Jack Straw Fortnightly*

motivated reasoning

The Treasury and IRS have finalized regulations relieving 501(c)(4) advocacy orgs of the requirement to report the identities of their "substantial contributors" on their annual information returns.

Well of course the regs are somewhat broader than that, but dark money is the crux, and it is what drove a large share of the eight thousand something comments, both pro and con.

[A great many of the "pro" comments were from folks simply forwarding talking points verbatim from shall we say "right wing" websites. Recurring theme "right to privacy." A penumbra formed by an emanation, per *Griswold v. Connecticut*. Consistency being a hobgoblin, y'know.]

It should be remembered that IRS had tried to accomplish this result back in 2018 via Rev. Proc. 2018-38, but a federal district court in of all places Montana invalidated the rev. proc., saying it conflicted with the existing regulation and thus required notice and an opportunity for public comment.

Rather than take an appeal the agency said okay, fine, we will issue proposed regs. And then disregard comments inconsistent with our predetermined result.

because we say so

So here we finally are. As of September 10 of last year, the date the proposed regs were published, (c)(4)s need no longer disclose the identities of their "substantial contributors" on schedule B of their 990 filings.

They still have to keep the info, and be ready to disclose it to IRS in the event of an audit, but the schedule B itself need show only the amounts contributed by "each."

Until of course the schedule itself might be revised to eliminate even that requirement.

The pull quote from the preamble, responding to the argument raised by any number of commenters that requiring this information would give IRS some indication whether an audit might be warranted, is as follows:

> IRS takes various factors into account when deciding whether to select a case for examination, and the IRS's process for selection

would not be affected by this change.

Or more specifically:

For the specific purpose of evaluating possible private benefit or inurement or other potential issues relating to qualification for exemption, the IRS can obtain sufficient information from other elements of the Form 990 or Form 990-EZ and can obtain the names and addresses of substantial contributors, along with other information, upon examination, as needed.

Presumably referencing schedules L and R.

The implication being that our existing methods of selecting returns for audit literally do not include looking to see whether, I dunno, a substantial contributor to the parent (c)(3) org is drawing a salary at the controlled (c)(4). Whatever. If they don't, they don't, but it would be nice to know. Maybe something for TIGTA to look into.

Your correspondent was somewhat selfishly disappointed to see the preamble did not directly address the comments he had submitted on behalf of the Greystocke Project, a micro (c)(4) of which he styles himself the director.

The gist of those comments was that the proposed regs are explicitly premised on the idea that schedule B will continue to require reporting of amounts received from "each" substantial contributor, separately. But this is not a literal requirement of the existing reg. section 1.6033-2(a)(2)(ii)(f), which speaks only in terms of "total" contributions, in the aggregate.

And the process for revising a form is a great deal less transparent than the procedure for amending a regulation. Forms and schedules and their supporting instructions are subject to revision with notice and comment only as to compliance burdens, not on substance.

For example the most recent revision of schedule B itself, implementing the 2018 rev. proc. This was buried deep in a comprehensive revision of the entire 990 and its many schedules. And you would have had to go to draft forms at irs.gov to see the proposed revision itself.

"The present regulatory project," our comments concluded, "might be seen as laying the groundwork for future revisions to the schedule and/or the instructions that would allow (c)(4)s, for example, to report only the aggregate amounts received from substantial contributors."

Crickets.

those pesky states

And then quite a lot of commentary toward the end of the preamble about how states have been relying on seeing the schedule B disclosures for their own enforcement purposes. Get your own, says IRS. Which some states are starting to do, but there are places where this will be a bit of a political lift.

Meanwhile our friends at Americans for Prosperity are awaiting a ruling on their petition to the Supreme Court for certiorari from the decision of the 9th Circuit federal

appeals court in rejecting their claim that a policy of the California state attorney general to require (c)(3)s to file copies of their federal schedule Bs with the state was unconstitutional as applied to them, as it threatened their contributors' freedom of association.

Several amicus briefs filed, including unfortunately one from the Philanthropy Roundtable, who also filed an amicus brief in the 9th Circuit.

