PROBATE AND PUMPERNICKEL

MARCH 7, 2014

Defending Those Exemption Gifts When the IRS Comes Knocking

presented by

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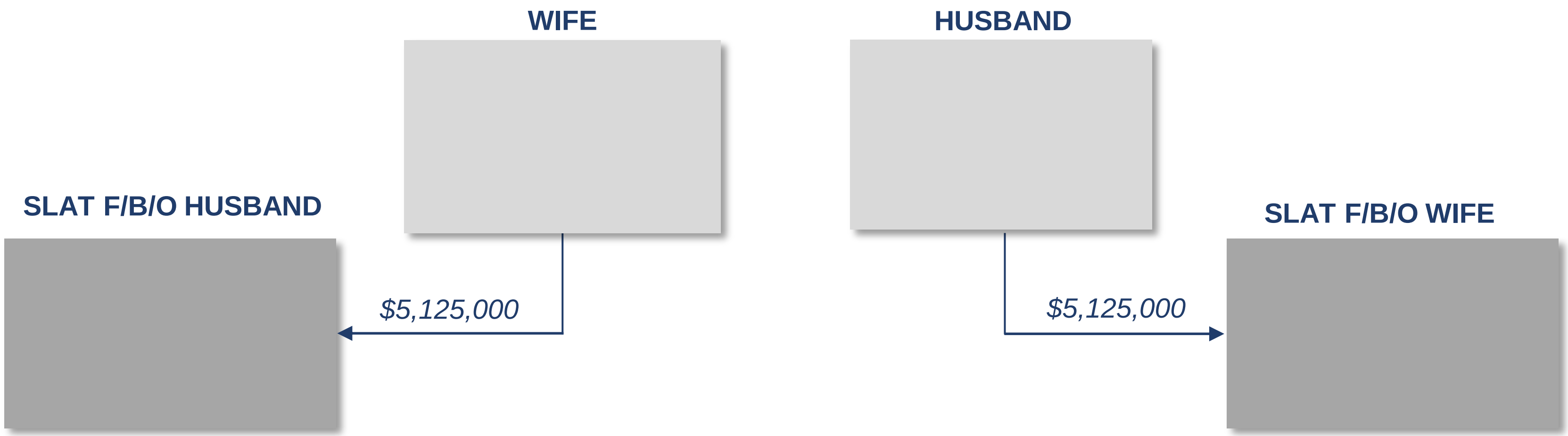
Inter Vivos Credit Shelter Trust or "SLAT" – Spousal Lifetime Access Trust



SLAT F/B/O HUSBAND

1. Income to husband and issue in Trustee's discretion
2. Principal to husband and issue in Trustee's discretion for HEMS
3. Husband has testamentary limited power of appt. in favor of issue
4. In default of husband's exercise of power, trust continues for benefit of wife

SLAT F/B/O WIFE

1. Income to wife and issue in Trustee's discretion
2. Principal to wife and issue in Trustee's discretion for HEMS
3. Wife has testamentary limited power of appt. in favor of issue
4. In default of wife's exercise of power, trust continues for benefit of husband

Potential Problems

1. Self-Settled Spendthrift Trust Treatment
2. Reciprocal Trust Doctrine
3. Step Transaction Doctrine

1. Self-Settled Spendthrift Trust Treatment

736.0505 Creditors' claims against settlor.–

(1) Whether or not the terms of a trust contain a spendthrift provision, the following rules apply:

(b) With respect to an irrevocable trust, a creditor or assignee of the settlor may reach the maximum amount that can be distributed to or for the settlor's benefit.

1. Self-Settled Spendthrift Trust Treatment

Treas. Reg. § 25.2523(f)-1(f); Example 11

Because D made an election under section 2523(f) with respect to the trust, on S's death the trust corpus is includible in S's gross estate under section 2044. Accordingly, under section 2044(c), *S is treated as the transferor of the property for estate and gift tax purposes*. Upon D's subsequent death in 1998, because the property was subject to inclusion in S's gross estate under section 2044, the exclusion rule in § 25.2523(f)-1(d)(1) does not apply under § 25.2523(f)-1(d)(2). However, *because S is treated as the transferor of the property, the property is not subject to inclusion in D's gross estate under section 2036 or section 2038.* (emphasis added)

1. Self-Settled Spendthrift Trust Treatment

736.0505 Creditors' claims against settlor.–

(3) Subject to the provisions of s. 726.105, for purposes of this section, the assets in:

(a) A trust described in s. 2523(e) of the Internal Revenue Code of 1986, as amended, or *a trust for which the election described in s. 2523(f) of the Internal Revenue Code of 1986, as amended, has been made*; and

(b) Another trust, to the extent that the assets in the other trust are attributable to a trust described in paragraph (a), shall, after the death of the settlor's spouse, be *deemed to have been contributed by the settlor's spouse and not by the settlor*. (emphasis added)

2. Reciprocal Trust Doctrine

Under a reciprocal trust arrangement, each grantor (usually related to the other grantor) transfers property to a trust, at about the same time, and gives the other grantor the lifetime right to enjoy the property as beneficiary. The trust created for the beneficiary is includible in the beneficiary's gross estate when the trusts are found to be interrelated and leave the grantors in the same economic position they would have been in had they created the trusts and named themselves as beneficiaries. In essence, inclusion will result when (1) the two trusts are substantially identical in terms, (2) the trusts were created at about the same time under some sort of arrangement, and (3) each grantor gives the other grantor approximately the same economic rights.

- CCH U.S. Master Estate and Gift Tax Guide, §170.

2. Reciprocal Trust Doctrine

The two prong test under the U.S. Supreme Court decision in *U.S. v. Grace*, 395 U.S. 316 (1969) that must be met to invoke the doctrine of reciprocal trusts: (1) the trusts leave the settlors in the same economic position; and (2) the trusts are interrelated.

