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## TAX COURT BLESSES FORMULA CLAUSES

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I. Introduction:<sup>2</sup>

- a. **Valuation Risk:** Many an estate planner has spent a sleepless night worried about the inherent valuation risk in gift tax planning with hard to value assets.
  - i. No appraisal is bullet proof and IRS challenges can range from the reasonable to the ridiculous.
  - ii. To obtain complete victory against the IRS, the client may face years of litigation the resolution of which ultimately depends on the temperament of a judge, “who appointed this guy?”
  - iii. How can we assure our clients that they won’t be required to pay substantially more gift tax plus interest many years down the road?
  - iv. Who wants to be the attorney forced to ask the client to write this check?
- b. Fortunately, one common technique for hedging the valuation risk, the “**Formula Adjustment Clause**,” cleared some important judicial hurdles in

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<sup>2</sup> This outline follows much of Attorney Peter Walsh’s article titled: “Formula Clause Changes Taxable Gift Into Charitable Donation,” published in the April, 2010 edition of Practical Tax Strategies, a courtesy copy of which is attached hereto as Exhibit B.

2009, and may now provide estate planners with the assurance they need to sleep through the night.

- c. In a series of recent decisions, courts have blessed the use of a type of formula adjustment clause, referred to as the “deductible donee adjustment clause” or “charitable cap adjustment clause,” to minimize transfer tax on the transfer of hard to value assets.
- d. Most recently, the Tax Court in *Estate of Petter v. Comm’r* allowed a taxpayer to avoid substantial gift tax through a “charitable cap adjustment clause.” TC Memo 2009-280, RIA TC Memo ¶2009-280, 98 CCH TCM 534, 2009 WL 4598137.
- e. When the taxpayer in *Petter* conceded to an IRS demand for a substantial increase in the value of property transferred, the taxpayer was able to avoid millions in additional gift tax through an adjustment clause that allocated the entire increase in value to donor advised funds offered by public charities.
- f. 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.

## II. What are Adjustment Clauses:

- a. Adjustment clauses are provisions in a trust or transfer contract which impose a “cap” on the portion of the transfer intended to be gratuitous. The clause articulates the donor’s intent to give only a specified value of property, *e.g.*, “I give to my children stock with the aggregate value of \$10,000.”
- b. 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 transfer tax liability through one of four approaches:
  - i. By requiring the return of the excess to the donor (*i.e.*, “retransfer clause”), *e.g.*, “to the extent the value of stock I transfer to trust exceeds \$10,000, this excess shall be returned to me;”
  - ii. By increasing the consideration paid by the donee for the property (*i.e.*, “price adjustment clause”), *e.g.*, “to the extent the value of

stock I transfer to trust exceeds \$10,000, the trust shall transfer to me a sum of money equal to the excess;”

- iii. By limiting the amount transferred to the amount of the cap (*i.e.*, a “defined value clause”), *e.g.*, “I transfer to trust so much of my stock that has a fair market value equal to \$10,000;” or
  - iv. By shifting the excess transferred to a “deductible donee,” such as a spouse or a charity (*i.e.*, a “deductible donee clause”), *e.g.*, “to the extent the value of stock I transfer to trust exceeds \$10,000, the trust shall transfer the excess to a public charity.”
- c. More examples of these varying approaches are set forth in Exhibit 1 to Walsh, “Formula Clause Changes Taxable Gift Into Charitable Donation,” 84 Practical Tax Strategies 212 (April, 2010) (attached hereto as Exhibit B).

### III. Why are adjustment clauses used:

- a. Traditionally, they are used with the transfer of hard to value assets, *e.g.*, closely held business interests or real estate, to hedge the valuation risk of additional transfer tax on a later increase in the value of the property transferred.
  - i. “I transfer an amount of limited partnership interests with an aggregate value of \$10,000 to trust. To the extent, the limited partnership interest transferred is later determined by an IRS audit to be in excess of \$10,000, the trust shall transfer this excess to my spouse.”
  - ii. They are commonly incorporated into the sales documents for installment sales to intentionally defective grantor trusts to mitigate the risk of a gift or a Section 2036 retained interest (a retained interest not exempted from taxable estate inclusion as an exchange of adequate and full consideration in money or money's worth).
- b. They may also be of use in 2010 to counter the looming uncertainty as to whether the federal estate tax will be retroactively reenacted.
  - i. 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 or to a qualified charity.

