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Recent Case Provides Overview of Special Needs Trust Disbursements

By S. Alan Medlin

Probate practitioners recognize that certain situations require the deployment of a special needs trust to benefit a beneficiary with disabilities. The rules regarding special needs trusts are arcane and complex and must be suited to particular needs and situations. One common theme of special needs trusts is to provide benefits to the beneficiary without disqualifying that beneficiary from receiving state or federal public assistance, which are commonly means-based. Threading that needle requires expertise, and perhaps the assistance of an expert special needs estate planner. As with the disclaimer scrolling across the bottom of certain car commercials warning against anyone but a professional driver attempting such a stunt, special needs drafting should be handled only by experienced professionals. Nevertheless, it is helpful to see certain issues discussed in actual cases, and a recent case, dealing with the propriety of a trustee's distributions from a special needs trust, not only offers some insight into the determination of whether a trustee should have made specific expenditures but also gives the probate practitioner insight into the purpose and rules of certain special needs trust situations.

In *McGee v. State Dept. of Health Care Services*, 309 Cal. Rptr.3d 93 (Cal. App. 2023), the State Department of Health Care Services objected to accountings filed by the trustee of a special needs trust, contending that the trustee improperly used

trust funds to make a number of unnecessary purchases. The trial court examined the language of the special needs trust created by the court in 2012 for the beneficiary, who survived on a feeding tube and was expected to permanently require tube feeding. In establishing the special needs trust, the court in 2012 found that the beneficiary would have special needs "that will not be met without this trust."

In reviewing the accounting filed in 2016, the trial court cited the trust language expressing that the trust's purpose was "to provide a discretionary, spendthrift trust to supplement public resources and benefits when such resources and benefits are unavailable or insufficient to provide for the Special Needs of the Beneficiary." The trust defined "special needs" as the requirements for "good health, safety and welfare" when the trustee using discretion determined that those needs were not being met by state or federal agencies. In addition, the trust authorized the trustee to use the trust as an "emergency or backup fund secondary to public resources." The trust specifically provided that it was not for the support of the beneficiary. The trustee had the discretion to make distributions to the beneficiary while considering any limitations on resources and income of any public assistance program for which the beneficiary might be eligible.

However, the trust also authorized the trustee to make distributions in the best interest of the beneficiary even if that would cause a reduction or elimination of the beneficiary's right to receive any public benefits. The language explicitly exonerated the trustee from liability if those benefits were lost.

Trial Court Determination of Proper Expenditures

Having examined the pertinent language of the trust, the trial court found that the trustee improperly expended trust funds in several areas reported in the 2016 accounting because those expenditures did not qualify as "special needs." The trial court disallowed expenditures for food because food expenses had to be pursuant to a prescription or a set of defined parameters, which was not given to the trial court. Moreover, expenditures for food for caregivers while traveling were improper. Nor were expenditures for the care of the beneficiary's animals allowed because the trustee failed to show that the beneficiary used the animals for therapy or some other authorized purpose. The trial court also disallowed distributions for credit card interest payments, donations, taxes, jewelry, clothes, and gifts. The trial court assessed all of these costs against the trustee.

The trial court ruled similarly on the Department's objections to the trustee's subsequent accounting in 2019. Also disallowed in the 2019 accounting were the trustee's attempts to use contributions from personal funds of the beneficiary to the trust as an offset against the trustee's personal liability from the 2016 accounting. These contributions stemmed from a worker's compensation award and reimbursements for property losses incurred in a fire.

The trustee appealed, arguing that the trial court

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misread the trust language through an overly-narrow construction of the trust's purpose and the trustee's authority.

Appellate Court Overview of Special Needs Trusts

The appellate court provided a basic explanation of special needs trusts. Citing a Senate Judiciary Committee report, the appellate court observed that a "special needs trust is a type of discretionary spendthrift trust designed 'to preserve public assistance benefits for the [disabled] trust beneficiary while, simultaneously, providing for the beneficiary's "special needs" that are not met by public assistance.'" Thus, federal law allows "a severely disabled individual under the age of 65" to shelter assets in a trust created by that individual or that person's parent, grandparent, or guardian, or by a court, with that special needs individual being the beneficiary of that trust. The assets in a complying special needs trust were not considered when determining the beneficiary's assets in a means-based test for qualifying for public assistance, whether federal, such as Supplemental Social Security (SSI), or state, such as Medi-Cal in California.

In the case of Medi-Cal, the trust must provide for the payment of the trust assets remaining at the beneficiary's death or termination of the trust to the state for reimbursement, up to the amount of state benefits paid to or for the beneficiary. In the case of SSI, "many disbursements from the trust for the beneficiary's benefit will not count as the beneficiary's income for purposes of qualifying for SSI." For example, payments to third parties for reasons such as "education expenses, therapy, transportation, professional fees, medical services not provided by Medicaid, phone bills, recreation, and entertainment" are not considered income to the beneficiary for purposes of the means-based qualification. Trust distributions of cash, food, or shelter to the beneficiary are not exempt, but disbursements to third parties resulting in the beneficiary receiving non-cash items, other than food or shelter, can also be exempt. These distributions would include such purposes as "a home; an automobile; household goods such as furniture, appliances, electronic equipment, and dishes; and personal effects such as personal jewelry, personal care items and clothing, pets, cell phones, and educational and recreational items."

