W H E R E T H E R E' S A W I L L

Part 1

Value definition clauses: The basics

By Dan W. Holbrook

Arecent tax court case, Knight v. Commissioner, 115 T.C. No. 36 (Nov. 30, 2000), sheds light on a relatively underutilized but highly promising estate planning technique.

Like irresistible forces encountering immovable objects, transfers of hard-to-value assets often collide with fixed dollar limits. Examples of hard-to-value assets are real estate, closely held stock, limited partnership interests, and artwork. Examples of dollar limits are the $10,000 annual gift tax exclusion, the $675,000 federal estate tax exemption equivalent, the $1,060,000 generation-skipping-tax (GST) exemption, and the $106,000 gift tax exclusion to a non-resident spouse.

One solution is to "define" the transfer in terms of the dollar value. A common example is the ubiquitous "marital deduction formula" clause in wills. It allocates the balance of the exemption equivalent at the time of death (currently $675,000) to a non-marital trust, and the rest of the estate to the spouse or marital trust. The irresistible force is the transfer of the entire estate at death, but the immovable object (the fixed dollar exemption) is met and conquered.

Now consider a lifetime gift. In Knight, the taxpayer first created a family limited partnership, then made gifts of limited partnership interests to trusts for children. The transfer document did not assign a specific number of partnership interests; rather, it assigned "that number of limited partnership units … which is equal in value … to … " $300,000 per trust.

Does this work? There is little authority, but what exists clearly says yes. In Technical Advice Memorandum 8611004, the IRS National Office was confronted with just such a situation. A decedent had made numerous transfers of limited partnership interests to trusts during his life, with each assignment document describing each gift as "such interest in the partnership as has a fair market value of … " [$3,000 or $10,000, whichever was the gift tax exclusion amount at the time of each gift]. After the gifts were made, the decedent and the trustees executed an agreement specifying the percentage interests allocable to the gifts based on the appraised fair market value of the limited partnership interests. The IRS upheld the taxpayer's valuation of the gifts. So in Knight, it should have been a slam-dunk. Wrong.

Mr. Knight made two mistakes. First, contrary to the transfer document, he reported the gift on his gift tax return as a "22.3 percent interest in the partnership." Second, also contrary to the transfer document, he reported the value of the transferred interest as only $263,165, instead of $300,000. The tax court held that such obvious disregard for the transfer document evidenced an intent to transfer 22.3 percent, rather than a defined value, and also held that if the taxpayer could value the gift at less than $300,000, the "door was open" for the IRS to establish a value higher than $300,000.

The broad lesson here is that regardless of the transfer document, the tax reporting must be consistent. Knight does not discourage the use of value definition clauses, although it would have been helpful if Mr. Knight's tax preparer had gotten it right, so that the case showed us how to do it rather than how not to do it. Perhaps the narrow lesson is that the tax attorney who creates the plan should also file the return.

Next column: Creative uses of value definition clauses to reduce almost all incentive for gift or estate tax audit.

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Tennessee Bar Journal
March 2001 - Vol. 37, No. 3

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