- ii. “To the extent any portion of this transfer becomes subject to Federal estate tax due to a subsequent change in the law, this portion, plus any accruing appreciation and income, shall pass to the marital deduction trust for my surviving spouse.”
- iii. 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 v. Commissioner*, 32 AFTR 750, 142 F.2d 824, 44-1 USTC ¶10110, 44-1 USTC ¶10123 (CA-4, 1944), *cert. den.*, 323 U.S. 756 (1944) (hereinafter “*Procter*”).
- iv. 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).
- v. Under the current transfer tax system of gift tax but no estate tax, moreover, any gift considered to be sheltered by the annual exclusion or unified credit that may, upon an increase in value, result in gift tax should be hedged with a formula adjustment clause.

IV. What legal challenges do adjustment clauses face:

- a. The IRS has challenged adjustment clauses as impermissible conditions subsequent that are void as against public policy:
  - i. In the context of an adjustment clause, a “condition subsequent” means that the adjustment, intended to eliminate gift tax, applies only if the IRS acts after the transfer has occurred, as opposed to the provision applying irrespective of the IRS actions.
    - 1. The condition subsequent defect, which requires the after-the-fact adjustment of the transaction by a transfer of assets back to the donor or seller or requires the donee to pay for the excess, has been at the core of additional court decisions invalidating price adjustment clauses.

2. The IRS has focused on this condition subsequent characteristic in its rulings that challenge the validity of price adjustment clauses.
- ii. The IRS argues that the condition subsequent aspect of adjustment clauses must be found void “*as against public policy*” because they:
    1. Discourage the collection of tax by negating the tax assessment upon triggering the clause because the only effect of an attempt to enforce the tax would be to defeat the gift, *e.g.*, the IRS increases the value of the gift then the adjustment clause eliminates this gift;
    2. Result in court decisions becoming moot upon entering a judgment because, if the clause was valid, the only effect of the holding would be to reduce the gift so it would not be subject to tax; and
    3. Render a judgment self-defeating and undermine the court’s authority and constitute an unsustainable “*trifling with the judicial process.*”
  - b. The public policy challenge was first sustained in *Procter*, and since has been relied upon by the IRS in numerous cases to challenge adjustment clauses with mixed success as summarized in Exhibit B to this outline.
    - i. *Procter* involved a “**retransfer clause**” in which the parties agreed that, in the event that any of the property to be transferred to a trust is determined to be subject to gift tax, this portion shall be deemed not to have been transferred to the trust.
    - ii. The Court found this retransfer clause to be void as against public policy.
  - c. The success of the IRS in challenging adjustment clauses has depended upon the type of adjustment clause used.
  - d. In this respect, the four types of adjustment clauses can be divided into three categories:

- i. “Savings Clauses” which include “retransfer clauses” and “price adjustment clauses.”
  1. These clauses impose a “condition subsequent” requiring either a reversion of property to the donor or the payment of additional consideration by the donee to avoid adverse transfer tax consequences.
  2. The IRS has had success in negating these clauses on public policy grounds, see *Procter, Estate of McLendon v. Comm’r*, T.C. Memo 1993-459, *Ward v. Comm’r*, 87 T.C. 78 (1986), and Rev. Rul. 86-41, 1986-1 CB 300, but see *King v. United States*, 545 F.2d 700 (10<sup>th</sup> Cir. 1976) (price adjustment clause found to be valid because the transaction was made in the ordinary course of business and at arms length).
- ii. “Defined Value Clauses” that seek to define, by reference to a specific dollar amount or formula, the amount being transferred, so that rather than transferring a particular asset, percentage interest or number of shares, a defined value clause designates the value of the interest transferred.
  1. In theory, defined value clauses are distinct from savings clauses because they do not trigger a condition subsequent or function to “undo” the transaction, but only to limit the amount initially transferred.
  2. The IRS has characterized defined value clauses as no different from savings clauses because a defined value clause operates to negate a portion of a previous transfer the value of which exceeds described value. See Field Service Advice 200122011 (June 4, 2001); Technical Advice Memorandum 200245053 (Nov. 8, 2002); and TAM 200337013 (Sept. 12, 2003).
  3. The Tax Court accepted this characterization of defined value clauses in *Ward v. Comm’r*, 87 T.C. 78 (1986) 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*."