Thus, the purpose of the special needs trust is essentially two-fold: to provide benefits to the beneficiary not otherwise provided by public assistance while isolating the trust assets from any means-based test for qualification for public assistance so that the beneficiary who otherwise would qualify is not excluded from receiving that public assistance.

In reviewing the trial court decision, the appellate court addressed the trust's intent for the meaning of "special needs." This consideration was part of a broader general construction of a trust when determining whether the trustee acted in a manner consistent with the settlor's intent. The trial court had construed the term to include only "the beneficiary's special needs as created by the limitations due to her condition." Thus, it had surcharged the trustee for any distributions beyond this limited purpose. The appellate court concluded that the trial court had based its construction on only one sentence from the trust: "Special Needs include without limitation special equipment, programs of training, education and habitation, travel needs, and recreation, which are related to and made reasonable necessary by this Beneficiary's disabilities." However, the appellate court concluded that this interpretation was too narrow when the trust actually defined the term broadly. Elsewhere in the document, special needs was defined to mean "the requisites for maintaining the Beneficiary's good health, safety, and welfare when, in the discretion of the Trustee, such requisites are not being provided by any public agency." According to the appellate court, "health, safety, and welfare" encompassed more than expenses stemming from the beneficiary's disability, while many of those

expenses would not be covered by any public agency. The appellate court buttressed its reasoning by noting that the trust also provided that it was not for the "beneficiary's support." Consequently, the trustee was empowered to make distributions for more than just the beneficiary's support.

The appellate court focused on the trust's stated purpose: "to supplement public resources and benefits when such resources and benefits are unavailable or insufficient to provide for the Special Need of the Beneficiary" — the essence of a typical special needs trust and consistent with "what little legal interpretation and commentary on special needs trusts exists." For explication, and observing that Congress did not define the term "special needs," the appellate court opined that those few authorities that have addressed the definition of that term did not limit its application to only care required because of a disability. As an example, the appellate court cited *Lewis v. Alexander*, 685 F.3d 325 (3d Cir. 2012): "A supplemental needs trust is a discretionary trust established for the benefit of a person with a severe and chronic or persistent disability and is intended to provide expenses that assistance programs such as Medicaid do not cover." The appellate court also cited treatises for the assertion that "special needs" means "anything that would be useful or in any way helpful to the beneficiary, if it is not paid for or provided to the beneficiary from a public assistance benefit program or some other source" or "the term 'special needs' is distinguished from 'basic needs,' that is, needs for food, shelter, and medical care, which public benefits like SSI and Medi-Cal are intended to cover." Thus, the appellate court applied the term broadly, as "encompass[ing] the broad range of everything else a human being needs in order to live, thrive, and realize his or her potential in life." *Citing* Dayton, et al, *Advising the Elderly Client (2022) Supplemental Security Income Eligibility and the Special Needs Trust*.

Types of Special Needs Expenditures

The appellate court reasoned that its interpretation of the trust was consistent with the treatment of special needs trusts afforded by the Social Security Administration (SSA). When determining whether the special needs beneficiary qualifies for SSI, the SSA does not exclude only trust assets and distributions related to the beneficiary's disability, but also excludes household goods and personal effects from the beneficiary's countable resources, regardless of the dollar limit. According to the SSA, "household goods" are those personal property items used at or near the home by the beneficiary on a regular basis, which are not held because of the asset's value or investment. "Examples of excluded household goods include furniture, appliances, electronic equipment such as computers and televisions, carpets, cooking and eating utensils, and dishes," while excluded personal effects would encompass such items as "jewelry, including wedding and engagement rings; personal care items and clothing; pets, such as a cat, dog, hamster, horse, monkey, or snake; educational and recreational items, such as books, musical instruments, or hobby materials; and items of cultural or religious significance to the individual, such as ceremonial attire."

Having determined that, for the reasons cited above, the trial court had interpreted "special needs" too narrowly, the appellate court remanded for the purpose of properly examining the expenditures subject to the State's objections under the proper definition of "special needs." However, in sending the case back to the trial court, the appellate court explained that it was not holding that the trust placed no limits on distributions. The trust did not give the trustee sole or absolute discretion but instead imposed a standard of "reasonably necessary" in providing for the beneficiary's special needs. A trustee with discretion but subject to a stated standard must exercise that discretion within the confines of the standard, subject to the applicable fiduciary responsibility.