> *"Rather, we hold that the application of the reciprocal trust doctrine requires only that the trusts are interrelated, and that the arrangement, to the extent of mutual value, leaves the settlors in the same economic position as they would have been if they had created trusts naming themselves as <u>life beneficiaries</u>."*

2. Reciprocal Trust Doctrine

In *Grace*, the following factors were specifically mentioned indicating that the trusts were interrelated:

1. Substantially identical terms; and
2. Created at the same time (i.e., pursuant to a plan).

2. Reciprocal Trust Doctrine

Can the doctrine of reciprocal trusts be broken merely by including a special power of appointment in one of the trusts, but not the other?

Planners that advocate that the above structure will break the reciprocal trust doctrine are focusing on the *first* prong of *Grace* – whether or not the trusts are interrelated. *Grace* stipulated two requirements to determine whether the trusts were interrelated:

1. the trusts had substantially identical terms; AND
2. the trusts were created at the same time (i.e. pursuant to the same estate plan).

2. Reciprocal Trust Doctrine

What is meant by the term "trust creation at the same time". Does it mean have husband settle an irrevocable trust in the current year, and in the next year the wife will settle an irrevocable trust. As explained in the case law, the *real* factor is whether the trusts were created pursuant to the same *plan*.

3. Step-Transaction Doctrine

The step-transaction doctrine requires that all the steps taken pursuant to a unitary plan to achieve an intended result should be reviewed as a **single** transaction, regardless of the tax effect of the recasting. Essentially, the interrelated series of transactions will be treated as parts of an entire plan, and evaluated as such.

The courts and IRS have adopted three different tests by which to determine whether the step-transaction doctrine should apply to a particular set of facts: the "end result" test, the "mutual interdependence" test, and the "binding commitment" test. The step-transaction doctrine applies if any one of these three tests is met.

3. Step-Transaction Doctrine

1. The **end result test** taxes as a single transaction and multiple steps that purport to be separate where the multiple steps are part of a single transaction that the parties always intended to complete in order to achieve the desired "end result." The end result test focuses on the taxpayer's actual subjective intent as shown from both the taxpayer's actions and statements; it ignores any hypothetical or putative intent that may be declared in the governing instruments if that intent is inconsistent with the parties' actions or declarations.

3. Step-Transaction Doctrine

2. The **mutual interdependence** test looks at whether "the steps were so interdependent that the legal relations created by one transaction would have been fruitless without the completion of the series." This test focuses on the relationship between the steps, rather than on the end result. As one court stated:

> "Disregarding the tax effects of individual steps under this test is, therefore, "especially proper where…it is unlikely that any one step would have been undertaken except in the contemplation of the other integrating acts…." *Kuper*, 533 F2d at 156.

3. Step-Transaction Doctrine

3. The **binding commitment** test is the least-often applied and the least difficult to satisfy of the three tests. Under the binding commitment test, the step-transaction doctrine applies only if, when the first step is taken, there is a legally binding obligation to take the next step, and thereafter, to take any further steps.

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3. Step-Transaction Doctrine

One of the key factors considered by the courts under all three tests is the **length of time between each of the steps**. The longer the time, the less likely it is that the steps will be treated as part of a single transaction. This factor, however, is not always dispositive. Compare *Henricksen v. Braicks*, 137 F2d 632 (9th Cir. 1943) (transactions one-half hour apart were independent), with *Commissioner v. Ashland Oil & Refining Co.*, 99 F2d 588 (6th Cir. 1938), cert. denied, 306 US 661 (1939) (steps six years apart were part of a single transaction).

3. Step-Transaction Doctrine

The Tax Court applied the step-transaction doctrine to prevent a donor from using intermediary steps to multiply the number of gift tax annual exclusions available for transfers to certain family members in *Estate of Bies v. Commissioner,* TC Memo. 2000-338. Marie Bies, the decedent, operated a family funeral home, together with her sons. Ms. Bies wanted to transfer ownership of the business to her sons without incurring a gift tax, so she made annual exclusion gifts of stock to each of her sons and to each of their wives. The son's wives each retransferred the stock to the sons immediately upon their receipt. The IRS recharacterized the gifts to the daughters-in-law as indirect gifts to the sons.

3. Step-Transaction Doctrine

The Tax Court held for the IRS, finding that the facts and circumstances evidenced that the decedent intended to make indirect gifts to her sons. The court explained:

> We consider the objective facts of the transfers and the circumstances under which they were made evidence of decedent's actual intent in making the stock transfers. See *United States v. Estate of Grace,* 395 U.S. 316, 323 (1969); *Heyen v. United States,* supra at 362-363; sec. 25.2511-1(g)(1), Gift Tax Regs. The evidence shows that the simultaneous transfers were all part of a prearranged single transaction.

3. Step-Transaction Doctrine

In *Linton v. U.S.*, 107 AFTR 2d 2011-565 (C30 F.3d 1211), 1/21/2011, Donor transferred real estate, cash, and securities (the bulk of which were municipal bonds) to a limited liability company (LLC) in which trusts for the donors' children were given interests. The court held these to be indirect gifts, to the trusts, of pro rata shares of the assets transferred to the LLC. Thus, no discount was allowable for limitations imposed by the LLC agreement.

3. Step-Transaction Doctrine

The various documents contributing property to the LLC, creating a trust for each child, and giving each trust percentage interests in the LLC, all indicated that they were signed on the same day (January 22, 2003). However, the attorney testified the intended date for the creation of the trusts and the transfers of interests in the LLC to the trusts was January 31, 2003 (i.e., several days after the donors had contributed property to the LLC).

3. Step-Transaction Doctrine

Thus, the express language of the documents established that the trusts were created and the gifts were made on January 22, 2003. Because the trusts were created, and gifts of LLC interests were made to the trusts, on January 22, 2003 — either before, or simultaneously with, the contribution of property to the LLC — the court held that the donors' transfers enhanced the LLC interests held by the children's trusts, thereby constituting indirect gifts to the trusts.

