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Defined Value Gifts and Sales Under the Microscope: What's Possible and What's Not? — Revisited

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The purpose of this piece is to update a 2003 article by the author about defined value gifts and sales.[1] There has been a lot of action in the arena of defined value gifts and sales since that article went to press. The IRS issued Technical Advice Memorandum (''TAM'') 200337012, the U.S. Court of Appeals for the Fifth Circuit reversed the Tax Court's opinion in *McCord v. Comr.*,[2] the Tax Court issued decisions in *Christiansen Est. v. Comr.*,[3] *Petter v. Comr.*,[4] and *Hendrix v. Comr.*,[5] and the U.S. Court of Appeals for the Eighth Circuit upheld the Tax Court's decision in *Christiansen*.[6] At press time, it should be noted that the IRS has appealed *Petter* to the U.S. Court of Appeals for the Ninth Circuit.[7]

Though difficult, this article will analyze defined value transactions in isolation of ''factual baggage'' that too often has muddied the waters of analysis of these transactions by the courts and by the IRS.

WHAT WE ARE (VIRTUALLY) CERTAIN STILL WILL NOT WORK

The first category of transactions to be considered consists of fact patterns that have not been respected for tax purposes in the past, and which the author is virtually certain will never be respected in the future. In the author's opinion, every one of the fact patterns [8] in this section could have been resolved without reliance upon *Comr. v. Procter*.[9]

Gift revocation on judicial determination that the transfer generates tax. This was precisely the fact pattern in the seminal case of *Procter*. The most significant issue in *Procter* was the proper legal effect to be accorded to the following clause in the transfer document:

> Eleventh: The settlor is advised by counsel and satisfied that the present transfer is not subject to Federal gift tax. However, in the event that it should be determined by final judgment of a competent federal court of last resort that any part of the transfer in trust hereunder is subject to gift tax, it is agreed by all the parties hereto that in that event the excess property hereby transferred which is decreed by such court to be subject to gift tax, shall automatically be deemed not to be included in the conveyance in trust hereunder and shall remain the sole property of Frederic W. Procter free from the trust hereby created.

However, like many other older, ''seminal'' pronouncements in tax law, lost to many practitioners in today's reality of foggy memories and fast-paced lives are the facts and underlying rationale of *Procter*. A principal reason for this is the significant attempted over-extension of *Procter* by the IRS. From a reading of *Procter*, it is readily apparent that transfer tax plan-

[1] Hood, ''Defined Value Gifts and Sales Under the Microscope: What's Possible and What's Not?'' 28 *Tax Mgmt. Est., Gifts & Tr. J.* 175 (July/Aug. 2003).

[2] 461 F.3d 614 (5th Cir. 2006), *rev'g and rem'g* 120 T.C. 358 (2003).

[3] 130 T.C. 1 (2008) (reviewed).

[4] T.C. Memo 2009-280.

[5] T.C. Memo 2011-133.

[6] 586 F.3d 1061 (8th Cir. 2009).

[7] Docket No. 10-71854 (9th Cir. 6/14/10).

[8] Save, obviously, *Procter* (cited in fn. 9, below) because the Fourth Circuit did not have *Procter* to rely upon in deciding the matter.

[9] 142 F.2d 824 (4th Cir.), *cert. denied*, 323 U.S. 756 (1944).

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ning had little to do with Mr. Procter's establishment of the trust in question. Indeed, the purpose of the subject trust was to settle litigation between Mr. Procter and his mother, who had sued him to collect on a note.

The IRS attempted over-extension of *Procter* is grounded in the Fourth Circuit's policy analysis in the *Procter* opinion, although the IRS effort here cannot be classified as disingenuous. Additionally, it possibly is not altogether a bad thing to scare taxpayers into tax compliance. The mere mention of "*Procter*" evokes concern from practitioners almost like some form of medieval incantation. However, the IRS interpretation of *Procter*, as evidenced in its most recent private rulings and its litigation positions, overlooks the significant changes in tax law that have occurred in the almost 67 years that have elapsed since the rendition of *Procter* during World War II, as well as the underlying facts in *Procter*.

The author asserts that the IRS interpretation of *Procter* also has strayed, over time, very far afield from the facts and legal reasoning that undergirded the Fourth Circuit's analysis in *Procter*, so much so that the IRS stance on *Procter* gives little or no guidance to taxpayers who honestly are trying to stay within the spirit of the law. In the author's opinion, the effect of the IRS interpretation of *Procter* is unsound administration of the tax laws, and this interpretation must be reined in. It perhaps is instructive that not another federal appellate court has followed *Procter* since the decision was rendered in 1944. It may be that taxpayers will attempt even more convoluted transactions in attempts to achieve technical compliance. As hopefully this article proves, most of the results desired by the IRS could have been achieved without invocation of *Procter* and its progeny.

What follows is an analysis of each of the policy rationales that the Fourth Circuit enunciated in *Procter* (in regular type), together with a comparison with the current state of the law and the author's commentary (all in italics):

> The donees might not be bound by the Tax Court's decision concerning the gift tax and could independently attempt to enforce the gift even though, for tax purposes, the gift of the excess value was determined to have never been made. *Arguably, such a clause would be an enforceable condition in a defined value transfer under state law, especially where all parties agree to be bound by any such decision. The IRS essentially noted this in TAM 8611004.*
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> The effect of an attempt to enforce the tax would be to defeat the gift. *This doubtless may be true with a revocable condition subsequent, as in Procter. Although this was true when Procter was rendered, defeating the gift may well have estate tax consequences in a donor's estate. In a properly designed defined value gift or sale, this concern should be nonexistent as there would be potential transfer and income tax consequences. In regulations, the IRS has recognized the contingent nature of both donative transfers by expressly permitting formula clauses, basis allocation, and contingent price adjustments.*[10] *Moreover, §2001(f)(2) assists the properly designed defined value gift. The bottom line is that there is a difference between "defeating" a gift and "defining" one, and that difference should be accorded respect for tax purposes. In situations where there is "factual baggage" that calls for a negative tax result, the author submits that the matter should be decided along those lines, instead of by invoking Procter and being done with it.*
>
> The effect of the condition would be to require the court to pass on a moot case because the condition subsequent would not be triggered until there was a final judgment that Mr. Procter's transfer was in fact subject to federal gift tax. *A case "defining" the amount of property gifted in a properly drafted defined value transfer would hardly be moot, and, in fact, would be authorized by §2001(f)(2). See the Tax Court's majority opinion in Christiansen.*[11] *Moreover, valuation litigation has come quite a distance since 1944 and can hardly be described as "trifling" today. In any event, valuation certainly is not any more "trifling" than most other issues involved in legitimate estate planning, much of which could be characterized as "trifling" by disinterested laymen, as can most of the other details of compliance with an overly complex tax law that, despite exhortations to the contrary, continues to exalt form over substance, and this pace has accelerated to warp speed since 1944. As the Tax Court pointed out in Christiansen, the issues of the amounts of the gifts or charitable deductions (for gift and income purposes) or the amount of property retained also hardly fit the "moot" description. In some ways, legitimate attempts to minimize*

[10] Regs. §§1.483-4, 1.1275-4 (contingent payment debt instruments); Regs. §15.453-1(c); Regs. §§25.2702-3(b)(1)(ii)(B) (GRATs), 1.664-2(a)(1)(iii) (CRATs). *See also* Rev. Proc. 64-19, 1964-1 C.B. 682.

[11] See fns. 3 and 6, above.

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valuation issues and uncertainty arguably are beneficial from the standpoint of tax policy and administration. Judicial frustration concerning the amount of valuation litigation, and the seeming inability of the parties to settle it, has manifested itself in cynical comments, both on and off of the record.

Courts cannot issue declaratory judgments in tax cases. *This is no longer the law.*[12]

As pointed out above, although many of the policy justifications for the *Procter* result have evaporated or just do not apply to properly designed defined value transfers, the result in *Procter* remains justified to this day.[13]

The bottom line: Could Mr. Procter have done what he wanted to do in a properly structured defined value transfer? In the author's opinion, Mr. Procter could not have done so, but not because of the policy considerations enunciated in that opinion. Instead, the limitations of true defined value transfers would have stopped Mr. Procter: There was really nothing to "define" in what he was attempting to do. Defined value transfers are not cure alls. Mr. Procter's effective "all-or-nothing-at-all" desires could not have been achieved with a defined value transfer. So why should *Procter* even be relevant with a properly designed defined value transfer? The Tax Court unanimously agreed that it should not be in *Christiansen*.

The facts of *Procter* certainly cannot be construed as routine estate planning.[14] This triggers the question of whether a restructuring of the facts in *Procter* should, from the standpoint of tax policy — if it were possible — be respected for tax purposes. This article discusses that question throughout. There is a strong argument that the *Procter* holding should be limited, possibly to conditions subsequent, and possibly only to conditions subsequent that are tied to court decree.[15] As noted above, no other federal appellate court has agreed with *Procter*. The Tax Court's majority opinion in *McCord*[16] did not make reference to *Procter* or its progeny. In *Hendrix*,[17] the Tax Court distinguished *Procter*.

Many practitioners found this fact surprising given that the parties in *McCord* had framed the principal issue as the validity and proper respect to be accorded a defined value gift clause, and they had briefed the case accordingly. Back in 2003, this author asked: "Could it be that a majority of the Tax Court recognizes that *Procter* truly is inapplicable to properly structured defined value gifts?" That question was prescient, because in *Christiansen*, a reviewed opinion, the Tax Court unanimously determined that the defined value disclaimer employed in that case did not call for application of *Procter*, expressly noting:[18]

> We are hard pressed to find any fundamental public policy against making gifts to charity — if anything, the opposite is true.
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> . . .
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> This case is not *Procter*. The contested phrase would not undo 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 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.

One-way adjustment — gift of specific property, with interest in gifted property reduced and returned to the donor on adjustment by the IRS. These are the facts of Situation 1 in Rev. Rul. 86-41.[19] In that ruling, a gift of an undivided one-half interest in a tract of income-producing property could only be reduced — and then only if the IRS determined that the value of the one-half interest exceeded $10,000 (the then-applicable annual exclusion amount). Thus, the subject gift was not of $10,000 worth of the property. If the value of the one-half interest had been less than $10,000, the donee would not have been entitled to anything else, and the donor would not have been obligated to give any additional interest in the gifted property to the donee.

The obligation to return an interest in the donated property arose only if the IRS determined that the one-half interest in the property was worth more than $10,000. In the author's opinion, the result in this rul-

[12] §7477.

[13] As pointed out by one commentator, the clause in *Procter* would not have insulated Mr. Procter from gift tax liability because the instant the court determined that he was liable for the federal gift tax on the subject transfer, he was, notwithstanding any subsequent event. *See* Cornfeld, "Formulas, Savings Clauses and Statements of Intent," *24th Annual Philip E. Heckerling Institute on Estate Planning*, Chapter 14 (1990) (hereafter, "Cornfeld").

[14] Can one imagine the following topic at any esteemed estate planning conference: "Estate Planning Utilizing Intrafamily Litigation?"

[15] *See, e.g.,* Johanson, "The Use of Tax Savings Clauses in Drafting Wills and Trusts," *15th Annual Philip E. Heckerling Institute on Estate Planning*, Chapter 21 (1981) (hereafter, "Johanson").

