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Practical Tax Strategies

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FORMULA CLAUSE

FORMULA CLAUSE CHANGES TAXABLE GIFT INTO CHARITABLE DONATION

A recent Tax Court decision upheld the validity of an adjustment clause that capped the taxable portion of a transfer and directed that the excess be allocated to charity.

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The Tax Court in *Estate of Petter*¹ allowed a taxpayer to avoid substantial gift tax through a "charitable cap adjustment clause." When the taxpayer in *Petter* conceded to an IRS demand for a substantial increase in the value of property given as a gift, the taxpayer was able to avoid additional gift tax through an adjustment clause that allocated the entire increase to donor advised funds offered by public charities. In this manner, the taxpayer traded a taxable gift for a charitable deduction. Accordingly, *Petter* indicates that a gift tax liability can be capped by an adjustment clause allocating all subsequent increase in value to a public charity.

Background

Adjustment clauses are typically used with the transfer of property that is difficult to value, such as closely held business interests, to mitigate the risk of additional gift tax on a later increase in value. If the value of the property transferred is later increased by findings of an IRS audit, an adjustment clause adjusts the transfer to avoid an increase in gift tax.

Adjustment clauses impose a cap on the portion of the transfer intended to be gratuitous. To the extent the value of the property transferred is determined to exceed this "cap," an adjustment clause seeks to limit the donor's resulting gift tax liability through one of four approaches:

- (1) By requiring the return of the excess to the donor (i.e., a "retransfer clause").
- (2) By increasing the consideration paid by the donee for the property (i.e., a "price adjustment clause").

- (3) By limiting the amount transferred to a dollar cap (i.e., a “defined value clause”).
- (4) By shifting the excess transfer to a deductible donee, such as a spouse or charity (i.e., a “deductible donee clause”).²

Examples of these varying approaches are set forth on Exhibit 1. It was the deductible donee clause that withstood scrutiny in *Petter*.

In *Petter*, Anne Y. *Petter* was able to avoid gift tax on an increase in the value of the property she transferred through an adjustment clause that allocated all such increase to charities. Thus, Anne “capped” the taxable portion of her transfers, with any adjustment to the value of the transferred property being allocated to recipients with respect to whom transfers were deductible for gift tax purposes.

The IRS challenged Anne's formula on public policy grounds, but the court denied the challenge. In doing so, the court observed that “public policy weigh[s] in favor of giving gifts to charities.”

The genesis of the IRS's public policy challenge is the now infamous Fourth Circuit case of *Procter*.³ *Procter* has become synonymous with the “public policy” challenge to “adjustment clauses.” Thus, an analysis of *Petter* requires a brief description of *Procter*.

In *Procter*, the taxpayer tried to avoid gift tax through a “retransfer clause” (also referred to as a “savings clause”) that negated any portion of the taxpayer's transfer later determined to be subject to gift tax. When it was later determined that the taxpayer's transfer included a taxable portion, however, the court did not allow the taxpayer to avoid gift tax through the retransfer clause. According to the court, the clause could not be given effect because it was contrary to public policy for the following three reasons:

[F]irst, it has a tendency to discourage the collection of the tax by the public officials charged with its collection, since the only effect of an attempt to enforce the tax would be to defeat the gift; second, the effect of the condition would be to obstruct the administration of justice by requiring the courts to pass upon a moot case. If the condition were valid and the gift were held subject to tax, the only effect of the holding would be to defeat the gift so that it would not be subject to tax; and third, the condition is to the effect that the final judgement [sic] of a court is to be held for naught because of the provision of an indenture necessarily before the court when the judgement [sic] is rendered. In the words of the court, “It is manifest that a condition which involves this sort of trifling with the judicial process cannot be sustained.”⁴

Following *Procter*, these public policy concerns have been raised by the IRS to challenge a variety adjustment clauses. A summary of the more notable cases is provided in Exhibit 1. *Petter* is the most recent of these cases. Its holding reveals the Tax Court's reluctance to use public policy grounds to negate a charitable cap adjustment clause.

Facts of the case

Anne inherited millions of dollars worth of stock in United Parcel Service of America, Inc. (UPS). Anne was a schoolteacher and mother of three. Her receipt of the UPS stock did not change Anne very much; she continued to teach and to live in the same house. Anne's estate planning aims were to provide a comfortable living for her three children

(Donna Petter Moreland, Terrence Petter, and David Petter) and her grandchildren, and to give money to charity.