The appellate court noted that, when making distributions, the trustee must take into consideration the public assistance programs and the applicable resource and income limitations for those providers' programs. The trust authorized the trustee to make distributions even if they would reduce or eliminate the beneficiary's eligibility for public assistance, "but only if he independently determines such distributions would be in the beneficiary's best interest." Accordingly, the trustee must be able to show the court that the distributions either did not operate to reduce or eliminate the beneficiary's qualification for public assistance under the programs, or if they did, then doing so was in the best interest of the beneficiary. And, as is always the case with a trustee using discretion, the trustee must act in good faith.

As an example of this distinction, the appellate court stated that the SSA does not exclude all items of personal property when determining a beneficiary's eligibility for SSI. Examples of property not excluded in the eligibility determination are second automobiles, jewelry not worn that lacks family significance, or animals acquired for investment purposes, such as dogs used for breeding or investment. Other examples of potentially disqualifying distributions would include payments of cash to the beneficiary, distributions of food or shelter, or payments for medical care otherwise provided by the public assistance program. In cases such as those, an expenditure by the trustee may be outside of the authorized exercise of discretion.

Basic Fiduciary Principles Apply as Well

Even though acting in bad faith is the governing principle in determining the appropriateness of a trustee's exercise of discretion, "a trial court is not expected simply to rubberstamp a special needs trust accounting." While a trustee's authority in a special needs trust may be broad, it is not unlimited and must take into account the applicable public resource qualification rules. Thus, the appellate court instructed the trial court upon remand to focus on whether the distributions did not disqualify the beneficiary from receiving public assistance or else had been made in the best interest of the beneficiary.

Probate Report

- **Silent Will Does Not Preclude Omitted Spouse Share**

In *Nystrand v. D'Antonio*, not reported in A. 3d (Conn. Super. 2023) (2023 Westlaw 6995315), the testator made his will before marrying his surviving spouse. They lived together for 12 years before they married, and he lived five years after their marriage, never changing his will. His will left his estate to his two daughters. Upon his death, his surviving wife sought a statutory omitted spouse's share, which would revoke his will to the extent necessary to provide her with her intestate share, or one-half of his estate. The will did not mention his wife. The trial court concluded that the omission of the will from the will was intentional, which precluded the operation of the omitted spouse's statute.

The wife contended that the omitted spouse's statute, which applies when a single testator subsequently marries and then dies without changing the will executed before marriage, operated to give her an omitted spouse's share. The only exceptions to the operation of the omitted spouse's statute were (1) if the will provided for the eventual spouse; (2) if the testator made a nonprobate transfer intended to be in lieu of the omitted spouse's share; or (3) if the will expressly provides that the omission was intentional. She argued that none of these exceptions applied. However, the trial court, using extrinsic evidence,

concluded that the testator did intend to override the operation of the statute. The wife argued that the determination of any intent to override the statute must be found on the face of the will, without the aid of extrinsic evidence.

The appellate court cited “the paucity of law” in the state dealing with the issue of whether the intent to override the statute must appear on the face of the will. Although the state had not enacted a version of the Uniform Probate Code, the applicable statute was similar to UPC section 2-301. Consequently, the appellate court looked to precedent in some other states with similar versions of the omitted spouse’s statute and, for comparison purposes, versions of the omitted child’s statute.

The appellate court cited an Alabama omitted spouse’s case that looked only to the face of the will to determine that the testator had not expressed an intent to override the statute.

The omitted child’s statutes examined in opinions from other states’ courts cited by the appellate court had an exception similar to the omitted spouse statute: The testator can override an omitted child’s share by expressing an intent in the will to override the statute. The theme of these cases was to exclude the use of extrinsic evidence and determine whether any intent to override the statute appeared on the face of the will. According to the appellate court, Connecticut state precedent agreed.

Consequently, the appellate court concluded that extrinsic evidence was not admissible and that the intent to override the omitted spouse’s share must appear only on the face of the will. Thus, the case was remanded to the trial court.

Editors’ Comment: The *Nystrand* appellate court also looked more broadly at the extrinsic evidence admissibility issue. The opinion cited the general view about the admissibility of extrinsic evidence when construing wills: “A court may not stray beyond the four corners of the will where the terms of the will are clear and unambiguous.” The opinion then noted two recognized exceptions to that general plain meaning rule. One involved a scrivener’s error, which was not applicable in *Nystrand*. The other exception was, of course, if the will was indeed ambiguous, which would allow extrinsic evidence to explain the ambiguity. However, in this case, the will was silent and made no mention of the testator’s future surviving spouse. “It is generally true that an ambiguity is not created by silence alone.” In effect, the appellate court reasoned that the statute means what it says: an expression of intent to override the statutory omitted spouse’s share must be expressed on the face of the will.

Of course, the omitted spouse’s share statute was a rule of construction that could be overridden by an expression of the testator’s intent that it not apply. Compare that treatment to an elective share statute, which is typically mandatory and may not be overridden by contrary intent.

