



Volume 10 (2012) | ISSN 1932-1821 (print) 1932-1996 (online)  
DOI 10.5195/taxreview.2012.8 | <http://taxreview.law.pitt.edu>

## ARTICLES

NOT ALL DEFINED VALUE CLAUSES ARE EQUAL

*Wendy C. Gerzog*



This work is licensed under a Creative Commons Attribution-NonCommercial-No Derivative Works 3.0 United States License.



This journal is published by the [University Library System](#) of the [University of Pittsburgh](#) as part of its [D-Scribe Digital Publishing Program](#), and is cosponsored by the [University of Pittsburgh Press](#).

# ARTICLES

## NOT ALL DEFINED VALUE CLAUSES ARE EQUAL

*Wendy C. Gerzog*\*

### Abstract

Defined value clauses, used to value nonmarketable family limited partnership (FLP) interests, create valuation distortions and other public policy issues. This article describes these abuses and proposes the employment of restrictions similar to those applied to pecuniary formula marital deduction clauses.

This article explains how pecuniary formula marital deduction provisions created valuation distortions by allowing for undervaluation of the marital share that were remedied by the IRS's Rev. Proc. 64-19 and the enactment of § 2056(b)(10). Additionally, this article analyzes recent case law expanding the use of defined value clauses into the FLP area and criticizes the courts for not applying the public policy doctrines of *Procter* and *Robinette* to those cases. This article also distinguishes defined valuation clauses in the FLP context and shows how all fixed value clauses are not equivalent. Finally, this article proposes solutions for overcoming the valuation distortions that these clauses create.

---

\* Professor, University of Baltimore School of Law. This article was supported by a generous summer research grant from the University of Baltimore School of Law.

## Table of Contents

I.	The Marital Deduction and Distortion Protection.....	4
A.	Funding Distortions: Rev. Proc. 64-19.....	4
B.	The Marital Deduction: Definition of Specific Portion.....	8
II.	Defined Value Clauses, Disclaimers, and Charitable Gifts.....	14
III.	Defined Value Clauses in the Context of Family Limited Partnerships.....	20
A.	Defined Value Clauses, Family Limited Partnerships, and Charitable Gifts.....	20
B.	Defined Value Clauses and Family Limited Partnerships (Without the Charitable Gift).....	30
IV.	Rejected, Ignored, and Inadequate Safeguards.....	32
A.	<i>Procter and Robinette</i> .....	32
B.	Other Safeguards.....	38
V.	Why All Defined Value Clauses Are Not the Same.....	40
VI.	Remedies.....	43
VII.	Conclusion.....	44

Estate planners routinely employ defined value clauses to coordinate the value of the exemption amount<sup>1</sup> at a decedent's death and the amount set aside to qualify for the marital deduction.<sup>2</sup> Since documents are not usually drafted immediately before a decedent's death, no one can know the exemption amount that will be current law at that time.<sup>3</sup> Likewise, the other elements in the calculation of the marital deduction can only be estimated before decedent's death.<sup>4</sup>

Defined value clauses in the context of marital deduction/exemption drafting and planning have been subject to potential abuse. Because the marital deduction provides only delayed taxation, whereas the exemption permanently shelters assets from transfer tax, estate planners drafted defined value clauses to freeze the amount that qualified for the marital deduction. Likewise, planners would fund the sheltered exemption portion with appreciating assets while funding the marital deduction trust with assets that had depreciated between decedent's death and the time of funding. Over the years, those attempts at marital deduction/exemption distortion have been thwarted both by agency restrictions<sup>5</sup> and by legislation.<sup>6</sup>

Assets transferred either during the decedent's lifetime or at death are valued at fair market value, respectively, at the date of gift<sup>7</sup> or at decedent's date of death.<sup>8</sup> Fair market value is defined as what a hypothetical buyer would pay and a seller would charge for an asset, with both having

---

<sup>1</sup> In this article I refer to exemption amount to refer to the exemption equivalent credit that has been in effect since 1976. For the difference between an exemption (deduction) and an exemption equivalent credit, see JOSEPH M. DODGE ET AL., FEDERAL TAXATION ON GRATUITOUS TRANSFERS: LAW AND PLANNING 33 (2011).

<sup>2</sup> While the coordination is mainly between those two untaxed properties or funds, calculating the amount of the marital deduction requires also factoring in other deductible items (e.g., charitable donations, administrative expenses, claims against the estate, mortgages, state death taxes).

<sup>3</sup> Likewise, it would be impossible to know the size of the decedent's estate or the value of the other elements factored into the calculation. See *supra* note 2 for a description of the additional elements factored into the calculation.

<sup>4</sup> For example, the values of assets included in decedent's estate and decedent's expenses normally fluctuate day to day. See *supra* note 2.

<sup>5</sup> Rev. Proc. 64-19, 1964-1 C.B. 682 [hereinafter Rev. Proc. 64-19].

<sup>6</sup> I.R.C. § 2056(b)(10).

<sup>7</sup> I.R.C. § 2512(a).

<sup>8</sup> I.R.C. § 2031(a).

reasonable knowledge of the relevant facts and neither being under compulsion to buy or to sell.<sup>9</sup> Most assets are valued by a facts and circumstances showing of value whereby the transferor has the burden of proof.<sup>10</sup> Because nonmarketable property interests are not easily valued, a transferor typically employs experts to sustain that burden.<sup>11</sup> Lately, transferors are increasingly relying on defined value clauses to limit the value of their transfers of nonmarketable assets.<sup>12</sup>

To date, the abuse potential of defined value clauses in the context of a family limited partnership (FLP) has not been properly addressed. The courts have not applied *Robinette*<sup>13</sup> or *Procter*<sup>14</sup> as they should have. Treasury has not issued regulations imposing requirements similar to those that Congress imposed with respect to marital deduction defined value clauses or those required by Treasury in the context of marital deduction funding formulas. Congress has not dealt with the fundamental valuation distortion of FLPs; therefore, not surprisingly, Congress has not concerned itself with the increased valuation distortion issues created by recent court decisions<sup>15</sup> in the context of defined value clauses and FLPs.

## I. THE MARITAL DEDUCTION AND DISTORTION PROTECTION

### A. Funding Distortions: Rev. Proc. 64-19

Before Rev. Proc. 64-19, estate planners typically employed a valuation distortion technique utilizing a defined value clause to freeze the marital deduction share. Before the revenue procedure, they would draft the

---

<sup>9</sup> Treas. Reg. § 20.2031-1(b) (1954).

<sup>10</sup> Partial, temporal property interests, such as remainders or annuities, must be valued by the actuarial tables. I.R.C. § 7520(a). See also Wendy C. Gerzog, *Annuity Tables Versus Factually Based Estate Tax Valuation: Ithaca Trust Re-visited*, 38 REAL PROP. PROB. & TR. J. 745 (2004), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=532062](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=532062).

<sup>11</sup> See, e.g., I.R.S. Field Serv. Adv. 2001-43-004 (Oct. 26, 2001); JOHN A. BOGDANSKI, FEDERAL TAX VALUATION § 4.04 (1996 & Supp. 2003); all cases cited *infra* Part III.

<sup>12</sup> See *Estate of Petter v. Comm'r*, 98 T.C.M. (CCH) 534, 541-42, 2009 T.C.M. (RIA) ¶ 2009-280 (2009), *aff'd*, 653 F.3d 1012 (9th Cir. 2011).

<sup>13</sup> *Robinette v. Helvering*, 318 U.S. 184 (1943).

<sup>14</sup> *Comm'r v. Procter*, 142 F.2d 824 (4th Cir. 1944).

<sup>15</sup> See *infra* Parts II & III.

transfer to a spouse as a pecuniary bequest (i.e., a fixed dollar amount),<sup>16</sup> funded with assets valued at decedent's date of death or an alternate valuation date. When the decedent died, the marital share was funded with assets that had depreciated from decedent's valuation date values. This technique allowed the marital gift to be less than the amount of the marital deduction claimed on decedent's estate tax return.<sup>17</sup>

Prior to the issuance of Rev. Proc. 64-19, some estate planning instruments attempted to provide additional tax planning flexibility by permitting assets distributed in satisfaction of a pecuniary gift to be valued at their estate tax values. There was no gain or loss on such an allocation because the assets were deemed to have a basis equal to their federal estate tax value. However, the significant aspect of this approach was that it allowed fiduciaries to allocate depreciating assets entirely to the marital share and appreciating assets to the nonmarital portion. The obvious purpose was a reduction of the value in the surviving spouse's estate.<sup>18</sup>

In 1964, the government issued its revenue procedure,<sup>19</sup> which “represents a compromise the government reached with representatives of the American Bar Association in recognition by all that an abuse existed under prior practice.”<sup>20</sup> Under the revenue procedure, a pecuniary bequest<sup>21</sup>

---

<sup>16</sup> See 2 EDWARD F. KOREN & ROBERT H. WALTUCH, *ESTATE TAX & PERSONAL FINANCIAL PLANNING* § 21:59 (2012) (“A pecuniary formula is a devise of a fixed amount, rather than a percentage of the testator's estate.”).

<sup>17</sup> KATHRYN G. HENKEL, *ESTATE PLANNING AND WEALTH PRESERVATION: STRATEGIES AND SOLUTIONS* ¶ 49.02[2][a] (Warren, Gorham & Lamont of RIA, abridged student ed. 2003). See KOREN & WALTUCH, *supra* note 16.

<sup>18</sup> 3 MONICA DELL'OSSO & FRAYDA L. BRUTON, *CALIFORNIA TRANSACTIONS FORMS—ESTATE PLANNING* § 15:46 (2012).

<sup>19</sup> The revenue procedure is applicable to instruments executed on or after October 1, 1964. Rev. Proc. 64-19, *supra* note 5, § 3.01. The marital deduction may be allowed for an instrument executed before that date if the IRS receives an agreement from the fiduciary and the surviving spouse stating that the assets of the estate, both cash and other property available for distribution, will be distributed according to the requirements of the revenue procedure, so that the cash and other property distributed in satisfaction of the marital deduction pecuniary bequest will be fairly representative of the net appreciation or depreciation in the value of the available property on the date or dates of distribution. *Id.* If the fiduciary fails to comply under this agreement and the value distributed is less than required, there will be a deemed gift from the surviving spouse to the beneficiaries of the amount of that failure unless the surviving spouse, on being informed, promptly takes steps to remedy the shortcoming. *Id.* § 3.02.

<sup>20</sup> Jeffrey N. Pennell, *Estate Tax Marital Deduction*, 843 TAX MGMT. PORT. (BNA) VII-E n.859 (2007). See STANLEY S. SURREY ET AL. *FEDERAL WEALTH TRANSFER TAXATION: CASES AND MATERIALS* 865 (Foundation Press 1987). The government described its purpose in promulgating the revenue procedure: “The purpose of this Revenue Procedure is to state the position of the Internal Revenue Service relative to allowance of the marital deduction in cases where there is some uncertainty

does not qualify for the marital deduction unless the aggregate assets, when distributed, have a value not less than the marital deduction claimed amount, or unless the fiduciary must distribute assets with date of distribution values that are fairly representative of appreciation and depreciation occurring between the estate tax valuation date and the distribution date.<sup>22</sup> Each method was intended to remove discretion from the executor to fund the marital bequest with assets having a disproportionately large amount of depreciation (or little appreciation) during the estate tax valuation and distribution dates.<sup>23</sup> However, the fiduciary may not be able to choose between the two approaches, which are also known respectively as “minimum worth” and “fairly representative” funding.<sup>24</sup>

---

as to the ultimate distribution to be made in payment of a pecuniary bequest or transfer in trust where the governing instrument provides that the executor or trustee may satisfy bequests in kind with assets at their value as finally determined for Federal estate tax purposes.” Rev. Proc. 64-19, *supra* note 5, § 1.

<sup>21</sup> Rev. Proc. 64-19, *supra* note 5, § 2.01 (“The Internal Revenue Service has received inquiries concerning the amount of the marital deduction which should be allowed for a pecuniary bequest in a will or for a transfer in trust of a pecuniary amount where the governing instrument not only provides that the executor or trustee may, or is required to, select assets in kind to satisfy the bequest or transfer, but also provides that any assets distributed in kind shall be valued at their values as finally determined for Federal estate tax purposes. The question is the same whether the amount of the bequest or transfer is determined by a formula fixing it by reference to the adjusted gross estate of the decedent as finally determined for Federal estate tax purposes, or its amount is determined in some other fashion by which a fixed dollar amount distributable to the surviving spouse can be computed. Any bequest or transfer in trust described in subsection 2.01 is hereinafter referred to as a ‘pecuniary bequest or transfer’ for purposes of this Revenue Procedure.”).

<sup>22</sup> *Id.* § 2.02.

<sup>23</sup> HENKEL, *supra* note 17. To illustrate the effect of the revenue procedure: “Sam died in 1997 with an estate of \$1,000,000 consisting of real estate valued at \$600,000 and a business valued at \$400,000. Sam’s will gives his wife, Tammy, an amount which is necessary to reduce his taxable estate to zero. Prior to funding the bequest to Tammy, the real estate increases in value to \$1,000,000 and the business decreases in value to \$100,000. If Sam’s executor could use federal estate tax values and give the business to Tammy as her share of the estate and the real estate to the bypass trust, he has significantly affected the amount of property given to Tammy. If the individual’s will allows the Executor to fund the marital share with property at its estate tax value after the property has substantially depreciated in value, then the IRS says the marital bequest does not qualify for the marital deduction.” RONALD R. CRESSWELL ET AL., 4 TEXAS PRACTICE GUIDE WILLS, TRUSTS AND ESTATE PLANNING § 12:61 (Thomson Reuters/West 2008).