To accomplish these desires, Anne formed a limited liability company under the name of Petter Family LLC (PFLLC) and contributed to it 423,136 shares of UPS stock worth \$22,633,545. In exchange, Anne received all of the ownership interests in PFLLC. The ownership interests in PFLLC were divided into three classes of units, one intended for Anne, designated as Class A units, and two separate classes intended for two of Anne's children, Donna and Terrence, designated as Class D units and Class T units, respectively.

The holders of each class of units could elect, by a majority vote of units, a manager to represent their class. According to the operating agreement for PFLLC, a majority vote of the managers controlled the operations of PFLLC, except that the manager representing the Class A units could override the decisions of the other managers. This effectively gave Anne, as the manager of the Class A units, veto power over the operations of PFLLC. The operating agreement for PFLLC imposed restrictions on the transfer of units. Manager approval was necessary to transfer units by gift or bequest to a nonfamily member, and transferees obtained only "Assignee Rights" unless they received manager approval for full membership in PFLLC.

Anne also created a separate irrevocable trust for each of Donna and Terrence. She provided for her third child, David, through separate estate planning. Both trusts were intentionally defective grantor trusts (IDGTs) the existence of which for income tax purposes (but not estate and gift purposes) is disregarded from the grantor of the trusts. The trusts were IDGTs because they permitted the trustees to purchase and pay premiums on a life insurance policy on the life of the grantor (Anne), in contravention of Section 677(a)(3). The use of this power to create grantor trust status for a sale to an IDGT is unusual because commentators have theorized that this power may create grantor trust status only as to the income of the trust but not the principal which could cause capital gain recognition on sales between the grantor and the trust.⁵

As IDGTs, Anne could enter into transactions with the trusts, such as sales and loans to the trusts, without income tax consequences, and Anne could pay the taxes arising from the income earned by the trusts from her assets without making a taxable gift to the trusts or the beneficiaries. Because of these benefits, IDGTs have become a premiere estate planning vehicle.

Anne then executed a plan in which she intended to transfer, without incurring gift tax, substantial ownership of PFLLC to the trusts. Most of this plan followed the now prescribed technique for an installment sale to an IDGT.

First, Anne funded each trust through a taxable gift of PFLLC units estimated to equal 10% of the total value of assets intended to be transferred to the trust. This initial contribution was intended to capitalize the trusts sufficiently so that the trusts "would be viewed by the IRS as a legitimate, arm's-length purchaser in the later sale." Commentators have warned that the sale of assets to an undercapitalized IDGT may be vulnerable to various IRS attacks, such as a sham transaction or debt versus equity argument.⁶

For the gift of PFLLC units to the trusts, Anne sought to avoid any gift tax liability through a pecuniary formula that limited the value of units given as gifts to the trusts to Anne's remaining applicable exclusion amount. The formula for each of the two trusts provided: "Transferor ... assigns to the Trust as a gift the number of Units ... that equals one-half

of the [maximum] dollar amount that can pass free of federal gift tax by reason of Transferor's applicable exclusion amount allowed by Code Section 2010(c). Transferor currently understands her unused applicable exclusion amount to be \$907,820, so that the amount of this gift should be \$453,910."

Second, Anne sold to the trusts PFLLC units estimated to equal 90% of the total value of assets intended to be transferred to the trusts. In exchange for the sale of PFLLC units, Anne received an installment note from each trust for the principal sum of \$4,085,190, with quarterly payments of principal and interest, at the applicable federal rate, over a term of 20 years. The trustees executed pledge agreements securing the installment notes with a security interest in the PFLLC units sold to the trusts.

The charitable cap

To this prescribed technique, Anne incorporated a twist. She combined her desire to minimize gift tax with her charitable intentions by incorporating "charitable cap adjustment clauses" into her transfers to the trusts. Essentially, Anne used pecuniary formulas to limit her gifts and sales of PFLLC units to the trusts to specific amounts (i.e., \$453,910 and \$4,085,190), with the balance of the units passing to two charities: the Seattle Foundation and Kitsap Community Foundations ("Foundations"). Both Foundations were public charities that offered donor advised funds. The court described donor advised funds in favorable terms as "owned and controlled by a charity, but kept separately identified" and allowing the donors at their "leisure [to] advise the charity where they want the money to go and how it should be invested."