UPC section 2-301 provides:

(a) If a testator's surviving spouse married the testator after the testator executed the testator's will, the surviving spouse is entitled to receive, as an intestate share, no less than the value of the share of the estate the spouse would have received if the testator had died intestate as to that portion of the testator's estate, if any, that neither is devised to a child of the testator who was born before the testator married the surviving spouse and who is not a child of the surviving spouse nor is devised to a descendant of such a child or passes under Sections 2-603 or 2-604 to such a child or to a descendant of such a child, unless:

(1) it appears from the will or other evidence that the will was made in contemplation of the testator's marriage to the surviving spouse;

(2) the will expresses the intention that it is to be effective notwithstanding any subsequent marriage; or

(3) the testator provided for the spouse by transfer outside the will and the intent that the transfer be in lieu of a testamentary provision is shown by the testator's statements or is reasonably inferred from the amount of the transfer or other evidence.

- **PR/Attorney/POA Agent Has to Follow Claims Process**

In *Estate of Reeder*, 217 N.E.3d 1071 (Ill. App. 2023), the latest chapter in a long saga involving fees dealt with the need to file a creditor's claim for fees sought from serving as the testator's agent under a power of attorney. The testator devised his entire estate to 27 different charities. The testator's attorney also served as his agent under a power of attorney. The will nominated the attorney as personal representative, which provided for independent administration, allowing a personal representative to avoid the need for court orders except in certain situations. The will also granted the personal representative the power to settle claims without a court order.

The personal representative sent summary accountings to the charitable devisees. One charity objected, and the state Attorney General intervened. The personal representative disputed the amount of fees sought for service as personal representative, as attorney for himself as personal representative, and as agent under the power of attorney. The case progressed to the appellate court and was remanded. Upon remand, the personal representative and the Attorney General argued over the fees sought as agent under the power of attorney. The Attorney General contended that the agent/personal representative/attorney was required to file a claim pursuant to the statutory creditors' process and that the agent had failed to timely do so and was thus barred. The agent contended that he was not required to follow the statutory claims process, but even if he were, he had satisfied the requirements by sending notices to the charitable devisees pursuant to the independent administration. The trial court granted summary judgment to the Attorney General.

The appellate court examined the language of the will with the independent administration statute. Although the will contained "boilerplate language" permitting the personal representative to settle claims against the estate without obtaining a court order, the appellate court concluded that the will did not specifically address any power of attorney agent fees or claims that the personal representative himself had against the estate. Nor did the will waive any conflict of interest the personal representative had in seeking payment for services he provided as agent during the testator's lifetime. Thus, the appellate court held that the personal representative's contention that the will overrode the statute was erroneous because the will was not inconsistent with the statute requiring a creditor to file a claim against the estate.

The appellate court also agreed with the Attorney General that the notices to the charitable devisees failed to satisfy the statutory filing process for creditor's claims. Importantly, the appellate court noted that the reports sent to the charitable devisees did not mention any power of attorney agent fees that were due or had been paid by the estate.

Consequently, the appellate court affirmed the reasoning and result of the trial court.

Editors' Comment: Although it is not per se impermissible for an attorney to serve as personal representative and as attorney for the personal representative during the administration of an estate, care should be taken to separate fees sought for service in these separate capacities. One of the concerns expressed by the Attorney General was that a portion of the fees sought by the personal representative for postmortem service as attorney was possibly for work done as the personal representative.

- **Prospective PR Cannot Bring Lawsuit**

In *Nieves v. Senior Health TNF, LLC,* 369 So.3d 760 (Fla. App. 2023), the decedent died in 2020. In 2021, her daughter sued the nursing home where the

decedent contracted COVID-19. She had not yet been appointed as the personal representative of the decedent's estate. The nursing facility moved to dismiss the complaint because the daughter lacked standing to bring the action. Although the daughter conceded the nursing home's contention, she argued that, under applicable state law, the authority of a personal representative related back upon appointment to pre-appointment actions by that personal representative. The trial court dismissed the suit without prejudice and did not grant the daughter's request to allow her to amend the action once she was appointed. At the time of the trial court's order, the daughter had yet to be appointed as personal representative.

The appellate court examined the relation-back statute:

> The powers of a personal representative relate back in time to give acts by the personal representative *appointed*, occurring before *appointment* and beneficial to the estate, the same effect as those occurring before *appointment.*

Because the daughter had yet to be appointed as personal representative at the time of the trial court's dismissal, the appellate court concluded that the statute did not apply and distinguished precedent when the appointment occurred before the final act of a trial court.

The appellate court emphasized that the issue on appeal was not whether the trial court should have stayed or abated the lawsuit pending appointment, for which precedent existed, because the daughter never sought that relief.

