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Tax Court Validates Defined Value Clause for Interfamily Transfers

***Wandry v. Commissioner* (March 26, 2012)**

In a big win for the taxpayer—and for estate and gift tax professionals—the Tax Court resoundingly rejected the Internal Revenue Service's (IRS) three arguments against defined value clauses, even in cases involving interfamily transfers. In its decision, the court also provided what amounts to a four-part "blueprint" for drafting successful formula clauses in the future.

Taxpayers began with an FLP. In 2000, a wealthy Colorado couple funded a family limited partnership (FLP) with cash and marketable securities to set up a tax-free gift-giving plan for their children and grandchildren, whereby they transferred partnership interests equal to the amount of the then-current annual gift tax exclusion. Since the number of LP interests could not be known until a subsequent valuation of the partnership's assets, their tax attorney (also a CPA) advised them to give gifts of a specific dollar amount rather than a set number of LP units. (These early transfers of LP interests were not at issue in this case.)

Two years later, when the couple used the FLP assets to start a new family business (an LLC), their tax attorney advised them they could continue a similar gift-giving program, also using a defined value clause. Accordingly, in 2004, they executed gift documents that expressly transferred a "sufficient number" of LLC units to each recipient such that the fair market value for federal tax purposes would equal the amount of the annual gift tax exclusion ($261,000 for their children, $11,000 for each grandchild). The documents also provided that the donors intended to have a "good faith determination" of fair market value by an independent and "qualified" third party. However, if the IRS or a court later determined a different, final value for federal gift tax purposes, then "the number of gifted units shall be adjusted accordingly, so that the value of the number of gifted units to each person equals the dollar amount" set forth in the documents.

An independent appraisal firm subsequently valued the LLC's assets as of Jan. 1, 2004, concluding that a 1 percent interest was worth $109,000. The LLC's accountant made handwritten entries to the members' capital accounts in an informal ledger, indicating a decrease in the parents' accounts equal to the value of the combined gifts and a corresponding increase in each of the recipient children's accounts. In filing its federal income taxes that year, the LLC also noted the same changes in each member's Schedule K-1 (partner's share of income, deductions, credits, etc.).

In preparing their 2004 gift tax returns, the couple's CPA reported gifts totaling just over $1 million, with the attached schedules accounting for net transfers from the taxpayers to their children ($261,000) and grandchildren ($11,000), but describing the gifts as specific percentages of LLC membership interests (2.39 percent and 0.101 percent, respectively). Their CPA derived the gift descriptions from the dollar values listed in the gift documents and also the independent appraisal.

Stipulation as to value. Two years later, the IRS determined that the value of the gifts exceeded

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the annual gift tax exclusion and claimed that the entire amount of the gifts was taxable under Section 2501 IRC. In particular, the IRS argued that the taxpayers transferred fixed percentage interests of the LLC to the recipients, as reflected in both the company's capital accounts and the gifting documents. Moreover, the value adjustment clause created a "condition subsequent" to the complete gift, making it void under federal tax law as well as public policy.

Importantly, the taxpayers stipulated to the IRS's determination of value, which amounted to $315,800 for a 2.39 percent interest in the LLC and $13,346 for a 0.101 percent interest. They denied having transferred fixed percentage interests in the LLC, however. Rather, they transferred percentage interests equal to the specific dollar value set forth in the adjustment clause of the gift documents, which did not violate public policy. The Tax Court reviewed each of the parties' claims in turn.

First, the IRS argued that the gift descriptions in the taxpayers' tax returns were "binding admissions" that they transferred fixed LLC percentage interests to the donees rather than specific dollar values. It cited *Knight v. Commissioner*, 115 T.C. 506 (2000), in which the taxpayers' gift documents transferred FLP interests worth $300,000 to their children, but then their gift tax returns reported transfers of percentage interests. When the IRS later challenged the value of the LP interests, the taxpayers claimed they were actually worth less than $300,000. This claim "opened the door" to the court's consideration of value, ultimately finding that the taxpayers' gift tax returns showed their "disregard" for the transfer documents and their intent to give percentage interests in the FLP.

