DEFINED VALUE CLAUSES IN ESTATE PLANNING

THE ROAD UP TO THE GIFT TAX COUNTY LINE!

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Introduction

Despite continuing IRS resistance, the use of defined valuation clauses in gifting assignments, sales agreements, disclaimers, and exercises of powers of substitution is now very common in estate planning. Due to the recent proliferation of defined valuation clauses in gifting assignments and sale agreements, estate planning practitioners are now seeing defined valuation clause issues being raised during audits of estates and fiduciary reviews of trusts as well as in some income tax audits.

This monograph examines the governing case law that has grappled with defined valuation clauses, provides examples of defined valuation clauses that are likely to work and identifies those defined valuation clauses that will not work, and it discusses how defined valuation clauses are being implemented in day to day practice. I've included a few forms to demonstrate how defined value clauses can be crafted.

What is a Defined Value Clause?

In a defined value clause, the gift assignment, disclaimer and/or the sales agreement defines a value for the transfer that is tied to both the value that the client intended to gift and/or sell for the asset as well as the value of the gift and/or sale of the asset that is finally determined for federal gift, estate, generation skipping transfer tax purposes. The defined valuation clause seeks

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to define the value, not as a stated pecuniary amount, but rather through a defined valuation contract.

Congress as well as the Treasury both expressly allow the use of formula language for gift tax purposes in the areas of charitable remainder trusts, qualified terminable interest property elections, disclaimers and grantor retained annuity trusts.[1] Nevertheless, the Internal Revenue Service has resisted defined value clauses for the straight gift, disclaimer and/or sale of an asset as discussed in the governing case law.

Why Use a Defined Value Clause?

If your clients are like mine were, their desire to make gifts ends at what I call the "gift tax county line," i.e., when they have to start writing checks to pay gift tax at 40% to the government. The reality of the subjectivity of business valuation and the specter of an IRS valuation challenge made it very difficult for many clients to pull the trigger on significant lifetime estate planning without some valuation certainty or protection. Enter the defined value clause.

The Early Case Law-*Procter*

The most significant issue in *Comr. v. Procter*[2] 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 mere cursory reading of *Procter*, it is readily apparent that transfer tax planning 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 private rulings and its litigation positions, overlooks the significant changes in tax law that have occurred in the 77 years that have elapsed since the rendition of *Procter*, during World War II, as well as the underlying facts in *Procter*.

I assert 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 my opinion, the effect of the IRS interpretation of *Procter* is unsound administration of the tax laws, and this interpretation must be reined in. Thankfully, the courts have been doing just that.

It perhaps is instructive that not another federal circuit appellate court has followed *Procter* in the 77 years since the Fourth Circuit rendered its decision in *Procter*. Indeed, only the Fourth Circuit has cited its *Procter* decision favorably.[3] Unfortunately, most of the results desired by 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 back in 1944 in *Procter*, together with a comparison with the current state of the law and our commentary:

> *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. IRS essentially noted this in TAM 8611004.

> *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 expressing permitting formula clauses, basis allocation and contingent price adjustments.[4]

Moreover, IRC Sec. 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, I submit 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 IRC Sec. 2001(f)(2). See the Tax Court's majority opinion in *Christiansen Est. v. Comr.* Moreover, valuation litigation has come quite a way since 1944 and can hardly be described as "trifling" today. In any event, valuation certainly is not anymore "trifling" than most other 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 Est.*, the issues of the amounts of the gifts or charitable deductions (for transfer and income tax purposes) or the amount of property retained also hardly fit the "moot" description. In some ways, legitimate attempts to minimize valuation issues and uncertainty arguably are beneficial from the standpoint of tax policy and administration. The fact that 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.[5]

As pointed out above, although many of the policy justifications for the *Procter* result have evaporated or just don't apply to properly designed defined value transfers, the result in *Procter* remains justified to this day.[6]

The bottom line: Could Mr. Procter have done what he wanted to have done in a properly structured defined value transfer? In my 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 shouldn't be in *Christiansen Est. v. Comr*.

The facts of *Procter* certainly cannot be construed as routine estate planning. 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 monograph will discuss 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.[7] It is noteworthy that ***no other federal circuit appellate court has agreed*** with

Procter for 77 years. The Tax Court's majority opinion in *Succession of McCord v. Comr.* did not make reference to *Procter* or its progeny.

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. In a 2003 article, I 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 Est. v. Comr.*,[8] 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:[9]

> *We are hard pressed to find any fundamental public policy against making gifts to charity--if anything, the opposite is true.*
>
> *…*
>
> *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.*

Modern Case Law and the Trend for Court Acceptance of Defined Value Clauses

The modern case law on defined value clauses usually is grouped into three categories of cases commonly known as (i) *McCord* and *Hendrix*, (ii) *Petter* and *Christiansen* and (iii) *Wandry*.[10]

McCord and *Hendrix* are often grouped together because the defined value clauses involved concluding subsequent agreements of value among the parties. *Petter* and *Christiansen* are often grouped together because they use values as finally determined for federal gift, estate and GST Tax taxes.[11]

McCord was a ten year, hard fought full victory for a taxpayer that used a defined formula valuation for transfer of partnership pecuniary amounts later determined in percentages. The partnership was known at MIL, a Texas limited partnership ("MIL") with contributing partners, Mr. and Mrs. McCord and their four children, Charles III, Michael, Frederick and Stephen. Mr. and Mrs. McCord then sought to divest themselves of their interests in MIL through a stated "Assignment Agreement," and a subsequent "Confirmation Agreement" to which Mr. and Mrs. McCord were not parties transferring and confirming their interests to generation skipping trusts, outright to their four sons, the Community Foundation of Texas, Inc. and Shreveport Symphony, Inc.[12] Despite its successful use in both *Succession of McCord* and in *Hendrix*, I find the post-gift confirmation agreement scheme very problematic on a number of levels and can't ever recommend using it.

The defined value clause in *McCord* was designed as a waterfall approach that (i) transferred to the GST Trusts a dollar amount of fair market value in interest of MIL equal to the dollar amount of Mr. and Mrs. McCord's net remaining generation skipping tax exemption, reduced by the dollar value of any transfer tax obligation owed by the trusts by virtue of their assumption thereof, (ii) to the four sons, $6,910,932.53 worth of fair market value in interest of MIL, reduced by the dollar value of (1) the interests in MIL given to the GST trusts and (2) any transfer tax obligation owed by the sons by virtue of their assumption thereof, (3) to the Symphony $134,000 worth of interests in MIL and finally (iv) to the Community Foundation the dollar amount of the interests of Mr. and Mrs. McCord in MIL, if any, that remained after satisfying the gifts to the GST trusts, the sons and the Symphony.

