FCG VALUATION CASE E-FLASH

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Issue 14:1

Joanne M. Wandry, Donor, Petitioner V. Commissioner Of Internal Revenue, Respondent, Albert D. Wandry, A.K.A. A. Dean Wandry, Donor, Petitioner V. Commissioner Of Internal Revenue, Respondent
T.C. Memo. 2012-88, Docket Nos. 10751-09, 10808-09, Judge: Hon. Harry Allen Haines, Filing date March 26, 2012

In an important gift tax case involving transfers among family members, the Tax Court determined that transfers of closely-held business interests were specific dollar amount transfers rather than transfers of fixed percentage interests. Further, the court ruled that the Petitioners intent was not contrary to public policy and their transfer documents were not void for federal tax purposes.

TAKEAWAY
The Wandry ruling has the potential to be a landmark case that provides taxpayers and planners with exceptional guidance on the use of formula gifts between family members. The ruling also carefully identifies the differences between "defined value" and "savings" clauses.

THE FACTS
In August 2001, Albert D. Wandry ("Mr. Wandry"), Joanne M. Wandry ("Ms. Wandry", collectively with her husband, the "Wandrys" or the "Taxpayers") and their children formed an LLC with assets of cash and marketable securities. The cash and securities had previously been held in a limited partnership.

In both entities, the Wandrys' tax attorney advised them of the following:
(1) make fixed dollar amount gifts rather than fixed percentage interests,
(2) the number of units equal to the dollar amount transferred could not be known on the date of transfer until a valuation could be performed, and
(3) so a mid-year closing of the entities' books was not required, December 31 and January 1 valuation dates were advisable.

On January 1, 2004, the Wandrys executed nine separate assignments and memorandums of gifts, four to their adult children for units totaling $261,000 each, and five to grandchildren for units totaling $11,000 each. The gift documents were drafted by the Wandrys' tax attorney and included the following clause:

> Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service ("IRS"). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if, after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law.

The Taxpayers believed the gifts were for specified dollar values, not percentage interests. Their tax attorney advised them that should a revaluation occur, no units would be returned to the Wandrys. However, the entity's capital accounts would be adjusted to reallocate each member's units to conform to the gifts.

The Taxpayers engaged an outside appraiser to value the January 1 gifts, which were valued at $109,000 per 1.0% interest. The Wandrys' CPA filed their Form 709 gift tax returns, which described the gifts as 2.39% interests and 0.101% interests in the LLC. The percentage interests were derived from the dollar values of the gifts and the value determined by the appraiser.

Using the description of the gifts on Form 709, the IRS asserted the Taxpayers intended to transfer specific percentage interests of the LLC, the value of the percentage interests transferred exceeded the Wandrys' gift tax exclusions, and the adjustment clause in the gift assignments were contrary to public policy (and therefore void for federal tax purposes).

DISCUSSION

As in *Knight v. Commissioner*, 115 T.C. 506 (2000), the IRS argued the gift descriptions attached to the gift tax returns are binding admissions that the Taxpayers transferred interests of the LLC to the donees. The court dismissed this argument because the tax returns in *Knight* did not report dollar values of the gifts. Further, the court found that the Wandrys' gift documents were consistent with the gift tax returns, all of which consistently reported dollar amounts. The CPA "merely derived the gift descriptions from the [Wandrys'] net dollar value transfers and the [appraiser's] report. Therefore, [the Taxpayers] consistent intent and actions prove that dollar amounts of gifts were intended."

Another argument advanced by the IRS was that the capital accounts of the LLC control the nature of the gifts. Further, the IRS contended the LLC's capital accounts reflect gifts of fixed percentage interests. Citing the case of *Thomas v. Thomas*, 197 P.243 (Colo. 1921), which is a Colorado case (state law controls the nature of the legal interest in property for federal tax purposes), the IRS asserted that the court must examine the capital accounts to determine the property rights divested by the donors and those acquired by the donees.

The court found the IRS' reliance on *Thomas* misplaced, noting:

> The facts and circumstance determine [the LLC's] capital accounts, not the other way around. Book entries standing alone will not suffice to prove the existence of facts recorded when other more persuasive evidence points to the contrary.

The court also faulted the IRS for its failure to produce credible evidence that the LLC's capital accounts were adjusted to reflect the gift descriptions.

Next, relying on *Commissioner v. Procter*, 142 F.2d , 824, 827-828 (4th Cir. 1944), the IRS asserted formula clauses were void as a matter of public policy in relation to federal tax purposes. However, the court cited *Estate of Petter v. Commissioner*, T.C. Memo 2009-280, aff'd, 653 F.3d 1012 (9th Cir. 2011) which examined *Procter* and other relevant cases to determine what the donors *intent* was. Savings clauses were determined to be against public policy and void because they create a donor that tries to take property back after the gift if the gift exceeds the tax limit. Formula clauses, however, were permissible because they merely transferred a "fixed set of rights with uncertain value". *Id.*

As with *Petter*, the court concluded the Taxpayers clear intent (as shown in the gift documents) was to transfer a fixed dollar amount of LLC interests, not a fixed percentage, even though the value of the LLC interest was unknown as of the date of transfer. Accordingly, public policy did not void the Wandrys' formula clause.

CONCLUSION
Thanks to effective record-keeping and a clear history of consistent and competent estate planning advice, the Taxpayers' use of a formula clauses was valid and enforceable.
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