- iii. "Defined Value Clauses with Excess to Deductible Donee" that:
  1. Supplement the traditional defined value clause, which defines, by reference to a specific dollar amount or formula, the amount being transferred, with the requirement that any excess be transferred not to the donor but to a deductible donee, *e.g.*, a spouse or a qualified charity.
  2. "I transfer to my children an amount of my real estate with an aggregate value of \$1 million, as finally determined for gift tax purposes, and the balance of my real estate to Marquette University."
  3. Adjustment clauses providing for the excess to go to charitable donees (*e.g.*, "charitable cap adjustment clauses") have withstood challenge in *Succession of McCord, Estate of Christiansen*, and most recently in *Estate of Petter v. Comm'r*.
  4. Accordingly, the defined value clause with the excess going to a deductible donee has emerged as the most reliable form of adjustment clause.

V. Emerging Acceptance of the Charitable Cap Adjustment Clause:

- a. The rising acceptance of the charitable cap adjustment clause began with *McCord* where the donors used an adjustment clause to allocate the transfer of interests in their *family limited partnership* between public charities and non-charitable beneficiaries. Tax Court Opinion 120 T.C. 358 (2003), Fifth Circuit Opinion 98 AFTR 2d 2006-6147, 461 F3d 614, 2006-2 USTC ¶60530 (CA-5, 2006), *rev'g*, 120 TC 358 (2003).
  - i. The assignment agreement used in *McCord* for the transfer of the partnership interests provided that: "the [non-charitable donees] were to receive portions of the gifted interest having an aggregate fair market value of [\$6 million], if the fair market value of the gifted interest exceeded [\$6 million], then [charity 1-symphony] was to receive a portion of the gifted interest having a fair market

value equal to such excess, up to [\$150,000]; and if any portion of the gifted interest remained after the allocations to the [non-charitable donees] and [charity 1]; then [charity 2-Community Foundation] was to receive that portion....” 120 T.C. at 364.

- ii. A major flaw of the assignment agreement was that, while it instructed that the property should be divided according to the “price at which the [property] would change hands as of the date of this [agreement] 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” (120 T.C. at 366) it failed to include any requirement for the reallocation of property following the results of an IRS audit.
- iii. Instead the assignment agreement left to the assignees the task of allocating the gifted interest among themselves, and the assignees subsequently agreed to an allocation set forth in a “confirmation agreement.”
  1. The donors were not parties to the confirmation agreement.
  2. The confirmation agreement preempted the terms of the assignment agreement through which the shares passing to charities was finally determined based on values as reported on the gift tax return, before any adjustment by an IRS audit could take place.
  3. Accordingly, if the assignment agreement was to be given effect to avoid gift tax, the donor would have to be given a charitable deduction for amounts that would not pass to charity.
- iv. The Tax Court held that the clause did not control for transfer tax purposes because it was the confirmation agreement, and not the defined value clause, which determined the amount going to the various donees.
  1. Judge Halpren wrote for the majority of the Tax Court: “Had petitioners provided that each donee had 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*, we might have reached a different result.” 120 T.C. at 397 (emphasis added).

2. The confirmation agreement fixed percentages for all the donees, and thus, negated any further effect of the adjustment formula.
  3. The Tax Court’s Majority opinion, however, did not cite or discuss the public policy arguments of *Procter*.
- v. The Fifth Circuit reversed and upheld the adjustment clause as setting forth an ascertainable value for transfer tax purposes. The Court observed that the Tax Court improperly “rel[ie]d on **post-gift events** ... the after-the-fact Confirmation Agreement to mutate the Assignment Agreement’s dollar-value gifts....” 461 F.3d 614, 626.
1. The Majority of the Tax Court should have stopped with the plain wording of the assignment agreement instead of relying on post gift events to define this wording.
  2. The Fifth Circuit did not address the *Procter* public policy arguments so the strength of the precedent was left in doubt.
  3. A take away from *McCord* is that the formula should be kept open until values are finally determined for Federal transfer tax purposes.
- b. Stronger support for the charitable cap adjustment clause was obtained in *Christiansen* where a beneficiary incorporated an adjustment clause into a disclaimer to provide that any amount of the disclaimant’s interest in the estate that exceeds a fair market value of \$6.35 million, **as finally determined for federal estate tax purposes**, was to be distributed to a charitable private foundation (25%) and to a charitable lead annuity trust (75%) created by the decedent’s will. 130 TC 1 (2008) (reviewed decision), *aff’d*, 104 AFTR 2d 2009-7352, 586 F3d 1061, 2009-2 USTC ¶60585 (CA-8, 2009). Family limited partnership interests represented a substantial portion of the value of the estate.
- i. Subjecting the allocation to a final determination for federal estate tax purposes was an important distinction from *McCord*.

