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

Part 2

Value definition clauses: Creative uses

By Dan W. Holbrook

Last month's column described how a value definition clause is an effective technique for integrating a transfer of a difficult-to-value asset with the dollar limitations imposed by gift tax exclusions, estate tax exemptions, etc. For example, a transfer document might assign to a trust whatever number of limited partnership interests have a fair market value of exactly $10,000, the annual gift tax exclusion. An appraisal would be necessary to determine the number of partnership units transferred, but if the IRS disagreed with the appraisal on audit, neither the value of the gift nor the amount of gift tax should be subject to increase.

A pending case, *McCord v. Commissioner,* Tax Court docket number 7048-00 (filed June 22, 2000), Tax Analysts document number 2000-18578, provides insight into an even more clever use of such a clause. Mr. and Mrs. McCord created a limited partnership and made one simultaneous gift of all of their limited partnership interests, spread among their sons, a trust, and two charities. The transfer document allocated the assigned partnership interests among the assignees as follows: (a) generation-skipping-tax (GST) exemption amount to a trust; (b) fixed dollar value to the sons outright; and (c) all the rest to charity. In other words, the transfer document specifically quantified the taxable gifts to trust and to sons, and any excess value transferred would qualify for a charitable deduction, no matter what the value of the total transfer was finally determined to be for federal gift tax purposes.

The IRS has challenged the valuation of the gifts and asserted additional gift tax. On what theory? We don't know for sure, since neither party has yet filed a brief.[1] But the attack will certainly be based on *Commissioner v. Procter,* 142 F.2d 824 (4th Cir. 1944), *cert. denied,* 323 U.S. 756 (1944). There, the taxpayer assigned a property interest to a trust for his children. The transfer document contained an unusual "savings clause," which provided that "in the event it should be determined by final judgment or order of a competent federal court … that any part of the transfer … is subject to gift tax, … the excess property hereby transferred which is decreed by such court to be subject to gift tax, shall automatically be deemed not to be included in the conveyance in trust …" The court held that this savings clause imposed a "condition subsequent" that violated public policy, and would not be enforced.

The transfer in *McCord* is not a condition subsequent, however; it is a condition precedent. The quantity of property transferred to trust or children is defined directly in the transfer document solely in terms of a specific dollar amount. What else, then, could the transferred amount be? The key distinction from *Procter* is that in *McCord* the grantors did not retain any reversion to themselves if the value were increased upon audit. Rather, they parted with the entire interest in the property transferred, and what remains uncertain, based on a final determination of value, is its allocation among two or more ultimate donees. In fact, if the asset transferred were determined to have a higher value, the grantors would qualify for an income tax refund on account of a larger income tax charitable deduction, which is exactly what the McCords' attorneys requested in their

Tax Court petition.

The opinion in *McCord* should be highly instructive, but this writer believes the law clearly favors the taxpayer.[2] An IRS victory in *McCord* would invalidate hundreds of thousands of marital deduction wills. After all, marital formula clauses involve a virtually identical type of value definition clause, allocating the applicable exclusion amount to a "credit shelter trust," and the residue to a tax-free marital share. *Procter* is a *value adjustment clause,* and void; *McCord* is a *value definition clause,* already widely used and approved in other contexts.

One objection by a taxpayer to using this technique might be that if the IRS successfully increases the value of the transferred assets on audit, then the effect could be to allocate a very large portion of the transfer to charity. One method of regaining control is for the family donees to purchase all the charity's interests, much like a quitclaim deed, provided there is no prearrangement and all parties are represented by independent counsel armed with independent appraisals. The charity is happy to receive cash, and the family is happy to merge all the interests, so that there is no longer any uncertainty as to the relative proportion of interests being held.

Obviously, the key to this technique is having any "excess" value pass to an "overflow entity" whose receipt of the asset incurs no additional gift tax. Other good candidates besides charity include: (1) spouse outright; (2) marital trust; (3) "zeroed-out" grantor retained annuity trust (GRAT); and (4) "zeroed-out" charitable lead annuity trust (CLAT). Or the latest wrinkle in the case of a lifetime gift is to pass the excess to a "lid" trust, where the donor has retained a limited power of appointment, the existence of which makes any gift incomplete and therefore non-taxable.

Keep your eye on *McCord.*

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1. As of March 1, 2001, the McCord case was docketed for hearing on May 7, 2001, in Tax Court in Houston, Texas, with briefs to follow that, and with an opinion not likely for many months after that.

2. For a more detailed analysis of value definition clauses, and why the social policy arguments in *Procter* should not apply in *McCord,* please e-mail the author at dholbrook@hpestatelaw.com for a copy of his paper presented at the UT Tax Conference on Oct. 26, 2000.

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