# STOPPING A HEADS-I-WIN-TAILS-YOU-LOSE TAX STRATAGEM: WHY CONGRESS SHOULDN'T LET TAXPAYERS USE TRANSFER CLAUSES TO FRUSTRATE IRS GIFT-TAX AUDITS

## INTRODUCTION

Although the estate tax makes up a small proportion in overall federal revenue, it generates billions of dollars annually.[1] Recently, the American Taxpayer Relief Act of 2012 (ATRA) provided some clarity in the estate tax arena by setting a 40% tax rate and a $5.25 million per person applicable exclusion amount for 2013.[2] The significant tax liability that could be created at death influences those taxpayers with estates close to or larger than the exclusion amount to want to move as much value as possible out of their estates by making lifetime gifts. This requires

[1] Roberton Williams, *The Numbers: What are the federal government's sources of revenue?*, TAX POLICY CENTER (Sep. 13, 2011), http://www.taxpolicycenter.org/briefing-book/background/numbers/revenue.cfm.

[2] Benjamin Harris, *Estate Taxes After ATRA*, 138 Tax Notes 1005, 1005 (Feb. 25, 2013). Instead of reverting back to 2001 tax law with a $1 million exemption and 55% top tax rate as scheduled, the ATRA indexed the 2011 exemption of $5 million for inflation. *Id.*

taxpayers to plan around the applicable exclusion amount to avoid the backstop to the estate tax: the gift tax.

In an effort to maximize the value transferred out of the estate at minimum risk, tax practitioners have come up with complex transactions involving family limited partnerships (FLPs), valuation discounts, and transfer clauses. While such transactions result in favorable results for taxpayers, they do so to the detriment of the Treasury because they create a heads-I-win-tails-you-lose situation. Taxpayers place their property into closely held entities to take advantage of valuation discounts and then give discounted interests in that entity to the desired donee. If the Internal Revenue Service (IRS) audits and disagrees with the taxpayer's stated valuation of the gift, then the excess value is reallocated in a manner that avoids the gift tax. The taxpayer has every incentive to take excessive discounts and undervalue the gifted interests because the transfer clause ensures no gift tax liability will be imposed. Accordingly, the transfer clauses operate to deprive the government of revenue while also wasting agency resources on fruitless audits, causing insult to injury.

The courts have shifted from being firmly opposed to the use of transfer clauses to allowing the use of certain types. This is largely because the courts have interpreted the initial case forbidding a clause narrowly instead of applying its overall premise to later cases. Nevertheless, the IRS remains firmly opposed to the use of all types of transfer clauses in the gift tax context even in the wake of this judicial approval.

The lack of judicial support for the IRS has resulted in an ongoing dual between the IRS and taxpayers. The IRS bears the responsibility to enforce the tax law, and, since Congress has continued to impose gift taxes, the IRS continues to attempt to enforce the law. To create clarity surrounding this issue, this Comment proposes that Congress needs to enact legislation disregarding transfer clauses that are triggered by IRS audits.

Part One provides a general introduction to the use of valuation discounts and their role in maximizing value that can be transferred out of the estate. Part Two describes the various kinds of transfer clauses and gives a history of the judicial shift from disregarding the clauses to favoring them. Part Three demonstrates that to protect the interests of both the public and the government, new legislation should be enacted that disregards transfer clauses triggered by an IRS audit for federal gift tax purposes. Part Four gives arguments both for and against allowing an exception for clauses involving charitable donees. Part Five concludes.

## I. THE GIFT TAX, VALUATION DISCOUNTS, AND THE DISAPPEARING WEALTH PHENOMENON[3]

The estate tax applies to transfers of wealth at a taxpayer's death exceeding the applicable exclusion amount.[4] The gift tax acts as a backstop to the estate tax by making sure that tax is collected on lifetime gifts that exceed the annual exclusion.[5] If lifetime gifts were allowed to go tax-free, then taxpayers would only be affected by the estate tax "to the extent they were unwilling or unable to part with the wealth sooner."[6]

One way taxpayers maximize the value transferred out of the estate under the annual exclusion is by gifting interests in closely held entities.[7] Taxpayers are able to take their easy-to-value assets, such as marketable securities and real estate, and make them hard-to-value by placing them into family limited

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[3] Discounting the value of FLP interests has been referred to as "the disappearing wealth phenomenon" in numerous articles. *See, e.g.*, Laura E. Cunningham, *Remember the Alamo: The IRS Needs Ammunition in its Fight Against the FLP*, 86 Tax Notes 1461, 1461 (Spec. Supp. Mar. 13, 2000).

[4] The exclusion level is determined by Congress each year. For 2013, the exclusion level is $5.25 million. Harris, *supra* note 2. While referred to as the "applicable exclusion amount," it is really a unified tax credit against gift and or estate tax for transfers at death or during life.

[5] Jeffrey N. Pennell, *Wealth Transfer Taxation: 'Transfer' Defined*, 128 Tax Notes 615, 623 (Aug. 9, 2010). Taxpayers are allowed an annual exclusion per gift per donee each year. I.R.C. § 2503 (2008 & Supp. 2012)., but can also choose to take advantage of the larger credit. The annual exclusion was adjusted for inflation in 2013, rising to $14,000 per gift per donee. Joseph DiSciullo, Julie Brienza & Emily Vanderweide, *IRS Releases Guidance Listing 2013 Inflation-Adjusted Amounts*, 137 Tax Notes 381, 381 (Oct. 22, 2012).

[6] Pennell, *supra* note 5, at 623.

