Wandryment and Merryment: Using Defined Value Clauses to Avoid Gift Taxes

Oh to Know What We are Truly Gifting

One of the more difficult strategies in estate planning is to maximize the lifetime transfers of discounted assets within the lifetime exclusion. The 2012 lifetime gifting exclusion was $5,120,000, which (as of this writing) declined to $1,000,000 starting in 2013. To maximize the amount that can be gifted free of gift tax, and that will be excluded from the estate, gifting discounted assets is often advocated.

Example 1: A's limited partnership interests have a liquidation value of $7.3 million. That is, if the partnership were liquidated the day of a proposed transfer, A would receive $7.3 million for his limited partnership interests. Limited partnership interests are by their nature illiquid and non controlling. At a 30 % discount from this liquidation value (as the limited partnership interests have no right to liquidate), the value of the interests for gift tax purposes is $5.120 million. As a result, A gifts all of these partnership interests, reports them on a gift tax return, and intends to pay no gift tax.

The concern in the above example is if the Service disagrees, successfully, with A's 30 % argued discount.

Example 2: If the Service were to successful argue for a 20 % discount, then the value of the gifted partnership interests is $6.4 million, or about $1.4 million over the gift tax exclusion amount. A owes an actual gift tax payment of about $450,000.

Regardless of the efficiency of making a full gift of the limited partnership interests, and even paying a bit of gift tax, most donors would prefer—would feel better—paying no gift tax. Practitioners have developed strategies to prevent the payment of gift tax in this situation.

Making Sure the Excess Goes to Charity to Avoid Gift Tax Payment

Example 3: A gifts his entire limited partnership interest, except that "that part of the limited partnership interest that is in excess of $5.120m is to pass to the Overland Animal Protection Fund, a 501 (c)(3) charity."

In the above example, the definitional gift over has been held to be appropriate and to avoid a gift tax. If the Service were to argue that the entire gift was greater than $5.120m, that is, that a 30 % discount was too high, the excess gift over $5.120m would pass to the charity, qualify for the gift tax charitable deduction, and there would be no gift tax payment owed by A. See, e.g., *Estate of Christiansen v. Comm'r*, 130 T.C. 1 (2008), *Estate of Petter*, T.C. Memo 2009-280, and *McCord v. Comm'r,* 461 F. 3d 614 (5th Cir. 2006). .

Not all donors want to construct gifts in this manner. The idea of having the excess pass to charity may be attractive to donors. Instead, donors would like to have their cake and eat it too.

Example 4: A gives all of his limited partnership interests to his children; however, if any portion of this gift is determined to be in excess of $5.120m, then that excess must be returned to A and will not be a gift to the children. In this way, A will not have to pay a gift tax.

That type of structure in example 4 is referred to as a condition subsequent, also known as a *Procter* gift, which has been held invalid. See *Comm'r v. Procter*, 142 F. 2d 827 (holding invalid a clause that returned to the grantor that part of the gifted property that is determined by a court to be "subject to gift tax" as against public policy). The theory is that any condition that operates to change a completed gift in a way that discourages the IRS from auditing the gift will be null and void as against public policy.

In *Procter,* the taxpayer attempted to change the landscape by redefining what was gifted if the IRS were to audit the return. The *Procter* Court's view seems reasonable, to void that gift as against public policy.

Having Your Gift Tax Cake but Not Having the IRS eat it too

But in the face of valuation uncertainty, how does a taxpayer avoid gift (and for that matter estate) tax risk? On the estate tax side, the taxpayers have been using definitional gifts, "the maximum amount that can pass free of estate tax to the credit shelter trust," or "the maximum amount that can pass free of generation skipping and estate tax to the GST credit shelter trust," for example, for many decades. These certainly have been respected by the Service.

How about, then, making gifts using the same formula.

Example 6: "I give the percentage of my limited partnership interests that equals my remaining gift tax exclusion amount, or $5.120 million, to my children."

Until the recent Tax Court Memorandum Opinion, *Estate of Wandry*, T.C. Memo 2012-88, the efficacy of this type of gifting was unknown. Would it be respected as a definitional gift, and therefore akin to the credit shelter formula under estate planning documents (and valid), or would it be treated as a Procter type condition subsequent (and invalid)?

Wandry Wonderment

To the joy of practitioners, the Tax Court, in a memorandum opinion issued in March, 2012, validated the use of a definitional gift, and differentiated it from the invalid type of condition subsequent found in Procter.

In its simplest iteration, if the gift is defined as a dollar amount, $X of limited partnership interests, that is a definitional gift. If the gift is defined as a percentage of partnership interests, but reduced by any amount held to be a taxable gift by the Service or a court, that is an invalid condition subsequent.

A distinction without a difference? Well, *Wandry* concludes it is a different. Be careful though. Another Judge, in the future, may conclude the distinction is mere nomenclature, and that this type of gift is no different than the *Procter* attempted gift.

Under the Court's reasoning in Wandry, to create a definitional gift, one would need a few elements:

1. The gift must be defined as a dollar amount: "$X worth of limited partnership interests."
2. There must be a good faith effort to obtain a disinterested valuation: "with the fair market value of the interests being what a willing buyer would pay a willing seller under the standards enunciated in the Treasury Regulations as determined by an independent appraiser."
3. There must be understood to be a limit as to the amount gifted: "if the Service or court were to adjust the appraisal to a value different that what was reported in good faith on a gift tax return, then the interests transferred shall be limited to that adjustment."
4. The gift tax return must reflect the amount as the gift, not the interests: "And the amount shall be reflected on the gift tax return, with the interests being transferred explained on the face of the return or as an adjustment in such manner as to allow the IRS to review the determined fair market value of the interests."
5. And the parties should have the corporate or business records reflect that there may be adjustments (post gift) to the records to reflect possible changes to the ownership.

<u>Conclusion</u>

Planners should be delighted to have the *Wandry* decision, probably one of the most important ones for estate planners in the last decade.[1] Until a court says to the contrary, planners should consider using definitional gifts in those difficult gift tax valuation cases to avoid possible gift tax payment on audit.

[1] Wandry was appealed, but then in mid-October, 2012, that appeal was dismissed.