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Defined Value Clauses and Fair Market Value

By Wendy C. Gerzog


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In this article, Gerzog discusses *Hendrix*, in which the Tax Court, applying the Fifth Circuit's rationale and holding in *McCord*, sustained the taxpayers' valuations of their transferred stock based on defined value clauses and held that those clauses were not void as against public policy.

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In *Hendrix*[1] the Tax Court once again considered whether defined value clauses were the result of arm's-length transactions and whether they were void as against public policy.[2] The underlying dispute was whether the taxpayers' transfers of the John H. Hendrix Co. (JHHC) stock were valued at fair market value.

In 1996 the taxpayers' attorney suggested that they change the structure of JHHC to an S corporation for tax reasons, and in connection with the company's preferred stock redemption, he suggested an appraisal firm to value the stock.[3]

Around 1999, the taxpayers consulted their attorney about making gifts of JHHC stock to their three daughters in trust and to a charitable entity. Because of the difficulty in valuing the stock, the attorney advised the taxpayers to use a defined value clause to fix the value of their stock transfers for federal gift tax purposes. He also recommended that they create a donor-advised fund at a community nonprofit organization. Accordingly, the taxpayers selected the Greater Houston Community Foundation to administer their fund. Although they had not previously been involved with that foundation, the taxpayers desired to help local and statewide charitable needs.[4]

The taxpayers' attorney told the foundation that his clients would be making a large charitable donation consisting of (1) $20,000 to create a donor-advised fund and (2) JHHC nonvoting stock. The foundation had a protocol on donations of hard-to-value property.[5] During the following three months, the parties negotiated their agreement to create a donor-advised fund. Also, the taxpayers' attorney sent the foundation a draft assignment agreement and a dispute resolution and buy-sell agreement. The draft explained that the taxpayers would give JHHC stock to the foundation and make a part-gift, part-sale transfer of JHHC stock to their daughters' trusts. The foundation's attorney returned the assignment agreement in November 1999 together with an attached rider addressing JHHC's duty to pay income in a timely manner.[6]

The taxpayers rehired their attorney's appraiser to value the transferred stock. The appraisal firm valued the stock based on the earlier redemption value and on the company's accounts and tax documents. Each taxpayer then determined gifts of $50,000 of the nonvoting stock to the foundation, $10.5 million to a generation-skipping trust, and $4.2 million to an issue trust that benefited the daughters. Those trusts were created by the taxpayers near the end of 1999, with a Mr. Klein and the taxpayers' eldest daughter as trustees. The following day the taxpayers partitioned their community property interests in the JHHC nonvoting stock so that each thereby owned 403,241.85 shares.[7]

On December 31, 1999, the taxpayers, the trustees, and the foundation executed an assignment agreement to assign irrevocably 287,619.64 shares of the stock to the generation-skipping trust and to the foundation. The three agreements contained a defined value clause. Reciting the definition of FMV from the regulations,[8] the agreements transferred $10.5 million of stock to the trusts for

[1] *Hendrix v. Commissioner*, T.C. Memo. 2011-133, *Doc 2011-13144, 2011 TNT 116-13.*
[2] *Id.* at 2.
[3] *Id.* at 3.
[4] *Id.* at 4-5.
[5] *Id.* at 5.
[6] *Id.* at 6.
[7] *Id.* at 6-7.
[8] *See* reg. section 20.2031-1(b).

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the taxpayers' daughters, and any remaining shares were assigned to the foundation for the benefit of the donor-advised fund.[9]

Each trust was required to pay its proportionate share of gift tax from the transfer, and the trustees were required to sign promissory notes to pay each of the taxpayers approximately $9 million. Also, the taxpayers each signed another set of assignment agreements similar to those above, but transferring 115,622.21 shares of stock to the issue trust and to the foundation, with the stock value fixed at $4.2 million and with the trustees obligated to execute promissory notes for $3.6 million to each taxpayer.[10]