[7] *See* Cunningham, *supra* note 3, at 1462; Laura E. Cunningham, *FLPs, the Transfer Taxes, and the Income Tax*, 127 Tax Notes 806, 809 (May 17, 2010); Calvin H. Johnson & Joseph M. Dodge, *Passing Estate Tax Values Through the Eye of the Needle*, 132 Tax Notes 939, 940 (Aug. 29, 2011).

partnerships or limited liability companies.[8] They then transfer minority interests in the entity to the desired donee at a discounted value.[9]

While the IRS contested the use of minority shareholder discounts in family transfer situations at first,[10] the IRS changed its position in Revenue Ruling 93-12.[11] Consequently, the IRS no longer assumes that family members are acting together when determining "whether the transferred shares should be valued as part of a controlling interest."[12] Therefore, discounts for minority interests in the family entity will not be disallowed just because such interest could be part of a controlling interest when the individual family member's interests are aggregated together.[13]

This shift by the IRS caused family limited partnerships to proliferate as "the tax shelters of the 1990's" because taxpayers were able to drop their assets into the entity, create minority interests, and gift those interests at a value much below what the underlying assets were worth.[14] Gift tax is assessed on the fair market value of the transferred property, or "the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[15] Since the transferred property is measured on an objective basis,[16]

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8 I refer to both family limited partnerships and limited liability companies as "family limited partnerships" for efficiency. *See* Cunningham, *supra* note 7, at 810; Laura E. Cunningham, *FLP Fix Must Be a Part of Transfer Tax Reform*, 112 Tax Notes 937, 937 (Sept. 11, 2006).

9 *See* Cunningham, *supra* note 3, at 1462.

10 *See* Rev. Rul. 81-253, 1981-2 C.B. 187 (holding that no minority shareholder discount was allowed in transfers of stock between family members when control of the corporation exists in the family unit).

11 Rev. Rul. 93-12, 1993-1 C.B. 202.

12 *Id.*

13 *Id.*

14 *See* Cunningham, *supra* note 3, at 1462.

15 Treas. Reg. § 20.2031-1(b) (as amended in 1965).

16 Alden Koste, *The IRS Fished its Wish: The Ability of Section 2703 to Minimize Valuation Discounts Afforded to Family Limited Partnership Interests in Holman v. Commissioner*, 59 CATH. U. L. REV. 289, 292 n. 19 (2009).

minority discounts are allowed to reflect the taxpayer's lack of control and the property's lack of marketability.[17]

The ability to transfer discounted minority interests allows taxpayers to maximize the value passed out of the estate through the use of the annual exclusion at the expense of the transfer tax base.[18] For example, assuming a $14,000 annual exclusion and a 40% discount, the actual value avoiding the gift tax is closer to $23,000.[19] Thus, roughly $9,000 of value could potentially disappear from the transfer tax base and forever avoid both the estate and gift tax.[20] Because the partnership interests are difficult to value, there is a lot of discretion involved in applying the discounts, which allows taxpayers to claim "a valuation at the low end of the range of possible values . . . ."[21] Since a gift tax return is only required if the gift exceeds the annual exclusion, a substantial amount of value can be passed out of the estate completely under the government's radar.[22] The difficulty in tracking these transactions makes it hard to ascertain how much revenue is disappearing through the use of minority discounts.[23]

Due to the large amount of disappearing wealth and lost taxes resulting from valuation discounts, the IRS continues to challenge the size of the discounts applied to family limited partnership minority interests.[24] The valuation discrepancy comes

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[17] *See* Cunningham, *supra* note 3, at 1464. The discount for lack of control reflects that the minority shareholder "is to some extent at the mercy of the controlling owners." *Id.* The minority shareholder can't influence entity management decisions, including decisions involving distributions and capitalization of earnings. *Id.* The discount for lack of marketability reflects the lack of a public market for minority interests. *Id.*

[18] *See* Cunningham, *FLP Fix*, *supra* note 8, at 937-38.

[19] *See* Cunningham, FLPs, *supra* note 7, at 809. This is calculated by dividing the $14,000 annual exclusion by 60%. Sixty percent represents the value of the minority interest remaining after the forty percent discount is taken. $14,000 divided by 60% equals $23,333.33.

[20] *See* Cunningham, *FLP Fix*, *supra* note 8, at 938.

[21] *See* Cunningham, *FLPs*, *supra* note 7, at 810.

[22] *Id.* at 809.

[23] *See* William S. Blatt, *Minority Discounts, Fair Market Value, and the Culture of Estate Taxation*, 52 TAX L. REV. 225, 226 n. 5 (1996-1997). "In 1998, the Joint Committee on Taxation estimated that a proposal eliminating non-business valuation discounts [for minority interests] would raise between $485 million to $628 million per year in the years 2000 to 2008." *Id.*

[24] *See* Koste, *supra* note 16, at 294.

down to a difference in expert opinions,[25] which is often the result of the difference between the objective of the two parties: the taxpayer wants to maximize the discount, thereby transferring more value out of the estate, and the IRS wants to minimize the discount, thereby making the transfer potentially subject to the gift tax.[26] If the taxpayer chooses to challenge the valuation of the IRS, then the court will decide between the different expert appraisals or come to a different conclusion.[27] The courts, however, have failed to apply a uniform approach when valuing minority interests[28], and claims for discounts for lack of marketability and control that range anywhere from "30 to 60 percent" of the property have been accepted.[29]

## II. THE TRANSFER CLAUSE: TAKING THE BENEFITS OF VALUATION DISCOUNTS A STEP FURTHER

While valuation discounts give taxpayers the opportunity to transfer more value out of their estate than if they made a gift of underlying property outright instead of gifting partnership interests, there is a possibility that the IRS will audit and impose the gift tax. To minimize the risk that the taxpayer will face tax liability and potential underpayment penalties,[30] tax practitioners have created clauses that "operate to adjust the transfer of property post-revaluation so as to avoid or minimize gift tax."[31] Over the past forty years, transfer clauses have evolved from void reversion clauses[32] to complex estate planning mechanisms that are carefully crafted by practitioners and then typically upheld by the courts. In this section, I will first describe the various clauses

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[25] *Id.*

[26] *Id.* at 300-02.

[27] *Id.*

[28] *Id.* at 312.

[29] *See* Johnson, *supra* note 7, at 941.

[30] Scott Andrew Bowman, McCord v. Commissioner*: Defined Value Clauses Redefined?* 33 ACTEC J. 169, 171 (2007-2008). If the taxpayer is found to have significantly undervalued the assets, then in addition to any tax liability, underpayment penalties may be imposed as well. I.R.C. § 6662 (2008 & Supp. 2012).

[31] Brian K. Duffey & Patrick J. Duffey, *Valuation Formula Clauses for the Noncharitably Inclined*, 38 Est. Plan. 30, 30 (2011).

[32] *See* Comm'r v. Procter, 142 F.2d 824 (4th Cir. 1944).

that have been used by practitioners. I will then provide a history showing the judicial shift from ignoring clauses to favoring them.

