Value Definition Clauses

Taxpayer victory in *McCord* revives a super technique

By Dan W. Holbrook

My two-part columns in March and April of 2001 ("Valuation definition clauses: the basics" and "Creative uses") described the what, why, and how of a "value definition clause" (VDC).[1] I cited the *McCord*[2] case, then docketed in Tax Court, as an important test of VDC viability, and concluded with "Keep your eye on *McCord*." After five years, a Tax Court loss and Fifth Circuit reversal, we have a stunning taxpayer victory and revived opportunities to counsel clients on a great way to transfer hard-to-value assets.

Briefly, a VDC is useful when an irresistible force, namely an asset transfer (such as a gift of closely held stock), encounters an immovable object, namely a fixed exemption or exclusion (such as the annual gift tax exclusion, or the generation-skipping tax [GST] exemption). The most commonly known and widely accepted VDC, long approved by the IRS, is a formula estate tax marital deduction clause in a will, leaving an amount equal to the decedent's remaining estate tax exemption to a "credit shelter trust," with the residue outright to the surviving spouse. Such a formula defines the dollar amount of transfer to a trust as the exact amount that can pass tax-free using the federal exemption and then eliminates estate tax on the rest by qualifying it for the marital deduction. An occasional variation is to leave the excess to charity instead of to the spouse, but either way the IRS's incentive to audit is virtually nonexistent.

So why shouldn't such a formula work just as well with a lifetime gift as with a testamentary transfer? That's what *McCord* was about.

In *McCord*, a VDC allocated an inter vivos gift of all of the parents' limited partnership interests among several donees, as follows (slightly oversimplified): (a) GST exemption amount to a GST trust; (b) another fixed dollar amount to the donors' children outright; and (c) all the rest to charity. As with a marital deduction formula clause, the *McCord* formula should produce completely predictable gift tax consequences, because it transfers fixed dollar amounts to the GST trust and to the children, and any excess value would be nontaxable by passing to charity. If the IRS were to assert a higher value per unit of limited partnership interest, no additional gift tax would be required, but more partnership units should be allocable to charity. In *McCord*, however, two months after the

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transfers were made, the various assignees negotiated among themselves and reached an agreement as to how many limited partnership units each owned, foreclosing any future transfers among the donees based on any potential subsequent IRS revaluation. There was no evidence that the McCords participated in the later agreement, nor that there was any prearrangement.

The Tax Court majority held that the McCords were bound by the assignees' subsequent agreement as to how many limited partnership units each assignee received, but not as to how much each unit was worth, for which the Tax Court set its own higher value, creating more gift tax payable. Tax Court Judge Foley, who had actually tried the case, dissented dramatically, including this blistering of the majority:

> Undaunted by the facts, well-established legal precedent, and [IRS Commissioner's] failure to present sufficient evidence to establish his determinations, the majority [of the Tax Court] allow their olfaction to displace sound legal reasoning and adherence to the rule of law.

The Fifth Circuit Court of Appeals reversed the Tax Court completely, wholeheartedly quoting the above passage by Judge Foley. The "plain wording" of the original formula assignment was held to accomplish exactly what it purported to do, i.e., to define the value of each portion of the gift other than the balance to charity. More importantly, in accordance with long-standing precedent, post-gift acts of the donees were to be ignored.

Unfortunately, the Fifth Circuit did not directly rule on certain "public policy" arguments that the IRS had argued to the Tax Court, on which the Tax Court had not ruled, and which the Fifth Circuit held that the IRS had waived. But most commentators are satisfied that the Fifth Circuit, at least, would have dismissed such policy arguments and delivered the same taxpayer victory, based on the strong language in the opinion. Unlike the Tax Court, which seemed to have an inherent distaste for VDCs and referred sardonically to the "sophistication of the tax planning before us," the Fifth Court clearly did not view such planning as inherently abusive nor as failing the "smell" test.

So where are we now?

1. Plan to use VDCs. They are terrific devices useful in many client situations. See my prior columns for some examples.

2. Trust *McCord*. It is an obvious application of well-established law. The IRS is unlikely to appeal or request reconsideration. Although Tennessee is in the Sixth Circuit, there is ample reason to believe *McCord* will be persuasive elsewhere, since it cited and relied on cases from other circuits.

3. Stick to *McCord* as closely as possible. Bad facts may make *McCord* easily distinguishable. Make a complete transfer of assets, so that any IRS success in challenging values does not cause any reversion of assets to the donor, only a potential reallocation among the donees. Use high quality appraisers. Be sure there is no prearrangement with any of the donees, especially any donee to whom a gift causes no gift tax, such as a charity or spouse. Be sure all donees are independent if they are likely to negotiate a post-gift arms-length agreement, preferably with independent legal counsel and separate appraisals.

4. Consider VDCs in analogous situations creatively but cautiously. For example, make taxable gifts under a VDC to "grantor trusts" for income tax purposes, so that any subsequent reallocation of assets among donees has no income tax consequence. Or make the entire gift by a VDC to a single trust containing subtrusts, alleviating any possible mechanical difficulties of re-registering assets if revised gift tax values require reallocation of assets among the donees. Or sell assets to children for a fixed value, using a VDC to transfer any excess value to charity or spouse.

5. On the negative side, expect IRS to drag out its "public policy" arguments to contest *McCord*-type VDC's. Taxpayers would have been better served by the Fifth Circuit had it gone ahead and addressed those arguments. Despite the strong language in *McCord*, therefore, IRS will likely view those arguments as their primary remaining weapon in a gift tax audit. There are strong defenses against a public policy challenge, but for now use of a VDC still carries some risk of making your client another test case.

6. Stay tuned for further developments. In *Morfeld*,[3] pending in Tax Court, the testator left limited partnership interests under his will to his children, and provided that any amount disclaimed by a child would pass to charity. With a post mortem VDC, the children retained a fixed dollar amount and disclaimed the excess to charity. The IRS has reprised its public policy arguments and asserted that the VDC disclaimer should not be recognized. Will the Tax Court, chidden by the Fifth Circuit, even address the policy issues? Keep your eye on *Morfeld*.

Notes

1. A value definition clause (VDC) might also be known as a defined value clause, marital or charitable formula clause, marital or charitable allocation clause, or zeroed-out excess gift clause. Perhaps we might call it an AFC (audit frustration clause).

2. *McCord v. Comm.*, __ F.3rd __ No. 03-60700 (5th Cir. August 22, 2006), revg. 120 T.C. No. 358 (2003).

3. *Estate of Morfeld*, Tax Court docket #012750-03.