Tax Court Ruling Highlights Importance Of Formula Clauses

By **Carsten Hoffmann, John Ashbrook and Eric Bardwell** (August 3, 2020, 4:57 PM EDT)

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The U.S. Tax Court's decision issued on June 10 in the case of James C. Nelson and Mary P. Nelson v. Commissioner of the Internal Revenue at first glance appears a victory for the IRS.[1]

After all, the court ruled that the fixed dollar amounts of certain gifts and the sale of interests in Longspar Partners — $2.1 million and $20 million, respectively — by the petitioners in December 2008 and January 2009 were, in fact, transfers of specific interests. Accordingly, the size of the gifts and sale, in terms of percentage interests in the partnership, could not be adjusted to ensure the values did not exceed the petitioners' originally intended dollar amounts.

Thus, the decision appears contrary to those in Wandry,[2] McCord[3] and Petter,[4] in which a formula transfer clause was successfully used to fix the value and thereby adjust the percentage interest size of the transfer to avoid gift tax in the case of a valuation adjustment. On second glance, however, this case also seems to have some good news for the taxpayer.

Background

The case involves the value of Longspar, a family limited partnership formed in 2008 with its primary asset a 27% interest in the common stock of Warren Equipment Co. Warren Equipment operated as a holding company with its largest subsidiary a Caterpillar dealership in Texas and its other major subsidiary, Compressor Systems Inc., or CSI, a producer of fuel pumps for the oil industry.

The common stock in Warren Equipment was subject to a shareholders' agreement that restricted transfers of stock to family members only. James and Mary Nelson together owned a 1% general partner interest — 0.5% each — in Longspar, and Mary Nelson owned a 93.88% limited partner interest.

Longspar's general partners had full control of all partnership activities, and transfers of limited partner interests were restricted and subject to the consent of the general partners.

In December 2008, the petitioners formed a trust for the benefit of their four daughters and James Nelson. Subsequently, Mary Nelson made gifts to the trust of limited partner interests in Longspar with a stated value totaling $2.1 million — $1.05 million attributable to each of the petitioners. The terms of the transfer memo stated the desire to make a gift and to assign the right title and interest in a limited partner interest having a fair market value of $2.1 million as determined by a qualified appraiser within 90 days of assignment.

Similarly, in January 2009, Mary Nelson sold a limited partner interest in Longspar with a value of $20 million to the trust in exchange for a promissory note with a 2.06% interest rate. The memorandum of sale again stated Mary Nelson's desire to sell and assign her right title and interest in a limited partner interest having a fair market value of $20 million as determined by a qualified appraiser within 180 days of the assignment.

The petitioners calculated limited partner transfers of 6.14% and 58.65% — 64.79% in total — respectively, in connection with the aforementioned transfers based on valuations of Warren Equipment and Longspar by professional appraisers as of Dec. 31, 2008.[5]

The 2008 gifts and 2009 sale were selected by the respondent for examination and entered IRS appeals in 2012. At the IRS appeals level, the IRS and the petitioners negotiated a settlement, which was never finalized, based on an adjusted percentage interest transferred of 38.55%.

Subsequently, the IRS sent the petitioners notices of deficiency claiming that the gifts were worth $3.5 million and that the $20 million sale was undervalued by $13.6 million. Thus, according to the IRS, the combined value of the gifts and sale was not $22.1 million, but $37.1 million despite the language of the transfer documents that, per the petitioners, was intended to fix a dollar amount on the gifts and sale.

Accordingly, the petitioners were assessed gift tax deficiencies of $6.7 million and $1.3 million in accuracy-related penalties.

Key Issues in the Case

Ultimately, the IRS conceded on the penalties, leaving the court to decide: 1) whether the aforementioned gifts and sale were fixed dollar amounts or, alternatively, percentage interests; and 2) the fair market value of WEC and the interests in Longspar.

In the estate planning world, it has become common for planners to use formula clauses in transfer documents with the intent of fixing dollar amounts on gifts and to provide a mechanism to reallocate ownership interests in a company or partnership should the values be successfully challenged by the IRS. Such formula clauses mitigate the risk of incurring a gift tax many years after the gifts have been made.

However, such adjustment clauses are not without controversy and court decisions have gone both ways. Wandry, decided in March 2012, is one of the better known and more recent cases in which a judge upheld the use of a formula clause.

Formula Clause Decision

The petitioners argued that the aforementioned transfers were of fixed dollar amounts as stated in the transfer memos, similar to clauses in the cases of Wandry, McCord and Petter.

In deciding the case, the court first looked to the precise terms of the transfer documents, which called for the transfers of limited partner interests with fair market values of $2.1 million and $20 million, respectively, as determined by a qualified appraiser within 90 days, with respect to the gifts, and 180 days, with respect to the sale, of the effective dates of assignment.

Clearly, the transfer memos reference fixed dollar amounts. However, those documents also called for the determination of the limited partner interest based on appraisals within a

certain period of time, which is exactly how the Longspar limited partner interests were valued and, thus, how ownership interests in Longspar were allocated after the gifts/sale.

Importantly, the transfer documents did not provide that the transfer of limited partner interests be based off their value as finally determined for federal gift tax purposes nor did they provide for an adjustment to the ownership allocation should the IRS or the tax courts later adjust the fair market value of Longspar.