- ii. When the value of the limited partnership interests was increased through an audit, the IRS challenged the effectiveness of this adjustment clause as an impermissible “*condition subsequent*” and contrary to the *Procter* public policy grounds.
- iii. The Tax Court in an unanimous decision upheld the clause as to the private foundation and rejected the IRS’s challenge:
  - 1. ***No condition subsequent:*** “The transfer of property to the [private foundation] 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.” 130 TC at 15.
  - 2. ***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...” 130 TC at 16-17.
    - a. The court advocated for a restrained use of the public policy argument: “the public policy being frustrated must be shown by a governmental declaration, and the frustration that would be caused by allowing the contested deduction must be severe and immediate.” 130 TC at 16.
    - b. No such public policy is present in these circumstances.
  - 3. “**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....” 130 TC at 17.

- iv. The Tax Court found to be a nonqualified disclaimer the transfer to the charitable lead annuity trust because of the disclaimant’s retained contingent remainder interest in the trust and not because of the adjustment clause.
- v. The Fifth Circuit affirmed the Tax Court:
  - 1. 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.” 586 F.3d at 1063-1065.
  - 2. The Court further noted: “we disagree with the Commissioner’s argument that we must interpret the statute and regulations in an effort to maximize the incentive to audit. First, we note that the Commissioner’s role is not merely to maximize tax receipts and conduct litigation based on a calculus as to which cases will result in the greatest collection. Rather, the Commissioner’s role is to enforce the tax laws.” 586 F.3d at 1064.

c. In the wake of *McCord* and *Christiansen* came *Petter*.

VI. The facts in *Petter*, T.C. Memo. 2009-280:

- a. Anne Petter used an installment sale to an intentionally defective grantor trust (“IDGT”) to transfer large holdings of United Parcel Service of America, Inc. (“UPS”) stock to her children.
- b. Most of Anne’s plan followed the now prescribed technique for an installment sale to an IDGT:
  - i. Anne contributed the UPS stock to a manager-managed limited liability company (“LLC”) in exchange for all of the membership interests and under an operating agreement through which Anne retained substantial control.

- ii. Anne created a separate trust for two of her three children to receive LLC interests.
  - iii. The trusts constituted IDGTs, the separate existence of which for income tax purposes (but not estate and gift purposes) were disregarded from Anne, because the trusts permitted the trustees to purchase and pay premiums on a life insurance policy on the life of Anne causing grantor trust status under Section 677(a)(3).
  - iv. Anne seeded the IDGTs with taxable gifts of LLC interests the amount of which was set according to a pecuniary formula that limited the amount of the LLC interests gifted to the trusts to the balance of Anne's applicable exclusion amount.
  - v. The amount of LLC interests given to the trust was also intended to equal approximately 10% of the total value of LLC interests transferred to the trust, via gift and sale, so that the trusts were sufficiently capitalized to support their purchase of additional LLC interests.
  - vi. Then Anne sold additional LLC interests to the trusts in exchange for an installment note from each trust, which provided for quarterly payments of principal and interest, at the applicable federal rate, over a term of 20 years, and were secured by the LLC interests sold to the trusts.
- c. To this prescribed technique, Anne incorporated the following twist:
- 1. She used pecuniary formulas to limit her gifts and sales of LLC interests to the trusts to specific amounts, with the balance of the interests passing to two "**public charities**" both of which offered donor advised funds.
  - 2. The pecuniary formula for Anne's gifts to the trusts provided:
    - a. "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 [charities] as soon as practicable."

