‘CHARITABLE LID’ DEFINED VALUE CLAUSE UPHELD

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Federal transfer tax laws provide for various fixed exemptions and credits, such as the unified credit amount, the annual exclusion gift maximum amount, and the generation-skipping tax exemption. Taxpayers seeking to make *inter vivos* transfers of difficult-to-value assets that are at or under an exemption amount have a practical problem. To make the transfer they need to transfer property (such as shares of a closely-held business), but unless and until the IRS audits the transfer, there can be a large swing in potential transfer tax value between the estimate provided by the taxpayer’s appraiser, and what the IRS may assert or believe. Attempts to make transfers based on a formula such as “so many XYZ Corp. shares that are equal in value to $x” are vigorously opposed by the IRS. They can also be impractical because some number of shares would need to be transferred based on the initial valuation, with a later adjustment and transfer of shares one way or the other if the value is adjusted by the IRS. The IRS generally challenges such formula gifts as being invalid “savings clauses” under *Procter*, 142 F2d 824 (4th Cir. 1944). The precise scope of *Procter* has never been fully delineated by the courts, with *King* in the 1970’s, and *Harwood* and *Ward* in the 1980’s, helping somewhat to define its parameters.

In 2003, the 5th Circuit in *McCord,* 461 F2d 614, *rev’g*. 120 T.C. 358 (2003)*,* reversed the Tax Court and gave tax effect to a defined value clause. Now, the Tax Court itself has ruled in a case that also gave effect to such a clause. The planning in the instant case was excellent – it included two elements presumably intended to defuse anticipated IRS arguments, and they appear to have functioned as designed.

The first such planning element was a the inclusion of small gift to a charitable recipient (here, a donor advised community fund), based on the donors’ valuation. The gift was structured that a fixed dollar amount of stock was to be transferred to family trusts, with any excess value passing to the charitable fund. This achieved two benefits, and since the charitable gift was relatively small as compared to the transfer to the trusts, it did not have a substantial economic cost to the donors.

First, it allowed the donors to defend against the IRS' argument that a defined value clause was against public policy. That argument is that the IRS is discouraged from challenging valuations in these circumstances since it has no transfer tax "upside" to disputing value - any increase in value would only create a deductible charitable gift. The donors instead could, and did, argue that the clause furthered a public policy of encouraging charitable gifts. This charitable benefit was noted by the Tax Court.

Second, it avoided the problem of the possibility of shares being returned to the donors, or additional shares being transferred from the donor, based on changes in value. Instead, the donors were taken out of the picture in regard to transfers that were needed by such subject revaluations. Any adjustments in value resulted in the adjustment in shares occurring between the trusts and the charitable fund – the donors were not a participant. This distinguishes these transfers from facts similar to *Procter*.

The other interesting element was that the transfers to the trusts were a part sale/part gift transaction. Only the excess of the total defined transfer to the trusts over the consideration paid by the trusts constituted a gift. The IRS argued that the formula clauses were invalid because they were not reached at arm's length. An important aspect of the court's decision to nonetheless find an arm's length transaction was the sale element. Pursuant to the sale, the trusts incurred economic and business risk – if the value of the stock used in the initial computation turned out to be too low, more shares would pass out of the trusts and go to the charitable fund.

It is important to note that the subject case is appealable to the 5th Circuit Court of Appeals – the same circuit as *McCord*. Thus, issues as to applicability of this case to cases arising in other circuits still remain. However, the case is still important because it was not a mere repeat of *McCord*. The Tax Court considered, and was not persuaded by, two arguments of the IRS that were not considered in *McCord*. Those two arguments were the public policy and lack of arms-length dealings discussed above. Further, the court also noted with approval the application of a similar clause in regard to a disclaimer in *Estate of Christiansen*, 586 F3d 1061 (8th Cir 2009), which should help bolster support for the use of such clauses outside of the 5th Circuit.

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