### *A. Types of Clauses*

This Comment focuses on three types of transfer clauses: (1) the savings clause, also known as a *Procter* clause;[33] (2) the formula allocation clause involving a charitable donee; and (3) the defined value clause with no charitable donee, referred to here as the *Wandry* clause.[34]

#### 1. The Savings Clause

A *Procter* savings clause results in any valuation difference between the taxpayer and government appraisals being transferred back to the donor.[35] Here is an example of such a clause:

> [I]n 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 . . . the excess property . . . 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.[36]

If the IRS appraises the property at a higher value than the taxpayer, then that portion of the gift subject to tax is revoked and returned back to the donor.[37] The donor then acts as if that amount was never transferred.[38] Savings clauses have been held void because they violate public policy by discouraging the collection of tax by decreasing the IRS's incentive to audit.[39] If the

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[33] Steve R. Akers & Edward F. Koren, Wandry v. Commissioner*: Further Support for Defined Value Clauses*, Jun-2012 Koren Est. Tax & Pers. Fin. Plan. Update art. Part II (June 2012).

[34] Gerzog, *infra* note 47.

[35] *See* Duffey, *supra* note 31, at 30-31.

[36] *Procter*, 142 F.2d at 827.

[37] Bowman, *supra* note 30, at 170.

[38] *Id.*

[39] Duffey, *supra* note 31, at 31.

clause were valid, any audit would be fruitless because the clause would be triggered and any excess value that was supposed to be taxed would be transferred back to the donor, thereby defeating the gift.[40]

### 2. The Formula Allocation Clause

A formula allocation clause transfers a fixed dollar amount of interests in an entity to the desired donee.[41] The dollar amount is usually equal to the annual exclusion. If the IRS determines that the fair market value of the interests transferred is greater than what was reported by the taxpayer, then any excess value will be allocated to a "tax-advantaged" donee, such as a charity.[42] Therefore, gift tax liability will be avoided because the adjustment would be a nontaxable charitable deduction.[43] Any valuation increase resulting from the audit would increase the taxpayer's charitable deduction, negating any gift tax liability.[44] These clauses are much more complicated than savings clauses because they typically involve multiple parties besides the family members.[45] The result for the taxpayer, however, is the same in that gift tax liability will be avoided pursuant to a government audit.

### 3. The *Wandry* Clause

A *Wandry* clause results in any valuation discrepancy between the taxpayer and the IRS being reallocated among the taxpayer and the donees.[46] The gift instrument conveys a sufficient number of units in a closely held entity to make up a fixed dollar amount that is less than or equal to the annual exclusion or the entire applicable exclusion amount.[47] While "the

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40 *Id.*
41 *Id.* at 30-31.
42 Akers, *supra* note 33.
43 I.R.S. FSA 200122011 (June 1, 2001).
44 *Id.*
45 Akers, *supra* note 33.
46 Wandry v. Comm'r, 103 T.C.M. (CCH) 1472 (T.C. 2012).
47 Wendy C. Gerzog, *Not All Defined Value Clauses Are Equal,* 10 PITT. TAX REV. 1, 20 (forthcoming 2012).

number of [u]nits gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted [u]nits, 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."[48]

The taxpayer has an appraisal done to value the units, but if the IRS determines the appraisal resulted in too low of a value and that the units are actually worth more than the taxpayer reported, then the units are reallocated among the donor and donees to match the fixed dollar amount that was initially given.[49] Here is the language of the *Wandry* clause:

> [I]f, 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 [in the conveyance] . . . .[50]

Since the clause doesn't require a third party charity like a formula allocation clause, it is a much simpler approach, making it easier for taxpayers to transfer more value out of their estate while minimizing the risks that arise from an IRS audit.[51]

### *B. The History of Transfer Clauses*

The savings clause was the first transfer clause that tax practitioners attempted to use. After the courts held such clauses void, formula allocation clauses became popular. The judicial success of formula allocation clauses led to the recent *Wandry* decision that allowed the use of a defined value clause without a charitable donee. This history from the *Procter* decision to the *Wandry* case and the IRS's current stance helps illustrate the problem and the need for a legislative fix.

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48 Wandry v. Comm'r, 103 T.C.M. (CCH) 1472 (T.C. 2012).
49 *Id.*
50 *Id.*
51 Akers, *supra* note 33.

### 1. *Procter*: Savings Clauses Are Void for Public Policy Reasons

In *Procter*, the Fourth Circuit held that a clause that operated to transfer property back to the donor if the property was found to be subject to gift tax was void and should be ignored for federal gift tax purposes.[52] The taxpayer wanted to give remainder interests in two trusts to his children, but wanted to revoke any portion of the transfer that resulted in gift tax liability.[53] The court held that the clause created a condition subsequent and was "contrary to public policy."[54]

The first, and most relevant, reason[55] the court gave was the clause "discourage[d] the collection of the tax by the public officials charged with its collection, since the only effect of an attempt to enforce the tax would be to defeat the gift."[56] If the clause was held to be valid, then the result of the IRS's audit would be to revoke the gift, and the property would transfer back to the donor. Thus, any finding by the courts or the IRS that there was a taxable gift would trigger the clause, causing the property to revert back to the donor and resulting in there being no taxable gift.[57] "[T]his sort of trifling with the judicial process cannot be sustained."[58] Therefore, the court held for the IRS, ruling the

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[52] Duffey, *supra* note 31, at 31.

[53] Comm'r v. Procter, 142 F.2d 824, 827 (4th Cir. 1944).

[54] *Id*.

[55] *Id.* Only the first reason is addressed here. The second reason the court gave was because the clause obstructed the administration of justice by requiring courts to pass on moot issues. *Id.* The only effect of a court's holding would be to defeat the gift. *Id.* If the court held that there was a taxable gift, the clause would render the gift invalid, leaving no controversy between the government and the taxpayer. *Id.* The actual controversy would be between the taxpayer and the absent donee. *Id.* Further, the court noted that using the courts for one's own purposes when there is no real controversy between those parties appearing "is an abuse which courts of justice have always reprehended, and treated as a punishable contempt of court." *Id.* Thus, the court took a strong view against the taxpayer partly because the clause, if held valid, resulted in there being no real controversy between the IRS and the taxpayer, since there would in essence be no gift to tax. *Id.* The third reason was because the clause made the final judgment of a court "to be held for naught," thereby making it a declaratory judgment. *Id.* "[I]t is not possible to obtain a declaratory judgment from a federal court as to whether the gift in question is subject to the gift tax." *Id.*

[56] *Id.*

[57] *Id.*

[58] *Id.*

clause to be invalid, and the transferred remainder interest to be subject to gift tax.

