Gift and Estate Tax Valuation Insights

"Reallocating" Wealth After *Christiansen*: A Fresh Look at Formula Clauses

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There seems to be a trend in the courts toward recognizing defined value clauses for gift and estate tax valuation purposes. This judicial trend allows taxpayers to make transfers with a limit on the amount of the taxable transfer. This discussion summarizes the two recent judicial decisions, McCord *and* Christiansen*. And, this discussion offers practical estate planning suggestions for crafting the defined value clause.*

Introduction

The transfer of hard-to-value assets is risky business.[1] At a minimum, a taxpayer should employ the services of a experienced valuation analyst. But with the increased willingness of the Internal Revenue Service (the "Service") to take extreme and, at times, unsupported positions at audit,[2] a taxpayer, even with the benefit of a sound valuation, may find herself in a time-consuming and expensive battle of the experts, which, if lost, could result in the payment of a very large transfer tax bill.

Yet, from an estate planning perspective, hard-to-value assets (e.g., family businesses) are often among the most attractive taxpayer assets to pass downstream. Accordingly, estate planners have sought methods by which to provide taxpayers entering into such transactions with a certain level of tax cost certainty and, in the event of a Service challenge, an extra arrow or two in their collective quiver of strategies.

One such method is the use of a formula clause. Generally, a formula clause is a provision designed to mitigate the risk of revaluation by:

1. altering either the property transferred or consideration paid based on the fair market value of such property as finally determined for federal transfer tax purposes (a "formula adjustment clause") or
2. allocating the property transferred between two or more transferees, one of which is an individual or entity to which the transferor may pass property without incurring transfer tax (a "defined value clause").

Given the uncertainty regarding the future of the transfer tax laws as a whole, and certain techniques such as zeroed-out grantor retained annuity trusts (GRATs)—in particular, a taxpayer may also employ a formula clause as protection against retroactive changes in the law.

Outside of certain specifically sanctioned devices, however, the Service typically frowns on the use of formula clauses. The Service typically argues that such clauses violate public policy. Accordingly, estate planners are generally wary about employing such unsanctioned clauses on a regular basis.

A pair of recent judicial decisions, however, may change the way estate planners view and use formula clauses, especially defined value clauses. In 2006, the Fifth Circuit decided *McCord* v. *Commissioner*,[3] in which it appeared to recognize a defined value clause. Two years later, the Tax Court, in *Christiansen v. Commissioner*,[4] upheld a defined value clause under a formula disclaimer and, in so doing, explicitly found that such clause did not violate public policy.

Taken together, the *McCord* decision and the *Christiansen* decision (which is currently on appeal before the Eighth Circuit), signal a departure from the judiciary's longstanding reluctance to enforce formula clauses in the pure transfer tax context. This judicial precedent may allow taxpayers to transfer hard-to-value assets with a new level of tax cost certainty.

Sanctioned Uses

While currently a hot topic for the Service, estate planners have used formula clauses for decades, albeit with mixed success. In fact, the Service and the tax laws permit the use of formula clauses in a variety of lifetime and testamentary transfer situations.

The Service, for example, has permitted the use of valuation definition clauses in allocating the residue of an estate between the marital and unified credit portions.[5]

Likewise, the Treasury Regulations (the "Regulations") under Chapter 13 of the Internal Revenue Code (the "Code") specifically sanction the use of a formula in allocating GST exemption—in both the lifetime and testamentary context—to produce an inclusion ratio of zero.[6] In addition, the Regulations expressly permit the use of formula disclaimers.[7]

The Regulations also sanction the use of formula clauses in determining the value of an annuity interest in multiple contexts. For instance, the charitable remainder annuity trust ("CRAT") rules specifically sanction the use of a formula to express the annuity amount as either a fraction or a percentage of the initial value of the property contributed to the trust as finally determined for federal tax purposes.[8]

Similarly, the Regulations under Section 2702 allow a "qualified annuity interest" to be defined as either a fraction or a percentage of the initial value of the property transferred to the trust as finally determined for federal tax purposes.[9]

Even if the annuity amount is incorrectly determined, the trust will still qualify as either a CRAT or a GRAT, as the case may be. This conclusion is true so long as the trust agreement provides for a corrective payment in an amount equal to the difference between the "amount which the trust should have paid the recipient if the correct value were used and the amount which the trust actually paid the recipient."[10]

In other words, the Regulations allow a taxpayer to use a formula to transfer assets to a GRAT or CRAT. In addition, the Regulations specifically allow for a subsequent equalization payment or adjustment, if the value as finally determined for transfer tax purposes is different than the appraised value.

