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Wendy G. Gerzog

University of Baltimore School of Law, wgerzog@ubalt.edu

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Wandering Far Afield With Defined Value Clauses

By Wendy C. Gerzog



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Wendy C. Gerzog is a professor at the University of Baltimore School of Law.

The *Wandry* decision extends the application of defined value clauses beyond those family limited partnership cases that transfer any excess value to a charity. In *Wandry*, the Tax Court reads *Procter* narrowly and ignores the fundamental rationale of *Robinette*.

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In *Wandry*,¹ the Tax Court held for the taxpayers, finding that their gifts to their children and grandchildren in 2004 were gifts of fixed dollar amounts equal to comparable amounts of family limited liability company share units. Likewise, the court decided that the defined value clause in their transfer documents was not void as contrary to public policy. The *Wandry* decision reinforces and expands the Tax Court's acceptance of defined value clauses. That acceptance and expansion will routinely shift the burden from the taxpayer to the IRS and the courts to determine the number of nonmarketable family limited partnership or LLC share units that a donor has transferred to his family, without the possibility of the government collecting any additional tax revenue.

In a fully stipulated case, the taxpayers formed an FLP in 1998 with cash and marketable stock. They had approached their attorney/CPA to make tax-free gifts to their children and grandchildren. At that time, a taxpayer's annual gift tax exclusion was \$11,000 per donee and a donor's lifetime gift tax exclusion was \$1 million. Because the value of their FLP interests could not be ascertained "on any

given date," the attorney advised them to make gifts of a fixed dollar amount instead of a fixed number of FLP units.²

In 2001 the taxpayers and their children formed Norseman Capital LLC, a family business. By 2002 all the FLP's assets were transferred to Norseman. The taxpayers' attorney made the same gift suggestions as he did with the FLP.³ In 2004 the taxpayers each made gifts to their children and grandchildren totaling the nine beneficiaries' annual exclusions, plus, to the four children, a quarter of a million dollars each, representing each donor's lifetime gift tax exclusion.⁴

The gift document stated, "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."⁵ Further, the instrument recited the donors' intention to have an independent appraiser value the number of units, with a proviso that if the IRS challenged the number, it would be adjusted as necessary "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."⁶

The taxpayers intended to make gifts that fell within the exempted amounts. Their attorney explained that if there were a revaluation, no units would be returned to them; rather, there would be a reallocation of their capital accounts to reflect the actual gifts. On July 26, 2005, the appraiser valued a 1 percent LLC interest at \$109,000.⁷ In 2004 the taxpayers' capital accounts decreased in the aggregate by \$3,603,311, increasing their children's and

²Those FLP transfers, however, were not before the court. *Id.* at 2-3.

³*Id.* at 4 ("(1) the number of Norseman membership units equal to the desired value of their gifts on any given date could not be known until a later date when a valuation could be made of Norseman's assets; (2) all gifts should be given as specific dollar amounts, rather than specific numbers of membership units; and (3) all gifts should be given on December 31 or January 1 of a given year so that a midyear closing of the books would not be required").

⁴*Id.* at 4-5.

⁵*Id.* at 5.

⁶*Id.*

⁷*Id.* at 6.

¹*Wandry v. Commissioner*, T.C. Memo. 2012-88, Doc 2012-6322, 2012 TNT 59-17.

grandchildren's capital accounts by approximately \$855,745 and \$36,066, respectively. Each taxpayer's gift tax return for 2004 indicated the total fixed value of his gifts, but described the gifts as 2.39 and 0.101 percent LLC interests, respectively, based on the appraiser's figure.⁸ Both the taxpayers and the government agreed that as of January 1, 2004, those percentage interests were worth \$315,800 and \$13,346, respectively.⁹

The government argued that the taxpayers' transferred fixed percentage interests exceeded the applicable exclusions. Their gift tax return descriptions constituted admissions, their capital account adjustments reflected those descriptions, and their gift documents transferred percentage interests. Also, citing *Procter*,¹⁰ the government asserted that the taxpayers' adjustment clauses created a condition subsequent that was void as against public policy.¹¹ By contrast, the taxpayers maintained that they did not transfer fixed LLC percentage interests, but fixed dollar amounts, to their children and grandchildren. Moreover, they contended that the adjustment clauses were not contrary to public policy.¹²

