# Petter v. Commissioner, T.C. Memo. 2009-280 (Dec. 7, 2009)

**Defined Value Clause Upheld; "One-Two Punch" to IRS's Fight Against Defined Value Clauses**

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**Steve R. Akers**
**Bessemer Trust**
**300 Crescent Court, Suite 800**
**Dallas, Texas 75201**
**214-981-9407**
**akers@bessemer.com**
**www.bessemertrust.com**

## Synopsis

On the heels of the IRS's loss in Christiansen (the Eighth Circuit Court of Appeals case that rejected the IRS's public policy argument against a formula disclaimer that operated much like defined value clauses) comes a resounding rejection of the IRS's public policy arguments against defined value clauses in Petter v. Commissioner. The "one-two" punch of Christiansen and Petter, rejecting the IRS's vehement objections to these types of clauses, may represent the most important estate planning development in 2009. These types of clauses have been used for years, but we have been waiting for years for cases to address the IRS's public policy objection to the clauses.

Petter involves classic inter vivos gifts and sales to grantor trusts using defined value clauses that have the effect of limiting gift tax exposure. The gift document assigned a block of units in an LLC and allocated them first to the grantor trusts up to the maximum amount that could pass free of gift tax, with the balance being allocated to charities. The sale document assigned a much larger block of units, allocating the first $4,085,190 of value to each of the grantor trusts (for which each trust gave a 20-year secured note in that same face amount) and allocating the balance to charities. The units were initially allocated based on values of the units as provided in an appraisal by a reputable independent appraiser. The IRS maintained that a lower discount should be applied, and that the initial allocation was based on inappropriate low values. The IRS and the taxpayer eventually agreed on applying a 35% discount, and the primary issue is whether the IRS is correct in refusing on public policy grounds to respect formula allocation provisions for gift tax purposes. The court held that the formula allocation provision does not violate public policy and allowed a gift tax charitable deduction in the year of the original transfer for the full value that ultimately passed to charity based on values as finally determined for gift tax purposes.

## Basic Facts

1. Mother wanted to transfer value from UPS stock that she inherited from her uncle to two of her children (the third child was disabled and she made other provisions for him) and to give some value to charity. She also wanted her two children to learn how to manage the family's assets.
2. In mid-2001, Mother transferred her UPS stock, worth $22.6 million, to an LLC. There were three classes of units. Mother (Anne) was manager of the A units, the daughter (Donna) was manager of the D units, and the son (Terry) was manager of the T units. Management decisions were made by a majority of the three managers, but the manager of the A units (i.e., Mother) had a veto power over all corporate decisions.
3. In late 2001, Mother established grantor trusts for the two children, with each child serving as trustee of his or her trust. (The grantor trust trigger power was the power of the trustee to purchase and pay premiums on life insurance on Mother's life, which caused §677(a)(3) to apply. Apparently, the IRS did not contest that this power caused the trust to be a grantor trust, but this was not an issue addressed by the case.)
4. In March 2002, Mother made gifts and sales to the grantor trusts, so that the gifts reflected about 10% of the trust assets. (The attorney indicated that he believed that, as a rule of thumb, a "trust capitalized with a gift of at least 10% of its assets would be viewed by the IRS as a legitimate, arms-length purchaser in the later sale.") The gift and sale transactions were implemented by formula transfers, described in Items 5 and 6 below. Donor advised funds of Communities Foundations (hereafter the "foundations") received some of the assigned units and counsel for one of the Communities Foundations negotiated to revise some of the terms of the assignment documents, including clarification that the foundations would become substituted members rather than "assignees" of the LLCs.

5. On March 22, 2002, Mother gave 940 units in the LLC to each of the children's separate trusts and to the foundations. The assignment documents allocated the assigned block by formula:

   "Transferor …

   1.1.1 assigns to the Trust as a gift the number of Units described in Recital C above that equals one-half of the minimum [the Court observed that this was a scrivener's error and this was meant to be "maximum" instead of "minimum"] dollar amount that can pass free of federal gift tax by reason of Transferor's applicable exclusion amount allowed by Code Section 2010(c). Transferor currently understands her unused applicable exclusion amount to be $907,820, so that the amount of this gift should be $453,910; and

   1.1.2 assigns to The Seattle Foundation as a gift to the A.Y. Petter Family Advised Fund of The Seattle Foundation the difference between the total number of Units described in Recital C above and the number of Units assigned to the Trust in Section 1.1.1."

   There was also a reallocation provision in the assignment documents. Each party agreed to transfer units to the other if a party initially received more units than it was entitled to receive based on values "as finally determined for federal gift tax purposes."