[16] See fn. 2, above.

[17] See fn. 5, above.

[18] See fn. 3, above (pp. 26–27 of Tax Court's slip opinion).

[19] 1986-1 C.B. 300.

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ing is correct and is proper from the standpoint of tax policy: The retained right of return was a condition subsequent under local law. As is evident below in this article, the IRS takes the apparent position that any transaction that is similar ''in effect'' to that created by a condition subsequent also is proscribed.

TAM 8549005 addressed the concept of a one-way adjustment in an ostensibly non-donation setting. The facts of TAM 8549005 involved a ''freeze transaction,'' in the form of a merger, which could not be accomplished today without satisfying the requirements of §2701. The interests in the merged entities that did not survive the merger ceased to exist after the merger. The merger document in TAM 8549005 contained the following clause:

> Although the Boards of Directors and shareholders believe that the rate of exchange fairly represents the value of stock being exchanged, in the event (and only in the event) that a valuation different than that originally determined is later arrived at, either by mutual agreement of the Constituent Corporations or by a court of competent jurisdiction, and it is determined, within five years of the Effective Date of the merger, that the actual fair market value of the [X Corporation] Common Stock is greater than the estimated fair market value upon which the initial distribution was based, [Y Corporation] will issue and deliver to the former holders of Common Stock additional shares of [Y Corporation] Class A Common and Preferred Stock (depending upon which type of stock was elected prior to the merger), proportionate to such increased valuation of [X Corporation] and reflective of any changes in capitalization in the interim. In connection with this contingent stock arrangement, the following limitations shall apply: all stock of [Y Corporation] to be issued to the shareholders of [X corporation] will be issued within five years of the Effective Date of merger.

In ruling that this stock adjustment provision was to be disregarded for gift tax purposes, the IRS actually focused more attention on the fact that the merger was of family-controlled interests and concluded that the clause lacked a business purpose. The ruling was bereft of analysis of the clause, which the author interprets as a condition subsequent, or how it actually might operate. Certainly, the clause in question was not limited in application solely to tax considerations, or even to judicial decision. It seems inherent within the concept of merger that shareholders of merged entities almost always receive proportionately equal value. In other words, one might assume that this is a built-in defined value transfer. Query whether a defined value transfer clause can really be of assistance in a matter such as this.

In the author's view, it is inconsistent with the concept of a properly designed defined value transfer to have only a one-way ''adjustment.'' Query, does providing for a two-way adjustment make any difference?

Two-way adjustment gift/transfer of specific property, with interest in gifted or transferred property increased or reduced on adjustment for federal gift tax purposes. This is the essential fact pattern in *Ward v. Comr.*,[20] which involved donations, as well as in TAM 8531003, which involved an intrafamily freeze recapitalization. In *Ward*, while the donation was of 25 shares of closely held stock to each donee, the donative instrument also contained the following clause:

> FUTURE ADJUSTMENT. Each party hereto agrees that if it should be finally determined for Federal gift tax purposes that the fair market value of each share of capital stock of the Corporation exceeds or is less than $2,000.00 an adjustment will be made in the number of shares constituting each gift so that each Donor will give to each Donee the maximum number of full shares of capital stock of the Corporation, the total value of which will be $50,000.00 from each Donor to each Donee and a total of $150,000.00 from each Donor to all Donees. Any adjustment so made which results in an increase or decrease in the number of shares held by a stockholder of the Corporation will be made effective as of the same date as this Agreement, and any dividends paid thereafter shall be recomputed and reimbursed as necessary to give effect to the intent of this Agreement.

In *Ward*, the Tax Court determined that the clause in question violated public policy and ''involves the same sort of 'trifling with the judicial process' condemned in *Procter*.''[21]

In the author's opinion, the result in *Ward* is correct, principally because the gift was of a specified number of shares that might have never been challenged or adjusted except on the trigger of a condition subsequent. In the author's opinion, there is a substantive difference between the transfer as arranged in *Ward*, and a gift to each donee of $50,000 worth of stock, valued either as of the date of the gift or as finally determined pursuant to §2001(f)(2).

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[20] 87 T.C. 78 (1986).

[21] *Id.* at 114.

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While there would have been some transfer tax implications on any audit of the donations in light of the two-way adjustment possibility, i.e., more shares could have been included in the donors' gross estates if the value of the gifted shares had been successfully increased,[22] the gifts in *Ward* really were not defined value gifts: Those gifts were more in the vein of ''intended value'' gifts. As we see in the discussion of the next two TAMs, ''intended value'' transfers are not defined value transfers, and they should not be treated as such.

''Intended value'' transfers. TAM 8531003 involved an old-style ''freeze transaction'' (that would now be rendered moot by §2701), one that the IRS used to battle, and an exchange of interests in a partnership and corporation. The transaction documents contained the following provisions:

> The Special Limited Partnership units and the assets contributed to the Partnership by the Special Limited Partners are not traded on any established market. Notwithstanding the uncertainty in valuing securities for which no market exists, the parties intend and believe that the fair market value of the assets contributed to the partnership and of the units issued by the Partnership are equal. If a valuation different than that determined according to the initial appraisal is later arrived at as a result of an Internal Revenue Service audit, then the number of Special Limited Partnership Units issued shall be increased or decreased until the fair market value of the Special Limited Partnership units outstanding equals the value of the assets contributed as of the date of contribution to the Partnership. Such increase or decrease shall require redeterminations of distributions and allocations made during the period from and after the date of this Agreement to the time such increase or decrease is determined.
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> . . .
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> Notwithstanding the uncertainty in valuing securities for which no market exists, the corporation and shareholders intend and believe that the fair market value of the assets contributed to the corporation by each shareholder are equal in value. If a valuation different than that determined according to the initial appraisal is later arrived at as a result of an Internal Revenue Service audit, then the number of shares of stock issued to each shareholder shall be increased or decreased until the fair market value of the shares of stock issued to such shareholder outstanding equals the value of the assets contributed as of the date of contribution to the corporation.

Clearly, the parties in TAM 8531003 stated that they intended equivalency in value. However, the IRS again focused attention on the family nature of the transaction and found that the clauses, which the IRS concluded were ''savings clauses,'' lacked a business purpose. While these adjustment clauses called for two-way adjustments, the result in TAM 8531003 probably is justified for a few reasons. First, there would be an adjustment after-the-fact, in the form of a condition subsequent, to less than all of the partnership interests, i.e., the ''frozen interests'' received by the senior generations. Second, the triggering event is an IRS audit that results in a value ''different'' from that arrived at in the initial appraisal, not fair market value as finally determined for gift tax purposes. Thus, it is questionable as to why an adjustment would be based upon a result that may not even be the final value for tax purposes.

Perhaps the best example of an ''intended value'' gift clause is seen in TAM 9309001. The clause at issue in that ruling was:

> [Donor] does hereby assign a [stated percentage] Limited Partnership Interest to [donee, individually or in trust], upon the following understanding and conditions. If the value of the undersigned's partnership capital given this date is determined to be different than [stated dollar amount], pursuant to any agreed settlement of bona fide disputes or any final determination of bona fide disputes by a court of competent jurisdiction, then the finally agreed or determined value shall control in finally establishing the fraction of Limited Partnership Capital assigned to the donee, it being intended that the value of this gift shall be [stated dollar amount].

Does a clause of this sort have any import as to the intention of the parties? On this question, opinions differ.[23] In *King v. U.S.*,[24] which involved an intrafamily sale, the court seemed to find that the par-

[22] This is precisely the argument that IRS made in TAM 8611004 and pointed out in Cornfeld, at p. 17; yet, in *Ward*, the Tax Court expressly rejected ''the mere possibility of estate taxation'' as a potential argument for upholding the formula. 87 T.C. 78, 114.

[23] This issue also is discussed in Moore & Buchanan, ''Valuation Readjustment Clauses: What's Possible?'' *45th Annual NYU Tax Institute*, Chapter 31, pp. 17–18 (1987) (hereafter, ''Moore & Buchanan'').

[24] 545 F.2d 700 (10th Cir. 1976). *See Comr. v. Wemyss*, 324

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ties did not intend the sale to be a gift, and intention as to whether a transaction is not a gift is relevant. In *Harwood v. Comr.*,[25] which involved purely a donation (with a built-in consideration trigger), the Tax Court made a reference to the possibility that the existence of a price adjustment clause has only a gift tax avoidance connotation. This, of course, overlooks the reality that *all* family transfers have potential gift or estate tax consequences; indeed, all family transactions are presumptively gifts.[26] In the view of the author, the Tax Court's statement in footnote 23 of its *Harwood* opinion, quoted below, borders on the overly cynical:

> We question whether the buyer's willingness to pay whatever amount the IRS determined the stock to be worth evidences an arm's-length transaction. If anything, it tends to show that the trustee did not bargain at arm's length with the trust grantor, since the trustee evidently did not care what price it paid for the stock, but cared only that no gift tax be incurred by the grantor-seller.

Taxpayers do lots of things that are required (or ''encouraged'') by the IRS, the Internal Revenue Code, the Treasury Regulations, and other rulings that taxpayers might not otherwise do or want to do. For example, taxpayers reluctantly charge or pay to or receive interest from related parties at the applicable federal rate in order to avoid a balkan recharacterization of the transaction for income and gift purposes under the complex morass of rules and regulations under §483, §1274 or §7872 and the accompanying regulations. Could compliance with these laws be characterized as a willingness to pay whatever interest that the IRS dictated should be paid? Surely. But, just as surely, compliance with those rules would not be disregarded for tax purposes. Taxpayers reluctantly enter into Congressionally mandated estate planning techniques such as GRATs and CRATs, all of which have some features that clients do not want, but to which they are resigned as a result of the law.

Even the Tax Court's statement in *Harwood* that the trustee cared only that the grantor-seller incur no gift tax liability overlooks the truism of fiduciary duty on the part of the trustee and the fact that the trust could be liable for the gift tax as a transferee if the donor did not pay or could not pay the gift tax.[27] The trustee of the trust in *Harwood* had a legitimate interest in acting under the clause in question.

In all defined value transactions, the intentions of the parties as manifested by the peculiar facts in a particular situation must be accorded importance, particularly the intentions of donors. The author humbly submits that when the IRS and the lower courts stray from this principle, tax policy and administration is damaged through irreconcilable results and less predictability.[28] In *McCord*, the Tax Court majority in essence overlooked the donors' intentions as well as the actual documents.

In the author's opinion, the clause employed in TAM 9309001 contains no adjustment mechanism. It should be noted that some commentators have had a different opinion on this point, one article having described that clause as ''strikingly similar to a formula gift.'' [29] The reference to ''fraction'' seems inconsistent with the intention that the transfer be of an interest that has a value equal to a stated dollar amount. If anything, the clause in TAM 9309001 presents at least two possible interpretations of what was gifted: a fixed percentage of limited partnership interests or of limited partnership interests worth a stated dollar amount. Suppose that the value of the specified donated limited partnership interest was less than the ''stated dollar amount.''

