McCord v. Commissioner: Defined Value Clauses Redefined?

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I. Introduction

In its recent decision in *Succession of McCord v. Commissioner*,[1] the Fifth Circuit ruled that the taxpayers' use of a defined value formula clause for gift and generation-skipping transfer ("GST") tax purposes was valid.[2] Since the recognition of this type of defined value clause would allow for more effective and efficient estate planning, the decision has begun to stir practitioners in the estate and tax planning community.[3] The use of defined value clauses in donative instruments, such as deeds of gift and trusts, would allow donors to make better use of the credits, exclusions, and exemptions available to them under the transfer tax regime.[4] Such clauses can ease taxpayers' attempts to value transferred assets and afford to taxpayers greater certainty in determining transfer tax liability.

This article addresses the impact of the *McCord* decision on the ability of taxpayers through new tax planning techniques to fully use the gift and generation-skipping transfer tax credits and exemptions. The discussion will begin by outlining the basics of defined value clauses, including the forms in which practitioners draft such clauses and the objectives practitioners seek to achieve for their clients. The focus will then shift to explaining the historical aversion of the IRS, the Tax Court, and the federal appellate courts to this planning technique. Based on this discussion, the article analyzes the *McCord* decision and assesses its impact on future estate planning practices.

Although the Fifth Circuit correctly decided *McCord*, the decision was highly fact-dependent. To the extent that practitioners and taxpayers can replicate the circumstances of *McCord*, they can reasonably rely on its holding and utilize a defined value formula. In other

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[1] Succession of McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006).

[2] *Id*. at 632.

[3] *See, e.g.*, Steve R. Akers, *McCord v. Commissioner: Fifth Circuit Upholds Defined Value Gift and Allows Offsetting Gift Value by Contingent Assumed Liability for Estate Tax if Donor Dies within Three Years* (Bessemer Trust), Aug. 2006 (copy on file with the author).

[4] While technically speaking, IRC §§ 2010 and 2505 provide a credit, IRC § 2503(b) provides an exclusion, and IRC § 2631 provides an exemption, this paper will use the terms credit, exclusion, and exemption interchangeably.

factual scenarios, taxpayers should proceed with caution until other circuits decide whether to follow *McCord*.

II. UNDERSTANDING DEFINED VALUE CLAUSES

A. Types of Defined Value Clauses

A defined value clause is a clause used in donative instruments that uses a defined value to effectuate a particular donative intent. The clause generally follows one of two forms — either as a savings clause or as a formula clause.[5] Taxpayers use the clauses in an effort to avoid unanticipated transfer taxes while still fully using the credits available to them under the transfer tax regime.[6]

Generally speaking, a savings clause is any clause in a donative instrument designed to negate an undesired result arising out of other terms of the instrument or out of some other anticipated contingency.[7] As the IRS has stated, a savings clause is "a provision that takes away a power or changes a provision that is expressly given in the instrument and is, therefore, in direct conflict with the other express power or provision."[8] Saving clauses might occur in one of several varieties in a donative instrument. For example, savings clauses have been used to attempt to alter fiduciary powers of a trustee that have been otherwise granted in the trust instrument.[9] Within the genre of defined value clauses, however, a savings clause will be one of two varieties, both of which function to "undo" a portion of the gratuitous transfer.[10]

The first variety of defined value savings clauses is the revocation savings clause. This type of savings clause seeks to revoke a portion of the transfer in the event that the IRS or a court determines that the value of the transfer exceeds the defined value in the instrument. A revocation savings clause would be one that states, "If the IRS determines that the value of the transferred property exceeds one million dollars, then I did not transfer the entire property, and the donee must return to me the amount of the property exceeding one million dollars in value." By revoking a portion of the transfer, the donor requires from the donee the return of an amount

[5] *See generally* A. Christopher Sega, *Using Defined Value Clauses to Obtain Transfer Tax Certainty*, 38 INST. EST. PLAN. ¶ 801.1 (2004).
[6] *See infra* text, § II.B.
[7] Shirley D. Peterson, *Savings Clauses in Wills and Trusts*, 13 TAX MGM'T EST., GIFTS, & TR. J. 83 (1988).
[8] Tech. Adv. Mem. 7916006.
[9] *See*, *e.g.*, Rev. Rul. 65-144, 1965-1 C.B. 442, 444 (holding invalid a savings clause that sought to negate broad fiduciary powers to allocate expenses and receipts between income and principal in a charitable remainder trust).
[10] *See* Sega, *supra* note 5, at ¶ 801.1[A].

of the transfer equal to the excess of the finally determined value over the defined value in the instrument. In so revoking, the donor maintains that the amount revoked should be deemed to never have been transferred since the donor's intent was to transfer only the amount of the defined value.

The second variety of defined value saving clauses is the consideration savings clause. A consideration savings clause requires that in the event that the IRS or a court determines that the value of the transfer exceeds the defined value in the instrument, the donee will pay to the donor as consideration an amount equal to the excess of the finally determined value over the defined value in the instrument. When the transferor actually possesses donative intent, this variety of savings clause entails the same objective as a revocation savings clause. However, consideration savings clauses are also used in bona fide arm's length transactions, where courts view the clauses with more favor than when used in a gratuitous transfer.[11]

In the 1980s, savings clauses became popular among practitioners, who used the clauses for planning purposes with the marital and charitable deductions.[12] Practitioners also began to use defined value clauses to solve valuation problems arising from transfers of certain assets such as real estate and partnership interests.[13] The IRS, however, responded to such clauses with aversion, and repeated court decisions have discouraged practitioners from drafting with this technique.[14] In fact, some authorities advise entirely against the use of savings clauses.[15]

In light of the aversion to savings clauses and for reasons discussed below, practitioners have more recently tried to achieve similar objectives with defined value formula clauses. A formula clause, like a defined value savings clause, uses a defined value in an effort to effectuate a particular donative intent.[16] However, a formula clause, in theory, differs from a savings clause because a formula clause seeks only to define the amount of the transfer rather than

