Guest Article

Wandry v. Commissioner: The "Secret Sauce" Estate Planners Have Been Waiting For?

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Introduction

A common estate planning technique is a transfer (by gift or sale) to an irrevocable trust. If the transfer is of a hard-to-value asset, such as an interest in a closely held business, the taxpayer risks that the IRS will challenge the valuation of the transferred interest and assert a gift tax deficiency.

As an example, suppose "T" desires to transfer by gift to an irrevocable trust T's interest in a closely held business, "Company." T retains a qualified appraiser to determine the value of T's interest in Company. Based on the appraisal, T transfers that portion of T's interest in Company that will make use of T's remaining gift tax exclusion. However, the IRS is not bound by the appraiser's valuation. Therefore, if it is determined that the appraisal report understates the value of the transferred interest, T will be required to pay gift tax.

Taxpayers have grappled with this dilemma for years. In many instances, taxpayers' counsel have attempted to draft around the risks associated with a valuation challenge by making a separate provision in the transfer documents for the portion of the transferred interest that would trigger gift tax. The IRS has challenged with mixed success these drafting "fixes" to the valuation risk. While the first significant case, *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944), held against the taxpayer, recent cases have been more favorable. Indeed, the most recent taxpayer victory, *Wandry v. Commissioner*, T.C. Memo 2012-88, may be a game-changer on this issue altogether.

Procter and the Evolution of Formula Allocation Clauses

In *Procter*, the donor assigned to his children his remainder interests in two trusts. To avoid the imposition of gift tax, the assignment was subject to a qualification in the transfer document that if it was later determined by a final judgment of a court of last resort that any portion of the transfer would be subject to gift tax, then the portion subject to gift tax would automatically be deemed excluded from the conveyance and would remain the donor's property.

The Fourth Circuit held that this clause was ineffective to eliminate a taxable gift. The court's holding speaks to a procedural defect with the provision, namely, that the clause created a condition subsequent that could not become operative until a final judgment had been rendered, but once a judgment had been rendered, it could not become operative because the matter involved had already been concluded by such final judgment. Notwithstanding that the decision turned on this narrow procedural defect, *Procter* has been "frequently misinterpreted to mean that a … clause cannot have an effect following the transfer. But it does not seem that the *Procter* court went that far. Instead, the court in *Procter* [held] that because the adjustment was intended to take effect subsequent to the court's judgment, it cannot avoid the imposition of gift tax, because the tax is imposed on the judgment, and is then final." Diana S.C. Zeydel and Norman J. Benford, *A Walk Through the Authorities on Formula Clauses,* ESTATE PLANNING, December 2010, at 4.

The misapprehension of the Fourth Circuit's narrow procedural holding in *Procter* caused many practitioners to avoid formula clauses altogether that involve adjustments between the transferor and the transferee in the event of a successful valuation challenge. Instead, estate planners began to make use of "formula allocation clauses" to address the revaluation risk. While *Procter* involved a provision that resulted in the deemed exclusion from the transfer of that portion of the interest that would trigger gift tax, formula allocation clauses operate differently. Specifically, with a formula allocation transfer, the quantity and identity of property that is conveyed is certain and fixed at the outset, but the formula allocation clause operates to adjust the allocation of that property between two transferees based on the ultimate valuation of the transferred property. The preferred transferee typically receives that portion of the transferred property that has a value equal to a fixed sum (such as the annual exclusion or the transferor's remaining gift tax exemption) and any excess would "spill over" to a second transferee, which is a person or entity that would not trigger gift tax, such as the transferor's spouse (either outright or in a qualifying marital trust), an incomplete gift trust, a charitable organization, or a "zeroed-out" GRAT. Therefore, if a revaluation occurs, there is a reallocation between the transferees, but the quantity and identity of property transferred away from the transferor does not change.

While estate planners have long made use of formula clauses in other contexts without IRS challenge (i.e., marital and credit shelter trust funding formulas and formula disclaimers), the IRS asserted that formula allocation clauses used in this context were invalid, principally because these provisions violated various public policies. The IRS made the public policy argument in four recent cases – and lost each case. *See McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006); *Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008) (affirmed by *Estate of Christiansen*, 586 F.3d 1061 (8th Cir. 2009)); *Estate of Petter v. Commissioner*, T.C. Memo 2009-280 (affirmed by *Estate of Petter v. Commissioner*, 653 F.3d 1012 (9th Cir. 2011)); and *Hendrix v. Commissioner*, T.C. Memo 2011-133.

While formula allocation clauses have been met with much success in the courts, they have a number of significant practical drawbacks. The most significant issue with formula allocation clauses has been the selection of the spillover transferee. Each of the recent cases approving formula allocation transfers involved a charitable organization as the spillover recipient. However, even charitably inclined clients may not be comfortable with a charitable organization owning an interest in a closely held business. In those situations, estate planners have no court precedent confirming that a formula allocation clause involving a non-charitable spillover transferee would be respected. Another issue is the cost and administrative inconvenience of implementing another trust or entity to receive the spillover amount. For example, if a GRAT is designated as the recipient of the spillover and the regulations under Section 2702 are not followed precisely (e.g., an annuity payment is missed or not timely), it is doubtful the GRAT will be recognized as a qualified annuity interest.

