THE USE OF DEFINED VALUE AND FORMULA ALLOCATION CLAUSES -- WHERE ARE WE?

CHICAGO ESTATE PLANNING COUNCIL

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I. Introduction

In planning involving the transfer of hard-to-value assets such as interests in closely held entities, job one is to engage a qualified and experienced appraiser to determine the value of the asset transferred. Some clients, however, do not desire to run the risk of the IRS attempting to take a contrary valuation position in an attempt to impose additional gift or estate tax. For this reason, formula clauses have been used by careful practitioners for years to remove valuation uncertainty from transactions.

In the typical valuation case, the taxpayer simply argues that the value determined by the appraiser is correct. With a formula clause, the taxpayer possesses additional arguments to avoid the imposition of transfer tax. Formula clauses are designed to limit the transferor's gift exposure by either adjusting the value of the interest transferred to the extent a different value is "finally determined for gift tax purposes" (a "value adjustment clause") or specifying the dollar value of the interest transferred (a "defined value clause").

Because a formula clause may negate an IRS attempt to impose additional transfer tax, the IRS has challenged their use under a variety of theories. The IRS asserts that the formula adjustment clauses are against public policy because they are a condition subsequent to the transaction that render any audit or litigation regarding value meaningless. The IRS claims that the clauses waste both the IRS's and the court's time, because once a determination is made that the value of the transferred property is higher than the taxpayer believed, the clause kicks in to adjust the transaction so that no gift tax is owed. Taxpayers assert that such clauses provide the taxpayer with certainty as to the tax they owe in a given transaction, and are designed with the very admirable goal of avoiding valuation disputes with the IRS.

Given the numerous types of formula clauses routinely sanctioned by the Treasury, the IRS's position seems disingenuous. These clauses include:

- Formula marital deduction clauses (Rev. Proc. 64-19, 1964-1 C.B. 682)
- Formula GST transfers (Treas. Regs. §§ 26.2632-1(b)(2)(11), 26.2632-1(d)(1))
- Split-interest charitable trusts (Treas. Reg. § 1.644-2(a)(1)(iii); Rev. Rul. 72-395, 1972-2 C.B. 340; Treas. Reg. § 20.2055-2(e)(2)(vi)(a))
- Formula transfers to a GRAT (Treas. Reg. § 25.2702-3(b)(1)(ii)(B))

In each example, the formulaic adjustment would be made ***only*** if the value of the transferred property is determined to be different than the originally reported value.

Over the years, several value adjustment clauses have been tested in the courts, with the results historically favoring the IRS's position that the transfer tax consequences of the transfer should be determined without regard to the clause. But recent decisions in *McCord*, *Hendrix*, *Christiansen*, *Petter*, and *Wandry* provide the taxpayer with

substantial reason to be optimistic about the use of formula clauses and provide needed guidance to practitioners in their use and implementation.

II. Value Adjustment Clauses

There are generally two types of value adjustment clauses. The first type of clause provides that if it is finally determined for transfer tax purposes that the value of the property transferred exceeds a specified dollar amount (*e.g.*, by agreement with the IRS or by a court decision), the size of the transferred interest is reduced so that the value of the property transferred equals the specified dollar amount. The second type of clause, rather than adjusting the size of the transferred interest, requires the transferee to give additional consideration to the transferor equal to the difference between the value of the interest as finally determined for transfer tax purposes and the specified dollar amount.

The validity of value adjustment clauses was first addressed in *Comm'r v. Procter*, 142 F.2d 824 (4th Cir. 1944). In *Procter*, the taxpayer transferred property and provided in the transfer document that if it were determined by a final judgment of a court of last resort that any part of the transfer was subject to gift tax, the property subject to gift tax would be deemed excluded from the transfer and would remain the transferor's property. The Fourth Circuit Court of Appeals held that the provision did not eliminate the taxable gift because it imposed a condition subsequent that violated public policy. The court determined that the provision would be "trifling with the judicial process" (*id.* at 827) and would inhibit tax collection since attempts to enforce the tax would defeat the gift. Moreover, the court held that giving effect to the provision would obstruct justice because courts would have to pass on a tax issue that became moot once the decision was rendered.

In *Ward v. Comm'r*, 87 T.C. 78 (1986), the Tax Court held that a gift of shares of stock of a closely-held corporation which the donor reserved the right to revoke the gift to the extent the value of each share was "finally determined for federal gift tax purposes . . ." to exceed $2,000 would be disregarded for purposes of determining the amount of the gift. The Tax Court opined that the transaction was a gift subject to a power of revocation exercisable upon the occurrence of an event beyond the control of the donor. Because the donor had no control over the possible revocation of the gift, the court determined that the donor parted with all dominion and control over the transferred property and that there was a completed gift of the entire property. Moreover, the Tax Court also determined that the clause violated public policy under the analysis set forth in *Procter*. The Tax Court also ignored valuation adjustment clauses in *Harwood v. Comm'r*, 82 T.C. 239 (1984), *aff'd*, 786 F.2d 1174 (1986), and *Estate of McLendon v. Comm'r*, 66 T.C.M. (CCH) 946 (1993), *rev'd on other grounds*, 77 F.3d 477 (5th Cir. 1995).