The assignment agreement gave the transferees the right to allocate the shares, and the dispute resolution and buy-sell agreement required any dispute about FMV to be resolved by arbitration, failing an agreement among the parties. On the same date as the assignment agreement, the trustees delivered the requisite promissory notes, and the taxpayers executed documents naming the trusts and the foundation as tenants-in-common owners of the transferred stock.[11]

The taxpayers' attorney negotiated the trusts' proposed confirmation agreements for the stock transfers, and the trustees hired the same appraisal firm previously recommended to the taxpayers. The firm appraised the FMV of the shares at $36.66 per share on December 31, 1999. The taxpayers' attorney sent that appraisal to the foundation and its attorney on April 12, 2000. Consistent with its practice of requiring an independent review of appraisals, the foundation retained its own appraiser, who on or about May 8, 2000, found the taxpayers' appraisal to be ''reasonable and fair.''[12]

On their gift tax returns for 1999, filed on April 12, 2000, each taxpayer claimed a gift of $1.4 million and a charitable deduction of $50,000.[13]

In June 2000 the foundation and the trustees concluded their confirmation agreement with an effective date of December 31, 1999, applying the $36.66-per-share FMV from the appraisal.[14] The taxpayers and the government agreed that if a final decision of the case resulted in the court's rejection of the defined value clauses in the assignment agreements, the share values would be based on a per-share value of $48.60, multiplied by the number of shares allocated to each transferee under the confirmation agreement.[15]

The taxpayers contended that the parties' transaction was at arm's length and that the formula clauses were used to set a value for a difficult-to-value asset. The taxpayers therefore asserted that the transferred share values were $36.66 per share and that their charitable deduction was $100,000. The government maintained that the defined value clauses were invalid because they were not the result of arm's-length negotiations and were contrary to public policy. The government concluded that the taxpayers transferred stock at $48.60 per share and that their charitable deduction was therefore limited to $66,284.57.[16]

The court considered who should bear the burden of proof. Both parties agreed that the government should bear the burden regarding the validity of the defined value clauses. Because the taxpayers agreed to deduct only a total of $50,000 as a charitable gift, the court held that the question of the valuation of the charitable deduction was rendered moot.[17]

The court started by explaining that the case was appealable to the Fifth Circuit and that under the *Golsen*[18] rule, *McCord*[19] governed the holding in the instant case, with the exception of the two issues the government was arguing — whether the defined value clauses were the result of arm's-length transactions and whether they were void as contrary to public policy. The court observed that the defined value clause in *McCord*, which was tied to gifts of limited partnership interests to family members and to charities, was ''nearly identical to the one here.''[20] The *McCord* assignment agreement also referred to the FMV definition in the regulations.

The donees were to allocate percentage interests in the company, but the donors did not participate in that decision. The appraisal firm used in *McCord* was the same one used here. Although the *McCord* charity did not hire its own appraiser to review the appraisal, its officers and their outside counsel expressed confidence in the taxpayers' appraiser and his firm, found his method and service appropriate, and accepted his valuation.[21] The donees used that computation to apportion their partnership interests.

The Tax Court held against the McCords, and the Fifth Circuit reversed. In its decision, the appellate

[9]*Id.* at 8.
[10]*Id.* at 8-9.
[11]*Id.* at 9.
[12]*Id.* at 10.
[13]*Id.*
[14]*Id.* at 10-11.
[15]*Id.* at 11.

[16]*Id.* at 11-12.
[17]*Id.* at 12-13.
[18]*Golsen v. Commissioner*, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971).
[19]*Succession of McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), *Doc 2006-15992*, *2006 TNT 164-11*, *rev'g* 120 T.C. 358 (2003), *Doc 2003-12175*, *2003 TNT 94-10*.
[20]*Hendrix*, T.C. Memo. 2011-133, at 14.
[21]*McCord*, 461 F.3d at 620.

