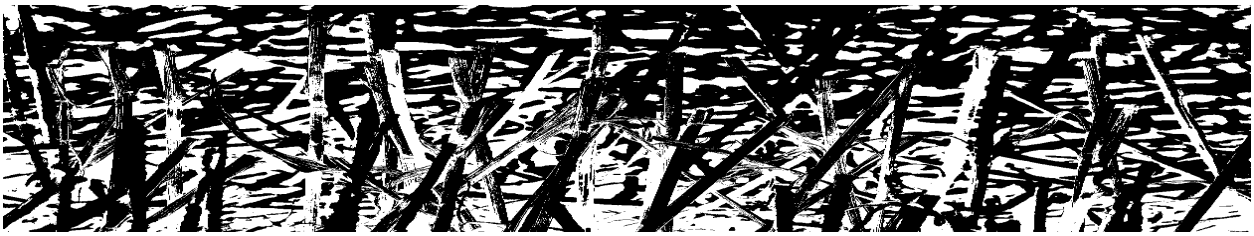

Jack Straw Fortnightly*

the mystification of

We wrote most of this issue last week, but held up publication to see whether this morning's order list would include a disposition of the petition for certiorari in *Bauerly v. Fielding*. It does not.

Meanwhile we have the respondent's brief in *Kaestner Trust*, which is already set for argument April 16.

In each case the question is whether a state may tax the undistributed income of a nongrantor trust where the only connection to the state is (in the case of *Kaestner Trust*) the residence of the contingent beneficiary for whom the income is being accumulated or (in the case of *Fielding*) the fact that the settlor lived in the state at the time it became a nongrantor trust.[1]

In each case, a state supreme court has said no, on due process, "minimum contacts" grounds.

As we have previously noted, the lower courts in both these cases sidestepped the question whether the state had a sufficient "nexus" to the trust for "dormant commerce clause" purposes.

Jack is prepared to lay odds that the delay in granting or denying cert in *Fielding* may indicate that the Court is preparing to remand both to develop that issue.

no other shoes dropping

Last week the 9th Circuit federal appeals court issued its opinion in *Estate of Dieringer*. Predictably, the result is "incoherent" -- at least according to your correspondent, who was quoted and paraphrased at some length to this effect in the writeup on Tax Notes.

That link is behind a paywall, but your correspondent has asked permission to post a .pdf copy to his website. Tax Analysts has a policy to embargo republication for at least two weeks, but assuming we get clearance, we will provide a link in an upcoming issue.

In the meantime, we are linking the entire text of my e-mail message to the contributing editor who wrote the piece.[2] She had asked me for comment because I had written a several thousand word article for them on the case back when briefing was complete but argument had not yet been set.

As you may remember, this was an appeal from a decision of the Tax Court sharply reducing the amount of a claimed estate tax charitable deduction for a residuary gift from the decedent's revocable trust to a private foundation.

We talked about this briefly in volume one, number six, just after the case was argued to the appeals court.

Tl;dr, the executor -- who was also the sole director of the foundation and the controlling shareholder of the corporation -- had engineered a redemption of most of the stock at a fraction of its reported value, in exchange for unsecured promissory notes.

the path not taken

What IRS ought to have done is pursue excise taxes for self-dealing. [3] Instead they sought to disallow a portion of the claimed deduction, arguing that reg. section 20.2055-2(b)(1) limits the deduction to only that portion of the transferred property that not subject to a power in a transferee or a trustee to divert the property to noncharitable uses.

Both the Tax Court and the appeals court bought the analogy, but each was unwilling to rely on the reg itself, because of course the executor did not have express authority to divert assets from the foundation.

Instead, each court extended the rule in *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1982), to the present circumstance.

In *Ahmanson*, the decedent had created a shell corporation to receive his voting stock in a closely held entity, and directed that only nonvoting stock in the shell be distributed to his private foundation. "By severing the voting power of the stock from its economic entitlement, and giving only the economic entitlement to charity," the court said, the decedent himself had "reduced the value of the stock to the charity" from the figure at which it was included in his gross estate.

In order to apply this logic to the present case, the appeals court had to place responsibility with the decedent herself for creating a situation in which the closely held stock could pass to the foundation at a discount, if the executor abused his authority.

This is the result your correspondent says is "incoherent." Is it inherently wrong to install the same individual in multiple roles in settling your estate? and do we measure the amount by which the deduction should be reduced with reference to what actually occurred? after all, the executor in his capacity as controlling shareholder could as easily have authorized the redemption of fewer shares.[4]

form over substance

Two years ago, IRS issued a pair of letter rulings, PLRs 201723005 and 201723006, concerning an arrangement under which the taxpayer, who had sold her interest in a closely held business[5] to an irrevocable trust in exchange for a promissory note, proposed to transfer the note to a limited liability company and then at

her death leave only nonvoting interests in that entity to her private foundation.