The only pre-*McCord* decision upholding the validity of a formula transfer was the Tenth Circuit's decision in *King v. United States*, 545 F.2d 700 (10th Cir. 1976), which involved the sale of stock pursuant to a value (or purchase price) adjustment clause. In *King*, the taxpayer sold stock to trusts for his children for $1.25 per share, a price the taxpayer believed to be equal to its then fair market value. The sales

agreements provided that "if the fair market value . . . as of the date of . . . [the agreement] is ever determined by the Internal Revenue Service to be greater than the fair market value determined in the . . . manner described above, the purchase price shall be adjusted to the fair market value determined by the Internal Revenue Service." 545 F.2d at 703-04. The IRS took the position that the shares were worth more than $1.25 per share, and that the price adjustment clause was ineffective. The Tenth Circuit rejected the IRS's argument, holding that the taxpayer had not made a taxable gift. The court distinguished the case from *Procter* since the sole purpose of the *Procter* clause was to rescind the transaction in the event it was determined to be a taxable gift. The *King* court stated that

> Here, there was at no time or in any way an attempt to alter or negate the plain terms of the valuation clause and no attempt by the trustees to reconvey the stock to King or to cancel the note in anticipation of an unfavorable valuation ruling. Authorities relied upon by the Government dealing with contingencies which, upon fruition, alter, change or destroy the nature of the transaction do not apply here. The proviso for adjustment of the purchase price of the stock to equal its fair market value did not effect the nature of the transaction.

Id. at 705. The Tenth Circuit found that the *King* clause had a proper purpose; that is, "an attempt to avoid valuation disputes with the Internal Revenue Service agents by removing incentive to pursue such questions is not contrary to public policy in the absence of a showing of abuse."

III. Value Definition Clauses

Although value definition clauses have the same dispute avoidance goal as value adjustment clauses, they operate very differently. Rather than adjusting the value of a gift after an adverse determination, a value definition clause seeks to specify the value of the transferred interests at the time of the transfer. For example, if a transferor desires to give a $1 million interest in an entity to a child, the transfer document would specify that the transferor assigns to his child that number of shares having a fair market value of $1 million on the date of the gift. Until recently, the IRS has not focused on value definition clauses in the same manner that it focused on adjustment clauses. But in FSA 200122011 (issued in connection with the *McCord* audit), the IRS took the position that value definition clauses are also void against public policy under the same theories as set forth in *Procter, Ward*, and their progeny.

IV. Recent Decisions Favor the Use of Formula Clauses

A. *McCord* – Value in Excess of a Defined Amount Goes to Charity (2006)

The application of *Procter* and *Ward* to value definition clauses was directly at issue in *McCord v. Comm'r*, 120 T.C. 358 (2003). In *McCord*, the taxpayers made a gift of their 82% limited partnership interests to a group consisting of their sons, generation-skipping trusts for the benefit of each son's family line, and two charities. The gift was made using a value definition clause in which the taxpayers specified that their sons and the trusts, collectively, had the right to receive that portion of the transferred interest having a fair market value of $6.9 million with the remainder of the interests passing to the charities. The taxpayers left it up to the donees to determine what portion of the 82% interest passed to the sons and the trusts (*i.e.* what portion of the interest had a fair market value of $6.9 million), and what portion passed to the charities. After the gift was made and after an appraisal was obtained, the donees entered into an arm's length agreement as to the percentage interest each received in a document entitled "Confirmation Agreement." The partnership redeemed the charities' interests approximately seven months after the gifts.

The IRS argued that the value of the partnership interests transferred by the McCords was substantially greater than that set forth in the gift tax return. Relying on *Procter*, the IRS also asserted that the defined value clause should be ignored. As to the value definition clause, the taxpayers countered that the clause should be respected, asserting that the gift tax is based upon the state law property rights transferred (*see United States v. Bess*, 357 U.S. 51 (1958)), and that the rights transferred to the sons and the trusts under the assignment agreement were the right to receive, collectively, interests in the partnership having a fair market value of $6.9 million. Thus, the value of the gift to the sons and the trusts was equal to $6.9 million.

The taxpayers also argued that clauses similar to the defined value clauses used to transfer the 82% interest are commonly used in other areas and have been approved by the IRS. Using such clauses, a donor can define the amount of a transfer that is subject to tax and ensure that the remainder is either entitled to a deduction from such tax or is not subject to such tax. *See, e.g.*, Rev. Proc. 64-19, 1964-1 C.B. 682 (defined value formula for funding the marital deduction). *See also* Treas. Reg. 25.2518-3(c) (defined value formula for pecuniary disclaimer). Similarly, the treasury regulations specifically sanction using formula allocations of GST exemption to ensure that a generation-skipping transfer is exempt from GST tax or that a generation-skipping trust has an inclusion ratio of zero. *See* Treas. Regs. §§ 26.2632-1(b)(2), 26.2632-1(d)(1). Likewise, the regulations permit the use of formula clauses in determining the amount passing to charity under a charitable trust. Treas. Reg. § 1.664-2(a)(1)(iii) (percentage of initial fair market value as finally determined for federal tax purposes); Treas. Reg. § 1.664-3(a)(1)(iii) (adjustments in annuity amounts if incorrect determination of fair market value has been made). *See also* Rev. Rul. 72-392, 1972-2 C.B. 573, 344, modified by Rev. Rul. 80-123, 1980-1 C.B. 205; Rev. Rul. 82-128, 1982-2 C.B. 71. The

IRS has even recognized the validity of a value definition clause in its pronouncements. T.A.M. 8611004 (Nov. 15, 1985).

The taxpayer also distinguished *Procter* and its progeny because the cases involved formula clauses that attempted to adjust the terms of a gift *after the gift was made*. In those cases, assets were purported to be transferred in such a way that, if it was determined by the IRS or the court that a portion of the transfer would be subject to gift tax, the transaction was adjusted after-the-fact such that those portions were no longer subject to gift tax. *See, e.g., Procter*, 142 F.2d at 827; *Ward*, 87 T.C. at 114. Contrasting the case with *Procter*, the value of the interests transferred under the *McCord* defined value clause to the sons and the trusts were readily determinable, and were not subject to change. The sons and the trusts were entitled, collectively, to the first $6.9 million of transferred interests. The value of the transfer to the sons and the trusts was unaffected by any determination by the court or by the IRS. The taxpayers were simply trying to determine and establish with certainty, through the use of a formula clause specifying the dollar value of the interest in the partnership passing to each donee, the amount of gift tax that would result from the transfers. The taxpayers argued that the property rights transferred by the taxpayers to the sons and the trusts -- the right to receive assignee interests in the partnership with a fair market value of $6.9 million -- were clearly set forth in the assignment agreement and should be given effect for purposes of calculating the taxpayers' gift tax. *See Morgan v. Comm'r,* 309 U.S. 78, 80-81 (1940).