<sup>24</sup> DELL’OSSO & BRUTON, *supra* note 18. After the IRS issued Rev. Proc. 64-19, the fairly representative formula and fixed sum or date of distribution formula became more common. *See* KOREN & WALTUCH, *supra* note 16. An example of the fairly representative date of distribution formula clauses is: “In determining the amount of this devise, the values as finally determined for federal estate tax purposes are to be used. In distributing the assets to satisfy this devise, however, the personal

Essentially, through the revenue procedure, “[t]he IRS prescribed rules to prevent manipulation of the amount which was transferred in satisfaction of the marital bequest when a pecuniary formula was used.”<sup>25</sup> Otherwise, without such safeguards, the interest “passing from the decedent to his surviving spouse would not be ascertainable as of the [decedent’s] date of death, if the property available for distribution included assets which might fluctuate in value.”<sup>26</sup>

The revenue procedure does not apply to pro rata fractional marital deduction formulas.<sup>27</sup> That is because “fractionalization of each asset automatically works to ratably apportion all appreciation and depreciation.”<sup>28</sup> Likewise, the procedure specifically states that the problem it addresses is not one attached to a transfer of specific assets, a transfer of cash, a pecuniary bequest where the fiduciary has no choice of which assets are to be distributed in kind, or a pecuniary bequest satisfied with date of distribution values.<sup>29</sup> Many states have statutes to cure certain non-complying instrument provisions to adhere to the revenue procedure requirements.<sup>30</sup>

Since 1964, estate planners must heed the requirements of this revenue procedure if they wish to employ a pecuniary formula clause and have that provision qualify for the marital deduction. With the procedure’s restrictions, all marital deduction funding formulas have advantages and disadvantages. Within that framework, the estate planner weighs different

---

representative shall select assets, including cash, that are fairly representative of the appreciation or depreciation in the value of all property available for distribution, based on fair market values of these properties on the date or dates of distribution.” *Id.* § 21:60.

<sup>25</sup> CRESSWELL ET AL., *supra* note 23.

<sup>26</sup> Rev. Proc. 64-19, *supra* note 5, § 2.03. Likewise, according to the government, the marital interest, which could be destroyed or reduced, would constitute a nondeductible terminable interest. See the government’s argument in *Estate of Hamelsky v. Comm’r*, 58 T.C. 741 (1972), which the court rejected.

<sup>27</sup> Rev. Proc. 64-19, *supra* note 5, § 4.01.

<sup>28</sup> Pennell, *supra* note 20, § I.2.b. See SURREY ET AL., *supra* note 20, at 866.

<sup>29</sup> Rev. Proc. 64-19, *supra* note 5, § 4.01.

<sup>30</sup> See George A. Wilson, *State Law Considerations Relevant to Choice of Domicile—Intestate Succession*, in 2 ESTATE TAX & PERSONAL FINANCIAL PLANNING § 20:6 (Edward F. Koren ed., Thomson/West 2012).

factors<sup>31</sup> and chooses the alternative most appropriate for each client; however, since Rev. Proc. 64-19, no one may use a pecuniary defined value clause to create the valuation distortions rampant before its promulgation.<sup>32</sup>

### *B. The Marital Deduction: Definition of Specific Portion*

Congress enacted the marital deduction in 1948<sup>33</sup> in order to give married couples in common law states tax treatment comparable to that available to couples in community property states who by law own 50% of the couple's marital assets.<sup>34</sup> Since 1981,<sup>35</sup> the marital deduction is unlimited in amount<sup>36</sup> and is intended to reflect that a husband and wife are treated as one unit for the purposes of transfer taxation,<sup>37</sup> a decision paralleling their income tax treatment.<sup>38</sup>

---

<sup>31</sup> Factors include the possibility of triggering gain or loss, overfunding the marital share, the need to revalue assets, complexity of calculations, accelerating I.R.D. (income in respect of a decedent), GSTT (generation skipping transfer tax) exemption planning, and DNI concerns. See Sebastian V. Grassi, Jr., *A Summary, a Checklist, and a Chart of Marital Deduction Formulas*, PROB. & PROP., January/February 2005, at 32, 34.

<sup>32</sup> See Pennell, *supra* note 20, § M.

<sup>33</sup> Revenue Act of 1948, ch. 168, 62 Stat. 110, 117.

<sup>34</sup> H.R. REP. NO. 80-1274, at 24–26 (1948), reprinted in 1948-1 C.B. 241, 260-61; S. REP. NO. 80-1013, at 26–29, reprinted in 1948-1 C.B. 285, 301.

<sup>35</sup> The Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 403(d)(1), 95 Stat. 172, 302-03 [hereinafter ERTA]. §§ 403(a)(1)(B), (b)(1) (amending I.R.C. §§ 2056, 2523 (1954)).

<sup>36</sup> I.R.C. § 2056(a). ERTA, *supra* note 35, § 403(a)(1)(A) repealed I.R.C. § 2056(c) (1954), which contained the dollar and percentage limitations placed on the deduction. The adoption of the unlimited marital deduction and the married couple as the unit of estate and gift taxation has rarely been criticized by scholars or practitioners. See Mark L. Ascher, *Curtailing Inherited Wealth*, 89 MICH. L. REV. 69, 123 (1990) (remarking on the lack of criticism of these 1981 changes).

<sup>37</sup> See Joseph Isenbergh, *Simplifying Retained Life Interests, Revocable Transfers, and the Marital Deduction*, 51 U. CHI. L. REV. 1, 32 (1984) (“Viewed broadly, the unlimited marital deduction has the effect of treating spouses as a single taxpayer with a lifetime equal to the survivor’s.”).

<sup>38</sup> Beginning in 1948, husbands and wives were able to file joint returns and split their income between them. See Revenue Act of 1948, ch. 168, 62 Stat. 110, 115. After the ERTA enactment of the unlimited marital deduction, the Tax Reform Act of 1984 provided that transfers between spouses, and ex-spouses, whether or not for adequate and bona fide consideration, are treated as gifts for income tax purposes, with no gain or loss recognized and with the property given a carry-over basis. See Tax Reform Act of 1984, Pub. L. No. 98-369, § 421, 98 Stat. 494, 793 (codified as amended at I.R.C. § 1041(a), (b) (1984)). The Joint Committee Explanation states: “The Congress believes that, in general, it is inappropriate to tax transfers between spouses. This policy is already reflected in the Code rule that exempts marital gifts from the gift tax, and reflects the fact that a husband and wife are a single

In order to qualify for the marital deduction, the property must pass from the decedent to his or her surviving spouse,<sup>39</sup> must be includible in the decedent's gross estate,<sup>40</sup> and must not be a non-deductible terminable interest.<sup>41</sup> There are statutory exceptions to the terminable interest rule.<sup>42</sup> Those statutory exceptions, however, include safeguards that prevent the property from evading transfer taxation.<sup>43</sup> The marital deduction is intended merely to defer the incidence of transfer taxation until it leaves the marital unit. The statutory exceptions are not intended to provide a double deduction for the same interest in each spouse's estate.<sup>44</sup>

One type of valuation distortion was implicitly condoned when the Supreme Court decided *Northeastern Pennsylvania National Bank*<sup>45</sup> wherein taxpayers challenged the definition of "specific portion" in the regulations.<sup>46</sup> "Specific portion" in this case applied a fixed dollar amount only to the income interest in a power of appointment trust (PAT) and not to the remainder interest subject to the surviving spouse's power of appointment.<sup>47</sup> However, the case opened the door to abuse because the term "specific portion" in the statute is a descriptive requirement of both the income interest and the property itself. That is, although the facts of this case did not apply to the amount included in the surviving spouse's estate (because the power of appointment referred to *all* of the property in the trust), when the same term exists in both parts of the same sentence in the same statute, estate planners would surely cite *Northeastern Pennsylvania*

---

economic unit." JOINT COMM. ON TAXATION, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 710 (Comm. Print 1984).

<sup>39</sup> I.R.C. § 2056(c).

<sup>40</sup> I.R.C. § 2056(a).

<sup>41</sup> I.R.C. §§ 2056(b); 2523 (b)–(g).

<sup>42</sup> I.R.C. §§ 2056(b)(3), (5) (a power of appointment trust (PAT)), (6), (7) (a qualified terminable interest property (QTIP) trust), (8), 2523(d), (e) (PAT), (f) (QTIP), (g).

<sup>43</sup> See, e.g., I.R.C. §§ 2519, 2044.

<sup>44</sup> See I.R.C. §§ 2056(b)(9), 2523(h).

<sup>45</sup> *Ne. Pa. Nat'l Bank & Trust Co. v. United States*, 387 U.S. 213 (1967).

<sup>46</sup> See Treas. Reg. § 20.2056(b)-5(c) (2004) (requiring a specific portion be expressed as a fractional or percentile share).

<sup>47</sup> *Ne. Pa. Nat'l Bank*, 387 U.S. at 215 ("The will provided that his widow should receive \$300 per month until decedent's youngest child reached 18, and \$350 per month thereafter.").

*National Bank* as authority to employ a fixed dollar amount to a “specific portion” of the property subject to the surviving spouse’s power of appointment and it is that effect that resulted in abuse.

Assume a trust estate of \$200,000, with the widow receiving the right to the income from \$100,000 of its corpus and a power of appointment over that \$100,000, and the children of the testator receiving income from the balance of the corpus during the widow’s life, their remainders to vest when she dies. Now suppose that when the widow dies the trust corpus has doubled in value to \$400,000. The wife’s power of appointment over \$100,000 applies only to make \$100,000 taxable to her estate. The remaining \$300,000 passes tax free to the children.<sup>48</sup>

In *Estate of Alexander*,<sup>49</sup> the warning in Justice Stewart’s dissent came to pass. In that case, the decedent’s will provided a marital deduction formula clause: “This amount, which was a specific dollar amount, was to be approximately equal to the maximum Federal estate tax marital deduction allowable in determining the decedent’s taxable estate.”<sup>50</sup> With the decedent’s adjusted gross estate valued at \$1,078,608.54, the widow received half of that value, “or \$539,304.27, minus the value of items that passed directly to [the widow] that qualified for the marital deduction, \$36,755, plus \$10,000, for a total fixed dollar amount of \$512,549.27.”<sup>51</sup>

Significantly, the widow was also given a testamentary power of appointment over that same fixed dollar amount, which was frozen at the

---

<sup>48</sup> *Id.* at 227 (Stewart, J., dissenting) (citation omitted). The dissent emphasized that such treatment would be unfair to surviving spouses in community property states who would have to include one-half of the appreciation in their estates at their subsequent deaths. “Thus, the Court’s interpretation of ‘specific portion’ affords common-law estates a significant tax advantage that community property dispositions cannot obtain.” *Id.* The dissent concluded by criticizing the uncertainty among estate planners that the majority’s holding would cause by invalidating a regulation in force for ten years. *Id.* at 229–30.

<sup>49</sup> *Estate of Alexander v. Comm’r*, 82 T.C. 34 (1984), *aff’d mem.*, 760 F.2d 264 (4th Cir. 1985).

<sup>50</sup> *Id.* at 36.

Specifically, the will provided that the—“Wife’s share was to be an amount equal to the maximum estate tax marital deduction (allowable in determining the Federal estate tax on the gross estate) plus the sum of ten thousand dollars, diminished by the value for Federal estate tax purposes of all other items in my gross estate, which qualify for the marital deduction and which pass or have passed to my wife. . . .”

*Id.* at 35 n.1.

<sup>51</sup> *Id.* n.2.

decedent's death.<sup>52</sup> The Tax Court held that the Supreme Court had already decided the issue in *Northeastern Pennsylvania National Bank* when it interpreted that "specific portion" of income could be expressed as a fixed dollar amount. In so holding, the Tax Court stated that "Congress used the same words 'specific portion,' which we find to be unambiguous, in stating the requirements with respect to both income and corpus to qualify for the marital deduction. Under the circumstances, we cannot say that Congress intended a different meaning to apply to the two categories."<sup>53</sup> While Judge Chabot concurred in *Estate of Alexander*, he had misgivings that the decision was bad tax policy.<sup>54</sup> Judge Simpson, in his dissent, stated that the Supreme Court expressly limited its decision to the income interest and not to the corpus: "The Court was aware that in considering a limited power over corpus, different questions would arise, and the Court, explicitly and directly, told us that it was not deciding the corpus question and in effect directed us to consider that question separately on its merits."<sup>55</sup> Although the government argued "that to conclude that the power to appoint a fixed dollar amount of corpus to qualify for the marital deduction would permit appreciation in the corpus to escape taxation altogether,"<sup>56</sup> the court was not persuaded that this valuation distortion was a significant problem.<sup>57</sup>

---

<sup>52</sup> *Id.* n.4.

<sup>53</sup> *Id.* at 43.

<sup>54</sup> *Id.* at 45 (Chabot, J., concurring) ("Notwithstanding my concern that this interpretation may be bad tax policy (see the dissenting opinion of Simpson, J., *infra*), I agree that we are obligated to give the same content to each appearance of a term when the term appears twice in a single sentence, unless the statute itself (or perhaps unambiguous legislative history) gives clear instructions that the term is to have different meanings.").

<sup>55</sup> *Estate of Alexander*, 82 T.C. at 50. Judge Simpson proceeded to state:

Permitting a bequest of the income from a specific amount of corpus to qualify for the marital deduction does no violence to the congressional scheme of equality, but applying a similar rule to the corpus of a trust will frustrate the clear and important objective of equality of treatment of residents of community property and common law States. To carry out that objective, we must construe 'specific portion,' when applied to a power over corpus, to be limited in the manner prescribed by the regulations.

*Id.* Judges Dawson and Parker agreed with Judge Simpson's dissenting opinion. *Id.* at 51.

<sup>56</sup> *Id.* at 44.