The date of the gifts was January 12, 1996. On February 28, 1996, an independent qualified appraiser assigned percentages of MIL to the parties, coordinating with the pecuniary amounts in the Assignment Agreement, and the donees agreed in a Confirmation Agreement to the final percentages owed by each party in MIL. Notably, each donee was represented by independent counsel. On audit, the IRS nearly doubled the valuation of the independent appraiser, assessed deficiencies and stated that the defined value clause was improper. The U.S. Fifth Circuit Court disagreed entirely and upheld the actual pecuniary amounts of the taxpayer as the reported gifts.[13]

Similar to *McCord*, *Hendrix* involved transfers to daughters of shares in a closely held S Corporation and a donor advised fund at a public charity. Shares equal to a certain pecuniary amount were transferred to trusts for the daughters and any excess went to the donor advised fund. Both the daughters and the public charity hired independent counsel and had independent valuations. Then, they came to a conclusion as the amount of shares that equaled the amount in the defined valuation clause and signed concluding transfer documents and agreements among themselves. Similar to *McCord*, there were a number of "good facts."

Petter is a Ninth Circuit case (which is not typically friendly to taxpayers) that involved Mrs. Petter transferring by gift and by sale family LLC units to trusts for her descendants and to two public charitable foundations. There were substantial gifting and sale documents. The transfer documents had the following adjustment clause for an under or over valuation as finally determined for federal gift, estate and transfer taxes:

> 1.2 The Trust 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, the Trustee will, on behalf of the Trust and as a condition of the gift t 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.[14]

Christiansen Est. was cited favorably in *Petter* for the Ninth Circuit's agreement with the Eighth Circuit's reasoning. *Christiansen Est.* involved a transfer under a will to a decedent's daughter with a direction that any amounts disclaimed by her would go in part to a charitable foundation. The daughter did disclaim any rights she had to amounts over $6.35 million as finally determined for federal estate tax purposes. The Eighth Circuit determined that this event, the valuation for transfer tax purposes, occurred on the date of her death and was not a condition subsequent. The *Christansen Est.* court found:

> *the resolution of a dispute about the fair market value of the assets on the date [the decedent] died depends only on a settlement or final adjudication of a dispute about the past, not the happening of some event in the future.*[15]

The final win for the taxpayer under modern defined valuation clause case law theory is *Wandry* which notably did not involve any public charities or independent third parties giving even more flexibility to the taxpayer for drafting of defined value clauses. It is important to note, however, before discussing the facts of *Wandry* that the IRS has disavowed *Wandry* for use in any other situations.[16]

In *Wandry*, Mr. and Mrs. Wandry transferred LLC Units equal to value of $261,000 to three children and $11,000 to five grandchildren where the fair market value of the units was determined for federal gift tax purposes and where the number of gifted units was adjusted accordingly so that the value of the number of units to each person equaled that value. The defined valuation formula was upheld. Like the cases before it, *Wandry* had a number of good facts, including: (i) an adjustment to the LLC capital account once values were finally determined, (ii) a gift tax return that described the gifts as percentage formula interests and not pecuniary amounts, and (iii) an old and well respected LLC.

However, it hasn't been totally smooth sailing for taxpayers around defined value clauses since the Fifth Circuit reversal of the Tax Court in *McCord*. Two recently decided cases illustrate that taxpayers have to be flawless in their arrangement and implementation of a defined value clause.

In the 22 page gift tax Tax Court memorandum opinion in *Nelson v. Comr.*,[17] issued on June 10, 2020, Judge Pugh ruled in favor of the IRS on an attempted defined value gift and a defined value sale, holding that the donors transferred *percentage interests* instead of *specific dollar* amounts, distinguishing *Wandry*. The court also determined the value of the percentage gift and the percentage sale, which resulted in a deficiency for both transactions. The case is appealable to the Fifth Circuit.

In *Nelson*, the issues for decision were: (1) whether the interests in Longspar Partners, Ltd. (Longspar), transferred by gift on December 31, 2008, and January 2, 2009, transferred by installment sale, were of fixed dollar amounts or percentage interests and (2) the fair market values of those interests.

Longspar was formed on October 1, 2008, as a Texas limited partnership based in Midland, Texas. It was formed as part of a tax planning strategy to (1) consolidate and protect assets, (2) establish a mechanism to make gifts without fractionalizing interests, and (3) ensure that WEC remained in business and under the control of the Warren family. Mr. and Mrs. Nelson are Longspar's sole general partners, each holding a 0.5% general partner interest (together holding a 1% interest in Longspar as general partners) and 99% as limited partners.

The biggest asset of Longspar was a 27% interest in a holding company that in turn held the stock of several operating subsidiaries, the business of which was primarily in two areas: oil field service and being the dealer of Caterpillar in just about the entire state of Oklahoma and much of west Texas.

Just three months after its formation, Mrs. Nelson made two transfers of limited partner interests in Longspar to a trust. The first transfer was a gift on December 31, 2008. The Memorandum of Gift and Assignment of Limited Partner Interest (memorandum of gift) provided:

> [Mrs. Nelson] desires to make a gift and to assign to * * * [the Trust] her right, title, and interest in a limited partner interest having a fair market value of TWO MILLION NINETY-SIX THOUSAND AND NO/100THS DOLLARS ($2,096,000.00) as of December 31, 2008 * * *, **as *determined by a qualified appraiser*** within ninety (90) days of the effective date of this Assignment. [Emphasis added]

Petitioners structured the second transfer, on January 2, 2009, as a sale. The Memorandum of Sale and Assignment of Limited Partner Interest (memorandum of sale) provided:

> [Mrs. Nelson] desires to sell and assign to * * * [the Trust] her right, title, and interest in a limited partner interest having a fair market value of TWENTY MILLION AND NO/100THS DOLLARS ($20,000,000.00) as of January 2, 2009 * * *, ***as determined by a qualified appraiser*** within one hundred eighty (180) days of the effective date of this Assignment * * *. [Emphasis added]

Neither the memorandum of gift nor the memorandum of sale contained clauses defining fair market value or aany other clause subjecting the limited partner interests to reallocation after the valuation date. In connection with the second transfer, the trust executed a promissory note for $20 million.

Mr. Nelson, as trustee, signed the note on behalf of the trust. The note provides for 2.06% interest on unpaid principal and 10% interest on matured, unpaid amounts, compounded annually, and is secured by the limited partner interest that was sold. Annual interest payments on the note were due to Mrs. Nelson through the end of 2017. The Longspar partnership agreement was amended on January 2, 2009 (the date of the installment sale to the trust) to reflect the trust as the holder of a 6.14% limited partnership interest in Longspar (acquired by gift) and a 58.65% limited partnership (acquired by sale).

The Nelsons retained an appraiser to value the Longspar interests that were given and sold. That appraiser in turn relied upon another appraisal of the operating companies that were included within the holding company, 27% of the stock of which was held in Longspar. The valuation issues weren’t that unusual, except to note that the appraisers for both the Nelsons and the IRS weren’t really that far apart. The real issue was the efficacy of the defined value clauses in the gift and in the sale.

Longspar reported the reductions of Mrs. Nelson's limited partner interest and the increases of the Trust's limited partner interests on the Schedules K-1, attached to its Forms 1065, U.S. Return of Partnership Income, for 2008 through 2013. Longspar also made a proportional cash distribution to its partners on December 31, 2011. The Trust's portion of the cash distribution — 64.79% — was based on the appraiser's valuation.