A majority of the Tax Court found that the charity received a specific partnership interest equal to 5.1208888%, which was the amount that the charities received collectively in the confirmation agreement signed between all of the donees (but not Mr. and Mrs. McCord) several months after the partnership interests were transferred. *McCord v. Comm'r*, 120 T.C. 358 (2003). The Tax Court opined that the formula clause was not self-effectuating, and it was thus necessary to look to the confirmation agreement to determine the percentage interest that each donee received.

The majority thus concluded that the donor was entitled to a charitable deduction equal to $594,743. This amount was higher than the dollar figure the charities received when their interests were redeemed six months after the assignment.

Judges Laro and Vasquez dissented, finding that under the IRS's common law arguments they would have allowed a deduction for only the amount actually received by the charity in the redemption. Judges Chiechi and Foley concurred in part and dissented in part. They rejected the majority's interpretation of the assignment agreement under Texas law. Both also found, in separate concurring opinions, that the assignment agreement should govern the property rights transferred to the donees and that under Texas property law, the value of the gift to the taxable donees was $6,910,933 -- the amount specified in the assignment agreement.

The Fifth Circuit reversed the Tax Court's Majority opinion. *See Succession of Charles T. McCord, Jr., et al. v. Comm'r.*, 461 F.3d 614, (5th Cir. 2006). The Fifth Circuit emphasized that the fair market value of the interests transferred must be determined on the date of the gift. The Fifth Circuit noted that

> The Majority's key legal error was its confecting sua sponte its own methodology for determining the taxable or deductible values of each donee's gift valuing for tax purposes here. This core flaw in the Majority's inventive methodology was its violation of the long-prohibited practice of relying on post-gift events. Specifically, the Majority used the after-the-fact Confirmation Agreement to mutate the Assignment Agreement's dollar-value gifts into percentage interests in MIL. It is clear beyond cavil that the Majority should have stopped with the Assignment Agreement's plain wording. By not doing so, however, and instead continuing on to the post-gift Confirmation Agreement's intra-donee concurrence on the equivalency of dollars to percentage of interests in MIL, the Majority violated the firmly-established maxim that a gift is valued as of the date that it is complete; the flip side of that maxim is that subsequent occurrences are off limits.

Id. at pp. 9-10; citing *Ithaca Trust Co. v. United States*, 279 U.S. 151 (1929); *Estate of McMorris v. Commissioner*, 243 F.3d 1254 (10th Cir. 2001); *Estate of Smith v. Commissioner*, 198 F.3d 515, 522 (5th Cir. 1999). Thus, the Fifth Circuit focused on the values of the interests transferred by Mr. and Mrs. McCord as stated in the Assignment Agreement, and not the percentage interests reflected in the donee's Confirmation Agreement that was executed several months after the gifts.

The court noted that the charities retained outside counsel to assist with the transaction, the charities independently analyzed the taxpayer's appraisal and found the methodology appropriate and the value reasonable, and that none of the Tax Court judges found any evidence of an understanding between the taxpayers and the charities that the donee was expected to or had agreed to accept a percentage interest in the partnership with a value less than the full value they were entitled to receive under the assignment agreement. As we will see in later cases, these facts can play an important role in sustaining the viability of a formula transfer.

B. *Christiansen* – Value in Excess of a Defined Amount As Finally Determined Is Disclaimed to Charity (2008/2009)

The application of *Proctor* to a defined value formula disclaimer was at issue in the *Estate of Christiansen v. Comm'r*, 130 T.C. 1 (2008). In *Christiansen*, the decedent's Will left her entire estate to her daughter. The Will further provided that any disclaimed assets would pass 75% to a charitable lead annuity trust (the "CLAT") and 25% to a private foundation (the "Foundation").

Mrs. Christiansen's estate tax return reflected assets having a fair market value of $6.51 million. The principal assets of the Estate were 99% limited partnership interests in two limited partnerships involved principally in the farming and ranching business. Within nine months of Mrs. Christiansen's death, her daughter executed a formula

disclaimer, disclaiming a fractional share of the estate exceeding $6.35 million. The formula disclaimer provided, in pertinent part, as follows:

> Intending to disclaim a fractional portion of the Gift, Christine Christiansen Hamilton hereby disclaims that portion of the Gift determined by reference to a fraction, the numerator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001, less Six Million Three Hundred Fifty Thousand and No/100 dollars ($6,350,000) and the denominator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001.

Id. at 5. The formula clause went on to define fair market value "as such value is finally determined for federal estate tax purposes." *Id.*

During the estate tax audit, the IRS asserted that the fair market value of the Estate's assets should be substantially increased. The IRS argued that the assets of both partnerships should be included in Mrs. Christiansen's Estate under I.R.S. § 2036 or, alternatively, that the fair market value of each 99% interest should be increased greatly. Approximately six weeks before trial, the Estate and the IRS reached an agreement whereby (1) the IRS conceded its § 2036 argument, and (2) the parties agreed that the value of the partnership interests should be based on discounts from pro rata net asset value of 37% and 34%, respectively. This agreement increased the size of the gross estate from $6.51 million to approximately $9.6 million.

The settlement caused an additional $3.1 million of value to pass to the CLAT and the Foundation as a result of the disclaimer If those transfers qualified for the estate tax charitable deduction, there would be no additional estate tax. A majority of Tax Court held that the disclaimer was not a qualified disclaimer as to the 75% portion that passed to the CLAT[1]. The majority opined that the disclaimed property did not meet the requirements of § 2518 because Mrs. Christiansen's daughter retained her contingent remainder interest in the CLAT. As to the 25% passing to the Foundation, there was no question that the disclaimer satisfied § 2518. However, the IRS challenged the formula disclaimer on two theories. First, the IRS argued that any increased amount passing to the Foundation was contingent on a condition subsequent. Second, the IRS argued that the formula clause based on values "as finally determined for federal estate tax purposes" was void as contrary to public policy based on *Proctor*.