Does the clause in TAM 9309001 provide for the donor's allocation to the donee of an additional amount of limited partnership interest? Arguably, the clause makes no such adjustment, making it at best a one-way adjustment. Moreover, it is arguable that the clause would have made no adjustment to the percentage interest transferred, even if the value of the percentage interest gifted would have been determined to be greater than the intended stated dollar amount. Finally, the mixed references in the TAM 9309001 formula to ''Limited Partnership Interest'' and ''Limited Partnership Capital'' seem inconsistent, or, at the very least, ambiguous as to what was to be adjusted.

Surprisingly, the IRS spilled virtually no ink in TAM 9309001 on the machination of the formula itself. In the author's opinion, as discussed above, the clause in TAM 9309001 was defective relative to making adjustments, and the IRS could have reached the result it did without playing the suspicious-of-all-family-transfers card by simply subjecting the formula to analysis, as it should have. In the author's opinion, the IRS is guilty of intellectual sloth when it simply classifies a transaction as ''fishy'' without analyzing the substance and form. In TAM 9309001, the IRS again focused on the family nature of the transaction at issue and found that the clause lacked a busi-

U.S. 303, 306 (1925).

[25] 82 T.C. 239 (1984), *aff'd*, 786 F.2d 1174 (9th Cir. 1986).

[26] *See, e.g., Reynolds Est. v. Comr.*, 55 T.C. 172 (1970).

[27] §§6324, 6901.

[28] *See also* Cornfeld, at p. 5.

[29] Handler & Chen, ''Formula Disclaimers: *Procter*-Proofing Gifts Against Revaluations by IRS,'' *J. Tax'n* 232–233 (Apr. 2002) (hereafter, ''Handler & Chen'').

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ness purpose, stating, ''The clause in this case is clearly distinguishable from those commonly found in agreements occurring as part of a bona fide arms-length sale of property between UNRELATED parties.''

In TAM 9309001, the IRS asserted that the donor's real purpose behind the clause was to take ''advantage of the proverbial 'audit lottery.' '' This comment deserves some critical analysis. The reference to ''audit lottery'' presents but one side of the story. The ''flip side'' of the story is the subjectivity of valuation and the range of possible fair market values. Valuation for tax purposes is imbued with far more preciseness than it should have because of the transfer tax's insistence upon a value expressed as a single number, even when value may best be expressed in the form of a range. As noted above, the IRS has acknowledged the subjectivity of valuation in regulations, litigation positions, and published rulings. Yet, despite a bevy of cases in which taxpayers argue against their own tax return positions on valuation,[30] the IRS continues to assume that taxpayer valuations are always skewed to the taxpayer's advantage.

The IRS position that related parties might arrange a transaction in a manner that is different from how unrelated parties might arrange a similar transaction is overly simplistic as it neglects to consider that, in the normal situation, transactions between unrelated people have no potential gift or estate tax issues. It is a fact of life and reasonable to expect that unrelated parties will arrange transactions in a manner that will fulfill their intentions and not trigger unexpected tax consequences. There are legitimate estate and business planning reasons why clients often opt for not wholly donative estate planning techniques, such as sales, and estate equalization and division.

One could interpret the IRS intransigence in this area as an attempt to erode Rev. Rul. 93-12.[31] Note that many of the rulings discussed in this article were issued prior to the IRS issuance of Rev. Rul. 93-12. From the standpoint of fair administration of the tax laws, it is not unreasonable for people who have certain intentions, i.e., that a gift be of a certain amount, or that there be no gift at all, to be permitted to properly set up transactions in accordance with their intentions that are respected for tax purposes. In the author's opinion, to do otherwise directly contravenes clear Congressional intent concerning tax exemptions and exclusions.[32]

Private annuity parties agreed to the value of the assets, with a seeming two-way adjustment to the annuity amount on adjustment of the values of those assets, either by IRS settlement or by final decision of the Tax Court. These were the facts in *McLendon Est. v. Comr.*[33] In *McLendon*, the private annuity contained the following adjustment clause:

> The parties here to recognize that the valuation of many of the assets set out on attached Exhibit A are, by their nature, as determined by the best judgment of the parties and independent consultants engaged to assist in the valuation process and may be subject to differing opinions. Therefore, the parties agree that, to the extent any of the values on the attached Exhibit A are changed through a settlement process with the Internal Revenue Service, or a final decision of the United States Tax Court, the purchase price hereunder shall be adjusted accordingly, with interest on said adjustment at the rate of ten percent (10%) from the date hereof until said final determination of value, and the annuity payments due and payable hereunder shall likewise be adjusted to reflect any such change in valuation.

The adjustment clause in *McLendon* could arguably be construed as having a two-way adjustment, albeit one that could conceivably be triggered with a value that would not be the one finally determined for tax purposes. In the author's opinion, the result in *McLendon* concerning the effect of that clause was not incorrect, particularly in light of the obvious deathbed nature of the comprehensive planning that was done in that situation. The Tax Court's result on this issue was foreshadowed by the court's reference to the subject clause as both a ''savings clause'' and a ''condition subsequent.''

Given the Tax Court's ultimate finding that Mr. McLendon's use of the actuarial tables in setting the annuity payout was inappropriate given his health, this finding should have been sufficient to have reached the correct result on the effect of that clause without the unnecessary application of *Procter* and *Ward*. Unfortunately, *McLendon* was tried piecemeal, with an interruption for appeals. The actuarial tables issue perhaps should have been disposed of first. In fact, in *Knight v. Comr.*,[34] the Tax Court shrewdly (and, in the author's opinion, correctly) avoided reliance upon *Procter* and *Ward*, noting:

> We need not decide whether *Procter* and *Ward* control here because we disregard the

[30] *See, e.g., Leichter Est. v. Comr.*, T.C. Memo 2003-66.

[31] 1993-1 C.B. 202.

[32] The IRS has acknowledged Congressional intent concerning estate tax exemptions and deductions. *See, e.g.,* TAM 200245053.

[33] T.C. Memo 1993-459, *rev'd and rem'd*, 77 F.3d 477 (5th Cir. 1995).

[34] 115 T.C. 506 (2000).

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> stated $300,000 gift value for other reasons. First, petitioners reported on their gift tax returns that they each gave two 22.3-percent interests in the partnership. Contrary to the transfer document, they did not report that they had given partnership interests worth $300,000. We believe this shows their disregard for the transfer document, and that they intended to give 22.3-percent interests in the partnership.

In any event, the adjustment clause in *McLendon* affected only the *value* of the assets subject to the private annuity. The clause arguably had no impact on changing the annuity *payments* to Mr. McLendon if it were to have been determined that the actuarial tables were not available, as the Tax Court ultimately ruled a few years later.[35] It seems undeniable that a private annuity can be properly arranged via a formula, but the clause in *McLendon* was not the way to do it in the author's opinion.

Gift of a specific interest in property, with a one-way obligation to pay consideration to the donor for value in excess of the original intended value of the gift. These are the facts in Rev. Rul. 86-41,[36] Situation 2. While the IRS did not expressly state that the arrangement in Situation 2 was a condition subsequent under applicable state law (as it did in Situation 1 of Rev. Rul. 86-41, discussed above), the IRS reached the same conclusion as it did for Situation 1. The IRS noted that, in its opinion, the real purpose for the adjustment clause in Situation 2 (in the eyes of the IRS) ''was to recharacterize the nature of the transaction in the event of a future adjustment to A's gift tax return by the Service.'' Again, in the author's opinion, the result in Rev. Rul. 86-41, Situation 2, is correct, even though it is not a condition subsequent in the truest sense of the term,[37] because the transaction was not arranged as a part-sale at the outset. It is the author's opinion that a properly designed defined value transfer in the form of a part-gift (tied to the annual exclusion) and a part-sale can be designed that should be respected for tax purposes. The Tax Court certainly agreed in *Petter*.[38]

Of course, this begs the question as to whether the true policy divining rod is the proper distinction between conditions subsequent and conditions precedent (or concurrent)[39] for tax purposes. On this point, there is a difference of opinion as to whether the courts would respect the difference on policy grounds.[40] The IRS has indicated that any clause that produces a similar ''effect'' as the clause in *Procter* is proscribed, in the IRS's view.[41] On balance, the author comes down on the side of favoring a tax distinction between a condition subsequent and a condition precedent, as it will provide a ''bright line'' that is beneficial to proper tax policy and administration and is not subject to any more potential manipulation or abuse than is presently going on. Moreover, as this article hopefully has demonstrated, given that many of these cases will be decided on the grounds of ineffectual drafting, ''factual baggage,'' or both, such a position would inure to the benefit of the ''good guys'' who strive mightily to adhere to the spirit of the laws.

It is reasonable to consider whether the IRS will ever respect any adjustment after-the-fact, whether or not it is a condition subsequent, properly speaking. It is noteworthy at this juncture to point out that, at least in the apparent opinion of the IRS as of the issuance of Rev. Rul. 86-41 (though irrelevant to the holdings in that ruling), a purchase price adjustment can be permissible. In Rev. Rul. 86-41, the IRS implied that a price adjustment based on an independent third-party appraisal would be respected. Query whether the IRS's distinction between an adjustment that it will respect and an adjustment that it will not respect is well defined enough to give taxpayers proper guidance.

There also was a one-way additional consideration clause at issue in *Harwood*.[42] In *Harwood*, which involved separate donations of 8.89% limited partnership interests to trusts, each trust contained the following clause:

> Article First. Property subject to this instrument listed in Schedule ''A'' is referred to as the ''trust estate'' and shall be held, adminis-

[35] *McLendon Est. v. Comr.*, T.C. Memo 1996-307 (on remand).

[36] 1986-1 C.B. 300.

[37] Other commentators agree that the clause in Rev. Rul. 86-41, Situation 2, was not a condition subsequent. Moore & Buchanan, at 18.

[38] See fns. 4 and 7, above.

[39] *See* Johanson, at p. 15.

[40] For examples of the argument that there is a justifiable difference between conditions subsequent and conditions precedent or concurrent, see Eastland & Harrison, ''The Effectiveness of Formula Defined Value Clauses in Estate Planning,'' *2002 ABA Tax Section May Meeting Materials*. For examples expressing some concern whether there will be a difference in legal effect between conditions subsequent and conditions precedent or concurrent, see McCaffrey, ''Tax Tuning the Estate Plan By Formula,'' *33rd Annual Philip E. Heckerling Institute on Estate Planning*, Chapter 4, at p. 14 (hereafter, ''McCaffery''), Handler & Chen, at pp. 232–233, and Hood, ''Defined Value Gifts: Does IRS Have It All Wrong?'' 28 *Est. Plan.* 582, 588 (Dec. 2001) (hereafter, ''Hood'').

[41] *See, e.g.,* TAM 200245053. The IRS also made this argument before the Tax Court in *McCord*.

[42] See fn. 25, above.

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> tered, and distributed in accordance with this instrument. In the event that the value of the partnership interest listed in Schedule ''A'' shall be as finally determined to exceed \$400,000 for purposes of computing the California or United States Gift Tax, and in the opinion of the Attorney for the trustee a lower value is not reasonably defensible, the trustee shall immediately execute a promissory note to the trustors in the usual form at 6 percent interest in a principal amount equal to the difference between the value of such gift and \$400,000. The note shall carry interest and be effective as of the day of the gift.

