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ABA SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW

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Articles

Estate of Korby v. Commissioner—Eighth Circuit Court of Appeals Upholds Including Partnership Assets Under §2036

*By **Steve R. Akers***

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(1) Basic Facts. Estate of Edna Korby v. Comm'r, T.C. Memo. 2005-102 and Estate of Austin Korby v. Comm'r, T.C. Memo. 2005-103 (May 10, 2005) are related cases (with substantially similar opinions) involving the estates of the wife (who died in July 1998) and the husband (who died several months later in December 1998). The Eighth Circuit Court of Appeals has affirmed the Tax Court's application of §2036. Cause Nos. 06-1201 and 06-1203, (8 th Cir. December 8, 2006).

Husband and wife funded an FLP with marketable securities worth about $1,850,000 in return for a 98% limited partnership interest, which they gave equally to irrevocable trusts for their four sons (24.5% to the trust for each son). These assets represented almost all of their assets, other than their residence and their right to receive social security checks (and a few other assets) which they retained in a living trust. Soon afterward, the FLP purchased an annuity, showing the FLP as the owner, but entitling the husband to receive annuity payments (and the sons as irrevocable beneficiaries if husband died during the payout period.) The FLP made substantial distributions to

the living trust, which it used in turn to pay “many of the Korbys’ household expenses.” The expenses paid by the living trust and the FLP directly included payments to a nursing home, medical care providers, drug stores, utility and heating bills, property taxes, and insurance payments for the residence. The estate later claimed that these payments to the living trust (ranging from roughly $19,000 to $39,000; and ranging from 27% to 50% of the FLP income) were for management fees rather than distributions, although the Korbys did not report any self employment income for the first three years of the FLP and although the distributions were not based on a percentage of assets under management as is normal for determining management fees.

(2) Tax Court Basic Holding. The Tax Court (Judge Goeke), in both related cases, held that §2036(a)(1) applies because of an implied agreement that the partnership income would be available to the Korbys, and held that the bona fide sale for full consideration exception to §2036 does not apply.

(3) Eighth Circuit Basic Holding. The Eighth Circuit affirmed the Tax Court in an opinion filed on December 8, 2006. The court upheld under a “clearly erroneous” standard the factual findings of an implied agreement and of the lack of a bona fide sale.

(4) Retained Interest. The Tax Court concluded that there was an implied agreement between husband (on his own behalf and on behalf of his wife) with the four sons that the income from the assets would continue to be available to the parents as long as they needed income. Despite their increasing expenses, which were not covered by their social security income, the spouses retained only the residence and relatively few other assets. The FLP paid some of the living expenses directly and made significant payments to the living trust, which paid the balance of the living expenses. The court did not believe that the payments to the living trust were management fees. The court cited various reasons, including that the payments were used only for husband and wife, and not for the other co-trustee (one of their sons).

The Eighth Circuit affirmed this factual finding, pointing out that substantial distributions had been made to the Korbys and that the distributions could not be justified as management fees. The court pointed out that “the Korbys retained less than $10,000 in assets in the living trust (their only source of income) following the funding of KPLP—despite the fact both of the Korbys were in poor health and could expect to incur living expenses beyond amounts their Social Security benefits would cover.” The Eighth Circuit went on to cite cases from the First (Abraham), Third (Thompson) and Fifth (Strangi) Circuits that also upheld Tax Court findings on this issue under a clearly erroneous standard.

(5) Bona Fide Sale Exception Not Satisfied. The Tax Court held that there was no legitimate and significant nontax reason for creating the FLP, so the bona fide sale for full consideration exception to § 2036 did not apply. Factors emphasized by the court include: (1) Taxpayer “standing on both sides of the transaction” and no involvement of decedent’s sons in creation of the partnerships; (2) Financial dependence on distributions; and (3) Creditor planning was not a significant factor.

The Eighth Circuit viewed the Tax Court's ruling on the bona fide sale exception as a factual finding that the circuit court reviewed under a clearly erroneous standard. [Observation: It would seem that this is a mixed question of law and fact—a question of law as to what standard applies for determining if a bona fide sale exists.] The circuit court mentioned in particular two legal standards to determine if a bona fide sale exists. (1) "A transfer is typically not considered a bona fide sale when the taxpayer stands on both sides of the transaction." (The court went on to explain that the husband with the help of his estate planning lawyer made all decisions about creating and funding the partnership without negotiation or input from limited partners.) (2) "The transaction must 'be made in good faith' which requires an examination as to whether there was 'some potential for benefit other than the potential estate tax advantages that might result from holding assets in the partnership form.' Thompson, 382 F.3d at 383." The court also quoted the "**no discernable purpose or benefit**" standard in Thompson and cited Strangi and noted in a parenthetical in that citation its "substantial business [or] other non-tax purpose" standard. The court found no clear error in the Tax Court's finding that the partnership was not created for creditor protection but that it was formed to make a testamentary transfer of assets to their sons at a discounted value.

The two standards mentioned by the Eighth Circuit are interesting. On the one hand, the first standard (standing on both sides of the transaction, no negotiation) is a throw back to the "arms length" standard originally used by the Tax Court but that was rejected in subsequent circuit court of appeals cases. Other cases have mentioned this as an element of discerning whether a "bona fide sale" exists (e.g., Rosen), but the Eighth Circuit only mentioned two elements, and this was one of them. In that respect, if having an arms length transaction with other parties is necessary to be a bona fide sale, this is more restrictive than any other circuit level case. On the other hand, the "discernable purpose or benefit" standard seems to be an easier standard to satisfy than the "legitimate and significant non-tax reason" standard announced in Bongard or the "substantial business [or] non-tax purpose" standard announced in Strangi (although the court did quote that standard in a parenthetical to a citation to Strangi). The court did not suggest in applying the standard to the facts that it is a more relaxed standard than used in other cases, but just from a linguistic standpoint, finding a "discernable" purpose seems much less stringent than finding a "legitimate and significant" purpose.

Because there was no bona fide sale, the Eighth Circuit did not have to address what standard is required to meet the "full consideration" requirement, which is the second leg of the "bona fide sale for full consideration" exception to §2036.

(6) Retained Interest Despite Transfers of Limited Partnership Interests. Section 2036(a)(1) should not apply at all with respect to a transferred limited partnership interest (even if the bona fide sale for full consideration exception does not apply) if there are no indications that the decedent has retained (even by implied agreement) the right to enjoy the transferred limited partnership interest or the FLP assets attributable to that interest. (However, if the decedent died within three years of relinquishing a retained right, §2035 would cause §2036 to apply.) The court did not state in the facts when the limited partnership interests were given to the sons in 1995. Even though the gifts may have been made more than three years before death (the Korbys died in July and December, respectively, of 1998), that apparently was irrelevant because the court

found the existence of an implied agreement to retain enjoyment of all of the income of the partnership even after the limited partnership interests had been given away. (A similar result occurred in Rosen, T.C. Memo 2006-115.)

(7) Marital Deduction Mismatch. If §2036 applies, at the first spouse's death there may be assets in the gross estate that do not qualify for the marital deduction because the partnership assets would be included without a discount, but the first decedent spouse does not own those assets to leave to the surviving spouse. In Bongard, the Tax Court raised that the possibility that the discounted limited partnership interests may not completely offset inclusion of the partnership assets under §2036. (A footnote in Bongard suggests that a marital deduction "may" be allowed for the full value of underlying assets, not just the limited partnership interest itself: "We note that decedent's estate may be entitled to a deduction under sec. 2056 for his inter vivos gift of [the LLC] *class B membership units* to Cynthia Bongard that was pulled back unto his gross estate under sec. 2035(a)." (Footnote 13, emphasis added). In Korby, the wife did not own any limited partnership interests to leave to her surviving husband, because all of the limited partnership interests had been given away before her death. The parties stipulated that if only 32% of the partnership assets were included in the wife's estate, the marital deduction would not offset those assets in her estate.

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McCord v. Commissioner: Fifth Circuit Upholds Defined Value Gift

By Steve Akers

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McCord v. Commissioner: Fifth Circuit Upholds Defined Value Gift and Allows Offsetting Gift Value by Contingent Assumed Liability for Estate Tax if Donor Dies Within Three Years

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I. Facts.

1. Creation of Partnership. Mr. and Mrs. McCord created a family limited partnership with the bulk of their assets on June 30, 1995. A partnership formed by their children also contributed substantial assets to the partnership. The partnership was restated in October 1995, among other things, to give the partnership a call right over any Class B limited partnership interest given to a charitable organization, if the charity was not admitted as a limited partner.