The public charity status of the Foundations provided Anne with an opportunity to obtain a larger charitable deduction than if they had been private foundations (i.e., 50% of income for public charities versus 30% for private foundations²), and it minimized the risk of an excise tax from a self-dealing with a private foundation under Chapter 42 of the Code.

The pecuniary formula for Anne's gifts to the trusts provided: "The Trust agrees that, if the value of the Units it initially receives is finally determined for federal gift tax purposes to exceed [\$453,910], Trustee will, on behalf of the Trust and as a condition of the gift to it, transfer the excess Units to the [Foundations] as soon as practicable."

The Foundations in turn agreed to transfer to the trusts excess units "if the value of the units is 'finally determined for federal gift tax purposes' to be less than [\$453,910]." (Interestingly, Judge Foley, in his dissent in McCord, ³ indicated that an agreement of a charitable organization to retransfer property, which the charity was otherwise entitled, to a noncharitable transferee could constitute "an impermissible private benefit" to the taxpayer's son negatively affecting the tax-exempt status of the charity or resulting in an excise tax.) Similarly, the sale documents allocated a total of 8,459 units of PFLLC between a sale to a trust and a gift to a Foundation through a pecuniary formula. This formula was set forth in the opinion as follows:

Transferor ... assigns and sells to the Trust the number of Units described in Recital C above [8,459] that equals a value of \$4,085,190 as finally determined for federal gift tax purposes; and ... assigns to The [Foundation] as a gift ... the difference between the total number of Units described in Recital C [8,459] above and the number of Units assigned and sold to the Trust....

The Trust agrees that, if the value of the Units it receives is finally determined to exceed \$4,085,190, Trustee will, on behalf of the Trust and as a condition of the sale to it, transfer the excess Units to The [Foundation] as soon as practicable. Likewise, the [Foundation] agrees to transfer shares to the trust if the value is found to be lower than \$4,085,190.

The Foundations played an active role in Anne's transfers. They signed both the gift and sales documents, and they were admitted to PFLLC as substitute members. The Foundations, moreover, obtained legal advice to ensure that their receipt of the units would not jeopardize their tax-exempt status. Based on this legal advice, the Foundations insisted, among other things, that they be allowed "to monitor the investment mix of the PFLLC to ensure that [they] did not become exposed to unrelated business taxable income." Once the Foundations received the units, Anne directed many gifts through the Foundations.

The valuation

A professional appraisal firm was retained to prepare a qualified opinion as to the fair market value of a unit of PFLLC. The appraiser compared PFLLC to a closed-end mutual fund owning domestic stock and having little or no debt. The court noted that closed-end mutual funds generally trade at a discount to net-asset value; in the case of PFLLC, the appraiser determined that PFLLC would trade at a 13.3% valuation discount from its net equity value. To this discounted value, the appraiser applied a second discount of 46% for nonmarketability to derive a per unit value of \$536.20. Based on the per-unit value of \$536.20, the units were allocated between the trusts and the Foundations in accordance with the gift and sales documents.

Anne timely filed a gift tax return, and she provided full disclosure of both her gifts and sales of units to the trusts and gifts of units to the Foundations. The IRS audited the return and challenged, among other things, the per unit value of PFLLC. According to the IRS, a unit of PFLLC was worth \$794.39.

Anne petitioned for review by the Tax Court, and in the process Anne and the IRS agreed to a per unit value of \$744.74. This represented a valuation discount of approximately 35% from the net asset value of PFLLC. With the agreement of the parties to a per unit value of PFLLC, the Tax Court was left with the issues of whether Anne should be allowed to avoid additional gift tax through the adjustment clauses in the gift and the sales documents, and whether Anne should be allowed a charitable contribution deduction for the resulting additional transfer of units to the Foundations.

Court gives clause effect

The court understood the adjustment clauses were nothing more than attempts to minimize or avoid gift taxation: "We have no doubt that behind these complex transactions lay Anne's simple intent to pass on as much as she could to her children and grandchildren without having to pay gift tax, and to give the rest to charities in her community." Nevertheless, the court concluded that Anne's adjustment clauses needed to be honored and that Anne was entitled to an additional charitable deduction.

To reach this conclusion, the court relied on what it characterized as "two maxims of gift-tax law":

- (1) "A gift is valued as of the time it is completed, and later events are off limits."
- (2) "[G]ift tax is computed at the value of what the donor gives not what the donee receives."

