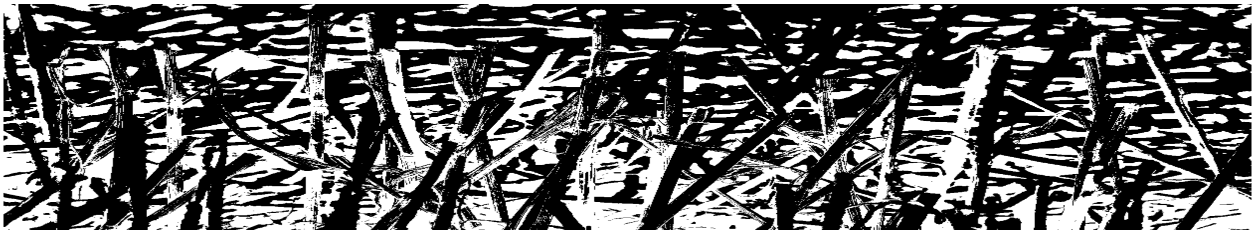

Jack Straw Fortnightly*

exposure

Many readers will already have seen that a federal district court in Montana entered an order two weeks ago invalidating Rev. Proc. 2018-38, which had dropped the requirement that exempt orgs other than (c)(3)s submit a schedule B with their 990s, identifying "substantial contributors."

The rationale of the order is essentially the argument we sketched in Jack Straw volume one, number nine, *i.e.*, that this was in effect a revision to an existing, substantive regulation, so the right way to go about this would have been to issue a notice of proposed rulemaking, with an opportunity for public comment.

No further filings in the intervening two weeks, but one imagines the IRS might take an appeal. Or they might go back and do what they should have done the first time around.

Or, says Jack, they might simply abandon the project as misguided. Not.

meanwhile

There is a motion for summary judgment pending in the lawsuit brought by the attorneys general of New Jersey and New York to require the Treasury and IRS to disclose records concerning the processes by which they had developed the rev. proc. in the first place.

In support of their motion, the plaintiffs argue

> (a) that the Treasury and IRS cannot justify their delay in producing responsive documents, and
>
> (b) that they have not laid any of the necessary groundwork for their claim that many of the documents they have withheld or redacted would be exempt from disclosure as reflecting "pre-decisional deliberative processes."

A responsive filing by the government is due next week.[1]

We mentioned this case briefly in volume two, number seven. At the time, we also noted that before the rev. proc. was issued, several (c)(3) and (c)(4) orgs had brought actions in federal court to challenge regulatory requirements in California and New York that they submit copies of their federal schedule B filings to state regulators as a condition of their being permitted to solicit contributions in those states.

The plaintiffs in these actions claimed that the state disclosure requirements unconstitutionally interfered with their donors' freedom of association by exposing them, potentially, to harassment and retaliation.[2]

And we noted that the appeals courts had recently ruled adversely to the plaintiff orgs in two of these cases. At the time, there was a petition pending for rehearing by the 9th Circuit *en banc*, but this was later denied, albeit with five judges dissenting.

The dissenters disagreed that the "exacting scrutiny" standard applied by the panel in vacating the trial court's decision was appropriate, and they argued that the panel had engaged improperly in "factfinding," ignoring contrary findings by the trial court.

The "exacting scrutiny" standard requires that there be a "substantial relation" between the disclosure requirement and a "sufficiently important" governmental interest.

Somewhat short of "strict scrutiny," which is the standard the dissenters argued should apply, but at least in theory more stringent than mere "rational basis."

The plaintiffs in the New York litigation have apparently decided not to pursue the matter further, but just a few weeks ago one of the plaintiffs in the California litigation[3] was granted an extension until August 26 to file a petition for a writ of *certiorari* to the Supreme Court.

We will follow the briefing on the cert petition and report on the outcome of the conference, but some of this is still months away.

clawing forward

The ABA Taxation Law section has submitted comments to IRS asking for formal guidance that would allow allocation of the temporarily increased exemption amount to pre-2018 generation-skipping transfers.

This might be seen as a belated response to the annual call for public input into guidance priorities, for which the deadline was back in June. As we noted in volume two, number six, the Treasury and IRS have said they do not have the capacity this year to take on new projects unrelated to implementation of the 2017 tax bill. But arguably this proposal would fall into that category.

The cover letter comes with the usual disclaimers that the proposal has not been approved by the ABA house of delegates or board of governors, and that while members of the drafting committee do have clients who would be affected, none of them is being paid to put this proposal forward.

Jack finds this latter disclaimer disingenuous, but be that as it may.

