WR marketplace

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The WR Marketplace is created exclusively for Finseca members by experts at Baker & Hostetler LLP. The authors for this piece are Michael P. Vito, Counsel, and Lindsay R. DeMoss D'Andrea, Staff Attorney, Baker & Hostetler LLP.

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Topic: Defined Value Clauses: An Important Tool for Turbulent Times.

Market Trend: As the 2020 presidential election approaches, uncertainty continues regarding the potential for tax legislation and changing market conditions, causing many to consider using current transfer tax exemptions with gifts before year-end. Individuals planning to transfer hard-to-value assets may wish to consider using a gift agreement with a defined value clause to shield against unwanted gift tax consequences.

Synopsis: Defined value clauses are designed to cap the gift tax value of hard-to-value assets at a fixed dollar amount to prevent a subsequent valuation adjustment from altering the value of a taxable gift. These clauses can be especially useful for closely-held business owners who want to implement lifetime succession planning but need to protect themselves from unforeseeable gift tax liabilities. Several courts have upheld the use of defined value clauses, such as the decisions reached in Christiansen v. Commissioner, Petter v. Commissioner, Hendrix v. Commissioner, and Wandry v. Commissioner. While the IRS has repeatedly challenged defined value clauses, certain forms of clauses have been approved by the courts, giving taxpayers some comfort in employing a defined value clause when making a gift of hard-to-value assets.

Take Away: When making a gift of a hard-to-value asset, a properly drafted defined value clause can limit the donor's gift tax exposure to unanticipated gift taxes if the asset value as finally determined for gift tax purposes is greater than expected. Defined value clauses generally take one of two forms: (i) formula allocation clauses, and (ii)

formula transfer clauses. Formula allocation clauses have been respected by the courts, but generally involve administrative complexities as well as a charitable or marital component. Formula transfer clauses offer a simpler approach, although the wording of the gift instrument is critical. Although the Internal Revenue Service ("Service") disfavors formula transfer clauses, a line of court decisions sanctions their use. Donors and their advisors should be able to use either type of formula clause to cap the value of hard-to-value gifts to predetermined amounts.

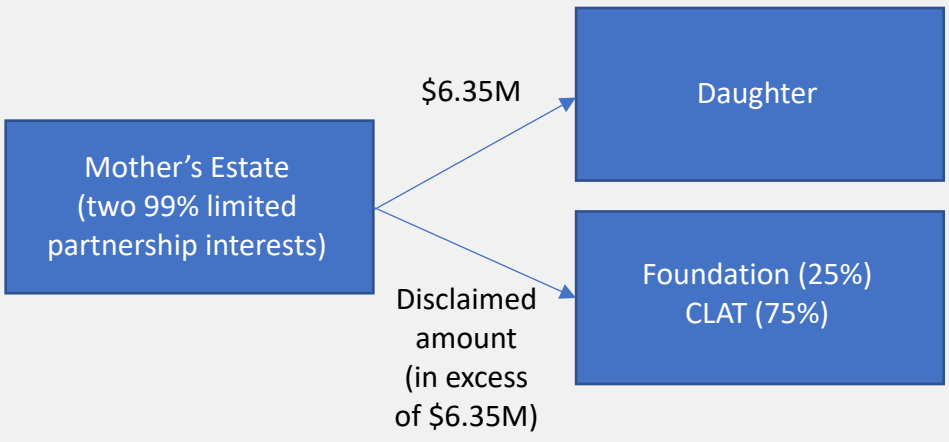
The big picture on defined value clauses

For many years, taxpayers have sought to use defined value clauses to make gifts of hard-to-value assets, like closely-held business interests, while minimizing the concern of later, unforeseeable gift tax liabilities based on subsequent valuation adjustments. In 2020, this is especially true, as clients rushing to complete year-end planning with hard-to-value assets are using these clauses to address concerns over obtaining time-sensitive valuation reports from busy valuation professionals.

Generally, defined value clauses fall into two categories: (i) *formula allocation clauses*, and (ii) *formula transfer clauses*. Each type of clause is illustrated in the case studies below.