Moreover, the court drew a distinction between Anne's charitable cap adjustment clause and the retransfer clause prohibited, on public policy grounds, in Procter.

According to the court, Anne's adjustment clause was consistent with the two maxims of gift tax law because it did not alter the units transferred by Anne, but only the ultimate recipient of the particular units. The allocation of units between the trusts and the Foundations was a "later event" that did not affect what Anne had personally given up.

The court analogized Anne's clause to those upheld in *Succession of McCord*⁹ and *Estate of Christiansen*¹⁰ and distinguished it from the clause disregarded in Procter: "The distinction is between a donor who gives away a fixed set of rights with uncertain value—that's Christiansen—and a donor who tries to take property back—that's Procter." From this comparison, the court framed an estate planning rule of thumb: "A shorthand for this distinction is that savings clauses are void, but formula clauses are fine." The court described savings clauses as "adjustment clauses requiring that any gift subject to gift tax revert back to the donor."

The Tax Court, in Christiansen, also drew a distinction between a formula clause and a savings clause. It found valid a formula clause providing for 25% of the value of the property in excess of \$6,350,000 to go to charity, while it found invalid a savings clause in a disclaimer in which the disclaimant promised to take "such actions to the extent necessary to make the disclaimer ... a qualified disclaimer." Such savings clauses are invalid, according to the Tax Court, because "they depend for their effectiveness on a condition subsequent" (i.e., the disclaimant taking additional action to ratify a previous disclaimer). Conversely, the formula clause required no further action by the transferor.

The court, in Petter, then examined the public policy considerations that have played such a key role in this area. As in Procter, King,¹¹ Ward,¹² McCord, and Christiansen, the IRS argued that Anne's "formula clauses are void because they are contrary to public policy, which would create an increased gift tax liability for Anne." The IRS also expressed concern that if Anne's formula was honored it would result in "low-ball" estate appraisals backstopped by contingent charitable contributions. The court was not moved by these concerns. Instead, the court noted that "public policy weighed in favor of giving gifts to charities."

Essentially, the court found that the benefits of a charitable contribution trumped the public policy concerns for lost tax revenue: "We certainly don't find that these kinds of formulas would cause severe and immediate frustration of the public policy in favor of promoting tax audits."

The court, moreover, characterized the IRS's fears of abuse of charities by "low-ball" appraisals as "exaggerated." The Foundations were not passive participants in an attempt to reduce Anne's tax bill. They actively negotiated in the transaction, retained their own counsel, and secured full membership in PFLLC. The court considered this participation important evidence of lack of abuse. According to the court, the fiduciary duties of the Foundations also hedged against abuse: "The directors of the [Foundations] owed fiduciary duties to their organizations to make sure the appraisal was acceptable before signing off on the gift—they also had a duty to bring a lawsuit if they later found that the appraisal was wrong."

The courts in McCord and Christiansen similarly observed that the participation of the charitable and fiduciary donees reduced the risk of abuse. In McCord, the Fifth Circuit noted: “[no] evidence of any agreement—not so much as an implicit, ‘wink-wink’ understanding between the Taxpayers and any of the donees to the effect that any exempt donee was expected to, or in fact would, accept a percentage interest ... with a value less than the full dollar amount....” ¹³

The Tax Court, in Christiansen, also commented: “But IRS estate-tax audits are far from the only policing mechanism in place. Executors and administrators of estates are fiduciaries, and owe a duty to settle and distribute an estate according to the terms of the will or law of intestacy. Directors of foundations ... are also fiduciaries.” (Emphasis in original; internal citations omitted.) Based on this, the Eighth Circuit, in Christiansen, found “sufficient mechanisms in place to promote and police the accurate reporting of estate values beyond just the threat of audit by the Commissioner....” Accordingly, active participation by a charity or an independent fiduciary can provide valuable substance to the transaction.

The court, in Petter, also discussed the inconsistency between the public policy arguments raised by the IRS to challenge Anne’s adjustment clauses with the acceptance of the IRS of formula clauses in other income and transfer tax contexts. For instance:

- Reg. 1.664-(a)(1)(iii), allowing formula provisions for charitable remainder trusts.
- Rev. Proc. 64-19, ¹⁴ sanctioning the use of formula clauses in the marital deduction context.
- Reg. 26.2632-1(d)(1), permitting formula allocations of generation-skipping tax exemption.