The Nelsons filed separate Forms 709, United States Gift (and Generation-Skipping Transfer) Tax Returns, for 2008 and 2009. On their 2008 Forms 709, they each reported the gift to the trust “having a fair market value of $2,096,000 as determined by independent appraisal to be a 6.1466275% limited partner interest” in Longspar. They classified it as a split gift and reported that each person was responsible for half ($1,048,000). They did not report the January 2, 2009, transfer of the Longspar limited partner interest on their 2009 Forms 709, consistent with its treatment as a sale.

With respect to the defined value clauses, the Nelsons relied upon *Wandry v. Commissioner.* The IRS countered that the Nelsons actually gave and sold percentage interests in Longspar and not defined value transfers.

Petitioners and the Internal Revenue Service (IRS) Office of Appeals (IRS Appeals) negotiated a proposed settlement agreement, but it was never completed before the IRS had to protect the statute of limitations by issuing a notice of deficiency, which ended the audit and moved the matter into the Tax Court.

Inexplicably, purely on the basis of their unfinalized settlement discussions with IRS Appeals, petitioners unilaterally amended Longspar's partnership agreement to record the Trust's limited partner interest in Longspar as 38.55%, and they made corresponding adjustments to the books for Longspar and the trust. Longspar also adjusted prior distributions and made a subsequent proportional cash distribution to its partners to reflect the newly adjusted interests.

In the August 29, 2013, notices of deficiency, the IRS determined that the Nelsons had undervalued the December 31, 2008 gift, and their halves of the gift each were worth $1,761,009 rather than $1,048,000 as of the valuation date. The IRS also determined that the Nelsons had undervalued the January 2, 2009 transfer by $13,607,038, and therefore they each had made a split gift in 2009 of $6,803,519. The Nelsons filed separate petitions in the Tax Court, which were consolidated for trial.

After its typical avoidance of IRC Sec. 7491 regarding the burden of proof shift, Judge Pugh determined that the Nelsons had given and sold percentage interests rather than having made defined value transfers. He reasoned:

> Unlike the clause in *Succession of McCord*, "fair market value" here already is expressly qualified. By urging us to interpret the operative terms in the transfer instruments as transferring dollar values of the limited partner interests on the bases of fair market value as later determined for Federal gift and estate tax purposes, ***petitioners ask us, in effect, to ignore "qualified appraiser * * * [here, their appraiser] within * * * [a fixed period]" and replace it with "for federal gift and estate tax purposes." While they may have intended this, they did not write this. They are bound by what they wrote at the time.*** As the texts of the clauses required the determination of an appraiser within a fixed period to ascertain the interests being transferred, we conclude that Mrs. Nelson transferred 6.14% and 58.35% of limited partner interests in Longspar to the Trust as was determined by their appraiser within a fixed period. [Emphasis added]

Judge Pugh went on to determine the value of the percentage interests transferred. He essentially split the difference, determining that Mrs. Nelson's transfers to the trust have fair market values of $2,524,983 (about a $430,000 difference) and $24,118,933 (and $4,118,933 difference), respectively.

Sadly, this is the correct result. The Nelsons have appealed the matter to the Fifth Circuit, but I fully expect the ruling to be affirmed. The value was to be finally determined ***by their appraiser***, not as finally determined for federal estate and gift tax purposes. The moral of this story: those ten missing words (as finally determined for federal estate and gift tax purposes) must be in *every* defined value transaction document!!! It's unclear whether the Nelsons engaged separate counsel for the trust, which always is advisable.

What *might* work?[18]

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. I submit that the IRS overuse of *Procter* 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 published article provided the following example of the GRAT residue technique:[19]

> [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...[20]

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:

> The Walton GRAT not only provides a safety net for a dispute over valuation. *It also will dissuade the IRS from auditing.*[21] [emphasis added]

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 advises "prudent" practitioners to "never" create a zeroed out GRAT, despite the holding in *Walton v. Comr*.[22] That arguably permits a "zeroed out GRAT," although the advice given in the article regarding how low to go in designing the *Walton* GRAT is as follows:

> "To be conservative, planners should aim for a gift of at least $1."[23]

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.[24] Will this trouble courts? In my 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 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 has clearly exhibited hostility to a "tax repellent" method, referring to it as a "tax neutralization" clause.[25]

In a recent family limited partnership case in which the estate lost under IRC Sec. 2036,[26] one aspect of the comprehensive, expensive yet failed estate plan was a transfer of funds to a charitable trust if the IRS asserted a higher estate value. The estate argued that the clause was within the ambit of similar clauses that courts had upheld in *Christiansen Est. v. Comr.* and in

Petter v. Comr. However, in denying to apply those cases to the estate's situation, the Tax Court noted:

> *This is unlike Estate of Christiansen, where we **knew** the charity would get a **transfer** of assets, just not the **value**, or Estate of Petter, where we **knew** the charity would get some **transfer** of value, just not how **much**. Here, we **don't know** if the charity would get any additional assets **at all**. Moore v. Comr.*, T.C. Memo. 2020-40, at *59. [Emphasis by the court, but additional emphasis added]

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,[27] if, for no other reason than to leave something on the table for IRS in an attempt to ameliorate the *Procter* policy concern, as well as, potentially (since this may be a matter of degree), the apparent IRS policy that a clause have audit potential as "tax effect."[28] 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?[29] 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 percent limited partnership interest]. The fair market value of [the 98.9 percent 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:

> *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.* [footnote omitted and emphasis added]

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 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 my opinion, the IRS is clearly wrong when it categorized the clause in TAM 200245053 as "indistinguishable" from the clauses in *Ward* and Rev. Rul. 86-41, Situation 1, as the latter two were clearly conditions subsequent.

In my 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 limitations;

● 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 monograph, the IRS discussion in this ruling really is more focused on the "factual baggage" than the formula clause.

This ruling raises the following issue: 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 my opinion that in the proper situation, free from unnecessary "factual baggage," one ought to be able to safely structure such a transaction. Nevertheless, 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,[30] involves a simultaneous gift of interests in the same property to a qualified charity and to family donees. The hope here is 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 charitable 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[31] and the client can utilize the charitable deduction. In my 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/sale. 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.

Discuss Moore

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 similar to the *Moore* issue discussed sbove, 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.

Defined Value Clauses I Know Won't Work

One way adjustment-gift of specific property, with interest in gifted property reduced and returned to the donor on adjustment by IRS.

These are the facts of Situation 1 in Rev. Rul. 86-41.[32] 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 worth 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 only arose if the IRS determined that the one-half interest in the property was worth more than $10,000. In my opinion, the result in this ruling is correct and is proper from the standpoint of tax policy: the retained right of return was a condition subsequent under local law. As will be evident a bit later into the 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.

In my 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.*,[33] 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*."[34]

In my 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 my 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 as of the date of the gift as finally determined pursuant to IRC Sec. 2001(f)(2).