6. Three days later, on March 25, 2002, Mother transferred 8,459 LLC units in two separate transactions for each of the two grantor trusts and the foundations. The assignment document allocated the units by formula, with the trusts receiving units worth $4,085,190 "as finally determined for federal gift tax purposes," and allocated the excess units to charitable foundations. In return for the assignments to the two respective trusts, they each gave Mother a 20-year $4,085,190 secured note with quarterly amortized payments. There were reallocation provisions if either party received more than its appropriate number of units after the value was "finally determined." (The pledge agreements contained a provision to adjust the number of pledged units if the "net fair market value has been incorrectly determined.")

7. On April 15, 2002, a formal appraisal valued the units, applying a 53.2% discount. Based on that appraisal, the attorney allocated the units among the parties to the gift and sale transactions. (The case does not indicate whether the trusts and foundations reviewed the appraisal or consented to allocations based on the appraised value.)

8. In August 2003, Mother filed a gift tax return reporting the gift and sale transactions. The return described the formula transfers and included copies of detailed documentation for all of the entities and transactions.

9. The IRS audited the gift tax return and increased the value of the units, determining that a 29.2% discount was appropriate. Furthermore, the IRS took the position that the reallocation clause would not be respected for tax purposes, even if additional units were allocated to the foundations under the formula allocation provisions. Therefore, the IRS did not allow any gift tax charitable deduction for the additional units that were passed to charities based on this valuation (but it did allow an additional charitable deduction for the increased value of the units that were allocated to the foundations under the initial allocation based on the April 15, 2002 appraisal).

10. Mother (or her estate, she died during pendency of this action) filed a petition with the Tax Court. The IRS and taxpayer agreed on a value using a 35% discount. There were no factual disputes in the case, and the only unresolved issues were whether the formula allocation is respected for gift tax purposes, and whether the increased gift tax charitable deduction is allowed in the year of the original transfer.

## Holding

1. The formula allocation provisions are not "void as contrary to public policy, as there was no 'severe and immediate' frustration of public policy as a result, and indeed no overarching public policy against these types of arrangements in the first place."

2. A gift tax charitable deduction is allowed for the year of the original transfer rather than in a later year when the reallocation was made after the value for federal gift tax purposes was finally determined. This result is appropriate because "[r]egardless of what might trigger a reallocation, Anne's transfer could not be undone by any subsequent events."

## Analysis

1. IRS's Argument That Donor Gave a Specific Number of Shares Is Rejected. The IRS argued [rather lamely] that Mother actually gave daughter a particular number of shares. The court responded that the plain language of the documents shows that Mother made transfers to the trusts of an ascertainable dollar value, not a specific number of shares.

2. Historical Review of "Savings Clause" Cases. The court summarizes a brief overview of 65 years of case law dealing with "savings clauses," beginning with the Second Circuit's 1944 Procter decision and ending with the Eighth Circuit's recent Christiansen decision. In Procter, the Second Circuit addressed a transfer providing that "any excess property... decreed by the court to be subject to gift tax shall automatically be deemed not to be included in the conveyance." The court refused to give effect to the "savings clause" because (1) it created a condition subsequent and (2) it violated public policy because (a) it discouraged the collection of tax, (b) it obstructed justice by requiring the court to pass on a moot case, and (c) it caused any court opinion to be a mere declaratory judgment.

   The court's review of the cases ends with Christiansen, in which a formula disclaimer (with the excess passing to charity) was found not to violate public policy in a unanimous decision (as to that issue) by the Tax Court, which the Eighth Circuit affirmed. The court begins its application of this historical review and the differences between Procter and Christiansen (in a section of the opinion captioned "Drawing the Line") by observing 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 (1929). And gift tax is computed at the value of what the donor gives, not what the donee receives. Id.

   The court draws a distinction between Procter-type clauses and Christiansen-type clauses:

   > "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."

3. Supreme Court Case Restricting Public Policy Argument. The court pointed repeatedly in its analysis to a U.S. Supreme Court case restricting public policy exceptions to the Internal Revenue Code:

   > "We also found that the public-policy arguments were undermined in Commissioner v. Tellier, 383 U.S. 687, 694 (1966), where the Supreme Court warned against invoking public-policy exceptions to the Code too freely. The 'frustration [of public-policy] that would be caused by allowing the contested deduction must be severe and immediate.'"

4. Public Policy Analysis. The court discusses four major reasons that the gift and sale transactions with the trusts and foundations by formula allocation do not violate public policy.

   a. General Public Policy Encourages Charitable Gifts. The general public policy encourages gifts to charities. The court detailed the ways in which the charitable foundations were "sticking up for their interests and not just passively helping a putative donor reduced her tax bill."

      > "Anne's gift made the charities equal members in the PFLLC, giving to charities power to protect their interests through suits for breach of the operating agreement or breach of a manager's fiduciary duties, as well as for the right to vote on questions such as amending the operating agreement and adding new members. These features leave us confident that this gift was made in good faith and in keeping with Congress's overall policy of encouraging gifts to charities."

   b. Other "Potential Sources of Enforcement." The gifts were not as susceptible to abuse as the IRS maintains. The court points to various factors suggesting that the allocation clauses would be implemented fairly.