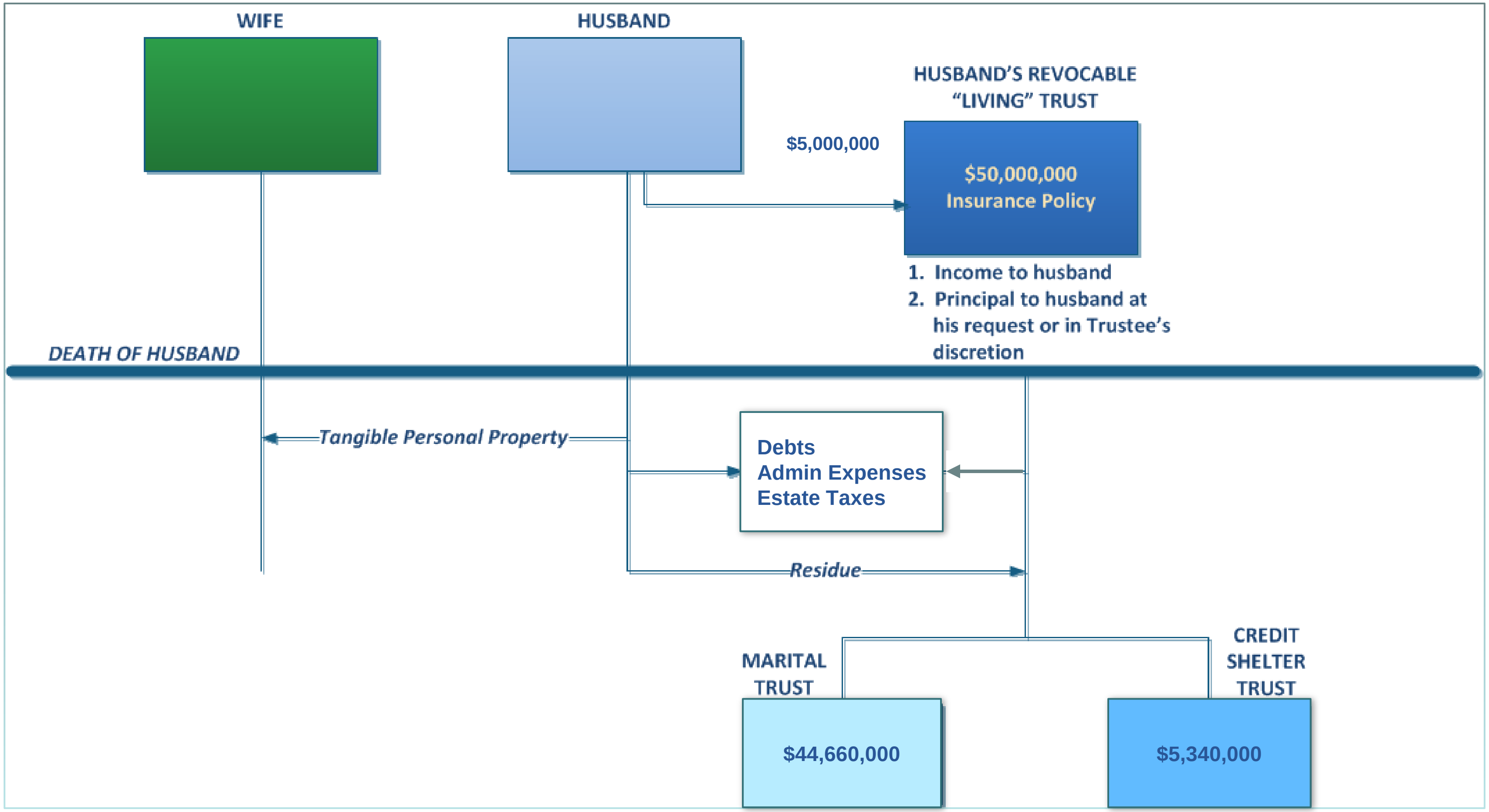
3. Step-Transaction Doctrine

Recent case law indicates that the existence or nonexistence of “real economic risk” of a change in asset value during the time period between steps is determinative of whether the step transaction doctrine will apply.

3. Step-Transaction Doctrine

The court distinguished *Linton* from two cases in which the step transaction doctrine was determined not to apply, *Holman v. Commissioner*, 130 T.C. 170 (2008) and *Gross v. Commissioner*, 96 T.C.M. (CCH) 187 (2008) because a purposeful delay (six and eleven days, respectively) between the funding and gifting of interests existed in those cases. In distinguishing *Holman* and *Gross*, the *Linton* court further noted that the plaintiffs in *Linton* did not present any evidence of "real economic risk" to assets during the period between funding and gifting.

Insurance Proceeds Subject to Creditors' Claims



F.S. 733.707(3) refers to a trust with respect to which a decedent who is the settlor ("grantor" in the Statute) has at the decedent's death a right of revocation, as defined in subsection (e), either alone or in conjunction with any other person, and which is *liable for the expenses of the administration and obligations of the decedent's estate.* Subsection (e) provides:

> For purposes of this subsection, a right of revocation is a power retained by the decedent, held in any capacity, to:
>
> 1. Amend or revoke the trust and revest the principal of the trust in the decedent; or
> 2. Withdraw or appoint the principal of the trust to or for the decedent's benefit.

Accordingly, after providing for statutory entitlements and all devises other than residuary devises, if the assets of the decedent's estate are insufficient to pay the expenses of the administration and obligations of the decedent's estate, the personal representative is entitled to payment from the trustee of a trust described in F.S. 733.707(3), in the amount the personal representative certifies in writing to be required to satisfy the insufficiency.