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 would have been successfully increased,[35] the gifts in *Ward* really were not defined value gifts: those gifts were more in the vein of "intended value" gifts. As we will see in the discussion of the next two private rulings, "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 for applicable family members by IRC Sec. 2701), one that IRS used to battle, and an exchange of interests in a partnership and 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 is "different" from that arrived at in the initial appraisal, not gift tax as finally determined. 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.[36] In *King v. United States*,[37] which involved an intrafamily sale, the court seemed to find intention that the parties didn't intend the sale to be a gift, and intention as to whether a transaction is not a gift is relevant.[38] In *Harwood*, 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.[39] In my view, the Tax Court's statement in footnote 23 of its *Harwood* opinion, quoted below, borders on the overly cynical and is just wrong:

> *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 and the Treasury Regulations and other rulings all of the time that they 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 in the original interest discount/applicable federal rate cases under IRC Secs. 483, 1274 or 7872 and 7520, as well as the accompanying regulations.

Surely, 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 forms such as GRAT's and CRAT's, 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 only cared that the grantor-seller pay incur no gift tax 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 didn't pay or couldn't pay the gift tax.[40] 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. I humbly submit that when the IRS and the lower courts stray from this principle, tax policy and administration is damaged through irreconcilable results and less predictability.[41] In *McCord*, the Tax Court majority in essence overlooked the donors' intentions as well as the actual documents.

In my 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."[42] 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, IRS spilled virtually no ink in TAM 9309001 on the machination of the formula itself. In my opinion, as discussed above, the clause in TAM 9309001 was defective relative to making adjustments, and I believe that 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 our opinion, the IRS is guilty of intellectual sloth when it simply classifies a transaction as "fishy" without first 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 business purpose, stating:

> *The clause in this case is clearly distinguishable from those commonly found in agreement 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 value.

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 earlier, IRS has acknowledged the subjectivity of valuation in regulations, litigation positions and in published rulings. Yet, despite a bevy of cases in which taxpayers argue against their own tax return positions on valuation,[43] the IRS continues to assume that taxpayer valuations are ***always*** skewed to their 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 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.[44] 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 my opinion, to do otherwise directly contravenes clear Congressional intent concerning transfer tax exemptions and exclusions.[45]

Private annuity, parties agreed to value of the assets, with a seemingly 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.*[46] In *McLendon Est.*, 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 Est.* 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 my opinion, the result in *McLendon Est.* 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 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 precarious 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 Est.* was tried piecemeal, with an interruption for appeals of each part. The actuarial tables issue perhaps should have disposed of first. In fact, in *Knight v. Comr.*,[47] the Tax Court shrewdly (and, in my opinion, correctly) avoided reliance upon *Procter* and *Ward,* noting:

> *We need not decide whether Procter and Ward control here because we disregard the 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 Est.* only affected 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.[48] It seems undeniable that a private annuity can be properly arranged via a formula, but the clause in *McLendon Est.* was not the way to do it in my opinion.

Gift of specific interest in property, with a one-way obligation to pay consideration to donor for value in excess of original intended value of gift.

These are the facts in Rev. Rul. 86-41,[49] 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), it 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 my 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,[50] because the transaction was not arranged as a part sale at the outset. It is my 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 v. Comr.*

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[51]) for tax purposes. On this point, there is a difference of opinion as to whether the courts would respect the difference on policy grounds.[52] The IRS has indicated that any clause that produces a similar "effect" as the clause in *Procter* is proscribed, in its view.[53]

On balance, I come down on the side 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 monograph 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 appraisal by an independent third party appraisal would be respected. Query whether the IRS' distinction between an adjustment that it will respect and an adjustment that it will not respect is well defined and consistent enough to give taxpayers proper guidance.

There also was a one-way additional consideration clause at issue in *Harwood v. Comr.*[54] 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, administered, 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 v. U.S.*,[55] 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 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 my 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 or 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, since no note was even potentially viable pursuant to the clause until the gift tax was "finally determined."

Query what effect would have been had the trustee's lawyer have 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.

Sample Defined Valuation Clauses - What I Think Might Work and Whether To Use or Not to Use

Both the early case law and the modern case law define situations where a defined valuation clause will likely work. However, before a summary of such situations where a defined valuation clause will likely work, it is paramount to carefully explain to the client the risks attendant to the defined valuation clause option and whether or not to include the defined valuation clause in the gift assignment and/or sale agreement. The principal risk is IRS audit and the defense costs associated therewith, which can be significant. The risk aversion of some clients make them poor candidates for defined value transactions or even rules out their participation.

Even though most clients understand the benefits of the defined value clause, some clients will decline to use the defined value clause in the gift assignment and/or sales agreement. Sometimes, clients will ask if the trustee will have a fiduciary duty to monitor facts and circumstances that might trigger the use of the defined value clause before or after the client's death. Clients often do not want to put the fiduciary under such obligation to monitor or trigger the implementation of a defined value clause that may require a subsequent, more accurate valuation, and some commercial trustees are reticent about being put in such a position.

Other clients decline to use the defined valuation clause because they do not want to be the subject of an ongoing court case or litigation brought by the IRS to test the defined value clause. Instead, some clients would rather argue straight valuation on audit by the IRS even if this means more tax would result. Only after the estate planner has an understanding of the client's appetite for the use of a defined value clause can the estate planner then move onto whether the clause is likely to work in the context of the client's unique facts and circumstances. Know your client; some don't tolerate the stress of the battle with the IRS well.

Petter v. Commissioner, which involved both a gift and sale of limited liability company units, provides a first scenario that is likely to succeed. In a *Petter* defined formula value clause for a gift and sale, adjusted as finally determined for federal gift tax purposes, with either the excess gifted to a public charity or an overpayment refunded by the public charity to the appropriate beneficiaries. *Succession of McCord v. Comr.* involved a public charity, and *Christiansen Estate v. Comr.* involved a charitable foundation. Both cases had similar defined valuation clauses to *Pette*r, albeit more complex than the *Petter* defined value formula.

Estate planners often gravitate to a charity option as it would imply involvement of an independent third party and their arms-length oversight. The second reason why many practitioners gravitate to *Petter* type language is that if there is an increase in the valuation of the asset on audit, there is a donation to charity that prevents any upside additional gift tax imposition from the IRS. In *Petter v. Commissioner*, the client made a gift of 10% of the value of the asset outright to the public charity, namely, the Seattle Foundation. It is unlikely that a public charity would be too enthusiastic about receiving only a donation if a defined value clause was implemented. Moreover, if the defined value clause is arranged so that the charity won't receive anything ***unless*** the adjustment clause was triggered, it is likely that the clause won't work.[56] In my opinion, each donee/purchaser, particularly charitable and marital deduction-favored parties, must have an immediate and real interest, and not one that stands merely as a contingent receptacle if the IRS successfully asserts a higher valuation on audit and subsequent litigation/negotiation.

Petter type language could be written as follows:

> Grantor assigns to the [Grantor Trust] as a gift the __ number of units of [LLC] that equals one-half of the minimum dollar amount that can pass free of federal gift tax by reason of the Grantor's applicable exclusion amount allowed by IRC Section 2010(c). Grantor currently understands his/her unused applicable exclusion amount to be $___________, so that the pecuniary amount of this gift should be $_______________.
>
> Grantor assigns to [Public Charity] the difference between __ number of units and the total number of units finally determined for federal gift tax purposes to be assigned to the [Grantor Trust].

