

Use of Defined Value Clauses (and Alternatives) in Transfers of Closely-Held Business Interests

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Facts

Adam and Sara Davis have two children ages 20 and 18. Adam is a former executive of a large public energy company who left to start a small exploration and production company, Davis E&P, LLC (“Davis E&P”) three years ago. Sara is an executive at a technology company.

Adam owns a 60% membership interest in Davis E&P with unrelated parties owning the remaining 40%. Davis E&P currently has no debt and has a book value of \$15 million. Adam thinks that the value of Davis E&P, taking into account current asset values, is probably \$20 million which is highly speculative given that most of the assets are non-producing oil and gas properties. However, Adam thinks that the value may increase substantially in the next few months since a large exploration company has announced plans to drill a well on property adjacent to property owned by Davis E&P.

Adam and Sara have read that, with asset values depressed and interest rates at all time lows, now is an ideal time to engage in wealth shifting. They believe that energy prices will eventually rebound thus increasing the value of Davis E&P. In addition, Davis E&P has taken acreage in some undeveloped areas which Adam believes will prove to be highly successful.

Facts

While they understand the opportunity, they do not believe that they can make substantial gifts of Davis E&P interests since they had each previously utilized their \$1 million lifetime gift tax exemption by making gifts of marketable securities to the Davis Children's Gift Trust (the "Gift Trust"). The Gift Trust was created in 2002 and was funded with \$2 million worth of marketable securities. With the decline in market, the assets in the Gift Trust are still worth \$2 million. The Gift Trust was designed to be treated as a grantor trust for income tax purposes.

In addition, Adam and Sara are very charitably inclined and established the Davis Family Foundation, which currently has assets of \$1 million.

Adam and Sara would ideally like to transfer a 50% membership interest in Davis E&P to the Gift Trust.

What options are available to Adam and Sara to transfer a 50% membership interest in Davis E&P while minimizing gift tax exposure?

Property Adjustment Clause

- Transfer Language. “Assignor agrees to sell to Assignee the Assigned Interest for the Appraised Value. In the event that the Appraised Value is less than the Gift Tax Value, the Assignee agrees to return to Assignor that portion of the Assigned Interest equal to the difference between the Gift Tax Value and the Appraised Value.”
 - ▶ Assigned Interest = 50% membership interest in Davis E&P.
 - ▶ Gift Tax Value = value as finally determined for federal gift tax purposes.
- In *Commissioner v. Procter* the Fourth Circuit held that a similar formula did not invalidate the taxable gift in that case because it imposed a condition subsequent on the gift.

Property Adjustment Clause

- Possible Transfer Language. “Assignor agrees to sell to Assignee a certain portion of the Assigned Interest calculated by the product of the Assigned Interest multiplied by a fraction the numerator of which is (a) the Appraised Value plus (b) 1% of the excess, if any, of the Gift Tax Value over the Appraised Value, and the denominator is the Gift Tax Value.”
 - ▶ Audit risk?
 - ▶ Still condition subsequent?

Price Adjustment Clause

- Transfer Language. “Assignor agrees to sell to Assignee the Assigned Interest for the Appraised Value as of the Effective Date. In the event that the Appraised Value of the Assigned Interest is less than the Gift Tax Value, then Assignee agrees to pay to Assignor the difference between the Gift Tax Value and the Appraised Value within five (5) business days of such determination, with interest at the AFR from the Effective Date.”
 - ▶ Similar provision held valid by Tenth Circuit in *King v. US*.
 - ▶ Transaction differs from *Procter* in that transferred assets were not returned to the taxpayer.

- Revenue Ruling 86-41.
 - ▶ IRS held that a purchase price adjustment is not valid because it is a condition subsequent.

McCord Transaction

- Transfer Language. “The Assigned Interest shall be allocated among the Assignees in the following order:
 - (a) that portion of the Assigned Interest having a fair market value as of the Effective Date equal to six million dollars (\$6,000,000) to the Gift Trust.
 - (b) any remaining portion of the Assigned Interest to Public Charity.”

- In *McCord v. Commissioner* the Fifth Circuit upheld the use of similar language.

McCord Transaction

- Need to have appraisal prior to transaction, or have confidence in internal valuation in setting dollar amount to Gift Trust.
- No reliance on “values as finally determined for federal gift tax purposes.”
- The transferees will need to reach an agreement between themselves as to ownership percentages after the transaction. The IRS does not determine who owns which percentage.
- Awaiting decision from the Tax Court in *Hendrix v. Commissioner*. The case was tried in December and any appeal would be heard by the Fifth Circuit.

Lifetime Transfer with “Values as Finally Determined for Federal Gift Tax Purposes”

- Transfer Language. “The Assigned Interest shall be allocated among the Assignees in the following order:
 - (a) that portion of the Assigned Interest having a value as finally determined for federal gift tax purposes equal to six million dollars (\$6,000,000) to the Gift Trust.
 - (b) any remaining portion of the Assigned Interest to Public Charity.”
- Differs from *McCord* in that the ownership percentages can be shifted by the IRS.
- Awaiting decision from the Tax Court in *Petter v. Commissioner*.

Non-Charitable Transferees

- Transfer Language. “The Assigned Interest shall be allocated among the Assignees in the following order:
 - (a) that portion of the Assigned Interest having a fair market value as finally determined for federal gift tax purposes equal to six million dollars (\$6,000,000) to the Gift Trust.
 - (b) any remaining portion of the Assigned Interest to (GRAT or Spouse).”
- ▶ With GRAT, argument that no taxable gift made upon redetermination by the IRS since GRAT allows for valuation adjustment.
- ▶ With Spouse, taxable gift risk if IRS asserts that percentage Spouse agrees he or she received is less than percentage determined by IRS valuation.

Non-Charitable Transferees

- ▶ Differs from *McCord* in that the ownership percentages can be shifted by the IRS.
- ▶ Uncertainty regarding ownership percentages can present a problem for allocation of income from Davis E&P. The remainder beneficiary of GRAT can be structured as a grantor trust for income tax purposes to alleviate this issue.

Testamentary Disclaimer

- Transfer Language (in Will). “In the event that any person disclaims all or any portion of an interest in property otherwise passing to the benefit of such person under this Will, the interest that is subject to such disclaimer shall pass to the Davis Family Foundation.”
- Disclaimer Language. “I hereby disclaim that portion of the membership interest in Davis E&P which exceeds \$6,000,000 as finally determined for federal estate tax purposes.”
 - ▶ Similar disclaimer held valid in *Estate of Christiansen v. Commissioner*.
 - ▶ Disclaimer will only be effective if all beneficiaries disclaim.
 - ▶ If assets under Will pass to a trust rather than outright to beneficiaries, the trust needs to address who has the power to disclaim.