All of these sanctioned uses of a formula clause rely—explicitly, for the most part—on the concept of value "as finally determined for transfer tax purposes." The use of such a phrase allows the fiduciary to reallocate, in the event of an incorrect valuation, the property passing under such a clause in a manner that will preserve the intended structure of the transaction without adverse transfer tax consequences.

Nonetheless, the Services does not take kindly to taxpayers employing the same language for essentially the same purposes outside these sanctioned bounds. The Service generally argues that such techniques are allowed because they are necessary to enable taxpayers to take full advantage of certain deductions and credits.

As such, such allowances do not reflect an intent to authorize the use of similar techniques outside these explicitly permitted contexts.[11]

Formula Adjustment Clauses

The Service has had better luck attacking formula adjustment clauses, as opposed to defined value clauses, especially in the pure transfer tax context. The type of formula adjustment clause employed in the pure transfer tax context generally requires that, if the value of the transferred property as finally determined for transfer tax purposes exceeds a specified amount, then the portion of the property transferred in excess of such amount is returned to the transferor. Such a clause effectively attempts to undo any portion of a transfer subject to gift tax.

The Service typically attacks such clauses, arguing that the condition subsequent—the potential payback of such excess—frustrates public policy. In a 1944 decision, *Commissioner v. Procter*,[12] the Fourth Circuit considered the Service argument.

In the *Procter* decision, the taxpayer transferred his remainder interests in certain trusts, which he believed to be worthless, to another trust established for the benefit of his children, with the proviso that if any part of the transferred interest was subject to gift tax, then such taxable portion would be excluded from the transfer and returned to the taxpayer.

The Appeals Court sided with the Service, concluding that the condition subsequent violated public policy. The Appeals Court reasoned that the provision would:

1. discourage the collection of tax and
2. upset "judicial process" by effectively rendering any finding of a "hypothetical gift" moot and, in turn, any final judgment meaningless.

In the decades following the *Procter* decision, the Service has relied on the decision to ignore formula adjustment clauses used by taxpayers to mitigate transfer tax exposure.[13]

Formula adjustment clauses, however, may still be useful to practitioners and taxpayers alike when property is transferred for consideration. In *King v. Commissioner*,[14] the taxpayer sold stock for its estimated fair market value to certain trusts. The trusts were established for the benefit of the taxpayer's children.

The sales agreement contained a clause providing that, if the Service determined that the fair market value of the stock was greater or less than the purchase price, then the purchase price would be adjusted in accordance with the Service's determination.

Such a sales agreement clause was designed to prevent the Service from (1) reclassifying the transaction as part sale, part gift by (2) linking the purchase price with the transfer tax value.

In considering the matter, the Tenth Circuit held the clause should be respected, noting that the adjustment clause, unlike the clause in *Procter*, did not undo the transfer or undermine the "nature" of the transaction and was made in the context of an arm's-length transaction.[15]

Defined Value Clauses

A defined value clause generally operates to allocate a transferred asset between two or more transferees, at least one of which is generally an individual or entity to which the taxpayer may transfer property transfer-tax-free.

In recent years, the courts have examined two types of defined value clauses:

1. one type in which the value of the transferred property was determined under an independent agreement between the donees
2. one type in which the value of such property was linked to its value as finally determined for federal transfer tax purposes

The *McCord* Decision

In *McCord v. Commissioner*,[16] the taxpayers transferred an 82 percent interest in a family limited partnership (the "Transferred Interest") to their children, trusts for the benefit of their children, a symphony (the "Symphony") and a community foundation (the "Community Foundation") under an agreement (the "Assignment Agreement") containing a defined value clause.

The Assignment Agreement directed that the children and the trusts were to receive a portion of the Transferred Interest having an aggregate fair market value of $6,910,000, with any portion of the Transferred Interest in excess of such amount (but no more than $134,000) flowing to the Symphony and the remainder to the Community Foundation.

The Assignment Agreement instructed that all values were to be determined in accordance with the transfer tax valuation rules but did not explicitly state "as finally determined for transfer tax purposes."

A few months after the transfer, the donees, each represented by independent counsel, entered into an agreement (the "Confirmation Agreement") under which the donees, based on a professional valuation obtained by the taxpayer's children and approved of by the other donees, agreed to (1) the total value of the Transferred Interest and, in turn, (2) the percentage of such interest to which each donee was entitled under the formula contained in the Assignment Agreement.