Case study #1 – Formula allocation clause: disclaimer with excess to charity

Daughter was the sole beneficiary of her mother's will. The will provided that any disclaimed portion of her estate would pass 25% to a charitable foundation and 75% to a charitable lead annuity trust ("**CLAT**") paying the charitable lead interest to the foundation. Daughter disclaimed a portion of her mother's estate exceeding $6,350,000. Daughter made her disclaimer with reference to a fraction, the numerator of which was the fair market value of the estate (before payment of debts, expenses and taxes) on her mother's date of death, less $6,350,000, and the denominator of which was the fair market value of the estate (before payment of debts, expenses and taxes) on her mother's date of death, *all as finally determined for federal estate tax purposes*. Daughter's disclaimer did not include a disclaimer of her contingent remainder interest in the property passing to the CLAT. On its estate tax return, the mother's estate reported an estate tax charitable deduction for the property passing to the foundation and the present value of the annuity interest passing to the CLAT, pursuant to the daughter's disclaimer.



The facts described above replicate those involved in *Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008). There, Daughter (acting as personal representative of her mother's estate) and the Service stipulated to a value of the mother's estate 35% higher than the value originally reported on the return. The Tax Court held that the entire value of the property passing to the foundation was deductible by virtue of the daughter's qualified partial disclaimer under Code[1] § 2518, which also included the increased amount passing to the foundation because of the increased value of the mother's gross estate. However, the court allowed no deduction for any of the property passing to the CLAT because the partial disclaimer of that property was not a qualified disclaimer under the Code due to her contingent remainder interest.

Christiansen is an example of a *formula allocation clause.*[2] A formula allocation clause typically allocates the value of a particular asset beyond a specified cap among one or more taxable and non-taxable transferees (*e.g.*, charities, spouses, marital deduction trusts, etc.).

> Example: Donor transfers 100 Family LLC units as follows: (1) such number of Family LLC units having a value of $5,000,000 to a dynasty trust and (2) the balance of Family LLC units to a public charity.

If the value of the Family LLC as finally determined for federal gift tax purposes is subsequently adjusted up, the trust delivers to charity the number of Family LLC units in excess of $5,000,000. In this example, the donor has made a completed gift of all 100 units, such that a valuation increase only results in an *adjusted allocation* of the units among the donees; nothing is allocated or returned to the donor. While several cases have upheld the use of formula allocation clauses, administrative complexities as well as a charitable or marital component make formula allocation clauses unappealing to some potential donors. Including a charitable element may also invite a review of the transaction by the respective State Attorney General.

Case study #2 – Dollar value formula transfer clause

A husband and wife (the "**Donors**") made various transfers of interests in two family entities equal to a specific dollar amount, rather than a set number of interests in the entities. The Donors each executed a separate assignment, which transferred interests among nine donees. The assignments transferred:

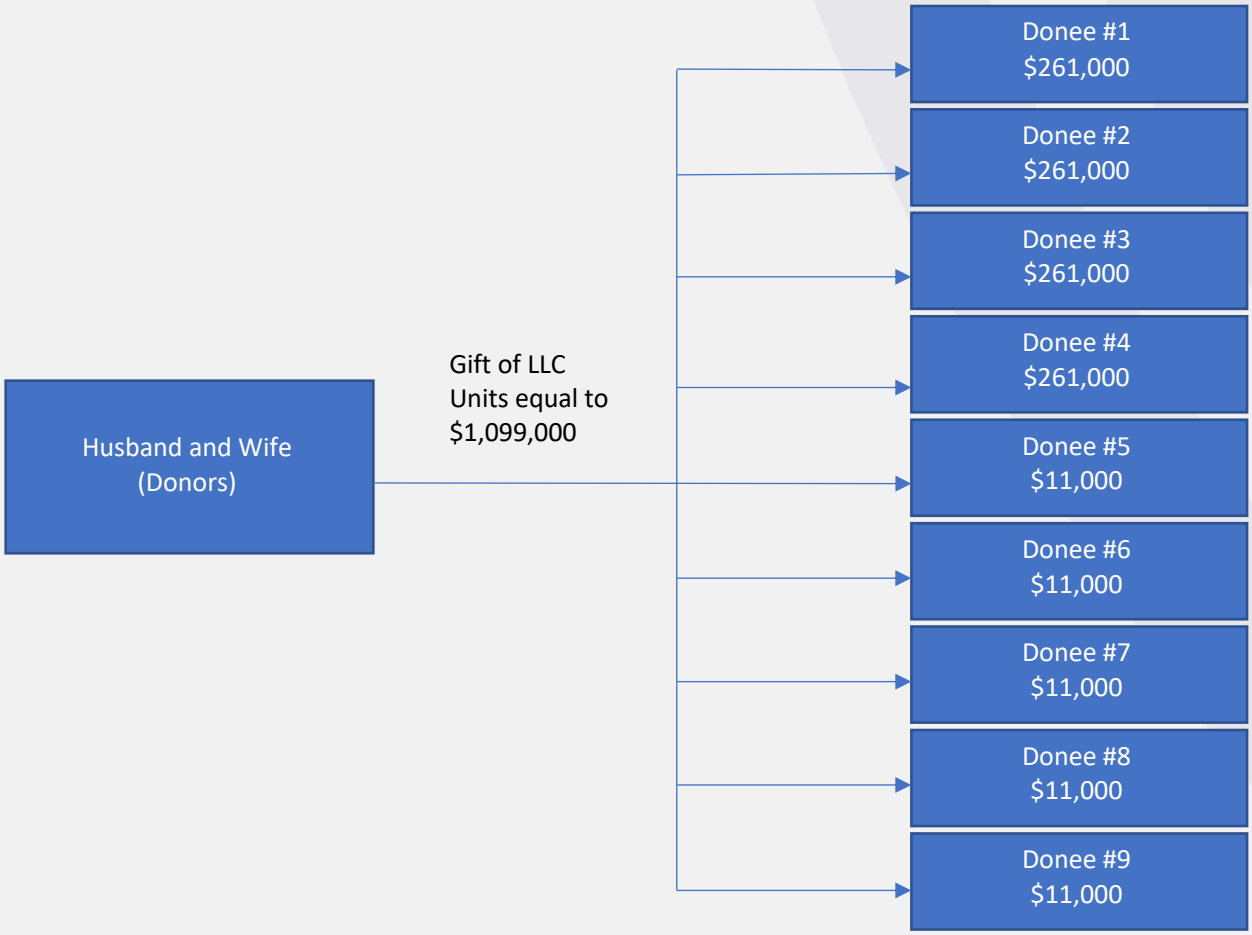
> "a sufficient number of my Units as a Member of [Company], so that the fair market value of such Units *for federal gift tax purposes* shall be as follows:

Name	Gift Amount
Donee #1	$261,000
Donee #2	$261,000
Donee #3	$261,000

Donee #4	$261,000
Donee #5	$11,000
Donee #6	$11,000
Donee #7	$11,000
Donee #8	$11,000
Donee #9	$11,000
	$1,099,000”[3]

Each assignment contained the following adjustment clause:

> “Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service ("IRS"). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if, after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law.”[4]



The facts described above replicate those involved in the widely-cited case of *Wandry v. Commissioner,* 103 T.C.M. (CCH) 1472, T.C. Memo. 2012-88. *Wandry* is an example of a *formula transfer clause*. Whereas earlier defined value cases involved formula allocation clauses, *Wandry* upheld the use of a simpler formula transfer clause, which limits the property transferred to a recipient to a fixed dollar amount.

> Example: Donor transfers to a dynasty trust a fractional share of the Donor's units in Family LLC, determined based on the following fraction:
>
> $5,000,000 / value of units as finally determined for federal gift tax purposes.

Any valuation adjustment to the underlying property would not change this dollar amount but would result in an *adjustment of the number of units transferred to the donee* (as opposed to another class of donees, as with the formula allocation clause). The effect is to minimize the donor's gift tax exposure risk by fixing the total value of the transfer to a predetermined cap.

Case study #3 – Gift and sale of partnership interests expressed as dollar amounts

Donor transferred her interests in a family-owned corporation ("**Corporation**") to a limited partnership ("**LP**"), formed as part of a planning approach to (1) consolidate and protect assets, (2) establish a mechanism to make gifts without fractionalizing interests, and (3) ensure that the Corporation remained in business under the control of Donor's family. Donor's stock in the Corporation comprised 99% of the value of the LP's assets. Donor and her husband were the sole general partners of the LP, owning a 1% general partner interest. Donor owned 93.88% of the limited partnership interests as well. The remaining limited partnership interests were held for the benefit of other family members.