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[11] *Compare* King v. United States, 545 F.2d 700 (10th Cir. 1976) (upholding the use of a savings clause in a bona fide arm's length transaction) *with* Harwood v. Commissioner, 82 T.C. 239 (1984) (denying the use of a savings clause used to effectuate a gratuitous transfer). *See also* Peterson, *supra* note 7.
[12] Peterson, *supra* note 7, at 83.
[13] *Id.*
[14] Caroline D. Strobel & George L. Strobel, II, *Savings Clauses Can Protect Against Revalued Transfers in Family Transactions*, 14 TAX'N FOR LAW. 22, 24 (1985).
[15] *See, e.g.*, HOWARD M. ZARITSKY, TAX PLANNING FOR FAMILY WEALTH TRANSFERS: ANALYSIS WITH FORMS, ¶ 1.03[2][f] (2006).
[16] Sega, *supra* note 6, at ¶ 801.1.

requiring a remedial action such as revocation or the payment of additional consideration.[17] Without the defined value formula, there can be no transfer because the formula determines the amount being transferred.[18] Later revaluation is irrelevant.[19] Formula clauses are often written with a variable defined value. For example, a clause that states "I give to my grandchild an amount equal to the amount of my remaining GST exemption on the date of my death" is generally a more effective planning tool than one that states "I give to my grandchild one million dollars."

Interestingly, formula clauses are used extensively in estate planning in ways that are widely accepted. Most prominent are formula clauses used in testamentary instruments to generate a martial deduction while still taking advantage of the full amount of the unified credit. Formula clauses are also often used for tax purposes with other varieties of trusts. Treasury regulations articulate formula clauses for taxpayers to use in grantor retained annuity trusts ("GRATs")[20] and charitable remainder annuity trusts ("CRATs").[21] Taxpayers also use approved formula-like clauses to execute disclaimers refusing their interests in gifts and bequests.[22] Treasury regulations even allow formula clauses for generation-skipping transfer tax purposes when a transferor seeks to exempt the transaction from generation-skipping transfer tax.[23]

B. The Purpose of Defined Value Clauses

The purpose of defined value clauses arises from the intersection of two fundamental ideas in the taxation of gratuitous transfers. First is the idea that the transferor desires to minimize taxation. Second is the idea that certain assets are inherently difficult to value. As such, a taxpayer's objective in using a defined value formula clause is to maximize the use of the transfer tax exemptions while transferring assets that are difficult to value.

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[17] *See* L. Paul Hood, Jr., *McCord and TAM 20024503: A Setback for Defined Value Transactions*, 30 EST. PLAN. 432, 434 (2003).
[18] Sega, *supra* note 7, at ¶ 801.1[B].
[19] *Id*.
[20] *See* Treas. Reg. § 25.2702-3(b)(1)(ii)(B). Usually, the grantor will use a formula clause to "zero-out" a GRAT. The IRS, however, has argued that this practice is abusive. Tech. Adv. Mem. 200245053.
[21] *See* Treas. Reg. § 1.664-2(a)(1)(iii).
[22] Brief of Petitioners-Appellants at 8, Succession of McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006) (No. 03-60700) (citing Treas. Reg. § 25.2518-3(d), Ex. 20).
[23] *See id*. (citing Treas. Reg. §§ 26.2632-1(b)(2)(ii) and 26.2632-1(d)(1). A taxpayer will generally use the clause to create an inclusion ratio of one or zero.

To minimize taxation, the taxpayer must fully utilize all the credits and exemptions available under the transfer tax regime, including the unified credit, the annual exclusion from gifts, and the GST exemption. The unified credit is provided by IRC § 2010 and IRC § 2505. The unified credit is applicable first to the gift tax imposed by § 2501.[24] For gift tax purposes, the amount of the credit is generally equal to the amount of the tentative tax that would be imposed under IRC § 2001(c) on an applicable exclusion amount of $1 million reduced by the amount of the credit that the taxpayer used in prior years.[25] For estate tax purposes, IRC § 2010 provides that the credit against tax imposed by IRC § 2001 is an amount equal to the tentative tax calculated under IRC § 2001(c) based on the applicable exclusion amount provided in IRC § 2010(c). The credit is "unified" because the tax base for calculating the estate tax includes the decedent's taxable estate plus the decedent's "adjusted taxable gifts."[26] The tax on this amount is then reduced by the amount of tax that would have been payable if IRC § 2001(c) would have been applicable at the time of the gift.[27]

In addition to the unified credit, which is a lifetime credit amount, the gift tax statutes provide an annual exclusion from gifts. IRC § 2503(b) excludes from taxable gifts an amount of gifts of present interests in property made to any person by the donor equal to the amount of the annual gift tax exclusion. The gift tax exclusion, which at the present time is $12,000, is indexed for inflation.[28]

The final exemption that the taxpayer must consider is the GST exemption. Pursuant to IRC § 2631(c), the applicable exemption amount for any calendar year is equal to the applicable exclusion amount provided in IRC § 2010(c) for that calendar year. This lifetime exemption amount may be allocated to any generation skipping transfer by the transferor or the transferor's executor[29] or in accordance with the special allocation rules in IRC § 2632.

To use the full amount of these credits and exemptions, the taxpayer must transfer assets equal in value to the statutory limits. When the assets that the taxpayer transfers are cash and marketable securities, matching the value of the assets to the credits and exemptions is simple.

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[24] *See* IRC § 2505(a).
[25] *Id*. A taxpayer's pre-1977 gifts may affect the amount of the credit. IRC § 2505(b)
[26] IRC § 2001(b)(1).
[27] IRC § 2001(b)(2).
[28] *See* IRC § 2503(b)(2).
[29] IRC § 2631(a).