2. Assignment Under Defined Value Clause. On January 12, 1996, parents assigned their Class B limited partnership interests by a formula clause, very simply summarized by the Fifth Circuit as follows:

"We have observed that these gifts divested the Taxpayers of their entire interest in MIL then remaining. It did so, however, *not* in *percentages* of interest in MIL, however, but in *dollar amounts* of the net fair market value of MIL, according to a *sequentially* structured "defined value clause":

Donee	**Gift**
First, to the Generation Skipping Tax Trusts ("GST trusts")	A dollar amount of fair market value in interest of MIL equal to the dollar amount of Taxpayers' net remaining generation skipping tax exemption, *reduced by* the dollar value of any transfer tax obligation owed by these trusts by virtue of their assumption thereof.
Second, to the Sons	$6,910,932.52 worth of fair market value in interest of MIL, *reduced by* the dollar value of (1) the interests in MIL given to the GST trusts, and (2) any transfer tax obligation owed by the Sons by virtue of their assumption thereof.
Third, to the Symphony	$134,000.00 worth of such in interest of MIL.
Last, to CFT	The dollar amount of the interests of the Taxpayers in MIL, *if any* , that remained after satisfying the gifts to the GST trusts, the Sons, and the Symphony."

The assignment agreement contains the following instruction concerning valuation: "For purposes of this paragraph, the fair market value of the Assigned Partnership Interest as of the date of this Assignment Agreement shall be the price at which the Assigned Partnership Interest would change hands as of the date of this Assignment Agreement between a hypothetical willing buyer and a hypothetical willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. Any dispute with respect to the allocation of the Assigned Partnership Interests as among Assignees shall be resolved by arbitration as provided in the Partnership Agreement."

3. Assignment Conditioned on Donee Paying Transfer Taxes, Including §2035(b) Estate Tax. As a condition to the gift, the McCords required their sons and the donee trusts (the "non-charity donees") to proportionately pay any federal or state transfer taxes imposed as a result of the gifts. These taxes expressly included gift taxes, estate taxes, generation-skipping transfer taxes, and any state taxes based on those federal taxes. In addition, if either of the McCords were to die within three years of making the gifts, the gift tax paid would be included in his or her gross estates under §2035(b), and the non-charity donees would be obligated to pay the resulting federal estate tax.

4. Confirmation Agreement Among Donees. About two months after the assignment (in March 1996), the various assignees agreed (in a "Confirmation Agreement") to specific percentage amounts that would pass to the various assignees. The charities (and their outside counsel) reviewed an appraisal report that had been prepared by Howard Frazier Barker Elliott, Inc. (the "Frazier appraisal") after the gifts were made. The Frazier appraisal concluded that a 1% assignee interest was worth $89,505. The charities

determined that it was not necessary for them to obtain their own appraisals. The donees agreed on the percentages passing to the various donees, using a value of $89,505 per 1% interest.

5. Exercise of Call Right to Acquire Charities' Interests. About three months later (in June 1996), the partnership exercised its call right to acquire the charitable interests. The appraiser updated his appraisal. The partnership and the charities reviewed it and agreed to accept its $93,540 value of a 1% interest. (The Fifth Circuit concluded that the donors had nothing to do with the exercise of the call rights or the redemption prices.)

6. Gift Tax Returns. Gift tax returns were filed, calculating the taxable gifts for the gifts to the non-charitable donees as $89,505 per 1% interest, less the gift tax and actuarially determined contingent estate tax liability under §2035(b).

7. Notice of Deficiency. The IRS Notice of Deficiency claimed that the gifts should have been calculated based on $171,749 per 1% interest (almost double the donors' $89,505 figure).

8. Trial. At trial, the donors continued to take the position that the gifts should be determined based on a value of $89,505 per 1% interest. The IRS trial expert (Dr. Bajaj) used a value of $150,665 per 1% interest. The parties agreed that the Commissioner had the burden of proof, and Judge Foley determined that the Commissioner had failed to meet his burden of proof, which would result in a total taxpayer victory. However, the Fifth Circuit summarized that the Acting Chief Judge of the Tax Court "issued an unusual order that resulted in a proceeding that resembles an en banc rehearing. In essence, the case was taken away from Judge Foley retroactively and reassigned to Judge James S. Halpern who, on the same day, filed an opinion on behalf of the Majority."

II. Tax Court Opinion, 120 T.C. 358 (2003)

The Tax Court opinion did the following:

1. Assignee Interests Recognized. The court recognized that assignee interests, rather than full-fledged partnership interests, were transferred and the gift values should be determined accordingly.

2. Discounts. Minority discounts were assigned for each of the five categories of interests. The minority discounts were 10% (for equities and bonds), 23.3% for real estate partnerships, 40% for directly owned real estate, and 33.5% for oil and gas. The weighted minority interest discount was 15%. A marketability discount of 20% was allowed (in large part based on the IRS's expert's private placement study.) The overall discount was 32%, after applying seriatim the 15% minority discount, and a 20% discount on the remaining value.

The Fifth Circuit used a calculator and rather pointedly observed that the Tax Court's value of a 1% interest was almost exactly halfway between the values urged by the taxpayers and the Commissioner: "Thus the Majority split this almost $10 million baby precisely halfway between the experts' respective values."

3. Defined Value Clause Not Recognized Because of Interpretation of Clause. In light of the defined value clause, gift value to the non-charitable donees should have been a fixed dollar value, regardless of what percentage interests were determined to pass in implementing that clause. The court did not decide whether this type of "defined value clause" would be disregarded on public policy grounds. Instead, the court held that the specific clause was not "self-effectuating" because the formula was based on the "fair market value" of the transferred interest, rather than being based on the "fair market value as finally determined for Federal gift tax purposes." The Court, in effect, ignored the Defined Value Clause, and gave effect to the percentages recognized by the parties in the Confirmation Agreement—despite the fact that the percentages agreed to in the Confirmation Agreement were based on appraised values that were far different than the finally determined gift tax values. The agreed percentages passing to the children and the GST trusts times the value of a 1% interest as determined by the court resulted in substantial additional gift and GST taxes. Curiously, the court allowed a full charitable deduction for the percentages that passed to the charities, even though the charities had cashed in their interests for far less than the values determined by the Tax Court.

Under the court's reasoning, the parties to the assignment documents were supposed to determine what interests passed to the various parties "based on the assignees' best estimation" of the value, and the Court gave effect to the percentage interests agreed to by the parties. The Court specifically said that if the parties had provided "that each donee had an enforceable right to a fraction of the gifted interst determined with reference to the fair market value of the gifted interest as finally determined for Federal gift tax purposes," the Court "might have reached a different result."

Interestingly, a dissent by Judge Chiechi points out that the formula clause was based on "fair market value" as defined in the Agreement, and the majority opinion acknowledged that the definition of "fair market value" in the Agreement is the same definition of that term as applies for Federal gift tax purposes. She points out that in essence, "the majority opinion concludes that the donees of the gifted interest made a mistake in determining the fair market value of that interest and that petitioners are stuck with that mistaken value solely for purposes of determining the respective assignee percentage interests transferred to the donees under that agreement."

Another dissent by Judge Foley points out that the IRS never made the "interpretation argument"—the court came up with that theory on its own. The Foley dissent (which was agreed to by Judge Chiechi) also concluded that the clause did not violate public policy and is distinguished from the Procter case because no assets were to be returned to the donor based on the results of the gift tax determination. Judge Foley, who was the trial judge, obviously was most displeased that the majority of the full Tax Court did not agree with his conclusions. His dissent opens with this volley: "Undaunted by the facts, well-established legal precedent, and respondent's failure to present sufficient evidence to establish his determinations, the majority allow their olfaction to displace sound legal reasoning and adherence to the rule of law."

4. Net Gift Calculation Could Not Consider Liability For Additional Estate Tax. The gift was valued by the taxpayers as a net gift, with an offset for federal and state gift taxes and for the present value of the contingent liability for additional estate taxes attributable to the gift (if the donor died within 3 years of making the gift) that the donees had agreed to pay However, the court refused to consider the donees' agreement to pay any estate tax liability that would arise if the donor died within 3 years of making the gift as an offset in determining the net gift. The primary reason for refusing to consider the possible estate tax liability is that it is too speculative and the taxpayers failed to show that their computation of that potential liability was reliable.

5. Summary. The Fifth Circuit quoted the concise summary of the Tax Court's holdings in the taxpayer's brief:

"[t]he Majority held that (1) the interests transferred [by the Assignment Agreement of January 12, 1996] were assignee interests in [MIL]; (2) the Majority was not required to follow the terms of the assignment agreement in determining the fair market value of the interests of the partnership transferred by [the Taxpayers]; (3) the fair market value of the total interests transferred was $9,888,832, or $120,046 per 1% interest; (4) the value of the interests transferred should be based on the value determined by the Majority on a per unit basis times the *percentage interests determined by the donees* in a Confirmation Agreement reached by the donees *two months after the gifts* were made; and (5) the value of the [non-exempt] donees' contractual obligation to pay estate tax liability [under § 2035] could not be deducted in determining the value off [the Taxpayers'] gift."

III. Fifth Circuit Opinion Holdings

Oral argument to the Fifth Circuit Court of Appeals was in May 2004. For some unknown reason, the three judge panel took almost 27 months to issue this unanimous opinion. (In light of the long delay, many had theorized that there must be a huge difference of opinion among the judges, which would suggest that there would have been a dissent. That was not the case.) The opinion was originally issued on August 22, 2006, and a revised opinion was released on September 15, 2006. The revised opinion apparently just makes formatting changes.