<sup>57</sup> In the FLP context, likewise, courts continue to underestimate the value distortion problem with defined value clauses. *See* *Estate of Christiansen v. Comm'r*, 586 F.3d 1061, 1064 (8th Cir. 2009) ("[W]e agree with the Commissioner that the Tax Court's ruling in this case may *marginally* detract from the incentive to audit estate tax returns.") (emphasis added), *aff'g* 130 T.C. 1 (2008); *Estate of*

With the 1981 enactment of the unlimited marital deduction and the qualified terminable interest property (QTIP) provision election,<sup>58</sup> taxpayer use of this type of defined value clause grew.<sup>59</sup> Essentially, under *Estate of Alexander*, when a surviving spouse held a power of appointment over a specific portion of the property in a PAT or when, as executor, she elected to make a QTIP election with respect to a dollar amount in the QTIP trust at her husband's death, the fixed dollar figure would freeze the amount subject to transfer tax. In both instances, the surviving spouse merely included the same fixed dollar amount in her estate.<sup>60</sup> By contrast, under the government's regulation, invalidated by *Estate of Alexander*,<sup>61</sup> when a specific portion must be expressed as a fractional or percentage share of the trust, the surviving spouse would have to include any appreciation that occurred between the decedent's and the surviving spouse's deaths. Without that regulation, after *Estate of Alexander*, there was no statute or other authority that required such inclusion at either the decedent's death (since no appreciation exists at that time) or at the surviving spouse's death (because the inclusion statutes would not apply to any of that appreciation). After *Estate of Alexander*, therefore, there was no safeguard to prevent this

---

Petter v. Comm'r, 98 T.C.M. (CCH) at 544, 2009 T.C.M. (RIA) ¶ 2009-280 (2009) ("The formulas used to effect these transfers were not void as contrary to public policy, as there was no 'severe and immediate' frustration of public policy as a result, and indeed no overarching public policy against these types of arrangements in the first place."), *aff'd*, 653 F.3d 1012 (9th Cir. 2011).

<sup>58</sup> Under the QTIP provisions, the decedent receives a marital deduction in the value of the underlying property in a QTIP trust despite that the surviving spouse receives only an income interest in the trust property. I.R.C. § 2056(b)(7). See Wendy C. Gerzog, *The Marital Deduction QTIP Provisions: Illogical and Degrading to Women*, 5 UCLA WOMEN'S L.J. 301 (1995), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1280999](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1280999).

<sup>59</sup> Under the QTIP provisions, the executor may elect to have a specific portion of a trust qualify as a QTIP trust with respect to which portion the decedent's estate receives a marital deduction. See, e.g., I.R.C. § 2056(b)(7)(B)(iv); Treas. Reg. § 20.2056(b)-7(b)(1)(ii), -7(b)(ii), -7(h) (2004). The QTIP form of the marital deduction was and is the most popular form of the deduction. See Ira Mark Bloom, *The Treatment of Trust and Other Partial Interests of the Surviving Spouse Under the Redesigned Elective-Share System: Some Concerns and Suggestions*, 55 ALB. L. REV. 941, 955 (1992) ("This scenario addresses both the multiple-marriage society phenomenon and the popularity of QTIP dispositions." (citation omitted)); Joseph M. Dodge, *A Deemed Realization Approach is Superior to Carryover Basis (and Avoids Most of the Problems of the Estate and Gift Tax)*, 54 TAX L. REV. 421, 466 (2001) ("In estates of the well-off, the most popular form of marital bequest is the QTIP trust. . . .").

<sup>60</sup> Inclusion of the fixed amount in the PAT in the surviving spouse's estate is required under § 2041 of the Code; inclusion of the fixed amount in the QTIP, is mandated under § 2044 or earlier taxed as a gift under § 2519.

<sup>61</sup> The regulation was resuscitated by the enactment of § 2056(b)(10) of the Code.

valuation distortion that arose solely because the courts did not consider the use of a defined value clause to define the amount of the marital deduction a significant abuse.

In 1992, Congress enacted § 2056(b)(10), which provided that the income interest or the property qualifying for the marital deduction must be expressed as a fractional or percentage portion and not as a fixed dollar amount.<sup>62</sup> According to the conference report,<sup>63</sup> exceptions to the terminable interest rule<sup>64</sup> that qualify for the marital deduction require that the surviving spouse receive a general power of appointment over, or an income interest in, a “specific portion” of property that could not be expressed as a fixed dollar amount. Consequently, when the surviving spouse dies, the fractional or percentile specific portion is subject to transfer tax by its inclusion in her estate. “Under the court holdings [in *Northeast Pennsylvania National Bank* and *Estate of Alexander*], appreciation in certain marital deduction property may be includible in *neither* spouse’s estate.”<sup>65</sup> The House Report explained the reasons for reversing the effect of those decisions: “The marital deduction postpones the imposition of the estate or gift tax until the property is transferred outside the marital unit. . . . Reversal of the holdings makes the law more certain by unequivocally implementing the policy underlying the marital deduction.”<sup>66</sup>

Thus, in 1992, Congress eliminated the ability to use the freezing technique of a defined value amount as an allowable definition of a “specific portion.” Because the marital deduction was enacted to defer and not reduce the property that would ultimately be subject to transfer tax, a proportional amount of appreciation between the two spouses’ deaths must now be taxed at the surviving spouse’s death or at a lifetime transfer.<sup>67</sup>

---

<sup>62</sup> Energy Policy Act of 1992, Pub. L. 102-486, § 1941, § 2056(b)(10), 106 Stat. 2776, 3036 (applicable to the estates of decedents dying after Oct. 24, 1992, the date the statute was enacted).

<sup>63</sup> H.R. REP. NO. 102-1034 (1992) (Conf. Rep.) [hereinafter 1992 Conf. Rep.]; H.R. REP. NO. 102-631 (1992) [hereinafter 1992 H.R. REP.].

<sup>64</sup> See I.R.C. §§ 2056(b)(5), (6), (7)(B)(iv), 2523(e), (f) (3).

<sup>65</sup> 1992 Conf. Rep., *supra* note 63, at 994 (emphasis added).

<sup>66</sup> 1992 H.R. REP., *supra* note 63, at 264. With this change, a representative share of appreciation between the two spouses’ deaths is includible in the surviving spouse’s estate.

<sup>67</sup> In *Estate of Turner v. Comm’r*, 138 T.C. 14 (2012), the court held that a pecuniary formula marital deduction clause could not shelter the inclusion of FLP assets in the decedent’s estate, the Tax

## II. DEFINED VALUE CLAUSES, DISCLAIMERS, AND CHARITABLE GIFTS

The defined value clause used in *Estate of Christiansen*<sup>68</sup> may not have resulted in distorted values because the parties agreed that the estate tax values were significantly higher than those stated on the decedent's estate tax return, and also because the court ruled that the disclaimer was not a qualified disclaimer. However, without the government's audit and the court's decision on the disclaimer (or stated alternatively, *with* the savings clause and the disclaimant's retaining her contingent remainder in the charitable lead trust), the court's description of the imagined government's scenario would have played itself out.

Consider how these insertions of uncertainty as to the amount actually being donated might come into play should the estate assign an unusually low value to the property being disclaimed. In such a scenario, Hamilton [the disclaimant] would take (and the estate tax would be paid on) her \$6.35 million. But the residue would be divided between the Foundation and the Trust. Should it turn out that the estate underreported that value, Hamilton's failure to disclaim her remainder interest in the Trust would mean that she would capture much of the value of that underreporting as she herself approached retirement age in 20 years' time. And if one took an especially skeptical view of the situation, the final quoted phrase in the disclaimer and the savings clause meant that the Commissioner would face an interesting choice if he thought the estate was lowballing its own value—any success in increasing the value of the estate might only increase the charitable deduction that the estate would claim. Which would presumably reduce the incentive of the Commissioner to challenge the value that the estate claimed for itself.<sup>69</sup>

Moreover, it *will* play out when the disclaimant is the decedent or donor's spouse instead of her daughter.<sup>70</sup>

The government argued in *Estate of Christiansen* that *Procter* applied because it was against public policy to have the government re-value the decedent's estate where the revaluation would merely result in an upward

---

Court based its decision on the policy rationale that the marital deduction was intended to be only a deferral provision. See Wendy C. Gerzog, *Another Turn with Turner*, 136 TAX NOTES 1613 (2012), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2151219](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2151219).

<sup>68</sup> *Estate of Christiansen v. Comm'r*, 130 T.C. 1 (2008), *aff'd*, 586 F.3d 1061 (8th Cir. 2009) (The Tax Court opinion was court reviewed and the majority opinion, written by Judge Holmes, was joined by Judges Colvin, Cohen, Wells, Foley, Vasquez, Thornton, Marvel, Haines, and Goeke).

<sup>69</sup> *Id.* at 5–6.

<sup>70</sup> I.R.C. § 2518(b)(4)(A).

adjustment to the amount of the estate's charitable deduction,<sup>71</sup> but the court rejected that contention and stated that there were several safeguards to prevent undervaluing the charitable donation. However, there is an issue of whether those purported safeguards are sufficient to prevent valuation distortions.<sup>72</sup> Additionally, there is a question of whether the defined value clauses combined with disclaimers to charitable lead trusts really promote charitable "gifts" as defined under *American Bar Endowment*.<sup>73</sup>

In *Estate of Christiansen*, the decedent had left everything she owned to her daughter, but she also provided that if her daughter disclaimed any part of the estate, the disclaimed portion would pass 75% to a testamentary charitable lead trust and 25% to a charitable foundation.<sup>74</sup> The daughter disclaimed all of the estate above \$6.35 million. "The \$6,350,000 that Hamilton retained was an amount she and her advisers carefully determined would allow the family business to continue, as well as to provide for her and her own family's future."<sup>75</sup> That considered decision of a fixed dollar amount, the defined value above which any additional value passed mostly to a charitable lead trust benefiting the disclaimant and to a charitable foundation meant that *at the time of the disclaimer*, the decedent's daughter (the disclaimant) and her advisors thought "that only \$40,555.80 would pass to the Foundation and \$121,667.20 to the [charitable lead] Trust."<sup>76</sup>

Before trial, the parties agreed that some of the assets in the estate were substantially undervalued: (1) the value of the decedent's interest in Christiansen Investments was \$1,828,718.10, representing more than 35% greater than the value stated on the estate tax return; and (2) the value of her interest in MHC Land and Cattle was \$6,751,404.63, greater than 60% of the value stated on the estate tax return. With those adjustments, the decedent's gross estate was stipulated to be \$9,578,895.93 instead of \$6,512,223.20.<sup>77</sup> Thus, with the disclaimer relating to amounts exceeding

---

<sup>71</sup> *Estate of Christiansen*, 130 T.C. at 16.

<sup>72</sup> See *infra* Parts IV.B. & V.

<sup>73</sup> *United States v. Am. Bar Endowment*, 477 U.S. 105, 117–18 (1986).

<sup>74</sup> *Estate of Christiansen*, 130 T.C. at 4.

<sup>75</sup> *Id.* at 5.

<sup>76</sup> *Id.* at 6.

<sup>77</sup> *Id.* at 7.

\$6.35 million, instead of a relatively small amount passing to charity,<sup>78</sup> \$2,421,671.95 passed to the charitable trust and \$807,223.98 passed to the charitable foundation.<sup>79</sup>

The estate asserted that the value increases entitled it to larger charitable deductions.<sup>80</sup> However, the court held that because the disclaimant held a contingent remainder in the charitable lead trust, no part of the amount that passed to the trust constituted a qualified disclaimer under the statute,<sup>81</sup> regulations,<sup>82</sup> or case law.<sup>83</sup>

At trial, the government conceded a charitable deduction for the amount claimed on the estate tax return as a donation to the foundation, but it refused to increase that amount to the actual value that passed to the charitable foundation after the revaluation of the decedent's estate.<sup>84</sup> The government's denial rested on two grounds: (1) the increase was contingent on a condition subsequent, which was the government's challenge to the value of the decedent's gross estate, and (2) the requirement that the value of the disclaimed property would be "as such value is finally determined for federal estate tax purposes" is void as against public policy.<sup>85</sup> The government explained that the charitable donation to the foundation was contingent not only because it was based on a disclaimer, but also because the increased donation was due to the IRS's return examination and challenge of the estate's valuation.<sup>86</sup> The essence of the government's second argument is that the disclaimer's adjustment clause was void because it would discourage the IRS from examining estate tax returns.<sup>87</sup>

---

<sup>78</sup> *Id.* at 6.

<sup>79</sup> *Id.* at 7. That meant that approximately twenty times the amount the disclaimant thought would pass to the foundation actually passed to that charity.

<sup>80</sup> *Estate of Christiansen*, 130 T.C. at 7.

<sup>81</sup> I.R.C. § 2518(b)(4).

<sup>82</sup> Treas. Reg. § 25.2518-2(e)(3) (1997).

<sup>83</sup> *Estate of Christiansen*, 130 T.C. at 10–12 (citing *Walshire v. United States*, 288 F.3d 342 (8th Cir. 2002)).

<sup>84</sup> *Id.* at 7.

<sup>85</sup> *Id.* at 14.

<sup>86</sup> *Id.* at 15.

<sup>87</sup> *Id.* at 16.

That is, reviewing such returns would inevitably result in no additional revenue for the government because any deficiency would be offset by an additional charitable deduction in the same amount.<sup>88</sup>

The court rejected the government's position.<sup>89</sup> First, the court explained that a qualified disclaimer meant that the transfer related back to the decedent's death.<sup>90</sup> The fact that the parties disputed the estate's value did not mean that the transfer was contingent on a future event.<sup>91</sup> Moreover, disallowance of a deduction based on public policy must be narrowly applied<sup>92</sup> and the court found no public policy against increasing charitable gifts.<sup>93</sup> The court considered *Procter* inapplicable here, where there was only a reallocation among the disclaimant, the trust, and the foundation. "If the fair market value of the estate assets is increased for tax purposes, then property must actually be reallocated among the three beneficiaries. That would not make us opine on a moot issue, and wouldn't in any way upset the finality of our decision in this case."<sup>94</sup> While the court acknowledged that the defined value clause might "marginally decrease" the government's inducement to audit such returns,<sup>95</sup> the court found sufficient protection in the fiduciary duties of executors and state attorneys general to police valuation "lowballing" and to protect the charities' interests.<sup>96</sup>

---

<sup>88</sup> *Id.*

<sup>89</sup> *Estate of Christiansen*, 130 T.C. at 15.

<sup>90</sup> *Id.*

<sup>91</sup> *Id.*

<sup>92</sup> *Id.* at 16 (citing *Comm'r v. Tellier*, 383 U.S. 687 (1966)).

