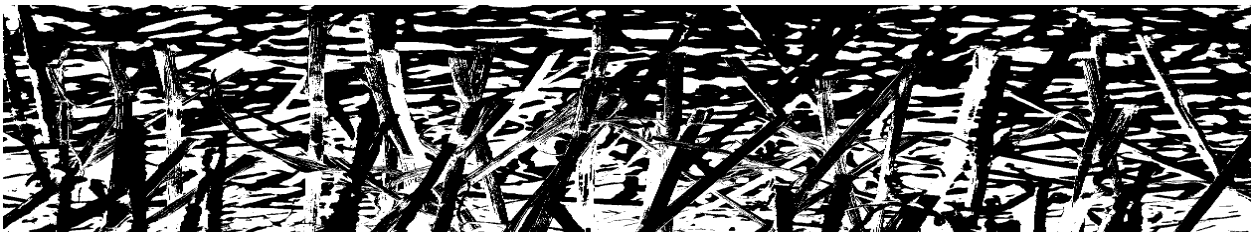

Jack Straw Fortnightly*

# and again

Awhile back, a reader sent me a link to a video posted online, ostensibly behind a paywall.[1]

The video was a recording of a one-hour webinar that had been presented some weeks earlier to a select audience of financial planners, life insurance brokers, and maybe some lawyers and accountants, at least some of whom were expecting continuing education credit.

What the video seemed to show was the promoter of a questionable tax strategy explaining to his subscribers why the strategy is not identical with the disaster that unraveled in Florida a few months back in the federal civil prosecution of a guy named Meyer.

And it is not. Or it need not be. But there are other difficulties.

We will get to Meyer in a minute, but first.

**what it looks like**

The strategy described in the video involves transferring nonvoting interests[2] in a limited liability company taxed as a passthrough entity into a donor advised fund.

Already you are thinking, okay, that can be done.[3] You would have to get a qualified appraisal, and the fund sponsor would want an exit plan that allows it to cash out at something like fair market value, but typically there is a realization event on the horizon anyway, and the idea is to have this occur within the exempt vehicle, so that should not be much of an issue.

Also, if the LLC was conducting an active trade or business you would have to be concerned about unrelated business taxable income. But again, this is something you could work around, require the LLC to make distributions at least sufficient to cover the anticipated tax liability, etc.

But there is something else or other going on here.

In the typical case as described in the video, the LLC would be holding marketable securities on the way in, so probably no UBIT problem,[4] and yes, there would be a plan to harvest gains soon after the contribution.

The DAF would then be holding a nonvoting interest, typically 99

pct., in an LLC holding cash. The transferor would retain the one pct. voting interest.

But there was no immediate exit plan -- in fact, quite the contrary.

**beyond here be dragons**

The transferor, in her capacity as managing member, would then cause the LLC to lend nearly all of the proceeds to an irrevocable life insurance trust she had created, to support premium payments under a split-dollar plan.

The loan would be secured by the policy itself, and would eventually be repaid either from cash value accumulations along the way, at the transferor's discretion, or from proceeds at her death. The note would pay interest only, at or slightly above the applicable federal rate, let's say two point something pct.[5]

The promoter acknowledges that the managing member has a fiduciary responsibility to the nonvoting members to invest prudently.[6] But Jack says it is difficult to see how putting everything into a promissory note paying an historically low rate of interest can be "prudent."[7]

Anyway, we seem to be looking at a scenario in which

(a) the transferor retains functional control of the transferred asset,

(b) the DAF itself is holding a nonvoting interest in an entity that holds only a promissory note that will not come due until the transferor's death,

(c) there is zero opportunity for growth, and

(d) the fund sponsor is unable as a practical matter to make grants to public charities, except from whatever trickles in from interest payments on the loan, when and if those are actually distributed to the members.[8]

**gimme shelter**

In at least some iterations, this strategy would almost certainly be a listed transaction under Notice 2004-30. Jay Adkisson recently wrote a rather energetic piece to this effect in Forbes.

That Notice describes a "tax shelter" in which shareholders transfer nonvoting stock comprising 90 pct. of the equity in an S corporation to an exempt org, so that passthrough items mostly escape income taxation -- but no distributions are actually made to the exempt org.

In the case described in the 2004 Notice, the voting shareholders are also holding warrants that if exercised would greatly reduce the price at which the exempt org could cash out, but it is not at all clear this is an essential element of the reportable "shelter" transaction.