In *Harwood*, the taxpayers attempted to rely on *King*,[43] but the Tax Court distinguished *King* on factual grounds. The Tax Court further reasoned that the adjustment prescribed in the above clause was never triggered because:

> [The trustees] evidently believed that a value lower than the appraised value and the value determined by the IRS was defensible. There, we believe, the matter ends, since we do not believe the savings clause in issue requires (or entitles) the trustees to issue promissory notes to the trust grantors in the event of a court judgment finding a value above \$400,000 for the limited partnership interests given to the trusts.

In the author's opinion, the result in *Harwood* is correct. The formula trigger element included a determination by the attorney for the trustee. However, the clause apparently never was triggered because there was neither a note for additional value nor an affirmative representation that none was required, leaving only a percentage gift of limited partnership interests. Of course, the court's rationale is susceptible to a cry of prematurity, because no note was even potentially viable pursuant to the clause until the gift tax was ''finally determined.'' Query what would have been the effect had the trustee's lawyer determined that the value exceeded \$400,000 and the trustee had issued a note? In its *Harwood* opinion, the Tax Court expressly stated that the question was not before it, so the court shed no light on its possible answer. Nevertheless, this clause provided for a one-way adjustment that required the input of but one party. On balance, the gift in *Harwood* looked more like an ''intended value'' gift than a ''defined value'' one.

[43] See fn. 24, above.

WHAT SHOULD (STILL) WORK?

It is critical that any defined value transfer be not only arranged properly, but reported properly and consistently for tax purposes.[44]

Purchase price adjustment on sale when the IRS revalues. These are the facts of *King*.[45] In *King*, the taxpayer sold some stock in a closely held corporation on credit to trusts for the benefit of his children and grandchildren, with his personal attorney as trustee. The sales document contained the following clause:

> However, if the fair market value of The Colorado Corporation stock as of the date of this letter is ever determined by the Internal Revenue Service to be greater or less than the fair market value determined in the same manner described above, the purchase price shall be adjusted to the fair market value determined by the Internal Revenue Service.

In a 2-1 decision, the Tenth Circuit distinguished *Procter*,[46] finding that the adjustment was made in the ordinary course of business at arm's length, and free from any donative intent.[47] Suffice it to say that the IRS was not enamored of the decision in *King*, although the IRS has never issued a nonacquiescence to *King*. While no other court has gone the way of *King*, the Tax Court approved a part-gift/part-sale in *Petter*.[48]

This is not to say that the IRS would not approve any purchase price adjustment. If one literally interprets the statement in Rev. Rul. 86-41,[49] the IRS would approve of a clause calling for a purchase price adjustment based on an appraisal by an independent third party retained for that purpose.

In the author's opinion, *King* was a very close case, and it is not inconceivable that the author would have voted with the IRS. The clause was clearly a condition subsequent. There are much better ways to have designed the transaction in *King* to have given it a better chance of respect for tax purposes. The *King* court's distinction of *Procter* does not even pass muster with the author. When the court stated that *Procter* would apply only ''if the transaction be construed as an inter vivos transfer undertaken to reduce Mr. King's estate,'' should that be construed as limited to a condition subsequent?

Gift of an amount of value tied to the federal gift tax annual exclusion, federal gift tax applicable credit

[44] *See Knight* (cited in fn. 34, above).
[45] See fn. 24, above.
[46] See fn. 9, above.
[47] Regs. §25.2512-8.
[48] See fns. 4 and 7, above.
[49] 1986-1 C.B. 300.

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equivalent, GST tax exemption, or some other tax-related item. In *East v. Comr.*,[50] a case that the IRS District Counsel and the taxpayer settled in a stipulated decision, the efficacy of a gift tied to a tax-sensitive amount was disputed by the IRS. According to the taxpayer's petition, the donor gave away her entire 75.3718% interest in a Texas general partnership by means of a formula clause (unfortunately not set out either in the petition or in the stipulated decision) dividing the gift between trusts for the benefit of her grandchildren, up to her remaining GST tax exemption (which she totally used up in the transfer), with the balance of the partnership interests passing to her children.

In its deficiency notice (which was attached to the taxpayer's petition), the IRS obviously attempted to disregard the formula allocation and to increase the value of the initial percentages of partnership interests transferred to the grandchildren's trusts. In the stipulated decision documents, it is equally obvious that the IRS wholly surrendered on its attempt to increase the gifts to the grandchildren's trusts because there was no adjustment to those gifts. While this decision cannot be cited as authoritative, it is instructive as to what sort of result that can be achieved in the absence of ''factual baggage.''

The author humbly suggests that the IRS at one time indicated that tax-related formulae can be properly used. In TAM 200245053, the IRS carefully conceded that formulae allocations are ''the only practical way a testator can take full advantage of these Congressionally authorized benefits [referenced earlier as the marital deduction and the applicable exclusion amount].'' But query whether the IRS reference to ''testator'' somehow indicates a position within the IRS that the ''Congressionally authorized benefits'' are limited to the estate tax. Because the transaction in TAM 200245053 was a lifetime transfer, why did the IRS discuss the ''Congressionally authorized benefits'' with a testamentary connotation? Such a position would be indefensible given that the applicable exclusion amount and marital deduction also apply to the federal gift tax.[51]

The author submits that if use of a tax-related formula is permissible, then the only way to fully and completely utilize the ''Congressionally authorized benefits'' is to use the value as finally determined for gift or estate tax purposes. To this end, through its enactment of §2001(f)(2), Congress has assisted with a ''Congressionally authorized'' definition of when the value of a gift is finally determined for gift tax purposes. Given this enactment, which includes administrative determinations, judicial determinations, and settlement agreements within the definition of ''final determination,'' the author believes that §2001(f)(2) overrules case law voiding adjustments tied to either judicial pronouncement[52] or administrative determination.[53]

Gift of a specified dollar amount that is not expressly tied to any tax-related number. In TAM 8611004, the donor made gifts of partnership interests over a number of years that had ''a fair market value of ($13,000, $10,000 or $3,000).'' While many of the subject donations obviously were in the amount of the then-applicable gift tax annual exclusion amounts, contrary to some interpretations of this ruling, the subject donations were not expressly so tied to the annual exclusion amount. The IRS respected the form of the donations, specifically noting:

> In the present case, each assignment made by the decedent is defined in terms of so much of a partnership interest that has a stated fair market value. . . Thus, the fractional portions indicated on the partnership agreement and income tax returns do not determine the fractional partnership interests conveyed by the decedent and a valuation of the partnership at the time each gift was made will be necessary to determine the fractional interests having fair market values of $13,000, $10,000 and $3,000, respectively.
>
> . . .
>
> In the present case, The A Trust, The B Trust and The C Trust were entitled to the portion of partnership income that was attributable to no more than the fractional interests; limited to values of $10,000 and $3,000 respectively. . . the proper fractional interest in each instance being based upon a valuation of the entire partnership and a determination of the fractional equivalent of the interest.

It is noteworthy that one commentator described the difference between the clause in Rev. Rul. 86-41, Situation 1, and the formula clause in TAM 8611004 as ''purely one of semantics.''[54] Given that the former clause is a condition subsequent and that the latter clause is a formula, the author disagrees with this characterization, although, in the end, perhaps all of this is but semantics.

It is important to note in TAM 8611004 that the partnership had correspondingly and consistently re-

[50] Tax Ct. Docket No. 12019-98.

[51] §§2505, 2523.

[52] *See, e.g., Procter* (cited in fn. 9, above).

[53] *See, e.g., Ward* (cited in fn. 20, above).

[54] Cornfeld, at p. 17.

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ported the fractional interests on the tax returns. In *Knight*,[55] the donation clause was as follows:

> Transferor irrevocably transfers and assigns to each Transferee above identified, as a gift, that number of limited partnership units in Herbert D. Knight Limited Partnership which is equal in value, on the effective date of this transfer, to $600,000.

Unfortunately, the taxpayers reported the gifts on the gift tax returns filed differently than the above formula, reporting the gifts of percentage interests in the partnership. The Tax Court found significant fault with that inconsistent reporting.

In TAM 200337012, the taxpayers attempted to give away limited partnership interests via a formula that read as follows:

> Assignor [Taxpayer] desires to transfer as a gift to Assignee [Trust] that fraction of Assignor's Limited Partnership Interest in Partnership which has a fair market value on the date hereof of $a.

Citing *Procter*, *Ward*, Rev. Rul. 86-41, Situation 1, and *McLendon*,[56] the IRS National Office stated:

> In this case, [the defined value gift formula clause] is similar to the Clauses in *Ward* and Rev. Rul. 86-41. In the instant case, [the parents] transferred an e% interest in Partnership to Trust pursuant to the assignment. However, if the Service determines that the value of the e% interest is greater than $a, and [the defined value gift formula clause] is given effect, the percentage interest in Partnership that exceeds the value of $a, would be retransferred to [the parents]. Such a clause is void as contrary to public policy.

The parents argued that the subject clause was a "definitional clause" and not a "formula clause," the latter of which the parents agreed was not entitled to tax respect.

The IRS thought little of this argument, reasoning:

> A different label does not nullify the effect [that the defined value gift formula clause] would have on the gift. [Each parent] argues that "the donor gets nothing back as he never intended to transfer any interest beyond that having a value of $a." However, pursuant to the assignment, Trust received an e% interest from [the parents]. If [the defined value gift formula clause] is given effect and the value of the e% interest, as finally determined by the Service, is greater than $a, a certain percentage of the Partnership interest held by Trust would be retransferred to [the parents]. This is the type of clause that the courts in *Procter* and *Ward* conclude are void as contrary to public policy.

The IRS concludes the substantive part of the TAM as follows:

> Accordingly, in conclusion, [the defined value gift formula clause] is void as contrary to public policy and the Service will make adjustments to the gift tax on the Year 1 return the reflect the value of the e% interest, as finally determined by the Service.

The author respectfully disagrees with the IRS ruling in this TAM. The IRS read a retransfer of partnership interests upon valuation by the IRS that simply is not in the formula as laid out in the TAM. Additionally, this formula was not dependent upon values as finally determined for transfer tax purposes, which is the way that one commentator seems to strongly believe is the only way to arrange a successful defined value gift.[57] The author takes issue with that conclusion because §2001(f)(2) is in the Code and clearly allows that possibility by setting out a statutory scheme for the value of a taxable gift to be finally determined.

Disclaimer of an amount that will trigger federal transfer tax of a certain amount. In PLR 9437029, the IRS determined that a proposed disclaimer along the following lines was qualified:

> The largest number of shares of X stock that can be disclaimed without causing federal and Minnesota estate taxes to total more than a specified dollar amount. The number of shares so disclaimed would be determined as of the federal estate tax valuation date by using the amounts and values as finally determined for federal estate tax purposes and after taking into consideration all amounts allowed as deductions for federal estate tax purposes together with all applicable credits other than the credit for state death taxes.

[55] See fn. 34, above.

[56] See fns. 33 and 35, above.

[57] *See* Dyer, "Use of Defined-Value Clauses (and Alternatives) in transfers of Closely-Held Business Interests," *ABA 20th Annual Spring Symposia* 18 (Apr. 30, 2009).