The question was whether this would shield the foundation from engaging in self-dealing with the irrevocable trust, which was a disqualified person because the taxpayer's descendants held beneficial interests aggregating more than 35 pct. And IRS said yes.

The foundation would end up holding, indirectly, 99 pct. of the equity in the note, but because its interest was nonvoting, it would not "control" the LLC. The one pct. voting interest would be held by the taxpayer's revocable trust, which of course would then have become irrevocable. The dispositive provisions of that trust are not detailed in the rulings, except to say that the taxpayer's "descendants are beneficiaries."

More to the point, we are not told who would be the trustee(s) of the trust holding the voting interest. But we are told that one of the taxpayer's two sons is presently the manager of the LLC, and that both sons are directors of the foundation. The taxpayer is a third director, and there is a fourth, "outside[,] independent" director.

Nothing is said about replacing the taxpayer on the board at her death. If she is not replaced, her two sons will control the foundation.

And they might well be co-trustees of the trust that will then be holding the voting interest in the LLC. We already know they are among the beneficiaries of the existing irrevocable trust, which owns the enterprise that is paying on the note. And they may well be the co-trustees of that trust as well.

deja deja

Jack was reminded of these rulings when he read PLR 201907004, released just this last Friday.[6] Rather similar setup behind some additional complexities.

Here, the taxpayer is creating a limited liability to hold promissory notes from several irrevocable trusts for descendants, which have purchased "certain business interests."

We are not told the relative percentages of voting and nonvoting interests in the LLC, but probably the voting percentage is nominal. The voting interests are held by a second LLC, of which the members are the taxpayer's "descendants" individually, *i.e.*, not the various irrevocable trusts.[7]

The taxpayer proposes to transfer the nonvoting interest to a charitable lead annuity trust,[8] of which his daughter is trustee. She happens also to be the manager of the second LLC, which holds the voting interests. We are not told whether she might hold a controlling interest in the second LLC.

Again, IRS determined the CLAT would not "control" the LLC, as it held only nonvoting interests.

In each of these rulings, IRS did make the usual disclaimers

- that they were not making a determination that the transferee was in fact an exempt foundation (in the case of the 2017 rulings)

or a qualified lead trust (in the case of last week's ruling), and

- that the favorable determination might be revoked if it turned out that "controlling facts" on the ground were different from what the taxpayer had represented,

but on its face this language does not cover the circumstance that one of the players abuses her role in the future -- say, by discharging the notes at a discount. But of course that would never happen.[9]

unbundling redux

A few weeks ago, ACTEC submitted comments on Notice 2018-61, in which as you may recall[10] IRS clarified that the suspension of miscellaneous itemized deductions through 2025 does not affect the deductibility by an estate or trust of expenses of administration otherwise deductible in full under section 67(e)(1), *i.e.*, expenses not subject to the two pct. floor because, per reg. section 1.67-4(b), they would not "commonly or customarily" be incurred by an individual holding the same property.

That Notice also requested comments on whether excess deductions on termination should be deductible by the distributees, despite the fact that these have been characterized in reg. section 1.642(h)-2(a) as "allowable only in computing taxable income," and as a preference item -- in effect, as "miscellaneous itemized," though that phrase is not used in the reg, which predates the enactment of section 67 by many, many years.

Without directly challenging the existing reg itself -- which, again, has been in place since pretty much the beginning of time --, ACTEC argues that the Treasury has authority to straighten out this problem by revising the existing reg "to separate the section 642(h)(2) deduction into its components," miscellaneous and non-.

AICPA commented to similar effect back in October.

There is no particular deadline for submitting comments, as this has not yet matured to a regulation project. As mentioned in footnote 10, we sketched out an argument some months ago in these pages that there was no express authority for the reg taking the position that excess deductions on termination are "below the line" -- or for that matter, a preference item -- in the first instance.

But this whole discussion is beyond the scope of the Greystocke Project, so probably we will not be submitting comments.

beware the ides

IRS has announced the 7520 rate for April a few days early, and it looks like we may be on a downward trend. After cresting at 3.6 pct. in November and December -- the highest rate in the ten years since the financial collapse, let that sink in for a moment --, we are now all the way down to 3.0 pct.

To put this in some alarmist context.

We did hit 3.4 pct. for three months running in mid-2009, and again in February and May 2010, with some 3.2s in between. But once we dropped below 2.0 pct. in October 2011 we did

not break that threshold again until August 2013. Along the way we hit 1.0 pct. a few times. And it was not until March 2018 that we made it back to 3.0 pct.

These rates are based on average yields over the preceding three months of Treasury notes with maturities between three and nine years. Jack is not a market analyst, but presumably these falling rates signify something or other.

In a previous existence, your correspondent used to run calculations to determine what was the minimum age for the beneficiary of a charitable remainder annuity trust with a minimum five pct. payout -- at the end of the year rather than, say, quarterly, in order to maximize the retained yield -- without failing the "probability of exhaustion" test.[11]

But with the issuance of Rev. Proc. 2016-42 a couple of years ago, allowing a CRAT to qualify for a younger annuitant if the trust document includes a "qualified contingency" that would terminate the trust early if the next payment would take corpus below ten pct. of the initial funding value, this is no longer as much of an issue.