Similarly, although the Notice mentions that in some cases the transferors may have claimed income tax charitable deductions for the contribution of the nonvoting stock, this is fairly clearly not an essential element. The Notice also mentions that under unspecified "appropriate facts and circumstances" IRS might argue that the warrants are

in effect a second class of stock, which would terminate the S election.

But the Notice is focused primarily on the sheltering of otherwise taxable income in K-1 passthroughs to an exempt entity the transferor controls, none of which is actually being distributed.

As is typical, the Notice extends to transactions that are "the same as, or substantially similar to" the transaction as literally described.

Jack says it is too obvious to require further elaboration here that "pairing an LLC with a DAF," as the transaction is described in the video, is "substantially similar" to the transaction listed in the 2004 Notice.

If the promoter is making $50k or more off the deal,[9] she and each of the participants, including the fund sponsor,[10] should be filing the appropriate disclosure forms and inviting IRS to take its best shot. There are penalties for failing to make these filings.

**it gets worse**

The strategy described in the video can also be seen as an attempt to work around the flat prohibition on "charitable split-dollar" arrangements set forth in section 170(f)(10).

That paragraph, enacted in 1999, denies a deduction for a transfer to an exempt org if "in connection with" that transfer the org "directly or indirectly" pays a premium on a life insurance, annuity, or endowment contract "with respect to the transferor."

There are as yet no regulations implementing or interpreting the quoted phrases.

The measure was included as a "negligible" revenue offset to a work incentives bill shortly after IRS had issued Notice 99-36, which took a considerably narrower approach.[11]

The Notice described a transaction in which the exempt org participates directly in a split-dollar arrangement with the taxpayer's ILIT, using funds nominally "contributed" by the taxpayer.

The promoters were taking the position that the transfer to the exempt org was unrestricted, there was no enforceable pre-arrangement, and the taxpayer was not a party to the split-dollar agreement and had no interest in the policy.

All technically true, but IRS said it would disregard the form of the transaction and treat it in substance as though the taxpayer had purchased the policy herself and then transferred portions of the policy to the ILIT and to the exempt org, thus "violating" the partial interest rule, section 170(f)(3) and reg. section 1.170A-7(a)(2)(i).

Although the Notice threatened promoters and participants with "adverse tax consequences, including penalties," it did not formally identify the transaction as "listed" or even "reportable."

Jack says the enactment of section 170(f)(10) did not obsolete the Notice, but supplemented it. In other words, substance over form, IRS could still argue nonqualified partial

interest, regardless whether the exempt org "directly or indirectly" paid the premiums.[12]

**between a rock**

But even if section 170(f)(10) were all we had to work with, Jack also says we do have at least "indirect" payment here, even if the fund sponsor is holding only nonvoting units in the LLC.

Why the strategy described in the video might be seen as a workaround is this interposition of an entity that -- if it were respected -- would separate the fund sponsor from participating in making the loan.

But Jack suggests IRS would readily collapse the transaction,[13] substance over form, if it appeared the fund sponsor either

> (a) knew or should have known the lay of the land walking into the deal and/or
>
> (b) slept on its rights as even a nonvoting member to challenge the transferor's abuse of her fiduciary obligation, in her capacity as managing member, to invest the proceeds prudently.

You cannot have it both ways, Jack says. Either the transferor has surrendered control of the asset or the fund sponsor has no control over how the proceeds are invested. There is no "try."

**so, what about Meyer**

Back in April a guy named Meyer entered into a consent judgment with the Department of Justice, permanently enjoining him from giving tax advice on charitable contributions, preparing returns, assisting with tax appraisals, etc. -- pretty much requiring him to seek another livelihood.[14]

What had he done to deserve this?

According to the DOJ's amended complaint, Meyer had "promoted and operated" an "abusive tax scheme" in which, um,

> a participant would transfer property to a limited liability or limited partnership and convey interests in that entity to a donor advised fund, while retaining control of the underlying assets.

At paragraphs 228 and 229, page 45, the amended complaint literally references Notice 2004-30.

Well, but. Meyer did much more than that. He backdated key documents. He signed off on inflated appraisals, though he was not a qualified appraiser. He treated the purported fund sponsor as his personal checkbook. And on and on and on.

A recurring theme of the video we have been discussing is that Meyer was a "bad actor," and that what happened to him can be avoided by implementing a checklist of "best practices." Some of which seem potentially at odds with the objectives of the strategy itself,[15] but be that as it may.