> The Trustee of the [Grantor Trust] also agrees that, if the value of the LLC units it initially receives is finally determined for federal gift tax purposes to exceed the amount described in the first paragraph above, the Trustee will, on behalf of the [Grantor Trust] and as a condition of the gift to it, transfer the excess Units to the [Public Charity] as soon as possible."
>
> The [Public Charity] agrees that, if the value of the LLC units the [Grantor Trust] initially receives is finally determined for federal gift tax purposes to be less than the amount transferred under the first paragraph above, the [Public Charity] will, as a condition of the gift to it, transfer the excess LLC units to the [Grantor Trust] as soon as possible.

Many practitioners use the *Petter* type language with another pour-over vehicle other than a public charity. The other vehicles will still aim to minimize the gift tax effects that could result as upon a defined formula revaluation. Vehicles include a ramp-up zeroed out grantor retained annuity trust, a qualified terminable interest property trust for a spouse, a donor advised fund, a private foundation, a charitable remainder annuity trust, a charitable remainder unitrust or a zero out charitable lead annuity trust.[57]

Another type of defined valuation clause is taken from *Wandry v. Comr.* in order to adjust the property in the hands of the donor and donee or the buyer and seller of an asset.

One type of *Wandry* clause could expressly refer to the IRS issue by calling out the IRS itself in face of the fact that the IRS has stated that it has disavowed *Wandry*. This language could be written as follows:

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

Some types of *Wandry* clauses do not refer to the IRS itself, but rather bind the parties to the transaction to readjust between themselves. This has become an issue in the last few years in the fiduciary realm as it is now a question of whether a trustee of a trust, rather than the IRS, must invoke the *Wandry* clause from time to time to privately value the asset and make any adjustments between the donor and donee and/or buyer and seller.

Defined value formulae not mentioning the IRS could be drafted as follows:

> The parties have agreed that the Purchase Value is represented by __ Class B Non-Voting Units of the LLC, which units will be transferred from Seller to Buyer ("Transferred Units").
>
> b. Upon the determination of the value of the Transferred Units in the same manner as value is finally determined for Federal transfer tax purposes in accordance with Internal Revenue Code Section 2001(f), or pursuant to any subsequently enacted provision of law replacing such section, if the value of the Transferred Units shall be different than the Purchase Value (the "Adjusted Value"), then the following shall occur:
>
> (i) If the Adjusted Value is greater than the Purchase Value, then Buyer shall promptly return to Seller those certain Class B Non-Voting Units of the LLC transferred from Seller to Buyer representing the value of the Transferred Units in excess of the Purchase Value, in addition to any items of income, deduction and gain attributed thereto, while retaining the remaining Class B Non-Voting Units held by the Buyer.
>
> (ii) If the Adjusted Value is less than the Purchase Value, then Seller shall refund to Buyer the difference between the Purchase Value and the Adjusted Value, in cash or in kind through additional LLC Units, plus interest at the lowest allowable rate which would avoid imputation of interest under the Internal Revenue Code Section 1274(d). The pecuniary amount described in this paragraph may be paid by Seller to Buyer on such terms and conditions as Buyer and Seller agree in writing.

It is critical that any defined value transfer be not only arranged properly, but it must be reported properly and consistently for tax purposes.[58] A review of successful case law offers drafting guidance for defined value clauses that might work.

Purchase price adjustment on sale when IRS revalues.

These are the facts of *King v. United States*.[59] 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*, finding that the adjustment was made in the ordinary course of business at arm's length, free from any donative intent.[60] 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 v. Comr.*

This is not to say that IRS would not approve any purchase price adjustment. If one literally interprets the statement in Rev. Rul. 86-41, 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 my opinion, *King* was a very close case, and it is not inconceivable that I 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 at respect for tax purposes. The *King* court's distinction of *Procter* doesn't even pass muster with me. When the court stated that *Procter* would only apply "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 equivalent, GST Tax Exemption or some other tax-related item.

In *Evelyn East v. Comr.*,[61] a case that 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 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 grandchildrens' trusts. In the stipulated decision documents, it is equally obvious that the IRS wholly surrendered on its attempt to increase the gifts to the grandchildrens' 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."

I humbly suggest 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? Since 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.[62]

I submit 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 IRC Sec. 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, judicial and settlement within the definition of “finally determined,” my belief is that IRC Sec. 2001(f)(2) overrules case law voiding adjustments tied to either judicial pronouncement[63] or administrative determination.[64]

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 “has 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 “is purely one of semantics.”[65] Given that the former clause is a condition subsequent and that the latter clause is a formula, I disagree 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 reported the fractional interests on the tax returns.

In *Knight v. Comr.*,[66] 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 Est.*, 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."

I respectfully disagree with the IRS holding 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 tax purposes, which is the way that one commentator seems to strongly believe is the only way to arrange a successful defined value gift.[67] I take issue with that conclusion since IRC Sec. 2001(f)(2) is in the Code and clearly allows that possibility.

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."

Even though the facts of PLR 9437029 involved a disclaimer[68] and the federal estate tax, I submit 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 IRC Sec. 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 outside cost exposure to those few clients still willing to wade out into the waters of paying gift tax.

Disclaimer of a formula amount of a lifetime gift.

In this technique,[69] 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.[70] Additionally, formula disclaimers are expressly authorized in the Treasury

Regulations.[71] The IRS has issued a number of private rulings blessing formula disclaimers,[72] 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 I have to rely upon the disclaimer of someone else to fix the amount of the gift that I intend to give? In my 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[73] 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. I suspect 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.[74]

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 Share of Estate.

In *Christiansen Est. v. Comr.*, 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 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 IRC Secs. 7801 and 7803.

The Tax Court and the Eighth Circuit are clearly correct about the validity of a defined value disclaimer.[75] The record was devoid of any facts that would cause trouble, *i.e.*, "factual baggage."

Implementation Trends in Defined Valuation Clauses

Finally, equally important to crafting a defined valuation clause that is likely to work to define value rather than one that will not work is the implementation of the defined valuation clause in the gift and/or sale in practice. When an IRS audit comes in, the auditor's general or specific request will likely ask for as much evidence as possible to support the legitimacy of the defined valuation clause. For that reason, estate planning practitioners often are keeping, along with the client, supporting records and evidence that can be produced to the IRS in twenty to thirty years' time in the future when these clauses are actually audited after the death of the person. Anecdotally, estate planning practitioners are reporting that the defined valuation clauses are assisting with offers in compromise on audit. Otherwise, the fallback position for the IRS that the defined value clause does not work may be reversed by the courts and allow further case law for the support of defined valuation clauses for the taxpayer.

For the *Petter* type defined valuation language, which may involve a public charity, private foundation, donor advised fund or similar non-profit structure, best practices could involve the following: (i)separate counsel representation for each of the individual beneficiaries and the charity in the review of the transfer documents, (ii) ensuring that there is no requirement for the charity to sell or redeem its interests back to the individuals, (iii) a board resolution from the charity authorizing the transfer documnets, (iv) two appraisers for the asset transferred – one to represent the individuals and the other to represent the charity, and (v) extensive due diligence filing to document the transfer of the asset, its legal requirements such as state and federal filings, tax returns, operating agreement, buy-sell agreement, stock certificates, restrictions on transfer and similar legal support and (vii) all bank transfers evidencing the transfer of the asset and in the case of the sale each and every interest payment and principal payment.