The Tax Court's decision with respect to the effect of the formula class was unanimous. With respect to the IRS's argument that the transfer pursuant to the formula was contingent on subsequent events and thus violated Treas. Reg. § 20.2055-2(b)(1), the Tax Court noted that the first problem with the argument was that the transfer of property to the Foundation was not a "testamentary charitable contribution." The Tax Court noted

[1] Judge Swift and Judge Kroupa (the trial judge) dissented from this portion of the opinion. Both opined that the disclaimer was qualified under § 2518.

that the transfer was the result of a disclaimer which is governed by Treas. Reg. § 20.2055-2(c), and relates back to the decedent's death as if it had been a part of the decedent's Will. The IRS also argued that the increased bequest to the Foundation was contingent because it depended upon the IRS examining the estate tax return and challenging the reported fair market value of the Estate's assets. The Tax Court disagreed, stating

> The regulations speaks of the contingency of 'a transfer' of property passing to charity. The transfer of property to the Foundation in this case is not contingent on any event that occurred after Christiansen's death (other than the execution of the disclaimer) -- it remains 25% of the total estate in excess of $6,350,000. That the estate and the IRS bickered about the value of the property being transferred doesn't mean the transfer itself was contingent in the sense of being dependent for its occurrence on a future event. Resolution of a dispute about the fair market value of assets on the day Christiansen died depends only on a settlement or final adjudication of a dispute about the past, not the happening of some event in the future. Our Court is routinely called upon to decide the fair market value of property donated to charity -- for income, or estate tax purposes.

Id. at 15-16.

The IRS also argued that the disclaimer's formula clause was void on public policy grounds because it would discourage the IRS from examining estate tax returns because any deficiency in estate tax would just end up being offset by an equivalent additional charitable deduction. The Tax Court rejected the IRS's public policy argument, noting that "we are hard-pressed to find any fundamental public policy against making gifts a charity -- if anything the opposite is true. Public policy encourages gifts to charity, and Congress allows charitable deductions to encourage charitable giving." *Id*. at 16-17. Rejecting the IRS's reliance upon *Proctor* and its progeny, the Tax Court noted that

> This case is not *Proctor*. The contested phrase would not undue a transfer, but only reallocate the value of the property transferred among Hamilton, the Trust and the Foundation. If the fair market value of the estate's assets is increased for tax purposes, then property must actually be reallocated among the three beneficiaries. That would not make us opine on a moot issue, and wouldn't in any way upset the finality of our decision in this case.

Id. at 17.

The Tax Court further noted that the Foundation's directors as well as executors of a decedent's estate owe fiduciary duties that are enforceable both by the IRS and by the state Attorney General. Thus, the Tax Court found that *Proctor* and its progeny did not apply to the formula disclaimer, and that the transfer to the Foundation qualified for the charitable deduction.

The Eighth Circuit affirmed the Tax Court's decision. *Christensen v. Comm'r*, 586 F.3d 1061 (8th Cir. 2009). With respect to the Commissioner's argument that the gift to charity was contingent, the Eighth Circuit opined that

> The regulation is clear and unambiguous and it does not speak in terms of the existence or finality of an accounting valuation at the date of death or disclaimer. Rather, it speaks in terms of the existence of *a transfer* at the date of death. See Treas. Reg. § 20.2055-2(b)(1) ("If, as of the date of a decedent's death, a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible."); see also 26 U.S.C. § 2518(a) (providing that a qualifying disclaimer relates back to the time of death by allowing disclaimed amounts to pass as though the initial transfer had never occurred); S.D. Codified Laws § 29A-2-801(b) (same). Here, all that remained uncertain following the disclaimer was the valuation of the estate, and therefore, the value of the charitable donation. The foundation's right to receive twenty-five percent of those amounts in excess of $6.35 million was certain.
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> It seems clear, then, that references to value 'as finally determined for estate tax purposes' are not references that are dependent upon post-death contingencies that might disqualify a disclaimer. Because the only uncertainty in the present case was the calculation of value to be placed on a right to receive twenty-five percent of the estate in excess of $6.35 million, and because no post-death events outside the context of the valuation process are alleged as post-death contingencies, the disclaimer was a 'qualified disclaimer.' 26 U.S.C. § 2518(a). We find no support for the Commissioner's assertion that his challenge to the estate's return and the ultimate valuation process and settlement are the type of post-death events that may disqualify a partial disclaimer.

With respect to the Commissioner's argument that the formula clause violated public policy because it might reduce the Commissioner's incentive to audit, the Eighth Circuit first noted "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." In addition, the Eighth Circuit found "no evidence of a clear Congressional intent suggesting a policy to maximize incentives for the Commissioner to challenge or audit returns. The relevant policy in the present context is clear, and it is a policy more general in nature than that articulated by the Commissioner: Congress sought to encourage charitable donations by allowing deductions for such donations. [Cite omitted.] Allowing fixed-dollar-amount partial disclaimers supports this broad policy."

Finally, the Eighth Circuit noted that "there are countless other mechanisms in place to ensure that fiduciaries accurately report estate values. State laws impose personal liability on fiduciaries, and state and federal laws impose financial liability or, in some circumstances criminal sanctions, upon false statements, fraud, and knowing misrepresentations." The Eighth Circuit also noted that the contingent beneficiaries taking the disclaimed property have an interest in ensuring that the executor does not underreport the estate's values and have an interest in serving a watchdog function. Accordingly, the Eighth Circuit noted that the executor owed a fiduciary obligation to both the estate and the foundation and that any self-dealing would be a clear violation of the general state-law fiduciary obligation to put the interest of the foundation above her own interests and possibly a violation of state and federal statutory prohibitions on certain forms of self dealing.

