2018 DELAWARE TRUST CONFERENCE

INTERESTING CHARITABLE PLANNING IDEAS IN THE POST-TAX REFORM ENVIRONMENT

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INTERESTING CHARITABLE PLANNING IDEAS IN THE POST-TAX REFORM ENVIRONMENT

# CHARITABLE AND TAX-EXEMPT MATTERS - Sections 170, 642, 664, 501, 509, 2055, 2522, and 4940-4947

## **Charitable Distributions From Trusts**

. Suppose a trust does not provide for distribution to charity but the beneficiaries desire such distributions to occur. If the trust is modified validly under state law to allow charitable distributions, will that allow the trust to take a section 642(c) deduction? In CCA 201651013 the IRS concluded no because the trust after modification was not the “governing instrument.” The ruling states:

In Old Colony Trust Company v. Commissioner, 57 S.Ct. 813 (1937), the Supreme Court reversed a decision of the First Circuit (87 F. 2d 131). A trust document authorized but did not require the trustees to make current charitable payments if they could do so without jeopardizing the payment of annuities from the trust to non-charitable beneficiaries. The Board of Tax Appeals denied most of the income tax charitable deduction under the predecessor of § 642(c)(1) because it found that the taxpayer had not met its burden of proof regarding whether most of the payments were actually made from trust income during the year made. The First Circuit denied the entire deduction because the charitable payments were "not imperatively directed" by the trust. If the trustee exercised discretion in making the payments, they were not "pursuant to" the terms of the trust. The Supreme Court referred to the plain dictionary meaning of "pursuant to" as "acting or done in consequence or in prosecution (of anything), hence, agreeable; conformable; following; according," which standard was met by the authorization in the trust instrument.

In Crown Income Charitable Fund v. Commissioner, 8 F.3d 571, 573 (7th Cir. 1993), *aff'g* 98 T.C. 327 (1992), the Seventh Circuit addressed the issue of commutation. The trust at issue in Crown contained a provision permitting the trustees to commute the charitable interest only if, as a matter of law, it was clear that doing so would not adversely affect the maximum charitable deduction otherwise available. The trustees of the Crown Income Charitable Fund distributed trust assets in excess of the annuity amount to the charitable beneficiary over a number of years and deducted, under § 642(c), the full amount distributed to the charitable beneficiaries. Both the Seventh Circuit and the Tax Court held that the excess distributions were not deductible under § 642(c) because those instruments were not made pursuant to the terms of the governing instrument.

In Brownstone v. United States, 465 F.3d 525 (2nd Cir. 2006), a deceased husband's will created a marital deduction trust, which granted the husband's surviving wife a general testamentary power of appointment. When the wife died, she exercised her power in favor of her estate, the residue of which passed to charitable organizations. The trustee of the marital deduction trust distributed $1 million to the wife's estate and claimed a charitable contribution deduction under § 642(c), because the $1 million distribution passed entirely to the charitable beneficiaries under the wife's will.

The Second Circuit in Brownstone held that the distribution to the charities was made pursuant to the wife's power of appointment and not pursuant to the governing instrument, the deceased husband's will. The Second Circuit interpreted the definition of governing instrument narrowly, stating that an instrument subject to the creating instrument (the wife's will) could not combine with the creating instrument (the husband's will) and qualify as the governing instrument. The sole governing instrument in Brownstone was the husband's original will; therefore, the marital deduction trust was not entitled to a deduction under § 642(c) since the distribution was made pursuant to the wife's will.

In Lyeth v. Hoey, 305 U.S. 188 (1938), the Supreme Court held that property received in the settlement of a bona fide will contest is treated for federal income tax purposes as passing to the beneficiaries by inheritance. In Middleton v. United States, 99 F.Supp. 801 (D.C. Pa. 1951), the court held, applying principles derived from Lyeth, that amounts distributed to a charity pursuant to an agreement compromising a will contest were made "pursuant to the terms of the will." The court concluded that the income from the property that was distributed to the charity was permanently set aside for a charitable purpose and allowed a deduction for these amounts for the years prior to the year that the parties entered into the settlement agreement. See also Estate of Wright v. United States, 677 F.2d 53 (9th Cir. 1982), cert. denied, 459 U.S. 909 (1982).

In Emanuelson v. United States, 159 F.Supp. 34 (D.C. Conn. 1958), decedent left two conflicting wills -- one which left 2/3 of the residue of decedent's estate to certain charities, and another which left the entire residue to non-charitable legatees. After decedent's death, a controversy arose among the beneficiaries of the two wills. The controversy was resolved in a written compromise agreement between the two sets of beneficiaries, under which 52/480 of the residue passed to the charities named in one of the wills. Payments made to the charities under the written compromise agreement were held to be made pursuant to the will. Rev. Rul. 59-15, 1959-1 C.B. 164, citing Emanuelson, held that a settlement agreement arising from a will contest qualifies as a governing instrument.

In the current case, the taxpayer makes a summary argument that the payments qualify under § 642(c) because they are pursuant to the governing instrument, citing to Old Colony. They do not address the authorities concerning deductions under modified trust instruments. Here there was no conflict with respect to Trust B subsequent to the division of Parent Trust. The trust terms were unambiguous. The purpose of the court order was not to resolve a conflict in Trust B but to obtain the economic benefits which the parties believe they will receive from the modification of the Parent Trust. Neither Rev. Rul. 59-15 nor Emanuelson hold that a modification to a governing instrument will be construed to be the governing instrument in situations where the modification does not stem from a conflict of some sort. Additionally, both Crown and Brownstone have a narrow interpretation of what qualifies as pursuant to a governing instrument. Therefore, any payments to Foundation 1 and Foundation 2 after the modification of Trust B would not be considered to be made pursuant to the governing instrument, and Trust B is not entitled to a deduction for such payments under § 642(c).

The IRS also held that a 661, DNI, deduction would not be available. This result is controversial as the ruling notes. Commentators are divided, for instance:

One standard treatise supports them on two policy grounds: "All of the courts but one [ U.S. Trust District Court] that have considered this issue have sustained these regulations, even though they substantially exceed the scope of the statutory language . . . The cases supporting the regulations take the appropriate view because a contrary rule has the effect of giving both an estate tax deduction (for the charitable disposition) and an income tax deduction (for the item distributed to charity) for the same payment. "Also, as a result of deducting distributions of corpus to charity, the non-charitable legatees in effect receive the estate's income tax-free. The benefit of the income tax deduction inures to the noncharitable legatees, rather than to the charity, so the court decisions favoring the regulation seem fundamentally sound." [citations omitted] Danforth, Robert T., et al., Federal Income Taxation of Estates and Trusts [current through 2016], at 4.07[1]

However, at least as many secondary sources in this area disagree with the disallowance under § 661(a), at least under some facts. Another standard treatise, Ferguson, M. Carr, et al, Federal Income Taxation of Estates, Trusts, & Beneficiaries (current through 2016), states at § 6.10: "The analysis [explaining why a single payment should not allow double deduction under §§ 642(c) and § 661(a)] does not, however, answer the question whether amounts that pass to charity in such a way as not to qualify for the deduction under § 642(c), such as amounts that pass to nonqualified quasi-charitable organizations or are used for purposes that are not exclusively charitable, escape the proscription of § 663(a)(2). Obviously, such amounts do not qualify 'for the deduction provided in § 642(c).' Are they therefore deductible as distributions under § 661? A literal reading of the statute strongly suggests that many such amounts should be. Even an undisputedly charitable beneficiary would be treated the same as any other beneficiary under the distribution rules, if it were not for §§ 642(c) and 663(a)(2). When no deduction is available under § 642(c), § 663(a)(2) seems to plainly not apply."

The regulations and history only add to the confusion:

Section 1.663(a)-2 provides that any amount paid, permanently set aside, or to be used for the charitable, etc., purposes specified in § 642(c) and which is allowable as a deduction under that section is not allowed as a deduction to an estate or trust under § 661 or treated as an amount distributed for purposes of determining the amounts includible in gross income of beneficiaries under § 662. **Amounts paid, permanently set aside, or to be used for charitable, etc., purposes are deductible by estates or trusts only as provided in § 642(c).** For purposes of this section, the deduction provided in § 642(c) is computed without regard to the provisions of §§ 508(d), 681, or 4948(c)(4). [emphasis added]

Section 663(c) provides that for the sole purpose of determining the amount of DNI in the application of §§ 661 and 662, in the case of a single trust having more than one beneficiary, substantially separate and independent shares of different beneficiaries in the trust shall be treated as separate trusts. Rules similar to the rules of the preceding provisions of § 663(c) shall apply to treat substantially separate and independent shares of different beneficiaries in an estate having more than one beneficiary as separate shares. The existence of such substantially separate and independent shares and the manner of treatment as separate trusts or estates, including the application of subpart D [the "throwback" rules of §§ 665-668], shall be determined in accordance with regulations prescribed by the Secretary.

Sections 661(a), 663(a)(2), and 663(c) were enacted as part of the original Internal Revenue Code of 1954. The only subsequent change relevant to the current issue was the amendment of § 663(c) by § 1307 of the Taxpayer Relief Act of 1997, P.L. 105-34, to apply to estates as well as trusts. Section 642(c), discussed under Issue 1, was also included in the original Code, and was bifurcated by § 201 of the Tax Reform Act of 1969, P.L. 91-172, into current §§ 642(c)(1) and (2), dealing respectively with deductions for current payments to charity and deductions for amounts "permanently set aside" for later payment.

The 1954 legislative history is not entirely clear on the purpose and scope of § 663(a)(2). Whereas the charitable and distribution deduction provisions had general counterparts under the 1939 Code (§§ 162(a) and (b), respectively), § 663(a)(2) was a new provision, as was the entire DNI mechanism. In general, under the 1939 Code, distribution deductions had to be actually traced to the trust's gross income, whereas such tracing is unnecessary under the 1954 and 1986 Codes, since § 661 distributions automatically take out DNI which then is generally taxable under § 662 to the beneficiaries. The tracing requirement formerly applying to all trust and estate distributions now only survives for the charitable deduction under § 642(c).

The House and Senate Reports on the 1954 Code (H.R. 8300) each explain the exclusion of § 642(c) amounts from §§ 661 and 662 with reference to the "additional" deduction which the entity would be able to claim if not for this provision, suggesting that § 663(a)(2) is meant simply as an anti-duplication measure, not that there is an underlying policy of § 642(c) exclusivity.4 The American Bar Association's submission regarding the bill also supports the adoption of this provision as preventing an "additional" deduction for distributions for which a deduction would already be allowed under proposed § 642(c). See Senate Finance Comm. Hearings on H.R. 8300, 83d Cong., 2d Sess. 4385

However, the example in the Senate Report demonstrating the application of §§ 661-663 (S. Rep. 1622 at 351-353) suggests the opposite interpretation. The terms of a testamentary trust require that half of the trust income be distributed currently to the grantor's wife for life. The remaining half in the trustee's discretion may either be paid to the grantor's daughter, paid to designated charities, or accumulated. At the wife's death, the entire trust principal will be payable to the daughter. In the given year, the trust income consisted of dividends, rentals, and tax-exempt interest, of which the trustee distributed half to the wife and one-quarter each to the daughter and a charity. In determining the § 661(a) distribution deduction, the example excludes the amount distributed to the charity since it was allowed as a deduction under § 642(c) to the extent that it was included in the trust's gross income. However, the entire amount paid to the charity is not deductible under § 642(c) because a ratable part of it is attributable to the tax-exempt interest which does not enter into gross income and thus fails one prong of the § 642(c) test. The example does not add the disallowed portion of the charitable payment back into § 661 for determining the distribution deduction, thus indicating that payments to charity are deductible, if at all, only under § 642(c). The example in the Senate Report was substantially adopted as the example illustrating §§ 661-662 in § 1.662(c)-4. That section and § 1.663(a)-2 were both published as part of the original subchapter J regulations, T.D.6217 (12/19/56). The latter originally only referred to limits on charitable deductions under § 681, and was later amended to include the limits under §§ 508(d) and 4948(c)(4) added by the 1969 Act.