- b. The charities 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].”
  - 3. Similarly, the sales documents limited the amount of LLC interests sold to the trusts through the following pecuniary formula: “The Trust agrees that, if the value of the Units it receives is finally determined [*for federal gift tax purposes*] 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 [charities] as soon as practicable. Likewise, the [charities] agree[] to transfer shares to the trust if the value is found to be lower than \$4,085,190.”
  - 4. Importantly, the charities played an active role in these transfers; they retained their own counsel, they negotiated both the gift and sales documents, and they were admitted to the LLC as substitute members.
- d. Anne timely reported the transfers, both the gifts and sales, on her Gift Tax Return for the year and a dispute arose as to the value of the LLC interests transferred:
- i. Anne reported the value of LLC interests reflecting an aggregate valuation discount of approximately 53% from the net assets value;
  - ii. The IRS countered with an aggregate valuation discount of approximately 21.4%; and
  - iii. Anne and the IRS ultimately split the difference and settled on an aggregate valuation discount of approximately 35%.
- e. With the agreement as to the value of LLC interests, 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 Charities.

VII. The Tax Court Upholds Anne’s Adjustment Clause:

- a. The IRS challenged the adjustment clauses as impermissible conditions subsequent and against public policy, but the Tax Court found to the contrary.

- b. The Court found “*no condition subsequent*.”
  - i. The clause did not alter the amount of interests transferred by Anne, but only the ultimate recipient of the particular interest;
  - ii. This allocation was a “*later event*” that did not affect what Anne had personally given up; and
  - iii. The court analogized Anne's clause to those upheld in *McCord* and *Christiansen* and distinguished it from the clause disregarded in *Procter*:
    - 1. “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*.”
    - 2. 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.”
    - 3. The court described savings clauses as “adjustment clauses requiring that any gift subject to gift tax revert back to the donor,” while formula clauses require no further action by the donor or return of property to the donor.
- c. The Court found that “public policy” supported Anne’s clause because “Public policy weigh[s] in favor of giving gifts to charities.”
  - i. “Public-policy arguments [are] undermined by *Commissioner v. Teller*, 383 U.S. 687 (1966), where the Supreme Court warned against invoking public-policy exceptions to the Code too freely.”
  - ii. “The ‘frustration [of public policy] that would be caused by allowing the contested deduction must be severe and immediate.’”
- d. The Court also found unpersuasive the IRS’s concern that if Anne’s formula was honored it would result in “*low-ball estate appraisals*” backstopped by contingent charitable contributions.

- i. The Court found the fiduciary duties of the charities hedged against abuse as evident from the active participation of the charities in the transaction.
- ii. Active participation by the charities in *McCord* and *Christiansen* was similarly deemed as important support:
  1. 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....” 461 F.3d at 620.
  2. In *Christiansen*, the Tax Court 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.” 130 T.C. at 17 (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....” 586 F.3d at 1065-1066.
  3. This highlights the importance of the participation of an independent fiduciary in the transaction, but begs the question of whether this fiduciary must represent the interests of a charity or if an independent trustee of a marital trust would be sufficient.
- e. The Court also discussed the inconsistency between the public policy arguments raised by the IRS to challenge Anne's adjustment clauses with the acceptance by the IRS of formula clauses in other income and transfer tax contexts.
  - i. For instance, the IRS accepts formula clauses in the following contexts:
    1. Reg. 1.664-(a)(1)(iii), allowing formula provisions for charitable remainder trusts.

2. Rev. Proc. 64-19, sanctioning the use of formula clauses in the estate marital deduction context.
  3. Reg. 25.2523(f)-1(b)(3)(i), allows for formula qualified terminal interest property elections in a gift tax context.
  4. Reg. 26.2632-1(d)(1), permitting formula allocations of generation-skipping tax exemption.
- ii. 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.
  - iii. 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.”
- f. Finally, the Court allowed Anne to take a charitable gift tax deduction for gift tax purposes as of the date of the initial transfer, even though the value of the transfer to charity was not determined until much later, because 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.”
  - g. In the end, the Petter family attorney did not have to ask for a large check to pay the IRS but was able to apprise the Petter family of the wonderful benefits of their additional gift to charity.
  - h. Unclear from the opinion, however, was 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.