<sup>93</sup> *Id.* at 16–17.

<sup>94</sup> *Id.* at 17.

<sup>95</sup> *Estate of Christiansen*, 130 T.C. at 15. The circuit court agreed with the Tax Court that such might minimally detract from the government's decision to audit, but maintained that the courts had no obligation to interpret the statutes in a way to maximize either the government's revenue or its desire to audit returns. *Estate of Christiansen*, 586 F.3d at 1064–65.

<sup>96</sup> *Estate of Christiansen*, 130 T.C. at 17–18. The court cited to the "famed case of Hawaii's Bishop Estate [that] illustrates how effectively the IRS can use the threat of the loss of exempt status to curb breaches of fiduciary duty." *Id.* at 18. In addition, the court cited to the government's powers under § 4958 of the Code. Likewise, the appellate court was confident that "there are countless other mechanisms in place to ensure that fiduciaries such as executors and administrators accurately report estate values." *Estate of Christiansen*, 586 F.3d at 1065. *See infra* Part IV.B.

Estate planners often recommend the use of a charitable lead trust to their wealthy clients whose self-interest, and not necessarily charitable intent, is paramount.<sup>97</sup> Advocated particularly when interest rates are low, a charitable lead trust generally results in an inflated charitable deduction and the non-taxation of much of the value that passes to the non-charitable beneficiary at the end of the charitable term.<sup>98</sup> Under *American Bar Endowment*, to receive a charitable deduction for a transfer to charity, the taxpayer must show that he intended to make a gift.<sup>99</sup> “The *sine qua non* of a charitable contribution is a transfer of money or property without adequate consideration. The taxpayer, therefore, must at a minimum demonstrate that he *purposely* contributed money or property in excess of the value of any benefit he received in return.”<sup>100</sup>

Even in the transfer tax context, where the presence of donative intent is unnecessary to produce a taxable gift,<sup>101</sup> and a gift is defined as a transfer of property “for less than adequate and full consideration in money or money’s worth,”<sup>102</sup> the regulation distinguishes transfer tax gifts from bad bargains in business. The purpose of the statute in omitting a requirement of transferor intent is to prevent property transfers from escaping the transfer

---

<sup>97</sup> See HENKEL, *supra* note 17, ¶ 35.09; Wendy C. Gerzog, *From the Greedy to the Needy*, 87 ORE. L. REV. 1133, 1135 (2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1268825](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1268825).

<sup>98</sup> For example, “Dad transfers \$1,000,000 in property to a CLAT with a ten year charitable term and an eight percent payout rate. The property earns ten percent (after-tax) yearly, and the [§] 7520 rate at the time of the transfer is eight percent. The remainder interest is valued at \$463,192 at the time of the transfer. At the end of the charitable term, the value transferred to Dad’s children is \$1,318,748.49. Had Dad initially made a gift of property worth \$463,192 rather than creating the CLAT, the gifted property would be worth \$1,201,400.76 at the end of ten years, assuming it grew at ten percent (after-tax) each year.” HENKEL, *supra* note 17, ¶ 35.09. As between a CLAT and a CLUT, “[i]f the CLT [charitable lead trust] property is expected to appreciate, a CLAT is usually the better choice, since the annuity remains fixed and more property can go to the family beneficiaries.” *Id.* ¶ 35.08. The charitable lead trust created in *Estate of Christiansen* was a CLAT. 130 T.C. at 3.

<sup>99</sup> *Am. Bar Endowment*, 477 U.S. at 117.

<sup>100</sup> *Id.* at 118 (emphasis added).

<sup>101</sup> See Treas. Reg. § 25.2512-8 (1992) (“However, a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm’s length, and free of any donative intent) . . .”).

<sup>102</sup> I.R.C. § 2512(b). This section of the Code defines the amount of the donor’s gift as “the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift . . .” *Id.*

tax. The statutes conferring a deduction for transfers to a charity require a “gift” for the transfer to be deductible for gift and estate tax purposes.<sup>103</sup>

When the decedent’s daughter made her disclaimer, she and her advisors made a studied review before determining the amount she would retain before stating the fixed value, \$6.35 million, above which she was making a transfer to charity.<sup>104</sup> At that time, as reflected on the decedent’s estate tax return, she intended to make a relatively small gift to the charitable lead trust and an even smaller gift to the charitable foundation.<sup>105</sup> She had expected “that only \$40,555.80 would pass to the Foundation” and the government at trial acceded to a charitable deduction of that amount.<sup>106</sup> This fairly modest amount is also in accord with the decedent’s daughter’s statements to the IRS when she sought tax exemption for the foundation.<sup>107</sup> It is difficult to believe that there was an intention to make a charitable donation of \$807,223.98, the amount that actually passed to the charitable foundation after the government’s audit, under the defined value clause and the parties’ pre-trial agreement to the substantially increased value of the decedent’s estate.<sup>108</sup> That is, the actual charitable transfer was *twenty times* the deduction claimed on the estate tax return after the decedent’s daughter and her advisors carefully determined the fixed dollar amount she would retain.<sup>109</sup>

The court’s stating that the IRS has great powers to deal with valuation distortions, such as those it uniquely applied in the *Bishop’s Estate* case,<sup>110</sup>

---

<sup>103</sup> I.R.C. §§ 2522, 2055.

<sup>104</sup> *Estate of Christiansen*, 130 T.C. at 5.

<sup>105</sup> *Id.* at 6.

<sup>106</sup> *Id.*

<sup>107</sup>

[I]n the Foundation’s application to the IRS for recognition of exempt status, Hamilton stated: ‘The initial source of funding for the foundation will be \$50,000 from the Helen Christiansen Estate providing a 5 percent income stream annually. Additionally, there will be annual funding from a 7 percent charitable lead annuity trust equaling \$12,500.’

*Id.* at 3.

<sup>108</sup> *Id.* at 7.

<sup>109</sup> *Id.* at 5.

<sup>110</sup> *Estate of Christiansen*, 130 T.C. at 18.

which involved public officials in decades of fraud, mismanagement, and the highest levels of fiduciary malfeasance,<sup>111</sup> is a non-starter. However, the Tax Court's and the appellate court's reliance on a fiduciary's duty to provide accurate valuations proved inadequate to deal with pecuniary formula and funding marital deduction clause abuses.<sup>112</sup>

### III. DEFINED VALUE CLAUSES IN THE CONTEXT OF FAMILY LIMITED PARTNERSHIPS

#### *A. Defined Value Clauses, Family Limited Partnerships, and Charitable Gifts*

In *McCord*,<sup>113</sup> the taxpayers, husband and wife, combined a defined value clause with a charitable donation and then undervalued their taxable transfers of FLP interests and overvalued their charitable deduction.<sup>114</sup> The

---

<sup>111</sup> See SAMUEL P. KING & RANDALL W. ROTH, BROKEN TRUST: GREED MISMANAGEMENT & POLITICAL MANIPULATION AT AMERICA'S LARGEST CHARITABLE TRUST (2006).

<sup>112</sup> See *supra* Part I.

<sup>113</sup> Succession of *McCord v. Comm'r*, 461 F.3d 614 (5th Cir. 2006), *rev'g* 120 T.C. 358 (2003). *Hendrix v. Comm'r*, 103 T.C.M. (CCH) 1642, 2011 T.C.M. (RIA) ¶ 2011-133 involved a technique virtually identical to *McCord*. Because *Hendrix* was appealable to the Fifth Circuit, the Tax Court was obliged to apply its rule in *Golsen v. Comm'r*, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971), which required the court to conform its opinion with that circuit's decision in *McCord*. ("We hold consistently with *McCord* that the formula clauses control the transfers of the JHHC stock to the trusts and the Foundation on December 31, 1999." *Id.* (citation omitted)). However, there are a few points about *Hendrix* that should be noted. The court emphasized that the charity in *Hendrix* obtained its own appraisal of the value of the FLP interests; however, the foundation did not independently appraise the donated property, but merely had the taxpayers' appraisal approved. See *Hendrix*, slip op. at 10 and 19. Rather, in both *Hendrix* and *McCord*, it is equally questionable "why a charity would ever want to receive a minority limited partnership interest, but for an understanding that this interest would be redeemed quickly for cash, and find relevant that the interest was subject to the call provision that could be exercised at any time." 120 T.C. at 430 (Laro, J., joined by Vasquez, J., dissenting). In *Hendrix*, moreover, the Tax Court went further than applying *Golsen*. The court rejected the government's public policy argument at least in part on the ground that the defined value clauses encourage charitable gifts. However, defined value clauses primarily promote private benefit to the donors in contravention of *Am. Bar Endowment*, 477 U.S. at 117-18. Through the use of a charitable conduit, the taxpayers pass a greater value to their children without properly assessed transfer taxes. By discouraging the government's incentive to audit the taxpayers' returns, the defined value clauses in both *McCord* and *Hendrix* impede an accurate valuation of the transferors' taxable gifts to their family and their donations to the charities.

<sup>114</sup> On the date of the assignment agreement, the FLP held assets consisting of marketable securities (approximately 65%); real estate limited partnership interests (approximately 30%) and a mix of direct real estate and oil and gas interests (approximately 5%). Succession of *McCord v. Comm'r*, 120 T.C. 358, 361, 367-68 (2003), *rev'd*, 461 F.3d 614 (5th Cir. 2006).

assignment agreement, dated January 12, 1996, defined the pecuniary value of the taxpayers' taxable gifts of FLP interests; anything valued above that fixed dollar amount passed to two charities.<sup>115</sup> In addition, the assignment agreement both allowed the assignees to allocate their proportionate interests in the gifted property among themselves (which they did in March 1996 in their confirmation agreement)<sup>116</sup> and included a call provision whereby the FLP could purchase a charity assignee's interest "at any time for fair market value, as determined under the partnership agreement."<sup>117</sup>

The appraisal report, dated February 28, 1996, valued a 1% assignee's interest as of January 12, 1996 at \$89,505.<sup>118</sup> Representatives of the two charities reviewed the report and decided it was unnecessary to seek an additional appraisal of their own, agreed not to contest the confirmation agreement allocations, and waived their right to arbitration.<sup>119</sup> On June 26, 1996, the FLP exercised its call right to purchase the charities' assignee interests at the appraiser's updated value of \$93,540 for a 1% "assignee's interest in the Class B Limited Partnership Interests" as of June 25, 1996.<sup>120</sup> Again, the charities voiced no objections and received \$338,967 (CFT) and \$140,041 (the Symphony) for their interests.<sup>121</sup>

---

<sup>115</sup> *Id.* at 358, 364–65. "Under the terms of a 'formula clause' contained in the assignment agreement (the formula clause), the children and the trusts were to receive portions of the gifted interest having an aggregate fair market value of \$6,910,933; if the fair market value of the gifted interest exceeded \$6,910,933, then the symphony was to receive a portion of the gifted interest having a fair market value equal to such excess, up to \$134,000; and, if any portion of the gifted interest remained after the allocations to the children, trusts, and symphony, then CFT was to receive that portion (i.e., the portion representing any residual value in excess of \$7,044,933)." *Id.* at 364. The taxpayers' sons agreed to pay transfer taxes resulting from either or both of their parents' deaths within three years of the gift. This article will not address the issue of discounting the value of a gift for what is known as "tax affecting," except to mention here that the Tax Court refused apply this discount and the Fifth Circuit reversed and allowed the taxpayers this valuation discount.

<sup>116</sup> *Id.* at 365.

<sup>117</sup> *Id.* at 363.

<sup>118</sup> *Id.* at 366.

<sup>119</sup> *Id.*

<sup>120</sup> *McCord*, 120 T.C. at 366.

<sup>121</sup> *Id.* at 365–66.

In its notice of deficiency, the government stated that Mr. and Mrs. McCord undervalued their gifts, causing gift tax deficiencies.<sup>122</sup> At trial, the government argued that the taxpayers' undervaluation was achieved "by mischaracterizing the assignment and applying excessive discounts."<sup>123</sup> Furthermore, the court maintained that the formula clause, intended to thwart any increase in the value of the gift, was void.<sup>124</sup>

The Tax Court held that the formula clause in the assignment agreement was "not self-effectuating" and left "to the assignees the task of (1) determining the fair market value of the gifted interest and (2) plugging that value into the formula clause to determine the fraction of the gifted interest passing to CFT."<sup>125</sup> According to the court, the formula supplied in the assignment agreement provided the computation to determine the fractional interests of the gifts to CFT, the Symphony, the sons, and the generation skipping transfer tax (GSTT) trusts. If any of the assignees disputed their respective interest, there was a provision in the partnership agreement detailing the appointment of an arbitrator and the binding

---

<sup>122</sup> *Id.* at 367; *see also McCord*, 461 F.3d at 621. The estate's deficiencies were based on increasing the value of each taxpayer's gifts, respectively by \$3,740,904 and \$3,730,439. *Id.* The government's notice also stated that the taxpayers had "improperly reduced such gross value by the actuarial value of the children's obligation to pay additional estate taxes potentially attributable to the transaction." *Id.* As earlier stated, this article will not address the issue of tax affecting the gifts. *See supra* note 115.

<sup>123</sup> *McCord*, 120 T.C. at 369. According to the Tax Court, the parties' differing valuations were at least partially due to their different interpretation of the extent of the assignee rights the taxpayers transferred, that is whether or not the taxpayers could and did admit the donees as class B limited partners. Under Texas law, the court explained that the assignees were not class B partners, which fact diminishes the value of their interests. *Id.* at 369–70. The court concluded that the taxpayers assigned only economic rights in the FLP. *Id.* at 370–73. The parties agreed that the FLP's net asset value (NAV) was \$17,673,760 on January 12, 1996. *Id.* at 375. The court then reduced that value by \$20,000 because the partnership agreement gave the class A limited partner a \$20,000 priority claim against the FLP's assets. *Id.* at 376. In so doing, the court agreed with the estate's expert. *Id.* The court calculated both a minority interest discount of 15% (*id.* at 387) and a lack of marketability discount of 20%. *Id.* at 387, 395. After applying those discounts, the court concluded that the value of each taxpayer's gift was \$4,941,916. *Id.* at 395. The taxpayers contended that since the total value of their gifts (\$9,883,832) exceeded \$7,044,933, the excess (\$2,838,899) above their defined value gift was a charitable contribution to CFT. *Id.* at 395–96. The court rejected that analysis. "Because the assignment agreement does not equate the term 'fair market value' with the term 'fair market value as finally determined for Federal gift tax purposes,' petitioners' argument must fail." *Id.* at 396.