However, not all assets are so easy to value.[30] In fact, valuation of transferred assets is the most contested area in estate planning.[31] Most valuation controversies arise when the donor transfers interests in closely held companies or family limited partnerships.[32] A transfer of interests in these entities usually requires valuation from a qualified appraiser, but even then there is still uncertainty.[33] The main contention between the taxpayer and the IRS in valuing interests in closely held corporations and family limited partnerships is the extent to which valuation discounts should be allowed. Generally, the taxpayer's appraiser will apply discounts for lack of control and lack of marketability; however, determining the appropriate discounts is contentious and often results in litigation.

Due to valuation difficulties, it is probable that the IRS will contest the donor's valuation on the ground that the donor has undervalued the asset. This is problematic for the donor because upon revaluation by the IRS, the donor will face substantial unanticipated tax liability.[34] Additionally, the donor could face significant underpayment penalties under IRC § 6662.[35]

The use of a defined value clause is an attempt to fully utilize exemption amounts in light of the difficulty of valuing certain assets. Because the IRS will often attempt to revalue interests in closely held companies and family limited partnerships, practitioners use defined value clauses in donative instruments to clearly define the amount the donor intends to transfer. Ideally, the clause allows the donor to better anticipate the amount of gift and GST tax liability and to more easily control the value of transferred assets.

III. Administrative and Judicial Decisions Involving Defined Value Clauses

A. Decisions Involving Savings Clauses

The first judicial challenge to a savings clause came in *Commissioner v. Procter*,[36] where the Fourth Circuit rejected the taxpayer's use of a revocation savings clause used for gift tax

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[30] *See* ROBERT E. MADDEN, TAX PLANNING FOR HIGHLY COMPENSATED INDIVIDUALS ¶ 11.06 (2006).
[31] David A. Handler & Kevin A. Chen, *Formula Disclaimers: Procter-Proofing Gifts Against Revaluation by the I.R.S.*, 96 J. TAX'N 231 (2002).
[32] *See id*. (providing example of valuation difficulty in closely held business).
[33] *Id*.
[34] Strobel & Strobel, *supra* note 14, at 22. Even if the statute of limitations imposed by IRC § 6501 has run, the assets might still be subject to revaluation by way of inclusion in the gross estate under IRC §§ 2035, 2036, 2037, 2038. *Id*.
[35] *See* Peterson, *supra* note 7. Peterson references the penalties imposed by former IRC § 6659 and IRC § 6660, describing these as the hazards of tax planning in this area.
[36] Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944).

avoidance.[37] The taxpayer in *Procter* settled a trust for the benefit of his children.[38] The terms of the trust stated that in the event that a court of competent jurisdiction entered a final judgment holding the taxpayer liable for gift tax, the amount of the transfer subject to gift tax would be deemed to not have been transferred.[39] The IRS disregarded this provision and assessed a gift tax deficiency against the taxpayer.[40]

In considering the validity of the savings clause, the Fourth Circuit held for the IRS, stating that the clause was void as a condition subsequent to the gift and as contrary to public policy.[41] The court reached this conclusion for several reasons. First, such a provision is contrary to public policy because it discourages the collection of tax deficiencies. Any assessment of liability on such a transaction would subsequently trigger the savings clause, thereby decreasing the value of the gift and negating the tax assessment. Second, the court found that such a clause not only impedes the ability of the government to collect tax revenue, it also frustrates the judicial process by forcing courts to issue opinions on moot issues. Upon revaluation, the true controversy would lie not between the donor and the IRS, but between the donor and the donee.[42] Third, in ruling against the taxpayer, the clause would render the judge's verdict self-defeating and undermine the authority of the court.[43]

Although the *Procter* court primarily discussed the adverse public policy implications of savings clauses, Revenue Ruling 65-144,[44] while still expressing public policy concerns, shed further light on the meaning of a condition subsequent. In Revenue Ruling 65-144, the IRS ruled that a savings clause altering a trustee's powers over an irrevocable charitable remainder trust was invalid.[45] The trust provided for three sequential income interests whereby the subsequent income beneficiary would be entitled to distributions subject to surviving the prior beneficiary.[46] Upon the death of all the income beneficiaries, the instrument required the trustee to distribute the corpus to certain educational institutions and hospitals.[47]

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[37] *Id*. at 828.
[38] *Id*. at 825.
[39] *Id*. at 827.
[40] *Id*. at 825.
[41] *Id*. at 827.
[42] *Id*.
[43] *Id*. at 827-28.
[44] Rev. Rul. 65-144, 1965-1 C.B. 442.
[45] *Id*.
[46] *Id*.
[47] *Id*.

The trust also contained two provisions granting to the trustees broad powers to allocate all expenses between income and principal and to apportion stock dividends and gains from dealings in property between income and principal.[48] These powers were expressly not limited to the constraints of local law or the Uniform Income and Principal Act.[49] However, a savings clause in the trust stated that if the IRS were to determine that the trustee's powers violated the provisions of Treas. Reg. § 25.2522(a)-2(a), thereby invalidating the deduction for the charitable remainder, then the powers would be revoked.[50] The IRS, in denying the gift tax charitable deduction, reasoned that since the powers were fully granted to the trustee and only became invalid upon the happening of an event subsequent to the settlement of the trust, the clause was a condition subsequent.[51] As such, the IRS ruled that the clause to be invalid pursuant to the holding in *Procter*.[52]

In *Ward v. Commissioner*,[53] the Tax Court disallowed a revocation savings clause similar to the one in *Procter*.[54] The taxpayers in *Ward* were the owners of a "cow and calf" ranching business,[55] which they operated in conjunction with their three sons.[56] To facilitate the transfer of the business to their sons, the taxpayers and their sons incorporated the ranching business.[57] Subsequent to the corporate formation, the taxpayers executed a gift agreement in which they agreed to gratuitously transfer to each of their sons 25 shares of stock in the ranching corporation.[58] The gift agreement asserted that the fair market value of each share was $2,000 and that the taxpayers intended to transfer to each son a value in the corporation equal to $50,000.[59] To effectuate this intent, the instrument included a savings clause. The "future adjustment" provision required that in the event the shares were "finally determined for Federal