Under the Confirmation Agreement, the Community Foundation received a 3.62 percent limited partnership interest, which, several months later, it redeemed for $338,967, the value specified in the Assignment Agreement.

The taxpayers relied on the values determined by the donees in reporting the transaction and claimed a charitable deduction for the amounts passing to the Symphony and the Community Foundation.

The Service attacked the transaction, arguing that the value of the Transferred Interest was underreported, an assertion with which the Tax Court agreed. In response, the taxpayers, relying on the defined value clause, argued that they should receive an offsetting charitable deduction.

This was because, under the terms of the Assignment Agreement, any such excess—that is, any amount above $7,044,000—passed to the Community Foundation. This was true even though the foundation actually received a lesser amount pursuant to the Confirmation Agreement and in the subject redemption.

The Service countered that the Tax Court should disregard such clause, in part, on public policy grounds.

The Tax Court rejected the taxpayer argument. However, the Tax Court declined to address the issue of whether the defined value clause ran afoul of public policy.

Instead, the Tax Court, while paying lip service to the well established principle that the value of a gift is determined on the date of the gift, concluded that the interest transferred to each donee was fixed under the terms of the Confirmation Agreement.

Engaging in some judicial gymnastics, the Tax Court explained that, because the Assignment Agreement allocated the Transferred Interest to the donees on the basis of fair market value, as opposed to the value as finally determined for gift tax purposes, the Assignment Agreement permitted the donees to determine independently the value of the Transferred Interest and, based on such determination, allocate such interest amongst themselves pursuant to the formula contained in such agreement.

Since the Confirmation Agreement fixed the rights of the donees under state law, the Tax Court concluded that the taxpayers, despite not having been a party to such agreement, were also bound by such agreement for gift tax purposes, but only to the extent of the allocation of the Transferred Interest, not the value of such interest.

Applying this method, the Tax Court held that the taxpayers were entitled to a charitable deduction in an amount equal to the value, as finally determined by the Tax Court, of the portion of the Transferred Interest allocated to the charities under the Confirmation Agreement.

In a somewhat venomous opinion, the Fifth Circuit reversed and remanded the case to the Tax Court for entry of judgment in favor of the taxpayers, including the assessment of all costs to the Service.[17]

The Appeals Court concluded that the "core flaw in the Majority's inventive methodology was its violation of the long-prohibited practice of relying on post-gift events."[18]

Accordingly, the Fifth Circuit held that the Tax Court erred in relying on the Confirmation Agreement, which was executed several months after the transfer, to determine the gift tax value of the Transferred Interest.

After finding that the Tax Court did not commit legal error in rejecting the Service's valuation, the Fifth Circuit concluded that the taxpayer's valuation was correct "by process of elimination."[19]

Like the Tax Court, the Fifth Circuit declined to address the Service's public policy argument, determining that the Service had waived such argument by neglecting to raise it on appeal.

Nonetheless, the Appeals Court noted that any successful valuation challenge would "have no practical effect on the amount of gift taxes owed here."[20]

It is easy to read this admission as an indication that the court implicitly approved of the defined value clause used by the taxpayers in the *McCord* decision.

However, it should be noted that the taxpayer valuation was upheld, if only be default. And, therefore, the Appeals Court did not need to confront the issue of what to do with any revaluation overflow.

The *Christiansen* Decision

In *Christiansen v. Commissioner*,[21] the Tax Court explicitly upheld a defined value clause (implemented by fractional disclaimer) against a *Procter*-style attack by the Service that the clause violated public policy.

Under the terms of her estate plan, the decedent's entire estate, which primarily consisted of interests in two family limited partnerships (the "FLP Interests"), passed to her daughter ("Daughter"), with the proviso that (1) any disclaimed property would flow three-fourths to a charitable lead annuity trust (the "CLAT") and (2) the remainder would flow to a foundation (the "Foundation").

Daughter executed a timely fractional interest disclaimer, under which she relinquished her share of the estate in excess of $6,350,000, based on values as "finally determined for federal estate tax purposes."

On audit, the Service challenged both:

1. the valuation of the FLP Interests and
2. the validity of the disclaimer.

The parties reached a pre-trial settlement on the valuation issue, under which the value of the gross estate increased from $6,510,000 to $9,600,000.

Such increase in value had the effect of increasing the value of the property flowing to the CLAT and the Foundation under the disclaimer. The estate, in turn, claimed an offsetting charitable deduction attributable to the increased amounts flowing to such charities.