1. The case involved, at most, a mixed question of law and fact, and because it turns on a legal conclusion, the court reviews the case de novo.

2. The IRS had the burden of proof, and the IRS did not meet its burden of proof to rebut values used by the taxpayers. The values of the transferred interests, for purposes of calculating gift and GST taxes, are the values used by the taxpayers (i.e., $89,505 for a 1% interest). The Tax Court erred in using the Confirmation Agreement to convert dollar gifts into percentage gifts. Post-gift acts of donees cannot change the value transferred on the date of the gift. The Tax Court should have applied the defined value clause under its plain wording (although the Fifth Circuit stated that the Commissioner chose not to argue the public policy issue and the court did not explicitly consider that issue).

3. The contingent estate tax liability under §2035 that is assumed by the non-charitable donees if either donor died within three years of the gift is not so speculative that it cannot be considered in determining the net value of the gifts.

IV. Fifth Circuit Analysis

1. Standard of Review. Conclusions of law, conclusions of fact (such as valuation) that require legal conclusions, and the determination of the nature of property rights are all reviewed de novo. The appellate court draws its own conclusion in place of those of the trial court. The determination of whether the defined value gifts are given effect and the nature of the property afforded by those gifts are law conclusions reviewed under a de novo standard. (If the court had determined that the defined value clause in the assignment should be ignored and the interests to be valued are the percentage interests agreed to by the donees in the Confirmation Agreement, the Tax Court's factual valuation findings would have been reviewed under a clear error standard. But that was not the case.)

2. Burden of Proof. The parties had stipulated that the Commissioner had the burden of proof.

3. Commissioner's Theory on Appeal. The Commissioner did not argue in the body of its brief what many believed to be its strongest arguments in fighting the defined value clause (substance over form, public policy, etc.). However, it did note those arguments (citing the Procter, Ward, Gregory, and Court Holding cases) in footnote 18 of its brief, and requested the Fifth Circuit to remand the case to the Tax Court if the court determined not to accept the Tax Court's "interpretation argument" that refused to apply the defined value clause. The Fifth Circuit's position is that the Commissioner waived those arguments, and the Fifth Circuit did not consider them. The Commissioner just sought to uphold the various steps of the Tax Court majority, as summarized in Item 5 above regarding the Tax Court opinion. Similarly, the Commissioner did not include in its brief the argument that the transferred interests should be valued as full limited partnership interest rather than assignee interests. (The Fifth Circuit specifically noted that its failure to address this issue should not be viewed as either agreeing or disagreeing with the treatment of the transferred interest as an assignee interest. Rather, the Fifth Circuit concluded that it did not need to reach that issue under its conclusion that the defined value clause should be respected.)

4. Defined Value Assignment Should be Respected. The Fifth Circuit spotted this as the key issue in the case: "[T]he feature that most fractionated the Tax Court here is the Taxpayers' use of the dollar-formula, or "defined value," clause specified in the Assignment Agreement … to quantify the gifts to the various donees in *dollars* rather than in *percentages*…"

a. Fair market value must be determined on date of gift. The Fifth Circuit emphasized that values must be determined on the date of the gift. The court observed that the Commissioner's value in the Deficiency Notice was significantly more than the values used by the IRS's valuation expert at trial. The taxpayers provided evidentiary underpinning of their proffered values (through the Frazier appraisal).

Judge Foley would have rendered judgment for the taxpayers based on the Commissioner's failure to meet his burden of proof. The Tax Court Majority independently appraised the donated property (reaching a value "precisely halfway between those of Mr. Frazier and Dr. Bajaj). The Majority's methodology is grounded in significant part on the donees' post-gift Confirmation Agreement. That constitutes legal error."

b. Reallocating values of gifts based on post-gift acts of donees is improper. The Tax Court Majority made its own determination of the value of a 1% interest, and allowed a gift tax charitable deduction for the percentage interests that passed to the charities under the Confirmation Agreement times the court's determined value of a 1% interest. The total value of the transferred interests, less such charitable deduction, was the amount of taxable gifts to non-charitable beneficiaries (less annual exclusions and the offset for gift taxes assumed by the donees). Judge Chiechi's dissent pointed out that in essence, "the majority opinion concludes that the donees of the gifted interest made a mistake in determining the fair market value of that interest and that petitioners are stuck with that mistaken value solely for purposes of determining the respective assignee percentage interests transferred to the donees under that agreement." The taxpayer's brief to the Fifth Circuit very simply summarized its objection to this approach by noting that "if the donees made a mistake in allocating the interests on a percentage basis, such error cannot result in a gift being made by Mr. or Mrs. McCord, who were not even parties to the Confirmation Agreement." Brief of Appellants n.8.

The Fifth Circuit summarized that "the Majority in essence suspended the valuation date of the property that the Taxpayers donated in January until the date in March on which the disparate donees acted, *post hoc*, to agree among themselves on the Class B limited partnership *percentages* that each would accept as equivalents of the *dollar values* irrevocably and unconditionally given by the Taxpayers months earlier." The "core flaw in the Majority's inventive methodology was its violation of the long-prohibited practice of relying on post-gift events. Specifically, the Majority used the after-the-fact Confirmation Agreement to mutate the Assignment Agreement's dollar-value gifts into percentage interests in MIL. It is clear beyond cavil that the Majority should have stopped with the Assignment Agreement's plain wording." The court pointed to the "immutable rule" that fair market value is determined, snapshot-like, on the day the donor *completes* the gift. The Fifth Circuit concluded that the Tax Court Majority's application of its "smell test" resulted in its failure to give effect to the dollar gifts in the assignment:

"Judge Foley's use of 'olfaction' is an obvious, collegially correct synonym for the less-elegant vernacular term, 'smell test,' commonly used to identify a decision made not on the basis of relevant facts and applicable law, but on the decision maker's 'gut' feelings or intuition. The particular olfaction here is the anathema that Judge Swift identifies pejoratively in his concurring opinion as 'the sophistication of the tax planning before us.'

The Fifth Circuit quoted with approval from Judge Foley's strong dissent, which had pointed out that "[t]here is no factual, legal, or logical basis" for the Tax Court Majority's approach. The Fifth Circuit concluded that because the gift was of a dollar value, whether the controlling value on the date of the gift was the value in the Frazier appraisal, the "halfway" value determined by the Tax Court, the value in the IRS's deficiency notice, or the (lower) value espoused by the IRS's expert has "no practical effect on the amount of gift taxes owed here."

c. Concluding logic. The Fifth Circuit concluded that given the Majority's non-erroneous rejection of the Commissioner's experts' values, its own legal error of refusing to discount the gift by the present value of the assumed liability for §2035 estate taxes, the fair market values "are, by a process of elimination, those determined by the Frazier report and used by the Taxpayers in preparing their gift tax returns for 1996." This logic reflects the organization of the gift tax return in reporting the gifts. The gift tax returns determined the taxable gifts by starting with the total value of the transferred interests (using the Frazier appraisal), subtracting the assumed gift tax liability and the actuarial present value of the assumed estate tax liability, and the charitable deductions for amounts passing to charity. While the court's logic follows the organization of the gift tax returns, it might seem that even the Frazier appraised value is irrelevant to determining the amount of the gift to the non-charitable donees, which was merely stated as a dollar amount. That would seem to be the only basis for refusing to remand the case to the Tax Court to determine the factual value consistent with the court's opinion (or reviewing the Tax Court's determined value under a clear error standard).

d. Court's logic is confusing; Did court actually recognize defined value clause? Some commentators have concluded that the Fifth Circuit case merely held that the Commissioner did not meet its burden of proof, and that it was error to use the Confirmation Agreement to impact the determination of the gift tax. I concur that the concluding logic is confusing, and that planners should not treat this as an unqualified validation of defined value clauses (even apart from the refusal to address the public policy issues). However, there are indications in the opinion that the court was doing more than just saying that the IRS did not meet its burden of proof and that gift values must be determined on the date of the gift without regard to post-gift acts of the donees.

The case states in the last sentence of section II.C.3.a of the opinion that "the results of the Majority's independent appraisal of the donated interests in MIL and their values for gift tax purposes *become irrelevant* to the amount of the gift taxes owed by the Taxpayers." (emphasis added). The clearest indication of this is the court's opening sentence of its concluding paragraph of the section II.C.3 of the opinion dealing with the fair market value of interests in the partnerships transferred by the taxpayers:

"In the end, whether the controlling values of the donated interests in MIL on the date of the gifts are those set forth in the Assignment Agreement based on Mr. Frazier's appraisal of $89,505 per one per cent or those reached by the Majority before it invoked the Confirmation Agreement (or even those used by the Commissioner in the deficiency notices or those reached by the Commissioner's expert witness for that matter), have no practical effect on the amount of gift taxes owed here."