<sup>124</sup> *McCord*, 120 T.C. at 369. At trial, the government bore the burden of proof. *Id.* The government's "value of a one-percent interest in MIL was \$171,749, almost double the Taxpayers' one-percent figure of \$89,505." *McCord*, 461 F.3d at 621.

<sup>125</sup> *Id.* at 396.

arbitration procedure that would be used to determine value.<sup>126</sup> That is, “the assignment agreement contemplates the allocation of the gifted interest based on the assignees’ best estimation of that value.”<sup>127</sup>

While binding among the assignees regarding their respective interests, the court found that the value of a 1% FLP assignee interest on January 12, 1996 was \$120,046. Thus, the non-charitable gifts constituted a 77.21280956% assignee interest valued at \$9,269,089; the Symphony’s 1.49712307% assignee interest was valued at \$179,724; and CFT’s 3.62376573% assignee interest was valued at \$435,019.<sup>128</sup> These amounts add up to the total transferred value, \$9,883,832 (\$4,941,916 for each taxpayer). Applying annual exclusions, the court held that the taxpayers were entitled to charitable deductions of \$415,019 (\$207,510 for each) for their donations to CFT.<sup>129</sup>

Reversing the Tax Court’s decision, the Fifth Circuit determined that the taxpayers had properly valued their gifts to family at a total value of \$6,910,932.52 and were entitled to charitable donations of \$458,277.16.<sup>130</sup> Thus, according to the appellate court, under the assignment agreement dated January 12, 1996, the taxpayers had transferred interests valued at \$2,475,896.40 and \$2,482,604.82, which, after annual exclusions and charitable deductions, amounted to total taxable gifts of \$4,420,156 (\$2,206,724 to their sons and \$2,213,432 to the GSTT trusts).<sup>131</sup>

The taxpayers had contributed an equal amount of assets totaling \$12,294,384 for their combined 82.33369836% Class B limited partnership interest.<sup>132</sup> On January 12, 1996, through their assignment agreement enabling them to make concurrent taxable gifts to their family members and

---

<sup>126</sup> *Id.* at 396–97.

<sup>127</sup> *Id.* at 397.

<sup>128</sup> *Id.* at 398.

<sup>129</sup> *Id.* at 404.

<sup>130</sup> *Succession of McCord v. Comm’r*, 461 F.3d 614, 632 (5th Cir. 2006), *rev’g* 120 T.C. 358 (2003). The court also held that the taxpayers were entitled to multiple discounts including a discount for their donee’s obligation to pay any estate taxes due under § 2035 for gifts made within three years of a donor’s death. *Id.*

<sup>131</sup> *Id.* at 621 n.13, 632.

<sup>132</sup> *Id.* at 616.

gifts to the exempt donees, the taxpayers irrevocably relinquished all of their Class B FLP interests.<sup>133</sup> The court held that this transfer was made “according to a sequentially structured ‘defined value clause’ and not, as the Tax Court had held, in percentage interests, in accordance with the donees’ confirmation agreement executed in March 1996.”<sup>134</sup>

According to the Fifth Circuit, the Tax Court’s decision was not based on any of the government’s arguments, but on its own theory, which “gave controlling effect to the post-gift Confirmation Agreement.”<sup>135</sup> The appellate court held “that the Majority’s unique methodology violated the immutable maxim that post-gift occurrences do not affect, and may not be considered in, the appraisal and valuation processes.”<sup>136</sup> The circuit court cited *Ithaca Trust*<sup>137</sup> as holding that a court may not rely on post-gift events to value a gift.<sup>138</sup> In *McCord*, the circuit court refused to look at any transaction that occurred after the date of the gift, regardless how probable and foreseeable under the assignment agreement.<sup>139</sup> Unlike the Tax Court

<sup>133</sup> *Id.* at 618.

<sup>134</sup> *Id.* For the March agreement, each donee, including CFT, retained an independent attorney and, although CFT did not seek its own appraisal, there was no finding of collusion or a tacit understanding to blindly accept the taxpayers’ figures. Near the end of June 1996, the FLP exercised its call right to redeem the charities’ interests. In connection with that event, the FLP sought an updated appraisal, which the charities reviewed and accepted. *Id.* at 619–20.

<sup>135</sup> *McCord*, 461 F.3d at 622 (“Stated differently, the Majority in essence suspended the valuation date of the property that the Taxpayers donated in January until the date in March on which the disparate donees acted, post hoc, to agree among themselves on the Class B limited partnership percentages that each would accept as equivalents of the dollar values irrevocably and unconditionally given by the Taxpayers months earlier.”).

<sup>136</sup> *Id.*

<sup>137</sup> *Ithaca Trust Co. v. United States*, 279 U.S. 151 (1929). The court also cited its own precedent on this issue: *Estate of Smith v. Comm’r*, 198 F.3d 515 (5th Cir. 1999), *rev’g, vacating, and remanding* 108 T.C. 412 (1997).

<sup>138</sup> *McCord*, 461 F.3d at 626 (“The core flaw in the Majority’s inventive methodology was its violation of the long-prohibited practice of relying on post-gift events.”).

<sup>139</sup> *Id.* at 628.

The assignment agreement leaves to the assignees the task of allocating the gifted interest among themselves; in other words, in accordance with the formula clause, the assignees were to allocate among themselves the approximately 82-percent partnership interest assigned to them by petitioners. . . . In March 1996, the assignees executed a Confirmation Agreement (the confirmation agreement) allocating the gifted interest among themselves.

*McCord*, 120 T.C. at 365.

that valued proportionate interests (as defined by the donees in the confirmation agreement as anticipated in the taxpayers' assignment agreement),<sup>140</sup> the appellate court sanctioned all of the taxpayers' valuation: both their use of a defined value clause and their valuation of a 1% FLP interest.<sup>141</sup>

While the value of a gift is what the donor transferred and not what the donee received, in this instance, because the assignment and confirmation agreements were integrally connected, there is a question about what property the taxpayers transferred: a fixed dollar amount or a percentage interest. The appellate court never addressed the government's integrated transaction argument though, implicitly, it was at the core of the Tax Court's opinion.<sup>142</sup> The court remarked that the government's value was twice that of the taxpayers' but did not consider that discrepancy significant. Yet, there was no explanation for such a marked valuation difference occurring between January and March 1996.<sup>143</sup>

---

<sup>140</sup> *McCord*, 120 T.C. at 365–66. “Specifically, the Majority used the after-the-fact Confirmation Agreement to mutate the Assignment Agreement’s dollar value gifts into percentage interests in MIL.” *McCord*, 461 F.3d at 626.

<sup>141</sup> According to the appellate court:

The complex appellate review required in this gift tax case implicates (1) the interpretation and effect of contractual agreements, (2) the nature of property interests transferred by gift, (3) determination of the fair market value of such interests, and (4) special law rules governing that kind of evaluation exercise, including the types and percentages of discounts that may be applied. Thus, our standard of review here cannot be covered adequately by rotely reciting the ubiquitous single-sentence mantra that ‘we review factual determinations for clear error and legal determinations *de novo*.’ The particularized standard of review applicable in this case is accurately stated in the Taxpayers’ appellate brief: ‘An appellate court reviews a trial court’s conclusions of law *de novo* and draws its own conclusions in place of those of the trial court.’

*McCord*, 461 F.3d at 622–23. The court ignored the estate’s significant overvaluation of a 1% MIL interest. *Id.* at 621 (“The Commissioner’s fair market value of a one-percent interest in MIL was \$171,749, almost double the Taxpayers’ one-percent figure of \$89,505.”). The appellate court should have been struck by the great distortion in value between the fixed defined value gift and the values under the confirmation agreement; however, it appears that the appellate court’s only analysis and criticism of the Tax Court’s analysis of value was that “the Majority split this almost \$10 million baby precisely halfway between the experts’ respective values.” *See id.* at 625 n.23.

<sup>142</sup> *See McCord*, 120 T.C. at 398 n.47; *see also infra* note 172.

<sup>143</sup> That striking difference should have triggered a “sanity check.” *See, e.g., Pollack v. Comm’r*, 366 F.3d 608, 612 (8th Cir. 2004) (“[S]ubsequent events that shed light on what a willing buyer would have paid on the date in question are admissible, such as ‘evidence of actual sales prices received for property after the date [in question], so long as the sale occurred within a reasonable time . . . and no

Likewise, the appellate court ignored the anticipated redemption by the FLP of the charities' FLP's interests and disregarded questions about the deductibility of that transfer. The charities did not hire their own valuation experts or conduct themselves like unrelated third parties.<sup>144</sup> Because the charities knew about the call right granted under the assignment agreement, they likely accepted the unmarketable FLP interests because they knew they would soon receive cash for them.<sup>145</sup> "Suffice it to say that, in the long run, it is against the economic interest of a charitable organization to look a gift horse in the mouth."<sup>146</sup>

It is also dubious whether the taxpayers had the requisite charitable intent under *American Bar Endowment*. When a donation is defined as transferring an unknown excess value over a fixed amount, the indefiniteness of the value transferred undermines any purpose<sup>147</sup> to make a charitable transfer, as there may in fact be *no* transfer to a charity under a defined value clause. Whatever public policy there is in favor of charities, there is no public policy to encourage transfers to charities unless those transfers are donations, characterized by the donor's intent to contribute money or property in excess of the personal benefit received. The taxpayers in these cases undervalue their non-charitable transfers, discourage a government audit, and, if they are audited, accede to whatever gift to

---

intervening events drastically changed the value of the property." (citing *First Nat'l Bank of Kenosha v. United States*, 763 F.2d 891, 894 (7th Cir. 1985)); *Okerlund v. United States*, 365 F.3d 1044, 1053 (Fed. Cir. 2004) ("The greater the significance of exogenous or unforeseen events occurring between the valuation date and the date of the proffered evidence, the less likely ex post evidence is to be relevant—even as a sanity check on the assumptions underlying a valuation model."); *Gross v. Comm'r*, 272 F.3d 333, 341–42 (6th Cir. 2001) (The appellate court held that although 79 of the 157 transactions were post-valuation-date, they could be considered to determine the value of the gifted stock because they could have been anticipated); *Saltzman v. Comm'r*, 131 F.3d 87, 93 (2d Cir. 1997) ("[S]ubsequent events are not considered in fixing fair market value *except to the extent that they were reasonably foreseeable on the date of the gift.*") (emphasis added).

<sup>144</sup> See *McCord*, 120 T.C. at 430 (Laro, J., dissenting) ("[T]he charities never obtained a separate and independent appraisal of their interests (including whether the call price was actually the fair market value of those interests), . . . the charities agreed to waive their arbitration rights as to the allocation of the partnership interests. . . .").

<sup>145</sup> *Id.* ("[W]hy a charity would ever want to receive a minority limited partnership interest, but for an understanding that this interest would be redeemed quickly for cash, and find relevant that the interest was subject to the call provision that could be exercised at any time.").

<sup>146</sup> *Id.* at 373 n.9.

<sup>147</sup> See *supra* notes 99–100 and accompanying text.

charity is necessary in order to avoid transfer tax on their taxable family gifts. Because the “gifts” of non-marketable FLP interests to a charity are not objectively valued by the charity, and because the interests are redeemed by the non-exempt donees shortly thereafter for cash (a good reason for the charities not to complain and motive for their compliance in all the taxpayers’ plans), moreover, the taxpayers have received an inflated charitable deduction for their unintentional charitable gift.<sup>148</sup>

Consider a decedent who left a fixed amount of her estate to her child and the (currently unknown) remainder of her estate to the American Cancer Society (ACS). If the decedent would not know the exact amount that would be going to the ACS, would that mean her gift is without charitable intent? That, of course, depends on the facts. If the fixed amount was \$20 million and the decedent had never had more than \$10 million, the decedent likely did not have the requisite intent.<sup>149</sup> That is, the purported charitable transfer would be illusory or too speculative. If the fixed amount were \$1 million and the decedent had more than \$20 million at all times, the decedent likely would have a purposeful charitable intention. In the typical FLP context where there is a transfer of any excess to charity if the taxable transfer triggers a tax liability, the formula clause has the primary purpose of ensuring that the taxpayer pays no tax; there is clearly no understanding that there will be any charitable gift because that transfer is conditioned on the taxpayer’s having been audited and found to have increased his tax liability. It is as if the decedent said, “I don’t want to pay any taxes, but if it looks as if I’ll have to do that, I would rather the money go to a charity instead of the government!” Because the IRS has a disincentive to audit a return that cannot produce additional taxable revenue, the taxpayer is more likely to avoid an audit; in that case, the taxpayer’s likely undervalued transfer to family members will escape taxation. With that aim in mind, and under those facts, it is likewise improbable that the taxpayer had a purposeful charitable intent outweighing more personal monetary motives.

Similarly, in *Estate of Petter*, the taxpayer made a part-gift, part-sale transfer of family LLC units to two trusts and a charitable donation of the

---

<sup>148</sup> See *McCord*, 120 T.C. at 427–29 (Laro, J., dissenting).

