Defined Value Clause Updates *Hendrix* and *Petter*

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a. *Hendrix v. Commissioner*, *T.C. Memo. 2011-133 (June 15, 2011).*

Synopsis

Parents transferred stock in a closely-held S corporation to trusts for their daughters and descendants and a charitable donor advised fund (the "Foundation") using a "McCord-type" defined value formula transfer. Parents transferred a block of stock to a trust and the Foundation, to be allocated between them under a formula. The formula provided that shares equal to a specified dollar value were allocated to the trust and the balance of the shares passed to the Foundation. The trust agreed to give a note for a lower specified dollar value and agreed to pay any gift tax attributable to the transfer. Under the formula, the values were determined under a hypothetical willing buyer/willing seller test. The transfer agreement provided that the transferees were to determine the allocation under the formula, not the parents. The trust obtained an appraisal of the shares and the Foundation hired independent counsel and an independent appraiser to review the original appraisal. The trust and Foundation agreed on the stock values and the number of units that passed to each. (This description is simplified; in reality, each of the parents entered into two separate transfer transactions involving a "GST trust" and an "issue trust" and the same Foundation using this formula approach.)

As indicated by the cause number, the case was first filed in 2003 (and delayed until the *McCord* result was determined). This case is appealable to the 5th Circuit, and the court held that *McCord v. Commissioner,* 461 F.3d 614 (5th Cir. 2006) controlled. The taxpayer filed a motion for summary judgment, in light of the ruling of the Fifth Circuit Court of Appeals in *McCord,* but the judge wanted to hear evidence as to whether there was any collusion between the taxpayers and the charity. The court addressed two distinctions from that case raised by the IRS — that the transfers were not at arm's length and were contrary to public policy.

As to the arm's length argument regarding the daughters' interests, the court observed that just because the daughters were close to the parents and benefitted did not necessarily negate an arm's length transfer and that having negotiations and adverse interests are not essential to the existence of an arm's length transaction. Furthermore, there was no evidence to persuade the court that there was no negotiation or that the trusts lacked adverse interests, because the trusts assumed economic and business risks under the transactions. As to the arm's length argument regarding the Foundation, the court listed several reasons for concluding that there was no collusion between the parents and the Foundation: (1) the transaction was consistent with prior charitable transfers by the parents; (2) the

Foundation accepted potential risks including the loss of tax-exempt status if it failed to exercise due diligence; (3) the Foundation negotiated some elements of the transaction, by insisting that the parents pay income taxes attributable to the S corporation income if the corporation did not distribute enough cash to pay those taxes; (4) the Foundation was represented by independent counsel; (5) the Foundation conducted an independent appraisal; and (6) the Foundation had a fiduciary obligation to ensure that it received the proper number of shares.

As to the public policy argument, the court determined that the formula clauses do not immediately and severely frustrate any national or State policy. The *Procter* case was distinguished because there is no condition subsequent that would defeat the transfer and the transfers further the public policy of encouraging gifts to charity. The court observed that there is no reason to distinguish the holding in *Christiansen v. Commissioner*, 130 T.C. 1 (2008), *aff'd*, 586 F.3d 1061 (8th Cir. 2009) that similar formula disclaimers did not violate public policy.

Observations

(1) *Fourth Case Recognizing Defined Value Clauses*. 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. So far, the IRS is losing that argument in the courts.

This is now the fourth case that has recognized the binding effect of defined value clauses for tax purposes, the others being *McCord, Christiansen*, and *Petter*. (*Christiansen*, *Petter*, and *Hendrix* all addressed the public policy issue. The 5th Circuit *McCord* Tax Court decision did not, although a majority of the Tax Court judges in the case seemed to have no problem with the public policy concerns in *McCord.*)

With these mounting taxpayer victories, if the taxpayer wins the appeal to the 9th Circuit in *Petter*, one wonders if the IRS will stop fighting these clauses, as least where the non-taxable "pourover" amount passes to charity.

(2) *John Porter Victories*. The taxpayers in all four of these cases have been represented by John Porter. The other attorneys who assisted John in this case were Stephanie Loomis-Price and Keri Brown.

(3) *McCord-Confirmation Agreement Approach vs. Petter-Finally Determined Gift Tax Value Approach*. Two approaches have emerged for structuring these defined value clauses to allocate the block of transferred assets among the family trusts and the charity (or other donees that would not generate gift tax consequences). *McCord* and *Hendrix* used an approach allocating the shares based on a "confirmation agreement" among the transferees. *Christiansen* and *Petter* used an approach of allocating the block of

transferred assets based on values as finally determined for estate (*Christiansen*) or gift (*Petter*) tax purposes.