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court noted that the government had initially relied on the rationale that the defined value clause violated public policy but that it had waived that doctrine on appeal.[22] Because the Fifth Circuit did not address the government's public policy argument or decide whether there was an arm's-length transaction, *McCord* did not control the Tax Court's consideration of those issues in *Hendrix*,[23] but the court still held for the taxpayers on both questions.[24]

The court explained that to conclude that the taxpayers' transactions were not at arm's length, it would have to find "credible evidence that the parties colluded or had side deals or that the form of the transactions otherwise differed from the substance."[25] That the taxpayers and their daughters were close and the transaction benefited the daughters "does not necessarily mean that the formula clauses failed to be reached at arm's length," the court said.[26] Likewise, there is no requirement that there be negotiations or adverse interests among the parties for the court to find that the transaction was at arm's length. The court noted that as buyers in the transaction, the daughters sustained a risk that the stock might be overvalued.[27] Further, the court refused to find collusion between the taxpayers and the foundation because the charity could lose its tax exemption if it failed to exercise due diligence regarding the gift and because it had used its own appraiser to review the taxpayers' appraisal.[28] Moreover, the foundation required that the taxpayers pay all taxes and penalties "if JHHC failed to distribute sufficient income to pay those taxes," and the foundation had a fiduciary duty to ensure that it received the full value it was entitled to receive under the defined value clauses.[29]

Finally, the court held that the defined value clauses were not void as against public policy. According to the court, those clauses would not "severely and immediately frustrate sharply defined national or State policies proscribing certain conduct."[30] Rather, the court found that the defined value clauses assisted the public policy of encouraging charitable gifts. The court distinguished *Procter*[31] as a case involving a savings clause that (1) deterred tax collection, (2) required the court to decide a moot issue, and (3) "would reduce a Federal court's final judgment to a declaratory judgment."[32] By contrast, the formula clauses in *Hendrix* had no condition subsequent that would undermine the transfer. Moreover, the formula clauses benefited a charity. The case was similar to *Christiansen*,[33] in which the court held that a defined value disclaimer clause was not contrary to public policy.[34]

Analysis and Conclusion

Under the *Golsen* rule, the Tax Court was bound to decide *Hendrix* in line with the Fifth Circuit's holding in *McCord*. The two cases are factually almost identical. Unfortunately, that means that defined value clauses designed to produce valuation distortions have once again been interpreted as benign.

In *McCord*, the taxpayers transferred a greater value to their children and grandchildren than the stated amount under the assignment agreement, and they received a larger charitable deduction than the amount the charities ultimately received when the donees, as anticipated, purchased the partnership interests from them.[35] In *McCord*, the charities received approximately $500,000, which they would not have received without "going along to get along" with their wealthy donors.[36] Indeed, as the court noted in *Hendrix*, the experts in *McCord* did

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[22]*Id.* at 623.
[23]*Hendrix*, T.C. Memo. 2011-133, at 16-17.
[24]*Id.* at 18, 22.
[25]*Id.* at 18.
[26]*Id.*
[27]*Id.* at 18-19.
[28]*Id.* at 19.
[29]*Id.* at 19-20.
[30]*Id.* at 20.
[31]*Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944).

[32]*Id.* at 827.
[33]*Estate of Christiansen v. Commissioner*, 130 T.C. 1, 16-18 (2008), *Doc 2008-1539*, *2008 TNT 17-7*, *aff'd*, 586 F.3d 1061 (8th Cir. 2009), *Doc 2009-25102*, *2009 TNT 218-18*.
[34]*Id.* at 21-22.
[35]In an earlier *Tax Notes* column, I contended:

> Applying the total value of the donated partnership interest, that is, the stated defined value clause plus the donated amount equaling $9,883,832.54, and working backwards, because the charity received only $479,008.55, that excess value should have increased the value of the donors' gift to their children and grandchildren to $9,404,824.56. That is, if the charity received only $479,008, the donees actually received more than the stated amount under the agreement. The donors received an unwarranted charitable deduction of approximately $2.5 million and their children and grandchildren netted approximately an additional $2 million not subject to transfer taxes. Logically, either the gift was greater than the donors had stated it would be or the donors retained that additional value. Because the extent of the donors' transfer was fixed and not at issue, and because the charity gained only $479,008 in a foreseeable transaction, the donors must have transferred $9,404,824 to the donees. [Citations omitted.]