<sup>149</sup> Of course, nothing would pass to the charity unless on the day he died he won the \$20+ million lottery.

units to two charitable foundations. The transfer documents included both a defined value clause and a reallocation clause.<sup>150</sup> The reallocation clause required gift transfers from the trust to the foundations if the value of the units, as finally determined for gift tax purposes, exceeded a fixed dollar amount.<sup>151</sup> Not surprisingly, after her audit, the donor's units were deemed to have a higher value for each unit; consequently, the reallocation clause required that the foundations receive additional units.<sup>152</sup> The taxpayer contended that she was entitled to an additional charitable donation equal to the increased units given to the foundations and both the Tax Court and the Ninth Circuit agreed.<sup>153</sup>

Not wanting to pay any gift tax, the taxpayer gave the trusts units equal to her unused unified credit (\$1 million) plus her available annual exclusions (in 2002, that amount was \$11,000 per donee).<sup>154</sup> Then, taking back a 20-year note bearing 5.37% interest and requiring quarterly payments of \$83,476.30, she sold additional units to the trusts.<sup>155</sup> According to the taxpayer's estate planner, those transfers created a charitable freeze under which, if the government challenged the gift valuation, an excess would not result in additional gift tax but in additional charitable donations.<sup>156</sup>

The IRS audit determined that each unit had a greater value than the taxpayer reported so that, according to the government, the taxpayer's gifts exceeded her unified credit and the sales were not for adequate consideration in money or money's worth.<sup>157</sup> The government further declared that the defined value clauses were void as against public policy and, citing a regulation,<sup>158</sup> refused the additional charitable deductions on

---

<sup>150</sup> *Estate of Petter*, 98 T.C.M. (CCH) at 536–37, 2009 T.C.M. (RIA) ¶ 2009-280, *aff'd*, 653 F.3d 1012 (9th Cir. 2011).

<sup>151</sup> *Id.* at 537.

<sup>152</sup> *Id.* at 539.

<sup>153</sup> *Id.* at 545. *See also Estate of Petter*, 653 F.3d at 1023.

<sup>154</sup> *Estate of Petter*, 653 F.3d at 1015.

<sup>155</sup> *Id.*

<sup>156</sup> *Id.* at 1015 n.2.

<sup>157</sup> *Id.* at 1017.

<sup>158</sup> Treas. Reg. § 25.2522(c)-3(b)(1).

the basis that the transfer resulted from a “post-audit reallocation of units between the foundation and the trusts.”<sup>159</sup>

While the government argued that the foundations’ right to the additional units adhered only after a successful IRS audit, the court held that the transfers were immediately effective when the transfer documents were executed and the units delivered.<sup>160</sup> Only the value of the units remained unsettled. According to the court, when the transfer was created, mathematical calculations could determine the number of units the foundations would receive. Those computations merely awaited a determination of fair market value.<sup>161</sup> The court acknowledged the practical unlikelihood of a valuation challenge by the trusts or the foundations, and that therefore, in reality, an IRS audit was required for such a challenge; however, the court stated that this fact did not transform the foundations’ rights into contingent ones.<sup>162</sup>

At the same time, while the foundations (the donees) may have had a right to the additional units, the taxpayer could not have had the requisite intent to make a charitable gift when the transfer occurred. At that point, the taxpayer was most concerned that her transfer be one exempt from tax by means of her annual exclusions and her unused unified credit amount. It was only if the low valuation of an LLC unit was brought to light in an audit that the taxpayer’s fallback, second choice intention, was to shelter the additional transfers from tax by transforming them into charitable donations.

The appellate court stated that “[b]ecause the fair market value of an LLC unit on a particular date is a constant, the foundations received gifts of a determinable amount.”<sup>163</sup> While the value of a unit may well have been constant, the number of units constituting a fixed value was unknown and whether or to what extent *any* unit might pass to a charity was likewise unknown. Because she did not know whether there would be any charitable gift, and because the taxpayer’s primary motive in using a defined value

---

<sup>159</sup> *Estate of Petter*, 653 F.3d at 1018.

<sup>160</sup> *Id.*

<sup>161</sup> *Id.* at 1018–19.

<sup>162</sup> *Id.* at 1019.

<sup>163</sup> *Id.* at 1023.

clause was likely to transfer more value untaxed to her family, the taxpayer probably lacked the requisite intent to make a gift to charity and receive a charitable donation deduction.

*B. Defined Value Clauses and Family Limited Partnerships (Without the Charitable Gift)*

In *Wandry*, the Tax Court held that the taxpayers' gifts to their children and grandchildren were gifts of fixed dollar amounts equal to comparable amounts of family limited liability company share units and that the defined value clause in their transfer documents was not void as contrary to public policy.<sup>164</sup> In 2004, the taxpayers each purportedly made gifts to their children and grandchildren totaling the nine beneficiaries' annual exclusions, plus, to the four children, a quarter of a million dollars each, representing each donor's lifetime gift tax exclusion.<sup>165</sup> The taxpayers intended to make taxable gifts that fell within the exempted amounts.

The gift document stated that “[a]lthough 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.”<sup>166</sup> Further, the instrument recited the donors' intention to have an independent appraiser value the number of units, with a proviso that if the IRS challenged the number, it would be adjusted as necessary “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.”<sup>167</sup> The taxpayers' attorney explained that if there were a revaluation, no units would be returned to them; rather, there would be a reallocation of their capital accounts to reflect the actual gifts (thus, a retained interest).<sup>168</sup> On July 26, 2005, the appraiser valued a 1% LLC interest at \$109,000.<sup>169</sup>

---

<sup>164</sup> *Wandry v. Comm'r*, 103 T.C.M. (CCH) 1472, 2012 T.C.M. (RIA) ¶ 2012-88.

<sup>165</sup> *Id.* at 1473.

<sup>166</sup> *Id.* at 1473–74.

<sup>167</sup> *Id.* at 1474.

<sup>168</sup> In 2004, the taxpayers' capital accounts decreased in the aggregate by \$3,603,311, increasing their children's and grandchildren's capital accounts by approximately \$855,745 and \$36,066, respectively. *Id.* at 1474. Each taxpayer's gift tax return for 2004 indicated the total fixed value of his

Applying the Ninth Circuit’s three-part test in *Estate of Petter* to the facts in *Wandry*, the Tax Court determined that under the gift document, the donees were at all times entitled to receive predefined LLC percentage units, expressed in a mathematical formula, and the value of an LLC unit, although unknown when the gift documents were executed, was a constant. Each child was entitled to receive approximately a 1.98% interest and each grandchild approximately a 0.083% interest.<sup>170</sup> Without the audit, the donees might not have received their proper LLC percentage interest, “but that does not mean that parts of petitioners’ transfers were dependent upon an IRS audit.”<sup>171</sup>

The court stated that it was unimportant that the adjustment clause reallocated the units between the parties instead of transferring excess valued units to a charity “because the reallocations [did] not alter the transfers. On January 1, 2004, each donee was entitled to a predefined Norseman percentage interest expressed through a formula.”<sup>172</sup> According to the Tax Court, the gift documents did not cause the taxpayers’ gifts to be revocable, but merely provided a method to correct the allocation of units because the appraisal undervalued the units. The court held that there was no public policy against formula clauses and that there were mechanisms apart from an IRS audit, such as competing interests of the LLC members, to ensure accurate valuation.<sup>173</sup>

However, the defined value clause in *Wandry* presents a scenario in which the taxpayer used a defined value provision as a way of nullifying his

---

gifts, but described the gifts as 2.39% and 0.101% LLC interests, respectively, based on the appraiser’s figure. *Id.* Both the taxpayers and the government agreed that as of January 1, 2004, those percentage interests were worth \$315,800 and \$13,346, respectively. *Id.* The court declined to adopt the government’s view that the LLC’s capital accounts controlled the nature of the taxpayers’ gifts. The court stated that “[t]he facts and circumstances determine Norseman’s capital accounts, not the other way around.” *Id.* at 1476. Moreover, the court found the capital account ledger “unofficial and unreliable.” *Id.*

<sup>169</sup> *Id.* at 1474.

<sup>170</sup> *Id.* at 1477–78.

<sup>171</sup> *Id.* at 1478.

<sup>172</sup> *Id.* That there is no charitable donation in *Wandry* “does not result in a ‘severe and immediate’ public policy concern.” *Id.* at 1479.

<sup>173</sup> *Id.* at 1478 (“Each member of Norseman has an interest in ensuring that he or she is allocated a fair share of profits and not allocated any excess losses.”). *See infra* Part IV.B.

transfer. That is, the effect of the defined value clause in the FLP context is a type of retained control, which cancels the purported transfer because the provision allows the donor to alter the identity of the donee or donees. As such, the case parallels *Procter*, which is explained in more detail in the next part of this article.

#### IV. REJECTED, IGNORED, AND INADEQUATE SAFEGUARDS

##### A. *Procter and Robinette*

In *Estate of Christiansen*, *McCord*, *Estate of Petter*, and *Wandry*,<sup>174</sup> the government argued that *Procter* applied and that the defined value clauses were void as contrary to public policy. In each of those cases, the courts either did not address this issue<sup>175</sup> or, most often, rejected the

---

<sup>174</sup> See *Hendrix v. Comm’r*, 101 T.C.M. (CCH) 1642, 2011 T.C.M. (RIA) ¶ 2011-133, a case almost identical to *McCord*.

<sup>175</sup> See, e.g., *Succession of McCord v. Comm’r*, 461 F.3d 614, 623 (5th Cir. 2006) (“At the outset, we reiterate that, although the Commissioner relied on several theories before the Tax Court, including doctrines of form-over-substance, violation-of-public policy, and, possibly, reasonable-probability-of-receipt, he has not advanced any of those theories on appeal. Accordingly, the Commissioner has waived them.”), *rev’g* 120 T.C. 358 (2003). The majority opinion in the Tax Court did not address any of these theories, but the dissent did. See *Succession of McCord v. Comm’r*, 120 T.C. 358, 425–30 (Laro, J., dissenting). Besides the application of *Comm’r v. Procter*, 142 F.2d 824 (4th Cir. 1994) and *Ward v. Comm’r*, 87 T.C. 78 (1986), Judge Laro also addressed the government’s integrated transaction argument and concluded that the taxpayer’s actions were parts of an integrated transaction. He based that conclusion on the following:

(1) Petitioners were seeking expert advice on the transfer of their wealth with minimal tax consequences, (2) the transaction contemplated that the charities would be out of the picture shortly after the gift was made, (3) the transfers of the partnership interests to the charities were subject to a call provision that could be exercised at any time, (4) the call provisions were exercised almost contemporaneously with the transfers to the charities, (5) the call price was significantly below fair market value, (6) the charities never obtained a separate and independent appraisal of their interests (including whether the call price was actually the fair market value of those interests), (7) neither charity ever had any managerial control over the partnership, (8) the charities agreed to waive their arbitration rights as to the allocation of the partnership interests, and (9) petitioners’ sons were at all times in control of the transaction. I also query as to this case why a charity would ever want to receive a minority limited partnership interest, but for an understanding that this interest would be redeemed quickly for cash, and find relevant that the interest was subject to the call provision that could be exercised at any time.

*McCord*, 120 T.C. at 429–30. Like in *McCord*, in its appeal to the Ninth Circuit in *Estate of Petter v. Comm’r*, the government abandoned its *Procter* argument. 653 F.3d at 1023 n.7.

government's position.<sup>176</sup> In *Procter*, a trust provided that a gift would revert to the donor if it were later determined that this gift would be subject to gift tax. The court held that the trust provision was void as contrary to public policy because it (1) discourages the government's tax collection by making futile the audit of returns; (2) renders the court's decision moot by negating the gift the court has examined; and (3) disturbs a final judgment.<sup>177</sup>

The taxpayer in *Procter* asserted that the Tax Court's decision in his favor should be affirmed because, under the terms of the trust, the gift was not to become effective if it were found to be subject to a gift tax. The circuit court, however, rejected the taxpayer's contention, and held that inserting such a clause in the trust could not prevent the imposition of the gift tax. The court explained that the reason that the court said the clause would likely discourage the government's tax collection was because "the only effect of an attempt to enforce the tax would be to defeat the gift"<sup>178</sup> and that it did not accept that the gift tax could be eluded by that means. The court further explained that if a court decided a donor had made a taxable gift, "the court making such decision must hold it not a gift and therefore not subject to tax" and that that incongruous result would create the "sort of trifling with the judicial process [that] cannot be sustained."<sup>179</sup> The courts have read *Procter* narrowly; they reject the application of *Procter*, stating that *Procter* requires that a clause constitute a "condition subsequent"<sup>180</sup> and that it must "undo the gift."<sup>181</sup> However, *Procter* should

---

<sup>176</sup> See, e.g., *Estate of Christiansen*, 130 T.C. 1, 17 (2008) ("This case is not *Procter*."), *aff'd*, 586 F.3d 1061 (8th Cir. 2009); *Hendrix*, 101 T.C.M. (CCH) at 1647, 2011 T.C.M. (RIA) ¶ 2011-133 ("The present case is distinguishable from *Procter* and its progeny. Here, unlike there, the formula clauses impose no condition subsequent that would defeat the transfer."); *Estate of Petter*, 98 T.C.M. (CCH) at 542, 2009 T.C.M. (RIA) ¶ 2009-280, *aff'd*, 653 F.3d 1012 (9th Cir. 2011) ("The Christiansen formula was sufficiently different from the *Procter* formula that we held it did not raise the same policy problems. A shorthand for this distinction is that savings clauses are void, but formula clauses are fine."); *Wandry*, 103 T.C.M. (CCH) 1472, 2012 T.C.M. (RIA) ¶ 2012-88 (There is no charitable donation for amounts in excess of the fixed value amount in the defined value clause at issue in *Wandry*. That fact "does not result in a 'severe and immediate' public policy concern." *Id.* at 1478-79.).

<sup>177</sup> *Procter*, 142 F.2d at 827.

<sup>178</sup> *Id.*

<sup>179</sup> *Id.*

<sup>180</sup> See, e.g., *Estate of Petter*, 98 T.C.M. (CCH) at 540-41, 2009 T.C.M. (RIA) ¶ 2009-280 ("The Fourth Circuit's opinion rested on two propositions that now frequently appear in gift and estate tax

be read more broadly to include other, similar forms of “trifling with the judicial process.”

