or intervention in a political campaign" by the parent itself, nor (b) provide private benefit or inurement to the for-profit subsidiary or the PAC. IRS ruled adversely on all the requested rulings.

Jack speculates the taxpayer did not withdraw the ruling request because they decided to back off the plan.

item: And just yesterday, February 05, the Tax Court ruled in *Railroad Holdings, LLC v. Commissioner*, T.C.Memo. 2020-22, that a conservation easement deed that allocated to the easement holder in the event of an extinguishment only that portion of the proceeds "at least equal to the fair market value of the easement" at its inception did not protect the conservation purpose "in perpetuity," as required by section 170(h)(5)(A).

Which sounds like a no-brainer, especially in light of cases like *Coal Property Holdings, LLC v.*

Commissioner, 153 T.C. No. 7 (10/28/19), which we mentioned very briefly, albeit apparently not by name, in volume two, number fourteen, back in December.

At least in that case they had an "improvements" clause, which might form a plausible ground for appeal. Here, any appreciation would go entirely to the holder of the servient estate.

self promotion

Yesterday morning, February 05, your correspondent participated in a panel discussion on charitable gift planning after the SECURE Act at the monthly breakfast meeting of the local roundtable here in Tucson.

We talked about the tradeoffs between making deductible contributions after age 70.5 and forgoing excludibility of QCDs,[11] of course, but also looking at the charitable remainder unitrust as a possible replacement to the "stretch" IRA.

We did not have time to get to -- and for a nontechnical audience this would have been a heavy lift anyway -- the last item on my one-page handout, funding a "testamentary" charitable gift annuity with proceeds of a decedent's IRA.

The scare quotes indicating of course it is not testamentary, you have the gift annuity agreement in place, and the consideration is the beneficiary designation itself. Probably not enforceable against the estate.

There is nonbinding precedent for this. In PLR 200230018, IRS declined to rule whether the annuitant might recover an "investment in the contract" over an expected return multiple, calculated as the estate tax inclusion value minus the deduction for the present value of the residuum, but did rule that no portion of the IRA proceeds would be taxed as income to the participant's estate.

Sort of a tradeoff: no recognition event, but the entire annuity payout likely taxed as ordinary income.

This is a subject Bryan Clontz and his crew are on top of. Say hello to Bryan if you stop by his table at the ACGA Conference in Atlanta in April. Disclosure, your correspondent is a consultant on Bryan's team.

Then on Tuesday, February 18, your correspondent will be the presenter for a one-hour webinar for AIP on "Opportunities for the CRT in Prenuptial and Divorce Planning," a subject that has gained particular relevance in the wake of the permanent repeal of the alimony deduction. The slide deck and probably an accompanying text will eventually be posted to the "presentations" tab on your correspondent's website.

And way off in May, at the invitation of Kent Weimer, their immediate past president, now the board chair of NACGP, I will be giving a lunch program for the Dallas Council on "recent developments." I may have to cull some material from back issues of the Jack Straw.

stray marks

[1]

There are exceptions, notably PLR 201908008, in which the distributions committee included an independent trustee, who also had a power to appoint additional members. Jack critiqued this ruling on other grounds in volume two, number four.

In the typical ING, the independent trustee is excluded from participating in decisions to make discretionary distributions.

[2]

But not income, as this would not fit within the exception at section 674(b)(5).

[3]

Whatever that even means. Reg. section 1.674(b)-1(b)(5) says that to be "ascertainable" the standard must be such that the holder of the power is "legally accountable."

But since there are no actual trust "beneficiaries" here, see footnote 7 below, there is no one who would have standing to enforce an abuse of the settlor's reserved power.

[4]

The word "favorable" is in scare quotes because in each of these rulings IRS has pretended to reserve ruling on the question whether the ING should be treated as a disregarded entity as to the settlor. But see discussion accompanying footnote 5 below.

[5]

Keeping in mind that the audit rate on 1041s is less than one tenth of one pct. See the 2020 Tax Data Book, table 9a.

[6]

Also in default of the distributions committee acting unanimously to distribute the entire trust corpus among themselves during the settlor's life.

The fact that this does not seem to be a plausible scenario -- unless maybe the settlor drops broad hints that she would like to complete the gift -- might suggest pre-arrangement.

It probably bears noting that in the particular case, each member of the distributions committee would be a "related or subordinate" party under section 672(c)(2) to the extent she is not "adverse."

[7]

Edwin Morrow at US Bank in Cincinnati made a similar argument in an article he posted to LinkedIn a couple or three years ago with reference to PLR 200729009, in which the distributions committee included several individuals who were, yes, permissible distributees during the settlor's life, but were not among the remaindermen at the settlor's death -- whose interests in any event were subject to defeasance by the settlor's exercise of a nominally limited testamentary power to appoint.

Ed also has a good article up on LinkedIn on the rev. proc. and this paragraph of the "no rule" list.

[8]

One ground for an adverse determination, says Jack, is that the ING is not a trust at all, as there is no "beneficiary" with an enforceable interest, and no fiduciary who owes anyone a duty of impartiality, apart from the "independent" trustee, whose role is limited to managing investments.

This is a corporation, and should be taxed as such.

[9]

The reg., at subsection (c)(4)(i), does allow a taxpayer to omit to report basis if she attaches an explanation of "reasonable cause" for its inability to include that information. The taxpayer in *Belair Woods* did attach an explanation, to the effect that it was not necessary to report basis, as this did not figure into the calculation of the deduction.

This "explanation" was obviously not to the point, and the court of course rejected the taxpayer's argument that this somehow constituted "substantial compliance" with the requirement to report basis.

The taxpayer took this reporting position on advice it had received secondhand from lawyers for the promoter -- who as it happens is one of the defendants in the lawsuit the Justice Department is pursuing in Georgia to shut down the operation, enjoin the principals from ever working in the industry again, and force them to disgorge every nickel they ever made on these deals.

Jack says he wants to see the opinion letter. The claimed deduction was for $4.8 million, which may be enough to justify an appeal. The letter would be part of the record on appeal.

[10]

Of course, IRS did select the return for audit even without the benefit of this information.

[11]

Here at the Jack Straw Fortnightly, asterisk, we bury our errata in footnotes.

In the linked issue, by way of illustrating the tradeoff between claiming deductions for ongoing IRA contributions after age 70-1/2 and excluding QCDs from income, we supposed that our taxpayer, "Jane," was making contributions of $10k per year. Forgetting in that moment that the limit is $7k.

Jack says, you know where to find me