Wendy C. Gerzog, "*McCord* and Postgift Events," *Tax Notes*, Oct. 23, 2006, p. 349, *Doc 2006-21031*, *2006 TNT 205-41*.
[36]*McCord*, 120 T.C. at 373, n.9 ("Suffice it to say that, in the long run, it is against the economic interest of a charitable organization to look a gift horse in the mouth").

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not hire their own valuation experts. They ''never obtained a separate and independent appraisal of their interests.''[37] However, neither did the foundation in *Hendrix*; its appraiser merely reviewed the taxpayers' appraisal for approval.[38] That is different from having your own expert independently appraise the donated property.[39] In both *Hendrix* and *McCord*, it is equally questionable ''why a charity would ever want to receive a minority limited partnership interest, but for an understanding that this interest would be redeemed quickly for cash, and find relevant that the interest was subject to the call provision that could be exercised at any time.''[40]

In *Hendrix*, moreover, the Tax Court went further than applying *Golsen.* The court rejected the government's public policy argument at least in part on the ground that the defined value clauses encourage charitable gifts. But there is one major problem with that statement: Defined value clauses primarily promote private benefit to the donors in contravention of *American Bar Endowment*.[41] Through the use of a charitable conduit, the taxpayers pass a greater value to their children without properly assessed transfer taxes.[42]

By discouraging the government's incentive to audit the taxpayers' returns, the defined value clauses in both *McCord* and *Hendrix* impede an accurate valuation of the transferors' taxable gifts to their family and their donations to the charities. *Procter* should have controlled the result in both these cases.

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[37]*Id.* at 430 (Laro, J., joined by Vasquez, J., dissenting).

[38]Although the Tax Court states that the charity performed its own independent appraisal, earlier the court describes its ''independent appraisal'' as *reviewing* the taxpayers' expert's appraisal. *See Hendrix*, at 10 and 19.

[39]Noteworthy is the fact that the taxpayers agreed with the government that if the court rejected the taxpayers' per share appraisal of $36.66, the per share figure should be valued at $48.60, resulting not only in a lower charitable deduction but also, more significantly, a much higher value transferred to the non-charitable beneficiaries and thus an undervaluation of assets subject to gift tax. *See* discussion and accompanying notes 12-16, *supra*.

[40]*Id.* In *Christiansen*, in contrast to *McCord* and *Hendrix*, because the court disallowed the family limited partnership discounts, the taxpayers transferred the partnership's underlying assets, which had easily verified FMVs, to both non-charitable and charitable beneficiaries. Because those transferred assets were liquid assets, the defined value clause could not result in sleight-of-hand valuation distortions that they were intended to create for a nonmarketable FLP interest. *See* Gerzog, ''Disclaimers and Defined Value Clauses: *Christiansen*,'' *Tax Notes*, Apr. 7, 2008, p. 91, *Doc 2008-5881*, or *2008 TNT 68-51*.

[41]*United States v. Am. Bar Endowment*, 477 U.S. 105, 117-118 (1986) (''Where a taxpayer receives a benefit of equal value for his donation, he is ineligible for a charitable contribution deduction''). Although the issue of the value of the charitable deduction was rendered moot in *Hendrix* because the taxpayers agreed to a much lower charitable deduction value, defined value clauses in this context will inevitably lead to overvaluations of a charitable deduction, which is contrary to public policy.

[42]I have argued that ''when a taxpayer seeks to use the tax system to benefit from her charitable gift in addition to the tax benefit derived from a commensurate charitable deduction, quid pro quo and the examination of donative intent should be expanded to encompass the consequences to the alleged donor, the charity, and the government.'' *See* Gerzog, ''From the Greedy to the Needy,'' 87 *Ore. L. Rev*. 1133, 1137 (2009).

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