Knight did not apply to this case, however, because the taxpayers did not similarly "open the door" to the IRS's argument, the court held. Instead, at all times, they "understood, believed and claimed that they gave gifts equal" to the specific dollar amounts set forth on both their transfer documents and their gift tax returns. Further, their CPA merely derived the gift descriptions from the taxpayers' net dollar value transfers and the independent appraisal; thus, their "consistent intent and actions" proved that the taxpayers intended to give dollar amounts.

Similarly, the LLC's capital accounts did not control the nature of the gifts. "The facts and circumstances determine [the LLC's] capital accounts," the court explained, "not the other way around." In this case, the undated, handwritten account ledger was not official; nor did it reconcile with any of the taxpayers' (or even the IRS's) determinations. In the same way, the Schedules K-1 simply tracked each member's capital account balances in 2004; they did not account for any portions of adjustments attributable to the taxpayers' gifts.

When the IRS later challenged the value of the LP interests, the taxpayers claimed they were actually worth less than $300,000...[which] "opened the door" to the court's consideration of value...

An 'old' argument. In its second line of argument, the IRS resurrected an "old issue that has evolved through a series of cases," the court said, beginning with *Procter v. Commissioner*, 142 F.2d 524 (4th Cir. 1944), which remains "the cornerstone of a body of law" regarding the permissibility of transfer clauses. In that case, the Fourth Circuit voided the clause at issue because it reversed a completed transfer in excess of the annual gift tax exclusion. Further, the clause was contrary to public policy because any attempts by the government to collect the tax would defeat the gift.

Since *Procter,* however, federal courts have upheld formula clauses that only limit the value of a completed transfer, but do not defeat the transfer itself. In particular, the court cited *Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008), aff'd, 586 F.3d 1061 (8th Cir. 2009); and *Estate of Petter v. Commissioner*, T.C. Memo. 2009-280, aff'd, 653 F.3d 1012 (9th Cir. 2011).

In *Petter*, the Ninth Circuit drew a distinction between the "savings clause" used in *Proctor*, which is void because a donor can use it to "take gifted property back," and a formula value clause, which is valid because "it merely transfers a fixed set of rights with uncertain value," the court explained. The IRS tried to fit the present case

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into the *Proctor* category. Rather than transferring a fixed set of rights with an uncertain value, the taxpayers transferred "an uncertain set of rights, the value of which exceeded their federal gift tax exclusions," the IRS argued. As a result, the defined value clauses operated to "take property back" upon the event of a condition subsequent.

The IRS was not interpreting *Petter* properly, the Tax Court said. In *Petter*, the Ninth Circuit provided a four-part test for discerning whether the defined value clauses in that case were valid. The Tax Court applied the test to the gift transfers in this case, in essence outlining a four-part "blueprint" for establishing such clauses in the future.

1. *Fixed rights to predefined percentage interests*. In the gift documents in *Petter*, the charitable donees "were always entitled to receive a predefined number of units, which the document essentially expressed as a mathematical formula." Likewise, in this case, each of the donees received rights to predefined LLC percentage interests, which could be expressed by the formula:

$$x = \frac{\text{[dollar amount of the annual gift tax exclusion]}}{\text{FMV of the LLC}}$$