The substantive text of the submission runs only two pages, and the argument in favor of allowing a retrospective allocation of the temporarily increased exemption to pre-2018 transfers is expressed in just a couple of sentences --

-- roughly to the effect, because we wish it.[4]

Again, as with the proposed regs published last November that would forgo "clawback" in the estate of a taxpayer who dies after 2025 of gifts she might have made while the applicable exclusion amount is temporarily doubled, the drafters of these comments acknowledge that the literal text of section 2010(c)(3)(C), as enacted in the 2017 tax bill, does not support the requested reading --

-- quite the contrary, the statutory text expressly states that the temporary increase applies only to "estates of decedents dying or gifts made after December 31, 2017" --,

but again, they argue that the "blue book" prepared by the JCT staff a year later[5] kinda does support this reading, in a computational example in a footnote.

If this does emerge as a regulatory project, the Greystocke Project will again be submitting comments, as we eventually did with the proposed "clawback" regs, but one supposes we will just be whistling in the wind.

In a paranoid scenario, Jack imagines that the Treasury and IRS might incorporate the present request into the existing project, for which the comment period closed back in February, though the NPRM did not request comments on this issue.

six forty-three

There was an interesting discussion on one of the message boards the other day concerning the so-called "total return" pooled income fund.

Your first thought might be -- and in fact, this was the premise of the question that kicked off the discussion -- that the PIF is "dead." But your correspondent was not alone in suggesting, quote,

> there might be an opportunity in this very low interest rate environment to open new funds, for which the deemed rate of return would be quite low as compared to expected actual returns, so that the deductible present value of the remainder to charity would be artificially high[,]

end quote, assuming, y'know, the "expected returns" would in fact materialize, which a couple of folks pointed out they might not.

The deemed rate would apply only for the first three years, until you get a track record, but if rates were still low then, you could open additional new funds.

At a certain point in the thread, someone suggested that if you invested the PIF for "total return," you could allocate some of the realized gains to "income," so that the beneficiaries would not be limited to current ordinary income. Apparently this is actually someone's business model.[6]

Citation was made to reg. section 1.642(c)-5, which indeed was revised in 2004 as part of the project to revise the regs under section 643 to accommodate then-emerging state law trends to allow a trustee who was investing for "total return" as a "prudent investor" to make "equitable adjustments" between income and principal to fulfill its duty of impartiality between income and remainder beneficiaries.

You might recall that we discussed this regulatory project in volume one, number seven, in connection with a letter ruling having to do with whether a conversion of an "income" trust to a unitrust with an ordering rule allocating realized gains to the unitrust payout would shift a benefit to a lower generation, causing the trust to lose its grandfathered exempt status as exempt from the generation-skipping transfer tax.

Your correspondent then expanded that discussion to a five thousand word article for Tax Notes. The gist being (a) that the regulatory project made unnecessary concessions to the proponents of the "total return" trust, but in any event (b) the 2004 regs did not justify the result in the particular case.

All of which is neither here nor there. The point I was trying to make on the message board was that the 2004 revision to the cited reg rather pointedly did not alter the basic rule, that "income" distributable to beneficiaries of a PIF "generally" cannot include realized long-term gains.

Okay, but what does that mean, "generally."

The proposed regs issued in 2001 would literally have disallowed a set-aside deduction if it were possible, under the terms of the trust instrument or under state law, for the amount distributable to "income" beneficiaries of a PIF to be determined with reference to unrealized appreciation in asset values. Period.

Justifying this position as a matter of tax policy, the preamble to the proposed regs said that if the trustee had a power to adjust which it might exercise to allocate unrealized appreciation to the "income" payout, or if "income" were defined as a unitrust amount which might carry out unrealized appreciation, this would create a situation in which realized gains otherwise deductible as a set-aside would in effect have already been distributed, or might be taken into account in calculating later distributions. Therefore.

There was some pushback from "the sector," in response to which the final regs adopted not a more relaxed, but a more explicit and detailed rule.

Not only can you not claim a set-aside deduction if there is any circumstance under which amounts distributable to the income beneficiaries might include unrealized appreciation, but if state law would otherwise permit a unitrust payout or an adjustment power, you need to amend or reform your trust instrument to prevent this. Within nine months of publication of the final regs, which is awhile back now.

Yes, you can have a unitrust payout, with or without an ordering rule, but at the expense of paying tax on realized long-term gains. Or you can have a power to adjust, but limited to distributing only post-contribution gains, and any such distributions would correspondingly reduce your set-aside deduction.

Presumably the existing players are working in the latter space.