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48 *Id*. at 442-43.
49 *Id*.
50 *Id*. at 443. The trustee's power to shift the benefits of the trust between the income beneficiaries and the remaindermen was clearly contrary to the regulations.
51 *Id*. at 444.
52 *Id*.
53 87 T.C. 78 (1986).
54 *Id*. at 116.
55 *Id*. at 82-83, 88.
56 *Id*. at 83.
57 *Id*. at 84.
58 *Id*. at 87.
59 *Id*.

gift tax purposes" to be worth more than $2,000, then the number of shares each son received would be adjusted so that each son would receive a number of shares totaling $50,000 in value.[60]

In holding the savings clause invalid, the Tax Court advanced the same reasoning articulated in *Procter*. The Tax Court further addressed the taxpayers' argument that portions of the *Procter* reasoning were no longer valid because of the unification of the estate and gift tax regimes that occurred subsequent to the *Procter* decision.[61] One of the public policy reasons against savings clauses stated in *Procter* was that the efforts of the IRS to revalue a gift would be pointless because the revaluation would trigger the savings clause and negate the additional gift tax liability. However, because of the inclusion of adjusted taxable gifts under IRC § 2001(b)(1)(B) in determining the amount of a decedent's estate tax, the taxpayers argued that the revaluation does result in additional tax.[62] Nonetheless, the Tax Court dismissed this argument, stating that the "mere possibility" of revaluation was insufficient.[63]

Additionally, the court in *Ward* emphasized that the gift tax is imposed upon completed gifts, not upon contingencies.[64] According to Treas. Reg. § 25.2511-2(b), a gift is complete when the donor has parted with dominion and control so that the donor has no power to alter interests in the property. The Tax Court reasoned that because the adjustment that the savings clause required was contingent upon the final determination of gift tax value, either the IRS or a court of competent jurisdiction controlled the contingency.[65] Furthermore, the court held that the contingent revocability did not reduce the value of the gift.[66] Although a donor may reduce the value of a gift on account of contingencies that might divest the donee of the donee's interest in the transferred property, the gift tax regulations disallow the reduction when the donor cannot accurately value the contingency.[67] The Tax Court held that because the taxpayers' retained interest was contingent upon the unpredictable actions of third parties, the interest could not be valued; therefore, the taxpayers could not justifiably reduce the value of the gift.[68]

[60] *Id*.
[61] *Id*. at 113.
[62] *Id*. (citing Strobel & Strobel, *supra* note 14, at 24)
[63] *Id*. at 113.
[64] *Id*. at 110.
[65] *Id*. at 110-11.
[66] *Id*. at 111.
[67] *Id*. at 111. *See* Treas. Reg. § 25.2511-1(e).
[68] Ward at 112.

A few months before the Tax Court issued its opinion in *Ward*, the IRS issued a similar revenue ruling. In Revenue Ruling 86-41,[69] the IRS considered first the validity of a revocation savings clause.[70] Under the hypothetical, A transferred to B a one-half undivided interest in real property. However, the deed stated that if the IRS were to value the interest at an amount exceeding $10,000, then B's interest would be reduced to a fractional share in the property equal to $10,000. A reported the gift and applied the annual exclusion; however, the IRS revalued the one-half interest at $15,000.[71] The revenue ruling also presented a second situation that was premised on the same set of facts. Rather than using a revocation savings clause, however, the deed contained a consideration savings clause.[72]

The IRS concluded that both the revocation savings clause and the consideration savings clause were invalid.[73] Relying on *Procter* and Revenue Ruling 65-144, the IRS emphasized that savings clauses discourage effective tax enforcement by triggering conditions that defeat the gift tax and render examination fruitless. As such, the IRS stated that it would refuse to acknowledge these clauses.[74] Interestingly, however, the revenue ruling distinguished the clauses at issue from those used to effectuate a bona fide intent of the parties, particularly as exhibited by a clause requiring an adjustment based on an appraisal by an independent third party.[75] While Revenue Ruling 86-41 did not make explicit reference to the decision in *King v. United States*,[76] the revenue ruling recognized, at least implicitly, a distinction between consideration savings clauses used in bona fide transactions versus those used in donative transfers.

This distinction is apparent in comparing two prominent cases that have addressed the use of consideration savings clauses. The Tenth Circuit held in *King* that the use of a savings clause in the ordinary course of business at arm's length must be respected for gift tax purposes.[77] The taxpayer in *King* created separate trusts for each of his four children.[78] The trustee of the trusts and the taxpayer's attorney negotiated the transfer to the trusts of shares in

[69] Rev. Rul. 86-41, 1986-1 C.B. 300.
[70] *Id*.
[71] *Id*.
[72] *See id*.
[73] *Id*.
[74] *Id*.
[75] *See id*.
[76] 545 F.2d 700 (10th Cir. 1976).
[77] *Id*. at 706.
[78] *Id*. at 703.

the taxpayer's oil business.[79] In exchange for the shares, the trustee, on behalf of the trusts, executed promissory notes payable by each of the trusts to the taxpayer. The taxpayer and the trustee intended the promissory note to represent consideration equal to the fair market value of the shares.[80] In determining the fair market value, the trustee used the same valuation technique defined in the corporation's qualified stock option plan.[81]

In addition to the promissory notes, the taxpayer and the trustee entered into an agreement that contained a consideration savings clause.[82] The clause required an adjustment of the fair market purchase price in the event that the IRS revalued the shares.[83] The IRS revalued the shares at nearly 13 times the amount recited in the agreement,[84] and the controversy ensued.