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Even though the facts of PLR 9437029 involved a disclaimer [58] and the federal estate tax, the author submits that there is no compelling policy reason for denying use of this strategy in the context of a lifetime gift of a value as finally determined pursuant to §2001(f)(2) that would trigger a gift tax liability of a certain amount. This technique could be designed to be merely an extension of the technique making a gift of a tax-tied exemption amount, and it could provide some upside protection to those few clients still willing to wade out into the waters of paying gift tax.

Gift of a certain amount to one or more sets of donees, with any remainder to a tax-advantaged recipient, such as a spouse or qualified charity. This technique, referred to by some commentators as a ''lid'' strategy (by virtue of putting a ''lid'' on the taxability of the transfer),[59] is the subject of FSA 200122011 and *McCord*.[60] This author has commented previously on these matters, which allegedly are the same situation.[61]

The facts in these matters possibly contain some ''factual baggage'' in the form of possible self-dealing, lack of true negotiation, etc., and it is submitted that this ''factual baggage'' may have drawn the ire of the IRS.

On January 12, 1996, pursuant to the Assignment Agreement and a Louisiana act of donation, the McCords assigned all of their Class B interests (''January Donation'') pursuant to the following formula:

1. that portion of the Assigned Partnership Interest having a fair market value as of the date of this Assignment which is as much as but not more than the dollar amount (''Assignors' GST Amount'') obtained by adding (i) the GST exemption provided for Assignors in section 2631(a) of the Internal Revenue Code of 1986 (the ''Code''), which has not been allocated by them or by operation of law to any property transferred or deemed transferred by them before the date of this Assignment Agreement, to (ii) the value of any consideration received or deemed received by Assignors from . . . [the trustees of the GST Trusts], as a result of the transaction effectuated by this Assignment Agreement, is assigned in equal shares to [the trustees of the GST Trusts];
2. any remaining portion of the Assigned Partnership Interest having a fair market value as of the date of this Assignment Agreement which is as much as but not more than the dollar amount obtained by subtracting Assignors' GST Amount from $6,910,932.52, is assigned outright and in equal shares to . . . [the McCords' children];
3. any remaining portion of the Assigned Partnership Interest having a fair market value as of the date of this Assignment Agreement which is as much but not more than the dollar amount obtained by subtracting the dollar value of the portions assigned under [the] subparagraphs above from $7,044,932.52 is assigned to the Shreveport Symphony, Inc.; and
4. any remaining portion of the Assigned Partnership Interest is assigned to Communities Foundation of Texas, Inc. for the benefit of the McCord Family Fund.

The partners did not admit the charitable assignees named in the January Donation as partners, and the McCord children assumed the gift tax liability, as well as the estate and GST tax liability. On their gift tax returns, the McCords reduced the value of the gift as a net gift by the amount of the gift tax as well as by the actuarial estimate of the potential for inclusion of the gift tax in the McCords' taxable estates under §2035(b) if Mr. or Mrs. McCord died within three years of the gift (which did not happen in either instance). The McCords' appraiser valued a 1% interest in the Partnership, which was then used to extrapolate into the percentages divided between the donees in the January Donation.

Subsequently, pursuant to an agreement between the donees approximately two months after the gift (''Confirmation Agreement''), the donees confirmed the sharing ratios provided in the Assignment Agreement *amongst themselves*, retroactive to the effective date of the January Donation. The McCords were not parties to the Confirmation Agreement.

The IRS audited the McCords' gift tax returns and assessed a higher value on two fronts. First, the IRS disallowed the actuarial reduction in the amount of the gift that the McCords had taken pursuant to the potential increase in the McCords' taxable estates under §2035(b). Second, the IRS asserted that the value of a 1% interest as estimated by the McCords on their gift tax return was too low.

The McCords argued that the formula was entitled to respect, and that if the IRS or the Tax Court increased the value of a 1% limited partnership interest, then any increase in the gifted amount would increase the charitable deduction because charity received the overage interest pursuant to the formula, even though the Communities Foundation of Texas sold its interest pursuant to the call and would not share in any excess value.

The IRS argued that the *Procter* and *Ward* line of cases invalidated the defined value gift formula on

[58] Formula disclaimers are expressly authorized in the Treasury Regulations. Regs. §25.2518-3(d), *Ex. 20*.

[59] *See, e.g.,* Handler & Chen, at p. 232.

[60] See fn. 2, above.

[61] *See, e.g.,* Hood.

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public policy grounds. In its trial memorandum, the IRS also argued that the:

> [F]ormation of the partnership, the transfer to petitioners' sons and to charity, and the redemption of the charitable interest was a single integrated transaction the effect of which was to transfer a combined 82.33369836% Class B limited partnership interest to petitioners' sons and their trusts.

The IRS further argued for denying charitable deduction, in that the Confirmation Agreement's subsequent call of the charities' interests should be invalidated based upon the doctrine of reasonable probability of receipt because the charities' interests were sold out prior to any increase in value, meaning that no charity would receive any increase in value.

In *McCord*, the Tax Court majority deftly avoided the public policy, substance-over-form/integrated transaction and realistic probability of receipt arguments by the IRS, as well as the McCords' argument for an augmented charitable deduction if the IRS was successful in increasing the value of the gifted partnership interests, by sidestepping the defined value gift formula altogether. The court noted: ''Because the assignment agreement does not equate the term ''fair market value'' with the term ''fair market value as finally determined for Federal gift tax purposes,'' petitioners' argument must fail.''

The Tax Court *McCord* majority placed excessive importance upon the effect of the Confirmation Agreement, because it relied upon the percentages as set in that agreement for setting the percentages of each gift under the formula. Judges Chiechi and Foley disagreed with that position, which Judge Chiechi characterized as in conflict with the Assignment Agreement. Judge Chiechi was even more harsh in her assessment of the majority's hair-splitting on the definition of fair market value in the Assignment Agreement, stating, ''the majority's construction of the above-quoted paragraph is strained, unreasonable, and improper and leads to illogical results.''

Judge Laro, dissenting on different grounds, stated that he disagreed with the hair-splitting, noting (footnote omitted but emphasis added):

> To my mind, the subject property's fair market value is its fair market value, notwithstanding whether fair market value is ascertained by the parties or ''finally determined for Federal gift tax purposes.'' I know of nothing in the tax law (nor has the majority mentioned anything) that provides that property such as the subject property may on the same valuation date have one ''fair market value'' when ''finally determined'' and a totally different ''fair market value'' if ascertained beforehand. The majority's interpretation of the assignment agreement *is at odds with the interpretation given that agreement by not only the trial judge, but by both parties as well*.

Despite extensive discussion of the *Procter* public policy arguments in the memoranda filed by the parties in *McCord*, the majority opinion contains *no* reference to *Procter* or its progeny. In a concurring opinion, Judge Swift expressly stated a belief that the reasonable probability of receipt doctrine[62] and public policy arguments were applicable to the *McCord* facts.

In his dissenting opinion in *McCord*, Judge Laro would have invalidated the charitable deduction increase either on public policy or integrated transaction grounds. Judge Laro provided the following factual basis for his conclusion as to the applicability of the integrated transaction theory in this matter:

1. petitioners were seeking expert advice on the transfer of their wealth with minimal tax consequences;
2. the transaction contemplated that the charities would be out of the picture shortly after the gift was made;
3. the transfers of the partnership interests to the charities were subject to a call provision that could be exercised at any time;
4. the call provisions were exercised almost contemporaneously with the transfers to the charities;
5. the call price was significantly below fair market value;
6. the charities never obtained a separate and independent appraisal of their interests (including whether the call price was actually the fair market value of those interests);
7. neither charity ever had any managerial control over the partnership;
8. the charities agreed to waive their arbitration rights as to the allocation of the partnership interests; and
9. petitioners' sons were at all times in control of the transaction.

Some of Judge Laro's ''factual justifications'' for his integrated transaction determination seem irrel-

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[62] *See, e.g., Hamm v. Comr.*, T.C. Memo 1961-347, *aff'd*, 325 F.2d 934 (8th Cir. 1963).

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evant. Of what real relevance is the fact that the McCords, persons of substantial means, sought out and acted on the advice of one of the leading estate planners in the country? Of what import was the fact the charities had no control in the transaction? On the other hand, Judge Laro arguably was inconsistent in his criticism that the call price was ''substantially below fair market value,'' where earlier he determined that the majority had overly split hairs in its tortured construction of the definition of ''fair market value'' in the Assignment Agreement.

However, other factors that Judge Laro identified clearly present difficulty for the McCords, including the call and the relatively short period of time that the charities were allowed to hold their interests.

In light of *McCord* and TAM 200245053, the question is whether *any* defined value gift clause will be respected. A reading of the Tax Court's majority opinion in *McCord* indicates that the answer to this question is ''yes.'' In *Christiansen*,[63] the Tax Court answered the question in the affirmative. in *McCord*, the majority noted:

> Had petitioners 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, we might have reached a different result. However that is not what the assignment agreement provides.

Thus, had the charity retained a continuing right to any valuation increase and had the values been ''as finally determined for tax purposes,'' then would the Tax Court in *McCord* have respected the defined value gift formula? Perhaps, although the Tax Court clearly seemed troubled by the ''tax neutrality'' effect of the technique, such that it might have even invalidated the technique either on public policy grounds or as an integrated transaction.

Query whether the distinction that the Tax Court majority drew between the definition of fair market value contained in the Assignment Agreement, which, the Tax Court majority, noted ''closely tracked'' the definition of fair market value set forth in Regs. §25.2512-1(b), and the ''fair market value as finally determined for gift tax purposes'' is legitimate and will withstand intellectual scrutiny. It seems fairly obvious that the McCords were attempting to avoid a problem with triggering the revaluation on judicial determination, which courts have found problematic.

In ruling that the formula should be disregarded in FSA 200122011, the IRS stated:

> Though *Procter* involved a savings clause as opposed to a formula clause, the principles of *Procter* are applicable to this case. If formula clauses like the one at issue actually function to require payment of any increased value to the charitable donee, these clauses would be similar in effect to savings clauses in that they recharacterize the transaction in a manner that would render any adjustment nontaxable. . . . Fair administration of the gift tax will become even more difficult if formula clauses are given effect, for scarce resources cannot reasonably be expended examining returns if the examination will have no tax effect.

In FSA 200122011, while the IRS attempted to extend *Procter* to transactions that violate the ''principles'' laid out in that case, as has been too often the case, the IRS resorted to its worn-out ''fishy'' theory, concluding:

> Here, the formation of the partnership, the transfer to Sons and to charity, and the redemption option of the charitable interest was in substance a single integrated transaction the effect of which was to transfer a * * * percent Class interest to the Sons. Petitioners and Sons were at all times in control of the transaction, and after the transaction, Sons were in control of the transferred interest. There is no evidence of any arm's-length negotiations with charity; the transactional documents were accepted by charity as presented. Indeed, the sole purpose of the presence of Charity 3 was to imbue the appraisals, which were an integral part of the donative plan, with the patina of third-party reliance. Any additional transfer to charity under the formula clause was illusory, and charity acknowledged as much when it signed the release. Charity 3 has received all that it was ever intended to receive. Accordingly, the transaction is appropriately treated as the transfer of a * * * percent Class * * * interest to the Sons.