(a) *Agreement Approach*. One advantage of the confirmation 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.

In *McCord*, the Tax Court did not recognize the agreement approach for purposes of determining the gift tax values of the shares involved. 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. The Tax Court gave effect to the percentage interests agreed to by the parties but did not find those values to determine the gift tax value of the property transferred. The Tax 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 5thCircuit, because it viewed the Tax Court as impermissibly looking to events occurring after the sale date. The end result was that the 5th Circuit did recognize the effectiveness for gift tax purposes of a formula allocation clause that gave a dollar amount to donees even though it provided for funding based on the agreement of the parties. *Hendrix* relied on the 5th Circuit's decision in *McCord* to avoid that issue, but it still might be raised in cases appealable to other circuits. The Tax Court's initial rejection of the agreement approach, 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 latter type of clause might be preferable.

To some degree, this concern is illustrated by the *Hendrix* court's concluding paragraph, as discussed above. The

Hendrix opinion does not directly address why the gift tax value passing to the family trusts should be based on $36.66 per share rather than some higher value, even though the formula allocation is respected for purposes of determining how many shares passed to each of the respective parties. That uncertainty does not exist with the "as finally determined for tax purposes" approach.

Furthermore, the taxpayer's public policy argument in some ways seems stronger with an approach allocating values based on values as finally determined for tax purposes. The *Hendrix* analysis of the public policy issue was extremely brief, omitting some of the reasons given in *Christiansen* and *Petter*. For example, *Hendrix* did not respond to the arguments from *Procter* that the clauses should be ignored on public policy grounds because they involve a moot issue and merely result in a declaratory judgment. *Petter* reasoned that those two reasons cited by *Procter* do not rise to the level of a "severe and immediate" threat to public policy. *Petter* reasoned that its 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. That reasoning does not apply in a confirmation agreement-type approach.

(b) *"As Finally Determined for Gift Tax Purposes" Approach*. While there may seem to be somewhat more certainty regarding the validity of these "as finally determined for gift tax purposes" types of clauses in light of the reasons discussed immediately above, be aware that there are potential disadvantages of this approach. The number of units passing under the formula transfer provision may not be resolved for years, until the final conclusion of a gift tax audit (and resulting litigation, if any). There could be underreporting and overreporting of income for income tax purposes by the respective transferees during the period of uncertainty. (This is a reason why all family trusts involved with the transaction should be grantor trusts so that all of the income is reported on the grantor's income tax return, regardless how shares are allocated to each party if all parties to the transaction are family trusts.) Furthermore, the gift tax audit itself will determine the number of shares passing to the charity (or other entity that does not result in the creation of a taxable gift). The family may feel more comfortable negotiating with the charity (or other "non-taxable" entity) in a real life context rather than using the values determined in a gift tax audit for that purpose.

(4) *Impact of Charity as "Pourover" Recipient*. Is it essential that the "pourover" party be a charitable entity rather than a family "non-

taxable" entity (such as the donor's spouse, a QTIP trust for the donor's spouse, a GRAT, or an "incomplete gift trust" that does not result in a current completed gift for gift tax purposes)? *McCord, Christiansen, Petter* and *Hendrix* all 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. *Hendrix* gives only two reasons for its public policy analysis, that there is no condition subsequent and that public policy encourages charitable gifts. *Christiansen* and *Petter* each have a more robust analysis of the public policy issue, and give additional reasons that the approach would not violate public policy even if a charity were not involved.

From *Christiansen*: (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. The court in *Christensen* reasoned that "the Commissioner's role is not merely to maximize tax receipts and conduct litigation based on a calculus as to which cases will result in the greatest collection. Rather, the Commissioner's role is to enforce the tax laws." *Christiansen v. Commissioner*, 586 F.3d 1061 (8th Cir. 2009). In light of the other more robust discussion of the public policy issue in *Christiansen*, it is perhaps significant that *Hendrix* cited *Christiansen* with approval even if it did not repeat all of its public policy reasoning.

From *Petter*: (1) There are other potential sources of enforcement (including references to fiduciary duties to assure that the parties were receiving the proper values); (2) the 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; and (3) the existence of other formula clauses sanctioned in 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) suggest there cannot be a general public policy against formula provisions.

Even so, all four cases that have approved defined value clauses have cited various reasons that just apply to a charitable "pourover" entity to support their public policy analyses. 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. No court has

yet addressed the validity of defined value clauses against the public policy issue where a charity is not the "pourover" party.

(5) *Structure Defined Value Clause 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.