C. *Petter* – Value Adjustment Clause Based on Values as Finally Determined With Lifetime Transfer to Charity (2009/2011)

In *Estate of Petter v. Comm'r*, 98 T.C.M. (CCH) 534 (2009), the taxpayer made a lifetime defined-value transfer of units of the Petter Family L.L.C. worth a specific value to trusts for her two children, with the excess portion over that specified value passing to charities, and with the division of the units to be based on values as finally determined for tax purposes. The gift documents required the trusts to transfer any excess units to the charities if the value of the units initially received was finally determined for tax purposes to exceed the defined-value amount. Similarly, the charities agreed to return any excess if the reverse were true.

The IRS argued that the value was higher than reported. Ultimately, the parties settled on a somewhat higher valuation. Thus, the only issues before the Tax Court were whether the defined-value clauses would work as intended by the taxpayer and whether the taxpayer was entitled to a charitable deduction based upon the value of the units passing to charity under the formula.

The Tax Court rejected the public policy arguments raised by the IRS under *Procter*. The Tax Court rejected the mootness argument, determining that any increase in value would result in an increased charitable deduction. The Tax Court pointed out that an adjustment to the value of the units "will actually trigger a reallocation of the number

of units between the trust and the foundation under the formula clause. So we are not issuing a merely declaratory judgment." The Tax Court also stated that "[we] simply don't share the Commissioner's fear, in gifts structured like this one, that taxpayers are using charities just to avoid tax. We 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."

In response to the IRS's assertion that regulatory formula transfers cited by the taxpayer did not support the defined-value transaction at issue in *Petter*, the Tax Court stated as follows:

> The Commissioner argues that the validity of these other types of formula clauses tells us nothing about the validity of the formula clauses at issue here. He says: 'The absence of an authorization of the formula clause under the instant situation is intentional, as the use of formula clauses in this situation is contrary to public policy, and frustrates enforcement of the internal revenue laws.' He seems to be saying that Congress and the Treasury know how to allow such gifts, and their failure to explicitly allow formula clauses under the Code and regulations governing gift tax means that they have implicitly banned them. But the Commissioner does not point us to any Code section or regulation generally prohibiting formula clauses in gift transfers, or denying charitable deductions for donors who use these formula clauses in transfers to charities. The Commissioner also fails to address the argument that Anne is actually making; the mere existence of these allowed formula clauses, which would tend to discourage audit and affect litigation outcomes the same way as Anne's formula clause, belies the Commissioner's assertion that there is some well-established public policy against the formula transfer Anne used.

The Tax Court thus upheld the defined-value structure. In its opinion, the Tax Court drew something of a bright line between *Procter*-style savings clauses, on the one hand, and formula clauses like *Petter*, *Christiansen*, and *McCord*, on the other hand. The Tax Court noted that 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*. . . . A shorthand for this distinction is that savings clauses are void, but formula clauses are fine."

The Ninth Circuit affirmed the Tax Court's decision. *Estate of Petter v. Comm'r*, 598 F.3d 1191 (9th Cir. 2011). The Ninth Circuit rejected the IRS's argument that the adjustment future of the formula clause makes the "additional charitable gifts subject to the occurrence of a condition precedent." Noting that "a condition precedent is one that must occur before a transfer to charity 'become[s] effective,'" the court held that

Mrs. Petter's transfers became effective immediately upon her execution of the transfer documents and delivery of the units. The only possible open question was the value of the units transferred, not the transfers themselves. The court further opined that while the reallocation clauses in the transfer agreements required the trusts to transfer excess units to the foundations if it was later determined that the units were undervalued, "these clauses merely enforce the foundations' rights to receive a pre-defined number of units: the difference between a specified number of units and the number of units worth a specified dollar amount. The court stated that the IRS's determination that the LLC units had a greater fair market value than what the Moss Adams appraisal said they had in no way grants the foundations' rights to receive additional units; rather, it merely ensures that the foundations receive those units they were already entitled to receive. The number of LLC units the foundations were entitled to was capable of mathematical determination from the outset, once the fair market value was known."

D. *Hendrix – McCord*-Like Transaction in the Tax Court Again (2011)

The issue in *Hendrix v. Comm'r*, T.C. Memo 2011-133 (June 15, 2011), was whether a defined value formula clause contained in an assignment agreement determined the fair market value of the stock in the John H. Hendrix Corp. ("JHC") that Mr. and Mrs. Hendrix transferred on December 31, 1999, to family trusts and to a charitable foundation. The Tax Court determined that the formula clauses were reached at arm's length and that they are not void as contrary to public policy.

The Hendrix's principal asset was the stock of JHC. On December 31, 1999, the Hendrixes, the trustees of trusts created for the benefit of their daughters and the Greater Houston Community Foundation (the "Foundation") executed an assignment agreement that irrevocably assigned 287,619.64 shares of each of Mr. and Mrs. Hendrix's JHC nonvoting stock to the trusts and to the Foundation. Mr. and Mrs. Hendrix utilized a formula that assigned (1) shares having a fair market value as of the effective date equal to $10,519,136.12 to GST trusts for the initial benefit their two daughters, and (2) any remaining portion of the assigned shares to the Foundation for the benefit of donor advised funds that the Hendrixes had established. The assignment agreements, similar to those used in *McCord*, defined fair market value in the same manner as defined under the gift tax Treasury Regulations. The assignment agreements also required the trusts to proportionately pay any gift taxes imposed as a result of the transfer. The trustees signed promissory notes obligating the trustees to pay $9,090,000 to each petitioner.