Nevertheless, despite the position of the IRS as stated in FSA 200122011, the author is of the opinion that such a transaction if, properly designed and carefully implemented, should pass muster.[64] In the author's view, the IRS requirement that its audits must have ''tax effect'' arguably is without statutory sup-

[63] See fns. 3 and 6, above.

[64] The author laid out extensive design suggestions in a transaction involving a multi-tranche gift of family partnership interests with the difference going to charity in Hood at pp. 589–590.

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port, and, in any event, represents an ambiguous position that represents the poorest in tax policy and administration.[65] This position, the author respectfully submits, is wrong-headed, as it generates additional, more convoluted attempts by taxpayers to obtain some valuation certainty. There seems almost to be a position within the IRS that the uncertainty of valuation is to serve as a deterrent against planning. Even if this is not a formal or even a subconscious motive within the IRS, the ''effect'' (a term that the IRS employs in this context) is certainly the same. The author posits that certainty in valuation is a laudable part of proper tax policy as it reduces the potential for controversy and promotes judicial economy.

The Fifth Circuit unanimously reversed the Tax Court's opinion in *McCord*, stating (footnotes omitted and emphasis added):

> 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.

It is particularly noteworthy that the IRS did not raise a *Procter* public policy argument in any of its *McCord* Fifth Circuit briefs, choosing instead to ride the coattails of the Tax Court majority. In the author's opinion, this was unfortunate because the Fifth Circuit might well have spilled some very important ink on this argument.[66] It is equally noteworthy that the Tax Court then unanimously found the defined value disclaimer in *Christiansen* not to be violative of *Procter*, and the Eight Circuit unanimously agreed. Nevertheless, the IRS continues to this day to raise *Procter* in defined value transfer cases.[67]

Donation of tax-related amount of property, such as annual exclusion, GST tax exemption, or applicable credit amount equivalent, with values as finally determined for tax purposes, with a sale of the remainder of the donor's interests in that property. In the author's view, a properly confected defined value gift of a tax-related amount, coupled with a sale of the remainder of the donor's interests in the property should work. If the clause ensures that fair market value as finally determined is paid, then even the IRS should have no problem, if its past statements are to be believed.[68]

A case that involved essentially a part-gift of remaining applicable exclusion amount/part-sale is *Petter*.[69]

Anne Petter, a lifelong schoolteacher, inherited a large amount of UPS stock from her uncle, but UPS was still a privately held company at that time. When she was interested in getting her affairs in order, she engaged the services of an estate planning attorney. She expressed an interest in getting two of her three children involved in managing property and in making some charitable provisions. The attorney recommended the formation of an LLC and that the UPS stock be transferred to the LLC. He further recommended that some of the LLC units be donated to separate trusts for the benefit of her two children and that other LLC units be sold to those trusts in exchange for 20-year promissory notes. The trusts were arranged as grantor trusts for income, but not, estate, tax purposes. Anne also created a life insurance trust to cover federal estate taxes as well as a lifetime 5% charitable remainder unitrust with approximately $4 million in UPS stock.

In both the gifts and the sales transactions, which occurred three days apart, the excess value was to be transferred to separate public charities. In the gift transaction, she intended that approximately 10% of the LLC units pass to the public charities, albeit in different relative shares. Each gift was made pursuant to a formula, which was:

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[65] For more on the author's thoughts on the problems with ''tax effect,'' see Hood at pp. 583–585.

[66] For an excellent article on the Fifth Circuit's decision in *McCord*, see Bowman, ''*McCord v. Commissioner*: Defined Value Clauses Redefined?'' 33 *ACTEC J.* 169 (2008). *See also* Shaftel, ''Defined Value Clauses,'' *Tr. & Est.* 18 (May 2007); *Steve Leimberg's Estate Planning Newsletter*, Nos. 1010 (L. Paul Hood, Jr.) and 1016 (Steve R. Akers).

[67] See, for example, the IRS briefs in *Hendrix* (cited in fn. 5, above), as well as the IRS Ninth Circuit briefs in *Petter* (cited in fn. 7, above).

[68] *See, e.g.,* Rev. Rul. 86-41; TAM 200245053 (''The clause does not serve a legitimate purpose, such as ensuring that the purchase price accurately reflects fair market value.'').

[69] See fns. 4 and 7, above. For commentary on *Petter*, see, e.g., *Steve Leimberg's Estate Planning Newsletter*, Nos. 1557 (L. Paul Hood, Jr.), 1562 (Charles Ian Nash), and 1578 (Steve R. Akers).

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Transferor. . .

1.1.1 assigns to the Trust as a gift the number of Units described in Recital C above that equals one-half the minimum[70] 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 the difference between the total number of Units described in Recital C above [940 Units][71] and the total number of Units assigned to the Trust in Section 1.1.1.

1.2 The Trust also agrees that, if the value of the Units it initially receives is finally determined for federal gift tax purposes to exceed the amount described in Section 1.1.1, Trustee will, on behalf of the Trust and as a condition of the gift to it, transfer the excess Units to the Seattle Foundation as soon as practicable.

1.3 The Seattle Foundation agrees that, if the value of the Units the Trust initially receives is finally determined for federal gift tax purposes to be less than the amount described in Section 1.1.1, The Seattle Foundation will, as a condition of the gift to it, transfer the excess Units to the Trust as soon as practicable.

The sale transactions also were made pursuant to a formula, which was:

Transferor. . .

1.1.1 assigns and sells to the Trust the number of Units described in Recital C above [8,459 Units] that equals a value of $4,085,190 as finally determined for federal gift tax purposes; and

1.1.2 assigns to The Seattle Foundation [in one child's trust-in the other trust, it was the Kitsap Community Foundation] as a gift to the A. Y. Petter Family Advised Fund of The Seattle Foundation [again, same difference in the other trust] the difference between the total number of units described in Recital C above and the total number of Units assigned and sold to the Trust in Section 1.1.1.

1.2 The Trust agrees that, if the value of the Units it receives is finally determined to exceed $4,085,190, Trustee will, on behalf of the Trust and as a condition of the sale to it, transfer the excess Units to The Seattle Foundation as soon as practicable.

1.3 The Seattle Foundation agrees that, if the value of the Units the Trust initially receives is less than $4,085,190, The Seattle Foundation will, as a condition of the gift to it, transfer the excess Units to the Trust as soon as practicable.

The sales were secured by separate pledges of the sold LLC units, and the pledge agreement that was used in each sale provided:

> It is the understanding of the Pledgor and the Security Party [sic] that the fair market value of the Pledged Units is equal to the amount of the loan — i.e., $4,085,190. If this fair market value has been incorrectly determined, then within a reasonable period after the fair market value is finally determined for federal gift tax purposes, the number of Pledged Units will be adjusted so as to equal the value of the loan as so determined.

It is particularly noteworthy that the parties agreed that the trusts had made all payments due under the notes. Moreover, the Tax Court expressly observed that the documents clearly contemplated that the trusts and the charities would be full members of the LLC, rather than mere assignees. Additionally, The Seattle Foundation hired counsel, who requested several substantive changes to the transaction documents, to which counsel for Anne consented. Anne also consistently described her gifts and sales in letters and on tax returns. Anne's attorney hired a competent appraisal firm to appraise the LLC units, and the attorney relied upon the appraisal to allocate units.

On audit, the IRS proposed to increase the value of the units from $536.20 per unit to $794.74 per unit. The parties agreed to a value of $744.74. However, the parties vehemently disagreed on the effect of the valuation increase on the formulae in the gift and sale documents. The IRS argued that the formula clauses

[70] The Tax Court, in footnote 10 of its opinion, noted that this was a typo and should have read "maximum."

[71] This number was intended by the attorney to provide "seed capital" of at least 10% to each trust to support the sale. This so-called "safe harbor" has been bandied about by pundits for years without any support, arguably until the *Petter* case.

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should be ignored pursuant to *Procter* and its progeny, to which Anne's estate[72] disagreed. The IRS also disagreed that Anne was entitled to any additional charitable deductions for the additional amounts passing to the charities pursuant to the formulae.

The Tax Court provided an excellent summary of *Procter* and the cases that followed. However, the Tax Court expressly determined that the ''Petter gift [was] more like a *Christiansen* formula than a *Procter* savings clause.'' [73] This determination foreshadowed the Tax Court's holding that the formulae were entitled to respect. Moreover, the Tax Court determined that the appropriate time of the gift was March 22, 2002, i.e., the date on which Anne actually signed the gift documents.

As was noted above, the IRS has appealed *Petter* to the Ninth Circuit Court of Appeals. On appeal, the IRS raised the following points of contention:

- the transfers as originally computed pursuant to the original appraisal are not deductible pursuant to Regs. §25.2522(c)-3(b)(1);
- the ''additional gifts'' (as viewed in the eyes of the government) to the charities caused by the mutually agreed to revaluation of the LLC units also are not deductible pursuant to Regs. §25.2522(c)-3(b)(1);
- Regs. §25.2522(c)-3(b)(1) denies deduction of amounts that charities are not certain to receive;
- *Christiansen* is not persuasive authority with respect to proper application of Regs. §25.2522(c)-3(b)(1);
- *Christiansen* is wrong;
- the Tax Court ignored the IRS argument that Regs. §25.2522(c)-3(b)(1) applied to deny the gift tax charitable deductions;
- the Tax Court erroneously decided that the ''additional gifts'' (in the eyes of the government) were not subject to conditions precedent under Washington law; and
- the Tax Court erroneously decided that the defined value clauses were not contrary to public policy, i.e., a *Procter*/*Ward* argument.

On appeal, the government asserted that the Tax Court ignored its argument that Regs. §25.2522(c)-3(b)(1) precludes the deduction for the ''additional'' LLC units.[74] While the Tax Court in *Petter* did not expressly reference that section of the regulations, the government's claim arguably misrepresents the truth, which was that the Tax Court expressly found that the transfers that Anne made were set back on the dates of the transactions (March 22 and 25, 2002), could not be undone, and were not subject to any condition precedent.[75] In the author's opinion, this finding expressly adopts a holding that Regs. §25.2522(c)-3(b)(1) was inapplicable on its face.

In like manner, the author believes that the government's argument that *Christiansen* was inapplicable because it involved Regs. §20-2055-2(b)(1), not Regs. §25.2522(c)-3(b)(1), is wrong pursuant to the maxim that the estate and gift tax regulations are to be read *in pari materia*.[76] Moreover, the government's case on this point cannot prevail by a simple comparison of the language of the two regulation subsections, which are set out in full below.

Regs. §25.2522(c)-3(b)(1) states (emphasis added):

> If, as of the date <u>*of the gift*</u>, *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.

Regs. §20.2055-2(b)(1) states (emphasis added):

> If, as of the date <u>*of the decedent's death*</u>, *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.

The underlined language above presents the only differences between the two regulation subsections, which otherwise are identical. In the author's opinion, this totally undercuts the government's argument that *Christiansen* is distinguishable because it involved the estate tax regulation instead of its virtually identical ''twin'' in the gift tax regulation. When one considers the fact that the same Tax Court judge wrote both *Christiansen* and *Petter*, the author argues that one can make a very compelling argument that he considered in *Petter* virtually the same regulation expressly

[72] Unfortunately, Anne Petter died during the pendency of the Tax Court proceeding.