While it is true that the property would revert back to the donor, making it possible for the government to collect tax on a later transfer, allowing use of such a clause would result in abuse year after year. Fruitless audits would waste government resources while not collecting any revenue.

#### 2. Uncertainty is Created by the Rise of the Formula Allocation Clause

From 1976 to 2006, courts refused to honor savings clauses in the gift tax context.[59] That changed in 2006, when the Fifth Circuit overruled the Tax Court and upheld a formula allocation clause that caused any valuation difference arising from an IRS audit to be allocated to charities.[60] Since then, five different cases have shifted the law to be more taxpayer friendly when it comes to transfer clauses.[61]

The first of these cases was *McCord v. Commissioner*, where a strange proceeding of events resulted in taxpayers being able to take advantage of formula allocation clauses. First, the taxpayer transferred assets into a limited partnership in which both he and his children held interests.[62] An assignment agreement was then created where the taxpayer gifted interests to: (1) trusts benefitting his children; (2) to the children, outright; (3) Charity 1; and (4) Charity 2.[63] The assignment agreement resulted in the charities receiving interests only if the value of the interests given to the trusts and children was found to exceed the amount excludible from gift tax.[64] Thus, unless the charities contested the

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[59] Petter v. Comm'r, 98 T.C.M. (CCH) 534, 27 (T.C. 2009).

[60] McCord v. Comm'r, 461 F.3d 614, 616 (5th Cir. 2006).

[61] *See id.*; Estate of Christiansen v. Comm'r, 586 F.3d 1061, 1061-62 (8th Cir. 2009); Estate of Petter v. Comm'r, 653 F.3d 1012, 1014 (9th Cir. 2011); Hendrix v. Comm'r, 101 T.C.M. (CCH) 1642, 2 (T.C. 2011); and Wandry v. Comm'r, 103 T.C.M. (CCH) 1472 (T.C. 2012).

[62] Duffey, *supra* note 31, at 31.

[63] *Id.*

[64] *McCord*, 461 F.3d at 618. The taxpayers used their available generation skipping tax exemption amount to make the gift to the trust and their available lifetime exemption for the gifts to the children. If the IRS determined the FMV to be greater

taxpayer's valuation, it was only upon an IRS audit that the charities would receive anything.[65]

The case was reviewed by the entire Tax Court, which came up with its own values on what was gifted, resulting in the transfer clause being void.[66] "The seven-judge majority based its holding on the consistently rejected concept of postponed determination of the taxable value of a completed gift."[67] On appeal, the IRS relied solely on the reasoning of the Tax Court and did not introduce the public policy arguments from *Procter*. [68] As a result, the Fifth Circuit's decision focused on the Tax Court's actions and did not address public policy issues surrounding formula allocation clauses. The Fifth Circuit determined that it was error for the Tax Court to revalue the interests and held that the formula allocation clause was valid.[69]

After *McCord*, the IRS lost three more cases involving formula allocation clauses.[70] First, in *Christiansen*, the Eighth Circuit upheld a clause involving a will and formula disclaimer.[71] The court rejected the public policy arguments brought by the government, noting that it is not the IRS's job to "maximize tax receipts," but to "enforce the tax laws."[72] Further, the court reasoned that there are other mechanisms besides IRS audits to influence taxpayers to make accurate valuations.[73]

Next, the Tax Court and the Ninth Circuit upheld another formula allocation clause in *Petter v. Commissioner*. The Tax

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than that determined by the taxpayer, any value subject to gift tax would be allocated to the charities, thereby increasing the taxpayer's charitable deduction. This is the outcome of the "sequentially structured defined value clause" used by the McCords in the gift instrument. *Id.*

[65] This was very unlikely to happen, as it is against a charitable entity's interest "to look a gift horse in the mouth." McCord v. Comm'r, 120 T.C. 358, 373 n. 9 (2003).

[66] *McCord*, 461 F.3d at 627.

[67] Duffey, *supra* note 31, at 31.

[68] *Id.*

[69] *Id.*

[70] Estate of Christiansen v. Comm'r, 586 F.3d 1061, 1061-62 (8th Cir. 2009); Estate of Petter v. Comm'r, 653 F.3d 1012, 1014 (9th Cir. 2011); Hendrix v. Comm'r, 101 T.C.M. (CCH) 1642, 2 (T.C 2011-133).

[71] Duffey, *supra* note 31, at 31.

[72] *Christiansen*, 586 F.3d at 1064.

[73] *Id.* at 1065-66. Such mechanisms include the fiduciary responsibilities of executors and administrators when the gift is coming from the estate. *Id.*

Court distinguished the clause at issue from a *Procter* savings clause, stating "that savings clauses are void, but formula clauses are fine."[74] The court then barely addressed policy arguments, but did acknowledge policy arguments in favor of encouraging charitable gifts.[75] The Ninth Circuit then upheld the Tax Court's decision in favor of the clause without addressing policy arguments but maintaining that the gift was not subject to a condition and was a fixed amount both before and after the IRS audit.[76] In conclusion, the Ninth Circuit called for the Treasury to amend its regulations if it had a problem with the court's decision.[77]

Third, in *Hendrix v. Commissioner*, the Tax Court followed the precedent of the Fifth Circuit by upholding the formula allocation clause established in *McCord*.[78] The court reiterated that formula clauses are not void against public policy because they impose no condition subsequent and they encourage gifts to charity.[79]

With these three cases, the Tax Court and the Fifth, Eighth, and Ninth Circuit Courts have all supported formula allocation clauses. However, the Fifth Circuit has not addressed public policy arguments and the Eighth Circuit's decision in *Christiansen* involved a clause in a will and disclaimer context. In *Petter*, the Ninth Circuit didn't address policy arguments, instead allowing the Tax Court's reasoning to stand. While it is unclear why the Tax Court changed its position regarding formula allocation clauses between the *McCord* and *Christiansen* cases, the Fifth Circuit overruling the Tax Court in *McCord* could possibly influenced the feelings of some of the judges.