Interestingly, the court has asked the solicitor general if he would like to chime in.

eighty-nine days short

On April 28, a panel of the 9th Circuit federal appeals court ruled in *Badgley v. United States* that the taxable estate of the settlor of a GRAT who died just weeks before the fifteen-year term was to expire includes an amount that would have been required to generate the annuity indefinitely -- at what was then an historically low 7520 rate of one pct.

Which in the particular case meant that the entire corpus, $10.9 million, was includible, rather than as one might expect the present value of the unexpired term, which was more like $101.3k.

An order of magnitude. An additional $3.8 million in estate tax. Kinda makes you wish you had done a series of rolling GRATs to hedge the mortality risk.

This is indisputably the result required by reg. section 20.2036-1(c)(2). The question is whether the reg is a reasonable interpretation of the statute.

Surprisingly, this appears to be the first time that question has been litigated. And now we have a precedent that may make things more difficult for others who may want to bring a similar challenge in the future.

seeking invalidation

Code section 2036(a)(1) includes in a decedent's estate the value of property, "to the extent of [her] interest therein," of which she has made a gratuitous lifetime transfer while retaining for life, or for a term of years that does not in fact end before her death, "possession or enjoyment of, or the right to the income from," the transferred property.

Think: transfer of a remainder after a reserved legal life estate. Or think: irrevocable trust with a retained right to income.

In those two cases it is clear the "extent of any interest" in the transferred property in which the decedent has retained "possession or enjoyment" or "the right to the income" is the entire property.

But a retained annuity in trust for a term of years is at least arguably a different matter.

It should seem obvious we do not have "possession or enjoyment," because the settlor herself is not holding the property. Except possibly in her capacity as trustee, if she is the trustee. Which believe it or not the government did actually argue at the trial level in this case.[1]

And while the annuity might be payable from income, absent an ordering rule it might not actually be paid from income.

And even with an ordering rule, to the extent current income exceeds the amount required to satisfy the annuity payout, the settlor has not retained a right to it.

But it does make sense to include something. And the question is, how much.

if you can't be just, be arbitrary

As noted, the reg says the lesser of the amount that would be required to generate income in the amount of the annuity at the current section 7520 rate or the remaining trust corpus. But this is premised on the idea that inclusion is per section 2036(a).

When the reg was proposed back in June 2007 it drew comments arguing that inclusion should be limited to the present value of the unexpired term, per section 2033, which requires inclusion of any property only "to the extent of the decedent's interest."[2]

In the preamble to the final regs, published in July 2008, the Treasury conflated this argument with an argument that section 2036 should cause inclusion only to the extent the annuity was to be paid from income.

Apples to oranges, but having framed the question in those terms, the Treasury was then able to dismiss both arguments by saying inclusion under section 2036 should not depend on how the trustee has balanced the portfolio or how investments have performed.

Which makes sense if you first assume that section 2036 is the appropriate vehicle. But that "begs the question," as they used to say.

***Chevron* step two**

The preamble catalogued what appears to be a fairly comprehensive legislative history of the predecessors to section 2036 under the 1931 Code and even the 1916 Code, and a handful of Supreme Court decisions under those prior statutes that the Treasury said supported their position.

We do not really have space here to ~~refute~~ analyze all that in detail, but the short of it is this.

The *Church* and *Spiegel* decisions from 1949, both citing *Hallock* (1940), have to do with the inclusion of a possibility of reverter that was extinguished at the transferor's death. Technically, these have been superseded by the enactment of section 2037(a), which expressly includes a possibility of reverter, but only if it has an actuarial value in excess of five pct.

In each of these three decisions, the Court read section 811(c) of the 1931 Code, which is a predecessor actually to several sections in this part of chapter 11 of the Code, to require inclusion of the full value of the subject property --

-- on the theory that because the vesting of an alternative contingent remainder had the effect of extinguishing the possibility of reverter, this was a transfer

"intended to take effect in possession or enjoyment at or after [the transferor's] death."