2. *Value is constant, though undetermined.* The mathematical formula in this case (like *Petter*) had only one unknown: the value of an LLC unit at the time the documents were executed. "But though unknown, the value was a constant," the court held. In fact, the parties stipulated that, as of Jan. 1, 2004, the value of a 2.39 percent LLC membership interest was worth $315,800. Accordingly, the value of all the LLC's assets equaled $13,213,389 on the transfer date. "The value was a constant at all times."
3. *Donees entitled to the same number of units.* Before and after the IRS audit, the donees in this case (as in *Petter*) were entitled to receive the same number of units. Each of the taxpayers' children would receive a 1.98 percent interest; or,

$$1.98\% = \frac{\$261{,}000}{\$13{,}213{,}389}$$

Similarly, each of their grandchildren was entitled to receive a 0.083 percent interest; or,

$$0.083\% = \frac{\$11{,}000}{\$13{,}213{,}389}$$

4. *Gifts are not dependent on IRS audit.* Absent the IRS audit in this case (and in *Petter*), the donees might never have received the percentage interests to which they were entitled, but "that does not mean that parts of [the taxpayers'] transfers were dependent upon an IRS audit," the court observed. "Rather, the audit merely ensured that the [taxpayers'] children and grandchildren would receive the 1.98 percent and 0.083 percent [LLC] interests they were always entitled to receive, respectively."

IRS's role is not to maximize tax receipts. As a final matter, that the donees were family members (rather than charitable institutions, as in both *Petter* and *Christiansen*) was "inconsequential," the court ruled. "The lack of a charitable component" did not result in a "severe and immediate public policy concern." On the transfer date, each recipient was entitled to a predefined LLC percentage interest expressed through a formula. The gift documents did not permit the taxpayers to "take property back," the court said, but merely corrected the allocation of LLC units due to the understatement of their value in the independent appraisal.

Stockdale's 'Top 10' List for Litigation Experts—or How to Avoid the 'Nightmare' of a *Daubert* or Credibility Disqualification

In June, John Stockdale Jr. (Schafer & Weiner) presented a case law update to the annual meeting of the Michigan Society of CPAs in Detroit. In the midst of his slides, he included the "Top 10 Issues with Experts," or the problems that he and his law firm colleagues frequently encounter when working with appraisal experts in cases ranging from bankruptcy to shareholder dissent and oppression.

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"I was first asked to talk about 'nightmares in valuation cases' over the years, but when I started reading through those cases, I realized that case nightmares come under two varieties: 1) being excluded under *Daubert,* or 2) giving testimony and being found not credible," Stockdale said. Rather than talk about the individual cases that resulted in these two situations, Stockdale chose to focus on the issues that lead to them—and the ways experts can avoid them:

1. Communicate with the lawyer.
2. Understand the standard of value. In contexts such as shareholder dissent and divorce, "Michigan has unsettled standards of value," Stockdale explains. "So you're going to want to talk to your lawyer."
3. Understand the case or even more importantly, understand your role on the litigation team. The attorney is the quarterback, and depending on the case, he or she may want to make the call regarding what standard of value is appropriate to apply.
4. Draft reports clearly.
5. Include backup in your reports.
6. Do not argue in depositions or on the stand.
7. Have a complete and detailed curriculum vitae. Stockdale recalls a recent case in which the expert listed his two schools and his many hours of continuing professional education, without specifying what all those hours entailed.
8. Avoid technical jargon whenever possible in written reports and in testimony.
9. Provide documentation.
10. Ensure your credentials are current. Stockdale told of another recent case in which the expert allowed his credentials to lapse between his retention and trial.

Proposed USPAP Revisions Prompt Sharp Criticism from ASA BV Committee

Members of the American Society of Appraisers (ASA) "are not happy with" some of the current proposed revisions to the Uniform Standards of Professional Appraisal Practice (USPAP), reports Linda Trugman, chair of the ASA Business Valuation (BV) Committee, in a recent e-update to members. Among other changes set forth in the exposure draft for the 2014-2015 USPAP, the most controversial are those to the definitions of "assignment results" in Section 2a and "report" in Section 2b.

In particular, a letter signed by Trugman on behalf of the ASA BV Committee expressed its concern that elevating draft reports to the status of "assignment results" would counter the prevailing trend in litigation matters to preclude discovery of an appraiser's draft materials. Moreover, the proposed broader definition of "report" would include "any communication of an opinion of value...at any time." Instead,"we believe the definition of a 'report' should be linked to the completion of an assignment."

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