      (i) The terms of the transfer documents made the LLC managers fiduciaries for the foundations, and they could police the trusts for "shady dealing." [The court did not fully explain this reason, particularly in light of the fact that the daughter and son were also the trustees of the trusts they would be "policing" as managers of the LLC. However, because the daughter and son were managers of their respective units and also trustees and beneficiaries of the trusts, they owed a high "duty of loyalty and duty of care" to the members (including the foundations), preventing them "from engaging in grossly negligent or reckless conduct, intentional misconduct, or knowing violations of the law."]

      (ii) The directors of the foundations "owed fiduciary duties to their organizations to make sure that the appraisal was acceptable before signing off on the gift — they also had a duty to bring a lawsuit if they later found out that the appraisal was wrong." [**Observe:** this is factually inconsistent under the facts of this case — the foundations signed the assignment documents before the appraisal was secured. However the facts are not clear, and perhaps the foundations were given the opportunity to "sign off" on the appraisal before the units were initially allocated.]

      The court acknowledged the issue of a recipient not wanting to alienate a donor. However, it observes that the transfers were irrevocable and that any lawsuits by a foundation would be against the trusts, not the donor.

      (iii) The IRS Commissioner could revoke the foundations' 501(c)(3) exempt status "if he found they were acting in cahoots with a tax-dodging donor."

      (iv) The state attorney general "is charged with enforcing charities' rights."

      Taxpayers are not using these clauses just to avoid tax. (Indeed, the court observed that at the time of trial the taxpayer was in the process of reallocating units based on the agreed value.) Because of these enforcement mechanisms, "[w]e certainly don't find that these kinds of formulas would cause severe and immediate frustration of the public policy in favor of promoting tax audits. See Tellier, 383 U.S. at 694."

   c. Mootness and Declaratory Judgment Concerns Rejected. The court reasoned that the second and third public policy reasons cited by Procter similarly do not rise to the level of

a "severe and immediate" threat to public policy. This case does not involve a moot issue because a judgment regarding the gift tax value would trigger a reallocation, and therefore it is not just a declaratory judgment.

d. Existence of Other Sanctioned Formula Clauses Suggests No General Public Policy Against Formula Clauses. The court pointed to various other formula clauses that have been sanctioned by regulations (formula descriptions of annuity amounts for charitable remainder annuity trusts, formula marital deduction clauses in wills, formula GST exemption allocations, formula disclaimers of the "smallest amount which will allow A's estate to pass free of Federal estate tax," and formula descriptions of annuity amounts in grantor retained annuity trusts). Therefore, there cannot be a general public policy against formula provisions.

The IRS tried to distinguish those other similar clauses because money passing under them will not escape taxation (if they result in assets remaining with the donor or assets passing to a spouse in which event they would be subject to estate tax in the donor's or spouse's estate). However, the court observed that is not always true, such as with formula provisions in charitable remainder trusts where the corpus of the trust will pass to charity tax-free. The IRS also tried to distinguish the other similar clauses as involving the assignment of a fixed percentage or fraction of value rather than an open ended amount exceeding a certain dollar amount. The court dismissed that as a mere semantics matter, and noted that the "children's gifts and sales were capped at the dollar amounts set in the transfer documents."

e. Summary of Public Policy Analysis.

> "In summary, Anne's transfers, when evaluated at the time she made them, amounted to gifts of an aggregate and set number of units, to be divided at a later date based on appraised values. The formulas used to effect these transfers were not void as contrary to public policy, as there was no 'severe and immediate' frustration of public policy as a result, and indeed no overarching public policy against these types of arrangements in the first place."

[**Observe:** The statement that the units were to be divided at a later date based on appraised values is an oversimplification; under the documents, the units were to be divided at a later date based on values as finally determined for federal gift tax purposes.]

5. Timing of Deduction; Allowed in Year of Original Transfer. The IRS argued that a gift tax charitable deduction should not be allowed for the year of the original gift/sale transactions with respect to the value of the additional units that passed to the foundations when the units were reallocated using the finally determined gift tax value. The court viewed this as a "difficult question," but did not address the practical impact if it had agreed with the IRS. [**Observation:** Under the IRS's approach, ostensibly a gift tax charitable deduction would be allowed in the later year of the actual reallocation, but what if the donor did not make gifts in that subsequent year that could be offset by those deductions? Furthermore, how can a gift tax charitable deduction be allowed as a result of assets passing to charity other than items listed as gifts on that year's gift tax return? If the court had ruled for the IRS on this timing issue, the practical impact may have been to deny totally the effectiveness of the defined value clause.]

The court analogized to §25.2511-2(a) of the gift tax regulations, providing that a gift is not necessarily determined by the measure of the donee's enrichment. Similarly, a donor's tax treatment should not change because of a later discovery of the true measure of enhancement by

the two parties, one of whom is a charity. Furthermore, "[r]egardless of what might trigger a reallocation, Anne's transfer could not be undone by any subsequent events." Finally, the fact that the charities "booked" the value or amounts of the units of a later date and initially "booked" a lower value did not matter; Mother "had no control over the Foundations' internal accounting practices."