The Service disallowed the deduction for the disclaimed amount passing to the Foundation. Echoing *Procter*, the Service argued that no charitable deduction should be allowed because:

1. the increased amount was impermissibly contingent and
2. the defined value clause ran contrary to public policy.[22]

The Service reasoned that the increased amount was impermissibly contingent because it was subject to a condition subsequent—that is, a successful valuation challenge.

The Service further reasoned that the defined value clause ran contrary to public policy because it discouraged Service audits.

The Tax Court rejected the Service's condition subsequent argument. After noting that a disclaimer "relates back" to the time of the decedent's death, the Tax Court concluded that:

> The transfer of the property to the Foundation in this case is not contingent on any event that occurred after Christiansen's death (other than the execution of the disclaimer)—it remains 25 percent of the total estate in excess of $6,350,000. That the estate and the IRS bickered about the value of the property being transferred doesn't mean the transfer itself was contingent in the sense of being dependent for its occurrence on a future event. *Resolution of a dispute about the fair market value of assets on the day Christiansen died depends only on a settlement or final adjudication of a dispute about the past, not the happening of some event in the future.* Our Court is routinely called upon to decide the fair market value of property donated to charity—for gift, income or estate tax purposes.[23]

The Tax Court also concluded that the defined value clause did not violate the public policy. The Tax Court noticed that it would be "hard pressed to find any fundamental public policy against making gifts to charity."[24] And, the Tax Court distinguished the defined value clause in the *Christiansen* decision from the formula adjustment clause in the *Procter* decision.

The Tax Court concluded that, in contrast to a formula adjustment clause, the taxpayers' defined value approach under the formula disclaimer "would not undo a transfer, but only reallocate the value of the property transferred . . . [so] if the fair market value of the estate assets [are] increased, then property must actually be reallocated...."[25]

Accordingly, the Tax Court further concluded that, because of such reallocation, they would not be opining on a moot issue or upsetting the finality of their decision in the case.

The Tax Court went on to note that, while defined value clauses may have an effect on the Service's incentive to audit, the fiduciary duties of trustees, executors and directors of charitable organizations provide other safeguards against valuation abuse in addition to Service audits.

Contrasting the *McCord* and the *Christiansen* Decisions

While both are cases under which taxpayers have successfully employed defined value clauses, *McCord* and *Christiansen* have significant differences. For instance, the manner in which such clauses are affected by a successful valuation challenge broadly differ.

McCord, which is a gift tax case, uses a defined value clause under which the dollar value transferred is not explicitly linked to the dollar value as finally determined for federal transfer tax purposes.

This means that, in the event the donees enter into a subsequent agreement, like the Confirmation Agreement, allocating the transferred property pursuant to such defined value clause, a successful valuation challenge will not affect the donees respective interests because such interests are fixed, for state law purposes, under such subsequent agreement.

By contrast, *Christiansen*, which is an estate tax case, employs a defined value clause in which the dollar valued transferred is based on values as finally determined for federal transfer tax purposes, effectively linking the value of the property transferred for gift tax and state law purposes in the transfer agreement itself.

This means that a change in the gift tax value of the transferred property will affect the actual allocation of such property between the transferee for state law purposes.

Christiansen on Appeal

Estate planners should follow the *Christiansen* appeal with great interest. In its published decision, the Tax Court made short work of the Service's public policy argument. However, the issue begs a broader analysis.

It is not disingenuous to say that most taxpayers who employ defined value clauses do so because they seek a higher degree of tax cost certainty then that offered by a qualified appraisal. This is the same certainty that a taxpayer seeks when utilizing a marital deduction formula or defining the annuity from a GRAT in terms of a percentage of the value of the property contributed to the trust.

It is difficult to see why these sanctioned formulas are perfectly acceptable but a defined value clause is abusive. Granted, the Service does not raise tax revenues on a successful audit if a taxpayer uses a defined value clause.

Nonetheless, the Service faces this same result if such taxpayer were to have used a marital deduction or GRAT formula.

Moreover, the Service has a Congressionally imposed substantiation function. The Service's public policy argument ignores this obligation. Is the Service now only in the audit business for the vigorish?

In any event, estate planners should hope that the Eighth Circuit engages in a more thorough analysis of the public policy argument.

Estate Planning Considerations

The Formula Adjustment Clause vs. The Defined Value Clause

The courts, in the pure transfer tax context, have consistently rejected formula clauses that have the effect of undoing the transfer.[26] Accordingly, a taxpayer should favor the use of a defined value clause, which may reallocate property, over a formula adjustment clause, which may return properly transferred property to the transferor.