Legal support for the *Wandry* type of defined valuation language for the contract between two parties should also involve an extensive due diligence file, tracking of bank transfers and possibly the following: (i) separate counsel representation and appraisal representation for each of the donor and donee and/or buyer and seller, (ii) consistent record keeping and tracking of items of income, deduction and gain between the two parties, (iii) a gift tax return in the case of a gift that describes the gift as a defined formula rather than a straight pecuniary amount, and/or (iv) a subsequent independent valuation audit of the appraisal completed by another appraisal company. Some practitioners have completed a subsequent revised valuation under the *Wandry* provisions and have found in some cases that the appraisal should have been higher and in others lower and have adjusted the documentation accordingly in order to get ahead of the IRS in case of an audit years in the future. As with any estate planning transfer and not only the use of a defined formula clause, the more adherences to "good facts" is preferred.

Suggested Steps for a Defined Value Transaction Involving a Charity

In fashioning a defined value formula donation or sale involving a charity, estate plnning advisors should consider the following design suggestions:

The charity should not be required to sell its interest, and if there is a sale price or a required sale set forth in the documents, the price must be for fair market value as finally determined, with input rights for the charity.

Each charity and other donee should be represented by separate counsel.

Some time should elapse between the donation and any sale.

Appraisals must be obtained for both the original donation as well as any subsequent sale or redemption.

Preferably, two separate appraisers should be used--one for the donation and one for the sale or redemption. Any sale or redemption by the charity, which is the remainder donee, would consist of an element (i.e., the contingent additional amount where there is any revaluation on audit) that was not considered in the first appraisal. This additional "bundle of rights" must be appraised using traditional valuation methods. The second appraiser would have to go back and carefully review the first appraisal of the partnership as of the date of donation in order to ascertain independently the likelihood that the first appraisal was correct. This could involve having to replicate totally the first appraisal. The second appraiser's role would involve, among other things, an analysis of the range of value involved in the first appraisal as of the original date of donation as well as a fresh review of the first appraisal's methodology and due diligence.

The reason why a different appraiser should be used for the second appraisal is that the second appraisal involves reviewing, and, indeed, second-guessing, the first appraisal, which, arguably, is more objectively done by a different appraiser. Arguably, anything less than a full-fledged review of the first appraisal for redemption of the charity's interests risks the "patina of third-party reliance" argument made in the FSA.

The charity or other residuary donee should sell its interest to another person rather than have the partnership redeem the interest in order to avoid having to face the argument by IRS that it is the donee family members--not charity--that benefitted. It seems far preferable that the donor-partner actually purchase the charity's interest (and be responsible for any additional amount on revaluation). Structuring the transaction as a sale rather than a redemption also avoids an argument that the charity's interests evaporated by operation of law, leaving only the family still in the partnership.

As far as the timing of the purchase of the residuary donee's interest, prudence strongly dictates that--just as in the sale of a remainder interest in a QTIP trust--any sale not occur until after the gift tax value is finally determined. Even though this delay may please neither the charity (which has to hold on to its interest when it may prefer cash now) nor the client (who may want a chance at an increased income tax charitable contribution deduction if the IRS raises the gift tax value), it seems imperative that the charity which holds the contingent remainder interest stay in the mix until the "tax smoke clears." If, however, the sale of the charity's rights occurs prior to gift tax finality, the residuary donee should not sell the contingent right but expressly retain it, which also avoids having to value the most difficult to value of the assets held by the charity.

The charity should be admitted to the partnership as a partner, or the partnership agreement should grant the charity as an assignee certain express rights such as a right to partnership information and a right of the charity to avail itself of the fiduciary duty owed by the partnership and the general partners. If the charity does sell its interests prior to the point of gift tax finality, it is recommended that the charity expressly retain its contingent remainder rights. The partnership agreement should expressly extend the protective rights of the charity discussed above (even though the charity has no partnership percentage interest as either partner or assignee) pending gift tax finality.

In the FSA, IRS argued that while the partnership agreement afforded certain protections to charitable partners, those protective provisions were inapplicable because the charities were only assignees. The documents must be consistent in this regard.

If the partnership agreement requires the charity to sell, it seems prudent to insert some baseline rights for the charity relative to the appraisal and sale process. The charity could be given full access to entity information, the right to participate in selecting an appraiser as well as the right to seek alternative dispute resolution if there is a disagreement about the valuation. All other things being equal, in order to avoid arguments of conflicts of interest, a cautious advisor should insist that the donor, rather than the other donees (as was the case in the FSA as well as in McCord), be in control of the partnership at the time of the sale by the charity of its interest, particularly if the charity is required to sell its interest.

Why is this *Belk* case even relevant?

Since it's a Fourth Circuit opinion that cited its own past precedent in *Procter* to affirm the striking down of a savings clause in a conservation easement case, I'll cover a little of the Fourth Circuit opinion affirming a decision of the U.S. Tax Court in *Belk v. Commissioner*.[76]

In the Tax Court, where the taxpayers lost for retaining a substitution power over a conservation easement, there was no mention of *Procter.* Instead, the taxpayers raised it on appeal, with respect to a savings clause, which read as follows:

> [the Trust] "shall have no right or power to agree to any amendments . . . that would result in this Conservation Easement failing to qualify . . . as a qualified conservation contribution under Section 170(h) of the Internal Revenue Code and applicable regulations."

The Fourth Circuit cited its past precedent in *Procter*. The Fourth Circuit stated:

> *The Belks' attempt to distinguish Procter fails. They find significant the fact that the savings clause there altered the conveyance "following an adverse IRS determination or court judgment," while the savings clause here does not expressly invoke the IRS or a court. Appellants' Br. 39. This is a distinction without a difference. Though not couched in terms of an "adverse determination" by the IRS or a court, the Belks' savings clause operates in precisely the same manner as that in Procter. The Easement plainly permits substitutions unless and until those substitutions "would result" in the Easement's "failing to qualify . . . under Section 170(h) of the Internal Revenue Code," a determination that can only be made by*

> *either the IRS or a court. Indeed, relying on Procter, the IRS has found a clause void as a condition subsequent notwithstanding its failure to reference determination by a court. See Rev. Rul. 65-144, 1965-1 C.B. 442, 1965 WL 12880. The Belks do not suggest that the IRS erred in so concluding, nor do they attempt to distinguish that clause from their own.*

No other appellate court has cited *Procter* with approval in the 77 years (and counting) since the Fourth Circuit rendered *Procter*, and at least two appellate courts have expressly declined to follow *Procter*.

One could argue that the Fourth Circuit's pronouncement on *Procter* in *Belk* was *obiter dicta* since *Procter* wasn't an issue in the Tax Court proceeding.

However, some of the Fourth Circuit's comments on the applicability *vel non* of *Procter* are troubling and tone-deaf in its abject failure to recognize that it may have been wrong given the log-term resistance on the part of peer federal circuit appellate courts to follow *Procter*.

Taxpayers who are in the Fourth Circuit (Maryland, Virginia, West Virginia, North Carolina, and South Carolina) may have more heartburn about defined value transfers.