The taxpayer attempted to inspire the IRS to accept a bona fide state court modification to the trust instrument as being the “governing instrument” but the IRS rejected inspiration in CCA 201747005. The taxpayer may seek court redress next.

There is no evidence that this is part of a larger exercise to limit the tax effect of prospective state court modifications (for instance, adding general power for basis). If a trust cannot be effectively amended, what can be done to obtain a charitable deduction for trust income? The assets of the trust could be contributed to an S corp. and the trust could become an ESBT (see discussion of the 2017 Tax Act). Or, distributions could be made to a 501(c)(4) organization, for which a section 661 deduction is allowable. A third way is that Rev. Ruling 2004-05 may help.

Gifts by partnerships or LLCs are deductible proportionately by the partners or members. IRC § 702(a)(4). Rev. Rul. 96-11 holds that when a partnership makes a charitable contribution of property, the basis of each partner’s interest in the partnership should be decreased, but not below zero, by the partner’s share of the partnership’s basis in the property contributed. Similarly, a partner’s charitable deduction for the contribution of appreciated property by the partnership does not seem to be limited to her share of the partnership’s basis in the assets. See Private Letter Ruling 8405084. Thus, contributions of appreciated property by partnerships preserve the tax benefit of receiving a deduction at fair market value for the contribution of appreciated property; the unrealized appreciation is not transferred to the partner’s interest in the partnership.

Rev. Rul. 2004-05 provides that a trust which is a partner will benefit from a charitable contribution made by the partnership even if the trust itself has no charitable beneficiaries. The Ruling does not state how the trust came to be a partner. May a trust with no charitable beneficiaries become a partner in a partnership which allows charitable contributions without the consent of the trust partner? Presumably the answer is yes so long as the beneficiaries are agreeable. See also Private Letter Ruling 200208019, in which the IRS considered whether the members of a partnership were entitled to a charitable deduction on account of the partnership’s grant of a conservation easement to a charitable organization. The IRS concluded that each partner was entitled to a charitable deduction equal to each partner’s distributive share of the gift. A trust could not benefit from that deduction because §642(c) allows only deductions for income.

PLR 201225004 involved a trust claiming the section 642(c) deduction for income distributed to charity and the requirement that the income be distributed “pursuant to the terms of the governing instrument.” Here, the distribution was directed by a beneficiary’s exercise of a lifetime special power of appointment and the IRS determined that satisfied the “pursuant to” requirement even though the governing instrument did not specify a charitable bequest. It only authorized exercise of the power in favor of charity. In PLR 9821029, an individual exercised a lifetime nongeneral power of appointment over a trust to create a charitable remainder trust for a term of years with the trust as the unitrust beneficiary. The IRS allowed the trust to be the beneficiary and allowed the charitable remainder trust to be created by the exercise of the power.

If a charity is given the right to withdraw a portion of the income and gains from a trust then the charity is the owner of that portion under section 678 which avoids the need for a section 642(c) deduction. This is a “BDOT solution” (see discussion of BDOTs).

The meaning of “income” for purposes of section 642(c) was presented in Green v. United States, 880 F.3d 519 (10th Cir. 2018). The trust in question had used business earnings – distribution from a partnership – to purchase real estate. The real estate appreciated and was contributed to charity. Was the charitable deduction available to the trust the basis of the property or the appreciated value, the fair market when contributed? Surprisingly, the District Court held for the taxpayer, giving the trust a fair market value deduction. As expected, the Tenth Circuit reversed, holding for the government:

As an initial matter, the IRS asserts, and the Trust agrees, that the statutory phrase “any amount of the gross income” means that charitable donations must be made out of a trust’s gross income, but that real property purchased with gross income can also be treated as the equivalent of gross income for purposes of the deduction outlined in § 642(c)(1). This, we conclude, is an entirely reasonable interpretation of the statutory language. More specifically, this interpretation is consistent with the statutory language, and also encourages charitable donations to a greater degree than an interpretation that fails to include a sourcing component, i.e., an interpretation that limits the deduction to donations made exclusively from gross income.4 See Old Colony, 301 U.S. at 384 (“Congress sought to encourage donations out of gross income . . . .”).

That still leaves open the question of the allowable amount of a deduction for donated real property that was purchased with a taxpayer’s gross income. The IRS has consistently asserted, both in addressing the Trust’s claim for a refund and in this litigation, that the deduction amount is limited to the taxpayer’s adjusted basis in the donated real property, i.e., the amount of gross income the taxpayer originally paid for the real property. Without granting any deference to the IRS’s position, we conclude that it is the most reasonable interpretation of the statutory language, particularly when considered in light of the Code as a whole.

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As the IRS correctly notes in this case, because the Trust never sold or exchanged the properties at issue, it never realized the gains associated with their increases in market value and was therefore never subject to being taxed on those gains. Thus, construing § 642(c)(1)’s deduction to extend to unrealized gains would be inconsistent with the Code’s general treatment of gross income. Consequently, unless and until Congress acts to make clear that it intended for the § 642(c)(1) deduction to extend to unrealized gains associated with real property originally purchased with gross income (similar to what Congress did in § 170, which, as we have noted, addresses charitable contributions by individuals and corporations), we conclude that we cannot construe the deduction in that manner.

Finally, we note that this interpretation finds support in a leading tax treatise, see 9 MERTENS LAW OF FEDERAL INCOME TAXATION, § 36:75 (Eric D. Roth ed., Dec. 2017) (“Where appreciated property purchased from accumulated gross income is donated, the amount of the deduction is limited to the adjusted basis of the property, rather than based on the fair market value of the donated property.”), as well as, at least in part, an older Third Circuit case dealing with § 642(c)(1)’s predecessor statute. See W. K. Frank Trust of 1931 v. Comm’r, 145 F.2d 411, 413 (3d Cir. 1944) (holding that the appreciated value of shares of donated stock, which was the result of them being “worth more on the market when the gift was made than . . . when the trust got them,” “was not gross income”).

## **Estate Tax Deduction Reduced Because of Post-Mortem Manipulation**

. In Estate of Victoria E. Dieringer et al. v. Commissioner, 146 T.C. No. 8 (2016), the decedent left a controlling interest, and a majority of the equity, in a real estate C corp (DPI) to a family foundation. After death, and before distribution to the foundation, the corporation redeemed the voting interests and a significant portion of the equity. Because the decedent owned the control, the non-voting interests were valued with a 5% discount in her estate, but with discounts of 15% for lack of control and 35% for lack of marketability in the redemption. A rationale for the redemption was the desire of the corporation to elect S status, and to avoid the problems of foundation ownership. Yet the foundation received less than the Form 706 value. The opinion states:

The estate contends that the foregoing subsequent events occurred for business purposes and should not affect the amount of decedent's charitable contribution. The subsequent events do appear to have been done for valid business purposes. Mr. Keepes, a director of DPI and advisory trustee for the foundation, suggested that DPI elect S corporation status in order to avoid the section 1374 built-in gains tax on corporate assets. Additionally, after consulting an outside attorney, DPI believed that a redemption would allow it to freeze the value of its shares into a promissory note, which would mitigate the risk of a continual decline in stock value during the year's poor economic climate. A redemption also made the foundation a preferred creditor to DPI so that, for purposes of cashflow, it had a priority position over DPI's shareholders. Eugene, Patrick, and Timothy purchased additional shares in DPI in order to infuse the corporation with cash to pay off the promissory notes that DPI gave the trust as a result of the redemption.

DPI's lawyer hired Lewis Olds & Associates to perform an appraisal of the DPI stock for purposes of determining the date-of-death value of decedent's property. The date-of-death appraisal valued decedent's DPI voting stock at $1,824 per share and her DPI nonvoting stock at $1,733 per share. The nonvoting stock appraisal included a 5% discount for the lack of voting power at stockholder meetings. The appraisal, however, did not include any discounts for lack of control or marketability.

Lewis Olds & Associates was also hired to perform an appraisal of decedent's bequeathed shares for purposes of the redemption. The March 24, 2010, appraisal valued decedent's DPI stock as of November 30, 2009, at $916 per voting share and $870 per nonvoting share. Mr. Olds credibly testified that he was specifically instructed to value decedent's DPI stock as a minority interest. The valuation of the voting stock included a 15% discount for lack of control and a 35% discount for lack of marketability. The nonvoting stock appraisal included the lack of control and marketability discounts plus an additional 5% discount for the lack of voting power at stockholder meetings. The appraisal, however, did not explain why these discounts were included. Decedent's bequeathed majority interest in DPI therefore was appraised at a significantly higher value only seven months before the redemption transactions without explanation.

Even though there were valid business reasons for the redemption and subscription transactions, the record does not support a substantial decline in DPI's per share value. Eugene testified that the precipitous drop in the value of the DPI shares was the result of a poor business climate. The evidence does not support a significant decline in the economy that resulted in a large decrease in value in only seven months. The adjusted net asset value of DPI was only $1,618,459 higher in the April appraisal. The reported decline in per share value was primarily due to the specific instruction to value decedent's majority interest as a minority interest with a 50% discount.

Given that intrafamily transactions in a close corporation receive a heightened level of scrutiny, Eugene's roles need to be examined. Harwood v. Commissioner, 82 T.C. 239, 258 (1984), aff'd without published opinion, 786 F.2d 1174 (9th Cir. 1986); Holden v. Commissioner, T.C. Memo. 2015-83; Alpert v. Commissioner, T.C. Memo. 2014-70. Eugene, as executor of the estate and, president, director, and a shareholder of DPI, instructed DPI's attorney to inform the appraiser that decedent's bequeathed shares should be valued as a minority interest. Eugene was also sole trustee of the trust and the foundation, with Patrick serving as advisory trustee. Decedent's majority interest therefore was redeemed for a fraction of its value without any independent and outside accountability. Eugene and his brothers altered decedent's testamentary plan by reducing the value of the assets eventually transferred to the foundation without significant restraints.

We do not believe that Congress intended to allow as great a charitable contribution deduction where persons divert a decedent's charitable contribution, ultimately reducing the value of property transferred to a charitable organization. This conclusion comports with the principle that if a trustee "is empowered to divert the property \* \* \* to a use or purpose which would have rendered it, to the extent that it is subject to such power, not deductible had it been directly so bequeathed \* \* \* the deduction will be limited to that portion, if any, of the property, or fund which is exempt from an exercise of the power." Sec. 20.2055-2(b)(1), Estate Tax Regs. Eugene and his brothers thwarted decedent's testamentary plan by altering the date-of-death value of decedent's intended donation through the redemption of a majority interest as a minority interest.