As in Wandry, the petitioners argued their intent to transfer fixed dollar amounts. In Wandry, however the transfer documents were far clearer with regard to the intent of not only a fixed dollar amount as finally determined for federal gift tax purposes but also a reallocation of interests should the valuation be successfully challenged. In Wandry, the exact language in the transfer document reads, in part:

I hereby assign and transfer as gifts ... a sufficient number of my units as a member of [LLC] ... so that the fair market value of such units for federal gift tax purposes shall be ... $1,099,000[.] If, after the number of gifted units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted units shall be adjusted accordingly so that the value of the number of units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law.

Ultimately, the court in Nelson found that the transfers were of interests — as opposed to fixed dollar amounts — as such interests were, in fact, determined based on a qualified appraisal as stated in the transfer memos. According to the court, to find otherwise would be asking the court to ignore the terms of the transfer documents regarding fair market value as determined by a qualified appraiser and instead to assume that the interest was determined based on fair market value as finally determined for gift and estate tax purposes.

In the words of Judge Cary Douglas Pugh, "While the taxpayer may have intended this, they did not write this." Although formula clauses similar to those in Wandry are popular tools that may mitigate damage caused by a subsequent valuation adjustment, the precise language of the formula in transfer documents should be well vetted against prior case facts and precedent to minimize risk in an IRS challenge and, eventually, risk of gift tax.

Specifically, the formula clause should provide for a transfer equal to a value as finally determined for federal gift tax purposes as well as include a readjustment clause that provides for a modification of the amount of property transferred in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination.

It is also useful to specify that in the case of an undervaluation of the transferred property, the parties agree that the transferee will promptly return the excess property to the transferor.

The court's rejection of petitioner's position that the transfer was of a fixed dollar amount and subsequent finding that it was instead of a fixed limited partner interest the value of which was determined by a qualified appraisal to be completed shortly after the transfer was proper. After all, when drafting formula clauses, the devil is in the details.

Fair Market Value Decision

With regard to the final determination of the fair market values of the gifts and sale, the court arrived at its own conclusion of value based on valuations performed by both the petitioners' and the respondent's valuation experts.

The petitioners had two valuation experts, one who valued the 27% interest in Warren Equipment and another who valued the minority transfers in Longspar on a nonmarketable, minority interest basis. The respondent had one valuation expert.

The respondent's expert took issue with the application of a 20% discount for lack of control for the 27% Warren Equipment interest, noting that the methods that the petitioners' expert applied had already resulted in a noncontrolling value conclusion.

The court disagreed with the respondent's expert, ultimately finding that "most" of the petitioners' expert's valuation analysis of Warren Equipment produced values with some elements of control and thus necessitated a discount for lack of control given that the subject interest had no prerogatives of control at all.

Judge Pugh reduced the petitioners' 20% lack of control discount to 15% and retained the original discount of 30% for lack of marketability.

With regard to the value of Longspar, both the petitioners' and the respondent's experts valued the partnership based on an adjusted net asset method. Given that the value determined for Warren Equipment accounted for 99% of the value of Longspar, the first expert's valuation of Warren Equipment, adjusted to reduce the discount for lack of control from 20% to 15%, was the starting point for both experts, leaving open only the determination of the appropriate discounts for lack of control and lack of marketability applicable to the minority transfers.

Despite the fact that the determination of the discounts for a minority interest in Longspar is relegated to the final 10 pages of the Tax Court memo, it represents an intriguing facet of this case.

Not since Astelford[6] in 2008 have we had a head-to-head discussion and presentation of data for the application of the appropriate tiered discounts. Judge Pugh decided upon a lack-of-control discount of 5%. With regard to the tiered discount for lack of marketability at the Longspar level, the court determined a discount of 28%, approximately the average of the two experts' conclusions of 30% and 25%.

We find it interesting that there is no discussion at all by either side of the applicability of a tiered discount as a starting point. It seems that the concept of tiered discounts being accepted in a situation in which a minority investor is not only removed from control of the subject entity but also removed from control of the subject entity's holdings — in this instance, Longspar and Warren Equipment — is now beyond question.

The Importance of Precise Language

Ultimately, the court determined the values of the 6.14% interest gifts and the 58.65% interest sale in Longspar at $2.5 million and $24.1 million, respectively, far less than the $3.5 million and $33.6 million in the notice of deficiency and the $3.1 million and $29.8 million provided by the respondent's expert. Yes, the values of the gifts and sale were ultimately adjusted upward at trial but to nowhere near the level of value the IRS sought.

A key takeaway is the importance of precise language in the transfer documents in any gift or sale transaction. The intent of the donors is only as strong as the specific language in the formula clause.

In order to avoid ending up in the situation faced by petitioners, a formula clause should both reference a transferred interest with a value as finally determined for federal gift tax purposes as well as contain a readjustment provision that applies in the event of a later adjustment in valuation. Regardless of the formula language, in the end, the strength of the valuation is vital in estate and gift tax.

Correction: A previous version of this article did not list Bardwell as an author. The error has been corrected.

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[1] James C. Nelson & Mary P. Nelson v. Commissioner of the Internal Revenue, T.C. Memo 2020-81. The cases were consolidated on July 14, 2014.

[2] Dean Wandry v. Commissioner of Internal Revenue, T.C. Memo. 2012-88.

[3] Succession of McCord v. Commissioner of Internal Revenue, 461 F.3d 614 (5th Cir. 2006).

[4] Estate of Petter v. Commissioner of Internal Revenue, T.C. Memo. 2009-280.

[5] Although 58.65% is a majority interest in Longspar, a limited partner's rights and privileges associated with such interest provide for no elements of control over Longspar or marketability of such interest. Thus, such interest is viewed as minority from a rights and privileges perspective.

[6] Jane Z. Astleford v. Commissioner of Internal Revenue, T.C. Memo. 2008-128.