Formula Transfer Clauses and *Wandry*

An alternative to a formula allocation clause is a "formula transfer clause." While a formula allocation clause fixes the quantity and identity of property transferred and self-adjusts the allocation of such transferred property between two transferees based on the ultimate value of the property conveyed, a formula transfer clause instead fixes the value transferred and self-adjusts the quantity of the property conveyed to achieve the fixed value. "Formula transfer clauses have been analogized to asking for $10 worth of gasoline … rather than a certain number of gallons of gas … [opening] up the simplicity of giving '$13,000 worth of LLC units' to make sure the gift does not exceed a desired monetary amount, or giving '[$5,120,000] worth of LLC units' to make sure that the transferor does not have to pay gift tax as a result of the transfer of a hard-to-value asset." Steve R. Akers, *Wandry v. Commissioner*, T.C. Memo 2012-88 (March 26, 2012), BESSEMER TRUST, March 2012. Notably, the formula transfer does not require a second transferee, as there is no excess value to spill over.

While the simplicity of a formula transfer clause is appealing, many estate planners have been hesitant to make use of it, fearing that the formula transfer clause is too similar to the clause rejected in *Procter*. Recall that in *Procter*, a transfer had been completed, only to be undone if gift tax resulted and, importantly, the ruling focused on the narrow procedural defect of the timing of the operation of the condition subsequent. With a formula transfer clause, the only transfer made is that portion of the transferor's property equal to the fixed value. Accordingly, the transfer is not undone because no transfer of excess value was made in the first instance. It is a key distinction, albeit a subtle one, and drafters' fear that a court may not appreciate that distinction has resulted in the proliferation of the formula allocation clause, notwithstanding its drawbacks. As a result of the limited implementation of the formula transfer clause, it had not been tested judicially … until last year. In its first challenge, the formula transfer clause resulted in a victory for the taxpayers. Indeed, *Wandry v. Commissioner*, T.C. Memo 2012-88 (March 26, 2012), may be the "secret sauce" estate planners have been waiting for.

In the *Wandry* case, the taxpayers engaged in a gifting program that involved the transfer of interests in two family entities. The taxpayers had been advised by their counsel that the value of the gifts on any given date would not be known until a later date when a valuation could be completed. As a result, the taxpayers' counsel advised them to make gifts of interests in the entities equal to a specific dollar amount, rather than a set number of interests in the entities.

The transfers at issue were made on January 1, 2004. The taxpayers executed separate assignments, which transferred among nine donees a "sufficient number of my [u]nits … [in the company] … so that the fair market value of such [u]nits for federal gift tax purposes shall be … $1,099,000" (i.e., the amount that would fully consume the available $1 million gift tax exemption and the $11,000 per donee annual exclusion amount). Each assignment went on to provide that although the gift of units was fixed on the date of the gift, the number of units gifted was based on the Fair Market Value of the units, which was not known as of the date of the gift and could be challenged by the IRS. So, if "the IRS challenges such valuation and a final determination of a different value is made … the number of gifted [u]nits shall be adjusted" so that the value of the gifted units equals $1,099,000 "in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law."

The IRS audited the gift tax returns and revalued the units for gift tax purposes. The IRS and the taxpayers ultimately agreed on an upward adjustment to the valuation of the transferred units. The issue before the Tax Court was whether or not a gift had been made in 2004 as a result of the subsequent revaluation given the formula used in the assignments. The IRS's central argument was that the taxpayers transferred a fixed number of units and that the adjustment clause was an invalid savings clause because it created a condition subsequent that was void as contrary to public policy. The taxpayers argued that they made a transfer of units equal to specific dollar amounts, not a fixed number of units, and that the cited public policy concerns were not applicable. Judge Harry A. Haines, in a memorandum decision, held for the taxpayers.

Judge Haines began his review by examining the evolution of the case law, including *Procter*, which he described as the "cornerstone of a body of law." and the recent cases of *McCord*, *Christiansen*, and *Petter* (*Hendrix* apparently had not yet been decided when Judge Haines wrote his opinion). The memorandum opinion noted that in *Petter* the Tax Court drew a distinction between a "savings clause" and a "formula clause." A savings clause is invalid because it operates to take property back as a condition subsequent, whereas a formula clause is valid because it transfers a fixed set of rights. The difference, according to Judge Haines, "depends on an understanding of just what the donor is trying to give away." Judge Haines concluded that the only gifts taxpayers intended to give were gifts of dollar amounts equal to the amount they could transfer free of gift taxes and that they understood and believed that the gifts were of a specified dollar value, not of a specified number of units. Taxpayers were advised by their counsel that if a subsequent revaluation occurred, nothing would be returned to them; rather, simple accounting entries would be made to reflect the actual gifts.