It was the intent of F.S. 733.707(3) to specifically target the traditional revocable inter vivos ("living") trust as the type of trust on which is imposed the duty to pay the expenses of administration and obligations if the assets of the probate estate are insufficient, and to specifically exclude irrevocable, charitable remainder, or lead trusts in which the settlor retains an interest, or other specific types of trusts or property ownership arrangements.

From a historical perspective, prior to the trust claim legislation first enacted in 1993, the process of administering a decedent's affairs, and the resulting rights of beneficiaries, were dramatically different if the decedent's affairs were administered pursuant to a will subject to F.S. Chapter 733, or under a trust subject to F.S. Chapter 737, and its' now successor, F.S. Chapter 736.

Thus, the newly enacted creditors claims process was designed to insure there would be absolutely "no daylight" between the rights of any interested party regardless of whether a decedent's assets were disposed of under a will or a revocable trust.

A life insurance policy and the proceeds thereof may be exempt from claims of the insured's creditors. However, F.S. 222.13(1) provides, in part:

> [W]henever the insurance, by designation or otherwise, is payable to the insured or *to the insured's estate or to his or her executors, administrators, or assigns, the insurance proceeds shall become a part of the insured's estate for all purposes* and shall be administered by the personal representative of the estate of the insured in accordance with the probate laws of the state in like manner as other assets of the insured's estate. (emphasis added)

Thus, as a matter of statutory law, insurance proceeds payable to an insured's estate are subject to payment of the estate's creditors. Similarly, as a matter of statutory law, insurance proceeds paid directly to a testamentary trust established under the terms of a will, rather than to the estate or the executors or administrators, never become subject to the jurisdiction or control of the personal representative and, therefore, are not available for satisfaction of the estate's obligations.

Consequently, in establishing the framework for making the principal of a revocable trust available for estate obligations, and to insure absolute consistency with respect to the rights of creditors and beneficiaries to insurance payable to the probate estate and the revocable trust, F.S. 733.707(3)(d) was enacted, and provides:

> "For purposes of this subsection, property held or received by a trust *to the extent that the property would not have been subject to claims against the decedent's estate if it had been paid directly to a trust created under the decedent's will or other than to the decedent's estate*, or assets received from any trust other than a trust described in this subsection, shall not be deemed assets of the trust available to the decedent's estate." (emphasis added)

F.S. 733.808, entitled “Death benefits; disposition of proceeds”, provides that death benefits of any kind, including insurance proceeds, may be made payable to the trustee under a trust agreement *in existence at the time of the death of the insured*, and the death benefits shall be held and disposed of as part of the trust assets in accordance with the terms of the trust. Clearly F.S. 733.808 is intended to distinguish trusts “in existence at the time of death of the insured” from testamentary trusts, which do not come into existence until the last will and testament under which the trust is established is admitted to probate. However, subsection (4) specifically provides:

> “Death benefits…, *unless paid to a personal representative…shall not be deemed to be part of the decedent’s estate, and shall not be subject to any obligation to pay the expenses of the administration and obligations of the decedent’s estate* or for contribution required from a trust under s.733.607(2) to any greater extent than if the proceeds were payable directly to the beneficiaries named in the trust.” (emphasis added)

In other words, notwithstanding the legislative intent to insist that rights of interested parties would not be substantively affected regardless of whether the estate was administered by will or revocable trust, F.S. 733.808(4) clearly establishes a statutory exemption from a settlor's creditors for insurance proceeds paid to the settlor's revocable trust. Therefore, if one relies upon F.S. 733.808(4), insurance proceeds paid to the probate estate are subject to creditors' claims under F.S. 222.13(1), whereas insurance proceeds paid to a revocable trust are not.

In *Morey v. Everbank* and *Air Craun, Inc.* (93 So. 3rd 482, 37 Fla.L. Weekly D1739, 1st DCA, July 24, 2012), the District Court held that the owner can waive the statutory exemption of insurance proceeds from creditors' claims by designating the insured's creditors as a beneficiary, by naming the insured's estate as beneficiary, or, as in this case, by naming as beneficiary a trust whose terms direct distribution of the trust assets to the personal representative, if requested.

After the Settlor's death, the Trustee filed a petition requesting a determination that life insurance proceeds payable to the trust were exempt from all "death obligations' and unavailable to the creditors of the Settlor's estate.

The Court held that F.S. 773.801(1) makes it clear that life insurance proceeds payable to a trust "shall be held and disposed of by the trustee in accordance with the terms of the trust as they appear in writing on the date of death of the insured..."

So notwithstanding the Trustee’s reliance on the first sentence of F.S. 222.13(1),

> [“Whenever any person residing in the state shall die leaving insurance on his or her life, the said insurance shall inure exclusively to the benefit of the person for whose use and benefit such insurance is designated in the policy, and the proceeds thereof shall be exempt from the claims of creditors of the insured unless the insurance policy or a valid assignment thereof provides otherwise”]

the Court relies upon the second sentence of F.S. 222.13(1)

> ["Notwithstanding the foregoing, **whenever the insurance, by designation or otherwise, is payable to the insured or to the insured's estate or to his or her executors, administrators, or assigns, the insurance proceeds shall become a part of the insured's estate for all purposes and shall be administered** by the personal representative of the estate of the insured in accordance with the probate laws of the state **in like manner as other assets of the insured's estate**."]

to conclude that because the exemption from the decedent insured's creditors is available for life insurance policy proceeds, it does not require the policy's owner to take advantage of the exemption. In other words, the exemption rendering life insurance policy proceeds unavailable to satisfy estate obligations can be waived. Reading F.S. 222.13(1) in its entirety, life insurance proceeds are not prohibited from paying the insured's estate's debts and other "death obligations", nor does it prohibit directing payment of policy benefits to a trust for that purpose.

