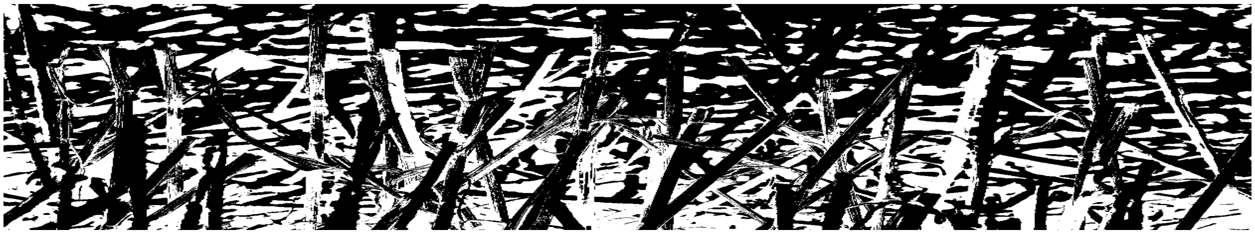

Jack Straw Fortnightly*

off the menu

Oral argument tomorrow in *Kaestner Trust*. Probably we will not run a special issue just to pick apart the transcript. But we might. What we will not do is delay this issue for something that might take more than a day or two to write up. Plus we have other stuff to cover.

Once again, in last Friday's conference the Court did not take up the petition in *Fielding*. Jack is giving odds on a remand in both cases to brief the "dormant commerce clause" issue. Expecting to see at least passing mention of this in tomorrow's argument.

We have sketched our own views on *Kaestner* piecemeal in each of the past four issues, including a lengthy footnote in volume two, number four that threatened to overwhelm the main text.

The department of revenue filed its reply brief last week, reiterating the argument that a trust is a relationship among several parties, not an "entity" that can be said to have "jurisdictional contacts" in itself.[1]

The relevant "contact" here, the petitioner says, is the beneficiary for whose benefit income was being accumulated.

The force of that argument is then somewhat blunted a few pages later when the petitioner argues that *Hanson v. Denckla*[2] does not apply because we are not trying to tax the trustee here, but "the trust," as though it were an entity. Jack says ya gotta choose. Or do you?

Of course, this is what you get when you try to tax undistributed ordinary income or realized gains in the hands of a trustee. For this purpose, you almost have to treat the trust as though it were an entity. And then you have to figure out how you are going to collect.[3]

would you like virtue with that

Some months ago, in volume one, number seven, I mentioned that I like to sit down at the computer of a Friday morning, cup of coffee at hand, to sift through the weekly release of letter rulings.[4]

Usually I pay not much attention to the revocations and rejections, because most of these are not close cases. But sometimes you get something interesting under uniform issue list code 503.36, which is how IRS codes adverse determinations based on what they see as substantial nonexempt, essentially "commercial" activity. Farmers' markets, art galleries, open source software developers.

Depending on the particular facts, these can make you think pretty hard about where the boundary between exempt and nonexempt activity "ought to" be. As consumer capitalism settles into its "post-growth" phase, secular stagnation, what have you, folks may be trying to build a sharing economy at the grassroots, and if they need to handle potentially taxable cashflows, we may have to make space for this.

Not to digress.

Anyway, it was sort of in that spirit that ten days ago, as I was reading through the week eleven release, I decided to open PLR 201911010, and found myself reading about a "pay what you can" cafe, at which some customers might pay nothing while others paid "forward," as the kids say.

And I immediately recognized that this was probably Panera Cares.[5] The letter was dated more than ninety days ago, so I checked the docket over at the Tax Court and sure enough.

The Tax Court does not post copies of filings online, so it may be difficult to follow this case as it unfolds. But a contributing editor[6] over at Tax Notes was kind enough to send me a copy of the petition, with exhibits attached, which she had retrieved from the court by hand.

Much of this is posted to the Jack Straw landing page, and we will link particular exhibits as we proceed.

taking it apart

The petition makes a pretty good pitch for the idea that the "pay what you can" model should qualify as an exempt activity -- feeding hungry people, educating folks about the problem of "food insecurity," inviting people who can pay to eat side by side with those who cannot, providing job training to disadvantaged people --, and it takes issue with the examiner's assessment that these five cafes were[7] located in "affluent areas," operating in direct competition with other, for-profit eateries.

Depending how this plays out, the decision could end up being all about the specific facts as found by the court, which would leave the losing party not much opportunity for appeal. But the burden will be on the foundation to establish that the operation of these cafes did not have a substantial nonexempt purpose.

No doubt the decision in *Living Faith, Inc. v. Commissioner*, 950 F.2d 365 (7th Cir. 1991), will figure prominently in both parties' briefs.

In that case, IRS denied exempt status to a corporation that operated two vegetarian restaurants and health food stores "in accordance with the tenets" of the Seventh Day Adventist Church. The Tax Court upheld the rejection, and the appeals court affirmed, noting that the applicant had set itself up "in direct competition with other restaurants," "using pricing formulas common in the retail food business."

