True v. Commissioner, Tax Court Docket Nos. 21896-16 and 21897-16 (petitions filed October 11, 2016)

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IRS Attack on "Wandry" and Price Adjustment Clauses

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SYNOPSIS

Mr. True made gifts of interests in a family business to one of his daughters and made sales of the business interests to all of his children and a trust. The transfers were made based on an appraisal from a recognized reputable national appraisal firm. The transfers to his children were subject to a "transfer agreement" with a defined value/price adjustment provision. The spouses made the split gift election, so any gift was made one-half by each spouse; hence separate Tax Court petitions for Mr. and Mrs. True.

A gift of units in the family business was made to one daughter (Barbara True), and the transfer agreement provided that if the transfer of those interests is determined for federal gift tax purposes to be worth more than the anticipated $34,044,838 amount of the gift, "(i) the ownership interest gifted would be adjusted so that the value of the gift remained at $34,044,838, and (ii) Barbara True would be treated as having purchased the ownership interests that were removed from her gift."

Sales of business interests were made to that daughter, the other two children, and a trust. According to the petition, the transfer agreement for the sales to his children "provided that if it is determined for federal gift tax purposes that the interests sold were undervalued by FMV Opinions, the purchase price would be increased to reflect the finally-determined fair market values."

The IRS has alleged a gift tax deficiency of $16,591,418 by each of Mr. and Mrs. True. The taxpayers contend that the valuations were correct, but if the transferred interests are determined to have a higher value, no gift should result because of the price adjustment provisions in the transfer agreement. *Karen S. True v. Commissioner,* Tax Court Docket No. 21896-16, and *H.A. True III v. Commissioner*, Tax Court Docket No. 21897-16 (petitions filed October 11, 2016).

The IRS filed a nonacquiescence in the *Wandry* case (a case approving a transfer of that percentage interest in an LLC equal to a specified dollar value), and has indicated informally that it is still looking for the "right case" to mount another attack on *Wandry* clauses. Apparently, this is that case.

BASIC FACTS

H.A. True III is the son of H.A. True, Jr., who was the taxpayer in *True v. Commissioner*, 390 F.3d 1210 (10th Cir. 2004), *aff'g,* T.C. Memo. 2001-167 (2001), involving, among other things, the value of family businesses and the effect of the price in a buy-sell agreement on the value for estate and gift tax purposes.

H.A. True III and his wife, Karen S. True, are residents of Wyoming [significant because any appeal would be to the 10th Circuit Court of Appeals]. They wanted to make transfers of interests in family businesses to their children and a trust, and to ensure the dealings were at arm's length, Mr. True obtained a valuation of the business interests from FMV Opinions, Inc. Based on that appraisal, Mr. True made a gift and sale of interests in family businesses to one of his daughters (Barbara True), and made sales of interests in family businesses to his other two children and to a trust. All of the transfers to his children were memorialized in a document

titled "Agreement for Transfer of Interests in the True Family Businesses to Thea True Wells, H.A. (Tad) True and Barbara B. True," referred to below as the "transfer agreement."

Mr. True gave business interests worth $34,044,838, based on the appraisal, to his daughter, Barbara True. Mr. True wanted to make a gift of precisely $34,044,838 to her, and the transfer agreement provided that an adjustment would be made if the value of the business interests transferred to her was determined to have a higher value for federal gift tax purposes. The petition summarizes the provisions of the transfer agreement as to this gift transaction as follows:

> With respect to the $34,044,838 gift to Barbara True, the transfer agreement provided that if it is determined for federal gift tax purposes that the $34,044,838 worth of gifted interests were worth more than $34,044,838, (i) the ownership interests gifted would be adjusted so that the value of the gift remained at $34,044,838, and (ii) Barbara True would be treated as having purchased the ownership interests that were removed from her gift.

(The petition does not describe the terms of any such purchase.)