Therefore, an owner of an insurance policy may waive the F.S. 222.13(1) exemption by designating the insured or one or more of the insured’s creditors as a beneficiary or beneficiaries, by naming the insured’s estate as a beneficiary of the policy, or, as in this case, by naming as beneficiary a trust whose terms specifically direct distribution of the trust assets to the personal representative, if requested.

A bill to be entitled "Waiver of Exemption Applicable to Death Benefits".

An act modifying s. 733.808 and 736.05053 relating to the waiver of the exemption of creditors' claims to certain death benefits.

Section 1. Section 733.808 (4) is amended to read:

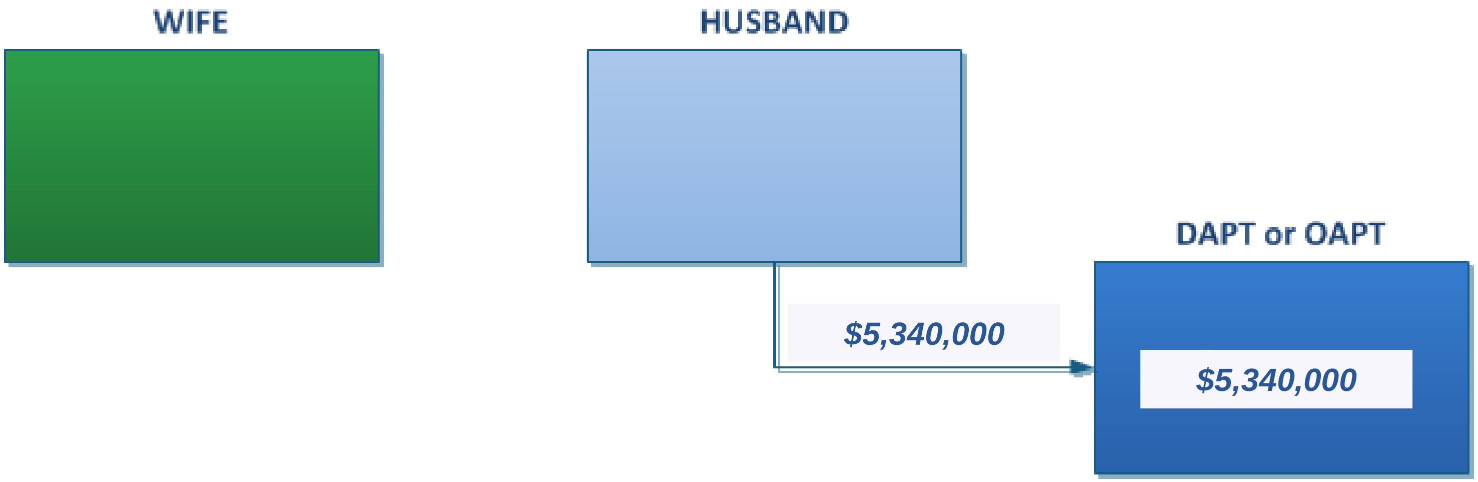
(4) Unless the trust agreement, declaration of trust or will expressly provides that this subsection does not apply, death benefits payable as provided in subsection (1), subsection (2), or subsection (3), unless paid to a personal representative under the provisions of subsection (3), shall not be deemed to be part of the decedent's estate, and shall not be subject to any obligation to pay the expenses of the administration and obligations of the decedent's estate or for contribution required from a trust under s. 733.607(2) to any greater extent that if the proceeds were payable directly to the beneficiaries named in the trust.

Section 2. Section 736.05053(1) is amended to read:

736.05053 Trustee's duty to pay expenses and obligations of settlor's estate.-

(1) A trustee of a trust described in s. 733.707(3) shall pay to the personal representative of a settlor's estate any amounts that the personal representative certifies in writing to the trustee are required to pay the expenses of the administration and obligations of the settlor's estate. Payments made by a trustee, unless otherwise provided in the trust instrument, must be charged as expenses of the trust without a contribution from anyone. The interests of all beneficiaries of such a trust are subject to the provisions of this subsection; however the payments must be made from assets, property, or the proceeds of the assets or property that are included in the settlor's gross estate for federal estate tax purposes, and may not be made from, (a) assets proscribed in s. 733.707(3), and (b) death benefits payable as provided in subsection (1), subsection (2) or subsection (3) of s. 733.808, unless the trust instrument expressly directs that s. 733.808(4) does not apply.

Self-Settled Spendthrift Trust



1. Income to husband, wife and issue in Trustee's discretion
2. Principal to husband, wife and issue in Trustee's discretion
3. Upon husband's death, Trust continues for wife and issue

Treas. Reg. § 301.7701-4(a) provides:

" ... the term "trust" as used in the Internal Revenue Code refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property ***for the purpose of protecting or conserving it for the beneficiaries*** under the ordinary rules applied in chancery or probate courts. Usually the beneficiaries of such a trust do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. However, the ***beneficiaries of such a trust may be the persons who create it and it will be recognized as a trust under the Internal Revenue Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries*** who stand in the same relation to the trust as they would if the trust had been created by others for them.

Treasury Reg. Section 25.2511-2(b) provides that a gift is complete if the donor “has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another… .”

Courts have consistently held that gifts to self-settled spendthrift trusts are not complete in jurisdictions that allow a settlor's creditors to reach the maximum amount that the trustee could distribute to the settlor. These courts reasoned that the settlor retained a beneficial interest in the assets because the settlor could incur debt, and the settlor's creditors could reach the trust assets to satisfy these obligations. Another way to describe the courts' view is that the settlor, indirectly, has retained the economic access to the trust assets through "running up" dept.

