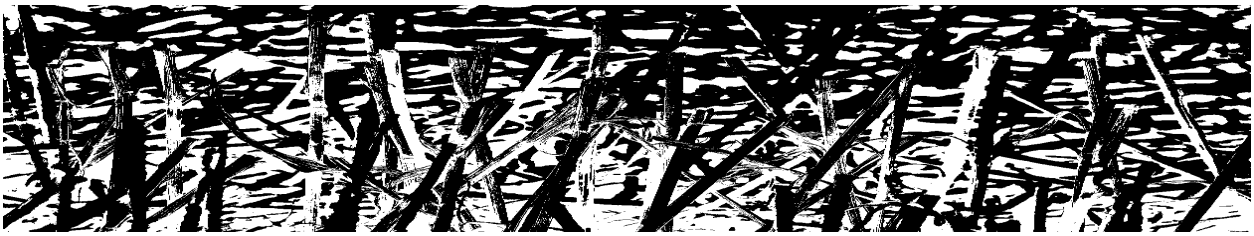

Jack Straw Fortnightly*

elevenses

A few weeks ago IRS released PLR 202022009, rejecting the application for (c)(4) status of an org it said was too heavily engaged in political campaign intervention.

An estimated sixty pct. of its "direct expenditures," attributed to two advertising campaigns, one opposing and one supporting named candidates for public office. Not "primarily" social welfare, as per the reg., much less "exclusively," which is what (c)(4) itself nominally requires.

It did not take your intrepid reporter long to track down who was the applicant. The letter had been issued February 20, after the Appeals Office had upheld the adverse determination. So we were looking for court filings pretty close to, but no later than, May 20.

And on May 20 to the penny we have a complaint filed in the DC District court by Freedom Path, one of the last stragglers from the "targeting" "scandal" of a few years back.

The complaint alleges that in making its adverse determination, IRS "relied heavily" on the eleven-factor "facts and circumstances" test set out in Rev. Rul. 2004-06, which the plaintiff argues is unconstitutionally vague and overbroad, forcing beleaguered (c)(4) orgs to self-censor their otherwise permissible issue advocacy.

off-label use

The revenue ruling does not, on its face, have to do with determining whether an org is or is not exempt under (c)(4). It uses the eleven factors to distinguish expenditures by an existing (c)(4) org that are within the scope of its exempt "issue advocacy" purposes from those that would have been "exempt function" expenditures had they instead been incurred by a 527 org., *i.e.*, attempting to influence "the selection, nomination, election, or appointment" of a candidates for public office.

Because section 527(f) taxes an exempt org on the lesser of its net investment income or its campaign intervention expenditures. Whereas a 527 org is required to disclose its contributors. You gotta choose.

But the rejection letter does cite the revenue ruling, and in determining that expenditures on

these two campaigns were in the nature of electioneering the letter does cite several of the eleven factors -- the timing of the campaign in relation to the state party convention and primary election, the identification of candidates by name, the mention of at least one candidate's position on issues on which there was no pending legislative activity, etc.

And the complaint to the district court makes marginally credible arguments that these factors may have been misapplied in the rejection of the plaintiff's application for (c)(4) status.

Which could maybe support a declaratory judgment that Freedom Path is, after all, exempt under (c)(4). If you disregard the forest for the trees.

the bright lines project

But the primary focus of the complaint is on the alleged unconstitutionality of the revenue ruling -- not just as applied here, but on its face.

Amusingly -- is that the right word? -- the plaintiff argues at paragraph 19 of its complaint that IRS itself has "acknowledged the need for 'sharper' rules that would afford 'greater certainty," etc., citing the ill-fated regulation project launched in November 2013 in the wake of the "targeting" "scandal."

Attentive readers may remember that the proposed regs were met with an unprecedented avalanche of adverse public comment, much of it angry and ill-informed, cribbed from a handful of talking points provided by a few provocateurs. Though in fairness, the regulation as proposed was not all that carefully thought through.

Ultimately, IRS withdrew the proposed reg. The project was finally dropped from the agency's priority guidance plan in October 2017 after several appropriations measures adopted by the Republican-controlled Congress had included language forbidding IRS to spend any money resurrecting it. That language, incidentally, is still in the current year's appropriations measure.

same river twice

Some of you may be asking, hey, wait a minute, didn't Freedom Path already take its shot on this very question several years ago? and didn't they lose? so shouldn't we have issue preclusion here?