Mr. True also sold additional shares to Barbara and to his other two children (in return for purchase prices of $26,538,754, $22,878,826, and $$22,878,826, respectively). The numbers of units transferred in return for these prices were also based on the appraisal. These sales were also memorialized in the transfer agreement, and the petition summarizes the price adjustment provision as follows:

> With respect to Mr. True's sales of ownership interests to his children, the transfer agreement provided that if it is determined for federal gift tax purposes that the interests sold were undervalued by FMV Opinions, the purchase price would be increased to reflect the finally-determined fair market values.

The sale to the trust of a non-voting interest in a particular LLC was not subject to a price adjustment clause.

Mr. and Mrs. True filed gift tax returns for the year in which these transfers were made, making the split gift election. Any gifts therefore were made one-half by each of the spouses for federal gift tax purposes.

The IRS issued notices of deficiency reflecting an underpayment of gift tax of $16,591,418 by each of the spouses. The deficiency notices made no mention of the price adjustment provisions in the transfer agreement.

Planning Observations

1. **General Description of Defined Value Clauses.** In making transfers of hard-to-value assets, clients are concerned that gift taxes may result if the assumed value at the time of the transfer ends up being lower than the value that is finally determined for gift tax purposes. Two types of clauses have emerged to define what is transferred by formula in order to avoid (or diminish) the gift tax risk—(1) formula allocation clauses and (2) formula transfer clauses. The agreement used in the *True* transfers was somewhat of a combination of these two approaches.

2. **Formula Allocation Clauses.** A "formula allocation clause" allocates the amount transferred among transferees (*i.e.*, transfer all of a particular asset, and allocate that asset among taxable and non-taxable transferees by a formula). Examples of non-taxable transferees include charities, spouses, QTIP trusts, "incomplete gift trusts" (where there is a retained limited power of appointment or some other retained power so that the gift

is not completed for federal gift tax purposes), and "zeroed-out" GRATs. With this type of clause, the allocation can be based on values as finally determined for gift or estate tax purposes, or the allocation can be based on an agreement among the transferees as to values.

Four cases have previously recognized formula allocation defined value clauses, all involving clauses with the "excess" value passing to charity. *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006); *Christiansen v. Commissioner,* 130 T.C. 1 (2008), *aff'd*, 586 F.3d 1061 (8th Cir. 2009), *Petter v. Commissioner,* T.C. Memo. 2009-280, *aff'd*¸ 653 F.3d 1012 (9th Cir. 2011), and *Hendrix v. Commissioner,* T.C. Memo. 2011-133). Two of the cases relied on an agreement among the transferees as to valuation (*McCord and Hendrix*) and the other two cases relied on finally determined estate (*Christiansen*) or gift *(Petter*) tax values.

3. **Formula Transfer Clause— *Wandry.*** In *Wandry v. Commissioner*, T.C. Memo. 2012-88, the court upheld a stated dollar value "formula transfer" clause of, in effect, "that number of units equal in value to $x as determined for federal gift tax purposes." The court addressed the IRS's argument that the formula assignment was an invalid "savings clause" under the old *Procter* case. *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944). Judge Haines concluded that the transfers of units having a specified fair market value for federal gift tax purposes are not void as savings clauses — they do not operate to "take property back" as a condition subsequent.

   As to the public policy issue, the court quoted the Supreme Court's conclusion that public policy exceptions to the Code should be recognized only for "severe and immediate" frustrations, and analyzed why the three public policy issues raised in the *Procter* case do not apply. First, the opinion responds to the concern that the clause would discourage the efforts to collect taxes by reasoning that the IRS's role is to enforce the tax laws, not just to maximize revenues, and that other enforcement mechanisms exist to ensure accurate valuation reporting. As to the second and third policy concerns raised by *Procter*, the court responded that the case is not "passing judgment on a moot case or issuing merely a declaratory judgment," because the effect of the case causes a reallocation of units between the donors and the donees. The court noted in particular that prior cases addressing the public policy issue have involved situations in which charities were involved in the transfers, but concluded that the lack of a charitable component in these transfers does not result in a "severe and immediate" public policy concern.