### Observations

1. Judge Holmes' Writing Style. The case is wonderful to read. It reads as a primer for a first-year law student (except that it is very understandable and easy to read). For example, Judge Holmes goes out of his way to include simple descriptions of sale to grantor trust transactions and the 10% "seeding" issue, ILITs, donor advised funds, and valuation discounts. The opinion portion of the case is only about 20 pages (large font, double-spaced). It is worth reading. (The writing style is reminiscent of Judge Holmes' Hurford opinion, which also read as a primer for estate planning transfer planning strategies.)

2. Tell a Good Story. The case is like various other recent cases that have ruled in favor of taxpayers, in which the court goes out of its way to tell the story about how the taxpayer is a good person trying to do good things. For example, the court observes that after Mother inherited the stock from her uncle, she continued her job as a school teacher, and she continued to live in the same house. The court details a number of local charities that have received distributions from the donor advised funds created by these gift/sale transactions.

3. Timing: Three Weeks After Christiansen Affirmance. Petter was issued about three weeks after the Eighth Circuit's decision in Christiansen. Judge Holmes also wrote the Tax Court's majority decision in Christiansen, and one wonders if Judge Holmes was waiting to see how the Eighth Circuit would rule in Christiansen before issuing his opinion in Petter in light of the similarity of the issues.

4. Second Devastating Blow to IRS Posititon on Defined Value Clauses. After going for decades without any court review of the IRS's public policy position against "savings clauses" and, in particular, defined value clauses, there have now been two cases within about three weeks of each other rejecting the IRS's position. Petter directly addresses defined value clauses in inter vivos gift and sale transactions, and the opinion has particularly strong language rejecting the IRS's public policy position. The court specifically acknowledged that the purpose of the transfers using the defined value clauses was "to ensure that the trust did not get so much that Anne would have to pay gift tax." The court viewed the transactions very simply:

   > "We have no doubt that behind these complex transactions lay Anne's simple intent to pass on as much as she could to her children and grandchildren without having to pay gift tax, and to give the rest to charities in her community."

   The decision's final sentence regarding the public policy issue drives home the court's strong feeling about the issue:

   > "The formulas used to effect these transfers were not void as contrary to public policy, as there was no 'severe and immediate' frustration of public policy as a result, and *indeed no overarching public policy against these types of arrangements in the first place.*" [emphasis added].

   Even so, this case does not necessarily resolve all issues regarding the effectiveness of defined value clauses. But, unlike Christiansen, it does directly address the validity of inter vivos transfers using defined value clauses that have the effect of limiting gift tax exposure.

Petter is appealable to the Ninth Circuit, and there would seem to be little doubt that the IRS will appeal. (If it should lose in two circuits, would it continue to take the same position and appeal to other circuits, eventually risking having the court assess administrative and litigation costs against the IRS under §7430 for continuing to take the same position despite the prior court losses? E.g., Estate of Baird v. Comm'r, 416 F.3d 442 (5th Cir. 2005)(for continuing to maintain the undivided interest discount for real estate is limited to cost of partition); Estate of Dailey v. Comm'r, T.C. Memo 2002-301 (because of continued attacks on family partnerships under a lack of economic substance argument).)

5. General Description of Defined Value Clauses. A general description of defined value clauses may be helpful to understand the significance of the court's reasoning and of the various observations in this section of the summary.

There are two general types of defined value clauses.

a. A "formula transfer clause" limits the amount transferred (i.e., transfer of a fractional portion of an asset, with the fraction described by a formula).

An example fractional formula transfer clause (with a provision for a small gift being produced if the IRS asserts higher values for gift tax purposes) is as follows:

> "I hereby transfer to the trustees of the T Trust a fractional share of the property described on Schedule A. The numerator of the fraction is (a) $100,000 plus (b) 1% of the excess, if any, of the value of such property as finally determined for federal gift tax purposes (the 'Gift Tax Value') over $100,000. The denominator of the fraction is the Gift Tax Value of the property." McCaffrey, Tax Tuning The Estate Plan By Formula, UNIV OF MIAMI SCHOOL OF LAW PHILIP E. HECKERLING INST. ON EST. PL. ¶402.4 (1999).

b. A "formula allocation clause" allocates the amount transferred among transferees (i.e., transfer all of a particular asset, and allocate that asset among taxable and non-taxable transferees by a formula). Examples of non-taxable transferees includes charities, spouses, QTIP trusts, "incomplete gift trusts" (where there is a retained limited power of appointment or some other retained power so that the gift is not completed for federal gift tax purposes), and "zeroed-out" GRATs. With this second type of clause, the allocation can be based on values as finally determined for gift or estate tax purposes, or the allocation can be based on an agreement among the transferees as to values. For example, the McCord case used the second type of clause with the allocation being based on a "confirmation agreement" among the transferees. The two recent cases have both involved clauses that were based on finally determined estate (Christiansen) or gift (Petter) tax values.