The trust did not transfer decedent's bequeathed shares nor the value of the bequeathed shares to the foundation. Accordingly, we hold that the estate is not entitled to the full amount of its claimed charitable contribution deduction. Respondent's determination is sustained.

The estate was also penalized:

The estate contends that it relied upon the advice of counsel and that its position in the estate tax return is amply supported by case law. We disagree. DPI's lawyer, who also served as decedent's attorney for over 30 years, is a competent professional who had sufficient experience to justify reliance. DPI's lawyer also likely had all necessary and accurate information to render his advice. Indeed, he knew about all the relevant parties and probably did not need to assume any facts (or law). Nonetheless, the estate did not actually rely in good faith on its lawyer's judgment.

DPI's lawyer's advice regarding the charitable contribution deduction was based on an errant appraisal. The date-of-death appraisal and the redemption appraisal -- performed only seven months apart -- differed substantially in value. The estate knew that a significant percentage of the value of decedent's bequeathed shares was not passing to the foundation and that Eugene and his brothers were acquiring a majority interest in DPI at a discount.

The estate's position is also not amply supported by case law. None of the cases the estate cites in its briefs stand for the principle that an estate may deduct as a charitable contribution the date-of-death value of assets that are not actually transferred to the charitable organization. The estate has not shown that it had reasonable cause or acted in good faith.

The Dieringer approach is almost certainly wrong. The abuse was not on the estate tax side but rather with the foundation not enforcing its rights which could have resulted in substantial penalties. Many transactions occur where a charity sells a remainder interest it owns for fair market value. When the predecessor interest terminates, the charity receives the asset but then transfers it to the previous purchaser. Those transactions are different from Dieringer because charity receives full value albeit earlier than the original gift contemplated.

## **Conservation Easement Deed And The Contemporaneous Written Acknowledgement Requirement**

. French v. Commissioner, T.C. Memo. 2016-53, is another botched easement case. The donor did not receive an appropriate acknowledgement of the gift as the court notes:

A written acknowledgment is contemporaneous if the taxpayer obtains the acknowledgment on or before the earlier of the date the return was filed or the due date (including extensions) for filing the return for the year in which the charitable contribution was made. See sec. 170(f)(8)(C). It follows that petitioners had to obtain a written acknowledgment contemporaneous with their 2005 return because they made the charitable contribution in 2005.

Petitioners have two written acknowledgments that may satisfy the requirements of section 170(f)(8)(B). The first is the conservation deed recorded on December 29, 2005. The second is the letter from an MLR representative to Davy and Priscilla French dated June 6, 2006. Petitioners filed their 2005 amended return on or before April 15, 2006. The letter is therefore not contemporaneous with petitioners’ 2005 return and cannot satisfy the substantiation requirements. *See* sec. 170(f)(8)(C). Because the conservation deed is the only written acknowledgment that is contemporaneous with petitioners’ 2005 return, we must decide whether the conservation deed complies with the strict substantiation requirements of section 170(f)(8)(B).

In principle, a deed may satisfy the requirements but did not here:

We have held that a deed of conservation easement may satisfy the substantiation requirements of section 170(f)(8), including subparagraph (B)(ii). See, e.g., Averyt v. Commissioner, T.C. Memo. 2012-198; Simmons v. Commissioner, T.C. Memo. 2009-208, aff’d, 646 F.3d 6 (D.C. Cir. 2011). Generally, to satisfy the requirement of section 170(f)(8)(B)(ii), the deed must contain a statement about whether the donee provided goods or services for the contribution. Schrimsher v. Commissioner, slip. op. at 8-9. When a deed does not contain an explicit statement, this Court has looked to the deed as a whole to determine whether the donee provided goods or services. See RP Golf, LLC v. Commissioner, T.C. Memo. 2012-282, at \*10-\*11; Averyt v. Commissioner, slip op. at 12-13.

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In the instant case, the conservation deed did not state whether the donee provided goods or services in exchange for the charitable contribution. Therefore we must analyze whether the deed taken as a whole shows compliance with section 170(f)(8)(B)(ii).

Although the conservation deed includes provisions stating that the intent of the parties is to preserve the property, those provisions do not confirm that the preservation of the property was the only consideration because the deed did not include a provision stating that it is the entire agreement of the parties. Without such a provision, the IRS could not have determined by reviewing the conservation deed whether petitioners received consideration in exchange for the contribution of the conservation easement. We conclude, therefore, that the conservation deed taken as a whole is insufficient to satisfy section 170(f)(8)(B)(ii). Because petitioners’ contemporaneous written acknowledgment does not comply with section 170(f)(8)(B)(ii), petitioners are not entitled to any claimed carryover charitable contribution deductions, *see* sec. 170(f)(8)(A), and respondent’s determination is sustained.

The contrary result was reached in 310 Retail, LLC v. Commissioner, T.C. Memo. 2017-164. The opinion states:

The deed of easement in the instant case is similar in all material respects to the deed in RP Golf, LLC, and we reach here the same result we reached there. The deed of easement was properly executed by LPCI’s president and recorded by the Cook County Recorder of Deeds on December 30, 2005. It thus constituted a “contemporaneous” acknowledgment. See sec. 170(f)(8)(C).

This acknowledgment included an affirmative indication that LPCI supplied no goods or services to LLC in exchange for its gift. The deed explicitly stated that it represented the parties’ “entire agreement” and that “[a]ny prior or simultaneous correspondence, understandings, agreements, and representations are null and void upon execution hereof unless set out in this instrument.” It thus negated the provision or receipt of any consideration not stated therein.

Apart from the charitable conveyance and the covenants attending the easement, the only “consideration” mentioned in the deed of easement is the granting provision’s reference to “consideration of One Dollar ($1.00) \* \* \* and other good and valuable consideration.” Neither party contends that LPCI actually furnished LLC with any valuable goods or services in exchange for its gift. Evaluating this clause in the context of the deed overall, we conclude that this clause constitutes “boilerplate language and has no legal effect for purposes of sec. 170(f)(8).” See RP Golf, LLC, 104 T.C.M. (CCH) at 416 n.7. Taken as a whole, therefore, the deed of easement includes the required affirmative indication that LPCI supplied LLC with no goods or services in exchange for its contribution. Because the deed of easement satisfied this and all other requirements in section 170(f)(8)(B), it constituted a CWA sufficient to substantiate LLC’s gift.

See also Big River Development, LP v. Commissioner, T.C. Memo. 2017-166, allowing a deed to be a contemporaneous written agreement.

## **Conservation Easement Deduction Reduced But No Overvaluation Penalty Imposed**.

 In Palmer Ranch Holdings Ltd. et al. v. Commissioner, T.C. Memo. 2014-79, the taxpayer’s appraiser valued the easement at $23.94 million but the Tax Court found a value of $19.955 million. With respect to the penalty, the opinion states:

Reasonable cause exists where a taxpayer relies in good faith on the advice of a qualified tax adviser where the following three elements are present: "(1) The adviser was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer provided necessary and accurate information to the adviser, and (3) the taxpayer actually relied in good faith on the adviser's judgment." Neonatology Assocs., P.A. v. Commissioner, 115 T.C. 43, 99 (2000), aff'd, 299 F.3d 221 (3d Cir. 2002); see sec. 6664(c)(3).

1. Professional Advisers

Palmer Ranch retained an experienced tax attorney to advise it on how to donate the conservation easement in compliance with section 170(h). That attorney retained Mr. Durrance, who respondent stipulated was a qualified appraiser providing a qualified appraisal. Palmer Ranch also retained Wilson Miller to provide advice on the relevant land planning, zoning, and other land use regulations relevant to the donated property. Respondent does not dispute that the conservation easement satisfied all the requirements for a qualified donation of a conservation easement as specified in section 170(h). Therefore, we have no trouble finding these advisers to have at least an adequate level of expertise.

2. Necessary and Accurate Information

There is some dispute as to whether Palmer Ranch provided the appraiser and the tax preparer with all necessary information. Messrs. Durrance and Bolano did not know about Ordinance 2004-055. However, as discussed above, this ordinance is not as critical as respondent contends, because it was outdated and dealt with a different land segment.

Therefore, we see no problem with the information Palmer Ranch provided the appraiser and the tax preparer.

3. Actual Reliance in Good Faith

Respondent contends that Palmer Ranch could not have relied on its advisers' analysis in good faith when it did not provide them with Ordinance 2004-055. Again, Ordinance 2004-055 is not as critical as respondent contends. Therefore, we do not find this fatal to a finding that Palmer Ranch acted in good faith in accepting this appraisal value as reasonable.

We conclude that Palmer Ranch had reasonable cause and acted in good faith with respect to its underpayment for 2006. Accordingly, we hold that Palmer Ranch is not liable for the accuracy-related penalty.

The Ordinance referred to deals with the need to maintain a wildlife corridor in the property on which the easement was placed. The government argued the Ordinance prevented any development but the taxpayer argued, and the court agreed, that moderate development was permitted.

The Eleventh Circuit has upheld the Tax Court in Palmer Ranch Holdings v. Commissioner, 812 F.3d 982 (11th Cir. 2016) with respect to the highest and best use of the property placed in easement (parcel B-10) being residential development. However, the court found the Tax Court did not justify the $21,005,278 value it put on the parcel (rather than the taxpayer’s $25,000,000 value). The opinion states:

In other words, the tax court’s valuation was premised on an old appraisal as modified by monthly appreciation rates, instead of on comparable sales. Without being based on comparable sales, the valuation cannot have been a comparable-sales valuation. Because the parties’ appraisers both used the comparable-sales method, and because the tax court neither voiced disapproval nor acknowledged (much less explained) its departure from the method, that departure was error. The tax court must at minimum explain why it departed from the comparable-sales method in valuing B-1018.

Footnote 18 reads:

18 To be as clear as the Sarasota sky, we do not hold that the tax court is obligated to use the comparable-sales method to value B-10. According to Palmer Ranch, the tax court is forbidden from adopting (or, in Palmer Ranch’s ostensibly outraged parlance, “sua sponte concocting”) an appraisal method proposed by neither party. But we recognize the tax court’s expertise in adjudicating tax disputes, and therefore will not lay down a hardline rule confining the tax court to the parties’ preferred appraisal method(s) in every case. The tax court has discretion to adopt a valuation method befitting the matter before it—even if the parties have not proposed that method. The cases relied upon by Palmer Ranch are not to the contrary because in each there was some identifiable flaw with the tax court’s method besides that it had not been suggested by the parties. Elkins, 767 F.3d at 445 (tax court erred by discounting valuation ten percent “despite the absence of any record evidence whatsoever on which to base the quantum of its self-labeled nominal discount”); Succession of McCord v. Comm’r, 461 F.3d 614, 626 (5th Cir. 2006) (tax court erred by engaging in the “long-prohibited practice of relying on post-gift events” for valuation), Caracci, 456 F.3d at 458 (tax court should have rejected valuation method that had “no legal support” and that both parties’ experts had recognized as “inferior” and “less rigorous”).