Editors' Comment: The daughter's attempt to file the lawsuit preceded the effective date of the statute enacted by the state legislature to protect certain businesses by requiring heightened standards for bringing a lawsuit based on COVID-19. The trial court seemed especially worried about that timing, which would deprive the defendant of those statutory protections: "This presents a fairly stark contrast to the cases applying the relation-back doctrine in other contexts, where the issue is generally the sense that the plaintiff would suffer injustice through the loss of substantive rights if the complaint is not permitted to relate back." The appellate court seemed less concerned about that factor, but instead found a simpler way to address the point by citing the "tipsy coachman rule," reasoning that the trial court reached the right result for the wrong reason. As the appellate court emphasized, the daughter never was appointed during the trial court proceedings. "She did not timely cure the standing problem." In essence, the appellate court reasoned that the trial court could not be placed in the position of guessing whether the daughter would actually be appointed.

Uniform Probate Code section 3-701is similar to the state statute in *Nieves* and specifically authorizes a personal representative to ratify pre-appointment acts by others:

> The duties and powers of a personal representative commence upon appointment. The powers of a personal representative relate back in time to give acts by the person appointed which are beneficial to the estate occurring prior to appointment the same effect as those occurring thereafter. Prior to appointment, a person named executor in a will may carry out written instructions of the decedent relating to the decedent's body, funeral, and burial arrangements. A personal representative may ratify and accept acts on behalf of the estate done by others where the acts would have been proper for a personal representative.

Tax Report

- **Conservation Easement Deduction Allowed, But at Reduced Valuation**

In *Mill Road 36 Henry, LLC v. Commissioner*, T.C. Memo. 2023-129 (October 26, 2023), the Tax Court held that the donation of a conservation easement on 33 acres of a 40-acre tract held by the taxpayer, a limited liability company, was a qualified conservation contribution and that the LLC substantiated the donation with a qualified appraisal. But the court also held that the taxpayer greatly overstated the value of the easement, that the taxpayer's deduction was limited to its adjusted basis in the contributed property, and that negligence penalties applied.

In 2015, two real estate professionals, acting through business entities, partitioned a 117-acre parcel of land on the southern edge of Atlanta, Georgia, into separate tracts. This case involves one of the tracts, a 40-acre parcel consisting of undeveloped land with a "wetland area" and "riparian buffer." That tract was contributed to the taxpayer, while the remaining tracts were sold to other entities. At the time of contribution, the adjusted basis of the 40-acre tract was about $416,000.

In September 2016, an investment fund paid $1 million for a 97-percent interest in the taxpayer. Three months later, the taxpayer donated a conservation easement covering 33 acres of the property to the Southern Conservation Trust, a qualified charity. On its federal income tax return, the taxpayer claimed a charitable contribution deduction in the amount of $8,935,000, representing the value of the easement as determined by an appraisal submitted with the return. After an examination, the IRS determined that the taxpayer's deduction should be disallowed or, in the alternative, that the amount of the deduction be limited to no more than $510,400. This led the taxpayer to seek a determination from the Tax Court.

Was the Donation a Qualified Conservation Contribution?

The IRS argued that the taxpayer should get no deduction because the taxpayer sought only to create a federal income tax deduction for its members and therefore lacked donative intent, pointing to a private placement memo given to investors in the investment fund promising a tax benefit of 4.25 times their original investments. But the Tax Court held it is sufficient that the taxpayer in fact donated an easement to charity. That a donor might be motivated by an income tax deduction does not detract from the fact that a donor makes a gift by transferring cash or property to a charity for less than full consideration.

The IRS also argued that the contribution did not serve a conservation purpose, as required by Code section 170(h)(2). According to the IRS, the easement did not protect a significant habitat or ecosystem, but the court noted that while the subject property was not home to any endangered or rare species, it contained four "high priority habitats" including forests, a beaver pond, and streams. That was sufficient to be a conservation purpose. Moreover, the easement preserved open space, ensuring that a "forested view will exist in perpetuity along Mill Road." In response to the IRS's claim that the parcel was too small to serve a conservation purpose, the Tax Court observed:

> The easement area is 33 acres of the 40-acre Mill Road Tract. Admittedly, this is not Yellowstone, with its 2.2 million acres. But in a suburban setting, an easement covering 33 acres is hardly negligible. It may be illuminating to compare the Mill Road easement not to Yellowstone but instead to something like the 50-acre Boston Common, which is the oldest and one of the best known city parks in the United States. … An undeveloped area, even on this modest scale—and especially when surrounded by development in an urban or suburban setting—can be a noteworthy

and beneficial feature.

Finally, the IRS claimed the contribution did not serve its purpose in perpetuity because of rights to enjoy the property for recreational purposes that were retained by the taxpayer. The Tax Court rejected this, too, finding that even if the reserved rights were exercised to the fullest extent allowable under the deed, the conservation purposes would still be served. Having rejected all of the claims against the validity of a deduction, the Tax Court concluded that the taxpayer made a qualified conservation contribution.

Did the Taxpayer Attach a "Qualified Appraisal" by a "Qualified Appraiser?"

But when the amount of a charitable contribution deduction exceeds $500,000, section 170(f)(11) requires a taxpayer to substantiate the deduction by attaching a "qualified appraisal" to the return. The taxpayer attached an appraisal, but the IRS claimed that it was deficient in two respects.