The IRS argued that the absence of a specific allowance of a gift tax adjustment clause in the context of Anne’s transfer demonstrates an implicit intent of Congress and the Treasury to ban them. The court disagreed and found “the mere existence of these formula clauses, which would tend to discourage audit and affect litigation outcomes the same way as Anne’s formula, belies the [IRS’s] assertion that there is some well-established public policy against the formula transfer Anne used.”

Finally, the court considered the issue of the availability and timing of a charitable contribution deduction for Anne’s transfer. Based on its reading of both income and gift tax regulations (e.g., Regs. 1.70A-1(c) and 25.2511-2(a)), the court found that the date of Anne’s transfers in 2002 was the appropriate date for the charitable deduction, even though the true value of the transfers to charity was not determined until much later. The court found “no reason a donor’s tax treatment should change based on the later discovery of the true measure of enrichment by each of two named parties, one of whom is a charity.” Accordingly, Anne was allowed to avoid additional gift tax despite a substantial increase in the value of PFLLC units transferred.

Income tax consideration.

The opinion, however, is ambiguous as to whether Anne was entitled to a charitable deduction for both gift tax and income tax. More than six years separated the year of Anne’s transfer and the final determination of the value of the gift. Without an agreement with the IRS, Anne would be unable to amend her income tax return for 2002 to claim the resulting income tax deduction. The loss of an income tax charitable deduction due to the duration of a valuation dispute may further mitigate the concern for low-ball appraisals. A lengthy but unsuccessful defense of a large valuation discount could result in the loss of a valuable charitable income tax deduction. A more conservative valuation

discount could minimize the risk of audit and ensure a maximum charitable deduction for both gift and income tax purposes.

Also absent from the opinion is any discussion of declaratory judgment provisions of Section 7477 which extended, for gifts made after 8/5/97, jurisdiction to the Tax Court to make declarations of the value of gifts. While Section 7477 is intended to give taxpayers a venue to dispute the valuation of gifts sheltered by the unified credit, it appears to conflict with the IRS's public policy argument against decisions by the court without resulting gift tax consequences.

Conclusion

Following in the wake of the opinions in McCord and Christiansen, the Tax Court's decision in Petter indicates further that a "charitable cap adjustment clause" can be used to minimize the risk of additional gift tax on the revaluation of hard-to-value property. The decision, moreover, sets forth a useful roadmap for the technique itself. It describes a manner in which a "donor advised fund" offered by a public charity can be incorporated into the prescribed steps of an installment sale to an intentionally defective grantor trust.¹⁵

Based on Petter, the Tax Court appears to be unwilling to use public policy to increase gift tax at the expense of a charitable donee. Therefore, the proper use of a charitable cap adjustment clause should provide a valuable hedge against the risk of additional gift tax from the transfer of hard-to-value assets.

Adjustment clauses may also be of use in 2010 to counter the looming uncertainty as to whether the federal estate tax will be retroactively reenacted. For instance, a bequest to a generational trust for the benefit of a surviving spouse, children, and grandchildren could include an adjustment clause allocating any portion later made taxable by a retroactive reenactment to a trust for the surviving spouse that qualifies for the federal estate tax marital deduction. The reenactment of the tax would be the triggering event causing a reallocation of a portion of the transfer to a deductible donee, in this case the surviving spouse.

When there is no spouse, the deductible donee could be a charitable lead or remainder trust. Highly respected commentators have submitted that under the current uncertainty in the law, such formulas would not appear to be the "trifling with the judicial process" prohibited by Procter.¹⁶ Such clauses would certainly be consistent with the reasoning of Petter.

Exhibit 1. Types of adjustment clauses

Retransfer clause

Authority: Procter, 32 AFTR 750, 142 F2d 824, 44-1 USTC ¶10110, 44-1 USTC ¶10123 (CA-4, 1944), cert. den. 323 U.S. 756 (1944).

Wording of clause: “[I]n the event it should be determined ... 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 transferor] free from the trust hereby created.”

Holding: The clause was not given effect to avoid gift tax based on the following public policy grounds:

- (1) The clause “has [the] tendency to discourage the collection of tax by the public officials charged with its collection, since the only effect of an attempt to enforce the tax would be to defeat the gift.”
- (2) “[T]he effect of the condition would be to obstruct the administration of justice by requiring the courts to pass upon a moot case.”
- (3) “[T]he condition is to the effect that the final judgment of a court is to be held for naught because of the provision of an indenture necessarily before the court when the judgment is rendered.”