Although the IRS relied on *Procter*, the Tenth Circuit distinguished the circumstances involved in *King* and upheld the validity of the clause.[85] Unlike the clause in *Procter*, the clause in *King* did not alter the nature of the transaction by revoking a portion of the transfer.[86] The parties in *King* intended a transaction for fair market value. According to IRC § 2512(b), when property is transferred for less than full and adequate consideration, the value of the property in excess of the consideration is deemed a gift. The IRS argued that for this reason the intent of the parties was irrelevant.[87] However, the trial court found that the transaction occurred in the ordinary course of business at arm's length, and the Tenth Circuit ruled that this finding of fact was not clearly erroneous.[88] Therefore, pursuant to Treas. Reg. § 25.2512-8, the taxpayer overcame the requirements of IRC § 2512(b) because the parties negotiated at arm's length. The court accordingly held the clause to be valid.[89]

However, where a taxpayer possessed donative intent in transacting with related parties, the Tax Court has held that consideration savings clauses are invalid.[90] In *Estate of McLendon v. Commissioner*, the taxpayer entered into a private annuity agreement with his son and with a

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[79] *Id*. at 703-04.
[80] *Id*. at 704.
[81] *Id*.
[82] *Id*. at 703-04.
[83] *Id*.
[84] *Id*. at 704. The agreement valued each share at $1.25. The IRS valued each share at $16.00.
[85] *Id*. at 706.
[86] *Id*. at 705.
[87] *Id*.
[88] *Id*.
[89] *Id*. at 706.
[90] Estate of McClendon v. Commissioner, 66 T.C.M. (CCH) 946, 970 (1993), *rev'd on other grounds*, 135 F.3d 1017 (5th Cir. 1998)

trust that he had settled for the benefit of his three daughters.[91] The taxpayer accepted an annuity as consideration for various partnership interests and real property. The consideration was purported to be full and adequate, and the agreement contained a consideration savings clause requiring adjustment of the purchase price and the payment of interest if the IRS revalued the assets.[92] Although the taxpayer relied on *King* to assert the validity of the savings clause, the Tax Court found the *King* holding inapplicable.[93] The transaction was not at arm's length and was not free from donative intent.[94] According, the court held the consideration savings clause invalid.[95]

B. Decisions Involving Formula Clauses

Around the same time that courts were striking down the use of defined value savings clauses, the IRS indicated that it would view defined value formula clauses with approval. In a 1986 National Office Technical Advice Memorandum,[96] the IRS concluded that the donor's grant to the donees of the fractional equivalent in a partnership equal to a defined value was valid.[97] As the facts were presented, the taxpayer made several transfers to trusts that he settled for the benefit of his children.[98] The taxpayer defined the amount of the transfers with a clause setting the value of each transfer equal to the annual gift tax exclusion.[99] After the taxpayer made the gifts, he and the trustee executed an agreement specifying that the trusts would receive fractional shares in the partnership in satisfaction of the gift.[100] The IRS found that so long as the taxpayer gave to the donees fractional shares with a fair market value equal to the defined value, no gift tax would ensue. However, if the fair market value of the fractional shares exceeded the defined value, then the taxpayer would be liable for gift tax on the amount exceeding the annual gift tax exclusion.[101]

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[91] *Id*. at 955.
[92] *Id*.
[93] *Id*. at 970.
[94] *Id*.
[95] *Id*. *See also* Harwood v. United States, 82 T.C. 239 (1984).
[96] Tech. Adv. Mem. 8611004.
[97] *Id*.
[98] *Id*.
[99] *Id*.
[100] *Id*.
[101] *Id*. The IRS also briefly mentioned the taxpayer's right to revoke any excess. Although the IRS failed to develop the issue, it presumably took the same position against this aspect of the clause as it does against revocation savings clauses in general.

The IRS later receded from this apparent approval of formula clauses. In a 2002 National Office Technical Advice Memorandum,[102] the IRS held that the taxpayer's use of a formula clause that implicitly required partial revocation of the transfer was invalid for gift tax purposes.[103] Under the facts presented in the memorandum, the taxpayer established a revocable trust and an irrevocable trust for the benefit of her children. She served as the trustee of both trusts.[104] The taxpayer, as trustee of the revocable trust, entered into a sale and purchase agreement with herself as trustee of the irrevocable trust.[105] Pursuant to the agreement, the revocable trust promised to sell to the irrevocable trust a fractional general partnership share in the family's limited partnership.[106] The agreement defined the fractional share with a formula clause.[107] The formula stated that the fractional share would be equal to the purchase price, as defined elsewhere in the agreement, divided by the fair market value of the general partnership interest subject to the sale. The catch, however, was that the agreement required valuation of the general partnership interest to be based upon the finally determined value for federal gift tax purposes of the previously transferred limited partnership interest.[108]

The IRS ruled that this clause was no different from the revocation savings clauses in *Procter* and *Ward*.[109] By using a formula that entailed the final valuation by the IRS of a related interest in the entity, the clause functioned the same way as one that would have required revaluation based upon a finally determined value of the general partnership interest.[110] Under either scenario, the IRS stated that the clause constitutes a condition subsequent in violation of Revenue Ruling 65-144.[111] The taxpayer also argued that the IRS should approve of the formula clause since the IRS has approved of formula clauses for purposes of the marital deduction and

[102] Tech. Adv. Mem. 200245053.
[103] *Id*.
[104] *Id*.
[105] *Id*.
[106] *Id*.
[107] *Id*.
[108] *Id*.
[109] *Id*.
[110] *Id*.
[111] *Id*. The IRS reached a similar conclusion in Tech. Adv. Mem. 200337012. The clause at issue stated that the donor granted to the donee a percentage interest in the partnership equal to a defined value. The clause, unlike a revocation savings clause, said nothing regarding a condition subsequent that would result in the return of the excess value to the donor. Nonetheless, the IRS held that even in the absence of such language, revaluation would result in a retransfer of property back to the donor. *Id*. This demonstrates the IRS's apparent desire to treat defined value formula clauses in the same manner as defined value savings clauses, despite their important differences.