First, said the IRS, the taxpayer's appraiser was not a "qualified appraiser," one of the requirements for a qualified appraisal. Regulation section 1.170A-13(c)(5)(ii) states that an appraiser is not qualified when "the donor had knowledge of facts that would cause a reasonable person to expect the appraiser falsely to overstate the value of the donated property." Here, said the IRS, the taxpayer's members knew the value claimed by the appraiser was far in excess of the actual value of the appraisal. But even if that was so, ruled the court, the regulation asks whether the taxpayer knew that the *appraiser* was crooked enough to overstate the value of the easement, not whether the taxpayer knew of facts that make the honest appraiser's assessment obviously overstated. And here there was no evidence that the taxpayer's appraiser was knowingly inflating the value of the easement. Although information furnished to the appraiser suggested that the property had been approved for a use as a large-scale senior living facility when in fact such approval had only been recommended, there was no evidence that the appraiser knew of this distinction. Thus, an appraisal based on the assumption that the property was approved for such use is not evidence that the appraiser was "in on" any scheme to manufacture an arbitrarily high deduction amount.

Second, said the IRS, two other appraisers involved in the valuation did not sign the final appraisal report, as required by Regulation section 1.170A-13(c)(5)(iii). The Tax Court held this was not an error, as the two individuals were employees of the appraiser who did sign the report, and at all times they were acting under his direction and supervision. Accordingly, the court ruled that the taxpayer in fact submitted a qualified appraisal with its return.

What Was the Value of the Easement?

But even when a taxpayer submits a qualified appraisal, the IRS can claim the appraisal reaches the wrong conclusion as to value, which is where the court next headed. At the Tax Court, both sides presented reports from experts as to the value of the donated easement. The taxpayer's expert concluded that the easement was worth $6,695,000, but the IRS's expert concluded it was worth no more than $900,000.

The Tax Court rejected the report of the taxpayer's expert, noting it too was based on the assumption that the property was approved for use as a high-occupancy assisted living facility. Although the county had in fact recommended approval of the use of the property for this purpose, the taxpayer withdrew its application on the eve of donation. The court noted that the county only approved a finite number of assisted living facilities, so there was hardly any guarantee that a new application would be recommended for approval. And even if there was approval of a later application, the Georgia Division of Healthcare Facilities would very likely not allow the 677-unit facility assumed by the taxpayer's expert, as the typical capacity approved by the state ranged from 60 to 120 units. Finding the taxpayer's expert assumption "extraordinary" and "grossly excessive," coupled with the use of evidence of comparable sales

from outside the subject property's county, the Tax Court opted to adopt the report from the IRS's expert that the value of the easement was $900,000. That report used in-county comparables and more accurately assumed the highest and best use of the property would be for a much smaller assisted living facility.

Was the Deduction Limited to Basis?

Having determined the value of the easement was only $900,000—about ten percent of the amount originally claimed by the taxpayer on its federal income tax return—the Tax Court went on to hold that, because the property was inventory in the hands of the taxpayer, the deduction was limited to the taxpayer's $416,000 basis in the contributed property under section 170(e)(1)(A). That provision requires the amount of the deduction to be reduced by any amount that would not be long-term capital gain upon sale of the donated property. If the property given to charity was inventory, therefore, the deduction was reduced to the taxpayer's basis in the donated inventory.

The taxpayer argued the property was not inventory because the land was the taxpayer's sole asset and because 97 percent of the taxpayer was owned by a fund controlled by investors who were not themselves dealers in real property. But the Tax Court observed that the taxpayer's original members (and the parties that contributed the land to the taxpayer) were engaged in the business of buying and selling real estate. When a partnership acquires inventory from a contributing partner, that property is inventory to the partnership, at least for purposes of sales within five years of contribution. See section 724(b). It does not matter that at the time of donation 97 percent of the taxpayer's equity was held by non-dealer investors. Because the taxpayer donated a conservation easement on inventory, its deduction was limited to its $416,000 basis in that property.

What Penalties Apply?

The IRS argued that the taxpayer owed a fraud penalty on top of a 40-percent gross valuation misstatement penalty on the amount deducted in excess of $900,000 and a 20-percent substantial understatement penalty on the amount deducted in excess of $416,000 but not in excess of $900,000. The Tax Court rejected the fraud penalty, finding just the opposite: the taxpayer had disclosed everything required to be reported on its return, to the point of flagging that this was a syndicated conservation easement transaction with a value well in excess of the basis of the contributed property. But because the claimed value of the deduction was so far in excess of the finally determined amount, the court upheld the understatement penalties.