#### VIII. Adjustment Clauses Going Forward:

- a. Open Issues and Alternatives:

- i. Whether the reasoning of *McCord*, *Christiansen*, and *Petter* are applicable to deductible donee clauses in which the donee is a spouse or a marital deduction trust.
  1. No case or regulation specifically approves a zero-tax marital deduction formula for Federal estate tax purposes but the effectiveness of such formulas is widely accepted;
  2. Like charitable bequests, public policy favors gifts to spouses;
  3. Reg. 25.2523(f)-1(b)(3)(i) allows for the gift tax QTIP election-marital deduction- to be made as to a “fraction or percentage of [an] entire trust” and that the “fraction or percentage may be defined by formula;”
  4. In PLR 200245053, however, the IRS described the policy reasons for allowing testamentary marital deduction formulas for estate tax purpose, but the IRS indicated that such policies do not apply to lifetime gifts supported by a nondeductible donee adjustment formulas; and
  5. A problem with using a spouse as a contingent beneficiary is it may only defer the transfer tax because the property may be subject to gift or estate tax upon the later transfer by the spouse.
- ii. Whether the charity needs to be a public charity or can a private foundation or a charitable split interest trust work.
  1. *Petter* and *McCord* involved public charities, but *Christiansen* included a private foundation;
  2. Private foundations and charitable split interest trusts (*e.g.*, charitable lead and remainder trusts) are generally subject to the self-dealing prohibitions under Chapter 42 of the Internal Revenue Code; these rules could add a substantial level of complication to the transaction;
  3. There are a number of private letters rulings setting forth the tax issues of having private foundations or split interest

trusts invested in family limited partnership or limited liability companies, see PLR 970513, PLR 200043047, PLR 200423029, and PLR 200548026; and

4. For transfers to public charities, donor advised funds provide the donor's with a low cost means of retaining control over the annual distributions of the donated funds. A list of Wisconsin Community Foundations, which offer donor advised funds, is attached hereto as Exhibit C.
- iii. Whether the charity needs to agree to retransfer excess property.
1. Reg. § 1.170A-1(e), "Transfers subject to condition or power. If as of the date of a gift a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible."
  2. Judge Foley, in his dissent in *McCord*, 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. 120 T.C. at 418, FN6.
  3. A retransfer by a charity can be avoided if the charity is to receive only the value of the property transferred determined to be in excess of the purchase price. See sample clause at the end of this outline.
- iv. Allowing for a partial transfer tax liability.
1. The formula provides that upon an increase in value through an IRS audit, a portion of the increased value passes to a taxable donee so that a decision of a court on the issue of value would not be negated by the operation of the formula.

2. The amount passing to a taxable donee would have to be significant:
  - a. PLR 200245053, transaction included a taxable portion equal to 0.1% of the property transferred, and the IRS found the amount to be too insignificant to circumvent the *Procter* public policy grounds.
  - b. There is no decision as to whether a formula clause providing for a substantial portion to go to a taxable donee would be respected.
3. May be a useful technique to include in an installment sale to an IDGT to avoid the potential of Section 2036 argument:
  - a. If the consideration paid by an IDGT is found to be less than “full and adequate consideration in money or money’s worth” then a portion of the IDGT may be included in the donor’s estate under Section 2036, if the donor dies while payments are being made on the installment note.
  - b. A formula adjustment clause could limit the amount of property transferred to the IDGT to the consideration paid by the IDGT, and thus minimize the risk of a Section 2036 argument.
- v. Whether a grantor retained annuity trust (“GRAT”) can serve as a contingent donee.
  1. A GRAT could be designated as the beneficiary of any excess property transferred and thus hedge the amount of the resulting gift tax by the value of the grantor’s retained interest, but
  2. By retaining interest in the contingent GRAT, the arrangement is close enough to the transfer of property back to the donor prohibited by *Procter*.

