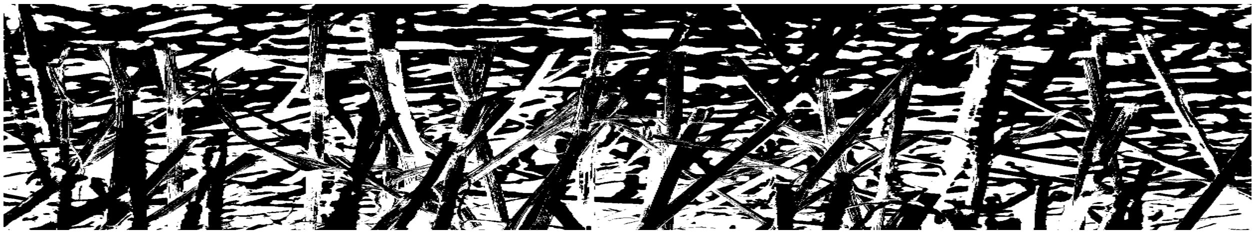

Jack Straw Fortnightly*

simplicity

Last Friday the federal appeals court for the DC Circuit affirmed the decision of the Tax Court in *RERI Holdings I, LLC v. Commissioner*, disallowing entirely a claimed charitable deduction for $32.94 million on what might be viewed as a technicality. The appeals court also affirmed the imposition of a forty pct. gross valuation misstatement penalty.

The facts of the particular case were egregious, but still you gotta ask, whatever happened to substantial compliance? We are talking about the omission of a single data point from the form 8283.

Jack says not to worry, it may actually have been a better use of judicial and enforcement resources to decide this case on the technicality than on the merits. Though plenty of resources were wasted already anyway, over more than a dozen years.[1]

And substantial compliance is still alive and well, kinda.

how we got here

The case involved the contribution to a university of an imaginary object called a "successor member interest" in a limited liability company,[2] with the proviso that it not be sold for at least two years. The taxpayer had acquired this object seventeen months earlier at a price of $2.95 million.

So either the object had increased in value tenfold in just over a year or we were using two different methods of valuation.[3]

In August 2007, just as it was getting ready to issue a notice of final partnership administrative adjustment, IRS published Notice 2007-72 identifying this arrangement as a "transaction of interest." Anyone who had closed a similar deal on or after November 02, 2006 was required to disclose.

Jack says there were probably only a couple or three people playing this particular game, and the Notice was probably intended only to smoke out any of these transactions IRS had not yet identified in examinations.[4]

The case was pending in the Tax Court more than nine years. Along the way, the court decided three motions for partial summary judgment on some pretty complex substantive questions. One of these orders was unpublished, one was issued as a memorandum opinion, and another as a published division opinion. The parties spent four days in trial, taking testimony from at least three expert witnesses on competing theories of valuation.

But in the end, the Tax Court disallowed the claimed deduction altogether because the taxpayer had left blank the field on the Form 8283 in which it was required to disclose its cost or adjusted basis in the contributed property.

The Commissioner had not made this argument in his answer or in any of his subsequent filings. The court raised the issue *sua sponte* and did not ask the parties to brief the question.

logic and proportion

Omitting to report basis, said the court, "prevented the appraisal summary from achieving its intended purpose," of "alerting [IRS] to a potential overvaluation" of the property.

The fact that the taxpayer had acquired the property only a little more than a year earlier at a price less than one-tenth the value claimed for the charitable deduction certainly would have been a red flag, but somehow IRS did manage to select the return for examination even without this information. But be that as it may.

The taxpayer did not file a motion to reconsider. But on appeal, it pointed out that the Tax Court itself had ruled in *Dunlap v. Commissioner*, T.C. Memo. 2012-126, that completing the "adjusted basis" field on the 8283 was not "absolutely necessary."[5]

The appeals court said, well yeah, but (a) the court is not bound by its own memorandum opinions, and (b) that statement was made in connection not with whether the claimed deduction should be disallowed, but whether the taxpayer had shown sufficient "reasonable cause and good faith" to meet the exception from imposition of an accuracy-related penalty.[6]

So the question for the rest of us is whether there is still such a thing as substantial compliance if you fail to report basis on the 8283.

The government did actually make the argument to the appeals court that omitting this data point should be *per se* fatal. The appeals court said, we do not have to reach that question because in this case substantial compliance would have required reporting basis.

Well, but in what case. In the case where omitting to report basis would "prevent the appraisal summary from achieving its intended purpose."

Jack says this seems to mean, where there is any meaningful spread between adjusted basis and the claimed value of the deduction, at least where you have had a relatively short holding period. Is that clear? Just complete the form.[7]

speaking of which

Until the Tax Court unexpectedly dropped this failure to substantiate ruling, the primary issue was valuation. And of course all that other stuff from Notice 2007-72 about economic substance, etc.

The appraisal submitted with the return had taken the position that the SMI should be valued by discounting the market value of the underlying property by the 7520 rate, without any reference to risks that might impair the value of the future interest.