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[74] Petter v. Comm'r, 98 T.C.M. (CCH) 534, at 12 (2009).
[75] *Id.*
[76] Estate of Petter v. Comm'r, 653 F.3d 1012, 1023 (9th Cir. 2011).
[77] *Id.*
[78] Hendrix v. Comm'r, 101 T.C.M. (CCH) 1642, 2 (T.C. 2011-133).
[79] *Id.* at 21-22.

### 3. *Wandry*: The Approval of a Defined Value Clause with no Charitable Donee

In March 2012, the Tax Court made tax avoidance even easier by upholding a defined value clause with no charitable donee.[80] In *Wandry*, the taxpayer created a limited liability limited partnership and contributed cash and marketable securities.[81] The taxpayer then began a gift-giving program that gave partnership interests in specific dollar amounts equaling the annual exclusion and the taxpayer's remaining lifetime exemption.[82] A defined value clause in the gift conveyance provided that if the IRS determined that the entity's units were worth more than the value determined by the taxpayer, the donor and donee capital accounts would be adjusted to reflect the actual gifts.[83]

In upholding the clause, the Tax Court reasoned that "[i]t is inconsequential that the adjustment clause reallocates membership units among petitioners and the donees rather than a charitable organization because the reallocations do not alter the transfers."[84] On the date of the gift, each donee was entitled to a predefined partnership interest expressed through a formula.[85] The clause didn't operate for the donor to take property back, but instead corrected the allocation of units to reflect the correct predefined partnership interests.[86]

The Tax Court rejected the IRS's public policy arguments from *Procter* against the defined value clause.[87] The court reiterated the Supreme Court's warning against invoking public policy arguments too freely, noting that the Court held "that the frustration caused must be severe and immediate."[88] It reasoned that the lack of a charitable entity did not raise a severe and

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[80] *See* Wandry v. Comm'r, 103 T.C.M (CCH) 1472, (T.C. 2012).
[81] *Id.* at 2.
[82] *Id.* at 3.
[83] *Id.* at 5.
[84] *Id.* at 25.
[85] *Id.*
[86] *Id.*
[87] *Id.* at 26.
[88] *Id.* (quoting Comm'r v. Tellier, 383 U.S. 687, 694 (1966)).

immediate concern.[89] The Court also rehashed various arguments from *Christiansen*, *Petter*, and *Hendrix* before upholding the clause. As a result, the defined value clause was found to be valid, the interests were adjusted accordingly, and no gift tax liability was imposed. On August 28, 2012, the IRS filed a notice of appeal for *Wandry* in the Tenth Circuit.

#### 4. The IRS Remains Firmly Opposed to Transfer Clauses in the Gift Tax Context

Ever since *Procter*, the IRS has remained firmly opposed to transfer clauses in gift conveyances, using the public policy argument that such clauses hinder the service's role in collecting gift tax.[90] The IRS argues that these clauses work to discourage government audits because any attempt to enforce payment of gift tax triggers the clause and reallocates the gift in a way to abolish the gift tax liability.[91] In each case that arises involving transfer clauses the government uses the condition subsequent and public policy arguments from *Procter* to maintain that the clauses should be ignored for federal gift tax purposes. If the IRS continues to

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[89] *Id.* at 27.

[90] *See* Rev. Rul. 86-41, 1986-1 C.B. 300 (ruling that an adjustment clause activated by a IRS revaluation was a void condition subsequent that was ineffective for federal tax purposes because it discouraged the enforcement of federal gift tax provisions and would "either defeat the gift or otherwise render examination of the return ineffective"); I.R.S. FSA 200122011, 2001 WL 587798 (June 1, 2001) (a formula clause allocating additional value to a charitable donee in the event of a government revaluation should not be given effect for federal tax purposes because "the tax effects of a particular transaction are governed by the substance of the transaction rather than its form" and "these clauses would be similar in effect to savings clauses in that they recharacterize the transaction in a manner that would render any adjustment nontaxable" by increasing the charitable deduction and not generating any gift tax deficiency) ("the sole justification for the Commissioner's examination would be to insure that charity received all that it was entitled to under the transfer documents," putting the Service in the "position of policing charitable transactions"); I.R.S. Tech. Adv. Mem. 200245053 at 5 (Nov. 8, 2002) (the Service advised that the valuation formula clause would be void because it was part of an integrated transaction designed to transfer assets at a discounted value while "foreclosing any realistic opportunity [for the Service] to challenge the transaction").

[91] Estate of Christiansen v. Comm'r, 586 F.3d 1061, 1062 (8th Cir. 2009).

lose judicially, it could potentially face the penalty of having to pay the opposing party's attorney's fees.[92]

Nonetheless, the IRS recently reinforced its stance by issuing a nonacquiescence to the *Wandry* decision.[93] Initially, the IRS appealed the decision, but subsequently withdrew the appeal and instead issued an action on decision denouncing the Tax Court's holding allowing the use of a defined value clause. In the action on decision, the IRS reiterated its long-held position that the final determination of value for federal gift tax purposes is an occurrence beyond the taxpayer's control. A gift is complete for federal tax purposes when the donor parts with dominion and control and any power to change its disposition. The IRS then distinguished a defined value clause from a formula allocation clause by stating that the gifts in *Wandry* were complete on the date of gift as fixed percentage interests, while in *Petter*, any adjustment went to a charity, not to the donor, so the court did not have to consider whether the gift was complete. Thus, in Wandry, the IRS said that the Tax Court erred in considering the gifts as anything other than fixed percentage interests. Further, the IRS reasoned that "[t]he application of the gift tax is based on the objective facts and circumstances of the transfer, and not upon the donative intent of the donor."[94]

The lack of clarity surrounding the legislative allowance of these clauses has resulted in an ongoing dual between the IRS and taxpayers. To allow the IRS to do its job in enforcing tax law, the Legislature needs to give guidance in this area so the IRS will know what exactly it is enforcing.