The court rejected the government's reliance on *Knight*¹³ to support its position that the taxpayers' gift tax return description was an admission that they had transferred percentage units to the donees because, unlike the taxpayers in *Wandry*, the donors in *Knight* argued at trial that their gifts were worth less than the value listed on their return. Because of that, the court in *Knight* held that the taxpayers had not intended to make a gift of a fixed amount but only percentage interest. The *Wandry* court held that the taxpayers consistently maintained that they had intended to make gifts of a fixed dollar amount.¹⁴

The court also declined to adopt the government's view that the LLC's capital accounts controlled the nature of the taxpayers' gifts. The court stated that "the facts and circumstances determine Norseman's capital accounts, not the other way around."¹⁵ Moreover, the court found the capital account ledger "unofficial and unreliable."¹⁶

⁸*Id.* at 7.

⁹*Id.* at 8.

¹⁰*Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944).

¹¹*Wandry*, T.C. Memo. 2012-88, at 9.

¹²*Id.* at 10.

¹³*Knight v. Commissioner*, 115 T.C. 506 (2000), Doc 2000-31015, 2000 TNT 232-11.

¹⁴*Wandry*, T.C. Memo. 2012-88, at 11-12.

¹⁵*Id.* at 15.

¹⁶*Id.* at 16.

Finally, the court held that *Procter* did not control. The court cited the clause used in *Procter*¹⁷ that functioned to reverse a completed gift in excess of the gift tax and stated the Fourth Circuit's objections to the condition subsequent: "(1) any attempt to collect the tax would defeat the gift, thereby discouraging efforts to collect the tax; (2) the court would be required to pass judgment upon a moot case; and (3) the clause would reduce the court's judgment to a declaratory judgment."¹⁸

With particular reliance on *Estate of Petter*,¹⁹ the *Wandry* court held that while a savings clause might violate *Procter*, a formula value clause was unobjectionable because "it merely transfers a 'fixed set of rights with uncertain value.'"²⁰ Likewise, the court cited the Ninth Circuit's decision in *Estate of Petter* as "holding that although the value of each membership unit was unknown on [the transfer] date, the value of a membership unit on any given date is a constant."²¹

Applying the Ninth Circuit's three-part test in *Estate of Petter* to the facts in *Wandry*, the Tax Court determined that under the gift document, the donees were at all times entitled to receive predefined LLC percentage units, expressed in a mathematical formula; the value of an LLC unit, although unknown when the gift documents were executed, was a constant; and before and after the government's audit, the donees received the same LLC percentage unit. Each child was entitled to receive approximately a 1.98 percent interest, and each grandchild approximately a 0.083 percent interest.²² Without the audit, the donees might not have received their proper LLC percentage interest, "but that does not mean that parts of petitioners' transfers were dependent upon an IRS audit."²³

The court held:

It is inconsequential that the adjustment clause reallocates membership units among petitioners and the donees rather than a charitable

¹⁷*Id.* at 17, citing *Procter*, 142 F.2d at 827 ("In the event it should be determined by final judgment or order 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" the taxpayer).

¹⁸*Id.*

¹⁹*Estate of Petter v. Commissioner*, T.C. Memo. 2009-280, Doc 2009-26779, 2009 TNT 233-14, *aff'd*, 653 F.3d 1012 (9th Cir. 2011), Doc 2011-16968, 2011 TNT 151-7.

²⁰*Wandry*, T.C. Memo. 2012-88, at 20-21, citing *Estate of Petter*, 653 F.3d at 1023.

²¹*Id.* at 21, citing *Estate of Petter*.

²²*Id.* at 23-24.

²³*Id.* at 25.

organization because the reallocations do not alter the transfers. On January 1, 2004, each donee was entitled to a predefined Norseman percentage interest expressed through a formula. The gift documents do not allow for petitioners to “take property back.” Rather, the gift documents correct the allocation of Norseman membership units among petitioners and the donees because the K&W report understated Norseman’s value. The clauses at issue are valid formula clauses.²⁴

The court held that there was no public policy against formula clauses and that there were mechanisms apart from an IRS audit, such as competing interests of the LLC members, to ensure accurate valuation. “Each member of Norseman has an interest in ensuring that he or she is allocated a fair share of profits and not allocated any excess losses.”²⁵ Likewise, the court held that its opinion did not undo the gift, decide a moot case, or issue a declaratory judgment. That there is no charitable donation in *Wandry* “does not result in a ‘severe and immediate’ public policy concern,” the court wrote.²⁶

Knight

After forming an FLP, the taxpayers each transferred a 22.3 percent FLP interest to their children’s trusts. After the transfers, the taxpayers each owned a 4.9 percent limited partnership interest. The transfer documents stated that each taxpayer transferred the number of partnership units equal to \$300,000.