The Tax Court rejected this approach, and the appeals court affirmed. Whatever an SMI even is, its future value is not appropriately determined by reference to the table rates.

At trial, the four days of expert testimony on both sides focused on projected cash flows, anticipated growth rates in cash flows when the renewal options kicked in, and appropriate discount rates for periods after the initial lease term.

As it turned out, all of this went to the question whether the valuation misstatement was "gross," *i.e.*, four hundred pct. or more, or merely "substantial," *i.e.*, at least two hundred pct. but less than four.

In this connection, Jack finds it interesting that the expert testifying for the taxpayer at trial was not trying to hit anything close to $32.94 million, but just over half, $16.55 million.

There were arguments on appeal about the penalty assessment as well. Whether the valuation methodology of the Commissioner's expert was valid, of course, but also

- whether it is proper to impose a penalty at all where the claimed deduction was disallowed on other grounds -- in other words, the underpayment was not "attributable to" the valuation misstatement --, and

- whether IRS could properly assert a penalty where a supervisor to the examining agent had not signed off on it.

The appeals court gave about four pages to the first of these questions, concluding that if the valuation misstatement was an "independent alternative ground" for disallowing the claimed deduction in excess of the value finally established, then "the penalty properly applies."

The 5th Circuit reached a similar conclusion in *PBBM-Rose Hill, Ltd. v. Commissioner*, 900 F.3d 193 (5th Cir. 2018), which we mentioned very briefly in volume one, number eleven.

On the second question, there actually is some lore developing around this, see *Chai v. Commissioner*, 851 F.3d 190 (2017), and *Graev v. Commissioner*, 149 T.C. 485 (2017), vacating an earlier decision in light of *Chai*.

But the appeals court here said the taxpayer had not raised the issue below, so it was not preserved. But wait, said the taxpayer, *Chai* had not been decided at the time, so we didn't know we had an argument.

"Fiddlesticks," said the appeals court,[8] you could have made the same argument the taxpayer in *Chai* made.

no reasoned analysis

A couple of weeks ago in these pages we mentioned that the state attorneys general of New York and New

Jersey had filed a complaint under the freedom of information act, seeking to force the Treasury and IRS to disclose the internal processes by which they decided last year to issue Rev. Proc. 2018-38, abruptly dropping the requirement that exempt orgs other than (c)(3)s submit a schedule B with their 990s, identifying "substantial contributors."

Brief update, the parties have agreed that formal discovery will not be necessary, as the government is embarking on a rolling production of responsive documents and should be able to say by June 21 when that will be complete. If that does not work out, the parties will be filing cross motions for summary judgment in July and August.

Meanwhile, in another federal district court, the governors of Montana and (again) New Jersey are pursuing a direct attack on the validity of the rev. proc. itself, arguing that because it purports to amend an existing regulation, there should have been a notice of proposed rulemaking and an opportunity for public comment. Also that there was no "reasoned analysis," as required by the administrative procedure act.

The government moved to dismiss for lack of standing -- we have not been forwarding this info to the states anyway, so how can the states be harmed if we no longer collect it? --, and the plaintiffs countered with a motion for summary judgment on the merits.

Jack has been collecting quite a number of pages at ten cents per, but for the moment we will link only the plaintiffs' reply brief on the summary judgment motion, which does neatly summarize the arguments.

These motions are set for argument June 05, so we should have something further to report in our next issue.

apparent plain meaning

In PLR 201920003, the IRS ruled favorably on several issues arising from the reformation of three related trusts, ostensibly to correct scrivener's errors. But it took several tries.

The letter mentions correspondence dated only a few days before the ruling was issued, "and prior correspondence." It appears some of that correspondence may have been in the nature of sending the taxpayer back to the state court to amend its initial order. Twice.

The settlor had created three trusts, one for the descendants of each of his three children. The trustees were instructed to divide each trust into separate trusts for each grandchild in that line of descent. Distributions of income and principal were discretionary, subject to an ascertainable standard.

Each grandchild was given a testamentary power to appoint the remainder of her separate trust at her death. In default of the exercise of that power, the remainder was to be distributed outright to her descendants, *per stirpes*. In addition, each grandchild was given a power, exerciseable within thirty days after notice from the trustee, to withdraw amounts contributed to the trust.

The attentive reader is asking, was the testamentary power of appointment limited? and was the withdrawal right limited to the annual exclusion amount for present interest gifts at section 2503(b), with any lapse limited to the amount that would not be treated as a release of a general power -- the so-called "five and five" limitation at section 2514(e), and any excess "hanging"?

Well, no and no, and that is most of why we are here.

The settlor and his spouse elected to split gifts to these trusts over a period of seven years, and after a gap of one year another three years, then the settlor died and left some portion of his estate to the trusts, and then the surviving spouse resumed making annual gifts for another eight years until her own death.

It was in the interval between the death of the settlor and the death of the surviving spouse that folks began to notice there were problems with the drafting of these trusts.

At first the trustee asked the state court to reform the trusts simply to scale the testamentary appointment power back to a limited power. Exclude the holder's estate, creditors, creditors of her estate.