- vi. Whether the declaratory judgment provisions of Section 7477 could be used to counter the "trifling with the judicial process" argument of the IRS.
  - 1. Section 7477 extended, for gifts made after 8/5/97, jurisdiction to the Tax Court to make *declarations of the value of gifts*.
  - 2. 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.
  - 3. According to Treas. Reg. § 301.7477-1(c) the declaratory judgment procedures “apply to adjustments involving all issues relating to the transfer, including without limitation valuation issues and legal issues involving the interpretation and application of the gift tax law.”
  - 4. Example (4) of Treas. Reg. § 301.7477-1(e), provides that the procedure may be applied to determine whether a transfer is a completed gift.
  - 5. Section 7477 is limited to transfers the amounts of which are sheltered by the unified credit, so its usefulness to the adjustment formula context may be limited to preserving available unified credit.

b. Drafting an Adjustment Clause:

- i. The value of the property transferred to each recipient should be in accord with a value as “finally determined for federal gift tax purposes” to avoid the *McCord* issue. Treas. Reg. § 20.2001-1(c) contains a useful definition of the final determination for federal gift tax which could be referenced.
- ii. An independent fiduciary should be included in the transaction to take advantage of the policing functions of fiduciary duty and to counter a low ball appraisal argument.

- iii. A defense can be further buttressed if the conditional donees under the clause have competing interests upon an increase in value of the property transferred (*e.g.*, contingent donee should have a significant legal and pecuniary interest in obtaining any excess upon an increase in value – such as a second spouse and children from prior marriage).
  - iv. Providing for a portion to go to a taxable donee upon an increase in value may counter the "trifling with the judicial process" argument because a revaluation would result in some tax revenue.
- c. Sample clause included in Covey and Hastings, “No More, No Less: Savings Clauses, Formulas and Defined Value,” 41 U. Miami Heckerling Inst. on Est. Plan. 1-115, at 1-152 (2007).
- i. “Property sold by the Grantor to the Trustees shall be divided in fractional shares and allocated between the trust under Article II for the benefit of the Grantor’s descendants and the marital trust under Article III for the benefit of the Grantor’s spouse in the following manner:
 

The fractional share allocated to the trust under Article II shall have a numerator equal to the sale price ***plus one percent (1%) of the excess*** over the sale price of the value of the sold property, and a denominator equal to the value of the sold property.

A fractional share consisting of the balance (if any) of the sold property shall be allocated to the trust under Article III.

In determining the fractional shares, property shall be valued in accord with the final determination of the federal gift tax on the transfer (as defined in Treas. Reg. §20.2001-1). Property allocated to the trust under Article III shall not be liable for payments on the note, which shall be solely the obligation of the trust under Article II.”
  - ii. This clause makes any transfer to the deductible donee (a marital deduction trust) contingent upon an increase in value of the property sold to the trust of more than one percent. The one percent excess retained by the taxable donee may result in some

transfer tax being due upon an increase in value and thus counters a “moot decision” argument.

- iii. While this is an adjustment clause in which the deductible donee is a trust for a spouse, the marital trust could be substituted with a charity.
- d. Regardless of how inventive the adjustment formula, a thorough and conservative appraisal still may be the best way to mitigate the valuation risk and to avoid substantial additional transfer tax.

IX. Additional Commentary:

- a. Walsh, “Formula Clause Changes Taxable Gift Into Charitable Donation,” 84 Practical Tax Strategies 212 (April, 2010).
- b. Covey and Hastings, “No More, No Less: Savings Clauses, Formulas and Defined Value,” 41 U. Miami Heckerling Inst. on Est. Plan. 1-115 (2007).
- c. Aucutt, “Defined Value Formulas: *Estate of Christiansen*; *Estate of Petter*,” 44 U. Miami Heckerling Inst. on Est. Plan. 1-135 (2010).
- d. Morden, “Reallocating Wealth After *Christiansen*: A Fresh Look at Formula Clauses,” Willamette Management Associates Insight at pages 10-17 (Winter, 2010).
- e. Mulligan, “Formula Transfers: *McCord* Is Pro-Taxpayer, But Other Developments Are Likely,” 34 Est. Plan. 7 (July, 2007).
- f. Gorin, “Defined Value Clause Upheld,” 35 Tax Management Estates, Gifts, and Trusts Journal at 100 (January, 2010).
- g. Bowman, “Defined Value Clauses Better Defined,” 148 Trust & Estates 14 (February, 2010).
- h. Shaftel, “How to Use an Escrow Trust to Implement a Defined Value Formula Clause,” 31 Estate Planning Journal 3 (March, 2004).