See, e.g., Commissioner v. Vander Weele, 254 F.2d 895 (6th Cir. 1958); *Outwin v. Commissioner*, 76 T.C. 153 (1981); *Estate of Paxton v. Commissioner*, 86 T.C. 785 (1986*); In re Estate of Uh*l, 241 F2nd 867 (7th Cir. 1957) (the settlors' retained rights under local law was viewed as a retention of the economic benefit and enjoyment of the entire trust income and corpus because the trust assets could be relegated to the settlors' creditors).

The IRS reached a similar result in Revenue Ruling 76-103 (1976-1 C.B. 293), holding that a transfer to a self-settled spendthrift trust was an incomplete gift because local law subjected the entire property of the trust to the claims of the grantor's creditors whenever such claims arose. Thus, when determining whether a transfer is a completed gift, the focus of the IRS and the courts is on whether the settlor's creditors ***could*** have reached the discretionary income or principal distributable to the settlor/beneficiary.

“[I]f the grantor dies before the gift becomes complete, the date of death value of the trust corpus will be includible in the grantor’s gross estate, for Federal estate tax purposes, under section 2038 of the Code because of the grantor’s retained power to, in effect, terminate the trust by relegating the grantor’s creditors to the entire property of the trust. Because inclusion in the grantor’s gross estate was premised upon **the grantor’s power to relegate his or her creditors to the assets of the trust**, it seems to follow logically that inclusion is not appropriate if the grantor cannot ‘relegate’ his or her creditors to the trust assets.”

IRC Section 2036 applies because the settlor has retained the enjoyment of, and income from, the property by the settlor’s ability to “run-up” debt that the settlor’s creditors may satisfy from trust assets.

IRC Section 2038 applies because the ability to relegate creditors to the trust assets is equivalent to the settlor's power to revoke the transfer of assets to the trust.

Utah Code Ann. § 25-6-14

Private letter Ruling 200944002 recites that, under state law, if the trust contains a transfer restriction (which the trust does), it is not subject to the claims of the grantor's creditors unless:

1. the grantor may revoke or terminate the trust,
2. the grantor is intending when the transfer of property is made to the trust to defraud a creditor,
3. the grantor is in default of child support payments by 30 days at the trust's inception, or
4. the trust requires that income or corpus be distributed to the grantor.

Utah Code Ann. § 25-6-14

5. the claim is for a payment owed by a settlor under a **child support judgment or order**;
6. the transfer is made when the settlor is insolvent or the transfer renders the settlor insolvent;
7. the claim is for **recovery of public assistance received** by the settlor allowed under Title 26, Chapter 19, Medical Benefits Recovery Act;
8. the claim is **a tax or other amount owed by the settlor** to any governmental entity;
9. the claim is **by a spouse or former spouse of the settlor** on account of an agreement or order for the payment of support or alimony or for a division or distribution of property;

12 Del, C. § 3573(2010)

1. § 3573. Limitations on qualified dispositions
   a. With respect to the limitations imposed by § 3572 of this title, those limitations on actions by creditors to avoid a qualified disposition shall not apply:
      i. To any person to whom the transferor is indebted on account of an agreement or order of court **for the payment of support or alimony** in favor of such transferor's spouse, former spouse or children, or for a division or distribution of property in favor of such transferor's spouse or former spouse, but only to the extent of such debt; or

12 Del, C. § 3573(2010)

a. With respect to the limitations imposed by § 3572 of this title, those limitations on actions by creditors to avoid a qualified disposition shall not apply: (continued)

   ii. To any person who suffers death, personal injury or property damage on or before the date of a qualified disposition by a transferor, which death, personal injury or property damage is at any time determined to have been caused in whole or in part by the tortious act or omission of either such transferor or by another person for whom such transferor is or was vicariously liable but only to the extent of such claim against such transferor or other person for whom such transferor is or was vicariously liable.

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Alaska Stat. §34.40.110

1. If a trust has a transfer restriction allowed under (a) of this section, in the event of the divorce or dissolution of the marriage of a beneficiary of the trust, the beneficiary's interest in the trust is not considered property subject to division under AS 25.24.160 or 25.24.230 or a part of a property division under AS 25.24.160 or 25.24.230. Unless other-wise agreed to in writing by the parties to the marriage, this subsection does not apply to a settlor's interest in a self-settled trust with respect to assets transferred to the trust
   a. **after the settlor's marriage**; or
   b. **within 30 days before the settlor's marriage** unless the settlor gives written notice to the other party to the marriage of the transfer.

“Acts of Independent Significance” are actions by a settlor that allegedly will not produce an adverse transfer-tax result. In these situations, authorities recognize that settlors will not engage in such acts to regain control over trust property. Acts of Independent Significance include divorce or legal separation, and the failure to support a spouse, as well as the ability to have or adopt children. Similarly, Regs. § 1.664-3 provides that the divorce of the beneficiary of a CRUT is an event “whose occurrence is not discretionary with, or within the control of, the trustees or any other persons and that such a divorce is a triggering event permitting an income-only CRUT to ‘flip’ to a standard CRUT”.

However, contrast Revenue Ruling 76-103 (infra) in which the focus was on whether the settlor’s creditors ***could*** have reached the discretionary income or principal distributable to the settlor/beneficiary

Savings Clauses v. Formula Clauses

“[I]t is agreed by all the parties hereto that in that event the excess property hereby transferred which is decreed by such court to be subject to gift tax, shall automatically be deemed not to be included in the conveyance in trust hereunder and shall remain the sole property of [the taxpayer].”

Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944)

In *McCord v. Commissioner*, 120 T.C. 358, 365 (2003), revd. 461 F.3d 614 (5th Cir. 2006), the Tax Court decided a case in which transfer documents specified that the children of the taxpayer should receive a gift having a "fair market value" of $ 6,910,933; anything in excess of that up to $ 134,000 would go to a local symphony, and all the rest would go to the Communities Foundation of Texas, Inc. The donees allocated the shares amongst themselves, and they applied a large discount. In a divided opinion, the Court found that the value of the gift was higher than the original appraisal. The Court also held that the formula did not reallocate the shares later, but worked only to allocate shares on the basis of the parties' estimate of their value at the time of the gift rather than later on. The Court did not find it necessary to consider Procter.