The IRS's primary position is that these types of clauses should not be recognized for tax purposes on public policy grounds because they reduce the IRS's incentive to audit returns.

6. Brief Historical Background.

a. Commissioner v. Procter. In Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944), cert. denied, 323 U.S. 756 (1944), a transfer instrument provided that if the federal court of last resort held that any part of the transfer was subject to gift tax, the gift portion of the property "shall automatically be deemed not to be included in the conveyance in trust hereunder and shall remain the sole property of [the donor]." The Fourth Circuit Court of Appeals concluded that the provision imposed a condition subsequent to the transfer, and

that the condition subsequent violated public policy for three reasons, discussed above in Item 2 of the Analysis portion of this summary.

*Interesting aside: In Procter, the Fourth Circuit raised the public policy argument on its own. It was not argued by any of the parties.*

Several lower court cases have relied on Procter in refusing to give effect to various types of clauses that reduce the IRS's incentive to audit returns. Indeed, prior to McCord and Estate of Christiansen, the trend of the cases has been to support the Procter result. E.g., Ward v. Comm'r, 87 T.C. 78 (1986) (gift with agreement that if finally determined gift tax value was different, the number of shares transferred would be increased or decreased; court construed agreement as power to revoke and expressed concern that if no challenge took place the "excess value" would pass without tax); Harwood v. Comm'r, 82 T.C. 239 (1984), aff'd, 786 F.2d 1174 (9th Cir. 1986) (transfer of limited partnership units with provision that if value finally determined to exceed $400,000 for gift tax purposes, the trustee was to execute a note back to the donor for the "excess value"); Estate of McLendon v. Comm'r, T.C. Memo 1993-459, rev'd, 77 F.3d 447 (5th Cir. 1995) (appellate opinion does not discuss value clause; Tax Court ignored the adjustment clause, based on Procter and Ward, concluding that it would not expend "precious judicial resources to resolve the question of whether a gift resulted from the private annuity transaction only to render that issue moot").

One case that did not fall in line with this analysis was King v. United States, 545 F.2d 700, 703-04 (10th Cir. 1976), which gave effect to a "price-adjustment clause." Even in that case, though, the court emphasized that the stock that was sold was difficult to value and that the sale occurred in the ordinary course of business with no donative intent.

b. IRS Position; Revenue Ruling 86-41, Revenue Ruling 86-41, 1986-1 T.C. 300 refused to recognize two different types of valuation adjustment clauses contained in a deed of gift of real estate. The first clause provided that the transferee would reconvey to the transferor a sufficient portion of the real estate to reduce the value of the transferred interest to $1,000 as of the date of the gift. The second clause required that the transferee repay to the transferor an amount equal to the excess of the value of the property over $1,000, as determined by the IRS. The Service rejected both of those provisions as an invalid transfer subject to a condition subsequent.

c. McCord v. Commissioner; Fifth Circuit Gives Effect to Defined Value Clause But Does Not Address Public Policy Argument. McCord involves a gift made by a formula giving specified dollar amounts of limited partnership interests to trusts for children and to charities. 461 F.3d 614 (5th Cir. 2006), rev'g, 120 T.C. 358 (2003). Under an assignment by parents, children and trusts for children were to receive limited partnership interests having an aggregate fair market value of $6,910,933 and the excess was to pass to various charities. The allocation was to be based on a "confirmation agreement" among the transferees. The Fifth Circuit held that the IRS had the burden of proof, and the IRS did not meet its burden of proof to rebut values used by the taxpayers. The values of the transferred interests, for purposes of calculating gift and GST taxes, were the values used by the taxpayers (i.e., $89,505 for a 1% interest). The Tax Court erred in using the confirmation agreement to convert dollar gifts into percentage gifts. Post-gift acts of donees cannot change the value transferred on the date of the gift. The Tax Court should have applied the defined value clause under its plain wording (although the Fifth Circuit

stated that the Commissioner chose not to argue the public policy issue and the court did not explicitly consider that issue).

The Fifth Circuit opinion gave no indication whatsoever that the judges viewed the dollar amount assignment as abusive or that it raised "smell test" concerns. To the contrary, the court went out of its way to chide the Tax Court for ignoring the "plain wording" of the dollar value assignment on the basis of its perceived "olfaction." The Fifth Circuit concluded that the Tax Court majority's application of its "smell test" resulted in its failure to give effect to the dollar gifts in the assignment.

d. Christiansen v. Commissioner Recognizes Formula Disclaimer Over Public Policy Objections. The Eighth Circuit rejected the public policy argument against a formula disclaimer that had the effect of limiting the estate tax exposure of an estate regardless of what values the IRS used in the estate tax audit (as to a portion of the estate). The court gave three reasons: (1) The IRS's role is to enforce tax laws, not just maximize tax receipts; (2) there is no clear Congressional intent of a policy to maximize incentive to audit (and indeed there is a Congressional policy favoring gifts to charity); and (3) other mechanisms exist to ensure values are accurately reported. Christiansen v. Commissioner, 104 AFTR2d 2009-7352 (8th Cir. Nov. 13, 2009, corrected Nov. 18, 2009).