In sum, then, we hold only that, when the parties both use one method to value a parcel of land, the tax court errs by departing from that method without acknowledgment and explanation. We do additionally note that it might be difficult to explain why valuing B-10 using data from a two-year-old appraisal in a different case makes more sense than relying on the valuations actually presented to the tax court.

## **Meaning of “Qualified Farmers”**

. In Rutkoske v. Commissioner, 149 T.C. No. 6 (2017), the taxpayers classified themselves as “qualified farmers” within section 170(b)(1)(E). A qualified farmer is defined as a taxpayer whose gross income from the trade or business of farming (as defined by section 2032A(e)(5)) is greater than 50% of his or her total gross income for the year. A qualified farmer may deduct the value of a qualified conservation contribution of up to 100% of his or her contribution base for the year of contribution. The issue was whether the proceeds from the sale of the property, as well as the proceeds from the sale of development rights attached to the property, while not specifically listed in section 2032A(e)(5), constitute income from the trade or business of farming.

The opinion states:

We recognize that an individual engaged in the trade or business of farming most likely will engage in activities beyond those enumerated in the statute. The sale of used equipment by farmers is common. The acquisition and disposition of land is necessary because without land none of the section 2032A(e)(5) activities could be carried on. But we are not reviewing petitioners' activities in the context of determining their operation expense deductions or any other provision of the Code that relates to a business' general operations.

Section 170(b)(1)(E) is a narrowly tailored provision intended to provide a tax benefit for a specific action, namely, the contribution of conservation easements by qualified farmers. We will not broaden the scope of activities listed in section 2032A(e)(5) beyond that ordinarily associated with them because our sole duty is to interpret the law as written by Congress.

We do not agree with petitioners' assertion that the disposal of property (and the development rights attached thereto) constitutes cultivating the soil, raising agricultural or horticultural commodities, the handling of such commodities, or tree farming. To cultivate means "[t]o prepare and improve (land), as by fertilizing or plowing, for raising crops". Webster's II New Riverside University Dictionary 335 (1988); to "raise" in the context of agriculture means "[t]o grow or breed"; 4at 972; and to "harvest" means "[t]he act or process of gathering a crop"; 4 at 566. For the contribution of the conservation easement to qualify for the special rule of section 170(b)(1)(E)(iv), we look to the income derived from the sale of the agricultural and/or horticultural products created when engaging in these activities, not from the sale of the land on which the agricultural and/or horticultural products are grown.

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We recognize that the statute makes it difficult for a farmer to receive a maximum charitable contribution deduction by disposing of a portion of property in a year in which he/she donates a conservation easement, especially in a State with high land values. But it is not our task to rewrite a statute.

## **Receipt of Benefits Disqualifies Charitable Deduction**

. In Wendell Falls Development, LLC v. Commissioner, T.C. Memo. 2018-45, the court found that the taxpayer received benefits in connection with the grant of a conservation easement. The opinion states:

That Wendell Falls expected a substantial benefit from the contribution of the easement is supported by the record. When it donated the easement, Wendell Falls owned land adjoining the eased property; i.e., the unencumbered portion of the 1,280 acres. On the unencumbered portion of the 1,280 acres, Wendell Falls planned to create a master-planned community, which was designed so that all of the clusters of residential areas would have access to the 125–acre park through a system of “greenways”. These plans were evidenced by the PUD approved by the town of Wendell. As the prospective seller of the residential lots in the clusters, Wendell Falls would benefit from the increased value to the lots from the park as an amenity. It is uncontested that the easement restricts the 125 acres to uses related to establishing a park. Ferguson, one of the two managing members of Wendell Falls, wrote in an email to Wake County that Wendell Falls “need[ed] to ensure that the County uses the park for its intended use.” This confirms that Wendell Falls expected to receive value from the park and intended the easement to ensure that there would be a park on the 125 acres.

We therefore find that Wendell Falls donated the easement with the expectation of receiving a substantial benefit. A charitable-contribution deduction is not allowable because of this expectation.

In Triumph Mixed Use Investments III, LLC v. Commissioner, T.C. Memo. 2018-65 a deduction was negated by the expectation that a development plan would be approved. The court stated:

The tax matters partner argues that Triumph is entitled to a deduction because it transferred the 746.785 acres of real property and 1,958 development credits without consideration. The tax matters partner argues that the agreement for charitable contribution demonstrates that Triumph did not receive any consideration, or that even if Triumph did receive some consideration, it was incidental. We disagree. In exchange for transferring this property, Triumph received the city council's approval of the concept plan and the expectation that the city council would approve the area plan.

The transfer of real property and development credits was integral to the city council's approval of both plans. The external features of the transaction demonstrate that the real property and development credits were transferred in exchange for the concept plan approval. The Traverse entities desperately wanted to have their new area plan approved to allow them to develop the additional units received in the Cabela's deal. However, before the city council would approve the area plan, the Traverse entities needed to get a new concept plan approved.

When the Traverse entities submitted the new concept plan, they were met with public opposition and resistance from the Planning Commission. The obstacles that the Traverse entities needed to overcome were the demands for more open space and a reduction in density. The city council's solution was to require the Traverse entities to dedicate open space and reduce density before the concept plan was approved.

After receiving contingent approval, the Traverse entities finished the area plan; and the Planning Commission approved the Traverse entities' request for recommendation of area plan approval. Triumph subsequently executed the agreement for charitable contribution thus satisfying the city council's demand for more open space. At its next meeting the city council approved the 2012 area plan. Thus, the Traverse entities' entire course of dealing with the city of Lehi shows that Triumph transferred the real property and development credits as part of a negotiation in which the city of Lehi received open space and the Traverse entities received as a quid pro quo concept plan approval.

Triumph also transferred the real property and development credits with the expectation that the Traverse entities would receive an area plan approval. Because an area plan was required to closely follow the concept plan, the Traverse entities expected the city council to approve the area plan after satisfaction of the contingencies that they had negotiated for the concept plan. Indeed, the city council approved the area plan on the finding that the Traverse entities had satisfied the contingencies in the concept plan approval. Accordingly, we also find that the Traverse entities transferred the real property and development credits because they believed that this transfer would lead to the city council's approving their area plan.

[footnotes omitted]

## **Trophy Hunting**

. Gardner v. Commissioner, T.C. Memo. 2017-165, involved the question whether when valuing contributed hunting specimens the correct method is comparable sales, as with collectibles, or replacement value (how much would it cost the taxpayer to obtain them again) as with commodities. The Tax Court had no difficulty holding that comparable sales is the right method. The fun part of the case, though, is the court’s description of the trophy room itself:

To paraphrase Ernest Hemingway, there is no hunting like the hunting for tax deductions. Petitioner, an avid big-game hunter, took this advice to heart. In 2006 he opted to downsize his trophy collection by donating to an ecological foundation many of his less desirable hunting specimens.

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He has been an ardent hunter from an early age; since the mid–1980s he has regularly traveled overseas to participate in safaris. He has hunted big game in Africa, Asia, Europe (including Russia), and South America, and throughout the United States. He has been on 20 to 25 safaris during the last two years, a pace that reflects his previous experience.

On a typical hunting expedition petitioner would kill multiple animals. Following a kill the animal was sometimes skinned on the spot, but was usually loaded onto a vehicle for transportation to the skinning shed. After the animal was skinned, the meat was distributed to the local population and the hide was prepared and dried.

Like many hunters petitioner preserved the remains of the animals he shot in a “trophy room” in his house. In petitioner's words, a trophy room is a “big, open room” with appropriate lighting and temperature and humidity controls, in which “you can anchor all the animals to the wall” or “hang stuff from the ceiling.” Petitioner had a professionally designed trophy room with special lighting to eliminate shadows, reinforced walls to provide better anchoring for heavier mounts, and an insect control system.

In his trophy room petitioner had a number of “full body mounts,” i.e., complete taxidermied animals, often lying on a rock or similarly displayed. He had many “shoulder mounts,” which consisted of the heads and necks of the animals down to the breastplates. And he had a variety of full animal skins displayed as wall hangings or rugs. Collectively, these are generally considered the most attractive and desirable types of hunting trophies.

When a taxidermist does a “full body mount,” he generally does not use the skull; instead he creates a mannequin and puts the skin around it. Similarly, when a taxidermist does a “shoulder mount,” he does not use hooves, backskin, or other body parts. And when a taxidermist prepares a full skin he does not use skeletal parts, horns, or antlers. Petitioner thus had numerous skulls, antlers, hooves, ears, horns, and other body parts that taxidermists had returned to him after completing their work. He displayed some of these items on coffee tables or on the floor of his trophy room. But that floor got “pretty cluttered,” and so he shifted many items into an adjoining room.

Following a divorce in 2005 petitioner moved to a new residence. He immediately began building in that house a new trophy room, which was completed in early 2006. That trophy room has since been featured in a hunting publication, “Trophy Rooms Around the World.”

The nature of the contributed specimens indicated they were commodities:

Mr. Ketner's written and oral testimony persuaded us that the 177 donated items were neither world-class trophies nor museum-quality research specimens, but were mostly “remnants, leftovers, and scraps” of the collection displayed in petitioner's trophy room. Petitioner's own testimony indicated that he wished to “downsize” his collection by deaccessioning unwanted items. Although his experts asserted that all specimens were of “excellent” quality, they offered no factual backing for that assertion and admitted that Dr. Fullington's photographs often indicated the opposite. And although petitioner had participated in several record hunts, not a single specimen that he selected for donation to DEF was of record-book quality.

In short, the 177 specimens were clearly commodities, not collectibles. For commodities such as these, the determination of FMV will generally be based on market prices for similar items. Mr. Ketner credibly testified that an active market existed in which taxidermied products like petitioner's have long traded and that the internet has vastly expanded that marketplace. Indeed, he found 504 comparable sales transactions on traditional and internet auction sites. Petitioner offered no evidence or expert testimony to contradict Mr. Ketner's testimony that an active market for such items existed at the time of the gift.

## **IRA Charitable Rollover Made Permanent**

. The Protecting Americans From Tax Hikes Act, 2016 Consolidated Appropriations Act, makes permanent section 408(d)(8), which allows individuals age 70½ and older to distribute up to $100,000 in a given taxable year from their IRAs to charities with that amount excluded from gross income. The provision applies only to distributions from an IRA directly to an organization described in IRC § 170(b)(1)(A) (other than a supporting organization [described in section § 509(a)(3)] or a donor advised fund [as defined in section § 4966(d)(2)]. Distributions from employer-sponsored retirement plans, including SIMPLE IRAs and simplified employee pensions (SEPs) do not qualify. Further, the donor cannot receive a benefit and must follow the usual substantiation rules.

The 2017 Tax Act makes charitable rollover more desirable, and may be used along with “bunching” for maximum benefit.