   Critics of the *Wandry* opinion have focused on one of the rationales given by Judge Haines—that there are other enforcement mechanisms to ensure accurate valuation reporting. Under the *Wandry* scenario, both the donor and donee will generally wish to transfer as many units as possible within the specified dollar amount.

   The IRS filed a Notice of Appeal in *Wandry* on August 28, 2012, but the government subsequently filed a dismissal and dropped the appeal. The appeal would have been to the 10th Circuit Court of Appeals, which is the circuit that approved a formula price adjustment clause in *King v. United States*, 545 F.2d 700 (10th Cir. 1976) (formula adjusted the purchase price of shares sold to a trust for children if the IRS determined the fair market value of the shares to be different than the sale price).

The IRS subsequently filed a nonacquiescence in the case. I.R.B. 2012-46 ("nonacquiescence relating to the court's holding that taxpayers made a completed transfer of only a 1.98 percent membership interest in Norseman Capital, LLC").

For a detailed discussion of *Wandry* and planning considerations in using defined value clauses, see Item 27 of the Hot Topics and Current Developments Summary (December 2013) found **here** and available at **www.Bessemer.com/Advisor**.

4. **Distinction of *True* Clause from the *Procter* and *Wandry* Clauses.** The *Procter* clause was analyzed as a transfer with a "condition subsequent" in which "excess" units were transferred back to the donor. The clause in Procter was as follows:

> Eleventh: The settlor is advised by counsel and satisfied that the present transfer is not subject to Federal gift tax. However, in the event it should be determined by final judgment or order of a competent federal court of last resort that any part of the transfer in trust hereunder is subject to gift tax, it is agreed by all the parties hereto that in that event the excess property *hereby transferred* which is decreed by such court to be subject to gift tax, shall automatically be *deemed* not to be included in the conveyance in trust hereunder and shall remain the sole property of Frederic W. Procter free from the trust hereby created. (Emphasis added)

The literal language of the transfer document in *Procter* contemplates that counsel believes the present transfer is not subject to gift tax, and that any property "*hereby transferred*" that would be subject to gift tax is "*deemed*" not to be included in the conveyance. This is different from the clause in *Wandry* that only purported to transfer a specified dollar value of property and nothing else. Similarly, the clause used in *True* did not contemplate that any of the transferred shares would be returned to the donor.

The *Wandry* clause provided as follows:

> I hereby assign and transfer as gifts, effective as of January 1, 2004, a sufficient number of my Units as a Member of Norseman Capital, LLC, a Colorado limited liability company, so that the fair market value of such Units for federal gift tax purposes shall be as follows:
>
> [Names and gift amounts deleted]
>
> Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service ("IRS"). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if, after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS 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 person 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 and/or a court of law.

The *Wandry* clause only transferred units equal to the specified monetary value. Some commentators have observed that the effect of the *Wandry* clause is as in *Procter*—the units in excess of the gift amount end up being owned by the donor. In fact, the clauses are different literally in that the *Procter* clause actually transferred the larger amount and the excess was "deemed" not to be included, whereas the *Wandry* clause never purported to transfer more than the specific dollar values. Perhaps that is just a matter of

semantics. In any event, the *True* clause makes a transfer of all of the units that were transferred to Barbara in the gift transaction. To the extent that their value exceeds the specified amount, the excess is purchased by Barbara; none of the shares are returned to Mr. True. In that regard, the *True* clause is somewhat like a formula allocation clause, in that all of a certain block of units are transferred, and the formula describes how many units are gifted and how many units are sold.

5. **Sale Transactions with Defined Value Transfers.** Sale transactions as well as gifts can be structured with a defined value clause. *Petter* and *Hendrix* both involved combined gift/sale transactions—with formula allocation clauses allocating the "excess" value over the stated purchase price to charity. *Petter v. Commissioner*, T.C. Memo. 2009-280, *aff'd,* 653 F.3d 1012 (9th Cir. 2011); *Hendrix v. Commissioner*, T.C. Memo. 2011-133.

