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Summer 2012 Newsletter

The final Nail in the Coffin for IRS Challenges to Formula Clauses

Formula clauses in estate planning documents have been popular because they allow planning even in the face of valuation uncertainty: what if the gift's value is challenged ? If the Service claims a big enough valuation increase, won't significant gift taxes become due ? This uncertainty has probably held wealthy donors from closing gift transactions.. until Wandry [*Wandry v. Commissioner*, Tax Court Memo 2012-88, filed March 12, 2012.]

In 2001, a couple and their children formed Norseman Capital, LLC as a partnership and started a gifting program to the next generation. In connection with the gifts, their attorney advised that (1) the number of Norseman membership units equal the desired value of their gifts on any given date could not be known until a later date when a valuation could be ordered; (2) all gifts should be given as specific dollar amounts, rather than specific numbers of membership units; and (3) all gifts should be given on Dec. 31 or Jan. 1 of any year so that the mid-year closing of the entity's books would not be required.

On January 1, 2004, the taxpayers assigned and transferred as gifts a significant number of units to their 4 children and 5 grandchildren. The gift documents had an adjustment clause which stated that "although the number of units gifted is fixed on the date of the gift, that number is based on the value of the units, which can not be known on the day of the gift and must be determined after such gift date after all relevant information, all as of that date, is received. If, after the number of units gifted is determined based on such valuation, IRS challenges it and a final determination of a difference value is made by the Service or a court of law, the number of gifted units shall be adjusted accordingly so that the value of the number of units gifted to each donee equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS or a court of law." The Service argued that substantial gift taxes were due because, under the Service's valuation, the federal gift tax exclusions were exceeded. The taxpayers originally claimed a 39% discount on the gift form, the Service in its deficiency notice allowed 14.5%, but a settlement at 26% was reached.

The Court cited *Knight* [115 T.C. 506 in 2000] as a case where the returns served as the determining description of the gifts. Other cases where a formula clause was upheld include *McCord* [affirmed by the 4th Circuit,] *Christiansen* [130 T.C. 1 in 2008] and *Petter* [T.C. Memo 2009-280.] The 1944 case in *Procter* had rejected such a clause because any attempt to collect the tax would defeat the gift. The Court drew a distinction between a "savings clause" - which a taxpayer may not use as it would permit taking the property back - and a formula clause which does not raise such issues. Here the Court determined, the petitioners believed they had gifted fixed dollar amounts, as in *Petter*, where the gift was irrevocable, albeit of a value to be determined later. Finally, the fact that in the latter case the reallocation of units did benefit a charity, was deemed irrelevant.

Estate of Louise Gallagher, deceased v. Commissioner
T.C. Memo 2011-148 filed June 28, 2011

At issue is a the value of a 15% non-marketable minority interest in a Kentucky LLC which had elected to be taxed as an S corporation. The entity's principal assets were various newspapers, specialty magazines and a TV station generally operating in small markets. The case represents, on balance, a victory for the estate as the Court determined value at $32.6 million, much closer to the estate's litigation value of $28.2 million than the IRS' revised litigation value of $40 million. However, both experts ran afoul of Judge Halpern, at times because the Judge's position was barely more supported than the positions of the experts he complained about.

The Service and the Estate disagreed about almost every aspect of the valuation such as the date of the relevant financial information to be used, the normalization adjustments, the propriety of relying on a market-based approach through the value of public guideline companies, the specific application of the DCF method, the appropriate adjustments to enterprise value and the nature and size of the valuation discounts.

The decedent died on July 5, 2004. The Court reasonably decided that it was appropriate to use end of June financial information for both the Company and the public guideline companies. The Estate's appraiser has used end of May and end of March data, respectively, perhaps an overreaching effort to use only what was known on the Valuation Date. All normalization adjustments of the Estate's appraiser were rejected because the latter did not explain them; some did sound quite plausible. Only the IRS appraiser used the public guideline company method, but the Court disagreed that it should be applied at all, since it only found one public firm, though larger than the subject, which was sufficiently comparable based on its own criterion. Projections used by a 3rd party lender in preparing a debt memorandum - the most sensible set to use - were disregarded by both appraisers and the Court. Accordingly, both appraisers and the Court actually reconstructed their own set of projections based on respective judgement calls on likely future results. The theoretical basis of doing so is very thin indeed.