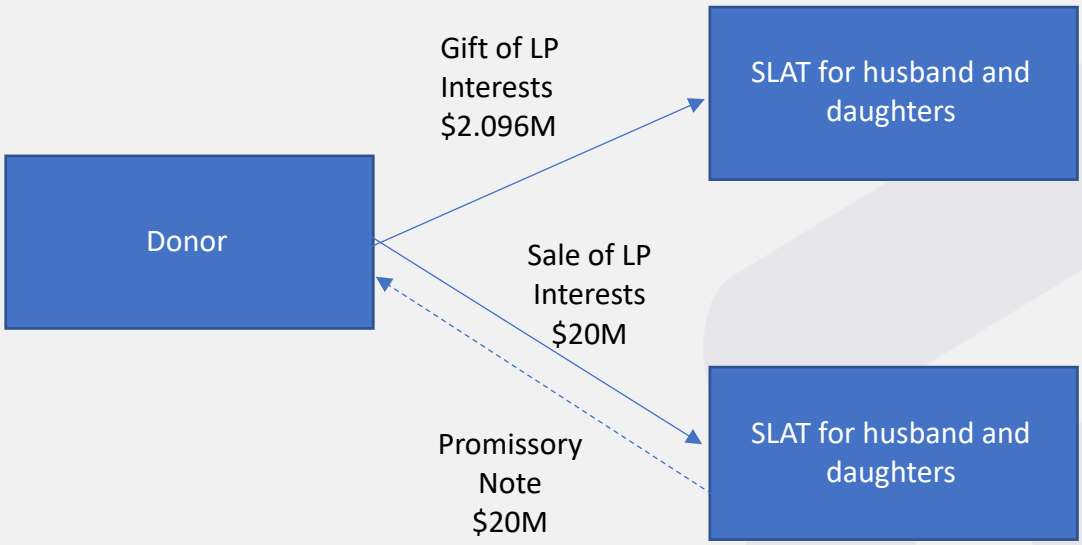
After forming the LP, Donor made a gift of a limited partnership interest in the LP to a spousal lifetime access trust ("**SLAT**") for the benefit of her husband and four daughters. Donor's gift assignment provided:

> Donor desires to make a gift and to assign to the SLAT 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*.

In a second transfer, Donor sold a limited partnership interest in the LP to the SLAT. The memorandum of sale provided:

> Donor desires to sell and assign to the SLAT 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.*



The facts described above replicate those involved in the recent case *Nelson v. Commissioner*, No. 27313-13, T.C. Memo. 2020-81. There, the court found that the plain language of the assignments, which transferred interests worth specified dollar amounts "as determined by a qualified appraiser" within a specific time frame (90 days for the gift, and 180 days for the sale), required the parties to use the values determined by the appraiser, and not the values as finally determined for federal gift and estate tax purposes. The court distinguished the *Nelson* assignments from the assignments in *Wandry*, which transferred property worth a specified dollar amount based on *values as finally determined for gift or estate tax purposes*.[5] However, *Nelson* should not be viewed as a rejection of defined value clauses. Rather, *Nelson* clarifies that a defined value clause must be based on values as finally determined for gift tax purposes, and not as determined by a qualified appraisal or other means. Thus, the wording and operative terms of the instrument of transfer are a critical component to an effective defined value clause.

The transaction in *Nelson* involved a part-gift/part-sale structure familiar to many advisors. In 2020, many donors who desire to use all of their available exemption but who wish to preserve as much flexibility as possible may consider creating a SLAT to be the recipient of their hard-to-value assets. Additionally, they may structure the transaction as a part-gift/part-sale to leverage low interest rates. As discussed in more detail in *WRMarketplace No. 20-07* and noted in *WRMarketplace No. 20-06* and *WRMarketplace No. 20-17*, SLATs are an excellent vehicle for married donors wishing to use their sunsetting transfer tax exemptions. However, as *Nelson* demonstrates, all transactions require a thoughtful approach and careful verbiage to protect against potential future adjustments to value for transfer tax purposes.

[1] All references to the Code are to the Internal Revenue Code, as amended, unless otherwise indicated.
[2] For additional examples of formula allocation clauses that have been respected, *see McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006); Est. of Petter v. Commissioner, 653 F.3d 1012 (9th Cir. 2011); Hendrix v. Commissioner, T.C. Memo 2011-133.*
[3] *Wandry v. Commissioner,* 103 T.C.M. (CCH) 1472, 1473, T.C. Memo. 2012-88.
[4] *Id. at* 1473-74.
[5] *See also Christiansen v. Commissioner; Petter v. Commissioner; Hendrix v. Commissioner.*