## III. TRANSFER CLAUSES REQUIRING GOVERNMENT VALUATION FOR REALLOCATION SHOULD BE DISREGARDED FOR FEDERAL GIFT TAX PURPOSES

The availability of transfer clauses results in taxpayers taking very aggressive discounts when valuing their gifted partnership interests because the risk is minimized that any

[92] Estate of Baird v. Comm'r, 416 F.3d 442, 454-55 (5th Cir. 2005).
[93] Wandry v. Comm'r, AOD 2012-004, 2012-46 I.R.B. at 2 (Nov. 14, 2012).
[94] *Id.* at 1.

disagreement with the IRS will result in a gift tax liability. These clauses work to take advantage of the resources of the IRS by using the agency to value the gifted units and to trigger the reallocation of the property in a manner that prevents the collection of the correct amount of gift tax. The clauses work to deny the Treasury the correct amount of tax and waste government monies allocated to the IRS to enforce tax laws.[95]

To prevent this abuse and to provide clarity for both taxpayers and the IRS, Congress should enact legislation that disregards transfer clauses for federal gift tax purposes when triggered by an IRS audit. In this section, I will first explain how transfer clauses present a win-win scenario for the taxpayer while presenting a lose-lose scenario for the government. Second, I will explain why the public policy doctrine of *Procter* should be expanded.[96] Third, I will distinguish transfer clauses from formula clauses that are allowed elsewhere in the Code. Finally, I will describe how legislation could be enacted that would invalidate transfer clauses for federal gift tax purposes.

### *A. The "Heads-I-Win-Tails-You-Lose" Scenario*

The availability of transfer clauses encourages taxpayers to engage in integrated transactions with the purpose of avoiding gift taxes.[97] A taxpayer can create a closely held entity, place property inside it, transfer discounted minority interests in the entity to the donee, and use a transfer clause to make sure the transaction is not subject to gift tax.[98] With the combination of large valuation discounts and the transfer clause, excess amounts above the allowed exclusion can be given away tax-free.[99]

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95 Wendy C. Gerzog, *Not All Defined Value Clauses Are Equal,* 10 PITT. TAX REV. 1, 43 (forthcoming 2012). "A taxpayer . . . should not be able to use the federal fisc to have the government value family entity membership units." *Id.* at 37.

96 *See* Gerzog, *supra* note 95, at 33. This idea came from Wendy Gerzog, who proposes that the arguments of *Procter* should be "read more broadly" instead of technically by the courts. *Id.*

97 *See e.g.*, McCord v. Comm'r, 120 T.C. 358, 429 (2003) (Laro, J,, dissenting).

98 I.R.S. Tech. Adv. Mem. 200245053 (Nov. 8, 2002).

99 Brief for the Appellant at 49, Estate of Petter v. Comm'r, 653 F.3d 1012, 56-59 (9th Cir. 2011) (No. 10-71854).

### 1. The Win-Win Situation for the Taxpayer

The recent court decisions regarding these transactions have created the ultimate "heads-I-win-tails-you-lose" scheme for the taxpayer.[100] Taxpayers can maximize the use of a transfer clause by "lowballing the value of transferred property" with large discounts, thereby maximizing the value transferred out of the estate.[101] The availability of a transfer clause then minimizes the risk that the taxpayer will face tax liability. Thus, the taxpayer has every incentive to take extreme discounts because the worst thing that can happen is the excess value either returning to the taxpayer or it being allocated to a tax-advantaged donee. Either way, the taxpayer will not have to pay gift tax.

### 2. The Lose-Lose Situation for the IRS

Transfer clauses discourage the IRS from auditing gift tax returns because once it is determined the taxpayer valued the property inaccurately, the clause is triggered and any gift tax deficiency is eliminated.[102] Government resources are wasted because money is used to conduct a fruitless audit that doesn't result in any revenue being collected. While the property may end up back in the taxpayer's estate, thereby creating an opportunity for the government to collect tax at a later date, the government is still out the cost of the audit and has nothing to show for it. Further, if the IRS continues to challenge the clauses unsuccessfully in the courts, it also could be assessed significant attorney's fees.

The use of a clause puts the IRS in a lose-lose situation because either the agency can conduct a fruitless audit and waste government monies or not audit at all and allow excessive value to pass free of tax.

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[100] *Id.* at 48.

[101] *Id.* at 49 (internal quotations omitted).

[102] Opening Brief for Respondent at 31, Estate of Christiansen v. Comm'r, 586 F.3d 1061 (8th Cir. 2009) (No. 15190-05).

### *B. The Public Policy Doctrine of Procter Should be Expanded*

In upholding transfer clauses, the courts have focused on the intricacies of the *Procter* decision instead of interpreting the decision broadly.[103] The courts have attempted to distinguish formula allocation clauses and the *Wandry* clause from a void *Procter* savings clause by ruling that the former two do not involve a condition subsequent or work to revoke the gift.[104] In so doing, the courts have failed to adequately address how these clauses do not frustrate public policy by discouraging the collection of tax and wasting government resources.[105] Thus, the courts have failed to address the bigger picture and have allowed the clauses to frustrate the collection of government revenue and the enforcement of tax laws enacted by Congress.

The public policy arguments of *Procter* should be extended to apply to formula allocation clauses and *Wandry* clauses because the premise has not changed—the clause works to use a government valuation to avoid the gift tax. First, these clauses are void against public policy because they encourage taxpayers to engage in integrated transactions with the purpose of tax avoidance. Second, public policy arguments have prevailed in other areas of tax law where the collection of revenue was threatened[106] and where Congress wanted to promote certain conduct.[107] Finally, the IRS is justified in bringing up public policy arguments against these clauses because the frustration caused by them is "severe and immediate."[108]

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[103] Gerzog, *supra* note 95, at 33.

[104] *Id.*

[105] Comm'r v. Procter, 142 F.2d 824, 827 (4th Cir. 1944).

[106] *See* United States v. Carlton, 512 U.S. 26, 32-33 (1994).

[107] Tank Truck Rentals, Inc. v. Comm'r, 356 U.S. 30 (1958).

[108] Comm'r v. Tellier, 383 U.S. 687, 694 (1966) (alteration in original) (citation omitted).

### 1. Transfer clauses are against public policy because they allow taxpayers to engage in integrated transactions that abuse and waste government resources in the effort to avoid gift tax.