One of the takeaways from Meyer, according to the video, is that the fund sponsor must be "independent" of the transferor. Not "your little mom and pop shop."[16] The promoter mentions "the multi-billion dollar donor advised funds. They have deep

boards," he says. "They've got committees, they've got employees. We work with a number of them," he says.

"One that we work with has 18 billion dollars of assets under management," he says. This last is a fairly clear reference to Fidelity.

Jack is skeptical that a legit fund sponsor would actually accept one of these. Certainly not a traditional community foundation, and almost certainly none of the "big three" commercial providers.

But there are others operating in what you might call a more "entrepreneurial" space.[17]

**what you want to see**

Probably the most striking thing about the video is how the promoter insists, repeatedly, that in pursuing a civil action against Meyer the Department of Justice was not interpreting tax law -- "not its job," he says -- but shutting down an abusive implementation of an otherwise valid tax strategy.[18]

Specifically, the promoter says, the theory of the DOJ's amended complaint was not that the tax strategy itself was not viable, but that Meyer abused multiple formalities in implementing the strategy.

The amended complaint alleged the purported gifts were not "complete" because the participants in fact retained control of the contributed assets. But the promoter says this was only because the purported fund sponsors were sham operations.

Jack suggests this may be a motivated reading of the amended complaint. Paragraphs 63 and following do argue that the strategy itself is not valid, regardless of Meyer's abuse of formalities.

Specifically, paragraph 66 alleges that because the transferor retains voting control of the limited partnership or limited liability company, she continues to control the underlying assets. And paragraph 67 specifically mentions the making of loans back to the transferor.

"Consequently," paragraph 68, "participants in Meyer's scheme receive a large income tax deduction and still get the use and enjoyment of the assets that generated the deduction."

No amount of crossing t's and/or dotting i's changes that result.

Jack speculates that Meyer may be an opening salvo, picking off an egregiously bad actor before zeroing in on other promoters who give slightly more attention to adhering to formalities.[19]

**stray bits**

It has been not quite eight weeks since our previous issue. The two thousand words you just read, plus another twelve hundred in footnotes, has taken awhile to craft, and we probably could have done yet further editing.

But at some point you just have to cut it loose. In the meantime, other stuff has been happening, for which we have left not very much space. So we will hit these quickly, and maybe come back to some of them in future.

**item**: The ACGA board made a mid-year course correction on their recommended gift annuity rates, retreating from the sharp upward adjustment they made back in early 2018, which Jack had questioned at the time.

Excellent analysis as usual by Bill Laskin on the PGCalc blog, noting that the new rates, which are to take effect January 01, are "similar to" those that had been effect for six years prior.[20]

**item**: Meanwhile, the 7520 rate seems to have settled for the moment at 2.0 pct., after hitting a nearly three-year low at 1.8 pct. in October. At the time of the ACGA announcement in April 2018 of the higher recommended gift annuity rates they have now abandoned, the 7520 rate had climbed to 3.2 pct., the highest in almost eight years. We did get all the way up to 3.6 pct. toward the end of 2018.

**item**: Last Friday, the Treasury and IRS finalized regs forgoing "clawback" in the estate of a decedent who dies after 2025 of gifts she might have made while the applicable exclusion amount is temporarily doubled in excess of the amount that might be in effect at the date of her death.

Readers may recall that the Greystocke Project submitted comments on the proposed regs, arguing

> (a) that the decision to forgo "clawback" was not within the authority granted by section 2001(g)(2), and
>
> (b) that the resulting increase in revenue losses outside the budget window would have violated the Byrd rule had this been what the Congress intended.

To their credit, the agency took four pages and several hundred words in the preamble to the final regs to respond to these comments. But the response is unsatisfactory.

It is true that section 2001(g)(2) asks the agency to issue regulations dealing with the problem of a mismatch between the exclusion amount in effect at the time an inter vivos transfer is made and that in effect at the decedent's death. And it is true that the problem arises only at the decedent's death.

But the legislative text does not directly reference the temporary doubling of the exclusion amount, and it does not say anything about "clawback" or no.

Which seems several steps short of authorizing regs forgoing "clawback." Particularly in light of the fact, as we noted in our comments, the revenue estimates seemed to suggest that "clawback" was expected to occur.