- **Proposed Regulations Clarify Donor Advised Fund Distributions Subject to Excise Taxes**

In Proposed Regulation sections 53.4966-1 through 53.4966-6 (November 14, 2023), the IRS announced draft guidance related to taxable distributions from "donor advised funds" (DAFs) under section 4966(a)(1). That statute imposes a 20-percent excise tax on a DAF's "sponsoring organization" for each "taxable distribution." The proposed regulations supplement the statutory definitions of these terms. Prop. Reg. §53.4966-1. Special attention is given to the definition of a DAF, Prop. Reg. section 53.4966-3, and to exceptions from this definition, Prop. Reg. §53.49566-4. The proposed regulations also go into greater detail as to the definition of a "taxable distribution" for purposes of the excise tax. Prop. Reg. §53.4966-5. The proposed regulations would become effective when published as final regulations. Prop. Reg. §53.4966-6.

Definition of a DAF

It is important as a threshold matter to know whether a distribution has been made from a DAF as opposed to an account that is not a DAF, for only distributions from a DAF face the 20-percent excise tax. If the account is not a DAF, the excise tax cannot apply.

The Code requires that a DAF must be "separately identified" by a sponsoring organization. IRC §4966(d)(2)(A)(i). Under the proposed regulations, if the sponsoring organization "maintains a formal record of contributions to the fund or account relating to a donor or donors," this requirement is met. Prop. Reg. §53.4966-3(b)(1). In the absence of a formal record, the requirement can still be met if all the facts and circumstances indicate that a fund or account is so held. *Id.* Among the factors to be considered are whether the fund is named for one or more donors or persons related to them, whether the sponsoring organization refers to the account as a DAF, and whether the donor receives regular accountings from the sponsoring organization. Prop. Reg. §53.4966-3(b)(2). A commingling of account funds with other assets of the sponsoring organization is not fatal to a claim that the organization has separately identified the account as a DAF. Prop. Reg. §53.4966-3(c).

The Code also requires that at least one donor has (or reasonably expects to have) "advisory privileges" with respect to distribution and investment decisions related to the account. This does not require that the donor actually give such advice or exercise such privileges to any extent. Prop. Reg. §53.4966-3(c)(1)(i). But it does require an examination of all facts and circumstances. *Id.* The proposed regulations state that a donor is deemed to have advisory privileges when: (1) the sponsoring organization allows the donor to give nonbinding advice as to distributions or investments; (2) the sponsoring organization and the donor have a written agreement stating the donor has advisory privileges; (3) the donor receives a document or marketing material indicating the donor may provide advice regarding distributions or investments; or (4) the sponsoring organization generally solicits such advice from the donor. Prop. Reg. §53.4966-3(c)(2). The proposed regulations offer eleven examples illustrating the application of these rules. Prop. Reg. §53.4966-3(e).

The proposed regulations also make clear that a fund established to make distributions to a single organization generally will not qualify as a DAF, except when the donor likewise has advisory privileges with respect to the recipient organization's use of a distribution for the benefit of other individuals or entities or when distributions to that entity will provide a "more than incidental benefit" to the donor or to another person related to the donor. Prop. Reg. §53.4966-4(a). The proposed regulations offer three examples illustrating these rules.

The proposed regulations also clarify that certain funds used to grant scholarships may not qualify as DAFs. Prop. Reg. §53.4966-4(b). Specifically, an account is not a DAF if the donor's advisory privileges relate "to which individuals receive grants for travel, study, or other similar purposes" if:

- The sole purpose of the account is to make grants for travel, study, or similar purposes;

- The donor's advisory privileges extend only to serving on the selection committee selecting award recipients;

- All members of the selection committee are appointed by the sponsoring organization;

- No combination of donors or related persons controls the selection committee;

- Grants from the account are based on objective and nondiscriminatory criteria pursuant to an approved, written procedure; and

- The account maintains adequate records proving recipients were selected on an objective and nondiscriminatory basis.

Id. The proposed regulations offer guidance for determining whether the selection committee is "controlled" by donors or related persons, as well as three examples illustrating application of these rules.

Taxable Distributions

The proposed regulations generally provide that a "taxable distribution" is any distribution to a "natural person" or any distribution to "any other person"

when the distribution is for any purpose other than a charitable purpose or when the sponsoring organization does not exercise "expenditure responsibility" with respect to the distribution. Prop. Reg. §53.4966-5(a)(1). The proposed regulations defer to Regulations section 53.4945-5(b) – (e) for procedures to be followed for the sponsoring organization to have expenditure responsibility for a distribution. Prop. Reg. §53.4966-5(d).

Any distribution from a DAF to a public charity, to the sponsoring organization, or to another DAF will not be treated as a taxable distribution. Prop. Reg. §53.4966-5(a)(2). But when, for example, a donor advises a distribution from a DAF to a charity subject to an agreement between the charity and the donor that the charity will use the funds for the benefit of individuals selected by the donor, the distribution will be treated as having been made directly to those individuals (thus making the distribution subject to the excise tax). Prop. Reg. §53.4966-5(a)(3).