Whether a trust qualifies under section 642(c)(5) as a PIF has been on the "no rule" list since IRS published a specimen form at Rev. Proc. 88-53 more than thirty years ago. So if there is a line somewhere that IRS thinks should not be crossed, you would find out about it only if someone did cross it and then brought a petition in the Tax Court on a deficiency assessment or in a federal district court on a refund claim. And we have seen nothing like that yet.

stray marks

[1]

In an interesting wrinkle, a few weeks back Sen. Ron Wyden (D-OR), the ranking member of the Finance committee, and Bob Casey (D-PA), another minority member of the committee, wrote to Commissioner Chuck Rettig asking, is it true what your staff tells us, that your own criminal investigations unit was not consulted prior to the decision to rescind this reporting requirement? are they going to have to ask for donor lists from (c)(4)s every time they want to investigate possible illegal political contributions from foreign entities, etc.?

And whose idea was this? did it come from outside the agency? did it come out of discussions with nongovernmental players?

The letter set a deadline of July 24 to respond, but we have heard nothing further yet.

[2]

At the time, we characterized the plaintiff orgs as (c)(4)s. This was inaccurate. The plaintiffs in the California litigation are the Americans for Prosperity Foundation and the Thomas More Law Center, both of which are nominally (c)(3)s. The plaintiffs in the New York litigation were Citizens United, a (c)(4), and its related foundation, again nominally a (c)(3).

Earlier similar lawsuits arguing that the disclosure requirement was unconstitutional on its face had failed. These are cited in the text of the 9th Circuit panel opinion.

These latest actions were instead brought on a theory that the requirement was unconstitutional "as applied" to the particular plaintiff orgs, largely premised on the idea that these nonpublic records might be inadvertently disclosed -- as in fact had occurred in the past, with the consequence that some identified contributors had in fact been subject to "harassment and abuse."

It is fairly widely known that a principal funder of the combined AFP operation is David Koch. The schedule A attached to the 990 for the foundation for calendar 2016, justifying its claimed status as a (b)(1)(A) public charity, would allow for as many as eight "substantial contributors" at a little over two million each, spread over the preceding five years, but it may just as easily be that it is just him and/or some of his controlled entities at just under half a million per year.

The foundation has a 501(h) election in place, but reported that none of its $23 million in "exempt purpose expenditures" in calendar 2016 was for direct or grassroots lobbying.

For its part, the related (c)(4) org reported that it had made $13.4 million in grants to other (c)(4) orgs during calendar 2016 for "political campaign activities," but apparently these were spread pretty thin, as only two are mentioned on schedule I, grants in excess of $5k.

One of these, a grant of $590k to something called "Defeat22," funded what you might have called an unsuccessful effort to defeat a clean elections ballot initiative in South Dakota --

-- might have, except that the initiative, which was approved by 51.63 pct. of voters, was immediately repealed by the state legislature in an "emergency" measure with much more than the two-thirds vote required in each chamber.

The Thomas More Law Center styles itself as a public interest law firm. According to its information return for calendar 2017, it is "organized under a stock basis," with all stock owned by its president and "chief counsel," who was drawing a salary of close to a quarter million. One other lawyer on staff drew a salary of about $100k.

Over the five-year period covered by the schedule A attached to that return, the firm brought in more than half a million in fee awards from litigation.

All of which is by way of saying, if the Supreme Court does grant cert in the AFP case, the issues will be framed with reference to (c)(3) orgs, rather than (c)(4)s.

[3]

The extension request names only the AFP Foundation as a petitioner.

It may be that the Thomas More Law Center has backed away because, as the 9th Circuit panel noted, their federal schedule B filings have routinely "over-disclosed" their contributor base, identifying not only those who have contributed two pct. or more of their total contributions, but anyone who contributed $5k or more.

[4]

A reader objects that this paraphrase is unfair. Okay, then, let's just quote the submitted comment directly.

Not allowing a late allocation of the increased exemption to pre-2018 transfers "would be contrary to the basic principles behind late allocations," as exemplified by the fact that when the exemption amount increased in 2009 from $2 million to $3.5 million, it was possible to make a late allocation to pre-2009 transfers.

Jack says the analogy is flawed. The 2009 increase was the last in a series of staged increases enacted back in 2001, leading to what was supposed to have been a complete repeal of the estate and generation-skipping transfer taxes in 2010.

A sort of phase-out, in other words. What we have here instead is a temporary stimulus, which implies nothing at all as to prior transfers.

[5]

In other words, no one voting on the bill itself would have read this report, so its value as legislative history is questionable.

[6]

Not to be disingenuous here. Obviously your correspondent is aware that there is something out there called a "total return" pooled income fund. Jack's purpose here is not to disparage anyone's business model, but simply to sketch what he believes to be the parameters within which any such vehicle would have to operate.

From the small amount of info he has seen, mostly marketing materials, Jack would guess that most "total return" PIFs are in fact operating under something like this model.

Jack says,
it is impossible to achieve the aim without suffering