On the same day, a second set of assignment agreements were executed containing the same terms as the first set of assignment agreements, except that Mr. and Mrs. Hendrix each irrevocably transferred 115,622.21 of the JHC nonvoting stock to his or her corresponding "issue" trust and to the Foundation, and the fair market value of the stock transferred to the issue trusts was set at $4,213,710.10. The second set of assignment agreements directed the trustees to deliver to each petitioner a note in the amount of $3,641,233.

The assignment agreements provided Mr. and Mrs. Hendrix with no right or responsibility for allocating the shares among the transferees on a per share basis. The

allocation was left to the transferees. Taxpayers had an appraisal prepared and after the transfer, their counsel sent the appraisal to the Foundation and its counsel. The Foundation, consistent with its policy regarding receipt of hard–to–value assets, retained another independent appraisal firm to review the appraisal. The Foundation's appraiser concluded that the appraisal was "reasonable and fair." One month later, the Foundation and the trustees entered into confirmation agreements that allocated the JHC shares between amongst the recipients according to the fair market value of $36.56 per share listed in the appraisal. Mr. and Mrs. Hendrix were not parties to the confirmation agreements.

The Tax Court noted that the case was appealable to the Fifth Circuit, and that it was obliged to follow *Succession of McCord v. Comm'r*, 461 F.3d 614 (5th Cir. 2006), *rev'g.*, 120 T.C. 358 (2003). The Tax Court held that *Succession of McCord* was dispositive of the case except to the extent that Respondent argued that (1) that formula clauses are not the result of an arm's length transaction or (2) the formula clause is void as contrary to public policy.

The Tax Court began its arm's length transaction analysis by noting that "generally, a taxpayer may structure a transaction in a manner that minimizes or avoids taxes by any means the law allows." The Tax Court noted that it may disregard the form of a transaction in favor of its substance whenever collusion, an understanding, a side deal, or other indicia that the transaction was not at arm's length exists. The Tax Court also noted that the disregard of a transaction for lack of substance cannot be based on mere suspicion and speculation arising from the fact that a taxpayer engaged in estate planning.

The Tax Court rejected Respondent's argument that the formula clause was not at arm's length because Mr. and Mrs. Hendrix and their daughters (or their trusts) were close and lacked adverse interests, the daughters benefitted from the petitioners' estate plan, and the clauses were not thoroughly negotiated. The Tax Court held that the mere fact that Mr. and Mrs. Hendrix and their daughters were close and that the petitioners' estate plan was beneficial to them does not necessarily mean the formula clauses failed to be reached at arm's length. The Tax Court also opined that a finding of negotiation or adverse interests is not an essential element of an arm's length transaction. The Tax Court noted, however, that there was nothing in the record to persuade the Tax Court that either the formula clauses were not subject to negotiation or that the petitioners and the daughters' trusts lacked adverse interests.

The Tax Court also declined to accept Respondent's request to find collusion between the Hendrixes and the Foundation. The Tax Court found that the creation of the donor advise fund at the Foundation did not diverge from their usual course of donation and that the Foundation had accepted various potential risks incident to its receipt of the gifts, including a loss of the Foundation's tax-exempt status if it failed to exercise due diligence as to the gifts. The Tax Court also noted that the Foundation, which manages nearly $270 million of assets, exercised its bargaining power when its counsel insisted on certain provisions being added to the assignment agreements. The Tax Court found it important that the Foundation was represented by independent counsel and the

Foundation hired an independent appraiser to review the petitioners' appraisal. Finally, the Tax Court noted that the Foundation had fiduciary obligations under state and federal law to ensure that it received the number of shares it was entitled to receive under the formula clauses.

The Tax Court also rejected Respondent's *Procter*-based public policy argument, noting that the formula clauses do not immediately and severely frustrate any national or state policy. To the contrary, the "fundamental public policy here is one of encouraging gifts to charity, and the formula clauses support that policy."

The Tax Court found the Hendrix transaction to be distinguishable from *Procter* and its progeny because the formula clauses imposed no condition subsequent that would defeat the transfer. The Tax Court concluded the formula clauses furthered the fundamental public policy of encouraging gifts to charity, citing *Estate of Christiansen v. Comm'r*, 130 T.C.-1 (2008). The Tax Court found no legitimate reason to distinguish the formula clauses in the *Hendrix* transfers from disclaimer in *Christiansen*, and declined to do so.

E. *Wandry* – Value Adjustment Clause Based on Values as Finally Determined, and No Third Party (2012)

In *Estate of Wandry v. Commissioner*, T.C. Memo 2012-88 (March 26, 2012) (non-acq.), the Tax Court upheld a dollar value formula transfer clause transferring LLC units. What is unique about this case is that it did not involve a charity or any other tax-free entity.

On January 1, 2004, the taxpayers decided to give LLC units in amounts equal to their (1) $1 million gift tax exemption, to be divided equally among each of their four children, and (2) $11,000 annual exclusion to each of their four children and five grandchildren. Following the advice of their counsel, they made gifts of LLC units under a formula specifying that the LLC units for federal gift tax purposes equaled each of the specific dollar amounts. The transfer documents provided as follows:

> 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 |

Name	Gift Amount
Grandchild B	11,000
Grandchild C	11,000
Grandchild D	11,000
Grandchild E	11,000

> 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.

After obtaining an independent appraisal, the LLC's accountant adjusted the capital accounts to reflect the transfers. The taxpayers filed gift tax returns reporting each gift on a percentage basis. However, the dollar value of each gift corresponded to the value of the interest each taxpayer desired to transfer, and the percentage interests were based on the value of a 1% interest reflected in the appraisal attached to their gift tax return.

After an IRS audit, the parties agreed to a higher value for the units transferred. The IRS claimed additional gift tax was due. The IRS asserted that the value of the gifts should be equal to the percentages listed in the gift tax returns multiplied by the stipulated value of a 1% interest. The taxpayer argued that the dollar value formula controlled and required a reallocation of units, which did not change the value of the units transferred to the children and grandchildren.