- **Proposed Regulations Implement Ban on Certain Conservation Easements from Pass-through Entities**

In Proposed Regulation section 1.170A-14(j) – (n) (November 20, 2023), the IRS issued draft guidance implementing section 170(h)(7), a provision added as a revenue-raiser to the SECURE 2.0 Act of 2022, P.L. 117-328. The rule takes direct aim at the so-called "syndicated conservation easement" by preventing an owner of a partnership interest or S corporation stock from claiming a share of the entity's qualified conservation contribution when the claimed amount of the charitable contribution deduction exceeds 2.5 times the owner's basis in the partnership interest or S corporation stock. Section 170(h)(7)(G) directs the IRS to issue interpretive guidance, and these proposed regulations fulfill that instruction.

Section 170(h)(7)(A) generally denies a partner or an S corporation's shareholder any conservation easement deduction when the amount of the deduction exceeds 2.5 times the sum of each owner's "relevant basis" in the entity. Section 170(h)(7)(B)(i), in turn, defines an owner's "relevant basis" as the owner's "modified basis" allocable to the portion of the real property to which the conservation easement applies. Under section 170(h)(7)(B)(ii), modified basis means the owner's adjusted basis immediately before the contribution, without regard to an owner's share of entity liabilities, and as determined "after taking into account … such other adjustments as the Secretary may provide."

This "anti-stuffing rule" avoids an easy evasion of section 170(h)(7). Without this rule, investors could easily avoid the 2.5 times rule by contributing other investment assets to the pass-through entity in addition to the amounts used to purchase a share of the real property on which the conservation easement will be placed.

The proposed regulations explain how an owner's modified basis should be computed for purposes of this rule. Proposed Regulation section 1.170A-14(l)(2) provides for four adjustments to be made in this order:

- First, increase the owner's adjusted basis for any **contributions** made after the start of the entity's taxable year and ending with the moment immediately prior to the qualified conservation contribution.

- Second, adjust this figure for the owner's **hypothetical distributive share** of entity items from the start of the entity's taxable year to the moment immediately prior to the qualified conservation contribution.

- Third, reduce this figure (but not below zero) by the amount of any **distributions** made to the owner from the start of the entity's taxable year to the moment immediately prior to the qualified conservation contribution.

- Finally, in the case of a partnership, reduce this figure by the owner's share of **partnership liabilities**, if any. Although this adjustment may cause the

modified basis amount to go negative, the 2.5 times rule is applied to the sum of each owner's relevant basis, and that sum may still be a positive number after the relevant basis of each partner is considered.

Editors' Comment: The proposed regulations recognize that these adjustments do not always make sense in the context of an S corporation. For one thing, S corporation shareholders do not get basis credit for entity debt, like partners in a partnership. For another, the subchapter S pass-through rules require that all items pass through to shareholders on the last day of the taxable year. Accordingly, the proposed regulations provide that only the first two adjustments apply in the case of an S corporation. Prop. Reg. §1.170A-14(l)(3)(i).

The statute provides three exceptions from the application of the 2.5 times rule. The first exception covers contributions of property held at least three years. In the typical syndicated conservation easement scheme, the entity purchases the subject land and immediately places an easement on the property. But under section 170(h)(7)(C), the 2.5 times rule will not apply when the entity donates the easement at least three years after the entity acquired the subject property (or, if later, three years after the date in which any owner acquired any interest in the entity). While the statute does not define the phrase "acquired any interest," the proposed regulations provide that, in the case of an S corporation, it refers to "any transfer, issuance, redemption, or other disposition of stock in the S corporation" except for any proportionate issuance or redemption. Prop. Reg. §1.170A-14(n)(2)(iii). In the case of a partnership, any "variation" within the meaning of Regulation section 1.706-4(a)(1) will suffice. The preamble to the proposed regulations explains that variations include acquisitions, partial dispositions, and complete dispositions. Rather than re-invent the wheel, the IRS found it simpler to incorporate those rules by reference.

The second exception relates to "family partnerships." Under section 170(h)(7)(D)(i), the disallowance rule in section 170(h)(7)(A) does not apply when "substantially all of the … interests in [the entity] are held, directly or indirectly, by an individual and members of the family of such individual." The statute defines "family" as one's spouse and dependents, but it does not define when "substantially all" of the entity interests are held by one family. The proposed regulations fill this gap, stating that "substantially all" means at least 90-percent ownership. Prop. Reg. §1.170A-14(n)(3)(i). In the case of a partnership, the family must own 90 percent of the interests in capital and profits. Prop. Reg. §1.170A-14(n)(3)(ii)(A). In the case of an S corporation, the family must own 90 percent of the voting power and value of the stock. Prop. Reg. §1.170A-14(n)(3)(ii)(B). The proposed regulations include anti-abuse rules under which the family must have held the subject real property for at least one year and the family must be allocated at least 90 percent of the resulting charitable contribution deduction. This latter rule prevents a partnership from allocating most of the deduction to a non-family member.

The third exception covers contributions made to preserve any building that is a certified historic structure. On this point, the proposed regulations merely remind taxpayers of the special reporting requirements applicable to donations of conservation easements related to certified historic structures.

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