(6) *Structure Transaction to Leave Significant Value to "Pourover" Party*. A corollary to structuring the transaction to require fiduciary review of the value determination is leaving enough value to the "pourover" recipient to justify a detailed examination and due diligence review of the transaction by that party. A detailed review, with outside counsel and an outside independent appraisal review, will cost money. If the "pourover" party is not receiving significant value, it might reasonably conclude that the transaction does not warrant a significant expenditure of funds to conduct a detailed and independent review of the values and overall transaction. In *Hendrix*, the transaction was designed to leave $100,000 of stock value to the Foundation, based on the estimate of values provided by the donors' independent appraiser.

(7) *Arm's Length Requirement*? Hendrix is the first court to address whether defined value clauses are recognized only if they are part of an arm's length transaction. Some planners have expressed chagrin that the court chose to validate the argument with a detailed analysis, suggesting that there is indeed such a requirement. Having an arm's length requirement is nonsensical in a pure gift transaction not involving a sale.

The *Hendrix* court approached the issue in terms of whether "there is collusion, an understanding, a side deal, or another indicium that the transaction was not at arm's length." The court applied the arm's length requirement rather narrowly, stating directly that "a finding of negotiation or adverse interests [is not] an essential element of an arm's length transaction." After making that

statement, the court went on to point out that in fact the clauses were subject to negotiation and that there were adverse interests even as to the daughters' trusts (apparently because of the purchase transaction).

As discussed above, having a "pourover" party with some degree of independence is essential in a confirmation agreement type of clause and is also important with an "as finally determined for gift tax purposes" type of agreement to establish the bona fides of the transaction and that it is not just a tax gimmick to facilitate "cheating" on values. The independence of the "pourover" party has been addressed by several other courts as part of the public policy issue — in terms of there being other mechanisms than just a gift tax audit to ensure appropriate enforcement of the clause.

(8) *Use Professional Appraiser*. As in all four of the defined value cases (*McCord, Christiansen*, *Petter*, and *Hendrix*), 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."

(9) *For Many, Defined Value Clauses Not as Important With $5 Million Gift Exemption*. Many individuals may wish to make gifts in excess of the $1 million gift exemption allowed under prior law, but far less than the full $5 million allowed in 2011 and 2012. For those individuals, perhaps the most important effect of the $5 million gift exemption is that it provides a great deal of "cushion" before a gift tax audit would require the payment of current gift taxes. For example, an individual who wishes to make a $3 million gift will not be as concerned as in the past with having a way to structure the transaction in a manner that will transfer as much value as possible to an irrevocable trust for children without having to pay gift taxes. Even if the individual claims substantial valuation discounts on the gift tax return, the individual may feel comfortable that current gift taxes will not be due even if there is a gift tax audit.

(10) *First Transfer Tax Case by Judge Paris*. This is the first transfer tax opinion by Judge Paris. Before being appointed to the Tax Court several years ago, Elizabeth Paris served as a Senate legislative counsel, and was deeply involved in particular with transfer tax issues coming before the Senate Finance Committee.

b. *Commissioner v. Petter Ninth Circuit Appeal.*

Tax Court Synopsis (T.C. Memo 2009-280, December 7, 2009)

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.

Ninth Circuit Court of Appeals Affirmation—Synopsis

The Ninth Circuit Court of Appeals has affirmed the Tax Court decision, but the IRS did not make the "stand alone" public policy argument under the *Procter* case. 108 AFTR 2d 2011-5593 (Aug. 4, 2011). On appeal to the Ninth Circuit Court of Appeals, the IRS argued "that part of the gifts to the charitable foundations were subject to a condition precedent—an IRS audit—in violation of Treasury Regulations 25.25222(c)-3(b)(1)." (The regulation provides that no gift tax charitable deduction is allowed for a transfer to charity that is dependent on a future act or "a precedent event" for the transfer to be effective.) The IRS dropped the public policy argument under *Procter*. The appellate court rejected the IRS's condition precedent argument. (1) There was no condition precedent to the transfers; the transfers were effective immediately on the execution of the assignment documents and "the only possible open question was the value of the units transferred, not the transfers themselves". (2) Section 2001(f)(2), which provides that a value as finally determined for gift tax purposes means the value reported on the return unless the IRS challenges the value, does not mean that the transfers were conditioned on an IRS audit, and the court gave various reason for rejecting that argument. (3) The result is consistent with *Estate of Christiansen v. Commissioner*, 586 F.3d 1061 (8th Cir. 2009), which held that an almost identical estate tax regulation did not prohibit an estate tax deduction with respect to transfers to a charity under an analogous defined value disclaimer. (4) Public policy does not invalidate a charitable deduction pursuant to this regulation because the regulation clearly does not preclude a charitable deduction in this situation. The Ninth Circuit did not address the general public policy argument against defined value transfers because the IRS explicitly dropped that argument.