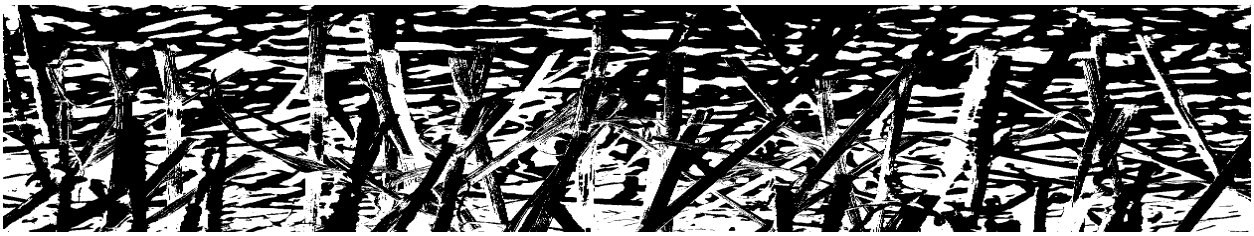

Jack Straw Fortnightly*

april fish

Still no word from the Supreme Court whether they will grant cert in *Fielding*. Meanwhile, we have a flood of amicus briefs in *Kaestner Trust* in support of the respondent trustee.

One from the respondent trustee in *Fielding* itself, reciting the due process, minimum contacts argument, [1] and suggesting that a state might simply wait until accumulations are actually distributed, and then impose a "throwback" tax on the beneficiary, calculated as though she had received the income in the years it was being accumulated.[2]

Another from a group of associations of trust companies in four states[3] that do not tax trust income at all -- plus Delaware, which does not tax income of a "resident" trust unless a beneficiary is also a resident --, another from the attorneys general of four states that do not tax trust income, yet another from a bunch of lawyers who practice in a state that does not tax trust income, etc.

Are we seeing a pattern here?

Weirdly, the New York State Bar filed an amicus brief in support of the respondent trustee, arguing that a trust is a distinct legal entity, rather than a relationship among several parties,[4] etc., and then asserting that the decision below "does not create a tax shelter" because, hey, look at these two articles explaining how you can avoid state income taxation of accumulated income by appointing a trustee resident in a state that does not tax trust income.[5]

Again, oral argument is set for Tuesday, April 16. We will defer a more detailed analysis until then.[6]

one step beyond

Another batch of five ING rulings in week eight, PLRs 201908003 through 007, identical verbatim, with the usual determinations that the initial funding of the trust is not a completed gift, but at the same time the settlor will maybe, probably not be treated as the income tax "owner" of any portion of the trust, because.

But then a sixth ruling, also an ING, with a new wrinkle.

In PLR 201908008, instead of reserving a power, exerciseable in a nonfiduciary capacity, to direct distributions to an individual

beneficiary, subject to an "ascertainable standard," which is the typical model,[7] in this case the settlor has reserved a limited power to direct distributions to one or more qualified charities.

Again the usual determinations -- not a completed gift until distributions are actually made, no taxable powers in any members of the distributions committee, probably not a "grantor" trust as to the settlor -- but here we are also asking, what happens if the settlor exercises her reserved power.

This would complete a gift, for which the settlor could claim a gift tax charitable deduction. But the question then is, could the trust itself also claim an income tax charitable deduction under section 642(c)(1).

IRS says yes, ruling number 6. After all, we are supposing this is a "complex" trust, a separate taxpayer. Unless on audit it turns out the settlor has been exercising a section 675 power for her own benefit.[8]

But look what has happened here. The income tax charitable deduction allowed to a nongrantor trust is not limited to some percentage of adjusted gross income, nor is it subject to what amounts to a floor, *i.e.*, the standard deduction.[9]

By moving income-producing assets into an ING, in other words, you are buying into larger tax subsidies for transfers to your private foundation. Plus, you can elect to treat distributions made in the current year as having been made in the previous year, and you have until the extended due date of the return for the current year to make that decision.

Oh, and it gets better. In ruling number 7, IRS accepts that because this is not literally a split-interest trust -- the trust will not ever be holding amounts for which a deduction was already allowed --, the private foundation excise tax rules will not apply, the settlor will not be a "disqualified person," there will be no exposure to excise taxes on self-dealing, excess business holdings, jeopardizing investments, etc.

the red wheelbarrow

Apart from the opportunities for manipulation we have just sketched, Jack says the ruling seems to be flat wrong on the question whether the settlor's reserved power does not itself make this a "grantor" trust.

But wait, Jack, doesn't section 674(b)(4) make an exception for a reserved power to allocate distributions among charities? Yes, but that is not what is going on here. That exception applies only to income or corpus that has already been irrevocably designated for exempt purposes. Think: nongrantor charitable lead annuity trust.

