

FCG VALUATION CASE E-FLASH

**Authored by John Walker and Chris D. Treharne, ASA, MCBA, BVAL
of Gibraltar Business Appraisals, Inc. a member firm of FCG
Issue 13:8**

John H. Hendrix and Carolyn M. Hendrix, Donors, Petitioners, v. Commissioner of Internal Revenue, Respondent
Docket No. 10503-03, T.C. Memo 2011-133, Judge: Hon. Elizabeth Crewson Paris, June 15, 2011

Following its ruling and logic in *Tempel v. Commissioner*, 136 T.C. No. 15 (2011) [refer to E-Flash 13:4], the Tax Court determined that state income tax credits are capital assets and the sale of such credits should not be taxed as ordinary income. Further the Tax Court again determined that the holding period for such credits begins upon receipt of the credit (i.e., after the donation of the conservation easement, not upon the acquisition of the real property underlying the conservation easement).

TAKEAWAY

The Tax Court determined that formula clauses reached at arm's-length can be used to determine fair market value. Further, the Court decided that formula clauses are not void as a matter of public policy.

THE FACTS

John H. Hendrix and Carolyn M. Hendrix ("Petitioners" or the "Hendrixes") and their adult daughters were the shareholders of JHHC ("JHHC" or the "Company"), a Texas corporation. JHHC's capital structure consisted of nonvoting and voting common stock, and it was an S corporation.

Seeking estate planning advice in 1999, their attorney advised them to transfer JHHC stock to their daughters (through trusts) and to a donor-advised fund at a nonprofit community foundation. A donor-advised fund permits donors (in this case, the Petitioners) to control the ultimate recipient of the donation.

The foundation's vice president and legal counsel negotiated the terms of the assignment agreement with the Hendrixes. Included in the drafts of the agreement was a stipulation that a formula clause would set the number of JHHC shares transferred to the daughters' trusts and the foundation.

Also during 1999, the Petitioners engaged a business appraiser ("Appraiser") to value the company's nonvoting stock. Relying on the appraised value, the Petitioners decided to donate \$50,000 of JHHC nonvoting stock to the foundation, more than \$10.5 million of Company nonvoting stock to a generation skipping tax ("GST") trust, and more than \$4.2 million of JHHC nonvoting stock to an issue trust for the benefit of their daughters.

On December 31, 1999, each Petitioner, trustees of the trusts, and the foundation executed an assignment agreement irrevocably assigning 287,619.64 shares of Company stock to the GST and the foundation. The assignment agreement established a formula by which JHHC stock having approximately \$10.5 million of value would be transferred to the GST, and any remaining portion was assigned to the foundation for the benefit of the Petitioners' donor-advised fund. As part of the transaction, the trusts also agreed to pay each Petitioner approximately \$9 million.

Additional assignment agreements were executed on the same day. In them, each Petitioner irrevocably transferred 115,622.21 shares of JHHC nonvoting stock to the issue trusts and the foundation as tenants in common. The value of the shares transferred to Petitioners' daughters was fixed at slightly more than \$4.2 million. The agreement also directed the trusts to deliver a note of approximately \$3.6 million to each Petitioner. Any share value in excess of \$4.2 million was to be transferred to the foundation.

For both sets of assignment agreements, the transferees were responsible for the allocation of shares on a per-share basis, and the Petitioners were relieved of such responsibility. The Hendrixes' attorney, acting as a representative for the trusts, retained the Appraiser to determine the December 31, 1999, value of the transferred interests. Fulfilling its fiduciary obligation, the foundation contracted an independent appraisal firm to review the Appraiser's December 31, 1999, value, and the second appraiser pronounced the value reasonable and fair. Accordingly, the December 31, 1999, value was used by the foundation and trusts to establish the fair market value of the JHHC nonvoting stock in their confirmation agreements. The Petitioners were not party to the confirmation agreements.

DISCUSSION

Petitioners assert that the formula clauses used in this instance are valid because 1) they were used to fix the transferred amount of JHHC's stock and 2) the parties to the clauses negotiated at arm's length. Respondent disagreed, asserting the clauses were not reached at arm's length and are contrary to public policy. Interestingly, the Petitioners successfully shifted the burden of proof for this case under [§ 7491\(a\); Rule 142\(a\)\(2\)](#). Respondent did not dispute Petitioners' claim with respect to the formula clauses, but did so under another element of the claim, which the court determined was moot.

On another point, Petitioners argued that the case was factually similar to [Succession of McCord v. Commissioner](#), 461 F.3d 614 (5th Cir. 2006), revg. 120 T.C. 358 (2003), and the court agreed. Even so, the Tax Court determined that the Fifth Circuit did not rule on the specific arguments made by the Respondent: "(1) The formula clauses are not the result of an arm's-length transaction or (2) the formula clauses are void as contrary to public policy."

Regarding Respondent's assertion that the formula clauses did not represent an arm's-length transaction, the Tax Court disagreed, saying:

The mere fact that the petitioners and their daughters were "close" and that petitioners' estate plan was beneficial to the daughters does not necessarily mean that the formula clauses failed to be reached at arm's length. Nor is a finding of negotiation or adverse interests an essential element of an arm's length transaction [citations omitted], although we find nothing in the record to persuade us either that the formula clauses were not subject to negotiation or that petitioners and the daughters' trusts lacked adverse interests. We also note economic and business risk assumed by the daughters' trusts as buyers of the stock (i.e., the daughters' trusts could receive less stock for their payment if the JHHC stock was overvalued) placed them at odds with petitioners and the Foundation.

Additionally, the court found no evidence of collusion, as asserted by the Respondent. Such evidence would have undermined the transaction.

As to the Respondent's public policy argument, the Tax Court again disagreed, saying the formula clause in the present case supports the public policy of encouraging gifts to charity. As a result, the court determined that the Hendrixes' formula clauses were not contrary to public policy.

CONCLUSION

The Tax Court determined that formula clauses may be evidence of a transaction negotiated at arm's-length and are not void as a matter of public policy. Furthermore, the ruling reinforces the use of properly determined formula clauses in gift and estate planning.

PERKINS VALUATION GROUP:

Perkins' dedicated business valuation practice group can help both companies and individuals with their valuation needs. Our team can perform an objective analysis to determine the fair market value of your business and advise you on the next steps. Our team has performed valuations for closely-held companies, trust and partnership interests, restricted securities and other intangibles for the purposes of estate and gift planning, ESOP and Phantom Stock issues, merger and acquisition studies, divorce, buy-sell agreements and business succession planning. In addition, we can offer expert witness and litigation support.

ABOUT FINANCIAL CONSULTING GROUP:

Perkins & Co has chosen to join [Financial Consultants Group](#) (FCG), one of the largest valuation organizations in the country. This membership helps us stay current on valuation best practices and industry issues and give us a forum of other professionals for discussions, consultations, and second opinions. It also provides us with additional training opportunities and resources, including access to the nation's top experts in valuation and litigation support.