## **IRS Issues Guidance on Charitable Remainder Annuity Trusts**

. With low 7520 rates, creation of a qualifying charitable remainder annuity trust will be difficult if the trust lasts too long, as with a trust for the lifetimes of most donors. The value of the remainder is often less than 10% and the 5% probability of exhaustion test may be failed as well. Rev. Proc. 2016-42 creates what amounts to a safe harbor:

Low interest rates in recent years have greatly limited use of a CRAT as an effective charitable-giving vehicle. For example, in May of 2016, the § 7520 rate was 1.8 percent. At this interest rate, the sole life beneficiary of a CRAT that provides for the payment of the minimum allowable annuity (equal to 5 percent of the initial FMV of the trust assets) must be at least 72 years old at the creation of the trust for the trust to satisfy the probability of exhaustion test. The § 7520 rate has not exceeded the minimum 5 percent annuity payout rate since December of 2007, which has necessitated testing for the probability of exhaustion for every CRAT created since that time.

Section 664(f)(1) provides in general that, if a trust would, but for a qualified contingency, meet the requirements of § 664(d)(1)(A) (relating to CRATs) or § 664(d)(2)(A) (relating to charitable remainder unitrusts), the trust is treated as meeting these requirements. Section 664(f)(2) provides that, for purposes of determining the amount of any charitable contribution (or the actuarial value of any interest), a qualified contingency is not taken into account. Section 664(f)(3) defines a qualified contingency for purposes of § 664(f) as any provision of a trust which provides that, upon the happening of a contingency, the payments described in § 664(d)(1)(A) or (d)(2)(A) (as the case may be) will terminate not later than these payments otherwise would terminate under the trust.

The required language is as follows:

.01 The following language is the sample provision designed to be used in an inter vivos CRAT for one measuring life:

“The first day of the annuity period shall be the date the property is transferred to the trust and the last day of the annuity period shall be the date of the Recipient’s death or, if earlier, the date of the contingent termination. The date of the contingent termination is the date immediately preceding the payment date of any annuity payment if, after making that payment, the value of the trust corpus, when multiplied by the specified discount factor, would be less than 10 percent of the value of the initial trust corpus. The specified discount factor is equal to [1 / (1 + i)]t, where t is the time from inception of the trust to the date of the annuity payment, expressed in years and fractions of a year, and i is the interest rate determined by the Internal Revenue Service for purposes of section 7520 of the Internal Revenue Code of 1986, as amended (section 7250 rate), that was used to determine the value of the charitable remainder at the inception of the trust. The section 7520 rate used to determine the value of the charitable remainder at the inception of the trust is the section 7520 rate in effect for [insert the month and year], which is [insert the applicable section 7520 rate].”

.02 In a testamentary CRAT, the phrase “the property is transferred to the trust” (the first underlined phrase) in this sample language must be replaced with “of my death”.

.03 If the inter vivos or testamentary CRAT is created using the sample form provided in Rev. Proc. 2003-53, 2003-2 C.B. 230, or Rev. Proc. 2003-57, 2003-2 C.B. 257, respectively, the insertion of this sample provision in place of the second sentence of paragraph 2 of that sample inter vivos form, or in place of the second sentence of paragraph 1 of the sample testamentary form, respectively, will satisfy the requirements of a qualified contingency as described in section 6.03 of each revenue procedure.

.04 If the CRAT annuity is payable consecutively for two measuring lives, the phrase “the Recipient’s death” (the second underlined phrase) in the sample provision must be replaced with “the death of the survivor of the Initial Recipient and the Successor Recipient(s)”. See Rev. Proc. 2003-55, 2003-2 C.B. 242, and Rev. Proc. 2003-59, 2003-2 C.B. 268. If the CRAT annuity instead is payable concurrently and consecutively for two measuring lives, the second underlined phrase in the sample provision must be replaced with “the Survivor Recipient’s death”. See Rev. Proc. 2003-56, 2003-2 C.B. 249, and Rev. Proc. 2003-60, 2003-2 C.B. 274.

The calculation is not merely whether at a future date the value of the trust is or would be less than 10% of the initial value. The Rev. Proc. illustrates with an example:

On January 1, Year 1, Donor transfers property valued at $1,000,000 to Trust, an inter vivos trust providing for an annuity payment of $50,000 (5 percent of the value of the initial trust corpus) on December 31 of each year to S for S’s life followed by the distribution of trust assets to Charity. Trust includes the precise language of the sample provision in section 5 of this revenue procedure providing for an early termination contingency and specifies the § 7520 rate in effect for January, Year 1, which is 3 percent. But for the early termination provision, Trust meets all of the requirements of § 664(d)(1). In accordance with this revenue procedure, the IRS will treat the early termination contingency as a qualified contingency under § 664(f). Therefore, the early termination provision does not cause Trust to fail to qualify as a CRAT under § 664. In addition, Trust qualifies as a CRAT regardless of whether it passes the probability of exhaustion test on January 1, Year 1.

Each year, prior to payment of the annuity to S, the trustee performs the calculations required to determine if Trust will terminate early in accordance with the terms of the qualified contingency. In each year from Year 1 through Year 17, the trustee determines that the value of the trust corpus, minus the $50,000 annual payment, and then multiplied by the specified discount factor, is greater than 10 percent of the initial trust corpus. The value of the trust corpus as of December 30 in Year 18 is $210,000. Only in Year 18 does the value of the trust corpus as of December 30, when reduced by the annuity payment and multiplied by the specified discount factor, fall below 10 percent of the value of the initial trust corpus. The calculations required to determine if Trust will terminate early in Year 18 are as follows:

1. $1,000,000 x 10 percent = $100,000

2. ($210,000 – 50,000) x [1 / (1 + .03)]18

$160,000 x (1/1.03)18

$160,000 x 0.97087418

$160,000 x 0.587397 = $93,984.

Because the value of the trust corpus ($210,000), when reduced by the annuity payment ($50,000) and then multiplied by the specified discount factor (0.587397), is less than 10 percent of the value of the initial trust corpus ($100,000), Trust terminates on December 30, Year 18, and the principal and income remaining in Trust (including the annuity payment for Year 18 that otherwise would have been payable to S) then must be distributed to Charity.

## **Commercial Real Estate Owned By a Private Foundation**

. PLR 201630009 dealt with a family foundation receiving commercial real estate – primarily office rental properties – and managing them in part in connection with a family management company. The ruling provides these facts:

Decedent died on Date 1, leaving a will providing that Foundation receives, among other things, commercial real estate properties. The Executor intends to distribute these real estate properties to Foundation as single member limited liability companies.

Any debt encumbering the properties will be paid in full by the estate prior to, or simultaneously with, the transfer of the properties to Foundation.

The real estate properties are primarily office rental properties. The rent received is at least 95% for the use of real property and any remainder of the rent is attributable to personal property leased with the real property that is an incidental amount of the total rents that are received or accrued under various leases. No part of the rent paid depends in whole or in part on the income or profits derived by any person from the property leased.

At least in the near term, Foundation intends to continue to hold the properties as part of a diversified investment portfolio that will also contain cash and publicly traded securities. The decision to retain or sell any of the real estate properties will be made by Foundation's Board of Directors based on the relevant facts and circumstances and in accordance with their fiduciary duty to prudently manage Foundation's investments. The real estate properties will be held as income producing properties and not as inventory used in a trade or business. The decision to sell or keep any one of the individual real estate properties will be made on a property-by-property basis, taking into consideration Foundation's overall investment portfolio, investment strategy, and capital appreciation. Foundation may decide to make capital improvements to the real estate properties as needed, but the real estate properties will not be held for the primary purpose of improving the properties for immediate resale. Foundation anticipates that any sales of the real estate properties will be sporadic and occasional.

At this time, Foundation does not anticipate acquiring additional real property in its investment portfolio. Any such acquisitions will be made by the Board of Directors based on the relevant facts and circumstances and in accordance with the Board's fiduciary duty to prudently manage Foundation's diversified investment portfolio.

Foundation intends to form a new limited liability company, X, of which Foundation will be the sole member and which will be treated as a disregarded entity for federal income and excise tax purposes, to manage the properties Foundation received by bequest.

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X may hire and supervise third party vendors who are not disqualified persons to provide landscaping; perform capital improvement projects; and provide certain in-house maintenance services, all of which will be limited to common areas such as public entrances, exits, stairways, and lobbies. X itself will not perform these services. X will not provide or arrange for cleaning or janitorial services for the lessees.

Y, a management company owned partially by Decedent and partially by Decedent's family, managed the properties during Decedent's lifetime. Decedent's interest in Y will be redeemed upon approval by the Surrogate Court and will not pass to Foundation.

Y will share certain employees including manager, a disqualified person, with X to assist X with the enumerated property management services. X will enter into a separate contractual arrangement with each shared employee, based on a reasonable determination of the value of that employee's services to X, to provide reasonable compensation to that employee for services provided to X. The shared employees will only be compensated by X for work they perform for X, as confirmed by detailed time records which will require the shared employees to log the time spent for X and Y on a daily basis. Other than manager, the shared employees will not be disqualified persons.

Foundation will have sole authority to appoint the managers of X. Foundation expects to appoint one or more disqualified persons to act as the manager or managers of X and thereby manage Foundation's properties. The manager or managers will receive reasonable compensation for providing the property management services to Foundation through X.

At least one such manager will be shared with Y. Any such manager will only be compensated by X for work done for X, as confirmed by detailed time records which will require the manager to log the time spent for X and Y on a daily basis. X and Y will maintain separate employee benefits, including retirement plans as well as health, dental and disability insurance.

Foundation represents that the property management services the manager or managers provide will be reasonable and necessary to carrying out Foundation's exempt purposes, and the compensation provided to manager or managers for services provided to X will not be excessive.

The income from the properties would be rental income, and thus not subject to unrelated business income tax, which would exclude the LLC from the excess business holdings limitation. With respect to sale of properties and unrelated business income, the ruling states:

Foundation intends to hold the real estate properties as part of a diversified investment portfolio that will also contain cash and publicly traded securities and intends to continue to hold the properties, at least in the near term. Foundation anticipates that any sales of the real estate properties will be sporadic and occasional. The decision to retain or sell any of the real estate properties will be made by Foundation's Board of Directors based on the relevant facts and circumstances and in accordance with their fiduciary duty to prudently manage Foundation's investments. Any such decision will be made on a property-by-property basis, taking into consideration the overall investment portfolio, investment strategy, and capital appreciation. Foundation may decide to make capital improvements to the real estate properties as needed, but the real estate properties will not be held for the primary purpose of improving the properties for immediate resale. The real estate properties will be held as income producing properties and not as inventory used in a trade or business. See Malat v. Riddell, supra. Accordingly, any income from the sale, exchange, or other disposition of the commercial real estate properties you received by bequest will be excluded from the computation of unrelated business taxable income by § 512(b)(5), provided no income results from debt-financed property.

The self-dealing analysis, very favorable to the taxpayer, provides:

In Madden v. Commissioner, T.C. Memo 1997-395, the Tax Court ruled that maintenance, janitorial, and security services provided by a disqualified person to a private foundation are not “personal services” for purposes of the exception to self- dealing. Citing § 4941‘s legislative history, the Court noted that one of Congress's stated goals in enacting § 4941 was to minimize the need for an arm's length standard by generally prohibiting self-dealing transactions between private foundations and disqualified persons and that any exceptions to the self-dealing transactions rules should be construed narrowly. The Court stated that the regulations under § 4941 contemplate only personal services that are professional and managerial in nature, and concluded that maintenance, janitorial, and custodial services do not meet the definition of “personal services” allowed under § 4941.