“To reach a reasonable conclusion in this case, we start with two maxims of gift-tax law: A gift is valued as of the time it is completed, and later events are off limits.” *Ithaca Trust Co. v. United States*, 279 U.S. 151,155, 49 S. Ct. 291, 73 L. Ed. 647, 67 Ct. Cl. 714, 1929-1 C.B. 313 (1929). And gift tax is computed at the value of what the donor gives, not what the donee receives. *Id*.

The Fifth Circuit held in *McCord* that what the tax-payer had given was a certain amount of property; and that the appraisal and subsequent translation of dollar values (what the donor gave each donee) into fractional interests in the gift (what the donees got) was a later event that a court should not consider. 461 F.3d at 627. In *Christiansen*, we also found that the later audit did not change what the donor had given, but instead triggered final allocation of the shares that the donees received. 130 T.C. at 15. The distinction is between a donor who gives away a fixed set of rights with uncertain value -- that’s *Christiansen* -- and a donor who tries to take property back -- that’s *Procter*. The *Christiansen* formula was sufficiently different from the *Procter* formula that we held it did not raise the same policy problems.

A shorthand for this distinction is that savings clauses are void, but formula clauses are fine.

***ESTATE OF ANNE Y. PETTER, DECEASED, TERRENCE D. PETTER, PERSONAL REPRESENTATIVE, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent*, T.C. Memo 2009-280; 2009 Tax Ct. Memo LEXIS 285; 98 T.C.M. (CCH) 534 December 7, 2009, Filed**

JOANNE M. WANDRY, DONOR, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent; ALBERT D. WANDRY, a.k.a. A. DEAN WANDRY, DONOR, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent, **T.C. Memo 2012-88; 2012 Tax Ct. Memo LEXIS 89; 103 T.C.M. (CCH) 1472 March 26, 2012, Filed**

"I hereby assign and transfer as gifts, effective as of January 1, 2004, a sufficient number of my Units as a Member of Norseman Capital, LLC, a Colorado limited liability company, so that the fair market value of such Units for federal gift tax purposes shall be as follows:

Name	Gift Amount
Kenneth D. Wandry	$261,000
Cynthia A. Wandry	261,000
Jason K. Wandry	261,000
Jared S. Wandry	261,000
Grandchild A	11,000
Grandchild B	11,000
Grandchild C	11,000
Grandchild D	11,000
Grandchild E	11,000
	1,099,000

Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service (“IRS”). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if, after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law.”

The court held it is inconsequential that the adjustment clause reallocates membership units among petitioners and the donees rather than a charitable organization because the reallocations do not alter the transfers. On January 1, 2004, each donee was entitled to a predefined Norseman percentage interest expressed through a formula. The gift documents do not allow for petitioners to “take property back”. Rather, the gift documents correct the allocation of Norseman membership units among petitioners and the donees because the K&W report understated Norseman’s value. The clauses at issue are valid formula clauses.

Adequate Disclosure Regulations

IRC §6501(c)(9)

(9) Gift Tax on Certain Gifts Not Shown on Return. —If any gift of property the value of which (or any increase in taxable gifts required under section 2701(d) which) is required to be shown on a return of tax imposed by chapter 12 (without regard to section 2503(b)), and is not shown on such return, any tax imposed by chapter 12 on such gift may be assessed, or a proceeding in court for the collection of such tax may be begun *without assessment, at any time*. The preceding sentence shall *not apply to any item which is disclosed in such return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature of such item*.

Duane Morris

Treasury Regulation §301.6501(c)-1(f)

A. REQUIRED BASIC INFORMATION

If a transfer of property is not adequately disclosed on a gift tax return, the statute of limitations does not begin to run. (For split gifts, the gift made by the consenting spouse is considered adequately disclosed if the return filed by the donor spouse satisfies the adequate disclosure rules.)

In order to meet the adequate disclosure rules, the following basic information is required to be submitted on the return (or a statement attached to it) describing each gift:

1. A description of the transferred property.
[Treasury Regulation Section 301.6501(c)-1(f)(2)(i)]
2. A description of any consideration received by the transferor of the property.
[Treasury Regulation Section 301.6501(c)-1(f)(2)(i)]
3. The identity of the transferor and each transferee, and the relationship between them.
[Treasury Regulation Section 301.6501(c)-1(f)(2)(ii)]
4. For a gift in trust, the trust's taxpayer identification number and either a copy of the trust instrument or "a brief description of the trust terms".
[Treasury Regulation Section 301.6501(c)-1(f)(2)(iii)]
5. The identification of "any position taken that is contrary to" any Proposed, Temporary, or Final Treasury Regulation or Revenue Ruling published at the time of the transfer.
[Treasury Regulation Section 301.6501(c)-1(f)(2)(v)]

Treasury Regulation §301.6501(c)-1(f)

B. ADDITIONAL DISCLOSURES

The "Required Basic Information" (above) applies to all gifts. Additional disclosures may apply to certain types of gifts. To determine the extent of additional disclosures required, check one of the following:

1. Cash Gift: Stop here-no further disclosures are required.
2. Gift of Marketable Securities: Skip to "Description Safe Harbor Alternative #1 -- For Gifts of Marketable Securities".
3. Gift of Property other than Cash or Marketable Securities: In addition to the above "Required Basic Information", either the "Appraisal Safe Harbor" or the "Description Safe Harbor Alternative #2-For Gifts of Property Other than Marketable Securities" must be satisfied.