We had also argued that the "blue book," which first mentioned the "clawback" issue, was issued more than a year after the 2017 tax bill was enacted, and cannot reasonably be seen as reflecting legislative intent. The preamble to the final regs simply rejects this argument.

**item**: A published opinion from the Tax Court disallowing a claimed $155.5 million deduction for a conservation easement on the ground that the grantee was "not absolutely entitled to a proportionate share of the proceeds in the event the

property was sold following a judicial extinguishment of the easement."

The problem was language in the deed reserving proceeds attributable to post-easement improvements to the owner of the servient estate. The Tax Court had ruled on this issue previously, in an unreviewed transcript opinion in *PBBM-Rose Hill, Ltd. v. Commissioner*, *aff'd* 900 F.3d 193 (5th Cir. 2018). We mentioned the appeals court opinion briefly in volume one, issue eleven.

There is a motion pending for reconsideration, and one supposes we might see an appeal to the 6th Circuit. There is some pretty high-end legal talent on board.

**item**: The Senate rejected a joint resolution to disapprove regs finalized back in June that treat a state or local tax credit for a contribution to an exempt org as a quid pro quo, reducing the amount allowable as an income tax charitable deduction. We reviewed the final regs in volume two, number nine.

The vote was not quite entirely along party lines. Sen. Rand Paul (R-KY) voted in favor, and erstwhile presidential candidate Sen. Michael F. Bennet (D-CO) voted against.

An identical measure was introduced in the House in July, but has not yet cleared Ways and Means.

**item**: We have the inflation adjustments for 2020. The annual exclusion for present interest gifts holds at $15k, while the exclusion for gifts to a nonresident spouse is up slightly, from $155k to $157k. The unified credit is up from $11.4 million to $11.58 million.

**item**: A fairly interesting letter ruling released last week, PLR 201947007, approving the reformation of a nonqualifying testamentary charitable remainder unitrust.

Reasonably complex factual scenario. We probably will give this some space in our next issue, simply because it is instructive.

Your correspondent gave a paper on this subject at the NCPG conference in DC back in 2009, and it is about time for an update.

## more words

[1]

The video, and several others posted by the same promoter to the same page, are accessible to anyone who also subscribes to the same video hosting service, though to find these you would have to know the particular URL of at least one, which is a lengthy string of random letters and numbers.

Your correspondent is not providing the link, nor is he naming the promoter in these pages.

[2]

In this particular video, the promoter does not use the word "nonvoting," but he does talk about discounting the value of the gift for lack of control. There may be some nuance here, see footnote 8.

[3]

Actually, it may not be all that simple.

In Rev. Rul. 81-282, IRS took the position that the transfer of voting stock to an exempt org was a nonqualified partial interest where the transferor reserved the voting rights. In his concurring opinion in *McCord v. Commissioner*, 120 T.C. No. 13 (2003), *aff'd* 461 F.3d 614 (5th Cir. 2006), Judge Stephen J. Swift cited this ruling in support of an argument that the transfer to an exempt org of assignee interests in a limited partnership should not have qualified for a deduction at all.

That question did not figure in the majority opinion, which focused on valuation issues, and it did not arise in the appeal to the 5th Circuit. But the argument is out there.

[4]

Also no credible nontax business or investment purpose, cf. *Estate of Thompson v. Commissioner*, T.C. Memo. 2002-346, aff'd 382 F.3d 387 (3d Cir. 2004). While that issue may seem tangential, Jack suggests the absence of a nontax purpose would be relevant to the substance over form analysis under Notice 2004-30, discussed below.

[5]

Although the transferor might choose, unilaterally, to pay down the note from cash value accumulations along the way, the principal balance is not due until her death, which is likely to be long term. Back in January, the long-term AFR was just above three pct. As of November, we are down to just under two pct.

[6]

Section 409(b)(1) of the revised uniform limited liability company act requires that a managing member hold "as trustee" for the LLC any "property, profit, or benefit" she has derived in the course of conducting its affairs, or from the use of company property. Although section 105(d)(3) of the uniform act does allow the operating agreement to alter or even eliminate the duty of loyalty, the waiver must not be "manifestly unreasonable" in light of existing circumstances.

[7]

In the video, the promoter suggests maybe additional collateral, maybe a somewhat higher interest rate, etc., but in context these seem almost to be concessions in response to the Meyer fiasco.