While here the remainder at the settlor's death is irrevocably designated to charities selected either by the settlor exercising her reserved limited testamentary power or by the independent trustee in default of exercise, that remainder is subject to complete defeasance by distributions to either or both of the individual beneficiaries during the settlor's life. That is to say, the assets from which the settlor can

appoint to charities during her life are not already "irrevocably payable" for exempt purposes.

So unless Jack is missing something obvious, the ruling is simply wrong on that point. We do have a "grantor" trust. Or anyone else doing the same thing would, unless they also got a letter ruling making the same error. Jack is suggesting this letter should be withdrawn.[10]

But if we fixed this glitch, the settlor's "consent" power could still be used to the same effect. Ruling 2 says a distribution either at the direction of the committee, subject to the settlor's "consent power," or simply by the independent trustee, who has "absolute discretion," would be a completed gift. And then the rest of Ruling 6 falls into place.

Of course Jack has issues with Ruling 2 as well, briefly sketched in footnote 7. But assuming IRS remains committed to the course it has marked out in well over a hundred ING rulings, we now have yet another, shall we say, unintended tax subsidy for transfers to private foundations.

briefly, this

On Friday, IRS issued Rev. Rul. 2019-11, providing guidance on whether a refund of state and local taxes for which a deduction was claimed in a prior year is reportable as income and if so in what amount.

The ruling gives four examples, proceeding from the unremarkable premise that you include the amount by which your deduction would have been reduced if you had not claimed it. A straightforward "tax benefit" rule.

The examples illustrate what happens at the margins. If subtracting the amount refunded would have taken you below the standard deduction, or brought you in under the $10k cap, you need report only the difference. If you would still have been over the $10k cap, the amount reportable is zero.[11]

godspeed you

A few weeks ago, Sen. Bernie Sanders (I-VT) introduced a bill that would significantly overhaul the federal transfer tax regime. As summarized in Sanders' two-page "one-pager" -- the document actually runs 23 pages, but most of this is a list of billionaires, comparing what each might pay in transfer taxes under existing law versus the proposed legislation --, S. 309 would

- restore the exemption equivalent to $3.5 million, where it was in 2009,
- impose higher marginal rates on larger estates, climbing to 77 pct. on estates of $1 billion or more,
- preclude a trust that might continue in existence for more than fifty years from claiming an exemption from the generation-skipping tax,
- impose a minimum ten-year term on grantor retained annuity trusts,
- include in a settlor's estate any portion of an inter vivos trust of which she was the "deemed owner" for income tax purposes, and treat the toggling off of "grantor" trust status as a taxable gift,
- simplify the gift tax annual exclusion by applying it across the board to all transfers, regardless whether these are of present or future interests, but

- precluding valuation discounts on the transfer of interests in entities holding "nonbusiness" assets, and
- precluding minority discounts on the transfer of interests in entities in which the transferor, the transferee, and members of their families collectively control the entity or hold a majority of ownership interests by value.

In short, the bill would enact the agenda of the Greystocke Project.

At this writing, the bill has only one co-sponsor, Sen. Kirsten Gillibrand (D-NY). It has been assigned to the Finance Committee, where it will probably never get a hearing.

There has as yet been no related bill offered in the House, though the "origination clause" may require this.

and finally

Back in December, the Justice Department filed an eighty-page complaint in federal district court in Atlanta, seeking to shut down one of these syndicated conservation easement promoters.

There was a press release, using words like "abuse" and "fraudulent" and "unscrupulous," and briefly sketching the argument that these transactions lack economic substance as investment partnerships and are in reality "conduits" for selling income tax deductions based on gross overvaluations.

The Land Trust Alliance immediately issued a release saying "thank god," or words to that effect.

The complaint itself is pretty brutal, too, asking the court not only to enjoin these folks from continuing to work in the industry at all, but also to require them to "disgorge" every nickel they have made on these projects over the past ten years.

But the defendants have lawyered up, and this promises to be a fiercely contested case.

We have posted copies of the opening salvos from both sides to the Jack Straw landing page, and we will write up a detailed analysis down the road a piece, as this unfolds.

lagan and derelict

[1]

And citing *Hanson v. Denckla*, 357 U.S. 235 (1958), in which the Court ruled, among other things, that a Florida court had no personal jurisdiction over a Delaware trustee who would have been a necessary party to an action to invalidate a trust agreement and the settlor's exercise of a reserved power to appoint the remainder at her death.

The fact that the trustee had made distributions to the settlor for a number of years after she moved to Florida was not a "sufficient affiliation" with the state, the Court said.

In its brief ostensibly supporting neither party, ACTEC suggested that the Court would have to "reconsider" its decision in *Hanson* in order to allow a state to tax the income of a trust administered elsewhere "based solely on the fact of the beneficiary's residence."