[73] *See Petter* (p. 33 of Tax Court's opinion).

[74] Brief for the Appellant, p. 29.

[75] *Petter* (slip opinion at p. 43).

[76] *See, e.g., Harris v. Comr.*, 340 U.S. 106 (1950).

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discussed in *Christiansen* and expressly found it to be inapplicable.

Whichever side one takes about the applicability *vel non* of the pertinent regulation subsections to the facts in *Christiansen* and in *Petter*, the author believes that there exists absolutely no tax policy justification for different results under the two essentially identical regulation subsections. Because the author believes that the result in *Christiansen* is correct on the inapplicability of Regs. §20.2055-2(b)(1), it follows that he believes that the result in *Petter* also is correct on the inapplicability of Regs. §25.2522(c)-3(b)(1).

A recently decided Tax Court decision involving a part-net gift/part-sale is *Hendrix*.[77] In *Hendrix*, John and Karolyn Hendrix transferred, partially by net gift and partially by sale, nonvoting common shares of John H. Hendrix Corporation, a closely held Texas corporation. The shares were transferred by formula, which read as to one of the transfers as follows:

a. that portion of the Assigned Shares having a fair market value as of the Effective Date equal to $10,519,136.12 is assigned to Michael L. Klein and Leslie H. Wood, as trustees of the John H. Hendrix Issue GST Trusts, to be held in equal shares for the John H. Hendrix Issue GST Trust for Leslie H. Wood, the John H. Hendrix Issue GST Trust for Kristin L. Hendrix, and the John H. Hendrix Issue GST Trust for Karmen M. Hendrix; and

b. then, any remaining portion of the Assigned Shares is assigned to the [Greater Houston Community] Foundation, for the benefit of the John H. Hendrix Family Fund.

Therefore, because the family transferees were obligated to pay all gift tax due as a result of the transfers, the amount of each family gift was the value of the shares transferred, less the principal amount of the notes received in consideration of the transfer, less all gift taxes paid. The formula gift, which unlike the clause in *Petter*, was not based upon gift tax value as finally determined, allocated all excess value to the foundation. The shares were appraised in connection with the transaction, and the per share value reached by that appraisal was $36.66.

While the foundation, which was represented by competent counsel, did not authorize a full-blown appraisal (although it clearly had the right to do so), it did authorize an appraiser to review the appraisal, and that review indicated agreement with the methods and results of the appraisal. Approximately five months after the transactions, family donees and the foundation entered into a confirmation agreement, which formally divided the shares amongst themselves. The taxpayers were not involved in the confirmation agreement.

In the Tax Court, the parties stipulated prior to trial that the per share value of the shares was $48.60. The taxpayers took the position that the excess value created by the stipulated value accreted to the foundation, thereby increasing the gift tax charitable deduction. Not surprisingly, the IRS took the position that the taxable gifts to the family donees increased substantially. In response to the taxpayer's position that the stipulated value simply passed to the foundation, the IRS argued that the charitable deduction is available only for amounts actually paid to charity. Because the foundation essentially forfeited its rights to an additional allocation of shares pursuant to the formula, no increased charitable deduction beyond that as to the shares that the foundation actually received should be permitted.[78]

The IRS also argued that the charitable transfers were "an incidental, but necessary aspect of the transaction." [79] The author wonders why this is an issue at all in light of the mountain of evidence presented at trial that the taxpayers had exhibited significant charitable intent and involvement. As such, the author believes that this argument is nonsensical and contrary to the facts of the case.

In *Hendrix*, the IRS attempted to make much out of its allegations that neither the original assignments nor the confirmation agreements were confected at arm's length and specifically alleged that the foundation somehow was not acting at arm's length because it failed to obtain a full-blown appraisal of the units prior to accepting the assignments or the confirmation agreements. The IRS unbelievably went so far as to accuse the foundation of being selected because it was "willing to work with [the taxpayers] in their aggressive tax avoidance scheme. . ." [80] The facts are that the foundation was represented by competent tax counsel, and that the foundation made a judgment call that, in light of the value of the gifts to it, a review of the appraisal by a qualified business valuation professional, rather than a full-blown appraisal, would satisfactorily protect its interests and satisfy its due diligence needs. The author submits that the business judgment rule should apply, such that the foundation clearly acted at arm's-length with the trusts.

In the Tax Court, the first news that the opinion gave the IRS was a harbinger of things to come. The

[77] See fn. 5, above.

[78] Contrast this to the government's position in *Petter*, where, on appeal, the government argues that no charitable deduction should obtain, even as to the original units transferred to charity, citing Regs. §25.2522(c)-3(b)(1).

[79] Respondent's Answering Brief, p. 62.

[80] Respondent's Answering Brief, p. 85.

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Tax Court shifted the burden of proof to the IRS. The Tax Court determined that the case was to be determined in significant part by the Fifth Circuit (the circuit to which any appeal would lie) in *McCord*. The two issues outside of *McCord* were the IRS arguments that either the formula clauses were not the product of an arm's-length transaction or were void as contrary to public policy. The Tax Court found against the IRS on both scores. The Tax Court expressly held that the formula clauses controlled the valuation of the stock. More importantly, the Tax Court expressly rejected the IRS request that the court find collusion between the taxpayers and the foundation.

It is impossible to speculate on what took the Tax Court so long to issue its decision in *Hendrix*. This author wondered whether this would be a reviewed decision because that is often what causes delay in the rendition of opinions, but it was a memorandum decision. The *Hendrix* case is appealable to the Fifth Circuit, which, in view of the *McCord* decision, does not, in the author's opinion, portend well for the IRS.

Disclaimer of a formula amount of a lifetime gift. In this technique,[81] the donor makes a gift, and the donee then executes a disclaimer of an amount in excess of a certain defined value, such as the donor's remaining applicable credit amount, etc. Clearly, disclaimers are expressly authorized by Congress for both gift and estate tax purposes.[82] Additionally, formula disclaimers are expressly authorized in the Treasury Regulations.[83] The IRS has issued a number of private rulings blessing formula disclaimers,[84] although none of these rulings directly involve the technique in question. The first question that a donor might ask in this technique, which might be regarded as the flip side of the defined value gift, is why should we have to rely upon the disclaimer of someone else to fix the amount of the gift that we intend to give. In the author's opinion, the answer again lies in the IRS overextension of *Procter*.

The lifetime gift disclaimer technique is not without its problems. First of all, if the disclaimer is planned and is the subject of an implied agreement on the part of the donee to disclaim, query whether the disclaimer will be disregarded. The ''implied agreement'' cases under the *Crummey* crusades[85] may provide some solace, although that situation potentially leaves clients in the less than enviable position of trying to prove a negative, i.e., that there was no agreement in advance. The author suspects that the IRS will probe into the circumstances of the gift. If the gift and disclaimer documents are drafted at the same time, or if they are executed at the same time, query how a court will feel about that in the context of a request by the IRS that it disregard the disclaimer.

Another potentially significant problem with the disclaimer technique alone lies in the period before the amount of the gift (as modified by the disclaimer) is finally determined for gift tax purposes. If the value of the gift is adjusted upward, such that the preliminary percentage of the property gifted is reduced, could the donee's access to property that after final determination of value is deemed to have been disclaimed have any negative effect on the disclaimer's validity? Prudence suggests that with risk alone, not to mention the potential ''implied agreement'' problem discussed above, some protective measures are in order.[86]

But what is the effect on the disclaimer technique where the preliminary amount of the property represented by the gift net of the disclaimer is less than the value as finally determined? Of course, one would hope that this would never happen, but valuation uncertainty cuts both ways. If this did happen, what is the mechanism for return and how could such be drafted? While this is hopefully unlikely, this technique probably should be used in combination with the defined value gift, immediately giving rise to the question as to whether this technique is too much sugar for a dime.

Formula fractional disclaimer of a share of an estate. In *Christiansen*, a legatee executed the following disclaimer:

> Partial Disclaimer of the Gift: Intending to disclaim a fractional portion of the Gift, [Daughter] 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 ($6,350,000.00) and the denominator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001 (''the Disclaimed Portion''). For purposes of this paragraph, the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001, shall be the price at which the Gift (before payment of debts, expenses and taxes) would have changed hands on April 17, 2001, between a hypothetical willing buyer and a hypothetical willing seller, neither being

[81] For an article about this technique, see Handler & Chen.

[82] §§2046, 2518.

[83] Regs. §25.2518-3(d), *Ex. 20*.

[84] *See, e.g.,* PLRs 200130034, 200001045, 9630034 , 9437029, 9435014, 8424103, 8318093, 7913118.

[85] *See, e.g., Kohlsaat Est. v. Comr.*, T.C. Memo 1997-212.

[86] Handler & Chen make some suggestions, at p. 238.

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> under any compulsion to buy or sell and both having reasonable knowledge of relevant facts for purposes of Chapter 11 of the Code, as such value is finally determined for federal estate tax purposes.
>
> . . .
>
> [To] the extent that the disclaimer set forth above in this instrument is not effective to make it a qualified disclaimer, Christine Christiansen Hamilton hereby takes such actions to the extent necessary to make the disclaimer set forth above a qualified disclaimer within the meaning of section 2518 of the Code.

The disclaimer caused the disclaimed amount to pass 75% to a charitable lead trust created in the will (in which the disclaimant held the reversionary interest) and 25% to a private foundation. The IRS and the estate agreed to an increase in the valuation of partnership interests that the testator owned, which caused the amounts passing pursuant to the disclaimer, and thus the estate tax charitable deduction, to increase. However, the IRS disallowed the increased charitable deduction for both the amount passing to the charitable lead trust and the portion passing to the private foundation, in part because of public policy concerns, evoking *Procter*.

The estate petitioned the Tax Court, which issued a split decision ruling in favor of the IRS as to the disclaimed portion passing to the charitable lead trust but in favor of the estate as to the disclaimed portion that passed to the foundation. In a reviewed decision, the Tax Court unanimously held that the disclaimer was not contrary to public policy, expressly stating that the disclaimer was not like the attempted revocation of the gift in *Procter*.

On the IRS appeal of the increased charitable deduction that arose upon the increase in the estate's value by virtue of the disclaimed portion that passed to the foundation, the Eighth Circuit unanimously affirmed the Tax Court's reviewed holding. In so doing, the Eighth Circuit expressly observed that the purpose of the IRS is not to maximize revenue, but, rather, to administer the tax laws, citing §§7801 and 7803.

The Tax Court and the Eighth Circuit are clearly correct about the validity of a defined value disclaimer.[87] The record was devoid of any facts that would cause trouble, i.e., ''factual baggage.''

WHAT *MIGHT* WORK?[88]

The real question with many of the techniques described in this section is not technical reliance on tax law, but whether taxpayers should have to go to such lengths to achieve desired results. The author submits that the IRS overuse of *Procter* [89] has contributed significantly to the employment of these sorts of techniques.