7. Formula Allocation Approach Favored. "Formula transfer clauses" are simpler to administer and do not require involving a third party. However, "formula allocation clauses" more squarely fall within the rationale of both Christiansen and Petter for rejecting the public policy argument, including having a third party with a fiduciary duty to police the valuation. Under Christiansen, the first reason for rejecting the public policy argument given by the Eighth Circuit (the "duty to enforce tax laws reason") applies to all defined value clauses, but the second and third reasons only apply to "formula allocation clauses" where there is a charity or someone with an interest that is adverse to a lower valuation can police the clause. The fiduciary duty rationale does not apply as strongly to a "formula transfer clause" even if the recipient is a trust, because the fiduciary has no duty to police that an excessive value is not being transferred to the trust. The sample "formula valuation clause" described in Item 5.a of this Observations section provides that the amount transferred will include 1% of any increased value from a gift tax audit. That provides one rationale for arguing that the public policy objection should not apply (because there is still some [albeit minimal] incentive to audit the return). However, the second and third reasons given by the Eighth Circuit in Estate of Christiansen for rejecting the public policy argument would not be applicable to that type of clause.

   Similarly, Petter emphasizes that there are other "potential sources for enforcement" under the allocation clause with a third party having fiduciary duties to make sure that the clause is enforced. Furthermore, the Petter opinion has language that may be viewed as drawing distinctions with formula transfer clauses. The court observed that Christiansen involved a situation in which a "later audit did not change what the donor had given, but instead triggered final allocation of the shares that the donees received." The court spoke negatively of a transaction involving "a donor who tries to take property back." The effect of a formula transfer clause is that whatever does not pass under the formula is retained by the donor, and a court might view that as a donor "taking back" property after a value is finally determined for gift tax purposes.

8. Using Values "As Finally Determined for Federal Gift Tax Purposes." As mentioned in Item 5.b above of these Observations, formula transfer clauses can be designed to be implemented based on

(1) values as finally determined for gift tax purposes, or (2) agreement of the various parties receiving the allocated assets.

In McCord, the Tax Court did not recognize a "formula allocation clause" that gave a dollar value to donees, with the excess passing to charities, and provided that the parties would agree on the number of units to be allocated to each of the parties. The formula allocation was to be implemented by agreement of the parties to the transaction, rather than being implemented based on values as finally determined for federal gift tax purposes. One advantage of the agreement approach is that actual sales or transactions are generally the best indicators of value, and that approach involves actual negotiated agreements among independent parties as to the amounts received. Another advantage is that the parties can reach finality rather quickly as to what the parties receive rather than having to wait for years for the finally determined gift tax value to determine how many units of the transferred asset each party receives.

The Tax Court held that the specific formula was not "self-effectuating." The Tax Court's reasoning is difficult to follow, but is based on the fact that the formula is not tied to values as finally determined for gift tax purposes, but fair market values as determined by the parties. Under the court's reasoning, the parties to the assignment documents were supposed to determine what interests passed to the various parties "based on the assignees' best estimation" of the value, and the court gave effect to the percentage interests agreed to by the parties. The court specifically said that if the parties had provided "that each donee had an enforceable right to a fraction of the gifted interest determined with reference to the fair market value of the gifted interest as finally determined for Federal gift tax purposes," the court "might have reached a different result." The Tax Court was reversed by the Fifth Circuit, because it viewed the Tax Court as impermissibly looking to events occurring after the sale date. The end result was that the Fifth Circuit did recognize a formula allocation clause that gave a dollar amount to donees even though it provided for funding based on the agreement of the parties. Even so, the Tax Court's rejection of that clause, suggesting that a different result may have been reached if the formula allocation was based on values as finally determined for gift tax purposes, causes planners to question whether that type of clause might be preferable.

Interestingly, both of the recent cases that have upheld the concept of defined value clauses against the IRS's public policy attack have involved clauses that based the allocation on values as finally determined for tax purposes. While the reasoning of the cases does not hinge on that fact, planners that want to most closely follow the approach of the favorable cases may tend toward using that approach.