The IRS attempted to differentiate this case from *Petter*, arguing that this case is different because the clause at issue operates to take property back upon a condition subsequent. Judge Haines disagreed with the IRS's interpretation of the Ninth Circuit's decision in *Petter* and reviewed each part of the Ninth Circuit's holding to the facts of this case. Ultimately, Judge Haines concluded that each donee was entitled to a predefined interest in the family entity expressed through a formula. The formula did not allow the taxpayers to take property back, but rather adjusted the allocation of interests among the taxpayers and the donees because of the understated value. As such, the clauses at issue were valid formula clauses.

As to the IRS's public policy concerns, Judge Haines observed that the "Commissioner's role is to enforce tax laws, not merely to maximize tax receipts." Judge Haines pointed out that mechanisms "outside of the IRS audit exist to ensure accurate valuation reporting," such as the fact that transferors and transferees have competing interests in ensuring that capital accounts properly state owners' interests. (Candidly, the authors do not follow this logic, as a transferor is incented to transfer as much as possible to remove those assets and the appreciation thereon from the transfer tax base and the transferee obviously would like to receive as much as possible.) Finally, Judge Haines concluded by addressing squarely the lack of a charitable presence: "In [prior cases] we cited Congress' overall policy of encouraging gifts to charitable organizations. This factor contributed to our conclusion, but it was not determinative. The lack of charitable component in the cases at hand does not result in a 'severe and immediate' public policy concern."

On August 28, 2012, the IRS filed a Notice of Appeal with the Tenth Circuit. On October 17, an Order dismissing the appeal was filed, following a stipulation by the parties on October 16 that the case be dismissed with prejudice. Notwithstanding the failure of the IRS to pursue its appeal, on November 13 the IRS published a statement in Internal Revenue Bulletin 2012-46 that the Commissioner would ***not*** acquiesce to the Tax Court's decision in *Wandry*. The authors speculate that the IRS abandoned its appeal in *Wandry* due to binding precedent unfavorable to the government, namely *King v. Commissioner*, 545 F.2d 700 (10th Cir. 1976), which upheld a taxpayer's purchase price adjustment clause in a sale transaction, finding that the taxpayer's attempt to avoid valuation disputes with the Internal Revenue Service (by employing such clause) was not contrary to public policy.

Conclusion

There has been a demonstrated trend in the courts to uphold formula allocation clauses, and planners now have the first reported case upholding a formula transfer clause as well. Formula transfer clauses offer a simple solution to the taxpayer's dilemma of wanting to make a transfer of a specified dollar amount of a hard to value asset without risking a revaluation of such transferred property that would result in a gift tax.

The timing of *Wandry* could not have been more fortuitous, as planners worked hastily in the last quarter of 2012 to make use of the increased $5,120,000 gift exclusion that many believed would be unavailable in 2013 and beyond. The American Taxpayer Relief Act of 2012 made permanent the increased exclusion, as may be further adjusted for inflation (subject, of course, to any future changes to the tax laws). Therefore, for those clients who have not yet utilized their entire exclusion and have been reluctant to do so because of the risk of revaluation, *Wandry* may provide the added comfort those individuals need to move forward. Naturally, the drafter can use the language from *Wandry* as a guide, but there are additional factors that should be considered during implementation as well:

- The transferee should be a grantor trust, if possible, to avoid the need for corrective income tax returns if the formula transfer clause results in an adjustment on the books to the quantity of property transferred.
- The *Wandry* court was focused on the intent of the transferors, so the drafter should document well the intention to transfer a fixed value. For example, the drafter might prepare contemporaneous correspondence to the transferor to reaffirm the transferor's desire to transfer a predefined interest in the company worth a fixed dollar amount expressed as a formula that references that if a subsequent revaluation occurs, nothing will be returned to the transferor. (Rather, simple accounting entries would be made to reallocate the interests to reflect the actual transfer).
- The gift tax return should not reflect a gift of a specified interest in the hard-to-value asset, but should instead reflect a gift of an amount of that portion of the hard-to-value asset having a Fair Market Value of the fixed dollar amount, as finally determined for federal gift tax purposes. (This was a "bad fact" in the *Wandry* case that Judge Haines overlooked on the grounds that "petitioners' consistent intent and actions prove that dollar amounts of gifts were intended.")
- It may be advisable to obtain a contemporaneous written disclaimer by the transferee of any portion of the gift in excess of the value that the transferor intends to convey. The regulations have long recognized formula disclaimers, so any excess gift should be avoided, even if the formula transfer for some reason fails. (The planner will need to determine under applicable state law where any disclaimed assets will pass.)
- Significantly, the appraisal should be reasonable and from a reputable valuation company.

Of course, the value of *Wandry* should not be overstated. *Wandry* is a Tax Court memorandum opinion, which means the content is attributed only to the particular Tax Court Judge who wrote it, namely, Judge Haines. More importantly, the non-acquiescence may suggest that the IRS will vigorously challenge a formula transfer once, in its view, a winning case presents itself.

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