"The profit-making price structure looms large in our analysis," the appeals court said.

It is an interesting problem whether a "pay what you can" model can simply never qualify, which IRS seems to almost believe, or whether it can only qualify if you set it up in a neighborhood that is "economically depressed" -- which on the one hand assures that you will be serving your target demographic, but also assures that you will "lose" money. And toward the end these cafes did lose money.[8]

When it applied for exempt status in 2002, the foundation described its proposed activity as grantmaking, though it did seek and obtain status as publicly supported. The idea there being that they would collect donations at the register from customers of the for-profit bakehouses and so on. Nothing in the form 1023 about the foundation itself operating cafes or directly feeding the hungry. In response to question 12a, will recipients of products and/or services be required to pay, the applicant checked the box indicating "not applicable."

And apparently this is pretty much how things actually worked until the foundation launched the "pay what you can" cafe project in 2010. That project quickly came to dominate the foundation's activity and cashflow.

The foundation's 990 for calendar 2012, the year under examination,[9] does report significant "grants and contributions" revenue, but these apparently include amounts paying customers voluntarily paid for food when they were not required to do so. Program service revenue, as such, is reported at zero. And close to one-third of total contributions were from the related for-profit entity, at something over a couple million a year. Food inventory, facilities, equipment, cash.

Anyway, an interesting case, which we will follow as best we can.

the integrity of the program

In our last issue, we briefly mentioned a lawsuit the Justice Department filed in December in federal district court in Atlanta, seeking to shut down a conservation easement syndication operation, to permanently enjoin the promoters from working in the industry, and to require them to disgorge every nickel they have made on these projects in the past ten years.

The parties are still positioning themselves through motions to dismiss, motions to strike affirmative defenses, etc. And we are posting copies of selected pleadings to the Jack Straw landing page so those of you playing at home can watch this unfold without going behind paywalls.[10] Any critical rulings we will cover here.

Meanwhile, the leadership of the Senate Finance Committee, which is to say the chair, Sen. Chuck Grassley (R-IA), and the ranking member, Sen. Ron Wyden (D-OR), have launched an inquiry into "the potential abuse of syndicated conservation easement transactions."[11]

The two senators sent essentially identical letters to fourteen individuals[12] who "appear to be associated with these investor groups that might have unfairly profited from conservation easements," asking them to produce quite a lot of information and documentation by the end of the month.

They got the names from a database accompanying a report published by the Brookings Institution Report in December 2017.

And we have proposed legislation, that would disallow altogether a passthrough deduction for the contribution of an easement by a partnership if the deduction would have been more than two and a half times the partner's adjusted basis in the partnership -- in effect codifying the listed transaction as described in Notice 2017-10, but only for contributions made during the first three tax years ending after the date the partner acquired her interest, and in tax years ending after the date of the Notice.

S. 170 was introduced January 16 by Sen. Steve Daines (R-MT) and co-sponsored by Sen. Debbie Stabenow (D-MI). Both do sit on the Finance Committee, but neither sits on the taxation subcommittee.

The two had introduced identical legislation in the previous session, and a companion measure was introduced in the House with a fair amount of bipartisan support, but both bills died in committee.[13]

Jack is not optimistic the present bill will move forward, despite the fact that Grassley is back as chair and apparently willing to engage on the issue. At the hearing to confirm Steve Mnuchin as Treasury secretary in January 2017 at least two Republicans on the committee asked him to delay enforcement of the Notice.[14]

in other news

My proposal for a breakout session at the NACGP conference in October was not accepted -- actually I submitted three --, but I am thinking of putting together a couple or three webinars on these topics, which might be accessed through my Patreon page.

One on how the repeal of the alimony deduction, and more particularly the repeal of section 682, might be creating new opportunities for the charitable remainder trust in pre-nuptial and divorce planning.[15]

And another on "bespoke" charitable gift planning, sort of riffing on some of the ideas that have come up in letter rulings and in my consulting practice -- a split interest trust that is not subject to the private foundation rules, converting a nongrantor lead trust to a "grantor" lead trust, using a charitable remainder trust as a vehicle to unwind a "failed" 1031 like-kind exchange, stuff like that.

Possibly also a quarterly update on recent developments.

Have not worked out the logistics yet, and we might record some of these "live." Watch this space.

scribblings

[1]

Jack says there has been a misjoinder of parties in this case from the outset. The trust in itself is not a juridical entity. Only the trustee, in his fiduciary capacity, can bring or defend an action on behalf of the trust. The pleadings throughout should have identified the taxpayer as "David Bernstein in his capacity as trustee," etc., not as "the Kaestner Trust."

[2]

357 U.S. 235 (1958), a landmark decision in which, as attentive readers will recall, the Court said a state court could not decide a controversy to which a nonresident trustee would have been a necessary party, where the only "contact" the trustee had with the state was that it had made distributions to the beneficiary who resided there.

[3]

Not a problem at the federal level, unless someone moves the trust offshore. But there at least we have throwback when distributions are finally made to a domestic beneficiary.