Reporting defined value gift transactions

Unfortunately, even if the defined value transfer documents are drafted correctly, the thing can still fail if not reported properly.

In *Knight v. Comr.*,[77] 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 22.3% percentage interests in the partnership. In holding against the taxpayers, the Tax Court found significant fault with that inconsistent reporting.

What is the proper way to report defined value transactions on tax returns, personal financial statements and loan applications? For starters, until the gift is finally determined for federal transfer tax purposes, you should use the ***exact same language as your defined value transaction documents***.

This is where many practitioners go wrong, and that's in client education on the front end and in managing the reporting and ongoing administration of the gift/sale, and not leaving it up to the tax return preparer. In fact, given the mission critical importance of consistent follow-through and proper reporting, it may well constitute professional negligence to not continue to advise and counsel on the defined value transaction.

Threat of Retroactive Legislation on the Defined Value Transaction Formula

A question can arise about the impact of a legislative change to a defining element used in a defined value transfer tax formula, e.g., the donor's remaining applicable exclusion amount, where that legislative change is made ***after*** the effective date of the defined value transfer but that is made ***retroactive*** in effect to a date that ***precedes*** the effective date of the defined value formula transaction.

Clearly, such a retroactive legislative change could adversely affect the desired result, with the result being an overfunding of the transfer, unless the defined value transfer formula expressly addresses and factors in the effect of a retroactive change in the law. This is because the defining amount limit may be different under the law in effect on the effective date of the transfer than it may be as a result of a retroactive change in the law.

The validity of a retroactive tax provision under the Due Process Clause depends upon whether "retroactive application is so harsh and oppressive as to transgress the constitutional limitation." *Welch v. Henry*, 305 U.S., at 147, quoted *United States v. Hemme*, 476 U.S., at 568-569. *United States v. Carlton*, 512 U.S. 26, 30 (1994). Not surprisingly, given this standard, the United States Supreme Court hasn't chosen to invalidate a retroactive amendment yet. Accordingly, in periods where there is a reasonable possibility of enactment of a retroactive amendment, it is prudent to carefully distinguish between a result under the defined value formula under the law in effect on the date of the transfer and any subsequent retroactive change in the law relating to the defined value formula measuring component, i.e., the applicable exclusion amount.

Best Practices for Wandry-type Transactions

What follows below are a series of suggested best practices for entering into Wandry-type defined value gift/sales transactions.

Use a ***value definition*** clause, e.g., that value equal to the donor's remaining applicable exclusion amount, all as finally determined for federal estate and gift tax purposes.

Make it ***crystal clear*** that the value is that as finally determined for federal estate and gift tax purposes.

The donor/seller and donee(s)/purchaser(s) must be separately represented by counsel and CPA, i.e., each should have their own.

The donor/seller and donee(s)/purchaser(s) must have separate appraisers. It's not necessary to obtain separate complete free-standing appraisal reports. The donee's/purchaser's appraiser should be able to do a review appraisal (as defined in USPAP) of the donor's/seller's appraisal. Obviously, if the review reveals some significant problems, then additional steps such as obtaining a new appraisal or going back to the original appraiser with the review of his appraisal are required.

Some time should elapse between the initial funding of the entity the interests in which are being given/sold and the gift/sale to avoid the ***integrated transaction*** argument.

Admit the donee(s) as a member/partner. Don't ever leave them hanging as mere assignees unless the entity governance documents clearly and expressly spell out the rights of assignees to avail themselves of the fiduciary duty owed to shareholders/members by the entity and its governing officers.

Don't do anything with the given/sold interests, e.g., redemption until the statute of limitations has run.

The gift/sale must be reported on the gift/income tax return using the ***exact formula set out in the transfer document***.

All personal financial statements, particularly those given to third parties, e.g., lenders, must use the ***exact same formula*** until the gift/sale is finally determined for federal estate and gift tax purposes. ***Consistent reporting is paramount***.

The books of the entity must ***consistently be similarly reported*** and administered as such.

The formula clause should contain a ***two way reallocation clause***.

Report all sales on a gift tax return anyway to cut off the gift tax statute of limitations.

Fully disclose the transaction(s) on the returns and include copies of all relevant documents, especially the appraisal(s). Paper the IRS to death should be the mantra.

All parties should appear and agree to the reallocation and further agree to return or to give/sell additional units.

Prepare for an audit because the IRS still detests these transactions. Client education is key to avoiding the hindsight 20/20 complaint. Some clients are poor candidates for using techniques like defined value gifts/sales due to the prospect for challenge by the IRS.

Pray for good luck!!!

Forms

What follows in this part are excerpts from a defined value sale document package.

Sales Document

WHEREAS, Seller owns 100% of the issued and outstanding common stock of ____, , a ___ ____ (the "Company"); and

WHEREAS, Seller desires to sell ____ Million Dollars ($__pts from ,000,000.00) worth of such issued and outstanding ____ in the Company; and

WHEREAS, Purchaser desires to purchase from Seller such interest in the Company on the terms and subject to the conditions set forth in this Agreement;

WHEREAS, the parties hereto acknowledge the subjectivity of business valuation and the significant impact of valuation on taxation, both as preliminarily determined by the independent, qualified appraiser engaged for this purpose and as potentially finally determined for tax purposes, and the parties have agreed to abide by valuation as provided herein for all tax and non-tax purposes and to act in accordance with values as finally determined for tax purposes; and

NOW, THEREFORE, in consideration of the mutual covenants and agreements set forth in this Agreement, and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties hereto agree as follows:

Number of Shares; Preliminary Estimate; Adjustments. The aggregate number of shares representing the Interest shall be as finally determined for Federal gift tax purposes. The number of shares shall be preliminarily estimated equal to the number of shares as preliminarily determined by ____ (the "Appraiser"), but as finally determined for Federal gift tax purposes, this is merely an estimate for purposes of conducting ordinary business in the interim between the Closing and any final determination of the correct number of shares representing $__,000,000 in value ("Preliminary Estimate"). The appraisal shall be delivered within _______ (__) Business Days of this Agreement to the Seller and to the Purchaser. The costs incurred in connection with the fees of the Appraiser shall be borne equally by the Seller and the Purchaser. The parties further agree that if the number of shares representing the number sold after any such final determination for gift tax purposes is greater or lesser than the Preliminary Estimate, then the Preliminary Estimate shall be adjusted accordingly, whether upward or downward, to reflect the final number of shares sold, and the parties agree that each shall file or cause to be filed all appropriate amended state and federal income tax returns for all years in which the income tax statute of limitations has not yet run to reflect any and all adjustments required hereby, and further to consent to extension of tax returns to the fullest extent permissible. The parties further agree to immediately inform each other in writing of any proposed or final determination for federal gift tax purposes pursuant to IRC Sec. 2001(f)(2) of a change in the Preliminary Estimate, and each agrees that the respective rights of the parties vis-a-vis the Company shall remain in accordance with the Preliminary Estimate set forth above above unless and until the final determination of the number of shares sold for federal gift tax purposes.