9. Impact of Charity as "Pourover" Recipient. Christiansen and Petter both address formula clauses where the "excess amounts" pass to a charity, and some (but not all) of the reasons given for rejecting the IRS's public policy argument apply specifically where a charity is involved. For example, Petter cites a general public policy favoring charitable gifts and some of the other enforcement mechanisms mentioned in Petter include the ability of the IRS Commissioner to revoke the 501(c)(3) exempt status of the charity and the state attorney general's possible involvement on behalf of charities. However, some of the other enforcement mechanisms mentioned in Petter could apply whenever a fiduciary is involved to make sure that its entity is receiving the appropriate amount under the formula clause. Accordingly, it is not critical that a charity be involved to come within the rationale of the cases, but using a charity follows the facts of the cases more closely, and all of the rationales given by those cases would apply, whereas some of the reasons given in those cases would not apply if charities are not involved. Of course, the

donor must have charitable intent and recognize that significant assets may pass to the charities under a formula allocation clause with the excess passing to charity.

10. Grantor Trust Trigger Power — Power to Pay Life Insurance Premiums. In Petter the grantor trust trigger power was the power of the trustee to purchase and pay premiums on life insurance on the grantor's life, which caused §677(a)(3) to apply. Apparently, the IRS did not contest that this power caused the trust to be a grantor trust, but this was not an issue addressed by the case.

    In other cases, the IRS has questioned whether the mere power to purchase life insurance on the grantor's life and pay premiums on any such policy is enough to cause the trust to be a grantor trust. Section 677(a)(3) provides that the grantor is treated as the owner of any portion of the trust whose income may be applied to the payment of premiums of policies of insurance on the life of the grantor or the grantor's spouse. This statutory provision appears to be very broad. Literally, giving a trustee the power to pay life insurance premiums on income of a trust would conceivably cause all of the income and corpus of the trust to be a grantor trust. A Field Attorney Advice (20062701F) takes the position that the mere power to purchase life insurance on the grantor's life causes grantor trust treatment. The complete analysis about §677(a)(3) in that ruling is as follows: "Article II of B Trust Agreement authorizes the trustee to purchase life insurance on taxpayer. There does not appear to be any limit on the amount the trustee may apply to the payment of premiums. Therefore, pursuant to section 677(a)(3), taxpayer is treated as the owner of B." (However, that was a ruling involving a foreign trust where it was in the IRS's interest that the trust be a grantor trust.) Cases have been more restrictive.

    The grantor clearly is taxed on any trust income actually used to pay premiums on policies on the life of the grantor or the grantor's spouse. Treas. Reg. §1.677(a)-1(b)(2). However, cases have imposed restrictions on grantor trust status merely because of the power to pay life insurance premiums. For example, if the trust does not actually own a life insurance policy on the grantor's life, one case concluded that the mere power to purchase an insurance policy and to pay premiums from income would not be sufficient to cause grantor trust status. Corning v. Comm'r, 104 F.2d 329 (6th Cir. 1939) (trust owned no policy on grantor's life). Even if the trust owns policies on the grantor's life, some cases have concluded that the grantor will merely be treated as the owner of so much of the income as is actually used to pay premiums. Weil v. Comm'r, 3 T.C. 579 (1944), acq. 1944 C.B. 29: Iversen v. Comm'r, 3 T.C. 756 (1944); Rand v. Comm'r, 40 B.T.A. 233 (1939), acq. 1939-2 C.B. 30, aff'd., 116 F.2d 929 (8th Cir. 1941), cert. denied, 313 U.S. 594 (1941); Moore v. Comm'r, 39 B.T.A. 808, 812 (1939), acq., 1939-2 C.B. 25; Letter Ruling 6406221750A (June 22, 1964). But see Letter Ruling 8852003 (power to pay premiums causes entire trust to be grantor trust). See also Letter Ruling 8839008 (actual payment of premium from income causes grantor trust treatment as to income so paid, even though trust instrument prohibited paying life insurance premiums from income). See generally Zaritzky, Drafting and Planning Life Insurance Trust for Policies Both Traditional and Unusual, UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶403.2.D.2.a. (1994).

11. 10%/90% Gift/Sale Transaction With Grantor Trust Not Questioned. The case involved "classic" sale to grantor trust planning. Mother made gifts and sales to the grantor trusts, so that the gifts reflected about 10% of the trust assets. The opinion specifically noted that the attorney indicated that he believed that, as a rule of thumb, a "trust capitalized with a gift of at least 10% of its assets would be viewed by the IRS as a legitimate, arms-length purchaser in the later sale."

    There are no hard and fast rules as to how much equity a trust should have in order to support the legitimacy of a sale to the trust. One concern is that if the trust is undercapitalized, the note given by the trust in purchasing assets will not be worth face value, and the transaction may result

in a larger gift amount than anticipated. It is interesting that in this gift tax audit, the IRS did not make the argument that the note was worth less than face value because of the structure of the sale transaction (or because of having an undercapitalized trust-purchaser). Observe, that argument could have resulted in additional gift tax being due, even if the formula allocation clause was recognized, because the clause merely allocated to the trust assets having a value equal to the face amount of the note. While the 10% equity rule of thumb is not addressed by the IRS or the court, the case does provide some comfort that the IRS did not attack the transaction on the basis of not having sufficient equity "seeding" in the trust prior to the sale transaction.