F. The Tax Return Position Was Not an Admission that Percentage Interests Were Transferred

Relying on *Knight v. Commissioner*, 115 T.C. 506 (2000), the IRS argued that the gift descriptions contained in the gift tax returns were binding admissions that the

taxpayers had transferred fixed percentage interests. The court disagreed, noting that in *Knight*, the taxpayers disregarded the formula by arguing that the gifts were actually worth less than the dollar value included in the transfer documents. The court contrasted *Knight* with the fact that the *Wandry* taxpayers believed that they had made dollar value gifts equal to the specified dollar amounts, noting "[a]t all times petitioners understood and believed that the gifts were of a dollar value, not a specified number of membership units." The court further noted that the gift tax returns and the schedules attached to them reported gifts of dollar amounts. The court found that the description of the dollar value transfers and the appraisal report attached to the gift tax returns demonstrated petitioners' consistent intent that dollar value gifts were intended.

The IRS also argued that the capital accounts controlled the nature of the gifts and the capital accounts reflected gifts of fixed percentage interests. The court rejected this argument, opining that the "facts and circumstances determine Norseman's capital accounts, not the other way around." The court pointed out that the Commissioner routinely challenges the accuracy of partnership capital accounts, resulting in reallocations that affect prior years.

G. The Formula Clause Was Not a Void Savings Clause

The IRS next argued that the formula contained an improper savings clause in violation of the public policy principles espoused in *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944). Relying on its analysis in *Estate of Petter*, the Tax Court drew a distinction between a "savings clause" (*Procter*) and a "formula clause" (*Petter*), noting that

> A savings clause is void because it creates a donor that tries 'to take property back.' On the other hand, a 'formula clause' is valid because it merely transfer a 'fixed set of rights with uncertain value.' The difference depends on an understanding of just what the donor is trying to give away. [citing *Petter*].

The court opined that it was inconsequential that the adjustment clause reallocated membership units among the taxpayers and the donees, rather than to a charitable organization, because the reallocation did not alter the transfer. As a result of the transfer, each donee was entitled to a predefined percentage interest in the LLC expressed through a formula. The transfer documents did not allow the taxpayer to take back units; rather, the transfer documents provided for the allocation of the units among the donees and the taxpayers.

The court's public policy analysis went on to address the specific public policy concerns raised in *Procter*. The court first stated that the Commissioner's role is to enforce the tax laws, not just maximize tax receipts. The court also noted that there are mechanisms outside of IRS audits to ensure accurate valuation reporting. As it stated in *Petter*, a judgment in the gift tax case regarding value will reallocate units among the

donors and donees. Therefore, the court is not ruling a moot case or issuing merely a declaratory judgment.

Finally, the court addressed the absence of a charity in the formula transfer. The court noted that while the charitable aspect of the formula clause contributed to the court's decision in *Petter*, it was not determinative. Accordingly, the court stated that the lack of charitable component in a formula clause does not result in a "severe and immediate" public policy concern as required by *Commissioner v. Tellier*, 383 U.S. 687, 694 (1966).

V. Potential Donees of the "Excess Amount" Under a Formula Clause

For a formula clause to be successful, the amount in excess of the defined value must pass to a person or entity that will not result in the imposition of transfer taxes. *McCord*, *Hendrix*, *Petter* and *Christiansen* all involved transfers of the excess amount to charity. However, some clients are not charitably inclined, yet they still desire some level of certainty with respect to their transfer.

Wandry involved the transfer of a specified dollar amount of assets, with any "overage" being retained by the transferor. Planners have also utilized QTIP trusts and GRATS as recipients of the non-taxable portion of the transfer.

A. Public Charity/Donor Advised Fund

As noted above, public charities were involved in transactions in each of *McCord*, *Hendrix*, and *Petter*. Preference of the independent charity in each of those cases were important attributes in the courts' decision.

Parties to the transaction must be aware that the charity has independent obligations to the state's attorney general and to the Internal Revenue Service that provide the charity with the obligation and incentive to "audit" the transaction.

Public charities are subject to private inurement rules and excess benefit rules. Section 501(c)(3) requires that a public charity ensure that "no part of the net earnings of [the organization] inures to the benefit of any private shareholder or individual . . . . I.R.C. § 501(c)(3). The transferor should expect the charity to be on the lookout for private inurement, both with respect to the initial transaction as well as the operation of the entity in the event that the charity holds its interest long term. The IRS has the ability to sanction a charity violating the private inurement rules by (1) revoking its tax-exempt status or (2) imposing intermediate sanctions. Treas. Regs. § 1.501(c)(3)-1(c)(3)-1(c)(2).

The intermediate sanctions provisions authorize the IRS to impose a 10% penalty on the charity's managers who authorized an excess benefit transaction and an escalating series of penalties against disqualified persons receiving the excess benefit. An excess benefit transaction is one involving an economic benefit passing from the charity to a disqualified person in excess of any consideration received by the charity. The taxes under the intermediate sanctions rules are draconian, with a first year tax of 25% being imposed on the disqualified person receiving the prohibited benefit, a second tier tax of

200% being imposed on a disqualified person when an excess benefit transaction is not corrected within a specified period, and a tax of 10% of the excess benefit imposed on the organization's managers who agreed to the transaction. Each of these taxes is subject to abatement under I.R.C. § 4962 if reasonable cause and the absence of willful neglect can be shown and corrective action is taken within 90 days of the notice of deficiency. The transferor, the transferor's family, the entity, and any other party involved in the transaction may be considered disqualified persons for purposes of imposition of intermediate sanctions.

The transactions in *McCord*, *Hendrix*, and *Petter* all involved donor advised funds of a public charity. The donor advised fund has the same private inurement and excess benefit issues discussed above. The primary benefit to the donor advised fund is the ability for the family to retain some level of control over the charitable purpose of the assets transferred to the charity through the recommendation of potential charitable donees.