Foundation will contract with X, managed by one or more of Foundation's disqualified persons, to manage Foundation's real estate properties. While the disqualified person manager or managers will be compensated by X, because X is a disregarded entity, for purposes of the analysis under § 4941, Foundation will be providing compensation to a manager or managers who are disqualified persons.

Payment of compensation by a private foundation to a disqualified person is an act of self-dealing under § 4941(d)(1)(D). However, § 4941(d)(2)(E) provides an exception to self-dealing for the payment of compensation by a private foundation to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation. Foundation received the real estate properties by bequest and, as such, they became part of Foundation's investment portfolio. Foundation does not intend to actively pursue other real estate investments which, historically, have not been part of Foundation's investments. Treas. Reg. § 53.4941(d)- 3(c)(2) provides examples of allowable personal services that consist of legal services, investment counseling services, and general banking services. Additionally, Madden v. Commissioner, supra, indicates that services that are professional and managerial in nature are the types of personal services that are allowed under § 4941. The property management services provided to Foundation by one or more disqualified persons, through X as a disregarded entity, are professional and managerial services that, under the current facts, are reasonable and necessary to administering Foundation's investments and thus in carrying out Foundation's exempt purposes. Thus, the payment of compensation for these personal services to a manager who is a disqualified person will not be an act of self-dealing as long as the compensation is not excessive.

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Y's employees are not disqualified persons but Y is a disqualified person because it is owned by decedent's family. X's time-sharing arrangements with Y for these employees to assist X with property management services, which are treated as Foundation's time- sharing arrangements since X is a disregarded entity, will provide each shared employee with compensation that is not excessive based on a reasonable determination of the value of that employee's services to X, confirmed by detailed time records logging the time spent for X and Y on a daily basis, and accompanied by separate benefit arrangements. Accordingly, the time-sharing arrangements and the compensation provided by X to the employees will not constitute self-dealing to Y under § 4941 because there will be no indirect benefit to Y.

The same is true of any managers of X that are shared with Y, even if the managers are disqualified persons with respect to Foundation. Since the time-sharing arrangement with Y provides the manager or managers will only be compensated by X for work done for X, as confirmed by detailed time records which will require the manager to log the time spent for X and Y on a daily basis and accompanied by separate benefit arrangements, the time-sharing arrangements and the compensation provided by X to any such manager will not constitute self-dealing to Y under § 4941 because there will be no indirect benefit to Y. The time-sharing arrangements and the compensation provided by X to any such manager will also not constitute self-dealing to the managers who are disqualified persons as long as the compensation is not excessive, for the reasons discussed above under Issue 3.

## **Syndicated Conservation Easement Transactions Now Listed**

. The IRS is very grumpy with syndicated easements. Notice 2017-10 states:

The Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) are aware that some promoters are syndicating conservation easement transactions that purport to give investors the opportunity to obtain charitable contribution deductions in amounts that significantly exceed the amount invested. This notice alerts taxpayers and their representatives that the transaction described in section 2 of this notice is a tax avoidance transaction and identifies this transaction, and substantially similar transactions, as listed transactions for purposes of §1.6011-4(b)(2) of the Income Tax Regulations (Regulations) and §§6111 and 6112 of the Internal Revenue Code (Code).

The specific transaction covered by the Notice is described as follows:

An investor receives promotional materials that offer prospective investors in a pass-through entity the possibility of a charitable contribution deduction that equals or exceeds an amount that is two and one-half times the amount of the investor's investment. The promotional materials may be oral or written. For purposes of this notice, promotional materials include, but are not limited to, documents described in §301.6112-1(b)(3)(iii)(B) of the Regulations. The investor purchases an interest, directly or indirectly (through one or more tiers of pass-through entities), in the pass-through entity that holds real property. The pass-through entity that holds the real property contributes a conservation easement encumbering the property to a tax-exempt entity and allocates, directly or through one or more tiers of pass-through entities, a charitable contribution deduction to the investor. Following that contribution, the investor reports on his or her federal income tax return a charitable contribution deduction with respect to the conservation easement.

The effect of the Notice is retroactive:

Transactions entered into on or after January 1, 2010, that are the same as, or substantially similar to, the transaction described in section 2 of this notice are identified as “listed transactions” for purposes of §1.6011-4(b)(2) and §§6111 and 6112 effective December 23, 2016. Persons entering into these transactions on or after January 1, 2010, [emphasis added] must disclose the transactions as described in §1.6011-4 for each taxable year in which the taxpayer participated in the transactions, provided that the period of limitations for assessment of tax has not ended on or before December 23, 2016.

Material advisors, including appraisers, who make a tax statement on or after January 1, 2010, with respect to transactions entered into on or after January 1, 2010, have disclosure and list maintenance obligations under §§6111 and 6112. See §§301.61113, 301.6112-1.

For rules regarding the time for providing disclosure of a transaction described in this notice, see §§1.6011-4(e) and 301.6111-3(e). However, if, under §1.6011-4(e)(1), a taxpayer is required to file a disclosure statement with respect to a transaction described in this notice after December 23, 2016, and prior to May 1, 2017, that disclosure statement will be considered to be timely filed if the taxpayer alternatively files the disclosure with the Office of Tax Shelter Analysis by May 1 (because April 30 is a Sunday). In addition, for purposes of disclosure of transactions described in this notice, the 90-day period provided in §1.6011-4(e)(2)(i) is extended to 180 days. Further, if under §301.6111-3(e), a material advisor is required to file a disclosure statement with respect to the listed transaction described in this notice by January 31, 2017, that disclosure statement will be considered to be timely filed if the taxpayer files the disclosure with the Office of Tax Shelter Analysis by May 1, 2017 (because April 30 is a Sunday).

Acts to prevent the enforcement of Notice 2017-10 have been introduced. In Notice 2017-29, 2017-20 I.R.B. 1243 (May 15, 2017), the IRS stated that disclosures of participation in a syndicated conservation easement, required by Notice 2017-10, 2017-4 I.R.B. 544, will not be due until October 2, 2017, rather than June 21, 2017, as original announced, and clarified that donee-charities are not material advisors, for purposes of the disclosure rules. This was the subject of intense lobbying.

## **Use of Section 501(c)(4) Organizations to Facilitate Business Interest Ownership**

. Under the Protecting Americans from Tax Hikes Act of 2015, IRC § 2501(a) was amended to specifically exclude from federal gift tax “transfers of money or other property to an organization described in paragraph (4), (5), or (6) of section 501(c) and exempt from tax under section 501(a), for the use of such organization.” This exclusion from federal gift tax is applicable to lifetime gifts to section 501(c)(4), (5), and (6) organizations, but does not apply to transfers at death. Accordingly testamentary transfers to section 501(c)(4), (5), and (6) organizations still would be taxable for estate tax purposes. Moreover, lifetime transfers to these organizations also could be subject to IRC § 2036. No private inurement is permitted for a section 501(c)(4) organization.

Section 501(c)(4) Organizations include “civic leagues” and “social welfare organizations,” which must be nonprofit and organized for the promotion of the common good and general welfare of the community as a whole, and “local associations of employees,” in which membership is limited to employees of a particular person or particular person in a designated locality, and the earnings of which must be used for charitable, educational or recreational activities. Specific examples of section 501(c)(4) organizations would be homeowners associations, veterans groups, community centers and community programs, volunteer fire departments, parks associations, public recreational facilities, and service organizations.

A section 501(c)(4) organization does not appear to fit within the definition of “disqualified person,” because it is:

• Not a substantial contributor or foundation manager;

• Not an individual

• Not a “35 percent” corporation, partnership, trust or estate; and

• Not a private foundation.

No cases or rulings appear to establish that a section 501(c)(4) organization would be a disqualified person. This may create a useful opportunity to use section 501(c)(4) organizations to avoid excess business holdings and self-dealing issues that could arise from transfers of closely-held business interests to a private foundation.

IRC § 4943 would preclude a private foundation from long-term ownership of more than 20 percent of the voting stock of a corporation or other business enterprise in combination with all disqualified persons. However, if a section 501(c)(4) organization is not a disqualified person, it could own a “business enterprise” with one or more private foundations in a manner that would avoid violating the prohibition against excess business holdings under IRC § 4943. If an owner transferred interests in a closely-owned business to a private foundation in conjunction with a transfer to a section 501(c)(4) organization, it may be possible to avoid excess business holdings.

To illustrate,

• Donor could recapitalize her closely-held business enterprise from 1 million shares of common stock to 100,000 shares of voting stock and 900,000 shares of nonvoting stock.

• Donor then could contribute 80,000 shares of voting stock to a new section 501(c)(4) organization that Donor’s family controls, without incurring gift tax.

• At death, Donor could contribute 20 percent of voting stock and all nonvoting stock to a private foundation, and the section 501(c)(4) organization would own 80 percent of the voting stock.

If a section 501(c)(4) organization is not a disqualified person (even if it is controlled by one or more disqualified persons) it would be permissible for a private foundation and the section 501(c)(4) organization to enter into transactions that ordinarily would be treated as self-dealing. For example a section 501(c)(4) organization could:

• Purchase or borrow assets from a related private foundation.

• Lease real estate to a related private foundation.

• Co-own and co-invest with a related private foundation.

## **Another Indirect Self-Dealing Issue Avoided Via Non-Voting LLC Interests**

. A note between a disqualified person and a private foundation is an extension of credit and self-dealing. This limits the ability of notes from a sale to a grantor trust to be given or bequeathed to a private foundation. In recent years the IRS has allowed notes to be transferred to an LLC and non-voting units given to the foundation. That’s what happened in PLR 201723005. The ruling recites these facts:

Founder sold membership interests in First LLC to Irrevocable Trust in exchange for a promissory note. Founder’s descendants are beneficiaries of Irrevocable Trust. Founder desires that, following her death, any part of the principal and interest on the promissory note which remains then unpaid be used to benefit Foundation.

To that end, Founder contributed and transferred the promissory note to New LLC in exchange for voting and nonvoting interests, which subsequently were transferred to Revocable Trust. Founder is the settlor and sole trustee of Revocable Trust and holds a revocation power in the form of a power to direct the trustee to distribute the assets of the trust to her during her lifetime. Founder’s descendants are beneficiaries of Revocable Trust.

New LLC will hold and administer the promissory note and receive payments of interest and principal on the promissory note. New LLC’s sole asset and source of income is, and will be, the promissory note.

Power to manage the affairs of New LLC is vested in the manager, who is selected and may be removed by the members holding voting interests in New LLC. One of Founder’s sons, who is also a director of Foundation, is the sole manager of New LLC. The members holding nonvoting interests possess no management rights or rights to vote on the manager of New LLC. New LLC may only be dissolved with written approval of all members, whether holding voting or nonvoting interests.

Founder proposes that at the time of her death, Revocable Trust (which will become irrevocable at that time) will distribute to Foundation all of the nonvoting interests in New LLC, which have a profit-sharing ratio of 99 percent. Revocable Trust will retain its voting interests in New LLC, which have a profit-sharing ratio of one percent.