   Similarly, a sale could be structured with the assignment being of that number of shares equal to the specified purchase price. The *Woelbing* cases involved sales transactions in which Mr. Woelbing sold to a grantor trust that number of shares of stock in a closely-held company having a value equal to $59 million, in return for a $59 million note. The IRS contested the valuation (and also argued that §§2702, 2036 and 2038 applied). *Estate of Donald Woelbing v. Commissioner*, Docket No. 30261-13; *Estate of Marion Woelbing v. Commissioner*, Docket No. 30260-13. The *Woelbing* cases were settled with the IRS reportedly giving effect to the *Wandry* provision in the sales agreement, but the IRS could assure that any shares that were not transferred were subject to estate taxation in the Mrs. Woelding's estate (because she had died days after receiving the gift tax notice of deficiency).

   Alternatively, the sale could be structured with a clause similar to the approach approved in *King v. United States*, 545 F.2d 700 (10th Cir. 1976). That case upheld a formula that adjusted the purchase price of shares sold to a trust for children if the IRS determined the fair market value of the shares to be different than the sale price. (That is the approach used in the sale transactions in the *True* cases.)

   The price-adjustment approach was subsequently rejected in a sale for a private annuity in *Estate of McLendon v. Commissioner*, T.C. Memo. 1993-459, *rev'd*, 77 F.3d 447 (5th Cir. 1995) (appellate opinion does not discuss value clause that would adjust purchase price and amount of annuity payments; Tax Court ignored the adjustment clause, based on *Procter* and *Ward* [87 T.C. 78 (1986)], concluding that it would not expend "precious judicial resources to resolve the question of whether a gift resulted from the private annuity transaction only to render that issue moot"). Similarly, a "price adjustment" clause in a gift transaction was not given effect in *Harwood v. Commissioner*, 82 T.C. 239 (1984), *aff'd without published opinion*, 786 F.2d 1174 (9th Cir. 1986) (gift transfer of limited partnership units with a provision that if the value was finally determined to exceed $400,000 for gift tax purposes, the trustee was to execute a note back to the donor for the "excess value"; *Procter* and *King* both distinguished; adjustment provision not given effect, based on interpretation of adjustment clause).

6. **Good Faith Independent Appraisal**. An IRS concern with defined value types of clauses is that they may encourage taxpayers to use aggressively (and perhaps abusively) low valuations. If the IRS audits the transfer, the worse that happens is to accomplish a transfer of what should have happened in the first place-without any gift tax risk. If there

is no audit, the taxpayer "gets away with murder." The *True* cases, on the other hand, involve a taxpayer who hired a reputable national appraisal firm to appraise the shares, and the transfers were made based on the appraisal.

7. **Current Status of *Wandry* Clauses.** A practical impact of the *Wandry* case is that before that case, estate and gift tax examiners would just give a very simple short one sentence response to formula clauses: "We don't' respect formulas." That is no longer the case (although there are anecdotal indications that some examiners say they cannot take a defined value clause into consideration at the examiner level, but it could be considered at Appeals).

   There were likely a number of *Wandry* transfers made in late 2012. Gift tax returns for many of them were likely filed in the late summer-early fall of 2013, and the statute of limitations of assessing additional gift tax generally expired by October 15, 2016 on those returns. Relatively few gift audits of 2012 gift transactions have been reported.

8. **"The Right Case."** The IRS informally has indicated that it has not given up on its opposition to *Wandry*-type clauses and is still looking for "**the right case**." That the IRS chose the *True* cases as the next vehicle to fight the *Wandry* clause is somewhat surprising. First, the cases involve transfers based on a reputable appraisal; one might have expected the "right case" to be one in which abusive extremely "low ball" figures were used without an appraisal and with the adjustment clause being used as a "backstop" in case the IRS audited the transaction. Second, the case will be appealable to the 10th Circuit Court of Appeals. The clauses for both the gift and sales transactions in the *True* cases involve a price adjustment clause, and the 10th Circuit has already approved price adjustment clauses in the gift tax context in *King v. United States* (albeit 40 years ago). Third, the case does not involve a situation in which "excess" transferred units are re-transferred back to the donor/seller, which would have most closely paralleled the "condition subsequent" analysis in *Procter*.