The government cited *Procter* and *Ward*²⁷ for its position that the defined value clause was void as contrary to public policy. Without deciding the applicability of the government’s cited precedents, the Tax Court held that the taxpayers had transferred percentage FLP interests. The taxpayers’ gift tax returns stated their gifts were of 22.3 percent FLP interests and omitted any reference to a dollar value. Also, the taxpayers testified that their gifts were actually less than the \$300,000 value in their transfer documents. Holding for the government, the court held that the taxpayers had allowed the court to address the government’s position that the percentage interests constituted a value greater than the \$300,000 value.

Estate of Petter

The taxpayer made a part-gift, part-sale transfer of family LLC units to two trusts and a charitable donation of the units to two charitable foundations.

The transfer documents included both a defined value clause and a reallocation clause. The reallocation clause required gift transfers from the trust to the foundations if the value of the units, as finally determined for gift tax purposes, exceeded a fixed dollar amount. After her IRS audit, the donor’s units were deemed to have a lower value; consequently, the foundations received additional units.

The taxpayer contended that she was entitled to an additional charitable donation equal to the additional units given to the foundations. Both the Tax Court and the Ninth Circuit agreed with her. Explaining the reason for employing a family LLC, the circuit court said:

Anne could have transferred her UPS stock outright, but doing so would have ‘enabled the Commissioner to tax her on its full value — UPS stock is publicly traded and easy to price.’ Conversely, ‘a gift of membership units in an LLC is harder to value [and] creates the possibility of a more taxpayer-friendly valuation’ because ‘provisions in the operating agreement restrict members’ rights to sell’ LLC units. These restrictions allow a taxpayer to discount the value of stock by a percentage that reflects the lack of marketability of LLC units.²⁸

Not wanting to pay any gift tax, the taxpayer gave the trusts units equal to her unused unified credit (\$1 million) plus her available annual exclusions (in 2002, that amount was \$11,000 per donee). Then, taking back a 20-year note bearing 5.37 percent interest and requiring quarterly payments of \$83,476.30, she sold additional units to the trusts.²⁹

According to the taxpayer’s estate planner, those transfers effected a charitable freeze under which, if the government challenged the gift valuation, an excess would not result in additional gift tax but in additional charitable donations.³⁰

The IRS audit determined that each unit had a greater value than the taxpayer reported so that according to the government, the taxpayer’s gifts exceeded her unified credit and the sales were not for adequate consideration in money or money’s worth. The government further declared that the defined value clauses were void as against public policy and, citing a regulation,³¹ refused the additional charitable deductions on the basis that the

²⁴*Id.*

²⁵*Id.* at 26.

²⁶*Id.* at 27.

²⁷*Ward v. Commissioner*, 87 T.C. 78 (1986).

²⁸*Estate of Petter*, 653 F.3d at 1015, n.1 (citations omitted).

²⁹The court stated that the trusts regularly made those payments to the taxpayer. *Id.* at 1015.

³⁰*Id.* at n.2.

³¹Reg. section 25.2522(c)-3(b)(1).

transfer resulted from a “post-audit reallocation of units between the foundation and the trusts.”³²

While the government argued that the foundations’ right to the additional units adhered only after a successful IRS audit, the court held that the transfers were “effective immediately upon the execution of the transfer documents and delivery of the units.”³³ Only the value of the units remained unsettled. “The number of LLC units the foundations were entitled to was capable of mathematical determination from the outset, once the fair market value was known,” the court said.³⁴

The court acknowledged the practical unlikelihood of a valuation challenge by the trusts or the foundations and that therefore in reality an IRS audit was required for such a challenge; however, the court stated that this fact did not transform the foundations’ rights into contingent ones.³⁵