One might remark that the quoted phrase, "intended to take effect at or after death," is not replicated in any of the sections that emerged in the 1954 Code to replace section 811(c). So the cited decisions are of questionable value as precedent in construing section 2036(a).

The preamble to the 2008 reg went on to cite *Northeastern National*, a 1967 decision to the effect that a trust paying a fixed annuity to a surviving spouse qualified for a marital deduction in an amount that would be required to generate the annuity payout under "a rate of return available to a trustee under reasonable investment conditions" (we did not yet have section 7520), but not limited by her actuarial life expectancy.[3]

Why not take into account the widow's life expectancy is not made clear in the text of the Court's opinion in *Northeastern*, but it may have something to do with her having also been given a general power to appoint the remainder at her death.[4]

But whatever the logic of that determination, it does not obviously apply where the annuity is for a term of years. And the preamble to the 2008 reg makes no effort to explain why it should.

The preamble also cited two revenue rulings to similar effect, Rev. Rul. 76-273 and Rev. Rul. 82-105, both having to do with the includible value of a deceased settlor's annuity or unitrust interest in a charitable remainder trust.

But it is widely understood that revenue rulings are "nothing more than the legal contentions of a frequent litigant, undeserving of any more or less consideration than the conclusory statements in a party's brief."

regrets only

So there are credible arguments that the 2008 reg did not get it right.

The arguments were not presented in quite this form in the briefing on appeal in *Badgley*.[5] But the taxpayer did argue strenuously

(a) that a retained annuity in trust is not within the ambit of section 2036(a), and

(b) that the method of calculating the amount to be included as set forth in the reg was "flawed" in that it did not "amortize" the principal balance from which the annuity was to be funded over the term of years.

But in the closing sentences of its opinion, the 9th Circuit in *Badgley* declined to rule on the validity of the reg, saying the taxpayer had effectively "waived" the argument by giving it only "two sentences and two footnotes, without a single citation to legal authority."

This seems particularly harsh. Because the question has never been raised before, there is no authority to cite.

The taxpayer has filed a motion for rehearing raising that very point.

relative simultaneity

On May 29 IRS released a letter ruling to the effect that a transaction between two trusts each of which is treated under the "grantor" trust rules as "owned" by the same individual is disregarded for income tax purposes.

Which on its face sounds like a "comfort" ruling, on which IRS has a blanket "no rule" position, most recently articulated in Rev. Proc. 2020-01, section 6.11.

But it is not as simple as that or we would not be picking it apart at the Jack Straw Fortnightly, asterisk, or occasional.

The setup in PLR 202022002 was this.

Parents create an irrevocable trust for their kids and grandkids. They put shares of corporate stock into the trust -- closely held? we are not told, but let's say maybe --, with the proviso that the stock itself cannot be distributed, but the proceeds of a sale of some or all of the stock might.

The trust in turn places all of its stock into an LLC taxed as a partnership, with distribution of membership interests subject to an identical restriction.

Then the trust places a portion of the LLC interests -- nonvoting? we are not told, but let's say probably -- into a "subtrust" for one of the children, a daughter.

At age forty, the daughter has a power to withdraw the entire corpus of the "subtrust," except for the LLC interests. She exercises that power.

are you with me so far

So then the daughter sets up her own irrevocable trust, which is said to be a "grantor" trust for income tax purposes. We are not told what is the mechanism for that, but let's say a section 675 "swap" power.

And we are not told what was the funding source for the daughter's "grantor" trust, but let's suppose it might have been the amounts she withdrew from the "subtrust." Because that makes a more interesting story.

Now for the fun part. The daughter's "grantor" trust then purchases the LLC interests from the "subtrust" in exchange for cash and a promissory note. How much cash we are not told, but let's say ten pct. Whether the note is secured we are not told, though this could in theory matter.

One supposes the cash flow from the stock through the LLC is expected to be sufficient to support the note. Whether this outcome is what mom and dad would have wanted is beyond our immediate concern.

At this point, the LLC interests that had been in the "subtrust" are held by the daughter's IDGT, and the "subtrust" is holding cash and a promissory note. And as you may recall, the daughter has a power to withdraw those assets. Which makes it entirely a "grantor" trust under section 678(a)(1), at least going forward.