Well, probably not.

It is true that Freedom Path brought an action in a federal district court in Texas back in 2014 that among other things did raise the validity of the revenue procedure, both on its face and as applied.

Interestingly, that lawsuit did not seek a declaratory judgment on the plaintiff's exempt status. The parties literally agreed that IRS should suspend processing the application pending the litigation, which focused on allegations of "targeting," improper disclosure of taxpayer information to ProPublica, etc. And the validity of the revenue ruling.

And it is true that the district court denied a motion for partial summary judgment that the revenue

ruling is invalid on its face -- not reaching the "as applied" claim because the record had not yet been developed -- and later entered a final judgment dismissing the facial invalidity claim with prejudice in order to clear the way for an appeal. [The parties stipulated dismissal of the "as applied" claim without prejudice.]

But the 5th Circuit federal appeals court declined to take up the question on its merits because, it said, Freedom Path did not have standing to raise it.

Why not? Because, as noted a few sentences back, section 527(f) imposes a tax on the "lesser of" net investment income or campaign intervention expenditures. And as it happened, Freedom Path had zero net investment income, so it would not have had to pay any tax in any event. So it could not have been affected by the revenue ruling.

Well, unless the ruling was applied in making an adverse determination on its application for (c)(4) status. But back in 2014 the determination had not yet been issued, and the parties had taken that question off the table.

So as it turns out, there actually has not been a prior determination here that would preclude Freedom Path pursuing claims that the revenue ruling is invalid both on its face and as applied.

marginalia

The election in which Freedom Path is said to have intervened was the 2012 Republican primary challenge to then Sen. Orrin Hatch of Utah.

According to its 990 for calendar 2012, Freedom Path spent almost $1.2 million that year, pretty much every nickel they had received over the course of two years. From whom of course we cannot know.

A little more than half this spending was on "advertising and promotion," of which they characterized about $300k on schedule C as "political expenditures," specifically, "television, mail[,] and internet advertisements advocating the election and defeat of federal candidates."

They closed out the year with assets of less than $20k, reported zero receipts over the next two years, paid out their remaining assets as compensation to one of their directors, and reported a deficit of $158k in 2014 attributable to "unpaid legal fees."

Since then they have been filing e-postcards, except that for 2018 they did file a short form 990-EZ reporting $14k received in "a legal settlement." Oh, and on that return the $158k deficit has disappeared.

But one wonders who is paying all this high-end legal talent.

"an abusive structure"

A couple of weeks ago, IRS released an advice memo two lawyers in the national office had written back in February concerning a "marketed structure" that purported to avoid entirely, not merely to postpone, the recognition of gain on the sale of appreciated property contributed to a charitable remainder annuity trust.

The memo was addressed to senior lawyers in both the SB/SE and TE/GE divisions, who apparently have "numerous" returns under examination involving this strategy.

The memo concluded that the "structure" does not in fact produce the tax results advertised by its promoters, to somehow "trap" realized gains at the entity level, while treating the greater portion of the annuity payout as a nontaxable return of corpus.

how it works (not)

The memo paraphrases several key provisions of what is said to be a representative trust document and quotes at length from "promotional materials" in the form of "a series of memoranda from the taxpayer's tax and financial advisors." Whom we can imagine to be drawing commissions on the sale of annuity contracts.

In broad strokes, the idea is to fund a charitable remainder annuity trust with appreciated property, sell the property within the exempt entity, and invest just short of ninety pct. of the proceeds in one or more single premium immediate annuity contracts.[1]

The question then is how distributions from the annuity contract into the trust and then from the trust to the "income" beneficiary are to be taxed.

The "materials" take the position that a portion of each annuity payment representing the unrecovered investment in the contract over an expected return multiple is to be excluded.

Which of course is true as to payments from an immediate annuity contract into the trust.

But what the "materials" omit to say is that the entire amount distributed to the beneficiary in excess of the ordinary income component will carry out accumulated gain from the sale of the appreciated property with which the trust was initially funded, until that amount is exhausted.[2]

but wait, there is more

So the "structure" simply fails to accomplish its stated objective, because the promoter lacks a basic understanding of the four tier, "worst in, first out" mechanism under section 664(b) for determining the character of distributions from the trust to the "income" beneficiary.