The gift documents defined the gifts to the foundations as the difference between a stated number of LLC units and a fixed dollar amount worth of LLC units. Citing the Eighth Circuit in *Estate of Christiansen*,³⁶ which dealt with the application of a similar estate tax regulation, the Ninth Circuit concluded that the requirement did not prevent a charitable deduction because the regulation does not refer to a final valuation but to the existence of a transfer. “Because the fair market value of an LLC unit on a particular date is a constant, the foundations received gifts of a determinable amount.”³⁷ The court then invited the government to change its regulation if it disliked the outcome of the case.³⁸

Procter

Procter reversed a Tax Court decision refusing to assess gift tax on the taxpayer’s transfer of remainder interests in two trusts to his children, assuming a balance existed after his payment of any amounts due on his promissory notes to his mother. The taxpayer had a vested remainder in those trusts following his mother’s life estate. However, the trusts were subject to divestment if the taxpayer’s death preceded hers. In one of the trusts, the taxpayer’s remainder was subject to the added condition that he be at least 40 years old at the time of his mother’s death.³⁹

The government calculated the taxpayer’s gift tax by subtracting the debt from the corpus of the first

trust and then computing the present value of the remaining amount and the value of the second trust.⁴⁰ The Fourth Circuit said, however, that in making its calculations, the Tax Court “reversed that order. When the resulting computation indicated that the present value of the corpus in the two trusts was less than the taxpayer’s outstanding debt, the court concluded that the taxpayer had not made any taxable gift to his children.”⁴¹

Because the calculations of the Tax Court were considered based not on a rule of law but on one of fact, and because the taxpayer and his mother had not agreed to delay the note’s collection until after her death, the Fourth Circuit stated that it could not hold that the court’s method of computation was erroneous.⁴² However, the circuit court held that for purposes of determining the amount of the debt to be subtracted from the value of the trusts, the Tax Court should have calculated the present value by reference to the taxpayer’s mother’s death and, with the second trust, with the additional condition of the taxpayer’s turning 40 — that is, when the taxpayer’s interests could not be divested.⁴³ After that amount was deducted, the remainder was an amount available to pay the taxpayer income for his life remaining at the mother’s death and that would pass to his children at his death.⁴⁴

The taxpayer asserted that the Tax Court’s decision should be affirmed because (1) the transfer would be subject to estate tax when the taxpayer dies; (2) the interest is too contingent to be subject to the gift tax; and (3) under the terms of the trust, the gift was not to become effective if subject to a gift tax. The court quickly dismissed the first two of the

⁴⁰*Id.* at 825 (“It was stipulated that the present worth of \$1 due at the death of a person aged 36, provided that a person aged 63 shall have died before the person aged 36, is \$0.25152, and that its present worth, upon the additional condition that the death of the person aged 36 occur after four years is \$0.24883. There was no stipulation or finding, however, as to the present worth of \$1 due at the death of a person age 63 years, provided a person aged 36 years should survive”). The government then used the stipulated amounts for its computations of the remainder values (after subtracting out the debt from the first trust).

⁴¹*Id.*

⁴²*Id.* at 825-826.

⁴³*Id.* at 826 (“We are told that the present worth of \$1 at the death of his mother was \$0.56445, or \$0.55377 when the additional condition is present that he attain the age of forty years.” By holding that the present value should be determined by reference to the taxpayer’s rather than his mother’s death, the Tax Court essentially held that the taxpayer’s interest was not available to pay the notes until his death, a conclusion the circuit court held was unsupported by the facts).

⁴⁴*Id.* at 826 (The circuit court provided calculations to illustrate its holding, but left it to the Tax Court on remand to calculate the values. “It is for the Tax Court, not for us, to find the correct formulae and apply them to the facts”).

³²*Estate of Petter*, 653 F.3d at 1018.

³³*Id.* at 1019.

³⁴*Id.*

³⁵*Id.*

³⁶*Estate of Christiansen v. Commissioner*, 586 F.3d 1061 (8th Cir. 2009), *Doc* 2009-25102, 2009 TNT 218-18.

³⁷*Estate of Petter*, 653 F.3d at 1023.

³⁸*Id.* at 1023-1024.