The availability of transfer clauses encourages taxpayers to engage in tax avoidance schemes through the use of family entities, excessive valuation discounts, and a clause. A taxpayer has an incentive to take easy to value assets like cash or marketable securities and turn them into hard to value assets by placing them into a family limited partnership instead of gifting the assets outright.[109] The taxpayer then can use a discount on the higher end of the appraisal range of the partnership interest in an attempt to pass the most value out of the estate. A transfer clause is then attached to the conveyance to prevent the government from collecting any gift tax in the event of an audit. Instead of collecting revenue, the audit triggers the clause, resulting in some type of allocation that avoids tax by decreasing the transfer tax base. As a result, any monies that are spent funding the audits is wasted

### 2. Public policy arguments have prevailed in other areas of tax law where the government's interest in revenue was threatened and where Congress wanted to promote certain conduct.

Both Congress and the courts have previously supported protecting government revenue and promoting compliant taxpayer conduct in other areas of tax law. First, courts have allowed the retroactive application of taxes to prevent revenue loss from taxpayers attempting to avoid tax liability after Congressional changes in the Code.[110] Such retroactive application prevents

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[109] Gerzog, *supra* note 95, at 37.

[110] United States v. Carlton, 512 U.S. 26 (1994). In Carlton, the taxpayer engaged in a transaction specifically to take advantage of a new estate tax provision created by the Tax Reform Act of 1986. *Id.* at 28. The provision granted a deduction for half of the proceeds from any sale of employer securities by the executor of an estate to an employee stock ownership plan. *Id.* The executor for the deceased taxpayer sought to take advantage of the deduction by using the estate funds to purchase securities and immediately sell them, which reduced the taxpayer's estate by a significant amount.

taxpayers from engaging in "sham transactions" to avoid tax in the time period between notice of the change and the date of enactment.[111] The Supreme Court has determined that retroactive treatment does not violate due process when there is a "legitimate legislative purpose."[112] Preventing significant and unanticipated revenue loss has been determined to be such a purpose.[113]

Second, Congress has disallowed deductions that "severely and immediately frustrate sharply defined national or State policies proscribing certain conduct"[114] by enacting § 162(c), (f), and (g). Most relevant of these sections is § 162(f), which disallows a deduction for any fine or penalty paid to a government for a violation of the law. Congress enacted this section after the Supreme Court's decision in *Tank Truck Rentals* when the Court disallowed a trucking company's business deduction for fines paid due to violations of state maximum weight laws. Allowing a business to deduct amounts paid for fines would lessen the disincentive to avoid the fine in the first place. Thus, to promote public policy, Congress maintained the disincentive to violate certain laws by disallowing a deduction for fines and penalties.

While the situation surrounding transfer clauses involves estate and gift tax and not income tax, the government's interest in collecting revenue and promoting taxpayer compliance is still the same. The government is losing revenue because taxpayers have an incentive to avoid paying their fair share of tax by using these clauses and engaging in integrated transactions. Such

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*Id.* Congress then amended the provision to require that the securities had to have been owned by the taxpayer prior to death. *Id.* at 28-29. The Supreme Court held that the amendment could be applied retroactively to the prior tax year because there was a legitimate legislative purpose in preventing an excessive loss of revenue. *Id.* at 32. When making the original provision, Congress estimated revenue loss to equal $300 million over 5 years. *Id.* at 31-32. After realizing taxpayers could engage in "essentially sham transactions" to qualify for the deductions, Congress estimated the potential revenue loss could be close to $7 billion without an amendment. *Id.* at 32.

[111] *Id.* at 32.

[112] *Id.* at 30-35.

[113] *Id.* at 32.

[114] Hendrix v. Comm'r, 101 T.C.M (CCH) 1642, 20 (T.C. 2011).
(quoting Tank Truck Rentals v. Comm'r, 356 U.S. 30, 35 (1958), where the Supreme Court disallowed business deductions for fines paid for violations of state maximum weight laws).

transactions parallel those Congress has thwarted in the past by retroactive application of tax law. Also, while taxpayers aren't necessarily breaking the law by avoiding tax, they are engaging in conduct that frustrates the government's interest in collecting revenue. To influence taxpayers to pay the amount of gift tax that actually reflects the value they are conveying, Congress could follow its treatment of fines and penalties by taking a stance against transfer clauses.

### 3. The IRS is justified in arguing that transfer clauses violate public policy because the frustration caused by them to the federal fisc is severe and immediate.

In *Commissioner v. Tellier*, the Supreme Court warned against using public policy arguments "too freely, holding that the frustration caused must be severe and immediate."[115] In upholding transfer clauses, the courts have determined that the consequences don't severely and immediately frustrate public policy.[116] The courts don't give an analysis of how these clauses don't do so. Instead, it is argued that there are other mechanisms to ensure accurate valuation reporting besides government audits.[117] The excess value that is passing free of gift tax is not addressed, nor is the waste of government resources in conducting fruitless audits.

Transfer clauses frustrate the government's interest in collecting revenue and "the adverse consequences for the public fisc are potentially severe."[118] The estate tax is the country's most progressive tax, generating billions of dollars each year. Contrary to this progressivity, transfer clauses create perverse incentives influencing taxpayers to avoid paying their fair share. Further, the clauses not only result in the correct amount of tax not being collected, but also work to waste those monies budgeted to the IRS for the enforcement of the tax law. The potential amount passing outside of the transfer tax base is impossible to calculate. At a

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115 Wandry v. Comm'r, 103 T.C.M. (CCH) 1472, 26 (T.C. 2012).
116 *Id.*
117 *Id.*
118 Brief for the Appellant, *supra* note 99 at 23-24.

time when the federal deficit continues to shadow the American economy, even the abuse of a small percentage of revenue can have an impact.

### *C. Legislation Should be Enacted Disregarding Transfer Clauses That Depend Upon Government Valuation for Gift Reallocation*

Congress should enact legislation that requires clauses to be disregarded for gift tax purposes if they are activated by a government audit. While the property still may pass to the desired donee pursuant to state law, the additional value found by the audit should be subject to gift tax.

As stated above, the recent proliferation of these clauses violates public policy by exploiting the resources of a government agency at the expense of federal revenues. While it may not be the IRS's job to "maximize tax receipts,"[119] it is the IRS's job to collect the correct amount of revenue. The use of these clauses coupled with aggressive valuation discounts hinders the agency from doing its job, and in the absence of legislative guidance the courts have failed to offer a solution.