The court specifically says that the appraisals and the Tax Court's determination of the value of a one percent interest in the partnership are irrelevant in determining the amount of gift taxes. What can be the basis for that statement unless the court is saying that the value of the gift is the dollar value stated in the Assignment Agreement where the agreement requires that the fair market of the assigned partnership interests be determined under a willing buyer willing seller test that is identical to the standard that is used in the gift tax regulations?

The court's logic that follows after that sentence seems questionable. The court seems to reason that (i) the Tax Court's rejection of the IRS's expert was non-erroneous, (ii) the government had the burden of

proof, therefore (iii) the fair market value is the value used in the taxpayer's expert's report. (In the court's words, "the fair market values applicable in this case are, *by a process of elimination*, those determined by the Frazier report and used by the Taxpayers in preparing their gift tax returns for 1996." (emphasis added))

If that logic is correct, almost every Tax Court valuation case is incorrectly decided. The Tax Court rarely accepts the valuation of either side's expert and typically determines a value somewhere between the two experts' values. The McCord panel's logic seems to say that if the court does not accept the expert report from the side that has the burden of proof, the expert's report for the other side sets the fair market value.

The panel at no place in the decision addresses the Tax Court Majority's determination of the value of a one percent interest under a clear error standard. If the value of a one percent interest was really critical to determining the gift amount, why did the court not review the Tax Court Majority's determination of the value of a one percent interest (i.e., $120,046 per one per cent interest) under a clear error standard of review? The answer seems to be the opening sentence of that tortured paragraph—stating that the values reached by the appraisers "or by the Majority before it invoked the Confirmation Agreement … have no practical effect on the amount of gift taxes owed here."

Perhaps the court's tortured path to reaching its conclusion, and referring to the $89,505 per one per cent interest suggests that the panel had some concern with just reaching a simple conclusion that the gift value was the dollar amount listed in the Assignment Agreement for non-charitable donees. Which, again, would suggest that planners should not view this case as an unqualified acceptance of defined value clauses, but as one panel's refusal to find these clauses to be abusive or to ignore them under a smell test.

5. Reducing Gift by Present Value of Potential Taxes under §2035. The non-charitable donees explicitly assumed liability for additional estate taxes under §2035 if either of the donors were to die within three years of making the gifts. The Tax Court Majority viewed that contingent liability as "too speculative" for allowing a gift offset.

The Fifth Circuit reasoned that there is "nothing speculative about the date-of-gift fact that *if* either or both Taxpayers were to die within three years following the gift (as did Mr. McCord)," the non-charitable beneficiaries were obligated to pay the additional estate tax imposed under §2035. The court acknowledged that some contingent liabilities can be too remote to consider, and that determining whether a contingent liability is too speculative is "a very elastic yardstick indeed." The court viewed that as a mixed question of law and fact, to be reviewed de novo. The court's approach was to determine if the "ubiquitous 'willing buyer'" would take that contingent liability into account in valuing the transfer at the date of the gift. It isolated each variable in the contingency and determined "which of those factors a willing buyer would (and we, as a matter of law, must) take into consideration in deciding whether it is too speculative for him to insist on its being used in reaching a price that the seller is willing to accept."

The court identified the following factors in estimating the present value of the potential liability for additional estate tax under §2035(b):

a. The amount of *gift* taxes owed by the Taxpayers;

b. Whether there would be an estate tax (or essentially identical death related transfer tax) at the date of death of the donors;

c. Whether gift taxes would be taxable under §2035 at the donor's death if a donor died within three years;

d. What estate tax rate would apply to any such §2035 amount at the donor's death;

e. Will §2035 still be conditioned on survivorship for three years at the donor's death;

f. What discount rate should be applied in determining the present value of the future contingent liability; and

g. What discount should be applied for determining the actuarial odds that a donor would die within three years.

As to item a, the court concluded that while the final amount of gift tax depended on the final result of the case, a willing buyer would apply the transfer tax law and rates in effect on the date of the gift.

As to items b-e, the court analogized to the "built-in gains discount" cases and reasoned that other courts have repeatedly held that the potential changes in the income tax and the capital gains tax (and the capital gains tax rate) are not contingencies that a willing buyer would ignore (citing Dunn and Jameson). The court observed that while the rates and particular features of the capital gains tax and estate tax have and will change with irregular frequency, "despite considerable and repeated outcries and many aborted attempts," neither the capital gains tax nor the estate tax have been repealed.

As to item f, the court concluded that the appropriate discount rate is not a matter of speculation, because "§7520 dictates precisely the rate of interest to be applied; and here, it is the rate that was applicable on the date of the gift." (Observation: That seems to be an overstatement; §7520 deals with the valuation of term interests and does not specifically apply to discounting contingent future liabilities.)

As to item g, the court observed that the IRS did not contest the Frazier appraisal's actuarially determined mortality factors (which apparently were based on Table 80CNSMT, in Treas. Reg. § 20.2031-7A(e)(4) (effective 4/30/89 through 5/1/99), as cited in footnote 46 of the opinion).

The court concluded that a willing buyer would take into account the contingent liability for §2035 estate taxes:

"… we are convinced as a matter of law that a willing buyer would insist on the willing seller's recognition that – like the possibility that the applicable tax law, tax rates, interest rates, and actuarially determined life expectances of the Taxpayer could change or be eliminated in the ensuing three years—the effect of the three-year exposure to § 2035 estate taxes was sufficiently determinable as of the date of the gifts to be taken into account."

Footnote 47 distinguishes three other cases (Armstrong Trust, Murray, and Robinette) that had rejected considering speculative contingencies—on the basis that those other cases involved situations with considerably more speculative contingencies.

6. Conclusion. The Fifth Circuit case concludes that given the Tax Court Majority's reversible errors in evaluating the interest on its own, employing the Confirmation Agreement in its calculations (i.e., by subtracting as the gift tax charitable deduction only the amount of interests that passed to the charities under that Agreement times the Majority's determined value per 1% interest), and rejecting the §2035 estate tax liability, the taxable value of the gifts to the non-charitable beneficiaries is not that determined by the Tax Court, but are those determined and used by the Taxpayers. The case details the dollar values passing to each of the donees. (At first blush, one might question why the Fifth Circuit did not remand back to the Tax Court to determine the factual values of the assignee interests; however, the value of a 1% interest is irrelevant under the Fifth Circuit's analysis. The taxable amounts passing to the non-charitable donees are the dollar amounts prescribed for the non-charitable donees under the Assignment Agreement, and the amount of gift tax charitable deduction is the amount of the total transferred amount less the dollar amounts passing to the non-charitable donees.)

7. Why Did It Take So Long? It is most curious to everyone why the three judges needed over two years to issue a unanimous opinion. I would have guessed that there must a great deal of dissension in reaching an opinion, and that there would be a strong dissent in the case whoever won. That obviously did not happen. There must have been some issue that was troubling to the judges even though they eventually reached a unanimous decision without a concurring opinion. Wouldn't it be fascinating to know what the troubling issue was? It makes you wonder if there was some difference of opinion among the three judges as to whether to address the policy issues—or whether to remand the case to the Tax Court to consider those issues.

V. Planning Issues in Light of Fifth Circuit Opinion

1. Is This Decision The “Green Light” for Using Defined Value Gifts?

a. Huge taxpayer victory. Although there are limits on the decision (it basically just rejects the Tax Court’s reasoning that few could even understand let alone support), it is a seminal case of a federal court of appeals case recognizing and applying a defined value gift transfer. The Tax Court has apparently been troubled by these types of clauses, and has rejected several defined value transfers in the recent past, in each case on technical grounds without agreeing with the IRS’s broad position that “dollar amount” gift transfers should not be recognized for public policy reasons. See Knight v. Commissioner, 115. T.C. 506 (2000) (court did not respect the clause because taxpayers did not); McCord, 120 T.C. 358 (2003). Tax Court judges referred pejoratively to the “sophistication of the tax planning before us.” This federal court of appeals case at least turns the tide of courts viewing these clauses as abusive and troublesome under a smell test.

b. Court did not consider public policy or substance over form doctrines. The taxpayer’s trial brief and brief to the Fifth Circuit summarized the response to the Commissioner’s public policy and substance over form arguments: “The Commissioner erred in relying on such cases [Procter, Ward, and McClendon] because (i) the fixed-value clause in the Assignment Agreement was materially different from the ‘savings arrangements’ in *Procter, Ward,* and *McClendon*, (ii) similar formula clauses are used commonly and have been approved by the Commissioner, and (iii) the Commissioner’s ‘substance over form’ argument ignores the independent character of both the Symphony and [Communities Foundation of Texas] as unrelated parties.”

The Court said that the Commissioner did not make the public policy or substance-over-form arguments in its brief, and that it waived those arguments to the Fifth Circuit. Some commentators have suggested that this opinion is not comforting at all because of that aspect of the opinion. Indeed, everyone has thought that the public policy arguments are the IRS best arguments against these types of clauses (i.e., that they discourage audits because anything the examining agent does adds no additional gift tax).

Why did the Commissioner not make the public policy argument to the Fifth Circuit?