Retransfer clause

Authority: Situation 1, Rev. Rul. 86-41, 1986-1 CB 300.

Wording of clause: “A transferred an interest in a tract of income producing real property to B. Under the deed of transfer, B received a one-half undivided interest in the tract. However, the deed further provided that if the one-half interest received by B were ever determined by the [IRS] to have a value for federal gift tax purposes in excess of \$10,000, then B’s fractional interest would be reduced so that its value equaled \$10,000.”

Holding: The IRS found the clause to be ineffective on public policy grounds; according to the IRS such clauses “tend to discourage the examination of returns and the collection[] of tax and therefore [are] ineffective for federal gift tax purposes.”

Price adjustment clause

Authority: In re King, 39 AFTR 2d 77-353, 545 F2d 700, 76-2 USTC ¶9784, 76-2 USTC ¶13165, 76-2 USTC ¶16240 (CA-10, 1976).

Wording of clause: “[I]f the fair market value of the [stock] ... is ever determined by the [IRS] to be greater or less than the fair market value determined ... above, the purchase price shall be adjusted to the fair market value determined by the [IRS].”

Ruling: Based on the facts of the case, the court upheld the effectiveness of the price adjustment clause to prevent a taxable gift, finding “that the parties intended that the [purchasers] pay a full and adequate consideration for the stock and that the clause was a proper means of overcoming the uncertainty in ascertaining the fair market value of the stock.” Key to its decision to respect the price adjustment clause was “[t]he trial court's finding that there was no donative intent and that the transaction was made in the ordinary course of business at arms [sic] length....”

Price adjustment clause

Authority: Estate of McLendon, TC Memo 1993-459, RIA TC Memo ¶93459, 66 CCH TCM 946 , rev'd on other grounds 77 AFTR 2d 96-666, 77 F3d 477, 96-1 USTC ¶60220 (CA-5, 1995).

Wording of clause: “[T]he parties agree that, to the extent any of the values ... are changed through a settlement process with the [IRS], 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....”

Ruling: The court gave no effect to this adjustment clause because in the court's view: “it makes little sense to expend precious judicial resources to resolve the question of whether a gift resulted from the [] transaction only to render that issue moot.” The court further noted that, because the buyers were not parties to the case, there was no assurance that they would pay the additional purchase price in accordance with the adjustment clause. The court also distinguished this case from King in that this transaction was “not an arm's-length deal,” and more generally, it called into question the factual findings supporting the holding in King.

Price adjustment clause

Authority: Situation 2, Rev. Rul. 86-41, 1986-1 CB 300.

Wording of clause: “The facts are the same as in situation 1, [described above] except that B was not required to reconvey any property to A. Rather, the transfer contained the condition that if the [IRS] determined that B received a gift in excess of \$10,000, B would transfer to A consideration equal to the amount of the excess.”

Ruling: The IRS relied on the public policy grounds of Procter to disregard the clause. The IRS considered the recharacterization of the transfer as a part-gift/part-sale to be irrelevant to the public policy considerations.

Defined value clause

Authority: Ward, 87 TC 78 (1986).

Wording of clause: "Each party hereto agrees that if it should be finally determined for Federal gift tax purposes that the fair market value of each share ... 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 [] stock ..., the total value of which will be \$50,000.00 from each Donor to each Donee and a total of \$150,000 from each Donor to all Donees."

Ruling: The court gave no effect to the clause finding "a condition that causes a part of a gift to lapse if it is determined for Federal gift tax purposes that the value of the gift exceeds a given amount, so as to avoid a gift tax deficiency, involves the same sort of 'trifling with the judicial process' condemned in Procter." The court found no relevant distinction between a clause requiring a return of the property transferred and a clause providing for a lapse of a previous transfer of property.

Defined value clause

Authority: TAM 200337012.

Wording of clause: "Assignor desires to transfer as a gift to Assignee that fraction of Assignor's Limited Partnership Interest in Partnership which has a fair market value on the date hereof of \$a.... Pursuant to this assignment, [Assignee] received an e% interest in Partnership from [Assignor]."