12. Practical Planning Tips.

a. Active Negotiations. Involve all of the parties to the formula allocation assignment in the planning process. The court emphasized that the charities actively participated in the assignment transaction, and obtained several concessions in the process. (See Item 4.a of the Analysis section above.)

b. Provide That Transferees Become Substituted Members of Partners. The court expressly pointed out that the charities negotiated to become substituted members, which made clearer that the LLC managers owed them fiduciary duties. Furthermore, partners have high fiduciary duties to each other. If the family trust and charities are both partners, they would each owe fiduciary duties to the other to make sure that neither is being cheated.

c. Clarify Rights of Parties Following Reallocation. The opinion does not address whether the agreement specifically addressed the charities' rights to income and dividends from the additional units that were allocated to them following the final determination of the gift tax value. Preferably, the agreement would clarify that upon reallocation of units under the formula allocation, any income and dividends received by the original transferee that are attributable to the transferred units would also have to be transferred in the reallocation.

d. Assignment vs. Trust Allocation. One approach of implementing a formula allocation approach would be to transfer all of a block of assets to a trust, and provide that the trustee would have to allocate those assets pursuant to formula provisions. That approach would have the advantage of requiring a fiduciary (hopefully an independent fiduciary) to implement the formula allocation. That approach was not used in Petter. Instead, the assignment document merely transferred the formula amount to the trust and the excess under the assignment document passed directly to the charity. (However, it is not clear how much additional protection that provides, because the trustee of the trust would not owe fiduciary duties to the beneficiary of the "excess" portion — perhaps unless the trust is also a fellow partner of the other beneficiary and owes a duty of fairness under partnership principles.)

e. Gift Tax Return Reporting. The donor disclosed the gift/sale transactions very fully. In the court's words, "she hid nothing." The gift tax return obviously drew a gift tax audit and this court fight. The taxpayer was required to report the gift transaction, but voluntarily disclosed the sale transaction (in order to get the gift tax statute of limitations running as to the sale transaction). There's no way of knowing of whether the additional disclosure of the sale transaction is what generated the gift tax audit.

For a client who wants to make full disclosure on a gift tax return, this case gives a good roadmap of what to include on the return:

> "She hid nothing: On that return, she listed gifts... For all of these gifts, her return indicated that the gifts were units in the PFLLC and 'the value of the limited liability company is based on the fair market value of the underlying assets with a 46% non-marketability discount and a 13.3% net asset value adjustment applied.' … She even attached to the return a disclosure statement that included the formula clauses from the transfer documents, a spreadsheet of the PFLLC unit allocation, the organizing documents for the PFLLC, the trust agreements and transfer documents, letters of intent to the Seattle Foundation and the Kitsap Community Foundation, the Moss Adams appraisal report, annual statements of account for the UPS stock, and Forms 8283, Noncash Charitable Contributions, disclosing her gifts to the Seattle Foundation and the Kitsap Community Foundation."

f. Consistent Reporting. In Knight v. Commissioner, 115 T.C. 506 (2000), the Tax Court refused to recognize a defined value transfer approach where the parties did not respect the formula transfer but treated the transfer as a transfer of a specific number of shares. For example, the gift tax return reported that the donors "gave two 22.3-percent interests in the partnership" rather than "the number of limited partnership units which equals $300,000 in value." Furthermore the taxpayers took position that the gift was actually less than $300,000, which is obviously inconsistent with a defined value of a transfer of units worth $300,000. The taxpayers in this case were careful to report the transaction consistently as a formula transfer. The transactions were described on the gift tax return as formula transfers, and the donor's letters to the foundations clearly described the donations to create the donor advised funds as formula transfers.

g. Structure "Formula Allocation Clauses" to Require Fiduciary Review of Value Determination. The Christiansen and Petter opinions emphasize that there are other mechanisms to enforce the valuation determination, specifically emphasizing the fiduciary duties of the parties involved. To come within the scope of this rationale, a formula allocation clause should allocate the excess over the formula amount to a charitable foundation or to a trust where there are parties with fiduciary duties that have an obligation to assure that the entity is receiving its appropriate share under the formula transfer. Furthermore, someone other than the donor should serve as trustee of that entity. (For example, if a "zeroed-out" GRAT is the excess recipient, the donor should not serve as the trustee of that GRAT.) Furthermore, the trustee should be someone other than the beneficiary of a trust that is the recipient of the primary formula transfer, or else there would be a huge incentive to violate fiduciary duties and permit excess value to pass to the trust for the benefit of that individual. Indeed, a stronger rationale would exist if a professional fiduciary serves as the fiduciary.

h. Use Professional Appraiser. As in Petter, use a reputable professional appraiser to prepare the appraisal for purposes of making the original allocation under the formula assignment. This helps support that the taxpayer is acting in good faith and avoid a stigma that the formula transfer is merely a strategy to facilitate (using words of the court in Petter) "shady dealing" by a "tax-dodging donor."