# "Stupid Is as Stupid Does," says the 5th Circuit to the Tax Court in *McCord*

Byline: This is part one of a two part article on the important 5th Circuit ruling, and focuses on the 5th Circuit's reversal of the Tax Court's invalidation of a so called formula clause used to make a gift.[1]

Text of Article:

When a reviewing court uses the work "immutable" three times to describe a doctrine ignored or missed by the lower court, the lack of respect to the lower court's decision is palpable. In reversing the Tax Court in the *McCord* decision,[2] the 5th circuit was not kind to the reasoning used by the lower court. It essentially lit up the Tax Court's decision like a Christmas tree.

The case involved a family partnership, referred to as the "MIL,"[3] a formula gift, and a net gift strategy. The taxpayers in *McCord*, after establishing a limited partnership, assigned all of their limited partnership interests to both charitable and non charitable beneficiaries. They did so by the use of a formula clause. These clauses, also known as "defined value clauses," define a gift by a dollar amount. For example, "I give $1,000 worth of my stock in IBM to my children, valued as of the date of the transfer." The number of shares transferred is defined by how many shares of stock (the value) will equal $1,000.

In *McCord*, as to the gift in controversy, the assignment provided that the formula gift to the sons was to be, according to the Appellate Court, "$6,910,932.52 worth of fair market value in interest of MIL…." Importantly, the assignment also disposed of the remainder of the taxpayers' limited partnership interests, after the defined value clause,[4] by providing that charitable interests were essentially to receive:

> "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 gifts were made irrevocable as of January 12, 1996. The defined value clause required a calculation of the value of the limited partnership interests in order to determine, for example, the amount of limited partnership units that would make up $6,910,932.52. The valuation was completed on February 28, 1996 (done by and referred to hereto as the "Frazier valuation"). Thereafter, in March, the donees used this valuation to determine their respective gifts pursuant to the defined value clause. Each donee was represented by separate counsel, and could use or not use the appraisal obtained. The taxpayers were not involved in the allocation decisions among the donees.

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[1] Part two to this article will focus on the net gift concept ruled on by the Fifth Circuit.

[2] *McCord v. Comm'r*, 120 T.C. 358 (2003)(Halpern, J., joined by Wells, Cohen, Swift, Gerber, Colvin, Gale and Thornton).2

[3] Standing for the McCord Interests Ltd.

[4] There were other non charitable recipients of gifts but for purposes of this analysis, and the language here is a paraphrase, but those other gifts are not included in this discussion.

The Service issued a deficiency based on a greater valuation of the MIL limited partnership units than that set forth in the Frazier valuation. If the defined value gift operated as intended, this greater valuation would have merely meant that the excess value, say approximately $4,000,000, passed to the charitable beneficiary and resulted in a greater charitable deduction. But no additional gift tax or gift tax payment.

However, the Service argued that "form over substance" and violation of public policy, were sufficient for the Tax Court to ignore the defined value clause and to assess additional gift tax. To understand how this could be done, consider the following example.

> Example: Dad gives $5,000,000 worth of Dad Limited Partnership Interests to son. An appraiser values dad's limited partnership interests at $1,000,000 per unit. Hence, dad gives away 5 units. If the defined value clause is ignored, and the Service successfully argues for a value of $2,000,000 per unit, the Service would conclude that dad gave away the same 5 units, but valued at $10,000,000, not $5,000,000. Dad would argue that no, he now gave away 2.5 units, instead of 5 units, at the same total value, $5,000,000.

The Tax Court seemed to be influenced by the fact that the assignees were given ultimate discretion to allocate the limited partnership among themselves, implying therefore that the assignees were the ultimate determinants of the value, not based on the defined valuation clause:

> "The formula clause is not self-effectuating, and the assignment agreement leaves to the assignees the task of (1) determining the fair market value of the gifted interest and (2) plugging that value into the formula clause to determine the fraction of the gifted interest passing to CFT."

In discussing this aspect of the Tax Court's opinion, the 5th circuit had nothing but disdain for the lower court's reasoning. It started out its analysis by referring to the lower court's reasoning as to an incomplete gift (because the shares could not be allocated until the value was determined, which was after the gift was made) as a "consistently rejected concept." It referred to the lower court's opinion as ascribing a "unique methodology," which violated an "immutable maxim." The Appellate Court's dislike of the lower court's opinion was much like the disdain shown by Muhammed Ali towards Howard Cosell before a fight, but not as good natured.

In discussing the valuation methodology employed by the Tax Court, the Appellate Court was as critical of the Tax Court as this author has been in recent speeches and articles. The Tax Court has, in valuation cases over the last few years, acted as its own appraiser. In *McCord*, the Tax Court reached it owns value, one that was not espoused by either party's appraisal experts in the litigation. The Appellate Court held this to be reversible error:

"[T]he methodology employed by the Majority in determining the taxable and non-taxable values of the various donations constitutes legal error, the results of the Majority's independent appraisal of the donated interests in MIL."

In invalidating the part of the lower court's holding that ignored the defined value clause, the Appellate Court indicated that post gift events cannot be relied on in determining gift value. The court held that the gift must be valued at the date the gift was complete, which was the date of the irrevocable assignment:

> "[C]onstant jurisprudence that has established the immutable rule that, for *inter vivos* gifts and post-mortem bequests of inheritances alike, fair market value is determined, snapshot-like, on the day that the donor completes that gift."

In dicta,[5] the Appellate Court gave validity to the taxpayers' use of the defined value clause. In so doing, it validated the use of defined value clauses in gifts, and certainly provides credibility to the clause's use in a sale strategy.[6] For example, if buyer and seller agree to buy/sell that amount of stock worth $5,000,000, for fair market value purposes (maybe or maybe not further conditioned on "as finally determined for gift tax purposes"), that dollar amount should define the amount of stock that is bought and sold. An argument could be made that there is a gift by the seller to the buyer for a value of the stock later determined to be valued at a lower amount than determined (by the IRS?) fair market value. But using this kind of defined value language creates the counter argument, *ala McCord*, that the result would be that less stock was sold, not that there is a gift.

But *caveat empto*, *McCord* deals with irrevocable assignments in a gift tax concept. Using a formula clause in a sale strategy can be characterized differently. Taxpayers will no doubt try to extend the reasoning in *McCord* to those sale cases, and the decisions provides compelling judicial evidence for so doing; but public policy arguments − not aggressively asserted in the *McCord* appeals-- loom on the horizon to try to invalidate these clauses in strategies other than straight gifts, or when the clause does not match the language and follow through used in *McCord*.

The news is good here, but the extension of the doctrine is not "immutable."[7]

More on *McCord* next month.

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[5] It is dicta because the Appellate Court accepted the taxpayers' expert's valuation, and therefore there would have been no gift independent of the effect of the defined value clause.

[6] But will the Service assert as public policy argument (not considered) by the Appellate Court), *ala Procter v. Comm'r*, _____.

[7] Sorry, couldn't resist. The author had to look up the word "immutable", as used by the Appellate Court, in the dictionary before writing this column.