So the question for IRS is, whether the exchange itself is a recognition event. Or to put it another way, when

exactly did the "subtrust" become a "grantor" trust.

The ruling spends three paragraphs summarizing Rev. Rul. 85-13, which is not exactly on all fours with the situation at hand. Or even really at all.

The revenue ruling involved an irrevocable trust for the benefit of the settlor's child, funded with stock in a closely held corporation. The trustee was the settlor's spouse, but that in itself did not make this a "grantor" trust, because she had no discretion to invade corpus or to accumulate income.

At some point the settlor bought back the stock, giving the trust a promissory note. Fair market value, adequate interest, but unsecured, and with a three-year term.

The revenue ruling says that in that moment,[6] the settlor became the "owner" of that portion of the trust for income tax purposes, with the result that (a) the purchase itself was not a recognition event, and (b) the settlor took an historical basis in the stock, despite his having given full value.

How the revenue ruling applies to the situation described in the letter ruling request is not made clear, but one takeaway seems to be that the transaction that causes the trust to be treated as a disregarded entity is itself disregarded. Sort of like Shrödinger's cat.[7]

In any event, the letter ruling concludes there is no recognition event. The daughter's IDGT is holding units in an LLC that holds the stock, but possibly not much else, and the daughter is holding cash and a promissory note from the IDGT. In effect she has pulled most of the equity out, with no tax consequence. And why not.

scrawls

[1]

The GRAT did also permit discretionary distributions to the settlor, above and beyond the fixed annuity, but that discretion was placed in the hands of the settlor's two daughters, who were the remaindermen at the expiration of the term and thus "adverse" to the exercise of that discretion.

[2]

As previously noted, the quoted phrase does also appear in section 2036(a).

[3]

The late Justice Potter Stewart, dissenting, observed that if the present value of a capitalized annuity stream was treated as "specific portion" of a trust from which the widow could be said to be entitled to the "income," then it should be possible to limit her general power over the remainder to that "portion" and still qualify.

Which he said would have the effect of freezing the value includible in her estate (this was all pre-QTIP). He may have been mistaken in that analysis.

[4]

Actually, this should have been enough, as by definition a trust from which distributions, if any, can be made only to the surviving spouse during her life, and over which she has a general power to appoint the remainder at her death, qualifies for the marital deduction, per reg. section 20.2056(a)-2(b)(4), which was promulgated in 1958 in pretty much its present form.

[5]

For the curious, your correspondent has posted all the briefing in this case to the landing page of his newsletter, the Jack Straw Fortnightly, asterisk, or occasional.

[6]

What section 675(3) literally says is that the trust becomes a "grantor" trust at the start of the following tax year if the settlor has not yet repaid the loan. This nuance is not mentioned in the revenue ruling.

[7]

It might be that the note is unsecured, or it might simply be that once the deal is done, the daughter can take down the remaining corpus of the "subtrust."

This folding of the space/time continuum is actually not unique in the annals of tax law.

There are for example several letter rulings, reaching back at least as far as PLR 200101021, to the effect that if a couple set up a joint revocable trust, with each spouse giving the other a testamentary general power to appoint the remainder at her death -- sort of a homegrown portability workaround, before we had portability --, this will complete a gift by the survivor to the first decedent spouse at the first death, which will qualify for the gift tax marital deduction, even though she is already dead.

Even deeper in the weeds, although reg. section 1.1361-1(j)(8) now says the that while the income beneficiary of a QSST is the deemed owner of the S corporation stock held in the trust, a sale of the stock that has the effect of terminating the election will not be treated as a recognition event in her hands, the Treasury decision finalizing this reg. in 1995 flatly reversed the position IRS had taken only three years earlier in Rev. Rul. 92-84.

So it is all a matter of perspective, as Heisenberg maybe said, depending who was listening.

If you have time on your hands you might enjoy reading an article your correspondent wrote a couple years ago for Tax Analysts in which that revenue ruling and the revision to the regulations obsoleting it featured.

Jack says, enough is too much