This would just be a matter of correcting some K-1s and the late payment by "income" beneficiaries of tax on distributed accumulated gains. But there are some other features of the "structure" that likely disqualify the annuity trust altogether.

For one, it does not appear the amount of the annuity is stated, or even necessarily fixed.

The "materials" say the payout to the "income" beneficiary is **the greater of** the stated annuity amount or whatever the single premium annuity contract is paying, provided it is not more than 49 pct. of the fair market value of the property contributed to the trust.[3]

Obviously this is an amount that cannot be determined until the

trustee sells the contributed property and buys the annuity contract.

But even worse, the "structure" anticipates that the trust will cash out the remainder charity early on, at ten pct. of the initial fair market value of the trust property, plus one hundred dollars. After which what? who does get the remainder at the end of the CRAT term?

trigger warning

The portions of the quoted "materials" supporting this latter feature are actually painful to read.

Reference is made to two letter rulings and to the annotations to the specimen CRAT document at Rev. Proc. 2003-53, indicating that the trust instrument may permit or require the trustee to make current distributions to one or more 170(b) orgs.

But these are emphatically **not treated as advancements** against the remainder. Again, the promoter appears to be in way over her head.

sheltering in place

The memo expressly withholds any comment on whether the "structure" might be a "reportable transaction" under reg. section 1.6011-4, either as a "confidential" transaction or as a transaction "with contractual protection."

But Jack says the "structure" is a "reportable transaction" on its face, because it purports to treat as a return of corpus amounts that are not traceable to cash contributions or to the settlor's basis in contributed property, contra reg. section 1.643(a)-8(b). See Notice 2000-15, item 6. The promoter should have been filing disclosure statements as a material advisor.[4]

here it comes

A couple issues back, we talked about the reviewed opinion in *Oakbrook Land Holdings*, in which a divided Tax Court upheld both

> (a) the validity of reg. section 1.170A-14(g)(6)(ii), which requires that the donee of a conservation easement 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, and
>
> (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.

And we remarked that we are about to see an avalanche of decisions disallowing claimed deductions for conservation or facade easements involving "improvements" clauses.

It is beginning.

Since *Oakbrook* there have been at least ten memo decisions, mostly on motions for partial summary judgment, disallowing seven- and eight-figure deductions on this ground.

Only one of the most recent batch, *Plateau Holdings LLC v. Commissioner*, T.C.Memo. 2020-93 (06/23/20), is essentially final and appealable, and there has already been a changing of

the guard, with new lawyers coming on for the appeal.

Unlike most of these other cases, which arise in Georgia and would be appealable to the 11th Circuit, an appeal in *Plateau Holdings* would lie to the 6th Circuit.

heading for the exits

On June 25, IRS issued a press release announcing that they are offering to settle some subset of the "syndicated" easement cases that are already pending in the Tax Court, on not very favorable terms.

By "syndicated" they mean the kind of thing that was described in Notice 2017-10 -- passthrough entity acquires real property, syndicates the ownership interests, promises a charitable deduction at least two and a half times the investment, secures inflated appraisals, etc.

The press release noted the Tax Court "has held in the government's favor in several opinions and orders in syndicated conservation easement cases," and said if your promoter has been telling you your case is "different," maybe you should be looking for independent advice.

Then on July 09, Judge Lauber entered nearly identical decisions on cross-motions for partial summary judgment in four separate cases, all involving the same tax matters partner based in Georgia.

Each of these cases involved not only an "improvements" clause, but also a failure to report adjusted basis on Form 8283. The court has not yet reached the question of valuation misstatement or penalties in any of these cases, so it will be awhile before we see any appeals.

IRS then issued another press release, crowing that the court had "struck down four more abusive syndicated conservation easement transactions" and urging anyone who had received a settlement offer to "accept it soon."

This second release cranked up the volume on the suggestion that folks with pending cases should stop listening to the promoters, thus:

> The IRS is aware that some promoters of these abusive transactions have downplayed the significance of the string of recent court decisions holding in the government's favor, arguing that their cases are somehow different or that those decisions might be reversed on appeal. These promoters ignore common sense and argue that the real dispute is about value, neglecting to explain how the reporting of short-term appreciation, often exceeding many multiples of reality, could possibly withstand judicial scrutiny.