Ruling: The IRS found this clause to be void as contrary to public policy under Procter and Ward because if it was "given effect and the value of the e% interest, as finally determined by the [IRS], is greater than \$a, a certain percentage of the Partnership interest held by [Assignee] would be retransferred to [Assignor]." Essentially, the IRS found little distinction between this clause and a retransfer clause found invalid in Procter. Either way the property is essentially returned to the transferor.

Defined value clause with excess to deductible donee

Authority: Succession of McCord, 98 AFTR 2d 2006-6147, 461 F3d 614, 2006-2 USTC ¶60530 (CA-5, 2006), rev'g 120 TC 358 (2003) (reviewed decision).

Wording of clause: An assignment agreement which provided that "the children and the trusts were to receive portions of the gifted interest having an aggregate fair market value of \$6,910,933, if the fair market value of the gifted interest exceeded \$6,910,933, then [charity 1] was to receive a portion of the gifted interest having a fair market value equal to such excess, up to \$134,000; and if any portion of the gifted interest remained after the allocations to the children, trusts, and [charity 1]; then [charity 2] was to receive that portion...." The assignment agreement left to the assignees the task of allocating the gifted interest among themselves, with dispute over the allocation to be resolved by arbitration. The assignees subsequently agreed to an allocation set forth in a

"confirmation agreement." The Transferors were not parties to the confirmation agreement.

Ruling—Tax Court: The defined value clause could not be given effect because it did not provide each donee with "an enforceable right to a fraction of the gifted interest determined with reference to the fair market value of the gifted interest as finally determined for Federal gift tax purposes...." Instead, the Tax Court found that the provisions of the assignment agreement were ratified by the confirmation agreement, so that any increase in value had to be allocated in accordance with the confirmation agreement. Thus, because of the confirmation agreement, no further interest could be allocated to the charities to avoid gift tax.

Ruling—Fifth Circuit: The Tax Court committed reversible error by improperly "relying on post-gift events ... the after-the-fact Confirmation Agreement to mutate the Assignment Agreement's dollar-value gifts...." Instead, the Fifth Circuit gave effect to what it considered the "ascertainable value" set forth in the assignment agreement.

Defined value clause with excess to deductible donee

Authority: Estate of Christiansen, 130 TC 1 (2008) (reviewed decision), aff'd 104 AFTR 2d 2009-7352, 586 F3d 1061, 2009-2 USTC ¶160585 (CA-8, 2009).

Wording of clause: "Christine Christiansen Hamilton 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 ..., less ... (\$6,350,000.00) and the denominator of which is the fair market value of the Gift ... ("the Disclaimed Portion"). For purposes of this paragraph, the fair market value of the Gift ..., shall be the price at which the Gift ... would have changed hands ... 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 [Internal Revenue] Code, as such value is finally determined for federal estate tax purposes."

Ruling: The Tax Court unanimously approved the operation of the formula clause and rejected the IRS's "condition subsequent" and "public policy" arguments:

No condition subsequent: "The transfer of property to the [charity] in this case is not contingent on any event that occurred after [the transfer]... —it remains 25 percent of the total estate in excess of \$6,350,000. That the estate and IRS bickered about the value of the property being transferred doesn't mean the transfer itself was contingent in the sense of dependent for its occurrence on a future event. Resolution of a dispute about the fair market value of assets on the date Christiansen died depends only on a settlement or final adjudication of a dispute about the past, not the happening of some event in the future."

Formula is not contrary to public policy: "The disclaimer in this case involves a fractional formula that increases the amount donated to charity should the value of the estate be increased. We are hard pressed to find any fundamental public policy against making gifts to charity—if anything the opposite is true. Public policy encourages gifts to charity...."

"This case is not Procter. The contested phrase would not undo a transfer, but only reallocate the value of the property transferred among [beneficiaries].... That would not make us opine on a moot issue...."

The Fifth Circuit affirmed the Tax Court finding that the only uncertainty—"the valuation of the estate, and therefore, the value of the charitable donation" was not a disqualifying condition subsequent, and that public policy favors charitable donations: "Congress sought to encourage charitable donations by allowing deductions for such donations."

Defined value clause with excess to deductible donee

Authority: Estate of Petter, TC Memo 2009-280, RIA TC Memo ¶2009-280, 98 CCH TCM 534 .

Wording of clause: "Transferor ... assigns and sells to the Trust the number of Units described in Recital C above [8,459] that equals a value of \$4,085,190 as finally determined for federal gift tax purposes; and ... assigns to the [charity] as a gift ... the difference between the total number of Units described in Recital C [8,459] above and the number of Units assigned and sold to the Trust...."