To remedy this abuse, Congress could place the new legislation near § 2701 of the Internal Revenue Code, which addresses special valuation rules in cases of transfers of certain interests in corporations or partnerships.[120] As a result, Congress would help ensure the appropriate amount of gift tax is being collected and would prevent government resources from being wasted. Such legislation would preserve the government's right to protect the revenue and would provide clarity to taxpayers, the courts, and the IRS.

Without Congressional interference, the IRS could potentially be charged with attorneys' fees penalties in the near future.[121] The agency has lost seven consecutive court battles, making it appear very unlikely that a decision protecting the government's interests

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[119] Estate of Christiansen v. Comm'r, 586 F.3d 1061, 1064 (8th Cir. 2009).

[120] 26 U.S.C. § 2701 (2006).

[121] Estate of Baird v. Comm'r, 416 F.3d 442, 454-55 (2005).

will be found judicially.[122] This losing streak is probably what influenced the IRS to withdraw its appeal of *Wandry* and to instead issue a nonacquiescence. With lack of judicial support, this was likely the only way the IRS could maintain its stance in an effort to enforce gift tax compliance. If Congress continues to ignore this issue, only those with unskilled lawyers will be paying the gift tax, allowing potentially millions of dollars to avoid becoming part of government revenue.[123]

## IV. SHOULD THERE BE AN EXCEPTION ALLOWING TRANSFER CLAUSES THAT BENEFIT CHARITIES?

Arguments can be made both in favor and against allowing an exception for transfer clauses that benefit charities. The tax code allows for exceptions when it wants to favor charitable giving. While the purpose of this Comment is not to take a stance on whether transfer clauses benefitting charities should be allowed, the code could allow for an exception.

### *A. Arguments in Favor of a Charitable Exception*

When the courts changed their perspective on transfer clauses, in the *McCord* decision in 2006, one of the main arguments was that the clause was not against public policy because it involved a donation to charity.[124] The tax court has noted that "there is a general public policy in favor of encouraging gifts to charities."[125] Further, it has been argued that charities have an adverse interest to the donor to make sure that the correct amount of property is received in a conveyance involving a transfer clause.[126]

In other areas of tax law, it has been argued that courts should look to the nature of the beneficiary in determining tax treatment. In estate tax, checks written but not withdrawn by the date of death are included within the estate.[127] This is to prevent

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[122] Cunningham, *supra* note 7, at 938-39.
[123] *Id.* at 938.
[124] Estate of Christiansen v. Comm'r, 130 T.C. 1, 26 (2008).
[125] Estate of Petter v. Comm'r, 98 T.C.M. (CCH) 534, 34 (2009).
[126] *Id.*
[127] McCarthy v. United States, 806 F.2d 129, 132 (7th Cir. 1986).

taxpayers from writing multiple checks equal to the amount remaining within the estate and telling the beneficiaries to wait until death to deposit them, thereby emptying the estate. In contrast, if a check is written to a charity, it is allowed to pass out of the estate, thus avoiding the estate tax.[128] Such treatment could be extended to lifetime transfers involving transfer clauses.

### *B. Arguments Against a Charitable Exception*

Although there is a strong interest in charitable giving, the abuse of formula allocation transfer clauses can outweigh such interests quantitatively.[129] While the courts have held that transfer clauses involving gifts to charity aren't void against public policy, they have failed to address how it is acceptable that the charity won't receive the correct gift value unless there is an IRS audit. While the audit does insure that the charity receives its full entitlement, the clause causes IRS officials to be charitable transaction police.

Even though a charitable gift might occur, the main purpose of the transaction is to avoid the gift tax.[130] In some taxpayer's perfect worlds, the charity wouldn't get anything because the gifts to the non-charitable donees would exactly equal the applicable exclusion. By *Procter's* standards, it really should not matter where the excess valuation is reallocated because the clause is still using the government agency's audit to avoid the tax.

The courts have reasoned that there are other mechanisms besides an IRS audit to insure correct valuation when a formula allocation transfer clause is used.[131] One of these is the charity's interest in making sure it receives the correct amount.[132] It seems highly unlikely though that a charity would really challenge the

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[128] Estate of Belcher v. Comm'r, 83 T.C. 227, 235-36 (1984).

[129] Wendy C. Gerzog, *From the Greedy to the Needy*, 87 OR. L. REV. 1133, 1179 (2008).

[130] Opening Brief for Respondent, Estate of Christiansen v. Comm'r, 586 F.3d 1061, 32 (8th Cir. 2009) (No. 15190-05); Brief for the Appellant, Estate of Petter v. Comm'r, 653 F.3d 1012, 59 (9th Cir. 2011) (No. 10-71854).

[131] Estate of Christiansen v. Comm'r, 586 F.3d 1061, 1065 (8th Cir. 2009).

[132] *Id.*

taxpayer's valuation since "it is against the economic interest of a charitable organization to look a gift horse in the mouth."[133]

These are just a sample of the arguments revolving around charities that Congress would need to consider before enacting a charitable exception.

## CONCLUSION

The judicial approval of transfer clauses has created a win-win situation for taxpayers and a lose-lose situation for the government. Taxpayers understandably want to lower their tax liability, and a transfer clause is an enticing way to do so. Unfortunately, transfer clauses hinder the government in collecting the appropriate amount of estate and gift tax and cause the government to waste money and resources on fruitless audits. To provide clarity for taxpayers, the IRS, and the courts, Congress should pass legislation that invalidates clauses triggered by IRS audits. Such legislation would discourage taxpayers from taking excessive discounts, would help insure that the government collects the correct amount of revenue, and would support the IRS in enforcing tax law.

**Blair K. Harden*

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[133] McCord v. Comm'r, 120 T.C. 358, 373 n. 9 (2003).

*Successful Certified Public Accountant Exam Candidate and J.D. Candidate, May 2014, University of Mississippi School of Law. I would like to thank Professor Karen Green for sharing her expertise in estate and gift tax and for her guidance in developing this article. I would like to thank Professor Jack Nowlin for his encouragement and advice throughout the writing process. I also would like to thank the Executive Editors and the Staff Editors of the *Mississippi Law Journal* for their hard work and support.