It is still interesting to note the tradeoff between the present value of the residuum of a gift annuity and the tax treatment of distributions over the expected return multiple. As the 7520 rate goes down, the present value of the annuity goes up, and the deduction goes down -- but the exclusion ratio goes up, so a smaller portion of the payout is taxable to the annuitant.

The effect is larger than one might suppose, so it is worth doing the calculations.

on the horizon

Briefing will begin next month in an appeal to the Mississippi supreme court from a chancery court decision construing a decedent's revocable trust to correct what appears to be a scrivener's error.

Some interesting questions here, having to do with patent versus latent ambiguities, the admissibility of extrinsic evidence to construe an ambiguity, and possibly even the application of the anti-lapse statute for wills to the construction of a revocable trust functioning as a "will substitute," per section 112 of the uniform trust code.[12]

At the moment there seems to be some controversy over whether certain arguments submitted to the chancery judge informally but not made part of the record below will be included in the record on appeal, and if not, whether one or more arguments advanced by one of the parties in those submissions might be deemed to have been waived.

postscript

We are continuing to try to build our reach -- in particular, to lawyers who work in estate and gift planning, probate and trust administration, and litigation in matters arising in those contexts.

Again, if you know someone who might be interested in the stuff we talk about here at Jack Straw, please point them to our page on Patreon. Thanks.

parentheticals

[1]

In each case there are other contacts that should weaken an "as applied" argument. The beneficiary in *Kaestner Trust* had borrowed from the trust, and had consented to a decanting that prevented an outright distribution to her at age forty. The settlor in *Fielding* was using the trust to shift equity in a large passthrough entity based in Minnesota to his descendants, and released his reserved "swap" power shortly before the entity was acquired in a taxable merger.

[2]

Including at least one typo.

[3]

A much, much larger revenue target, incidentally. Initial tax of ten pct. on each disqualified person participating in the transaction, and another five pct. on the foundation manager, and then second tier taxes of two hundred pct. on each self-dealer and fifty pct. on the foundation manager.

Jack continues to ask why IRS did not go this route. And why the Oregon attorney general has not yet acted to surcharge the executor in his capacity as foundation director.

[4]

Or more. This was a partial redemption. The foundation was left holding some nonvoting shares.

[5]

Apparently this was an active trade or business. The taxpayer also sought and received a ruling that because the "new" LLC would hold only a promissory note, at least 95 pct. of its income would derive from "passive" sources, and the foundation would not have excess business holdings.

[6]

Albeit with a nominal release date of February 15, reflecting the continuing backlog resulting from the partial shutdown.

[7]

This is a rather unusual use of the word "descendants," which usually refers to a class that is "subject to open," as they say.

If individuals rather than multi-generational trusts are holding interests in the second LLC outright, their relationships to the transferor could be described more exactly. It does not seem this is a question of redacting identifying information, as we are hearing about the daughter, rather than a "child."

[8]

Interestingly, unlike the 2017 rulings, we do not see a request here for a ruling that the nonvoting interest in the LLC would not be an excess business holding in the hands of the CLAT. No doubt IRS would again rule that an LLC holding only promissory notes is not conducting an active trade or business, but once

you have paid the user fee you may as well ask.

Assuming this is the only asset held by the trust, it is also possible that the present value of the annuity stream at inception was not more than sixty pct. of the value of the amounts contributed, bringing us within the exception at section 4947(b)(3)(A), but typically folks setting up CLATs are looking for greater leverage than that.

[9]

In the case of the nongrantor lead trust, of course, it probably would not happen, at least until after the expiration of the annuity term. Jack's point here is to ask, what would be the tax treatment of these arrangements if we disregarded the imaginary entities.

[10]

We talked about this briefly in volume one, number nine.

[11]

Which, for the record, would be age 67 with the 7520 rate down to 3.0 pct., as compared with age 62 when the rate was up to 3.6 pct. in November and December. Most of the online calculators will still not give you results below these ages, despite the rev. proc.

For those playing at home, reg. section 25.7520-3(b)(2)(v), example 5, requires that the annuity stream be valued with reference to the lesser of the annuitant's life expectancy or the term of years at which the annuity would exhaust the trust.

[12]

Regular readers will recall that in volume one, number three we went into some depth on the question of the applicability of rules of construction for wills to revocable trusts. The issue in *Craig Trust* was the pretermitted heir, but the problem is considerably broader.

Your correspondent has been asked by the folks at Thomson Reuters to write a long form piece on the subject for their Estate Planning Journal. We are looking at a deadline in late April, not sure when this would actually be published, but when it is, we will post an "attribution" copy to the site.

Jack says,
mild-mannered supermen are held in kryptonite