for GRATs.[112] The IRS distinguished the use of formula clauses for the marital deduction on the grounds that Congress intended testators to be able to take full advantage of this deduction and because it would be unreasonable to require testators to continually redraft their wills upon changes in the value of their assets.[113] As for the use of formulas clauses for GRATs, the IRS simply stated that such clauses are widely abused.[114]

In addition to these technical advice memorandums, the IRS articulated its view of formula clauses in a 2001 Field Service Advisory.[115] Responding to a set of facts strikingly similar to those in *McCord*,[116] the IRS implied that it makes no distinction between savings clauses and formula clauses.[117] Although the IRS recognized that formula clauses are different from the type of clause in *Procter*, it reasoned that the underlying principles are the same.[118] According to the IRS, if an auditor or a court were to revalue the assets, no additional tax liability would ensue.[119] As such, the IRS asserted that the same public policy considerations involved in *Procter* also arise from formula clauses.

IV. THE *MCCORD* DECISION

Succession of McCord v. Commissioner[120] began in the Tax Court, where Judge Foley, finding that the IRS failed to meet the burden of proof required by IRC § 7491, held for the taxpayers.[121] However, a majority of the Tax Court disagreed with Judge Foley, and, two years after the trial, the Acting Chief Judge of the Tax Court issued an "unusual order"[122] that effectively revoked Judge Foley's decision and reassigned the case to Judge Halpern, who on the same day filed the majority's opinion holding for the IRS.

The facts of the *McCord* case are complex. In June of 1995, the taxpayers, Mr. and Mrs. McCord, and their four sons formed a Texas limited partnership, McCord Interests, Ltd., L.L.P.

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[112] Tech. Adv. Mem. 200245053.
[113] *Id*.
[114] *Id*.
[115] FSA 200122011.
[116] *See infra* text, § IV.
[117] FSA 200122011.
[118] *Id*.
[119] *Id*.
[120] 461 F.3d 614 (5th Cir. 2006), *rev'g* 120 T.C. 358 (2003) (Foley, J., concurring in part and dissenting in part; Laro, J. and Vasquez, J., dissenting).
[121] *Id*. at 622.
[122] *Id*.

("MIL" or "the partnership").[123] Each son contributed $40,000 to the partnership in exchange for a one-quarter general partnership interest. The taxpayers each contributed $10,000 in exchange for a one-half interest as a Class A limited partner. The taxpayers also each contributed about $6.1 million for a 41% Class B limited partnership interest. McCord Brothers ("MCB"), a second partnership that the sons controlled, held the remaining Class B limited partnership interest, for which MCB paid about $2.5 million.[124] MIL also contained standard provisions designed to enhance the lack of control and lack of marketability discounts.[125] Notable among these provisions was MIL's right to redeem shares owned by any charitable organization.[126]

In January of 1996, the taxpayers, using an assignment agreement, made irrevocable gifts of their Class B partnership interests[127] to four irrevocable trusts, the taxpayers' four sons, the Shreveport Symphony, and the Community Foundation of Texas.[128] Both the Symphony and the Foundation were tax exempt organizations as defined in IRC § 501(c)(3).[129] The complicating issue involved in the assignment agreement was the manner in which the taxpayers structured the gift. Rather than giving percentage interests in the partnership, the assignment agreement used sequential defined value formula clauses to give dollar amounts of the partnership's fair market value.[130]

First, the assignment agreement gave to the four trusts an amount of the taxpayers' interest in the partnership equal to the taxpayers' remaining GST exemption reduced by the dollar value of any transfer taxes the trusts assumed.[131] Second, the sons received an amount of the taxpayers' interest in the partnership equal to $6.9 million reduced by the amount given to the GST trusts reduced further by the dollar value of any transfer taxes the sons assumed.[132]

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[123] *Id*. at 616.
[124] *Id*.
[125] *See id*. at 617.
[126] *Id*.
[127] The taxpayers had already disposed of their Class A partnership interests through a charitable contribution that was not at issue in the case. *Id*. at 617-18.
[128] *Id*. at 618. The Foundation was a very prominent charity, handling assets of over $400 million for charitable purposes. Brief of Petitioners-Appellants at 9, Succession of McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006) (No. 03-60700). The Foundation was allegedly a very donor friendly institution. It was willing to except '"highly structured 'interests'"' [citation omitted] and to liquidate the non-cash interests shortly after receipt. Brief of Respondent-Appellee at 10-11, Succession of McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006) (No. 03-60700).
[129] 461 F.3d at 618.
[130] *Id*.
[131] *Id*. The assignment agreement required the noncharitable donees to assume any gift tax payable by the donors on account of the donees' respective portions of the gift. *Id*. at 619.
[132] *Id*. at 618.

Third, the taxpayers gave to the Symphony a $134,000 interest in the partnership. Finally, the assignment agreement entitled the Foundation to any interest in the partnership remaining after the satisfaction of the gifts to the preceding three donees.[133]

At the time of the gift, no other agreements existed among the taxpayers, the trusts, the sons, or the charities regarding the percentage interest that each donee would receive.[134] The assignment agreement specified the valuation technique that the donees were to apply.[135] The taxpayers "washed their hands"[136] of the entire transaction, leaving the donees with the responsibility of determining their respective shares in the partnership.[137] Two months later, the donees resolved the valuation issues and entered into a confirmation agreement delineating the percentage shares that each would receive.[138] Although the sons arranged the appraisal, all the donees were independently represented and had the right to retain their own appraisers.[139] Following the confirmation agreement, the partnership exercised its call right and redeemed the shares given to the Symphony and to the Foundation, thereby consolidating ownership of the entire partnership in the sons and the trusts.[140] The IRS ultimately assessed against each of the taxpayers a $2 million gift tax deficiency resulting from these transactions.[141]

