

# Managing Gift Tax: The Magic Wand(ry)

Few cases become standard references in gift tax planning: *Crummey, Cristofani, Hackl*.[1] Add another to our short list: *Wandry*,[2] a case many of us dared hope for, one that a reviewer said "may be the 'Blockbuster Case of the Year.'"[3] It provides a simple yet revolutionary way to limit gift tax exposure, and I predict that the language of the assignment document in *Wandry* will become the verbatim model for many future gifts.

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## The Problem

The best assets to give away for estate planning purposes are often not easily valued, such as partial interests in a family enterprise or real estate.[4] Without certainty of valuation, however, the IRS might audit and claim a higher value, causing the taxpayer to incur additional gift tax at worst or to use up additional gift tax exemption at best.

On a small scale, the $13,000[5] annual federal gift tax exclusion remains a formidable barrier to making any significant gifts. A gift valued at even one dollar more than the exclusion amount requires filing a federal gift tax return — a nuisance and expense.[6]

On a big scale, the $5,120,000[7] federal unified gift and estate tax exemption in 2012, scheduled to drop to $1 million in 2013 and beyond, encourages really big gifts this calendar year. A valuation fight with the IRS on such a gift could be disastrous.

At any scale, clients want certainty in gift tax planning[8] since it can affect death tax planning.[9]

## The Simple (But Previously Unavailable) Solution

What we need is a way to specify the exact dollar amount to be given, such as exactly $13,000 of stock or $5,120,000 of LLC interests, even if the precise value of the gifted assets is somewhat uncertain at the time of the gift. This is analogous to buying $10 worth of gasoline rather than a specified number of gallons. Such a transfer of a fixed dollar amount worth of shares or LLC units to one donee is known as a "formula transfer clause." Any value in excess of the stated dollar amount is intended to remain with — or revert to — the donor.

Unfortunately, prior case law, especially *Procter v. Commissioner*,[10] suggests that a formula transfer clause cannot succeed. The court in *Procter* held that the formula created a "condition subsequent" whereby any increase in valuation became a contingent reversion to the donor. In effect, said the court in *Procter*, the donor "took property back" if an IRS audit produced a higher gift value. Thus, a formula transfer clause gives the IRS no incentive to audit, frustrates the collection of tax, and is void as a matter of public policy.

## The Wandry Case

Mr. and Mrs. Wandry owned interests in a closely held LLC and wanted to make gifts to their descendants. In 2004, the annual gift tax exclusion was $11,000, and each spouse's lifetime federal gift tax exemption was $1 million. Simplifying the facts somewhat, each spouse executed an assignment to their child of LLC units worth exactly $1,011,000. The document of assignment read substantially as follows:

> I hereby assign and transfer to my Child as a gift, effective as of January 1, 2004, a sufficient number of my Units as a Member of Wandry Family LLC so that the fair market value of such Units for federal gift tax purposes is exactly $1,011,000.
>
> Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service (IRS). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if, after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, 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 taxpayers obtained an appraisal of the LLC Units, filed federal gift tax returns showing the total dollar amounts of gifts, and listed the donee as having received the number of LLC Units corresponding with the appraisal. On audit, the IRS and the taxpayers agreed on a higher value for each LLC Unit. But rather than changing the number of LLC units received by the donee to reflect the changed value, the IRS assessed gift taxes based on the number of Units shown on the gift tax returns. The taxpayers appealed to Tax Court.

Predictably, the IRS argued that the formula transfer clause was void as against public policy, citing *Procter*.

There is little doubt that a decade ago the Tax Court would have upheld the IRS's position. However, the law of formula clauses has evolved. Basically, a formula transfer clause, as in *Wandry*, gives a defined dollar amount to one donee. A parallel approach is a formula allocation clause, as in *Petter v. Commissioner*,[11] in which the donor gave 940 LLC units to a family trust and to a charity, with the trust to receive whatever number of units equaled the gift tax exemption and the charity to receive the balance of LLC units. Because any "excess" value passed to a charity, the court in *Petter* held that no matter what value the IRS might assign to the transferred LLC units, the donor's gift tax charitable deduction for the excess precluded any further gift tax liability.

*Petter* is only one of several recent taxpayer victories upholding formula allocation clauses, and this author has enthusiastically welcomed the trend.[12] But such taxpayer victories have all involved two donees, one being an independent charity, creating complexity. The question has been whether this line of cases could pave the way for recognition of a far simpler, single-donee formula transfer clause.

*Wandry* answers with an emphatic yes. Said the court: "In *Estate of Petter* we examined *Procter* and other relevant cases to draw a distinction between a 'savings clause,' which a taxpayer may not use to avoid the tax imposed by section 2501, and a 'formula clause,' which is valid. A savings clause is void because it creates a donor that tries 'to take property back.' On the other hand, a 'formula clause' is valid because it merely transfers a 'fixed set of rights with uncertain value.'" The court found that the formula in *Wandry* was more like *Petter* than *Procter*, in that the donors were transferring an "ascertainable dollar value" of the business interest, and not "a specific number of shares or a specific percentage interest." Said the court: "In other words, the clauses at issue were valid formula clauses because the 'ascertainable dollar value of stock' transferred was a fixed set of rights even though the units themselves had an unknown value."

The court rejected the notion that the formula clause operated to "take property back" based upon a condition subsequent, which *Procter* would prohibit. Said the court: "The gift documents do not allow for petitioners to 'take property back.' Rather, the gift documents correct the allocation of [LLC] membership units among petitioners and the donees because the [appraiser] understated [LLC unit] value. The clauses at issue are valid formula clauses." The court added that "… there is no well-established public policy against formula clauses. The commissioner's role is to enforce tax laws, not merely to maximize tax receipts."