Only two of the Tax Court judges who participated in the McCord decision specifically agreed with the Commissioner’s public policy argument. Some attorneys have suggested that the taxpayers’ arguments in the trial brief responding to the public policy arguments and in Judge Foley’s dissent were so strong that it is not surprising that the Commissioner did not make the argument again on appeal. Did the Commissioner view the argument as such a loser that there was no point in making the argument? Or did the Commissioner specifically strategize not making the argument before the perceived taxpayer-friendly Fifth Circuit to preserve the argument in other more receptive courts?

I do not think either of those happened. Despite the fact that the Fifth Circuit said that the Commissioner did not make the argument in its brief and waived the argument, the Commissioner’s brief DID restate the argument (albeit in a footnote—but are footnotes not still part of the brief?) and specifically requested the Fifth Circuit to remand the case to the Tax Court to consider the policy issues if the Fifth

Circuit decided not to approve the Tax Court's "interpretation argument" about the defined value gift:

"In the Tax Court, the Commissioner argued that the estate planning device utilized here was akin to those in *Commissioner v. Procter*, 142 F.2d 824, 827 (4 th Cir. 1944) and in *Ward v. Commissioner*, 87 T.C. 78, 110-14 (1986), which the courts rejected as contrary to public policy. The Commissioner had also argued that the series of transactions should be treated as a single integrated transaction pursuant to the substance-over-form doctrine. *See Gregory v. Helvering*, 293 U.S. 564 (1935); *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945). Although Judge Laro's dissent (Op. 109-117) is based on his view that the Court should have adopted the Commissioner's position on both matters, and Judge Foley's partial dissent (Op. 101-106) would have rejected it, the eight judges comprising the Tax Court majority specifically declined to deal with these arguments and made no finding with respect thereto. (Op. 64 n.47.) Therefore, if this Court disagrees with the Tax Court's conclusions with respect to the interpretation of the Assignment Agreement , it should remand the case to the Tax Court so that it can address these arguments in the first instance." Appellee Brief, n.18.

Indeed, one wonders in light of this very specific request how the Fifth Circuit procedurally avoided either dealing with this issue specifically requested by the Commissioner in making its own decision regarding the public policy and substance over form argument under de novo review, or remanding the case back to the Tax Court to consider those issues that the Tax Court did not have to consider in light of the reasoning in its opinion. If the Fifth Circuit was correct in ignoring the Commissioner's specific request for remand, on the basis that the Commissioner waived the argument despite the request for remand, the Commissioner made a critical procedural error in its approach.

The Fifth Circuit opinion gives no indication whatsoever that the judges viewed the dollar amount assignment as abusive or that it raised "smell test" concerns. To the contrary, the court went out of its way to chide the Tax Court for ignoring the "plain wording" of the dollar value assignment on the basis of its perceived "olfaction." If there had been concerns that the clause was abusive, would the judges not at least have expressed some concern about the policy concerns, to be decided another day? (It is interesting that the court went out of its way to say that the Commissioner waived its argument about whether the transfer should be valued as an assignee interst or as a full limited partnership interest, but "[o]ur failure to address it should not, however, be viewed as either agreeing or disagreeing with the Majority's determination on this point." The court did not make a similar statement about the public policy or substance over form argument.)

In sum, I have no doubt that this same three judge panel would have recognized a dollar amount assignment despite public policy or substance over form issues. As to the substance over form issue, the court went out of its way to emphasize the independence of the charitable donees and that there were no side understandings, which would seem important in a substance over form situation. (See item 4 below.)

A fundamental difficulty with the public policy or substance over form argument for defined value clauses for gifts is that the clauses are practically identical to long recognized dollar amount clauses used in wills for marital or charitable bequests. For example, if there is a dollar amount (e.g., the remaining "exemption" amount) bequest to individuals in a will with the balance passing to a spouse, no one

questions that this results in a zero estate tax situation, even though actual funding of percentage interests is based on later actions of the executor. The IRS tried (lamely, in this author's view) to identify why defined value clauses during lifetime were so different from testamentary marital deduction clauses from a policy viewpoint in TAM 200245053.

The taxpayer's trial court brief observed that these types of clauses are not abusive. "Petitioners simply were trying to determine and establish with certainty, through the use of a formula clause specifying a dollar value of the interst in MIL passing to each donee, the amount of gift tax that would result from such transfers." Transfers under clauses that fix the amount of estate taxes or GST taxes are routinely recognized. Why should it not be possible to make a transfer in a manner that established with certainty the dollar value that passes as a taxable gift, with any excess passing in a manner that does not result in a taxable gift?

c. Will defined value transfers become more common? Individual IRS agents have informally indicated that they view defined value transfers as being extremely abusive and that returns reporting defined value transfers are viewed with great skepticism. At least in the Fifth Circuit, my prediction is that we will see attorneys using dollar amount transfers (often referred to as defined value transfers) on an increasing basis. Despite the skepticism of IRS agents, they know that the circuit level court has (at least arguably) upheld a defined value clause and certainly did not comment on it pejoratively or treat it as being abusive. Beyond the Fifth Circuit, attorneys will be somewhat more comfortable using defined value clauses than in the past, now that one federal court of appeals has refused to treat them as being abusive. However, in light of the confused logic in McCord, the failure to address the policy concerns in McCord, and the perception of the Fifth Circuit as a taxpayer-friendly circuit, attorneys may feel a much greater degree of comfort when another circuit court recognizes defined value clauses.

2. Crafting the Defined Value Clause.

a. McCord defined value clause. The precise language of the defined value clause used in the McCord case is in the attached Appendix I. (This paragraph from the Assignment document is included in the taxpayers' brief to the Fifth Circuit.)

b. Should "values as finally determined for Federal gift tax purposes" be used? The Tax Court said the particular clause was not "self-effectuating" because the formula was based on the "fair market value" of the transferred interest, rather than being based on the "fair market value as finally determined for Federal gift tax purposes." The opinion said the donees were left the task of dividing the interests. The Tax Court specifically said that if the parties had provided "that each donee had an enforceable right to a fraction of the gifted interest determined with reference to the fair market value of the gifted interest *as finally determined for Federal gift tax purposes*," the Court "might have reached a different result." (Interestingly, a dissent by Judge Chiechi points out that the formula clause was based on "fair market value" as defined in the Agreement, and the majority opinion acknowledged that the definition of "fair market value" in the Agreement is the same definition of that term as applies for Federal gift tax purposes.)

There are various reasons why using a clause that refers to same valuation standard that is used for gift tax purposes but not requiring the use of finally determined gift tax values is preferable.

(i) Mechanical difficulties. The difficulty in requiring the use of values "as finally determined for Federal gift tax purposes" is that the ownership percentages could be in abeyance for many years. Knowing the precise fractional interest owned by the various transferees will be uncertain until the gift tax value is "finally determined" in accordance with the principles of section 2001(f)(2) of the Internal Revenue Code. Until that time, there may be questions regarding the distribution of income earned on the transferred property, the reporting of income from the transferred property for federal and state income tax purposes, and exercise of various ownership rights with respect to the property. In addition, there can be practical difficulties in re-registering shares, where the transfer agent will want to register a specified number of shares in each transferee's name.

What if a court never determines the values for Federal gift tax purposes? Under the logic of the clause, the non-charitable donees receive a stated dollar amount, and as of the date of the gift, the percentage interests represented by that dollar amount are irrelevant. Indeed the logic of the Fifth Circuit opinion is that the court really did not need to determine the value of the partnership interests passing to the donees (although the court did proceed to determine the values in that case.)

The McCord children and their charities have had to wait over *10 years* to get a value as finally determined for Federal gift tax purposes. Instead of being required to use finally determined gift tax values (requiring a 10 year wait), they were allowed to reach agreement among themselves as to the percentages that each of the donees acquired under the assignment. If any of them had disagreed, that party could have brought an independent legal action (they were contractually bound to use an arbitration proceeding) to determine the amounts passing under the clause that assigned dollar amounts under the same valuation standard that is used for Federal gift tax purposes.

(ii) Having an arm's length transaction as evidence of value. The subsequent arm's length transaction among the donees is itself outstanding evidence of value—where the parties have some adverse interests. An arm's length transaction is typically viewed as the best evidence of value. In McCord, there were two different charities that had fiduciary obligations to ensure that they received no less than the appropriate percentage interests of the partnership to which they were entitled. They had independent counsel. Having this arm's length transaction close in time to the original transfer involving parties who had a direct economic stake in the outcome may be preferable to merely waiting for a court to make its determination of value years later. Using a clause with valuation standards that are the same as the gift tax valuation standards, rather than using finally determined gift tax values, invites such a subsequent arm's length transaction. (However, if the donees are all family members who all have incentive to maximize the value passing to one donee, the subsequent agreement about percentages that pass under the dollar amount formula will not appear arm's length. Even then, if the donees are all trusts, there are fiduciary duties on the trustees to maximize the value for their respective trusts.)