The Trust agrees that, if the value of the Units it receives is finally determined to exceed \$4,085,190, Trustee will, on behalf of the Trust and as a condition of the sale to it, transfer the excess Units to the [charity] as soon as practicable. Likewise, the [charity] agrees to transfer shares to the trust if the value is found to be lower than \$4,085,190."

Holding: The court found the adjustment clause to be consistent with the gift tax laws because it did not affect the number of units transferred, but only the ultimate recipient of the particular units. The allocation of units between the recipients due to an adjustment in value was a "later event" that did not affect what the transferor had personally given up. The court analogized this clause to those upheld in Succession of McCord and Estate of Christiansen and distinguished it from the clause disregarded in Procter: "The distinction is between a donor who gives away a fixed set of rights with uncertain value—that's Christiansen—and a donor who tries to take property back—that's Procter." From this comparison, the court framed an estate planning rule of thumb: "A shorthand for this distinction is that savings clauses are void, but formula clauses are fine."

[1](#)

[2](#) TC Memo 2009-280, RIA TC Memo ¶2009-280, 98 CCH TCM 534 .

[3](#) See Covey and Hastings, "No More, No Less: Savings Clauses, Formulas and Defined Value," 41 U. Miami Heckerling Inst. on Est. Plan. 1-115 (2007).

[4](#) 32 AFTR 750, 142 F2d 824, 44-1 USTC ¶10110, 44-1 USTC ¶10123 (CA-4, 1944), cert. den. 323 U.S. 756 (1944).

[5](#) This passage reflects an IRS summary of the public policy grounds of the Fourth Circuit, in Procter, supra note 3, set forth in GCM 33848, 6/11/68.

See Zaritsky, "Amounts That May Be Used to Pay Premiums on Insurance on the Life of the Grantor or Grantor's Spouse (Section 677(a)(3))," 43 U. Miami Heckerling Inst. on Est. Plan. 3-29 (2009); Davis, "Interaction of the Grantor Trust Rules and Life

Insurance," 26 Est. Plan. 418 (November 1999).

[6](#)

See Zaritsky, "Sale to an Intentional Grantor Trust," 43 U. Miami Heckerling Inst. on Est. Plan. 3-74 (2009); Aucutt, "Installment Sales to Grantor Trusts," 4 Bus. Entities 28 (March/April 2002); Dunn, Such, and Park, "The Incomplete Equity Strategy May Bolster Sales to Grantor Trusts," 34 Est. Plan. 2 (February 2007); Balakrishna, "Defective Grantor Trusts: Greater Flexibility and Income Tax Leverage," 32 Est. Plan. 30 (December 2005).

[7](#)

See Sections 170(b)(1)(A)(vii), (B), and (F).

[8](#)

120 TC 358 (2003).

[9](#)

98 AFTR 2d 2006-6147, 461 F3d 614, 2006-2 USTC ¶160530 (CA-5, 2006), rev'g 120 TC 358 (2003).

[10](#)

130 TC 1 (2008) (reviewed decision), aff'd 104 AFTR 2d 2009-7352, 586 F3d 1061, 2009-2 USTC ¶160585 (CA-8, 2009).

[11](#)

39 AFTR 2d 77-353, 545 F2d 700, 76-2 USTC ¶9784, 76-2 USTC ¶13165, 76-2 USTC ¶16240 (CA-10, 1976).

[12](#)

87 TC 78 (1986).

[13](#)

See McCord, *supra* note 9.

[14](#)

1964-1 CB 682.

[15](#)

For more guidance on the use of defined value clauses see Covey and Hastings, "Structuring a Defined Value Clause," 41 U. Miami Heckerling Inst. on Est. Plan. at page 1-142 (2007); Morden, "'Reallocating' Wealth After Christiansen: A Fresh Look at Formula Clauses," Willamette Management Associates Insight at pages 10-17 (Winter 2010); and Mulligan, "Formula Transfers: McCord Is Pro-Taxpayer, But Other Developments Are Likely," 34 Est. Plan. 7 (July 2007).

[16](#)

See Blattmachr, Gans, Zaritsky, and Zeydel, "The Impossible Has Happened: No Federal Estate Tax, No GST Tax, and Carryover Basis for 2010," 112 J. Tax'n 68 (February 2010).