In *Procter*, the taxpayer purported to have made a gift of a certain value. When audited, the taxpayer tried to nullify the gift because it was found to be taxable. The taxpayer tried to do that through the application of a trust provision. At trial, because the court agreed with the government that the transfer was a taxable one, the court then had to decide whether to void the provision on public policy grounds. In the defined value clause cases in the FLP context, the taxpayer claimed to make a gift of a certain value. When audited, the taxpayer attempted to change the donee for the part of that claimed gift through the application of a defined value provision. The gift tax is imposed on the donor’s transfer of control of the property. What constitutes a completed transfer is defined in the regulations.<sup>182</sup> If the taxpayer retains the ability to change the identity of the donee, he has made an incomplete gift.<sup>183</sup> At trial, because the court agreed with the government that the transfer would have been a taxable one as purported by the taxpayer on his gift tax return and because the provision allowed an alteration of donee to nullify part of a purported taxable gift, the court then had to decide whether to void the provision on public policy grounds. This situation differs from typical cases where the taxpayer had undervalued his gift. The usual result when a court has found that the taxpayer has made a taxable gift or one with a higher value is one where the taxpayer has increased his gift tax liability. If a deduction or additional exemption applied to exempt the gift, it would have applied initially, as the taxpayer described the gift in his return. The effect of the defined value clause in the FLP context is a type of retained control, which could nullify part of the claimed transfer. This issue requires the application of *Procter*.

---

cases involving adjustment clauses. The first is that the gift was a ‘present gift of a future interest in property’ and that the formula therefore created a condition subsequent.”).

<sup>181</sup> See, e.g., *Wandry*, 103 T.C.M. (CCH) at 1478, 2012 T.C.M. (RIA) ¶ 2012-88; *Estate of Christiansen*, 130 T.C. at 17 (distinguishing *Procter*: “The contested phrase would not undo a transfer, but only reallocate the value of the property transferred among Hamilton, the Trust, and the Foundation. . . . That would not make us opine on a moot issue, and wouldn’t in any way upset the finality of our decision in this case.”).

<sup>182</sup> See Treas. Reg. § 25.2511-2 (as amended in 1999).

<sup>183</sup> See Treas. Reg. § 25.2511-2(c) (as amended in 1999).

A policy reason the government has advanced in these cases is that the defined value clauses provide an impetus for undervaluing property interests.<sup>184</sup> While *Tellier*,<sup>185</sup> in the income tax context, holds that deductions should not be denied unless there is a clear public policy against allowing the particular deduction, valuation distortion in the area of transfer taxation is an abuse equivalent to undermining the tax itself. The taxpayer creates valuation complexities and then undervalues his gifts by using a defined value clause. The government has two choices: it can either ignore the abuse, undercutting the tax, or it can challenge the taxpayer's valuation, spending the government's money litigating that value without any possibility of recovering any of the tax.<sup>186</sup> Most of the courts acknowledge that a defined value clause is a disincentive for the government to audit a return although most considered the deterrent "marginal."<sup>187</sup> However, the expectation or hope in employing a defined valuation clause in this context is that the government will stop enforcing the law. Is that not a conundrum similar to that in *Procter*?

In *Wandry*, rejecting the application of *Procter*, the Tax Court stated that, without the audit, the donees might not have received their proper LLC percentage interest, "but that does not mean that parts of petitioners' transfers were dependent upon an IRS audit."<sup>188</sup> As a practical matter, it means just that: parts of the taxpayers' gifts would go to another party instead of being retained by the donors and includible in their estates. If the defined value clause *inhibits* a government audit, the taxpayer's transfer of

---

<sup>184</sup> *Estate of Christiansen*, 586 F.3d 1061, 1064 (8th Cir. 2009) ("The Commissioner argues that a policy supporting audits as a means to enforce accurate reporting requirements mandates that we disallow fixed-dollar-amount partial disclaimers because of the potential moral hazard or untoward incentive they create for executors and administrators to undervalue estates."), *aff'g* 130 T.C. 1 (2008).

<sup>185</sup> *Comm'r v. Tellier*, 383 U.S. 687 (1966).

<sup>186</sup> As Judge Laro indicated, like in *Procter*, "the possibility of an increased charitable deduction serves to discourage respondent from collecting tax on the transaction because any attempt to enforce the tax due on the transaction is of no advantage to the fisc." *McCord*, 120 T.C. at 429 (Laro, J., dissenting).

<sup>187</sup> *Estate of Christiansen*, 130 T.C. at 17. *See also Estate of Christiansen*, 586 F.3d at 1064 ("[W]e agree with the Commissioner that the Tax Court's ruling in this case may marginally detract from the incentive to audit estate returns. It is possible that in some hypothetical case involving a fixed-dollar-amount partial disclaimer, a post-challenge correction to an estate's value could result in a charitable deduction equal to the increase in the estate, resulting in no increased estate tax.").

<sup>188</sup> *Wandry*, 103 T.C.M. (CCH) at 1478, 2012 T.C.M. (RIA) ¶ 2012-88.

value to family members is dependent on the government *not* auditing those returns. Thus, by allowing the transferor to retain the ability to choose the identity of the donee in order to avoid a taxable transfer through a defined value clause, at least part of the transfer is dependent on a government audit.

The Eighth Circuit in *Christiansen* stated: “[W]e disagree with the Commissioner’s argument that we must interpret the statute and regulations in an effort to maximize the incentive to audit. . . . Rather, the Commissioner’s role is to enforce the tax laws.”<sup>189</sup> However, it is not the court’s role either to maximize *or minimize* the government’s incentive to audit taxpayers’ returns. Because defined value clauses in the context of FLPs promote tax evasion, the courts should find that there is a strong public policy reason to invalidate them.

While the second and third *Procter* policy rationales of mootng a court’s decision and disturbing a court’s judgment are not literally applicable to the use of a defined value clause in the context of the transfer of an FLP interest, they are indeed essentially violated.

Furthermore, a condition that causes a part of a gift to lapse if it is determined for Federal gift tax purposes that the value of the gift exceeds a given amount, so as to avoid a gift tax deficiency, involves the same sort of “trifling with the judicial process” condemned in *Procter*. If valid, such condition would compel us to issue, in effect, a declaratory judgment as to the [property’s] value, while rendering the case moot as a consequence. Yet, there is no assurance that the [donors] will actually reclaim a portion of the [property] previously conveyed to [the donees], and our decision on the question of valuation in a gift tax suit is not binding upon [the donees], who are not parties to this action.<sup>190</sup>

In *Ward*, the court accepted that the gift might not be legally negated or undone. However, the court considered the upshot fundamentally identical to *Procter*. If a court finds an excess value over the defined value, the court has been obliged to “issue, in effect, a declaratory judgment as to the [property’s] value, while rendering the case moot as a consequence.”<sup>191</sup>

---

<sup>189</sup> *Estate of Christiansen*, 586 F.3d at 1064.

<sup>190</sup> *Ward v. Comm’r*, 87 T.C. 78, 114 (1986), *cited in* *Succession of McCord v. Comm’r*, 120 T.C. 358, 429 (Laro, J., dissenting), *rev’d*, 461 F.3d 614 (5th Cir. 2006).

<sup>191</sup> In *Estate of Petter*, the Tax Court draw a distinction “between a donor who gives away a fixed set of rights with uncertain value—that’s *Christiansen*—and a donor who tries to take property back—that’s *Procter*.” 98 T.C.M. at 542, 2009 T.C.M. (RIA) ¶ 2009-280. *Ward*, however, minimizes that

Besides *Procter* the government and the courts have not applied *Robinette* in their discussion of public policy; however, the holding in *Robinette* underscores the government's position. Before the taxpayer in *Robinette* married, she, her mother, and her stepfather sought an estate planning attorney's advice. All three created trusts with successive life estates, with the remainder to pass to their daughter's issue at age twenty-one and with alternative dispositions if at the last surviving life tenant there were no issue.<sup>192</sup> The taxpayer contended that in computing the value of the remainder for gift tax purposes, she should be allowed to subtract the value of her reversionary interest. However, the government maintained that a reduction in the value of the remainder interest was inappropriate because the value of the reversionary interest could not be ascertained through the actuarial tables.

The Supreme Court agreed with the government because the grantor's reversionary interest was not only dependent on survivorship, but also on her death without issue attaining twenty-one years. There is no actuarial method to determine the value of her interest. "But before one who gives this property away by this method is entitled to deduction from his gift tax on the basis that he had retained some of these complex strands it is necessary that he at least establish the possibility of approximating what value he holds."<sup>193</sup>

A taxpayer who holds liquid assets, like cash and marketable securities, and who could have transferred her stock outright, but realized that doing so would have enabled the IRS to tax its full value, and thereafter transfers those assets to an FLP or family LLC and creates a "hard-to-value" asset in order to obtain a reduction in gift or estate tax liabilities, should not be able to use the federal fisc to have the government value family entity membership units. Under *Robinette*, when a donor creates an unmarketable FLP interest from marketable assets, she should not be entitled to use a defined value clause on the rationale that the property is difficult to value. Thus, the use of a defined value clause in the FLP context

---

difference. Moreover, the price-adjustment clause that was upheld in *King v. United States*, 545 F.2d 700, 705 (10th Cir. 1976) involved a sale in the ordinary course of a trade or business and one lacking donative intent—in sharp contrast to a defined value clause in a gift of FLP interests to family members.

<sup>192</sup> *Robinette v. Helvering*, 318 U.S. 184, 185–86 (1943).

<sup>193</sup> *Id.* at 188.

differs in another way from pecuniary formula marital deduction clauses: the valuation complexities as in *Robinette* were taxpayer made; the unknown variables, like the exemption amount at a decedent's death, depend on Congress' actions—not the taxpayer's.<sup>194</sup>

Finally, regarding those FLP defined value cases that incorporate a charity as a potential donee, as briefly mentioned already,<sup>195</sup> while there may be a clear congressional policy is to encourage charitable gifts,<sup>196</sup> any excess over amounts that pass to a charity do not have the charitable intent required under *American Bar Endowment*. If the value of the FLP interests is equal to or less than the fixed amount under the defined value clause, the taxpayers will make no charitable transfer. It is only where the taxpayers have undervalued their taxable gifts to family members that *any* charitable donation results. The taxpayers' primary objective is to avoid an audit and evade gift taxes for their actually larger non-charitable transfers. Only secondarily, if "caught," do the taxpayers intend a charitable gift. With any donation or charitable gift value purely speculative at the time the FLP interests are transferred to family members, and with the taxpayer's main purpose to avoid an audit and transfer more property untaxed to her family, there is either no or an indeterminate amount of a purposeful "charitable gift" intention.<sup>197</sup>

### B. Other Safeguards

Rejecting *Procter*, courts have maintained that there are plenty of safeguards: "countless other mechanisms [are] in place to ensure that fiduciaries such as executors and administrators accurately report estate values."<sup>198</sup> *Estate of Christiansen* pointed to state and federal law sanctions

---

<sup>194</sup> The use of pecuniary formula marital deduction clauses have been restricted by legislation and government rulings. *See supra* Part I.

<sup>195</sup> *See supra* Part II.

<sup>196</sup> *Estate of Christiansen v. Comm'r*, 586 F.3d 1061, 1065 (8th Cir. 2009), *aff'g* 130 T.C. 1 (2008).

<sup>197</sup> *See* *Succession of McCord v. Comm'r*, 120 T.C. 358, 429 (Laro, J., dissenting) (The charity "receives no benefit from the Court-determined increase in the value of the subject property, but petitioners benefit in that they are entitled to an additional charitable deduction."), *rev'd*, 461 F.3d 614 (5th Cir. 2006).

<sup>198</sup> *Estate of Christiansen*, 586 F.3d at 1065.

and criminal penalties for fiduciaries that breach their fiduciary duties.<sup>199</sup> In *Estate of Petter*, the managers of the LLC were in the position of fiduciaries. The foundation directors had fiduciary responsibilities, including “a duty to bring a lawsuit if they later found that the appraisal was wrong.”<sup>200</sup> The IRS has powers to penalize fiduciaries that misappropriate the assets of a charity and can threaten a charity with removing its tax-exempt status. As the Tax Court stated in *Estate of Christiansen*, the IRS has used these weapons against the *Bishop Estate* defendants.<sup>201</sup> Charities have an interest “in ensuring that the executor or administrator does not under-report the estate’s value. Such beneficiaries, therefore, have an interest in serving a watchdog function.”<sup>202</sup> Likewise, FLP members have competing interests that should protect accurate valuation.<sup>203</sup>

Is it just chance that each of the fiduciaries in *McCord*, *Estate of Petter*, and *Wandry*<sup>204</sup> had understated the value of the transferred interest and none had overstated that value? Defined value clauses in the context of valuing an FLP interest breed valuation distortion and abuse. That lopsided sampling is not fortuitous. Moreover, the reality is that no beneficiary (taxable or exempt) of a defined value clause will sue a fiduciary for understating the value of his interest, charities are not likely “to look a gift horse in the mouth,”<sup>205</sup> and the government will not, and probably cannot, afford to bring out the big guns as it did in the mammoth and decades long fiasco in *Bishop Estate*.<sup>206</sup> Those court statements fall flat as they sound like

---

<sup>199</sup> *Id.* “[T]here are sufficient mechanisms in place to promote and police the accurate reporting of estate values beyond just the threat of audit by the Commissioner, thereby undercutting the Commissioner’s policy-based argument.” *Id.* at 1065–66. In *Estate of Christiansen*, the Tax Court also cited to various state law statutes imposing fiduciary duties applicable to executors, estate administrators, and foundation directors. 130 T.C. at 17.

<sup>200</sup> *Estate of Petter*, 98 T.C.M. (CCH) at 543, 2009 T.C.M. (RIA) ¶ 2009-280.

<sup>201</sup> *Estate of Christiansen*, 130 T.C. at 17-18; *Estate of Petter*, 98 T.C.M. (CCH) at 543, 2009 T.C.M. (RIA) ¶ 2009-280 (“The Commissioner himself could revoke the foundations’ 501(c)(3) exemptions if he found they were acting in cahoots with a tax-dodging donor.”).

<sup>202</sup> *Estate of Christiansen*, 586 F.3d at 1065.

<sup>203</sup> *Wandry*, 103 T.C.M. (CCH) at 1478, 2012 T.C.M. (RIA) ¶ 2012-88.