(iii) Rebutting policy argument. The Procter and Ward public policy position is that a savings clause, returning a portion of transferred property to the donor that exceeds a specified value, is not respected where the event that triggers the readjustment was a determination by the IRS or a court. The cases reasoned that if such terms were given effect, there would be no way to determine the amount of the

transfer until a court determined whether the transfer was subject to the gift tax. Using an approach that does not depend on final gift tax values removes some of the steam from that argument. An independent arm's length transaction determines the percentages rather than having the percentages set in a gift tax proceeding.

(iv) Court precedent. The one opinion that rejected the defined value clause specifically because it did not require using finally determined gift tax values (i.e., the McCord Tax Court decision) has been reversed.

(v) Conclusion. Many attorneys drafted defined value clauses following the Tax Court decision in McCord to refer to values as finally determined for Federal gift tax purposes. Despite the practical problems that arise in using gift tax values, I anticipate that defined value clauses for inter vivos transfers will often continue to refer to values as finally determined for Federal gift tax purposes. "Final determination" is now delineated in the Internal Revenue Code and regulations. The Code and Regulations address how gift tax values are "finally determined" in four different circumstances: (1) Uncontested return; (2) Unchallenged IRS audit determination, (3) Court determination, or (4) Settlement agreement. I.R.C.§2001(f)(2) (added by 1997 Act and amended by the 1998 Act); Treas. Reg. §20.2001-1. The formula allocation will likely make reference to those provisions.

However, there are certainly strong reasons to consider using a clause that refers to the same valuation standards that are used for gift tax purpose but that do not require the use of finally determined gift tax values. **Following the McCord reversal of the Tax Court's decision criticizing a defined value clause that did not refer to finally determined gift tax values, there are stronger reasons to consider the advantages of not depending on finally determined gift tax values. This is particularly true if some of the donees arenon-family members or if some of the donees are trusts represented by independent trustees.**

c. Transfer everything; nothing returns to donor. A key feature of defined value clauses, as opposed to Procter type clauses, is that the donor is making a transfer of a particular block of assets, and the clause merely allocates who receives that block of assets according to dollar amounts or formula clauses. No part of the transferred block of assets will ever revert back to the donor. Under defined value clauses, no assets are returned to the transferor. In this manner, the formulas will operate like the formula clauses in hundreds of thousands of wills that have been through federal estate tax audits. The goal is to mirror standard marital deduction clauses that dispose of all of a decedent's estate, leaving the largest amount possible without generating estate taxes to individuals (or a bypass trust) and leaving the balance to a surviving spouse.

For example, in TAM 200337012 the taxpayer transferred to a trust "that fraction of Assignor's Limited Partnership Interest in Partnership which has a fair market value on the date hereof of $A." The IRS ruled that this is not recognized because it is similar to the clauses in Ward v. Comm'r, and Rev. Rul. 86-41, 1986-1 C.B. 300, and is void as contrary to public policy. The taxpayer argued that this clause is distinguishable from the clauses in Procter because the donor never receives anything back. The IRS did not agree: "However, pursuant to the assignment, Trust received an X% interest in Partnership from Taxpayer. If Paragraph B is given effect and the value of the X% interest, as finally determined by the

Service, is greater than $A, a certain percentage of the Partnership interest held by Trust would be retransferred to Taxpayer. This is the type of clause that the courts in Procter and Ward conclude are void as contrary to public policy."

d. Building in some taxable element to refute public policy argument. An example fractional formula transfer clause, with a provision for a small gift being produced if the IRS asserts higher values for gift tax purposes, is as follows:

"I hereby transfer to the trustees of the Trust a fractional share of the property described in the Schedule A. The numerator of the fraction is (a) $1,000,000 plus (b) 1% of the excess, if any, of the value of such property as finally determined for federal gift tax purposes (the "Gift Tax Value") over $1,000,000. The denominator of the fraction is the Gift Tax Value of the property." McCaffrey, Tax Tuning The Estate Plan By Formula, UNIV OF MIAMI SCHOOL OF LAW PHILIP E. HECKERLING INST. ON EST. PL. 3-14 (1999).

The "1% of the excess" provision is designed to result in some gift tax if the IRS audits the gift tax values of the assets. This will assist in avoiding the public policy argument that a contest by the IRS would be a moot issue because the clause would take away any gift consequences.

The McCord case does not specifically address the public policy issue. However, as discussed above, the judges certainly left the clear impression that they did not find the "dollar amount" assignment to be abusive. In light of the Tax Court's refusal to reject the defined value clause on policy grounds and in light of the impression from the Fifth Circuit that the clauses are not abusive, we may see fewer attorneys building in 1% (or greater) taxable amount clauses to rebut a public policy argument. That would seem particularly true in the Fifth Circuit.

e. Advantage of using grantor trusts. The uncertainty of ownership for a long period of time emphasizes the advantage, if at all possible, of making transfers to grantor trusts under defined value clauses. In that case, regardless of the percentages owned by the grantor and the various donees, all of the income is reported for federal income tax purposes on the grantor's income tax return. If there is any subsequent adjustment in the percentages passing under the formula, there would be no change in income tax liabilities of any person and there may be no necessity of amending income tax returns. (Of course, having all of the donees as grantor trusts diminishes the perceived arm's length character of the subsequent negotiation to determine the percentages that pass under the dollar amount clause. Having separate independent trustees of the trusts, each with fiduciary duties to maximize the amount passing to their respective trusts, would increase the appearance of the arm's length character of the negotiations.)

f. Allocation to single trust with formula subdivision alleviates mechanical registration difficulties. If property is transferred to a single trust under which the trustee is required to allocate the assets among various subtrusts, the transferred property could be registered in the name of the trustee under the trust agreement until the gift tax values have been finally determined. At that time, the trustee can make allocations of shares among the various sub-trusts, and re-register the shares in the names of those particular trusts at that time. (However, using a single trustee for all family trusts that are donees will weaken the perceived arm's length nature of negotiations among the donees to determine the

percentages passing under the dollar amount clause.)

3. Using Defined Value Clauses in Sales Transactions.

The same type of defined value clause that was used for a gift transfer in McCord could also be used in sales transactions to identify the donees of various blocks of assets that are being transferred. The client could sell assets to children and a spouse, a lifetime marital trust (if a lifetime QTIP is used, a Form 709 would have to be filed making the QTIP election and describing the assets of the QTIP), or a charity, or a zeroed out GRAT under an agreement providing that the child purchases a fractional share of the assets, the numerator of which is the “intended value” and the denominator of which is the finally determined gift tax value. The remaining fractional interest in the assets will be allocated to the spouse, marital trust, charity, or GRAT (all of which would not be gift tax-free transfers). See Trapp, Thinking About Valuation Adjustment Clauses, ACTEC 1999 Annual Meeting HT II-16-JMT. (Another alternative is to leave the excess to a trust in which the grantor has retained a sufficient interest/control to make the gift incomplete. Handler & Dum, The LPA Lid: A New Way to “Contain” Gift Revaluations, 27 EST. PL. 206 (June 2000).)

Assume that the liquidation value of a partnership is $10.0 million, and that the appraised value of the limited partnership interest is $6.0 million. The client could sell the first $5.9 million worth of the limited partnership interest to the client’s children for a note. The sale document (i.e., the bill of sale) could indicate that if the value exceeds $5.9 million, the excess will pass to a Communities Foundation. The $5.9 million would be described as the value determined under U.S. gift tax principles (i.e., under a willing buyer willing seller test that is identical to the gift tax valuation standard).

In the past, IRS agents have viewed defined value cause as abusive, reasoning, “if your values are right, why do you need a defined value clause?” There has been a reluctance to use defined value clauses in some sale transactions, for fear the clause might invite greater IRS scrutiny. That concern is still present, though the existence of a circuit level case upholding the clause is at least some indication that the courts will not view the clauses as abusive. I anticipate that we will see more frequent use of defined value clauses in sales transactions.

4. Critical Importance of Avoiding “Wink-Wink” Side Understandings. The Fifth Circuit opinion emphasized at various points that there were no understandings between the donor and the donees as to how the transferred assets would be divided among the donees in implementing the dollar amount transfers. In stating the facts of the case, the court emphasized that “[n]o other agreements—written or oral, express or implied—were found to have existed between the Taxpayers and [the various donees] as to what putative *percentage* interest in MIL belonged to, or might eventually be received by, any of the donees under the dollar-value formula clause.” The court emphasized that the facts before Judge Foley as the lone trial judge included “the absence of any probative evidence of collusion, side deals, understandings, expectations, or anything other than arm-length, unconditional completed gifts by the Taxpayers on January 12, 1996, and arm’s-length conversions of dollars into percentages by the donees alone in March.” Another place in the fifth Circuit opinion observed that “[n]either the Majority Opinion nor any of the four other opinions filed in the Tax Court found evidence of any agreement—not so much as an implicit, ‘wink-wink’ understanding…”

5. Advisability of Post-Gift Cash Out? If a defined value transfer involves a charity, it is likely that there will be significant pressure by the charity to "cash out" its interest under the "bird in a hand" theory, and under the theory that charities need cash for their special projects, not interests in closely held family entities. However, doing so raises the risk of the situation in the Tax Court opinion, where the court determined that the values of the interests are much greater than the amounts used by the parties, thus resulting in values of the residual percentage interests passing to charities that are much lower than the requested gift tax charitable deduction. Cashing out the charities soon after the transfer highlighted that the court ended up allowing a charitable deduction for a larger amount than what the charities actually received. There is obviously a smell test problem with allowing a charitable deduction for a greater amount than what the charity actually receives. That risk is minimized if the charity does not "cash out" before the gift tax proceeding is concluded.