Finally, the court held that *Procter* did not apply even though *Wandry* had no charitable donee for the excess value, as in all the cases upholding formula allocation clauses. Even though all the donees in *Wandry* were family members, the court held that they still had competing interests, which would ensure that each family member was entitled to a fair share of profits, etc.

## Can We Rely on Wandry?

*Wandry* opens up a whole new door for creative planning. With the exception of *Procter* itself, which was a federal Fourth Circuit case, all rulings disapproving of formula transfer clauses were either Tax Court cases or IRS pronouncements.[13] In finding for the taxpayer in *Wandry,* the Tax Court virtually eliminated every prior adverse case, in effect confining the Tax Court's prior adverse precedents to their specific bad facts.

So at least in the Tax Court, which is the court of first resort for most taxpayers, *Wandry* is the precedent and *Procter* is dead. A successful appeal of *Wandry* appears unlikely.[14] Unless and until a contrary case is successfully

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appealed in another federal circuit, *Wandry* seems to be the law of the land.

In a shift of paradigm, practitioners might now consider either a formula transfer clause or a formula allocation clause as the first option, not the bold exception, for a gift of assets with uncertain fair market value.

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Holbrook's column, "Where There's A Will," has appeared regularly in the *Journal* since January 2001, but this is his last. The Editorial Board, readers and staff appreciate greatly his insightful contributions. Look for feature articles from him in the future and for this column to be authored by Knoxville lawyer Eddy R. Smith, beginning later this year.

## Notes

1. *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968), holding that a gift to a trust (which would normally be a future interest) would be treated as a present interest (and therefore qualify for the annual gift tax exclusion) if the beneficiary is given a limited time to withdraw the gift from the trust; *Estate of Cristofani v. Commissioner*, 97 T.C. 74 (1991), upholding *Crummey* powers given to persons holding only contingent remainder interests in the trust; *Hackl v. Commissioner*, 118 T.C. 279 (2002), aff'd 335 F.3d 664 (7th Cir. 2003), holding that an outright gift of LLC units was a future interest when the LLC distributed little or no income, the chief manager had no fiduciary duty to make distributions, and members had limited ability to sell their units or to withdraw. For a review of *Hackl*, see my column of August 2002.

2. *Wandry v. Commissioner,* T.C. Memo 2012-88 (March 26, 2012).

3. Steve R. Akers, "*Wandry v. Commissioner*: Defined Value Gifts of Specific Dollar Amounts Worth of LLC Units to Children and Grandchildren Respected and Do Not Violate Public Policy," a publication of Bessemer Trust Company. See www.bessemertrust.com, log in to free advisor site, search "wandry."

4. The value of a partial interest in an entity such as a family limited partnership (FLP) or limited liability company (LLC) is often different from its proportion of the value of the underlying assets. In fact, because of its minority position and potential lack of marketability, such value is usually less, which is often referred to as a "discount" in value from the value of the whole enterprise.

5. Of course, spouses can consent to "split gifts" so that one spouse's gift can use both spouses' gift tax exclusions, allowing $26,000 from one spouse to one donee to be excluded. But that still requires filing gift tax returns.

6. At least Tennessee no longer has a gift tax. On May 21, 2012, Gov. Haslam signed SB2777, repealing the Tennessee gift tax in its entirety, effective retroactively to Jan. 1, 2012.

7. The federal applicable exclusion amount (AEA) is $5,120,000 per decedent in 2012 (after indexing for inflation), with a 35 percent top tax rate. In addition, for decedents who die in 2011 or 2012, the AEA is "portable" to the surviving spouse if certain conditions are met, effectively doubling the AEA automatically for most couples. Although the AEA is scheduled to drop to $1 million per decedent in 2013, with a 55 percent top tax rate, and without "portability," most commentators assume that Congress will ultimately extend something similar to 2012 law into 2013 and beyond, but there are no certainties about Congress except its uncertainty.

8. In addition to the gift tax exclusion and the federal exemption, the generation-skipping tax (GST) exemption is often a precise target or limit for taxpayer gifts.

9. On May 21, 2012, Gov. Haslam signed HB 3760, phasing out the Tennessee inheritance tax over four years, by increasing the current $1 million exemption per decedent to $1,250,000 in 2013, $2 million in 2014, $5 million in 2015, and complete repeal beginning in 2016.

10. *Procter v. Commissioner*, 142 F.2d 824 (4th Cir. 1944).

11. *Petter v. Commissioner*, T.C. Memo. 2009-280, aff'd 653 F.3d 1012 (9th Cir. 2011).

12. Formula transfer clauses and formula allocation clauses are the two types of a broader category known as "defined value clauses" or "value definition clauses." See my columns of March 2001, April 2001, December 2006, April 2008 and March 2010.

13. Revenue Ruling 86-41, 1986-1 C.B. 300; Technical Advice Memorandum 9309001; Private Letter Ruling 200245033.

14. The final decision in *Wandry* was entered on June 6, 2012, so the 90-day deadline by which the commissioner can appeal to the Tenth Circuit Court of Appeals is Sept. 4, 2012, after the publication of this column. In an alignment of stars for taxpayers, the only prior case upholding what amounted to a formula transfer clause was also in the Tenth Circuit. *King v U.S.*, 545 F.2d 700 (10th Cir. 1976). Since the commissioner's prospects for success on appeal are questionable, the commissioner may well elect not to appeal.

So at least in the Tax Court ... *Wandry* is the precedent and *Procter* is dead. A successful appeal of Wandry appears unlikely [therefore it] seems to be the law of the land.

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