The petition was supported by an affidavit from a lawyer -- presumably the scrivener of the trust instruments? -- saying the settlor "did not recognize" that giving each grandchild a general power would cause inclusion in her estate.

Which may not be quite the same as saying I screwed up.

But then the trustee went back and asked the court to limit the power further, so that it would be exerciseable only in favor of descendants of the holder's parent who was a child of the settlor.

The court amended its previous order to make this change. The text of the letter ruling does not say what evidence was offered to support this amendment.

The two orders together were made contingent upon a favorable ruling from IRS.

And then, sometime later, the trustee filed a separate petition to reform the "Crummey" withdrawal provisions to bring them within the five and five and annual exclusion limits. Again, the court granted the petition, again contingent on a favorable ruling from IRS -- and presumably retroactive to the date the trusts were initially created, though this is not stated in the text of the ruling.

And again, the text of the ruling does not say what evidence was offered to support this change.

Somewhere in here, possibly before the third state court order, the surviving spouse died.

The ruling concludes, as requested,

(1) that none of these changes cause any portion of these trusts to be includible in the estate of the surviving spouse,

(2) that none of the grandchildren is holding a general power that would cause inclusion in her estate,

(3) that the reformations did not

trigger an exercise or release of any general power held by any of the grandchildren, and

(4) that transfers to these trusts were direct skips under section 2632(b)(1), so that allocation of GST exemption amounts by each spouse were automatic.

Which latter tells us why we also had an affidavit from the settlor's accountant saying the settlor and his spouse had intended these trusts to be exempt. But we are not told anything about how the gifts were reported that would have interfered with this result. Probably nothing, probably everyone just got excited with all this other stuff going on.

The ruling does mention *Bosch* this time, and says a review of the trust documents, the affidavits submitted to the state court, and other unspecified "representations of the parties" "strongly indicate" that the settlor did not intend the beneficiaries to have testamentary or *inter vivos* general powers.

Which again is a step short of saying he intended to limit the testamentary powers to be exerciseable only in favor of descendants, but that distinction has no tax consequences.

The applicable state statute permits the court on a petition for reformation to correct a mistake to consider extrinsic evidence of the settlor's intent, even if it contradicts "the apparent plain meaning" of the trust instrument.

The ruling seems to have been requested by the trustee, but the tax implications affect several classes of individual beneficiaries. Still, the letter includes the usual disclaimer that it is "directed only to the taxpayer requesting it."

complexifiers

[1]

And apparently there are other cases still out there, some of which might not involve the same reporting error -- unless omitting to report adjusted basis is itself part of the strategy.

[2]

The LLC held a parcel of real estate in California on which AT&T was operating a web hosting facility under a long-term lease with several options to extend.

The property itself was subject to a mortgage securing a loan in an amount that was actually slightly higher than the purchase price. If the LLC were to default on the loan, the term of years interest would be forfeited and the successor interest would be accelerated.

One might ask, what was supposed to happen in the real world when the term of years ran out and the successor interest kicked in. Was the payment of $2.95 million on day one really supposed to suffice to support an uncontroversial change of ownership eighteen years out? Would the term of years interest be losing value as the term ran down?

Fortunately, we will not have to face these questions, as the underlying property was sold in 2016 for close to twice the original purchase price. No word on how much was allocated to the SMI.

[3]

When the university tried to sell the object two years later, the only buyer it could find was an entity "indirectly owned by" the tax matters partner for RERI Holdings.

They paid only $1.94 million, held the object just over a year, and contributed it to another (c)(3) org, claiming a deduction of $29.93 million.

[4]

The recontribution mentioned in footnote [2] was made on December 26, 2006. So this would be captured by the Notice.

We have not yet seen further activity of this kind in any reported cases apart from *RERI Holdings*, though apparently the individual on whose behalf this particular contribution was made did himself engage in several similar transactions, with the same university.

Probably limitations on partnership adjustments in other similar cases have been suspended by agreement pending the outcome here. But without a decision on the merits, it might still be necessary to litigate some of these.

The two individuals who designed this strategy have since pleaded guilty to unrelated charges of felony tax evasion. The appraiser is still practicing.

[5]

Interestingly, one of the lawyers who had represented the taxpayer in *Dunlap* was also on the team representing the taxpayer here.

[6]

A close reading of the *Dunlap* decision suggests that the Tax Court was just trying to throw the taxpayer a bone. Substantial compliance with the Form 8283 reporting requirements was the last hook on which the court could hang a finding of "reasonable cause and good faith" after having rejected reliance on the appraiser or on the petitioner's tax advisors.

[7]

There is a mechanism in the reg. that allows you to explain to IRS why you are unable to provide basis information, and if that explanation establishes "reasonable cause," they can work with you.

[8]

I kid you not, "fiddlesticks." Page 15, second paragraph, fourth line.

Note: we have linked all three briefs on this appeal in previous issues. These are posted to the Jack Straw landing page.

Jack says, some things are just pictures