B. Private Foundation

The private foundation is a permissible charitable transferee of an interest under a formula clause, and was one of the recipients of interests in the *Christiansen* case. The private foundation rules prohibiting self-dealing (I.R.C. § 4941), excess business holdings (I.R.C. § 4943), jeopardizing investments (I.R.C. § 4944), and taxable expenditures (I.R.C. § 4945), provide substantial barriers to using the private foundation as a donee under a formula clause.

C. Lifetime QTIP Trusts

Because the transfer of assets to a QTIP trust is exempt from gift tax, many planners have coupled a defined value transfer to taxable transferees with a gift of the value above the specific dollar amount to a QTIP trust. Testamentary formula transfers to QTIP trusts have been used for decades, and the theory underlying the courts' decisions in *McCord*, *Hendrix*, *Petter*, and *Christiansen* should apply equally to a transfer to a QTIP trust as it does to a charity. But if (1) the trustee of any trust receiving the defined value portion of the transfer (such as an IDGT) is the same as the trustee of the QTIP trust, or (2) the remainder beneficiaries of the QTIP trust are the same persons as those receiving the defined value portion, the IRS may question whether a party with the incentive (and the fiduciary obligation) to enforce the terms of the formula transfer really exists. The obvious response is the QTIP trustees have an independent fiduciary obligation to all beneficiaries of the trust to ensure the proper valuation of the interests being transferred. In other words, the trustees of the QTIP have an obligation to protect the interests of the trust similar to the charity's obligation to protect its interests. *See*, *e.g.*, *Estate of Duncan v. Comm'r*, T.C. Memo 2011-255 (Oct. 31, 2011). To avoid this argument, planners should consider (1) having different trustees of any trust receiving the defined value portion and the QTIP; and (2) having remainder beneficiaries of the QTIP who are different from the recipients of the defined value portion of the transfer.

D. Grantor Retained Annuity Trusts

Another commonly used technique is to have the "non-taxable" portion of the transaction pass to a grantor retained annuity trust. One of the benefits of the GRAT is the formula provisions are substantially similar to those contained and blessed by the Treasury in the Regulations contained under I.R.C. § 2702. The IRS may make arguments similar to those outlined above with respect to lifetime QTIP transfers. As with lifetime QTIPs, the parties might consider (1) having different trustees of any trust receiving the defined value portion and the GRAT; and (2) having remainder beneficiaries of the GRAT who are different from the recipients of the defined value portion of the transfer.

VI. Gift Tax Reporting

When using a formula adjustment clause based on values as finally determined for gift tax purposes, a gift tax return for the calendar year of the transaction should be filed. My preference is to lay out the formula provisions in detail, as well as attaching copies of the appraisal and the transaction documents as exhibits to the return. Attaching all of this information fully discloses the transaction to the IRS and begins the statute of limitations running on the determination of final gift tax values. If the formula clause is based on gift tax values as finally determined, it would seem that filing the gift tax return is required to achieve "finality" on gift tax values.

If transfers are not reported on the gift tax return, the IRS will argue that the statute of limitations has not started to run and the IRS may raise the valuation at issue at any time during the transferor's lifetime or upon death. Even where the taxpayer asserts that no gift occurred as the result of a sale transaction, the Treasury Regulations provide that adequate disclosure is required to start the gift tax statute of limitations running. Regulations provide that a non-gift transfer will be adequately disclosed on a gift tax return if the following information is provided:

(i) a description of the transferred property and any consideration received by the transferor;

(ii) the identify of, and relationship between, the transferor and each transferee;

(iii) if the property is transferred in trust, the trust tax identification number and a brief description of the terms of the trust, or in lieu of a brief description of the trust terms, a copy of the trust instruments; and

(iv) a statement describing any position taken that is contrary to any proposed, temporary or final Treasury Regulations or Revenue Rulings published at the time of the transfer.

Treas. Regs. § 301.6501(c)-1(f)(2)(i)-(v). The Treasury Regulations also require an explanation regarding why the transfer is not a transfer by gift. Treas. Regs. § 301.6501(c)-1(f)(4).

The transaction should be reported consistently with the formula to avoid the argument faced by the taxpayers in *Knight v. Comm'r*, 115 T.C. 506 (2000) (IRS successfully argued that the gift descriptions contained in the gift tax returns were binding admissions that the taxpayers had transferred fixed percentage interests instead of interests pursuant to a formula). That is why I prefer to see the formula reflected in the gift tax return schedules, with an explanation of how the percentage interest allocated was derived (*i.e.*, based on the attached appraisal), and with copies of the appraisal and the transaction documents attached.

VII. Income Tax Issues

If the charity receives an interest in the entity pursuant to the formula, the value of the interest transferred to charity should be deducible for income tax purposes (subject to percentage limitations and reduction rules).

For transactions based on values "as finally determined," there will be an initial allocation of units based upon either an appraisal or agreement. If the value is "finally determined" to be different from the initial allocation (as was the case in *Petter*), the parties will need to reallocate income and expense items retroactive to the date of the initial transfer. Likewise, it may be necessary to file amended returns to account for the fact that the parties were entitled to the proportionate interest finally determined at the time of the initial transfer. That is because all income items and deduction items would be retroactive to the date of the initial transfer.

Because the three-year statute of limitations would apply, the parties to the transaction (particularly the taxable donees and the entity) should consider filing protective claims for refund before the expiration of the three-year statute of limitations to preserve the right to amend income tax returns in the event that it is determined that the interest received by the taxable transferee is less than what was initially anticipated. In addition, the transferor should consider filing a protective claim for refund in the event that the charity receives a gift greater than the amount anticipated to be received in the initial allocation preserve the ability to obtain a larger income tax charitable deduction than was initially anticipated for the year of transfer.

Because the *McCord*-type transaction is not based on values as finally determined, any change in value of the asset transferred by a court does not affect the allocation of the units. Thus, no amended income tax returns will need to be filed by the recipients of the transferred interests.