[8]

Your correspondent has had some extended e-mail exchanges with the promoter, and a fairly lengthy telephone conversation, and he has reviewed a specimen of what is represented to be a typical operating agreement --

-- which, to be fair, contemplates that the DAF would hold units that have limited voting rights, notably to set "investment performance benchmarks" and to approve loans to the transferor, or to a member of her family, or to an entity controlled by either. Jack suggests this is two-edged blade, as it implicates the fund sponsor directly in the loan.

Also, while the operating agreement may set a floor on distributions, the decision to make distributions to the members remains with the transferor, who remains the managing member for life, subject to removal only for gross negligence or breach of her fiduciary obligations to the LLC.

Restrictions on transferability of units are expressly reserved to a separate document your correspondent has not seen.

[9]

Jack says the threshold is artificial, and rather high.

[10]

Notice 2004-30 does expressly state that the exempt party to this transaction is treated as a "participant."

[11]

The sequence of events here is of some interest.

A sort of rough draft of what is now section 170(f)(10) was first offered as a stand-alone measure in the House in February 1999. That bill died in committee, but several months later the provision in essentially its final form found its way into the initial version of a Senate bill dealing with education incentives.

In its report accompanying that bill, the Finance committee anticipated Notice 99-36 by asserting that the transaction was a nonqualified partial interest, for which no deduction was allowable under existing law, but said legislation was needed "[to] stop the marketing of these transactions immediately." Much of the language in this section of the report was cribbed from the floor statement of the representative who had introduced the House bill back in February.

The Senate bill stalled, the Notice was issued in June, but then the provision was included in a tax extenders bill in the Senate, supported by identical language in the Finance committee report, which passed the Senate in October. The revenue offsets from that bill were then added to the House work incentives bill in conference.

The conference report did not replicate the urgent framing of the two Finance committee reports, but it did describe the provision as "restat[ing]" existing law, and the effective date was made retroactive to February, when the stand-alone House bill had been introduced.

Jack's take on all this is that IRS may not have had complete confidence in its litigating position and was urging a legislative fix, but issued the Notice during a hiatus when it appeared the proposed legislation might not be enacted in that session.

[12]

And there are yet other avenues of attack. In *Addis v. Commissioner*, 374 F.3d 881 (9th Cir. 2004), the appeals court, affirming a decision of the Tax Court, 118 T.C. No. 32 (2002), found it unnecessary to reach the question whether a charitable split-dollar arrangement would have "violated" the partial interest rule absent the enactment of section 170(f)(10), instead ruling that the written acknowledgment provided by

the exempt org "inaccurately stated" that no goods or services had been given in exchange. The Supreme Court denied cert, 543 U.S. 1151 (2005).

[13]

If the transaction were collapsed, the fund sponsor would be required to report the payment of premiums on a form 8870, and to file a form 4720 and pay an excise tax in the full amount of premiums paid. See Notice 2000-24.

[14]

The DOJ's amended complaint also sought "disgorgement" of every nickel Meyer had made in setting up these transactions over a period of more than twenty years.

It appears he actually did pay some amount to settle the disgorgement claim, but the details are not in the court record.

[15]

See for example footnote 8 above.

[16]

As we were starting to put this issue together, IRS released PLR 201944017, revoking the exempt status of a purported fund sponsor that had been created and/or operated with Meyer's assistance. The revocation was made retroactive to the start of the year in which the org had first accepted contributions of LLC interests.

This was quite literally a "mom and pop" fund sponsor, with a husband and wife serving as two of the three directors. Your correspondent has not yet found that any petition has been filed in the Tax Court or elsewhere seeking to set aside the revocation.

[17]

Jack is reasonably confident he has tracked down several of these, but that information is not yet ready for publication.

[18]

In the closing minutes of the video, the promoter reinforces this argument through two of the six "polling" questions to which attendees must respond if they are to claim CPE credit.

[19]

In the video, the promoter says he looked at some of the 990s filed by some of Meyer's purported fund sponsors, and saw, quote

> they had almost all, and in one case all their assets -- and I'm talking tens of millions of dollars -- were LLCs, and no other assets. None. No stocks, mutual funds, real estate holdings, cash, nothing. It was all LLC after LLC after LLC after LLC.

end quote. The same can be said for at least two of the other players in this arena.

[20]

In a separate item on the PGCalc blog, the suggestion is made that there is a window of opportunity here to motivate prospective donors to close on annuity contracts before the lower recommended rates take effect in January. Because marketing.