Gift or sale of a certain amount, with all increases on final determination to a ''backup Walton GRAT.'' A recently published article provided the following example of the GRAT residue technique:[90]

> [T]he transferor could assign an X percent limited partnership interest to be allocated $Y worth to a defective dynasty trust in exchange for a promissory note, and the rest (whatever amount that may be) to a simultaneously created GRAT. The GRAT would be nearly zeroed out using a *Walton* GRAT so that the value of the gift is a small fraction of the value of the asset transferred. . .[91]

Will this technique pass the policy smell test? The following quoted comment made in the above referenced article may come back to haunt the technique in this regard and very well might end up in the IRS brief (emphasis added): ''The *Walton* GRAT not only provides a safety net for a dispute over valuation. *It also will dissuade the IRS from auditing*.'' [92]

Now, this is not to suggest that *all* actions attempting to dissuade the IRS from auditing transfer tax returns are suspect. Clearly, a quality valuation report has a far better likelihood of dissuading the IRS from auditing than a shoddy appraisal report, and it would be ludicrous to believe that compliance with the appraisal report minimum guidelines would be violative of the public policy concerns enunciated in *Procter*. Now, with that said, the article goes on to advise ''prudent'' practitioners to ''never'' create a zeroed-out GRAT, despite the holding in *Walton v. Comr.*[93] That arguably permits a zeroed-out GRAT, although the advice given in the article regarding how low to

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[87] For commentary about the *Christiansen* case, see, e.g., *Steve Leimberg's Estate Planning Newsletter*, Nos. 1234 (Jeffrey N. Pennell), 1239 (Steve R. Akers), 1556 (Steve R. Akers), and 1560 (Richard L. Fox). *See also* Morden, '' 'Reallocating' Wealth after *Christiansen*: A Fresh Look at Formula Clauses,'' 35 *ACTEC J.* 97 (Summer 2009).

[88] No warranties, express or implied.

[89] See fn. 9, above.

[90] With attribution to the technique's inventor, Stacy Eastland.

[91] Oshins, ''New Twist on a Popular Technique,'' *Tr. & Est.* 12–18 (Sept. 2002) (hereafter, ''Oshins''). *See also* Oshins & Simmons, ''The SCIN-GRAT,'' *Tr. & Est.* 18–26 (June 2008); Oshins, Oshins & Keebler, ''The SCIN-GRAT: An Innovative Strategy to Hedge Your Bet,'' *Est. Plan.* 3–6 (Sept. 2007).

[92] Oshins, at p. 17.

[93] 115 T.C. 41 (2000).

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go in designing the *Walton* GRAT is as follows: "To be conservative, planners should aim for a gift of at least $1."[94]

Nevertheless, an example given in that article demonstrates the possible gift tax leverage of the technique, where an audit increase of $100 million will generate a $10,000 gift.[95] Will this trouble courts? In the author's view, such a technique will have to be virtually free of factual baggage, although that could be said of virtually every defined value transaction.

Query whether a backup GRAT can be created with no current property for tax purposes. Or how will this get reported for tax purposes? As a gift of (if one is "prudent") $1? "Almost zero?" Query how truly "conservative" this position is. The gift tax reporting of a GRAT funded with the contingent increase in value as finally determined at not less than $1 may well be characterized as "trifling with the system" along the lines discussed in *Procter*.

The Tax Court clearly exhibited hostility to a "tax repellent" method, referring to it as a "tax neutralization" clause.[96]

Gift by formula that, on revaluation as finally determined for gift tax purposes, creates a small or insignificant taxable gift. This is a technique that several commentators have suggested,[97] if for no other reason than to leave something on the table for the IRS in an attempt to ameliorate the *Procter* policy concern as well as, potentially (because this may be a matter of degree), the apparent IRS policy that a clause have audit potential as "tax effect." [98] The problem is the subjective determination involved in this technique, which is a game of "valuation limbo" — how low can one safely go before the IRS attempts to disregard the small gift as well?[99] In TAM 200245053, the taxpayer caused a very small limited partnership interest, 0.1%, to be gifted, while, at the same time, causing a sale of 98.9% of limited partnership interests pursuant to a formula that readjusted the amount of sold interests on revaluation of the gifted interest.

The formula clause in TAM 200245053 was:

> The numerator of such fraction shall be the Purchase Price, and the denominator of such fraction shall be the fair market value of [the 98.9% limited partnership interest]. The fair market value of [the 98.9% limited partnership interest] shall be such value as finally determined for federal gift tax purposes based upon other transfers of limited partnership interests in the Partnership by Seller as of [Date 2], in accordance with the valuation principles set forth in Regulation Section 25.2512-1 as promulgated by the United States Treasury under Section 2512 of the Internal Revenue Code of 1986, as amended.

In disregarding the formula adjustment clause, the IRS stated (footnote omitted):

> In this case, the gift of the 0.1 percent interest and the sale to Irrevocable Trust were part of an integrated transaction. The Taxpayer has placed an insignificant portion of the transaction at issue in order to circumvent well-established case law that has developed regarding savings clauses. We do not believe the courts would permit these decisions to be so easily avoided. For example, in *Procter*, under the clause at issue, the gift was revoked to the extent it was finally determined that the gift was subject to gift tax. The court determined that the savings clause "device" was contrary to public policy. It is doubtful that the court would have reached a contrary conclusion, if the gift was revoked in its entirety but for $1.00, thus creating the potential for a nominal deficiency, in the event the Service contests the matter. Such a provision would have the same effect of discouraging the collection of tax by public officials, and would constitute the same "trifling with the judicial process," as the actual clause involved in *Procter*. Accordingly, we do not believe the clause at issue is in any meaningful way distinguishable from those presented in *Procter* and *Ward*.[100]

In TAM 200245053, the IRS provided the following analysis of the operation of the formula clause:

> We see no difference between the effect of the adjustment clauses at issue in *Ward* and Rev. Rul. 86-41, and the adjustment provision in this case. In the instant case, Spouse, as trustee of Trust B, transferred the entire 98.9 percent limited partnership to the Irrevocable Trust pursuant to the Sales Agreement and The Agreement. However, if the Service adjusts the value of the gift of the 0.1 percent

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[94] Oshins, at p. 14.

[95] Oshins, at p. 17.

[96] See footnote 47 in *McCord* (cited in fn. 2, above).

[97] McCaffrey, at p. 14; Oshins, at pp. 14 and 17.

[98] FSA 200122011.

[99] Other commentators have raised this question as well. *See, e.g.,* Raby & Raby, "Gift Tax Effect of Valuation Adjustment Clauses," 37 *Tax Practice* 17 (Jan. 24, 2003) (hereafter, "Raby & Raby").

[100] See fn. 20, above.

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> limited partnership interest transferred by the Spouse on Date 2, then under the formula in the Sales Agreement, the denominator of the fraction must be adjusted, but not the numerator, thereby reducing the fractional portion of the 98.9 percent interest subject to the sale and compelling a retransfer of a portion of the 98.9 percent interest back to Trust B. Thus, we believe the case is indistinguishable from the facts presented in *Ward* and Situation 1 of Rev. Rul. 86-41. In all three situations, under the adjustment clause at issue, if the Service, or the courts, determined that the property subject to the transfer exceeds the value initially placed on the property by the donor, then a portion of the property sufficient to eliminate the imposition of any additional tax liability is transferred back to the transferor.

In the author's opinion, the IRS was clearly wrong when it categorized the clause in TAM 200245053 as ''indistinguishable'' from the clauses in *Ward* and Rev. Rul. 86-41,[101] Situation 1, as the latter two were clearly conditions subsequent.

In the author's opinion, the facts in TAM 200245053 contained ''factual baggage'' that was the real reason why the IRS ruled as it did, including:

- formation of a partnership and an immediate gift/sale of almost all of the significant initial contributing partner's interests;
- a gift of a ''sliver'' interest in what possibly was an attempt to trigger the running of the gift tax statute of limitation;
- disclosure of a sale between trusts on an individual's gift tax return;
- a sale controlled on both ends by the same person; and
- a valuation clause that was not adjustable if the value of the sold partnership interests was challenged only in an income tax setting (and, quite possibly from an interpretation of the formula, only if the sliver interest was revalued on gift tax audit, as opposed to the sale itself being considered a gift).

As is discussed elsewhere in this article, the IRS discussion in this ruling really is more focused on the ''factual baggage'' than the formula clause.

One issue that this ruling raises is: Is there a legitimate distinction between a clause that serves as a ''lid'' for others via a reallocation to tax-advantaged recipients and a clause, like the one in TAM 200245053, which in essence returns property to the transferor? Given that one cannot make a taxable gift to oneself, it is the author's opinion that in the proper situation, free from unnecessary ''factual baggage,'' one ought to be able to structure such a transaction. Nevertheless, it is uncertain whether any clause that has the effect of ''tax neutralization'' will be respected.

A gift to family donees, with a contemporaneous transfer to charity. This technique, described in a recent article,[102] involves simultaneous gifts of interests in the same property to a qualified charity and to family donees. The hope here is that, if there is an increase in the value of the taxable gift, there is an increase in the charitable contribution deduction to hopefully offset the increased gift tax cost on revaluation. While this strategy may help, it obviously is only going to be useful where a client has donative intent, where the size of the charitable deduction is somewhat similar to the size of the taxable gift, the charity actually receives the value,[103] and the client can utilize the charitable deduction. In the author's opinion, this technique, if properly done, should work, but the real question is whether it has widespread application or is more useful than a properly structured defined value gift. It might be useful in conjunction with a defined value gift. Nevertheless, any such technique should be structured to ensure that the charity actually receives the claimed value.

A sale or gift with a gift over of any excess to a spouse or a marital deduction trust. This is an attempt to put a marital deduction ''lid'' on a transaction by deflecting any excess to a gift tax-advantaged recipient like a spouse or a marital deduction trust. Assuming no ''factual baggage,'' this should work, but it is not without potential problems. The first problem is that a QTIP trust may not work unless there is an actual gift to the QTIP trust, as opposed to simply interposing a QTIP trust on the top of the transaction to suck up any excess value caused by IRS revaluation, because how would one make a lifetime QTIP election over nothing but a contingency? Can one make a protective QTIP election over a mere contingency? For this reason, it would be preferable to have part of the gift actually pass to the QTIP trust. Alternatively, the trust could be a power of appointment marital deduction trust, which requires no election in order to obtain the gift tax marital deduction.

OTHER ISSUES

There are a host of other issues pertaining to defined value transfers that have not been discussed

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[101] 1986-1 C.B. 300.

[102] Raby & Raby.

[103] *See McCord* (cited in fn. 2, above).

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herein, but that should be the subject of research and writing, including, without limitation, drafting, valuation issues, the potential effect of valuation adjustments of other gifts on a subsequently made defined value transfer of a tax-tied amount, such as remaining GST tax exemption, issues of practical operation of the gifted property before the values of the gifted property are finally determined for tax purposes, reallocation of temporary interests upon final determination, the contingent payment obligations,[104] basis recovery,[105] and whether §6501 or the Treasury Regulations preclude the running of the gift tax statute of limitation on all defined value gifts.[106]

In the author's opinion, the bottom line is that properly designed and implemented defined value transfers are more legitimate now than ever before and should be accorded respect for tax purposes, and it is well past time for the IRS to accommodate them with formal guidance.

[104] Regs. §§1.483-4, 1.1275-4.

[105] Temp. Regs. §15a-453-1.

[106] *See, e.g.,* ILM 200221010; Regs. §25.6019-4.

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