The ruling concludes:

Irrevocable Trust and Revocable Trust are disqualified persons under section 4946(a)(1)(G) with respect to Foundation because they are trusts in which Founder’s descendants, who are disqualified persons under section 4946(a)(1)(D) with respect to Foundation, hold more than a 35-percent beneficial interest. Irrevocable Trust is the obligor of a promissory note that was held by Founder. Founder desires that, following her death, any unpaid principal and interest on the promissory note be used to benefit Foundation. An act of self-dealing would occur if Founder transferred the promissory note to Foundation, which would become creditor under the note. See Treas. Reg. §53.4941(d)-2(c).

Instead, Founder contributed and transferred her ownership of the promissory note to New LLC. At Founder’s death, Foundation will acquire the nonvoting interests in New LLC, which have a profit-sharing ratio of 99 percent, by gift through a distribution from Revocable Trust, rather than through a self-dealing transaction. If Foundation will “control” New LLC within the meaning of Treas. Reg. §53.4941(d)-1(b)(5), then Foundation will be indirectly serving as the creditor under the note by reason of its ownership interest. See Treas. Reg. §53.4941(d)-1(b)(8), Example (1). However, Foundation will not “control” New LLC within the meaning of Treas. Reg. §53.4941(d)- 1(b)(5) due to lack of voting power.

As holder of the nonvoting interests, Foundation will have no management rights or right to vote on the manager of New LLC. Revocable Trust (which will have become irrevocable at Founder’s death) will own all of the voting interests, giving Revocable Trust the right to select and remove the manager of New LLC. As a holder of nonvoting interests, Foundation will have a right to receive distributions only if New LLC dissolves or chooses to make current distributions, but the timing and amount of such distributions will be uncertain and could not be compelled by Foundation. Only Revocable Trust as the holder of the voting interests may elect or remove the manager of New LLC, and such manager will have the sole power to manage the affairs of New LLC and determine the timing and amount of distributions. Thus, Foundation and Foundation’s managers (acting only in such capacity) will not have sufficient votes or positions of authority to cause New LLC to engage in a transaction.

Additionally, Foundation will not have the power to compel dissolution of New LLC since New LLC may only be dissolved with written approval of all members, including Revocable Trust. The power associated with the nonvoting interests of New LLC as a necessary party to vote on the liquidation of the LLC is not considered equivalent to a “veto power” within the meaning of Treas. Reg. §53.4941(d)-1(b)(5) because the power cannot be exercised over an action relevant to any potential act of self-dealing.

Accordingly, Foundation’s receipt from Revocable Trust upon Founder’s death of nonvoting interests in New LLC will not constitute a loan or extension of credit between a private foundation and a disqualified person within the meaning of section 4941(d)(1) and Treas. Reg. §53.4941(d)-2(c) because Foundation will not acquire an interest in the promissory note; instead, Foundation will acquire nonvoting interests in New LLC, with respect to which it will not have any management rights or control over distributions.

## **Exception to Indirect Self-Dealing**

. We see very little guidance on indirect self-dealing. PLR 201642001 is helpful because it does not go out of its way to imply an agreement or plan. Here the Taxpayer is a private foundation. The ruling states:

Both A and B, as foundation managers of Taxpayer, are disqualified persons under section 4946(a)(1)(B) with respect to Taxpayer. Company A is a disqualified person with respect to Taxpayer under section 4946(a)(1)(E), because A owns stock representing more than 35% of the total combined voting power in Company A. Company B is also a disqualified person with respect to Taxpayer under the attribution rules described in Treas. Reg. § 53.4946-1(d)(1). Any direct purchase of Land by Taxpayer from Company B, which is a disqualified person with respect to Taxpayer, would be considered an act of self-dealing under section 4941(d)(1)(A). However, Taxpayer will not make a direct purchase of the Land from Company B.

Taxpayer will make a grant to Supporting Organization, an intermediary organization, which will be placed into a segregated account for use by Supporting Organization to construct and operate a new performing arts stage/center. Taxpayer’s grant will not be used by Supporting Organization to purchase the Land. Rather, the funds used by Supporting Organization to purchase the Land will be raised from the general public and/or from government grants. Additionally, Supporting Organization had complete control over the selection of the Land for purchase. Supporting Organization is not controlled by Taxpayer, A, or B within the meaning of Treas. Reg. § 53.4941(d)-1(b)(2) or § 53.4941(d)-1(b)(5). There is no agreement, express or implied, between Taxpayer and Supporting Organization or Supported Organization regarding the purchase of the Land.

The reasoning applied in Treas. Reg. § 53.4941(d)-1(b)(2) and Example (3) of Treas. Reg. § 53.4941(d)-1(b)(8) with regard to transactions with a government official may be analogized to a situation in which a grant is provided by a private foundation to an intermediary section 501(c)(3) organization that is not controlled by the private foundation within the meaning of Treas. Reg. § 53.4941(d)-1(b)(5) and the intermediary may independently use the grant to construct and operate a performing arts venue on land purchased from a disqualified person with other funds raised for that purpose. In the absence of the grant funds being earmarked for use in purchasing the Land and the absence of any other control by Taxpayer of the Supporting Organization’s decision to purchase the Land, no act of indirect self-dealing occurs.

## **Defective Gift Equals No Deduction**

. In Fakiris v. Commissioner, T.C. Memo. 2017-126, the taxpayer wanted the Richmond Dance Ensemble, Inc. to own the St. George Theater. Because Richmond Dance was not yet a charity the taxpayers transferred the Theater to the WEMGO Charitable Trust which was recognized as a charity. However, in the “contract of sale” for the Theater was a fatal restriction:

d. The Bargain and Sale Deed with covenants against grantors [sic] acts conveying the Premises [St. George] to Purchaser [WEMGO] shall have a restriction prohibiting the sale/transfer or conveyance of the Premises during the first five (5) years after the conveyance to Purchaser herein except that [sic] a conveyance during that period to Richmond Dance Ensemble Inc. [Hereinafter, paragraph 43d.]

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49. Purchaser [WEMGO] its successors and/or assigns shall be prohibited from selling the premises [St. George] for the first five (5) years after delivery of the deed. Notwithstanding the aforesaid, Seller [Grou] may transfer the premises to Richmond Dance Ensemble Inc. once it receives its 501C(3) [sic] status from the Internal Revenue Service. The provisions of this paragraph shall survive closing. [Hereinafter, paragraph 49.]

The Tax Court held that dominion and control had not transferred so no deduction. The Court also upheld penalties.

## **Estate Income Tax Deduction**

. Where a decedent lacks a taxable estate, but wants to make a charitable bequest, consideration should be given to providing that the first dollars of income of the estate go to charity in an amount equal to the amount of the bequest. The estate will receive an income tax deduction if the estate has sufficient income.

## **Donor Advised Fund Guidance**

**.** Notice 2017-73 deals with several long-time concerns of the IRS and Treasury. One is so-called bifurcated grants. Certain distributions from a donor-advised fund that pay for the purchase of tickets that enable a donor or donor advisor (or certain related persons under section 4958(f)(7)) to attend or participate in a charity-sponsored event would result in “more than incidental benefit” to the donor or donor advisor and thus give rise to an excise tax under section 4967. The Notice provides that this transaction may also result in an excess benefit transaction under section 4958. This issue is controversial. Many commentators and practitioners believe that a no grant should be allowed if any part of the transaction is non-charitable; others believe that if a charity – a DAF – pays the portion that would be deductible for income tax purposes then there is no abuse.

Certain distributions from a donor-advised fund that the recipient charity treats as fulfilling a pledge made by a donor or donor advisor (or certain related persons) would not result in a more than incidental benefit under section 4967, regardless of whether the recipient charity treats the distribution as satisfying the pledge and regardless of whether the pledge is enforceable under current law. A suggested requirement that the sponsoring organization make no reference to the existence of any individual’s pledge when making the distribution. Further, no donor or advisor may receive any other benefit that is more than incidental following the distribution has been criticized. The donor or advisor must not attempt to claim a charitable contribution deduction under Section 170 with respect to the distribution. These rules would not apply for purposes of determining whether this transaction gives rise to excise taxes for self-dealing under section 4941. The IRS specified that taxpayers could rely on these rules until additional guidance is issued.

Changes to the public support computation for publicly-supported charities described in sections 170(b)(1)(A)(vi), 509(a)(1) and 509(a)(2) would treat a sponsoring organization’s distribution from a donor-advised fund as coming from the donor (or donors) that funded the donor-advised fund rather than from the sponsoring organization. The new rules would also require a donee organization to treat all anonymous contributions (including a donor-advised fund distribution for which the sponsoring organization fails to identify the donor that funded the donor-advised fund) as being made by one person. Lastly, distributions from a sponsoring organization can be treated as public support without limitation if the sponsoring organization specifies that the distribution is not from a donor-advised fund or states that no donor or donor advisor advised the distribution. The issue here is the ability of a taxpayer to “launder” money through DAFs to avoid creating what would otherwise be a private foundation.

Treasury and the IRS requested comments regarding these issues and suggestions for future guidance with respect to donor-advised funds. The IRS has also requested guidance regarding whether a transfer of funds by a private foundation to a donor-advised fund should be treated as a “qualifying distribution” for purposes of Section 4942. The argument in favor is that a DAF is just another public charity. The argument against is the concern that DAFs warehouse contributions.

## **Conversion Of A Nongrantor CLAT To A Grantor CLAT**

. PLR 201730017 (one of a series) dealt with these facts:

The information submitted states that on Date 1, Grantor, as settlor and initial trustee, created Trust pursuant to Agreement. Agreement provides that until the X anniversary of the initial contribution date, an amount equal to the annuity amount will be distributed to Charity. Trust represents that it was previously allowed income tax deductions pursuant to § 642(c)(1) for the amounts of gross income included in the annuity amount each year.

Trust is seeking to amend Agreement to delete and replace Article pursuant to the laws of State. The amended Article permits the Substitutor to have the power, exercisable at any time in a nonfiduciary capacity (within the meaning of § 675(4)), without the approval or consent of any person in a fiduciary capacity, to acquire or reacquire Trust principal by substituting other property of an equivalent value, determined as of the date of such substitution. Substitutor is not a trustee of Trust. Substitutor and Grantor are siblings.

The IRS concluded that the conversion would not be a taxable event for income tax purposes:

Rev. Rul. 77-402 concludes that the lapse of grantor trust status during the grantor owner’s life may have income tax consequences, but does not impose such consequences on a non-grantor trust that becomes a grantor trust. Rev. Rul. 85-13 describes the income tax effects of a non-grantor trust becoming a grantor trust, which effects did not include the realization or recognition of any income by the grantor-owner by reason of the conversion. Given the lack of authority imposing such consequences, we conclude that the conversion of Trust from a non-grantor trust to a grantor trust will not be a transfer of property to Grantor from Trust under any income tax provision.

The person with the substitution right is a sibling, and thus not a disqualified person for self-dealing purposes.

The IRS denied an income tax deduction upon the conversion.