Pledge Agreement

Pledge. The Pledgor hereby assigns and delivers to the Pledgee that number of ____ of the Company equal in value to __ Million Dollars ($__,000,000.00) as preliminarily estimated by ___ (the "Appraiser"), but as finally determined for Federal gift tax purposes, represented by certificate number _____________, which has been duly endorsed in blank. However, such number of pledged shares may be adjusted, upward or downward, on final determination for federal gift tax purposes. The parties agree that if, upon any such final determination for gift tax purposes, the number of pledged shares is greater or lesser than the number of shares reached by the Preliminary Estimate by the Appraiser, they shall cause a new stock certificate representing the proper and correct number of shares to be pledged to be delivered in substitution to the Pledgee.

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[1] *See*, Edward F. Koren,"Defined Valuation Clauses: Taxpayer Wins a Few," 59 Tul. L. Sch. Ann. Inst. on Fed. Tax'n, 13-1, (2010-2011), p. 13-18 through 13-22.
[2] 142 F. 2nd 824 (4th Cir. 1944).
[3] Belk v. Commissioner, 774 F.3d 221 (4th Cir. 2014).
3 Treas. Reg. Secs. 1.483-4 and 1.1275-4 (contingent payment debt instruments); Treas. Reg. Sec. 15.453-1(c); Treas. Reg. Secs. 25.2702-3(b)(1)(ii)(B) (GRAT's) and 1.664-2(a)(1)(iii) (CRAT's). See also Rev. Proc. 64-19, 1964-1 C.B. 682.
[5] IRC Sec. 7477.
[6] As pointed out by one commentator, the clause in *Procter* would not have insulated Mr. Procter from gift tax liability because the instant that 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")
[7] 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").
[8] 130 T.C. 1 (2008); aff'd, 586 F. 3d 1061 (2008).
[9] 130 T.C. at pp. 17-18 [26-27 of slip opinion as originally issued].
[10] *McCord v. Commissioner*, 461 F. 3d 614 (5th Cir. 2006); *Hendrix v. Commissioner*, T.C. Memo 2011-1233; *Petter v. Commissioner*, 653 F. 3d 1012 (9th Cir. 2011); *Christiansen v. Commissioner*, 130 T.C. 1 (2008), *aff'*d, 586 F. 3rd 1061 (8th Cir. 2009); and *Wandry v. Commissioner*, T.C. Memo 2012-88, followed by IRS Action on Decision 2012-004, http://www.irs.gov/pub/irs-aod/AOD%202012-04.pdf.
[11] See, "Structuring Defined Value Clauses in Trust Transfers: Formula Allocations and Price Adjustment Clauses," Stafford Webinar, July 19, 2017, Ban-Yaacov, Paige K., Duffey, Patrick J. and Rikoon, Jonathan J. at p. 19.
[12] *McCord v. Commissioner*, pp. 7-8

[13] *Id* at. 40.
[14] See, e.g., *Petter*, at 10194.
[15] See, e.g., *Christiansen*, at 1062.
[16] See, AOD 2012-04.
[17] T.C. Memo 2020-81.
[18] No warranties, express or implied.
[19] With attribution to the technique's inventor, S. Stacy Eastland, Esq.
[20] Oshins, "New Twist on a Popular Technique," *Trusts & Estates* (September 2002), pp. 12-18 (hereafter, "Oshins"), at p. 17. See also Oshins and Simmons, "The SCIN-GRAT," *Trusts & Estates* (June 2008), pp. 18-26; Oshins, Oshins and Keebler, "The SCIN-GRAT: An Innovative Strategy to Hedge Your Bet," *Estate Planning* (Sept. 2007), pp. 3-6.
[21] Oshins, at p. 17.
[22] 115 T.C. 41 (2000).
[23] Oshins, at p. 14.
[24] Oshins, at p. 17.
[25] See footnote 47 in *McCord*.
[26] Moore Est. v. Comr., T.C. Memo. 2020-40.
[27] McCaffrey, at p. 14; Oshins, at pp. 14 and 17.
[28] FSA 200122011.
[29] Other commentators have raised this question as well. See, *e.g.*, Raby and Raby, "Gift Tax Effect of Valuation Adjustment Clauses," *Tax Practice*, Vol. 37, No. 4 (January 24, 2003) (hereafter, "Raby & Raby"), at p. 117.
[30] Raby & Raby.
[31] *McCord*, *supra*.
[32] 1986-1 C.B. 300.
[33] 87 T.C. 78 (1986).
[34] 87 T.C. 78, 114.
[35] This is precisely the argument that IRS forwarded 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.
[36] This also is discussed in Moore & Buchanan, at pp. 17-18.
[37] 545 F. 2d 700 (10^{th} Cir. 1976).
[38] *Commissioner v. Wemyss*, 324 U.S. 303, 306 (1925).
[39] See, *e.g.*, *Reynolds Est. v. Comr.*, 55 T.C. 172 (1970).
[40] IRC Secs. 6324 and 6901.
[41] See also, Cornfeld, at p. 5.
[42] Handler and Chen, "Formula Disclaimers: *Procter*-Proofing Gifts Against Revaluations by IRS," *Journal of Taxation* (Apr. 2002) (hereafter, "Handler & Chen"), at pp.232-233.
[43] See, *e.g.*, *Leichter Est. v. Comr.*, T.C. Memo 2003-66.
[44] 1993-1 C.B. 202.
[45] IRS has acknowledged Congressional intent concerning estate tax exemptions and deductions. See, *e.g.*, TAM 200245053.
[46] T.C. Memo 1993-459.

[47] 115 T.C. 506 (2000).

[48] T.C. Memo 1996-307.

[49] 1986-1 C.B. 300.

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

[51] See Johanson, at p. 15.

[52] 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, Handler & Chen, at pp.232-233 and Hood, "Defined Value Gifts: Does IRS Have It All Wrong?" 28 *Estate Planning* 582 (Dec. 2001), at p. 588.

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

[54] 82 T.C. 239 (1984), aff'd, 786 F. 2d 1174 (9th Cir. 1986).

[55] 545 F. 2d 700 (10th Cir. 1976).

[56] See Moore Est. v. Comr., T.C. Memo. 2020-40 (2020).

[57] *Id.* at footnote 1.

[58] See *Knight v. Comr.*, 115 T.C. 506 (2000).

[59] 545 F. 2d 700 (10th Cir. 1976).

[60] Treas. Reg. Sec. 25.2512-8.

[61] Tax Court Docket No. 12019-98.

[62] IRC Secs. 2505 and 2523.

[63] See, *e.g.*, *Procter*.

[64] See, *e.g.*, *Ward*.

[65] Cornfeld, at p. 17.

[66] 115 T.C. 206 (2000).

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

[68] Formula disclaimers are expressly authorized in the Treasury Regulations. Treas. Reg. Sec. 25.2518-3(d), Example 20.

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

[70] IRC Secs. 2046 and 2518.

[71] Treas. Reg. Sec. 25.2518-3(d), Example 20.

[72] See, *e.g.*, PLR's 200001045, 9437029, 9435014, 9630034, 8424103, 8318093, 7913118 and 200130034.

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

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

[75] For commentary about the *Christiansen Est.* 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).

[76] 774 F.3d 221 (4th Cir. 2014)

[77] 115 T.C. 506 (2000).