Based on these facts, the Tax Court, in a reviewed opinion, held that the defined value formula clause used in the assignment agreement was an invalid basis for gift tax valuation.[142] At trial, the IRS had argued that the transaction was invalid as a matter of equity, basing his argument on the substance-over-form, violation of public policy, and reasonable-probability-of-receipt doctrines.[143] In its decision, however, the Tax Court paid little attention to these arguments and instead conducted an extensive revaluation of the gifts.[144] In a cumbersome

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[133] *Id*.
[134] *Id*. at 619.
[135] The valuation technique mirrored Treas. Reg. § 25.2512-1.
[136] Brief of Respondent-Appellee at 8, 27, Succession of McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006) (No. 03-60700). *See also* Brief of Petitioners-Appellants at 3, Succession of McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006) (No. 03-60700) (emphasizing that the taxpayers were not a party in the confirmation agreement).
[137] *See* McCord, 461 F.3d at 619-20. The Fifth Circuit reaffirmed the Tax Court's finding that there was no evidence of any implicit understanding between the taxpayers and any of the donees, not even a "wink-wink". *Id*. at 620.
[138] *Id*. at 619.
[139] *Id*. at 619-20.
[140] *Id*. at 620.
[141] *Id*. at 621.
[142] McCord v. Commissioner, 120 T.C. 358, 404 (2003) (Foley, J., concurring in part and dissenting in part; Laro, J. and Vasquez, J., dissenting) *rev'd*, 461 F.3d 614 (5th Cir. 2006).
[143] *See id*. at 416 (Foley, J., concurring in part and dissenting in part). *See also* McCord, 461 F.3d at 623.
[144] *See* McCord, 120 T.C. at 373-95.

discussion of valuation techniques, the Tax Court revalued the partnership interest by selecting a value precisely halfway between the taxpayers' and the IRS's appraisals.[145] The court reached this conclusion by finding that the assignment agreement was not the final factor in determining valuation and instead relied, in part, on the confirmation agreement.[146]

On appeal, the Fifth Circuit reversed the Tax Court and held that the formula clause in the assignment agreement was the necessary measurement for determining the value of the gifts.[147] The Fifth Circuit strongly rebuked the Tax Court for using the post-gift confirmation agreement to determine the amount of the taxpayers' gifts rather than the formula clause in the assignment agreement.[148] Despite the fact that the taxpayers' use of the defined value clause was aggressive,[149] the court observed that the legal standards for valuing gifts were clear. The court stated the rule that valuation of a gift must occur upon a snapshot taken at the moment the gift is complete.[150] Although the court did not expressly approve of the formula clause, the court criticized the Tax Court's "palpable hostility to the dollar formula of the defined value clause."[151] The Fifth Circuit accordingly accepted the values stated in the formula clause and disregarded the donees' subsequent negotiation of the confirmation agreement.[152]

V. THE FUTURE OF DEFINED VALUE CLAUSES

The Fifth Circuit's decision in *McCord* is unlikely to redeem defined value savings clauses from their current state of impermissibility. The rationales and policy arguments against savings clauses are still viable in the aftermath of *McCord*. Under Treas. Reg. § 25.2511-2(b) it is clear that a gift is complete at the point at which the donor has parted with dominion and control over the asset. As Revenue Ruling 65-144 demonstrates, conditions subsequent have no bearing on valuation. The *McCord* decision does not alter the fact that savings clauses involve conditions subsequent, and the public policy concerns in *Procter* remain valid as to such conditions.

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[145] McCord, 461 F.3d at 625.
[146] *Id*. at 628.
[147] *Id*. at 626-29.
[148] The decision criticizes the Tax Court for "confecting sua sponte its own methodology" which violated "the long-prohibited practice of relying on post-gift events." *Id*. at 626.
[149] *Id*. at 624.
[150] *Id*. at 626. *But see* Wendy C. Gerzog, *McCord and Postgift Events*, 113 TAX NOTES 349 (Oct. 23, 2006).
[151] *Id*. at 627.
[152] *Id*. at 628.

The impact of *McCord* on the use of defined value formula clauses, however, is potentially significant. Its effect will turn predominantly on whether the IRS can successfully assert the *Procter* public policy arguments against taxpayers using formula clauses. The Fifth Circuit appears to have avoided this issue,[153] and there is a significant probability that the IRS will raise the *Procter* arguments again in other circuits, particularly in those that are perceived to be less taxpayer friendly than the Fifth.[154] Although the IRS will raise these arguments again, it is unlikely to prevail.

The Fourth Circuit's first concern in *Procter* was that savings clauses discourage the collection of tax deficiencies. This concern does not arise from a taxpayer's use of a formula clause. Technically speaking, the taxpayer actually gives to each donee the amount specified in the formula; as *McCord* stressed, the donees' subsequent actions cannot affect the donors' tax liability.[155] Interestingly, however, the IRS could possibly raise an argument regarding gift tax liability against the donees. If the donees resolve to divide the property in proportions other than those required by the donor's gift instrument, then the IRS can argue that donees who accept less than the amount to which they are entitled make deemed gifts to the other donees. Holding the donees liable for the gift tax more accurately reflects the nature of the transaction. When a charity is involved, however, a deemed taxable gift between the donees is unlikely.

The second public policy argument in *Procter* is also probably inapplicable to formula clauses. The *Procter* court asserted that upholding a savings clause would frustrate the judicial process because the true controversy would lie between the donor and the donee, the latter not being a party in the case. However, when a formula clause is at issue, the true controversy does in fact lie between the IRS and the donor. Their dispute is the value of the gift, not what occurs following revaluation. The court's decision would have no bearing on the ultimate disposition of the property.