³⁹*Procter*, 142 F.2d at 824-825.

taxpayer's arguments as already decided by *Smith v. Shaughnessy*⁴⁵ and *Robinette v. Helvering*.⁴⁶ However, regarding the third contention, the court stated that such a clause could not prevent the imposition of the gift tax:

We do not think that the gift tax can be avoided by any such device as this. Taxpayer has made a present gift of a future interest in property. . . . A contrary holding would mean that upon a decision that the gift was subject to tax, the court making such decision must hold it not a gift and therefore not subject to tax. . . . It is manifest that a condition which involves this sort of trifling with the judicial process cannot be sustained.⁴⁷

The court said its first reason that the condition was contrary to public policy was that it would likely discourage the government's tax collection because "the only effect of an attempt to enforce the tax would be to defeat the gift."⁴⁸ In discussing the reasons to void the condition, the court emphasized "that it is not possible to obtain a declaratory judgment from a federal court as to whether the gift in question is subject to the gift tax."⁴⁹

Robinette

In *Robinette*, the taxpayer was about to marry, and she, her mother, and her stepfather sought the advice of an attorney to ensure that their wealth would remain in her family. All three created trusts with successive life estates, with the remainder to pass to the daughter's issue when they turned 21 and with alternative dispositions if at the last surviving life tenant there were no issue in existence.⁵⁰

The taxpayer contended that in computing the value of the remainder for gift tax purposes, she should be allowed to subtract the value of the reversionary interest.⁵¹ The government, however, argued that a reduction in the value of the remainder interest was inappropriate because the value of the reversionary interest could not be ascertained through the actuarial tables.

The Supreme Court agreed with the government:

In this case, however, the reversionary interest of the grantor depends not alone upon the possibility of survivorship but also upon the death of the daughter without issue who

should reach the age of 21 years. The petitioner does not refer us to any recognized method by which it would be possible to determine the value of such a contingent reversionary remainder. . . . But before one who gives this property away by this method is entitled to deduction from his gift tax on the basis that he had retained some of these complex strands it is necessary that he at least establish the possibility of approximating what value he holds. Factors to be considered in fixing the value of this contingent reservation as of the date of the gift would have included consideration of whether or not the daughter would marry; whether she would have children; whether they would reach the age of 21; etc. Actuarial science may have made great strides in appraising the value of that which seems to be unappraisable, but we have no reason to believe from this record that even the actuarial art could do more than guess at the value here in question.⁵²

Analysis and Conclusion

The Tax Court's decision in *Wandry*, narrowly construing *Procter*, was no surprise in light of *Estate of Christiansen*, *Estate of Petter*, and *Hendrix*. However, it is unfortunate that the sense and sentiment of *Robinette* and *Procter* did not play a greater part in *Wandry*.

In *Robinette*, the Supreme Court refused to buy into the taxpayer's created complexities to reduce the grantor's gift tax. As that court stated, "Before one who gives this property away by this method is entitled to a deduction from his gift tax on the basis that he had retained some of these complex strands it is necessary that he at least establish the possibility of approximating what value he holds."⁵³

A taxpayer who holds liquid assets like cash and marketable securities and who, as the Ninth Circuit in *Estate of Petter* noted, could have transferred her stock outright, but realized that doing so would have enabled the IRS to tax its full value, and therefore transfers those assets to an FLP or family LLC and creates "hard-to-value" assets in order to obtain a reduction in gift (or estate) tax liabilities, should not be able to use the federal fisc to have the government value family entity membership units. The *Wandry* court stated that there were safeguards to insure valuation accuracy, such as the competing interests of the LLC members. How likely is it in a family LLC that that check is a real one?

⁴⁵318 U.S. 176 (1943).

⁴⁶318 U.S. 184 (1943).

⁴⁷*Procter*, 142 F.2d at 827.

⁴⁸The court gave two other reasons: It would require the court to pass on a moot issue and it would render nugatory the final judgment of the court.

⁴⁹*Id.*

⁵⁰*Robinette*, 318 U.S. at 185-186.

⁵¹*Id.* at 188.

⁵²*Id.* at 188-189.

⁵³*Id.* at 188.

COMMENTARY / ESTATE AND GIFT RAP

Wandry narrowly interprets *Procter*, but as the Fourth Circuit in the latter case reminded us, “it is not possible to obtain a declaratory judgment from a federal court as to whether the gift in question is subject to the gift tax.”⁵⁴ Likewise, it should not be the function of the IRS to recalculate a taxpayer’s gifts when the taxpayer has created the valuation complexities in order to avoid the accurate and easy valuation of his gifts. Besides calling it a waste of the government’s money, I think someone might call that chutzpah.

⁵⁴*Procter*, 142 F.2d at 828.