Even so, charities and families will both want to get dollars to the charities and cash out the interests. If the individual donees and the charities all demand an early cash out, at the least take steps to help document the independence of the cashed out charities in the negotiations. In McCord, the court noted that the Communities Foundation of Texas retained experienced outside counsel (which trial briefs identify as Michael Graham, a very experienced Dallas attorney), and the president and director of development of the charity were both attorneys. They had the opportunity to retain their own outside appraiser, although they chose not to in this case because of their confidence in the appraisal, the appraiser and his firm's reputation. I suspect that the donor's attorneys would have liked for the Communities Foundation to have hired its own independent appraiser, but they obviously could not force the Foundation to spend its assets to do so.

6. Structuring Net Gifts to Obligate Donees to Assume Potential §2035(b) Gross Up Estate Tax Liability. In an unusual and creative move, the net gift transaction was structured so that the donees assumed liability for all gift, estate and GST taxes attributable to the transfer, specifically including estate tax attributable to the rule under §2035(b) requiring gross-up rule of gift taxes if the donor died within three years. The court recognized that some potential contingent liabilities are too speculative to take into consideration, but the contingent §2035(b) liability could be considered.

a. Actuarial determination. The court upheld the appraiser's use of actuarial life expectancy factors used in the §2031 regulations (the Table 80CNSMT effective from 4/30/89 to 5/1/99). (The analogous table would be the Life Table 90CM, found in Treas. Reg. §20.2031-7(d)(7), for transfers after April 30, 1999.) This seems reasonable.

b. Discount factor. The appraiser used the §7520 rate in effect on the date of the gift as the discount factor for discounting the potential future liability to a present value. The court said that §7520 mandated the use of that factor, but §7520 only deals with valuing term interests, and does not directly apply to discounting potential future liabilities. The IRS did not dispute the use of the §7520 rate as the discount rate in McCord, and its use seems reasonable for that purpose. One could argue, however, that the short term AFR may be a more appropriate rate. The AFRs are presumably based on real life interest factors, and the §7520 rate is 120% of the mid-term rate. Using a rate that is based on actual current interest factors rather than 120% of that amount may be more reflective of actual interest rates. In addition, the

tax would be due nine months after the date of death. The death must occur within three years of the gift in any event. If a death occurs sometime within three years, it may be more likely than not that the death would occur sometime in the first two years rather than in the last year. If that were the case, the short term rate (which applies to transactions up to 3 years) may be more appropriate than the mid term rate. However, in light of the fact that the Fifth Circuit has blessed using the §7520 rate as the discount factor, planners will probably use that approach. The added advantage of using the lower short term AFR as the discount factor would be minimal.

c. §2035(b) offset. The Tax Court thought the potential liability under §2035(b) was too speculative to consider; the Fifth Circuit did not. Other than the actuarial likelihood of dying within three years, taking into account the potential §2035(b) tax seems no more speculative than taking into consideration the built-in capital gains tax if a corporation sells assets. In many ways, the §2035(b) tax is much less speculative; the primary unknown is the likelihood of dying within three years and firm statistical data of that actuarial likelihood is used for a wide variety of tax purposes. On the other hand the likelihood that a corporation will actually sell assets and when it might sell those assets seems much more uncertain. If the built-in gains tax can be estimated and considered in valuations, it would seem that the §2035(b) potential tax liability could also be considered.

The case distinguishes other cases cited by the Commissioner as representing situations with much greater uncertainties than the specifically assumed §2035(b) gross up liability. For example, the most recent of those cases was Armstrong Trust v. United States, 132 F. Supp.2d 421 (W.D. Va. 2001) that dealt with the donees' general transferee liability under §6324(a)(2) for additional estate taxes under §2035(b) if the donor died within three years of the gift. That involves much more uncertainty, because not only must the donor die within three years, but the estate must be depleted to the point that it cannot pay the additional estate tax before the donees are liable under the transferee liability rule.

The Fifth Circuit opinion seems a reasonable approach. We have routinely seen net gift transfers (i.e., net of gift taxes) for decades. For donors trying to reduce the current gift tax outlay, we may begin seeing an increasing number of net gift transfers also considering potential §2035(b) liability. However, the offset would typically be much less than the standard gift tax offset for net gifts.

*For example, assume that a 70 year old individual makes a gift in September 2006 (when the §7520 rate is 6%) in which the donee assumes the potential §2035(b) liability. For a 70 year old individual, the likelihood of surviving three years is 65,154/71,357 [the "l(x)" factors from Table 90CM for a 73 and 70 year old, respectively], or 91.3%, and the actuarial likelihood of dying within three years is 8.7%. The 3-year discount factor, using a 6% discount rate, is 0.84. Therefore, the gift tax offset because of the §2035(b) assumed liability for a 70 year old donor would be the amount of gift tax times 8.7% times 84%, or only 7.3% times the gift tax (as compared to 100% times the gift tax for the standard assumed gift tax liability for net gifts.) This obviously presents a circular calculation because this factor in determining the gift tax depends on the amount of the gift tax itself. If the gift tax bracket is 45%, running the math shows that the net gift, after subtracting the present value of the potential §2035(b) liability for a 70 year old using a 6% present value discount rate is **96.82% of the initial gift amount**, representing a decrease of 3.18% of the initial gift amount. This would decrease the gift tax by 45% of that, or just 1.4% times the amount of the initial gift. To check the math:*

Gift Tax = .45 x Net Gift

= .45 x .9682 x Initial Gift

= .43569 x Initial Gift

And

Gift Tax = .45 x (Initial Gift – Offset for §2035(b) liability)

= .45 x (Initial Gift – [.073 x Gift Tax])

= .45 x (Initial Gift – [0.73 x .43659 x Initial Gift {inserting from above calculation}])

= .43569 x Initial Gift

It checks out.

Particularly in the Fifth Circuit, it is highly likely that the IRS will allow an offset of gift tax value for that purpose. The planner will have to decide whether decreasing the gift tax by about 1.4% of the gift amount (for transfers by a 70 year old individual when the §7520 rate is 6.0%) is worth the added complexity of this approach.

7. Formula Disclaimer Approach. The IRS made arguments that a somewhat similar post-mortem planning approach involving a formula disclaimer violated public policy. Estate of Lowell Morfeld, Tax Court Docket # 012750-03. In that case, the residuary beneficiaries disclaimed the remainder of the estate exceeding “x” dollars (before payment of debts, expenses and taxes) in which the decedent’s will provided that any disclaimed assets would pass to a Community Foundation to fund a Donor Advised Fund in the name of the disclaiming child. The estate consisted in part of a 49% limited partnership interest that the estate’s appraiser valued with a 45% discount for lack of marketability and lack of control. The IRS agent refused to allow any discounts, citing Procter. The case was settled prior to trial. John Porter, who represented the taxpayer in Morfeld, reports that he is handling another case involving a formula disclaimer in which the IRS is again arguing that the disclaimer violates public policy under the Procter rationale.

Appendix I

Actual Defined Value Clause Used in McCord Assignments

The taxpayer’s brief to the Fifth Circuit in the McCord case includes the full actual language of the assignment used in the transfers by Mr. and Mrs. McCord:

"Paragraph 2 of the Assignment Agreement allocated the assigned partnership interests among the assignees as follows:

(a) that portion of the Assigned Partnership Interest having a fair market value as of the date of this Assignment Agreement which is as much as but not more than the dollar amount ("Assignors' GST Amount") obtained by adding (i) the GST exemption provided for Assignors in section 2631(a) of the Internal Revenue Code of 1986, as amended (the "Code"), which has not been allocated by them or by operation of law to any property transferred or deemed transferred by them before the date of this Assignment Agreement, to (ii) the value of any consideration received or deemed received by Assignors from Charles T. McCord, III, Michael S. McCord, Fredrick R. McCord, and Stephen L. McCord, as trustees of the McCord Issue GST Trusts, as a result of the transaction effectuated by this Assignment Agreement , is assigned in equal shares to Charles T. McCord, III, as trustee of the Charles T. McCord, III GST Trust, Michael S. McCord, as trustee of the Michael S. McCord GST Trust, Fredrick R. McCord, as trustee of the Fredrick R. McCord GST Trust, and Stephen L. McCord, as trustee of the Stephen L. McCord GST Trust;

(b) any remaining portion of the Assigned Partnership Interest having a fair market value as of the date of this Assignment Agreement which is as much as but not more than the dollar amount obtained by subtracting Assignors' GST Amount from $6,910,932.52, is assigned outright and in equal shares to Charles T. McCord, III, Michael S. McCord, Fredrick R. McCord, and Stephen L. McCord;

(c) any remaining portion of the Assigned Partnership Interest having a fair market value as of the date of this Assignment Agreement which is as much as but not more than the dollar amount obtained by subtracting the dollar value of the portions assigned under subparagraphs (a) and (b) above from $7,044,932.52 is assigned to Shreveport Symphony, Inc.; and

(d) any remaining portion of the Assigned Partnership Interest is assigned to Communities Foundation of Texas, Inc. for benefit of the McCord Family Fund.