C. DESCRIPTION SAFE HARBOR

[Treasury Regulation Section 301.6501(c)-1(f)(2)(iv)]

The Description Safe Harbor is satisfied if, in addition to the above "Required Basic Information", the donor submits with the gift tax return a "detailed description of the method used to determine the fair market value of the property transferred". An appraisal is not needed, which will make the Description Safe Harbor especially attractive for relatively small transfers, such as annual-exclusive on gifts, where the methodology might be to simply apply the analysis of a recent appraisal to current financial data.

Treasury Regulation §301.6501(c)-1(f)

1. Description Safe Harbor Alternative #1-For Gifts of Marketable Securities:
   [See Treasury Regulation Section 301.6501(c)-1(f)(2)(iv); Treasury Regulation Section 301.6501(c)-1(f)(7), ex. 1]

   In the case of the transfer of an interest that is actively traded on an established exchange, a recitation of the following information will be deemed to satisfy the requirement of "a detailed description of the method used.":

   a. State that the stock is publicly traded, and specify the name of the exchange (i.e., New York Stock Exchange; American Stock Exchange; NASDAQ National Market; or name of regional exchange in which quotations are published on a daily basis, including recognized foreign exchanges).

   b. The CUSIP number of the security.

   c. Specify the date of the transfer, and list the mean between the highest and lowest quoted selling prices on the applicable valuation date.

2. Description Safe Harbor Alternative #2-For Gifts of Property Other than Marketable Securities:

   For gifts of property other than marketable securities, the "detailed description of the method used to determine the fair market value of the property transferred" must include the following information.

   a. The financial data used in valuing the transferred property (such as balance sheets, etc., with explanations of any adjustments).

   b. Any restrictions on the transferred property that were considered in determining its fair market value.

   c. A description of any discounts claimed (such as discounts for blockage; minority or fractional interests; and/or lack of marketability) and how the discounts were determined.

Treasury Regulation §301.6501(c)-1(f)

d. For a gift of an interest in an entity such as a corporation or partnership that is not actively traded, a description of any discounts claimed in valuing any assets owned by the entity (as well as any discounts claimed in valuing the transferred interest itself).

e. For a transfer of an interest in an entity properly valued with reference to the value of the assets held by the entity, a statement regarding the undiscounted fair market value of 100 percent of the entity; the pro rata portion of the entity subject to the transfer; and, the fair market value of the transferred property as reported on the return. (Note: If 100 percent of the value of the entity is not disclosed, the taxpayer bears the burden of demonstrating that the fair market value of the entity is properly determined by a method other than a method based on the net value of the assets held by the entity.)

f. For a transfer of an interest in a non-actively-traded entity that itself directly or indirectly owns an interest in another non-actively-traded entity, a detailed description of the method used to determine the fair market value of that owned interest, including all the foregoing information, if the information is "relevant and material" in determining the value of the interest.

D. APPRAISAL SAFE HARBOR

The Appraisal Safe Harbor is satisfied if, in addition to the above "Required Basic Information," the donor submits an appraisal of the transferred property which meets the requirements set out in the Treasury Regulations.

Treasury Regulation §301.6501(c)-1(f)

1. The appraisal must be prepared by an appraiser who satisfies the following requirements:
   a. The appraiser is an individual who holds himself or herself out to the public as an appraiser, or who regularly performs appraisals.
   [Treasury Regulation Section 301.6501(c)-(f)(3)(i)(A)]
   b. The appraiser is qualified by background, experience, education, and professional memberships (if any) in professional appraisal associations to appraise the type of property involved.
   [Treasury Regulation Section 301.6501(c)-1(f)(3)(i)(B)]
   c. The appraiser is not the transferor or transferee (or a member of the family of the transferor of transferee, or a person employed by any such individual).
   [Treasury Regulation Section 301.6501(c)-1(f)(3)(i)(C)]
2. The submitted appraisal must contain the following information:
   a. A description of the appraiser's qualifications that details the appraiser's background, experience, education, and professional memberships (if any).
   [Treasury Regulation Section 301.6501(c)-1(f)(3)(i)(B)]
   b. The date of the transfer (i.e., the "as of" date of the appraisal) and the date the property was appraised.
   [Treasury Regulation Section 301.6501(c)-1(f)(3)(ii)(A)]
   c. The purpose of the appraisal. (Note: The usual recital of a purpose "to determine the fair market value of the property for gift tax purposes" should be sufficient.)
   [Treasury Regulation Section 301.6501(c)-1(f)(3)(ii)(A)]

Treasury Regulation §301.6501(c)-1(f)

d. A description of the property.
[Treasury Regulation Section 301.6501(c)-1(f)(3)(ii)(B)]

e. A description of the appraisal process employed.
[Treasury Regulation Section 301.6501(c)-1(f)(3)(ii)(C)]

f. A description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the appraiser's analyses, opinions, and conclusions.
[Treasury Regulation Section 301.6501(c)-1(f)(3)(ii)(D)]

g. The information considered in determining the appraised value. In the case of "an ownership interest in a business," the appraisal should include "all financial data that was used in determining the value of the interest that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value." (Note: If the Appraisal Safe Harbor is to be relied upon, every judgment made by the appraiser that affects his or her use of financial data should be made explicit in the appraisal.)
[Treasury Regulation Section 301.6501(c)-1(f)(3)(ii)(E)]

h. The appraisal procedures followed, and the reasoning that supports the appraiser's analyses, opinions, and conclusions.
[Treasury Regulation Section 301.6501(c)-1(f)(3)(ii)(F)]

i. The valuation method utilized, the rationale for that valuation method, and the procedure used in determining the fair market value.
[Treasury Regulation 301.6501(c)-1(f)(3)(ii)(G)]

j. The specific basis for the valuation. (Note: examples given are: "specific comparable sales or transactions; sales of similar interests; asset-based approaches; merger-acquisition transactions, etc.")
[Treasury Regulation Section 301.6501(c)-1(f)(3)(ii)(H)]

Thank You!