The final concern in *Procter* was that in upholding a savings clause, the court would issue a self-defeating judgment. Because formula clauses do not involve conditions subsequent, however, courts' decisions regarding formula clauses would not be self-defeating. A defined value formula clause does not require the donee to return to the donor property valued in an

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[153] The Fifth Circuit stated that the IRS failed to raise these arguments on appeal. *See id*. at 623. However, the IRS did raise these arguments in a footnote in its brief. *See* Brief of Respondent-Appellee at 37, note 18, Succession of McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006) (No. 03-60700); *see also*, Akers, *supra* note 3, at 5.
[154] *See* Akers, *supra* note 3; Tech. Adv. Mem. 200245053.
[155] McCord, 461 F.3d at 626.

amount exceeding the defined value, nor does it require additional consideration. As such, the court's decision would not trigger a subsequent event that could negate the assessment of tax liability.

Aside from *Procter*, the IRS must successfully confront a donor's persuasive argument that defined value formula clauses function in the same manner as formula clauses used in a variety of other transfer tax situations. Treasury Regulations provide for the GRAT, CRAT, disclaimer, and inclusion ratio formula clauses. Administrative articulation of some formula clauses, however, is not tantamount to repudiation of formula clauses that are not expressly stated in the regulations.[156] Additionally, the IRS has offered an unconvincing response to this argument.[157] The IRS has stated that Congress enacted the marital deduction with the intent that taxpayers would utilize the full amount, and that in light of this intent and the difficulty of valuing certain assets, taxpayers may use formula clauses in testamentary planning.[158] These arguments, however, equally support the use of formula clauses in inter vivos planning. The IRS needs a more convincing argument on this issue.

Nonetheless, *McCord* presents its own potential pitfalls that other circuits might recognize. The Fifth Circuit did demonstrate consistency in applying the tax law. Savings clauses are invalid under the rule that conditions subsequent to the transfer cannot be considered in valuing gifts. In reversing the Tax Court, this is precisely the same rule that the Fifth Circuit applied in *McCord*.[159] The Tax Court erred in using the donees' negotiation of the confirmation agreement as a factor in determining the value of the gift since the gift was completed upon the signing of the assignment agreement nearly two months prior.[160] The Fifth Circuit was understandably angered by the Tax Court's apparent misapplication of well-settled law; however, the Fifth Circuit's opinion was premised on a very specific set of facts.

Although the IRS failed to prove important facts and fell short of meeting its burden, one wonders whether the Fifth Circuit's frustration diverted its attention away from certain facts that might have spelled a different outcome. Despite the Fifth Circuit's understanding that not so much as a "wink-wink" existed between the taxpayers and the donees,[161] facts that the IRS

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[156] *See supra* notes 20-23 and accompanying text.
[157] Tech. Adv. Mem. 200245053.
[158] *Id*..
[159] McCord, 461 F.3d at 626.
[160] *Id*.
[161] *Id*. at 620.

argued seemed to indicate otherwise. These facts, if proven, might yield different results in future cases.

For example, the taxpayers argued and the Fifth Circuit emphasized that the Symphony and the Foundation were independently represented and had the right to obtain alternative appraisals.[162] However, the IRS argued that the taxpayers knew that the Foundation had a policy of not obtaining appraisals on assets estimated to be worth less than $1 million.[163] The taxpayers allegedly knew that the Foundation had a policy against holding illiquid assets, such as shares in family limited partnerships, and would want to liquidate the interests quickly.[164] Finally, Mrs. McCord ostensibly did not even know she was making a contribution to the Foundation.[165]

These facts are not relevant as to when valuation should occur; rather, they call into question whether the parties intended to value the assets fairly. The Fifth Circuit emphasized the adverse nature of the Foundation's interest.[166] However, the likelihood of an implicit understanding, even in the absence of strong proof, is a potential public policy ramification weighing against the permissibility of defined value formula clauses. This likelihood would seem even greater when charities are involved to which the donor might otherwise give nothing but for the charities' silent acquiescence.

The fact that the Foundation obtained appraisals only for assets potentially worth over $1 million also raises the concern that even though the donors "intended" to make gifts equal to the defined amounts, they believed that the donees would not follow the donors' "intent." If the donors made the gifts knowing that the Foundation would not receive an appraisal and that the sons would, a logical conclusion is that the taxpayers knew that the sons could dominate the negotiation of the confirmation agreement by undervaluing the assets and then redeeming the shares at a deflated price. This fact would undermine the legitimacy of the assignment agreement.

There are, however, significant arguments against these concerns. The Foundation retained in-house and outside counsel, who presumably acted ethically and advised the Foundation to abide by its fiduciary duties. The presence of counsel independent from the

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[162] *Id*.
[163] Brief for Respondent-Appellee at 39, Succession of McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006) (No. 03-60700).
[164] *Id*. at 10-11.
[165] *Id*. at 12.
[166] McCord, 461 F.3d at 620.

donors certainly weighs in favor of a bona fide transaction. The board also consisted of several prominent community leaders who would likely have opposed questionable activities by the Foundation.[167] A misbehaving charity also faces the potential loss of tax-exempt status and is policed, to some extent, by the state attorney general.

VI. Conclusion

The *McCord* decision provides greater support for the use of formula clauses, but taxpayers should not rush to use the clauses in all settings. By focusing primarily on the Tax Court's misapplication of the law, the Fifth Circuit arguably overlooked important facts that could defeat future valuation based on defined value formula clauses. Practitioners should view the *McCord* decision as highly fact-dependent and tailor their strategies accordingly. Courts will be unlikely to expand the *McCord* holding to taxpayers who fail to take such painstaking measures to create favorable factual circumstances. Additionally, the *Procter* public policy arguments still remain untested in respect to formula clauses, and the IRS will almost certainly raise these arguments in other circuits. Even if the IRS fails on these arguments, other public policy concerns might arise and defeat taxpayers' ability to use this strategy. If used properly, however, defined value clauses may become a powerful estate planning technique.

[167] Brief for Petitioner-Appellants at 9, Succession of McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006) (No. 03-60700).