And then more idiomatically:

> "Taxpayers should ignore this nonsense, take an objective look at their cases, and cut their losses," said IRS Chief Counsel Mike Desmond. "Abusive transactions, like settlement offers, do not get better with time, and this is a good opportunity to get out."

okay, but

Obviously Jack is not carrying a brief here for syndicated easements

or for gross valuation misstatements. But he would note

> (a) IRS has been winning these cases not on any of the grounds mentioned in the 2017 Notice -- overvaluation of the easement, abuse of the partnership form, substance over form, etc. -- but on what might be termed "technicalities," and
>
> (b) if anyone can get an appeal going in which the question whether reg. (g)(6)(ii) is invalid has been preserved and is potentially dispositive, *i.e.*, none of this failure to report adjusted basis stuff, IRS will have to go back and litigate valuation after all.

Plateau Holdings may be that case.

Judge Lauber (again) did find that the taxpayer had grossly overstated the claimed value of the easement, so that a forty pct. penalty applied, and the appeals court will almost certainly not disturb the factual determination as to value.

But there is still a $2.7 million deduction that might have been allowed were it not for the "improvements" clause. A small fraction of the $25.5 million claimed, but probably worth pursuing on appeal. And there are all these other cases in the pipeline.

As we noted in Jack Straw three comma five, there is a credible argument that the reg. is invalid and/or that IRS' reading of the reg. is unreasonable. Again Jack commends the reader to Judge Toro's separate opinion in *Oakbrook*, concurring in the result only.

the commentariat

Your friends at the Greystocke Project did submit a comment on the proposed revision to reg. section 1.642(h)-2 that would treat excess deductions on termination as having the same character in the hands of the distributees as in the hands of the terminating decedent's estate or irrevocable nongrantor trust.

Meaning in particular that excess expenses of administration deductible under section 67(e)(1) would actually pass through as above-the-line income adjustments.

Our comment was to the effect that the proposed reg "corrects a longstanding error and should apply retroactively not only to tax years beginning after 2017 but to any open years." Details in Jack Straw three comma five.

Comments were also submitted by ACTEC, AICPA, and the Bankers Association, all mentioning that an example in the proposed regs mistakenly treats excess real estate taxes on rental property as an indirect expense rather than as generating an operating loss.

zero point four

And finally, in Rev. Rul. 2020-15 we have the announcement that the 7520 rate for August will be -- get this -- zero point four pct.

Historic opportunities for leveraging gift tax remainder values through GRATs, CLATs, and installment sales to IDGTs. Meanwhile midterm Treasury yields continue to trend yet further down.

fragments

[1]

Why less than ninety pct.? The "materials" do not say, but presumably the idea is to avoid an implication that the annuity payout to the settlor is being funded from assets for which a deduction was allowed, *i.e.*, the minimum ten pct. remainder to charity, which would engage the private foundation excise tax regime, and in particular the prohibition against direct or indirect self-dealing.

There is some confusion in the "materials" whether the annuity pays out over the life of the "income" beneficiary or over a term of years, but for purposes of the present discussion we will assume life.

[2]

This would be true even if we were looking at a net income unitrust with a deferred annuity contract, the so-called "spigot" trust. Any distributions in excess of the income component of the annuity would carry out accumulations.

The "materials" cite a 1998 technical advice memo approving a "spigot" arrangement. That TAM was issued some months after the publication of Rev. Proc. 97-23, in which IRS announced it would no longer rule privately on the question whether a net income unitrust would qualify under section 664(d) if the settlor or the trustee or a beneficiary could control the timing of the receipt of fiduciary accounting income from a partnership or a deferred annuity.

[3]

Evidently a nod to the fifty pct. limit imposed by section 664(d)(1).

The stated annuity in the particular case is ten pct. of initial fair market value. Even assuming we are looking at trusts that were funded back in late 2018 when the 7520 rate was 3.6 pct., which is the highest it has been since the 2008 collapse, a ten pct. annuity trust would fail the "probability of exhaustion" test if the annuitant was less than 88 years old. Unless they included a qualifying contingency per Rev. Proc. 2016-42, but that is not mentioned in the memo.

[4]

A reader objects that the reg. was promulgated specifically in response to the so-called "accelerated" CRT, which this is not. And that is true, but in its literal terms the reg. applies to any circumstance in which you have distributions in excess of current net income and you have unrealized appreciation and/or undistributed realized gains.]

Jack says, it's a simple thing, trying to stay afloat