Section 170(f)(2)(B) provides, in part, that no deduction is allowed under § 170 for the value of any interest in property (other than a remainder interest) transferred in trust unless the interest is in the form of a guaranteed annuity or the trust instrument specifies that the interest is a fixed percentage distributed yearly of the fair market value of the trust property (to be determined yearly) and the grantor is treated as the owner of such interest for purposes of applying § 671.

Rev. Proc. 2007-45, 2007-2 C.B. 89, provides guidelines for creating charitable lead annuity trusts including sample trust agreements as well as explanations of the various provisions involving in these sample agreements. It also describes some tax consequences to different actions involving these trusts. Rev. Proc. 2007-45, section 8.01(2) provides that the donor to a grantor charitable lead annuity trust may claim a federal income tax charitable deduction under § 170(a) in the year that assets are irrevocably transferred to the trust.

Upon the conversion of Trust from a nongrantor trust to a grantor trust, the owner of the grantor trust can claim a federal income tax charitable deduction under § 170(a) only if property has been transferred to the grantor trust from the nongrantor trust. Because the conversion of Trust from a nongrantor trust to a grantor trust is not a transfer of property held by Trust for income tax purposes, Grantor is unable to take an income tax charitable deduction under § 170(a).

Interestingly, the IRS continues to conclude that section 675(4)(c) allows anyone to have the substitution power, thus ignoring a literal reading of “reacquire”. See also CCA 200923024.

## **Unusual Grant Exception**

. PLR 201729025 approved a grant as an “unusual grant”. The facts presented were:

You were formed in the state of C in D. You are a nonprofit corporation exempt from taxation under Section 501(c)(3) of the Internal Revenue Code and classified as a public charity under Sections 509(a)(1) and 170(b)(1)(A)(vi) of the Code. Your purpose is to promote the mental, moral, intellectual, artistic, and physical improvement of those in F which is a rural area in C.

You will receive a grant from B for x dollars. The grant will be a distribution of cash or investments from B and will take effect on the death of the grantor. A condition of the receipt of the grant requires that you will hold the funds in a separate endowment known as E. The grant will be used to benefit of residents in F at the discretion of your board of directors. You received one small grant for y dollars from B several years ago. B is not your creator and does not stand in a position of authority over you. You have carried on a successful program of public solicitation to attract public support and have consistently met the public support test. Your program of public solicitation includes conducting an annual mailing campaign to solicit contributions from the general public, and sending letters to the local funeral homes requesting they inform families of your existence so that they can make memorial gifts to you.

Furthermore, you have a large board including an elected county official, an elected member from the local board of education, an officer/employee of a local bank from your community, as well as three directors elected at large. Other than your current president serving as B's attorney, there are no other relationships between you and B.

The IRS concluded it was an unusual grant based on the following:

Based on the information provided, the proposed grant meets the requirements of Treasury Regulations section 1.170A-9(f)(6)(ii) because the grant is from a disinterested party, and:

The grant was attracted by reason of your publicly supported nature:

The grant is unusual or unexpected with respect to the amount:

The grant will adversely affect your status as normally being publicly supported.

The grant meets the requirements of Treasury Regulations section 1.509(a)-3(c)(4) based on the following facts and circumstances.

a) The grant was not made by a person who created you or who previously contributed a substantial amount of your support. The grantor also does not stand in a position of authority with respect to you and does not exercise control over you.

b) The grant is a bequest and is in the form of cash or investments.

c) You have carried on an actual program of public solicitation, have exempt activities, and have attracted a significant amount of public support over the years.

d) You have met the public support test in past years.

e) Because you have relied on public support in the past, it can be assumed that you will be able to maintain that level of public support in the future.

f) You have a large representative governing body.

In addition, no material restrictions or conditions within the meaning of Treasury Regulations section 1.507-2(a)(7) have been imposed by the transferor upon the transferee in connection with such transfer.

The “out of the blue” nature of a grant is a working description of an unusual grant.

## **Private Foundation Grants To Foreign Organization**

. In order to satisfy sections 4942, and 4945, a private foundation must satisfy the expenditure responsibility test or must make an equivalency determination. Rev. Proc. 2017-53 provides new guidance on making such a determination. The Rev. Proc. states:

Private foundations may wish to treat grants to foreign grantees as qualifying distributions that satisfy the distribution requirements imposed by § 4942 of the Internal Revenue Code (Code) and not as expenditures requiring expenditure responsibility in order to not be subject to the excise tax on taxable expenditures imposed by § 4945 of the Code. If a private foundation makes a “good faith determination” that a foreign grantee qualifies as a qualifying public charity (as defined in section 3.03(3) of this revenue procedure), the grant will generally be a qualifying distribution that does not require expenditure responsibility in order to not be a taxable expenditure.

This revenue procedure modifies and supersedes Rev. Proc. 92-94, 1992-2 C.B. 507, which provided a simplified procedure that private foundations could follow in making good faith determinations (also known as equivalency determinations). This revenue procedure reflects the changes to the equivalency determination final regulations published in 2015 (TD 9740; 80 FR 57709; 2015-42 IRB 573), including the elimination of the ability of a private foundation to rely on a grantee affidavit for purposes of the special rule. This revenue procedure also reflects the changes to the public support tests for § 170(b)(1)(A)(vi) and § 509(a)(2) organizations set forth in final regulations published in 2011 (TD 9549; 76 FR 55746; 2011-46 IRB 718), and applies these changes in the context of equivalency determinations. In addition, this revenue procedure includes other updates and changes in response to comments from the public.

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A private foundation may make an equivalency determination to demonstrate that the following three provisions under chapter 42 of the Code and the related regulations apply and thereby potentially prevent the imposition of excise taxes:

(1) Under §§ 4945(d)(5) and 53.4945-6(c)(2), a private foundation’s grant to an organization described in § 501(c)(3) ordinarily need not be maintained in a separate charitable fund;

(2) Under §§ 4942(g)(1) and 53.4942(a)-3(a), a private foundation’s grant to a qualifying public charity ordinarily is a qualifying distribution that counts toward its minimum charitable distribution requirement; and

(3) Under §§ 4945(d)(4) and 53.4945-5(a), a private foundation’s grant to a qualifying public charity ordinarily is not a taxable expenditure and the foundation does not need to comply with a detailed set of grant procedures known as “expenditure responsibility” to ensure that the grant is used for charitable purposes.

## **New Excess Business Holdings Exception**

. A few items that were to have been in the 2017 Tax Act were instead added in early February because of procedural issues. One was new subsection 4943(g), which is said to have been inserted for the Newman’s Own company but which applies by its terms much more widely. The provision exempts businesses from the excess business holdings rules if all the vote is owned by the private foundation (and was given to the foundation), all the net operating income is distributed to the foundation, the business is not run by substantial contributors to the foundation, and the foundation is not controlled by family members of substantial contributors. The business can’t have loans outstanding to a substantial contributor to the foundation and split-interest trusts cannot use the exception nor may DAFs or supporting organizations. Until or unless regulations further explain the meaning of net operating income, a private ruling may be desirable.

The provision states:

(g) EXCEPTION FOR CERTAIN HOLDINGS LIMITED TO INDEPENDENTLY-OPERATED PHILANTHROPIC BUSINESS. —

(1) IN GENERAL. — Subsection (a) shall not apply with respect to the holdings of a private foundation in any business enterprise which meets the requirements of paragraphs (2), (3), and (4) for the taxable year.

(2) OWNERSHIP. — The requirements of this paragraph are met if —

(A) 100 percent of the voting stock in the business enterprise is held by the private foundation at all times during the taxable year, and "(B) all the private foundation's ownership interests in the business enterprise were acquired by means other than by purchase.

(3) ALL PROFITS TO CHARITY. —

(A) IN GENERAL. — The requirements of this paragraph are met if the business enterprise, not later than 120 days after the close of the taxable year, distributes an amount equal to its net operating income for such taxable year to the private foundation.

(B) NET OPERATING INCOME. — For purposes of this paragraph, the net operating income of any business enterprise for any taxable year is an amount equal to the gross income of the business enterprise for the taxable year, reduced by the sum of —

(i) the deductions allowed by chapter 1 for the taxable year which are directly connected with the production of such income,

(ii) the tax imposed by chapter 1 on the business enterprise for the taxable year, and

(iii) an amount for a reasonable reserve for working capital and other business needs of the business enterprise.

(4) INDEPENDENT OPERATION. — The requirements of this paragraph are met if, at all times during the taxable year —

(A) no substantial contributor (as defined in section 4958(c)(3)(C)) to the private foundation or family member (as determined under section 4958(f)(4)) of such a contributor is a director, officer, trustee, manager, employee, or contractor of the business enterprise (or an individual having powers or responsibilities similar to any of the foregoing),

(B) at least a majority of the board of directors of the private foundation are persons who are not —

(i) directors or officers of the business enterprise, or

(ii) family members (as so determined) of a substantial contributor (as so defined) to the private foundation, and (C) there is no loan outstanding from the business enterprise to a substantial contributor (as so defined) to the private foundation or to any family member of such a contributor (as so determined).

(5) CERTAIN DEEMED PRIVATE FOUNDATIONS EXCLUDED. — This subsection shall not apply to —

(A) any fund or organization treated as a private foundation for purposes of this section by reason of subsection (e) or (f),

(B) any trust described in section 4947(a)(1) (relating to charitable trusts), and

(C) any trust described in section 4947(a)(2) (relating to split-interest trusts).

(b) EFFECTIVE DATE. — The amendment made by this section shall apply to taxable years beginning after December 31, 2017.

## **Indirect Self-Dealing Inapplicable To QTIP While Spouse Is Living**

. In PLR \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_, the key issue was whether a QTIP whose assets would pass to a private foundation at the surviving spouse’s death was subject to the self-dealing rules. Because no charitable deduction was taken, there was no self-dealing. The ruling states:

Upon Spouse’s death, all the assets of Trust will be includible in Spouse’s gross estate pursuant to section 2044 and deductible from Spouse’s taxable estate pursuant to section 2055. Subsequently, at such time as no non-charitable interests continue to exist and amounts have been deducted under section 2055 with respect to amounts held in Trust, Trust generally would become described as a nonexempt charitable trust under section 4947 (a)(1) and be subject to the provisions of sections 4941, 4943, 4944, and 4945.

However, the regulations under section 4947 provide that, in the case of a trust created by will, from which the trustee is required to distribute all the assets in trust for or free of trust to charitable beneficiaries, the restrictions imposed by section 4947(a)(1) do not apply for a reasonable period of settlement. Treas. Reg. §§ 53.4947-1(b)(2)(v). The term “reasonable period of settlement” means that period reasonably required (or, if shorter, actually required) by the trustee to perform the ordinary duties of administration necessary for the settlement of the trust. These duties include, for example, the collection of assets, the payment of debts, taxes, and distributions, and the determination of rights of the subsequent beneficiaries. Only after a reasonable period of settlement is a trust described in Treas. Reg. § 53.4947-1(b)(2)(v) considered a charitable trust under section 4947(a)(1).

We note, however, that during this reasonable period of settlement, transactions with respect to Foundation’s interest or expectancy in Trust may result in indirect self-dealing between Foundation and a disqualified person with respect to Foundation if the requirements of Treas. Reg. 53-4941-1(b)(3) are not met. We are not ruling whether the proposed transaction will meet these requirements.

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