<sup>204</sup> See *Hendrix v. Comm’r*, 101 T.C.M. (CCH) 1642, 2011 T.C.M. (RIA) ¶ 2011-122, a case almost identical to *McCord*.

<sup>205</sup> See *McCord*, 120 T.C. at 373 n.9.

<sup>206</sup> See KING & ROSS, *supra* note 111.

hollow justifications or passing the buck when the courts should be acknowledging that their suggested remedies are inadequate.

#### V. WHY ALL DEFINED VALUE CLAUSES ARE NOT THE SAME

The taxpayer in *Estate of Petter* argued that the government specifically sanctions formula clauses, thus, “there can’t be a general public policy against using formula provisions.”<sup>207</sup> Specifically, she cited clauses in a charitable remainder annuity trust (CRAT),<sup>208</sup> a grantor retained annuity trust (GRAT),<sup>209</sup> in Rev. Proc. 64-19,<sup>210</sup> a GST tax exemption formula,<sup>211</sup> and a fractional formula in the gift-tax qualified-disclaimer regulations<sup>212</sup> to underline the government’s support for formula clauses.<sup>213</sup> But each example she gave is remarkably different from a defined value clause used to value an FLP interest.

With a CRAT, while the annuity is a fixed amount, the full remainder will actually go to a charity. With a defined value clause used to value an FLP interest that incorporates a charity as beneficiary for any excess value, there is nothing that will pass to a charity where the fixed amount is equal to or more than the value of the property transferred to the non-charitable beneficiaries. A CRAT is a highly regulated trust,<sup>214</sup> ensuring that the

<sup>207</sup> *Estate of Petter*, 98 T.C.M. (CCH) at 543, 2009 T.C.M. (RIA) ¶ 2009-280.

<sup>208</sup> See I.R.C. § 664.

<sup>209</sup> See I.R.C. § 2702(b)(1); Treas. Reg. § 25.2702-3(b), (d) (2005).

<sup>210</sup> See *supra* Part I.B.

<sup>211</sup> Treas. Reg. § 26.2632-1(d)(1) (2005).

<sup>212</sup> Treas. Reg. § 25.2518-3(d), Example (20) (1994).

<sup>213</sup> *Estate of Petter*, 98 T.C.M. (CCH) at 543, 2009 T.C.M. (RIA) ¶ 2009-280.

<sup>214</sup> A CRAT is a trust in which not less than 5% and not more than 50% of the initial contribution value of the trust must be paid annually, for no more than a twenty year fixed term or for life, to at least one individual who is not a charity. I.R.C. § 664(d)(1)(A); see generally H.R. REP. NO. 91-413, pt. 2, at 38-39 (1969) (discussing generally the legislative history of charitable remainder trusts). A CRAT is prohibited from paying any other amounts to anyone other than to a qualified charity. I.R.C. § 664(d)(1)(B). A CRAT may not receive additional contributions from anyone. Treas. Reg. § 1.664-2(b) (as amended in 2011). The CRAT’s governing instrument must provide that no additional contributions may be made to the charitable remainder annuity trust after the initial contribution. For purposes of this section, all property passing to a charitable remainder annuity trust by reason of death of the grantor shall be considered one contribution. *Id.* There are income tax ordering rules for determining the character of CRAT distributions made to the non-charitable beneficiaries that begin as the least tax favored. See I.R.C. § 664(b)(1)-(4). At the end of the annuity term, the remainder, valued at

annuity will in fact be paid to the annuitant, which will increase, to the extent not consumed, the non-charitable beneficiary's gross estate.<sup>215</sup> A GRAT is similar to a CRAT.<sup>216</sup> While both techniques may be criticized,<sup>217</sup> they do not share the outrageous abuse of a defined value clause in the context of valuing an FLP interest.

The *Petter* court cited the 1964 revenue procedure as authorizing the employment of formula clauses in marital deduction bequests, which was clearly *not* the objective of that administrative ruling. The purpose of the 1964 revenue procedure was in fact just the opposite. The ruling was issued in order to stem the abuses of pecuniary formula marital deduction clauses.<sup>218</sup> The disclaimer clause formula and the GST tax exemption formula are part of regulations that ensure no valuation abuse; the disclaimer

---

a minimum of 10% of the value of the initial contribution to the trust must pass to a qualified charity. I.R.C. § 664(d)(1)(C), (D). However, the remainder may also be retained by the trust in certain forms and for certain purposes. I.R.C. § 664(g). While the income interest of either a CRUT or a CRAT may be subject to a qualified contingency, the value of that interest will be computed without reference to that contingency. I.R.C. § 664(f)(1) and (2); *see also* I.R.C. § 664(f)(3).

<sup>215</sup> When the CRAT was proposed, Treasury preferred the annuity form because the trustee would no longer have an incentive to manipulate trust investments or misallocate deductions or receipts. *See Treasury Department, Studies and Proposals, as reprinted in Tax Mgmt. Primary Sources Ser. I (BNA) at § 170.34 (1970).*

<sup>216</sup> A GRAT is valued according to the rules in § 7520 of the Code. *See* I.R.C. § 2702(a)(2)(B). Chapter 14 valuation rules, which include those for GRATs refer to, have a similar history and purpose with, and were meant to be consistent with, the rules allowing a deduction for split interest gifts to charities. *See* I.R.C. § 170(f)(2)(A) (denying an income tax deduction for remainders given to charity “unless the trust is a charitable remainder annuity trust or a charitable remainder unitrust (described in § 664) or a pooled income fund (described in § 642(c)(5)).”). A CRAT has been criticized as providing an immediate charitable deduction for a transfer that the charity can only enjoy some time in the future and avoiding capital gains on sales of trust assets so that the untaxed proceeds from those sales can produce more income. *See* Ron Shoemaker & David Jones, *K. Charitable Remainder Trusts: The Income Deferral Abuse and Other Issues*, in CPE FOR FY 1997, <http://www.irs.gov/Charities-&-Non-Profits/CPE-for-FY-1997>, 140, <http://www.irs.gov/pub/irs-tege/eotopick.pdf>; Wendy C. Gerzog, *The Times They Are Not A-Changin’: Reforming the Charitable Split Interest Rules (Again)*, 85 CHI.-KENT L. REV. 849, 873–76 (2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1484615](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1484615).

<sup>217</sup> *See* STAFF OF JOINT COMM. ON TAXATION, 111TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT’S FISCAL YEAR 2010 BUDGET PROPOSAL—PART ONE: INDIVIDUAL INCOME TAX AND ESTATE AND GIFT TAX PROVISIONS 149 (Comm. Print 2009), but that restriction was not incorporated in the 2010 Act. Subsequent to *Estate of Walton v. Comm’r*, 115 T.C. 589, *acq.*, 2003-44 C.B. 964, practitioners use short term (2 year) GRATs, minimizing the risk of the grantor’s death during the term and avoided estate tax inclusion under I.R.C. § 2036(a)(1). The Obama Administration proposed enacting a minimum ten-year term for GRATs to even the risk of loss between the government and the taxpayer. *Id.*

<sup>218</sup> *See supra* Part I.B.

formula is subject to the regulation requiring that the disclaimant must disclaim a proportional “slice of the pie”<sup>219</sup> and the GST tax exemption formula is only part of the calculations required so as not to abuse the exemption amount.<sup>220</sup>

The *Petter* court chastised the government for not citing to any statute or regulation that prohibits formula clauses in making either taxable gifts or tax-deductible charitable donations. Further, the court criticized the government for not explaining how these other formula clauses, “*which would tend to discourage audit and affect litigation outcomes the same way as Anne’s formula clause*, bely the Commissioner’s assertion that there is some well-established public policy against the formula transfer Anne used.”<sup>221</sup> However, the other formula clauses do not discourage a government audit and they do not distort value because they are further regulated—unlike the defined value clauses in an FLP context.

While the court admitted that the government explained that the other clauses entailed circumstances “where money passing under those formulas will not escape taxation,” the court stated that it was not necessarily true that money sheltered by the marital deduction will be taxed in the surviving spouse’s estate.<sup>222</sup> Although the deferral rules do not guarantee later taxation, they are pretty good protection for unspent deferred amounts.<sup>223</sup> The court compared a CRAT with a defined value clause gift of an FLP interest with any excess passing to a charity and considered them alike. That conclusion is wrong. CRATs are subject to a multitude of statutory and regulatory restrictions;<sup>224</sup> defined value clauses in this context are not.

Essentially, defined value clauses are not equivalent. Defined value clauses like those in *McCord*, *Estate of Christiansen*, *Estate of Petter*, and

---

<sup>219</sup> *Estate of Christiansen v. Comm’r*, 130 T.C. 1, 19 (2008) (citing *Walshire v. United States*, 288 F.3d 342, 347 (8th Cir. 2002)) (analyzing the requirement in Reg. § 25.2518-3(b) (as amended in 1994)), *aff’d*, 586 F.3d 1061 (8th Cir. 2009).

<sup>220</sup> I.R.C. §§ 2631, 2632, 2641, 2642 (and regulations thereunder).

<sup>221</sup> *Estate of Petter*, 98 T.C.M. (CCH) at 544, 2009 T.C.M. (RIA) ¶ 2009-280 (emphasis added).

<sup>222</sup> *Id.*

<sup>223</sup> *See, e.g.*, I.R.C. §§ 5219, 2044 (requiring the inclusion of the full value of a QTIP trust in the surviving spouse’s estate or taxing the surviving spouse’s earlier transfer of her income interest as a gift of the full value of the trust).

<sup>224</sup> *See supra* note 214.

*Wandry*<sup>225</sup> have received court approval despite their promotion of valuation distortions and abuse of the tax system. In the context of valuing FLP interests, that is, in the context of a taxpayer taking marketable interests and voluntarily making those assets non-marketable in order to receive valuation discounts, defined value clauses encourage undervaluation of taxable transfers, discourage audits, overvalue transfers to charity, and are accorded specious charitable deductions.

## VI. REMEDIES

Estate planners are quick to associate defined value clauses in the FLP context with the popular and accepted pecuniary formula marital deduction clauses, but those latter clauses have been restricted both by legislation and administrative rulings. The same is true with the formula clauses cited in *Estate of Petter* and outlined in Part V of this article.

Courts should be mindful that both *Procter* and *Robinette* apply to this issue. The donor or decedent creates valuation complexity when she converts marketable assets into unmarketable interests by establishing an FLP and contributing her marketable property to that FLP. She should not be able then to complain that it is too difficult to value an FLP interest and that she needs a simple defined value clause to value her transferred interests. *Robinette* would be reluctant to give effect to a defined value clause under these circumstances and would leave the taxpayer with the consequence of having created a too difficult to value interest. With that in mind, a taxpayer should not be able to use a defined valuation clause to discourage audits, waste the government's and court's funds and time by effectively shifting the primary burden of its FLP interest valuation to the IRS, and create valuation distortions. *Procter* should apply to require a court to hold that defined value clauses in the FLP context are void as against public policy.

Treasury should propose regulations that require defined value clauses in the context of family limited partnerships to be expressed as entity units and not as fixed dollar amounts. Taking a lesson from § 2056(b)(10), which reversed the holdings in *Northeast Pennsylvania National Bank* and *Estate*

---

<sup>225</sup> See *Hendrix v. Comm'r*, 101 T.C.M. (CCH) 1642, 2011 T.C.M. (RIA) ¶ 2011-122, a case almost identical to *McCord*.

of *Alexander*, a fixed dollar amount may indeed result in valuation distortions. Likewise, the funding valuation manipulations created by the use of pecuniary formula marital deduction clauses that were curbed by Rev. Proc. 64-19 should inform the government that defined value clauses in the FLP context need to be limited by an administrative ruling or Treasury regulation.

Clearly, since the underlying problem began with the courts<sup>226</sup> allowing FLP and related entities unwarranted discounts, Congress should not recognize for transfer tax purpose those family entities that do not primarily engage in an active business. FLP assets should be valued at their net asset value without non-marketability or minority discounts. The valuation of gifts would thereby be easy and there would be no reason to use a defined value clause.

## VII. CONCLUSION

Estate planners like to analogize defined value clauses used to value nonmarketable FLP interests to the pecuniary formula clauses routinely used to denote the values of the marital deduction trust or the credit shelter trust (that is, the amount exempt from transfer taxation). That ostensible correspondence has lulled the planner and the courts into believing that the two types of provisions are equivalents. The view that the two types of provisions are synonymous has led courts to reason that there are no significant valuation distortions or public policy reasons to invalidate defined value clauses in an FLP context. That assumed equivalence, however, ignores the history of valuation distortion and corrective measures that the government employed to make pecuniary formula marital deduction provisions acceptable to both the taxpayer and the government.

---

<sup>226</sup> See *Estate of Bongard v. Comm'r*, 124 T.C. 95 (2005). See also James R. Repetti, *Minority Discounts: The Alchemy in Estate and Gift Taxation*, 50 TAX L. REV. 415 (1995); Mary L. Fellows & William H. Painter, *Valuing Close Corporations for Federal Wealth Taxes: A Statutory Solution to the Disappearing Wealth Syndrome*, 30 STAN. L. REV. 895 (1978); Karen C. Burke & Grayson M.P. McCouch, *Family Limited Partnerships: Discounts, Options, and Disappearing Value*, 6 FLA. TAX REV. 649 (2004); Walter D. Schwidetzky, *Family Limited Partnerships: The Beat Goes On*, 60 TAX LAW. 277 (2007); Wendy C. Gerzog, *Valuation Discounting Techniques: Terms Gone Awry*, 61 TAX LAW. 775 (2008), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1286216](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1286216); Brant J. Hellwig, *On Discounted Partnership Interests and Adequate Consideration*, 28 VA. TAX REV. 531 (2009); Wendy C. Gerzog, *Bongard's Nontax Motive Test: Not Open and Schutt*, 107 TAX NOTES 1711 (2005), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=890202](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=890202).

Defined value clauses in the FLP context create their own valuation distortions and public policy issues. Like the pecuniary formula marital deduction clauses in the past, defined value clauses need regulation.