In its opening brief, the North Carolina department of revenue argued that *Hanson* simply does not control, because "[t]he issue there was adjudicative jurisdiction over a trustee, not tax jurisdiction over a trust."

Jack says, if the Court does decide *Kaestner Trust* on the merits, rather than remanding both it and *Fielding* to develop arguments under a "dormant commerce clause" analysis, it will have to grapple with what exactly *Hanson* implies in this context: how as a practical matter a state might impose an income tax on accumulated income when it would not be able to secure personal jurisdiction over the trustee in a collection action.

[2]

The difficulty in the actual case being that the beneficiary has since moved to another state.

[3]

Including our friends from New Hampshire, see Jack Straw volume one, number one and number three.

[4]

Don't get Jack started, just yet.

[5]

One of the cited articles is behind a paywall on the ACTEC website, and a version of the other is linked here. But Jack, a reader objects, if those folks are promoting this, surely it is not a "shelter." Jack finds this syllogism unsound.

[6]

Except to say this. The respondent's brief, and several of the amicus briefs submitted in support of the respondent, make much rhetorical use of the word "contingent" to characterize the individual beneficiary's interest in the Kaestner Trust. The implication being that any connection to the state by reason of the beneficiary's residence there was entirely "speculative."

The ostensibly neutral brief submitted by ACTEC did not much to clarify the matter -- indeed, the respondent cited that brief half a dozen times in support of its argument on this point.

So what exactly is the quality of the beneficiary's interest here.

It is true that current distributions of income and/or principal were subject to the trustee's "absolute" discretion, and that in fact the trustee did not distribute anything at all during the tax years in issue. Unless you count that one loan of $250k, which was paid back only after the decanting. What decanting is that, you ask.

The 1992 trust instrument provided that the entire trust principal was to be distributed to the settlor's daughter when she attained age 40, or if she did not survive to that age, to those she might designate under a

limited testamentary power of appointment, or in default of her exercise of that power, in further trust for her descendants, per stirpes.

Just before the daughter turned 40, and with her consent, the trustee decanted into another trust for her benefit that would continue for her life.

The NYSBA brief, which we (gently?) mocked in the text accompanying fn. 5 above, also attempted to distinguish *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Conn. 1999), in part on the ground that the income beneficiary in that case had "more significant vested rights" than the beneficiary here. And what were those rights? Outright distribution at age 45, or if she did not survive to that age, remainder to her appointees under a limited power, etc. In other words, essentially identical.

What is telling here is not so much that the authors of the NYSBA brief "got it wrong" -- the statute at issue in *Gavin* imposed a state income tax on a trust where the settlor was a resident at the time it became irrevocable -- the situation in *Fielding*, in other words --, and the fact that a "noncontingent" beneficiary was a resident came into play only with respect to an apportionment rule --, as that they inadvertently "got it right," correctly using the word "vested" to characterize the beneficiary's interest.

In the language of future interests, from which the common law of trusts derives, what the beneficiary in *Kaestner Trust* had was not a "contingent" interest, but a "vested" remainder that would have been "subject to defeasance" by her not surviving to age 40, except that it was coupled with a limited power, also vested, to appoint the remainder in that event. The fact that current income was being accumulated merely enhanced the remainder.

Okay, it is not quite as simple as that. The daughter's vested remainder could also have been defeated by the trustee exhausting the trust through distributions to her descendants, or more likely to trusts for their benefit, before she turned 40. Or, as in fact happened here, by decanting to another trust for her and their benefit, which is actually another way of saying the same thing.

The daughter participated in the decision to decant because she would have had a right to object. Nothing "speculative" about it. Whether she could actually have prevented the decanting is a question of New York law, beyond our immediate scope. But she did have immediate, enforceable rights.

The ACTEC brief might have done a better job of clarifying all this.

[7]

Exploiting the exception at section 674(b)(5), while at the same rendering the gift incomplete until distribution is actually made, because the members of the distributions committee are treated under reg. section 25.2511-2(e) as not having an "adverse" interest in the exercise or nonexercise of the settlor's "consent power," even though they are also permitted distributees, and even though each of them is a default taker of a piece of

the remainder at the settlor's death if she does not exercise her limited testamentary power. Smoke and mirrors.

[8]

But of course the audit rate on 1041s is practically nil. On the other hand, maybe within that zero point one pct. the settlor of an ING will have painted a target on her back by seeking one of these rulings.

[9]

Nor is it limited to distributions to domestic charities.

[10]

Your correspondent has put in an inquiry to the folks at IRS who cut and pasted this letter together. We will report what we hear back in these pages.

[11]

The example does not pro rate the components of the claimed deduction, presumably because in the typical case this would become a circular exercise.

Jack says,
let us not talk falsely now, the hour is getting late.