Finally, the Court refused to tax-effect results in spite of there being several available models since *Gross* [T.C. 1999-254] which calculate the benefits of the S election [in fairness, none of the experts has used such models.] The reason given by the Court is that the estate's appraiser did not consistently use one tax rate. This opinion thus conflicts with common sense [who would buy equity which, in effect, belongs to the tax authority ?] and thus may very well be revisited by the 11th Circuit Court of Appeals. The Court noted further inconsistencies such as the estate's appraiser [who did not use the public guideline method] was chastised for using the industry's percentage of equity versus debt in the calculation of Weighted Average Cost of Capital. The Court still does not like using the weighted-averaged cost of capital ["WACC"] concept for a relatively small company, but in the end used it because both appraisers did. Another phobia is the capital asset pricing model or CAPM, which the Court simply refused to sanction despite common use by practitioners, for decades since Sharpe, Markowitz, Miller obtained their 1990 Nobel prize for their work in that area.

Finally, despite admitting that his Discounted Cash Flow approach produced a minority value, the Service's appraiser took a 17% lack-of-control discount which the Court proceeded to approve and increase to 23%, while criticizing the approach as simplistic [the expert had used the inverse of the control premium data published by Mergerstat.] Finally, both appraisers determined the LOMD at 30% based on a benchmark analysis; faced with rare consistency across parties, the Court agreed but criticized the theory used without going into details.

While it does not sound like the experts were using the latest in their tool boxes, the Court's refusal to use common techniques well past the acceptance stage is disturbing.

The Court decision can be found at http://www.ustaxcourt.gov. Click on Opinions Search, then enter "Gallagher." The file's name is GallagherEst.TCM.WPD.pdf. The decision is also available at http://www.NYNJCT-BV.com/GallagherEst.TCM.WPD.pdf.

Estate of Beatrice Kelly, deceased v. Commissioner
T.C. Memo 2012-73 filed March 19, 2012

In 1946, the decedent and her family opened a quarry in rural Georgia. All her family worked in the business. Her husband died in 1990. Her will provided that, after specific bequests, her estate be divided equally between her children, including a child with disabilities. After the decedent's health declined, one of the children was appointed guardian of both his brother and of his mother. An interim agreement was signed by the children without knowing the content of their mother's will. When she died, it was discovered that the will provided unequal distribution between the children as different assets had appreciated unevenly. This matter was corrected through a second agreement, and its execution necessitated court approval. As of 2002, her estate consisted of publicly traded stock, privately held stock, 2 quarries, a subdivision with rental homes, a post office, and land with a waterfall and picnic facilities.

At that point, the children hired an estate attorney, who recommend the formation of 4 limited partnerships and a corporation which was designed to act as general partner of the partnerships. Each of 3 partnerships would be for the benefit of each of the children, and the 4th partnership would specifically hold the quarries, which were believed to be the most prone to accident litigation. The agreements creating the partnerships and the corporation were signed in 2003 and the estate retained over $1 million in liquid assets. Various assets funded the partnerships and the corporation was to collect a 0.7% fee annually for the decedent's support. Limited interests were then gifted by the decedent to her children; she died in 2005. The Service sent a notice of deficiency which assumed that the value of contributed assets should be included in her estate under IRC 2036(a).

The Court, on the other hand, estimated that the decedent had valid and non-tax based reasons for contributing assets to the partnerships, specifically to reduce liability by interposing the partnerships and insure an equal distribution among her children without litigation. The tax savings which resulted were apparently not considered except as a secondary benefit. The Court also believed that the assets transferred to the partnerships did not constitute a retained interest, as the fee paid to the corporation was reasonable, and arrangements had been made for the decedent's support.

Creation of Family Asset Satisfies Nontax Reason for FLP - the *Stone* Case
T.C. Memo 2012-48 filed February 22, 2012

We are delighted to announce that a recent article written by JLP and covering this U.S. Tax Court decision has been published by Insights & Strategies, a trust and estate law publication. It can be found at http://www.NYNJCT-BV.com/2012 MayI&S.pdf

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