[4]

Close to half the word count in that issue -- about twelve hundred words -- was given over to a critique of PLR 201825007, in which IRS said the conversion of a pre-1986 "income" trust to a unitrust, with an ordering rule allocating realized gains to "income," would not shift a benefit to a lower generation, and thus would not affect the trust's "grandfathered" status as exempt from the generation-skipping transfer tax.

Last week, finally, I submitted a considerably longer text to Tax Notes -- well over five thousand words --, fleshing out an argument that the ruling is simply wrong. And also questioning the logic of the 2004 revision to the regs under section 643(b), which is at the bottom of all this.

The article is set to appear in the May 13 issue, and once we get reprint clearance we will post a copy on the Greystocke Project page.

[5]

Or it might have been something like the So All May Eat cafe in Denver, on which Panera Cares was loosely modeled, but the examiner's report referenced multiple locations, and it seemed to focus on what the examiner perceived as a purpose to use the foundation as a vehicle for making deductible contributions of unsold food inventory and used restaurant equipment. So, Panera.

There actually is a growing network of these "pay what you can" cafes, not all of them in church basements. Many of them are also involved in the "farm to table" movement, preparing and serving locally grown produce.

[6]

Kristen Parillo, who had written up the decision in *Estate of Dieringer*, quoting and paraphrasing your correspondent at length. We do have clearance to reprint that article, and we have posted a copy.

[7]

Past tense. The last of five locations at which the foundation conducted this experiment closed earlier this year.

So it would appear the primary issue facing Panera itself at this point might be the deductibility of tens of millions of dollars of support, cash and noncash, it provided to the foundation over the course of seven years, going back to 2012, the year under examination.

Assuming IRS has kept all those years open. Which you might not guess by looking at the last 10-K Panera filed before they were acquired by JAB Holding Company for $7.5 billion cash, roughly forty-one times earnings.

The examiner here seemed to think the operation of these cafes was a form of advertising for the for-profit entity. Which maybe would make at least some of the expense deductible under section 162.

For its part, the foundation would be facing tax on unrelated business income, but at least in later years it was operating at a loss.

[8]

Whereas SAME in Denver, see fn. 5 above, appears to be operating in the black.

Your correspondent will mention here that when he lived in Portland, Oregon a few years back, he was an occasional patron of the Panera Cares cafe in the Hollywood neighborhood. If you are looking only at household incomes, this is not a "distressed" area, but neither is it particularly "affluent."

The cafe itself shared a parking lot with a Trader Joe's. It was directly across the street from a transit hub for both the bus and the light rail systems, and about three blocks from a public library. Plenty of homeless folks on hand to feed. There was quite a bit of vacancy and decay in the surrounding commercial properties. Gentrification was coming, but it had not yet really taken hold.

They had some problems with the rollout, but these should not be relevant to the pending case.

[9]

Returns for more recent years are available online. The method of reporting receipts is the same, year over year.

[10]

Among the current batch is the government's reply to Ecovest's response to the government's motion to strike its affirmative defenses. Fiercely fought, as we have said. In this reply, the government argues that disgorgement is "remedial" and thus cannot be an "excessive fine," in violation of the Eighth Amendment. The theory being that we are restoring funds to the Treasury that these folks in effect took by creating these "tax shelters."

Of course, there is a mismatch in amounts here, but the government addresses this in a footnote on page 5 of its motion, pointing out that even if IRS were able to recover "some or all of the tax loss" through audits of the various participants, still the agency has had to "devote substantial resources to identifying defendants' scheme and customers."

Maybe Brookings and/or ProPublica could get a piece of this as a sort of finder's fee. According to Bloomberg, there may be some whistleblowers in for a cut as well.

[11]

As though there were a nonabusive version of the syndicated easement. Which, if you accept the two and a half multiplier mentioned in Notice 2017-10 as some kind of threshold, maybe there is.

[12]

Including our friends down in Atlanta, who appear to be one of the largest players.

[13]

The Notice was issued in the closing days of the Obama administration. When Republicans still controlled the House in 2018, the appropriations committee reported out a spending bill that would have forbidden IRS from committing any resources to "implement or enforce" the Notice "with respect to transactions entered into before January 23, 2017." That language was stripped from the legislation as finally enacted.

[14]

In response, the nominee mentioned the regulatory freeze issued "on Day One" by the incoming administration, and said he would prioritize review of regulatory actions that had been taken by the previous administration in the "11th hour." An executive order issued in April 2017 formalized the latter commitment.

But the Notice has not been withdrawn, and as recently as July 2018 then-acting Commissioner David Kautter updated ranking member Wyden on the agency's analysis of the response to the reporting requirements imposed by the notice.

[15]

Section 682, you might recall, overrode "grantor" trust provisions that would otherwise have taxed income in trust for the benefit of a former spouse to the settlor, and instead treated distributions to the former spouse as though they were made from "complex" trust. That is gone now.

Jack says,
we got a thousand points of light