For purposes of this paragraph, the fair market value of the Assigned Partnership Interest as of the date of this Assignment Agreement shall be the price at which the Assigned Partnership Interest would change hands as of the date of this assignment Agreement between a hypothetical willing buyer and a hypothetical willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant acts. Any dispute with respect to the allocation of the Assigned Partnership Interests among Assignees shall be resolved by arbitration as provided in the Partnership Agreement."

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ABA SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW

RPPT eREPORT

NEWS, PRACTICE UPDATES AND MEMBER BENEFITS

Article

Year-End Planning to Minimize Florida Intangible Personal Property Tax Liability No Longer Necessary

By Amy E. Heller

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For the first time in decades, year-end planning to avoid the Florida Intangible Personal Property Tax (the “Intangibles Tax”) will not be necessary for Florida residents and their tax advisors. This past summer, Florida Governor Jeb Bush signed legislation repealing the Intangibles Tax, effective January 1, 2007. Intangibles Tax liabilities for 2006 and prior tax years are unaffected by the repeal.

Subject to certain exceptions, the Intangibles Tax is an annual tax on the market value, as of January 1 of the tax year, of stocks, bonds and other intangible personal property owned, managed or controlled by a person domiciled in Florida. For 2006, each taxpayer is entitled to an annual exemption of the first $250,000 of the value of property otherwise subject to the tax. Thereafter, the rate of the Intangibles Tax is 0.5 mils per dollar (*e.g.*, $5 per $10,000) of taxable intangible personal property. The rate of the Intangibles Tax was significantly reduced over the

decade preceding the repeal.

In order to avoid the Intangibles Tax, many Florida residents created irrevocable trusts to hold their intangible assets, frequently near the end of a calendar year as January 1 of the next year approached. Following numerous Florida Technical Assistance Advisements issued in response to inquiries regarding the use of such trusts, the Florida Department of Revenue amended the Florida Administrative Code in 1998 to provide “safe harbor” requirements that, if met, would enable trusts to avoid the Intangibles Tax. Trusts meeting the safe harbor requirements popularly became known as Florida intangible tax trusts (“ FLINTs”) and Florida intangible tax exempt trusts (“FLITEs”). Now that that the Intangibles Tax has been repealed, FLINTs and FLITEs will no longer be essential tools of Florida estate planners.

What about existing FLINTs and FLITEs? If a FLINT or a FLITE was established as part of a broader estate plan, and not just to minimize exposure to the Intangibles Tax, it may make sense for the trust to be retained in its present form. If, however, a FLINT or a FLITE is no longer desirable or is no longer desirable in its existing form, it may be possible to amend the trust pursuant to an amendment power included in the trust agreement. Depending on the terms of the trust, it may also be possible for trust assets to be distributed to a beneficiary (*e.g.,* the settlor or the settlor’s spouse) or for the settlor to exercise a limited power of appointment over trust assets in favor of individuals or other trusts, thereby effectively terminating the FLINT or FLITE.

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Articles

IRS Rules That Stock in New York Cooperative Apartment is Real Property For Purposes of Code § 1031

By Amy E. Heller
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In Private Letter Ruling 200631012, issued on August 4, 2006, the IRS concluded that stock in a cooperative apartment located in New York constitutes real property for purposes of the like-kind exchange rules of Internal Revenue Code §1031. The IRS reasoned that (1) the question of whether interests in a New York cooperative apartment constitute real property is determined based on New York law and (2) several New York statutes treat interests in a cooperative apartment as the equivalent of interests in real property.(1 - below)

New York practitioners may be surprised by PLR 200631012 because New York courts generally treat interests in cooperative apartments as intangible personal property. The New York Court of Appeals, for example, has held that such interests are not real property for purposes of the New York rule that entitles judgment creditors to a lien on the property by docketing his judgment.(2 - below) In *Danforth v. McGoldrick*, 109 NYS 2d 387 (N.Y. Sup. Ct. 1951), the New York State Supreme Court held that a

person who purchases stock in a cooperative buys shares in a corporation and contractual rights to occupancy of an apartment in a building. Similarly, in *re Miller's Estate*, 130 N.Y.S.2d 295 (N.Y. Surr. Ct. 1954), the Surrogate's Court held that "considered separately, the shares of stock (in the incorporated cooperative organization) and the proprietary apartment lease (for the hire of an apartment for 21 years) each would be considered personalty."

The New York State Department of Taxation and Finance has also long taken the position that interests in cooperative apartments are intangible personal property for purposes of New York income (3 - below) and estate tax, (4 - below) a position confirmed, as to the estate tax, by the New York Surrogate's Court. (5 - below) In each instance in which an interest in a cooperative apartment is treated as real property for New York tax purposes, there is a particular provision of the New York tax law that specifies this treatment. For example, in 2004, the legislature amended the New York Tax Law to tax gains recognized by non-New York residents who sell interests in New York cooperative apartments. To impose tax on such gains, the legislature modified a provision of the statute dealing with intangible personal property. Specifically, New York Tax Law § 631(b)(2) was amended to provide that any gain from a disposition of stock in a New York cooperative apartment is subject to tax, notwithstanding the general rule that a non-resident is not subject to New York income tax on income from intangible property. (6 - below)

Furthermore, the IRS has itself concluded that, based on New York case law, interests in a cooperative apartment constitute personal property. In Rev. Rul. 66-40, which dealt with former Code § 2515,(7 -below) the IRS ruled that because the stock and leasehold interests of a New York cooperative apartment constitute personalty, a transfer of these interests by their owner to her spouse and herself as joint tenants with rights of survivorship did not fall within an exception to gift tax for joint tenancies in real property between spouses.

The New York cases cited in Rev. Rul. 66-40 still appear to be good law, so why has the IRS changed its view about the appropriate classification of interests in New York cooperative apartments? It is possible that the IRS was swayed by the New York statutory sections cited in PLR 200631013 (see footnote 1), none of which existed in their present form at the time that Rev. Rul. 66-40 was released. Alternatively, it is possible that, in reaching its conclusion in PLR 200631012, the IRS did not consider authorities such as New York Tax Law §631(b), *Danforth v. McGoldrick* and *in re Miller's Estate*.

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(1) The IRS cited the following New York statutes: N.Y. Civ. Prac. L.& R. § 5206(a) (McKinney 1997) (homestead exemption); N.Y. Real Prop. Law § 279(5) (McKinney 1989) and N.Y. Pub. Auth. Law § 2402(5) (McKinney Supp. 2006) (mortgage for cooperative interest); N.Y. Real Prop. Tax Law § 467(3-a) (McKinney Supp. 2006) (real property tax for senior citizens); N.Y. Tax Law § 1402-a(a) (McKinney 2004) ("mansion tax"); and N.Y. Real Prop. Law § 254-b(1) (McKinney 1989) (limit on mortgage late charges).

(2)*See State Tax Commission v. Shor*, 371 N.E.2d 523 (N.Y. App. Term., 1977).

(3) *See* New York Advisory Opinion No. TSB-A-88(6)I (May 25, 1988) and New York State Department of Taxation and Finance, Nonresident allocation 313 (May 4, 1998).

(4)*See* TSB-M-81(1) (Feb. 20, 1981).

(5) *In re Estate of Verna S. Jack* , 484 NYS2d 489 (N.Y. Surr. Ct. 1985), holding that a NY resident decedent's ownership of a cooperative unit in Florida is tangible personal property and therefore includable for New York State estate tax purposes.

(6)*See also* §6-2.2 of the New York Estates, Powers and Trusts Law (the "EPTL"), which creates default rules that govern the way in which multiple owners take title to real and personal property when a transferor does not specify how title is to be held. In 1995, the New York legislature added a new subsection (c) to EPTL §6-2.2, creating a special rule applicable to transfers of interests in cooperative apartments. EPTL §6-2.2(c) provides that a transfer of interests in a cooperative apartment to a husband and wife creates a tenancy by the entirety, unless the transferor specifies that the property is to be held by the couple as joint tenants or as tenants in common. Prior to the addition of EPTL §6-2.2(c), a husband and wife receiving interests in a cooperative apartment took their interests as tenants in common, under the general rule applicable to transfers of personal property. *See e.g., Matter of Schultz*, N.Y.L.J., October 19, 1992, at 30, col. 2 (Surrogate's Court, New York County) and *Estate of Menon v. Menon*, 303 A.D.2d 622 (March 24, 2003) (applying pre-1995 EPTL §6.2-2).

(7) Former Code §2515 was repealed in its entirety in 1981.

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