The Feasibility of Noncharitable "Residue" Transferees

In analyzing the Service's public policy argument, the *Christiansen* court stressed the countervailing public interest in charitable contributions and the policing role of the fiduciaries overseeing such charitable organizations as an additional mechanism against undervaluation.

Accordingly, the courts may be less inclined to uphold defined value clauses where a charity is not a transferee, or even where the charity, as in *McCord*, does not stand to benefit from a successful Service challenge.

That said, if a taxpayer is not charitably inclined and willing to assume some risk, a defined value clause may be structured using one or more noncharitable "residue" transferees—that is, a transferee entitled to any excess over the set dollar sum gift(s). One such structure would be the use of a marital trust to catch any revaluation excess.

For example, let's suppose a taxpayer ("Taxpayer") transfers an interest in a family limited partnership to a trust. Under the terms of the trust, the transferred partnership interest having a value equal to a set dollar amount is further transferred to a trust for the benefit of Taxpayer's children (the "Children's Trust"), and any property in excess of such amount is transferred to a trust for the benefit of Taxpayer's spouse qualifying for the marital deduction (the "Marital Trust").

In each case, the allocation is based on values as finally determined for federal gift tax purposes.

Under these facts, if the Service mounts a successful valuation challenge, any increase in value over the appraised value would pass to the Marital Trust, and, assuming the defined value clause was upheld, the Taxpayer would owe no additional gift tax.[27] In addition, the value of the property held in the Marital Trust will be included in the spouse's gross estate.

Since the Service will eventually collect tax on such amounts, the Service should have a difficult timing showing that such a structure violates public policy.

Furthermore, this situation is very similar to testamentary transfers using a standard martial formula clause, a basic estate planning tool that has never been considered to violate public policy.

Other options exist if Taxpayer is unwilling or unable to transfer property to a marital trust. For instance, the defined value clause could allocate any revaluation excess to a trust over which Taxpayer retained a special power of appointment.

Under this structure, the portion of the transfer attributable to such excess would be an incomplete gift and, therefore, not subject to girt tax at the time of the transfer.[28]

Another interesting solution is to construct a defined value clause that allocates any revaluation excess to a GRAT. Like a Marital Trust, a GRAT is a statutorily sanctioned device that essentially allows a taxpayer to transfer property and choose how much gift tax, if any, she desires to pay on such transfer.[29]

Because the annuity interest may be defined in terms of a percentage or fraction of the initial value of the assets contributed to the trust, a GRAT is an excellent vehicle to which to contribute hard-to-value assets.

Given the Service's public policy arguments against defined value clauses, as well as the Service's general wariness concerning zeroed-out GRATs, however, cautious planners should consider structuring a GRAT that is a residue transferee under a defined value clause so that the remainder interest is worth more than a trivial amount.[30]

Care should also be given to selecting the remainder beneficiaries, especially if the taxpayer's plan, as in *Christiansen*, incorporates a disclaimer. Because a transferee should be able to enforce such donee's property rights from the time of the gift, the planner should consider allocating a portion of the appraised value of the transferred property to the GRAT. This will ensure the trust is a respected entity for state law purposes from the outset and, thus, capable of enforcing its property rights at any time.

Some estate planners suggest that the Service's public policy argument may be thwarted by structuring the transaction so that a part of the revaluation overflow is subject to transfer tax. A formula clause may accomplish this by directing that a modest portion of any such excess flows to a taxable transferee.

For instance, if the clause used by Taxpayer directed that 1 percent of any excess overflow went to the Children's Trust and the Service successfully demonstrated that the transferred interest was undervalued by $1,000,000, then $10,000 of such excess would be subject to gift tax. It is unclear, however, what amount of a transfer, if any, would have to be subject to transfer tax in order to satisfy the Service.

In *Technical Advice Memorandum 200245053*, the Service rejected a similar tactic, determining that subjecting 0.1 percent of the transferred property to tax merely "placed an insignificant portion of the transaction at issue in order to circumvent well-established case law."[31]

The *McCord* Clause vs. the *Christiansen* Clause

The clause in *Christiansen*, while more difficult to administer than a *McCord*-type clause, may offer greater protection against a public policy attack by the Service, especially if the transfer flows to a noncharitable residue transferee.

A *Christiansen* clause is challenging to administer because the fiduciary cannot allocate the transferred property with certainty until the value of such property is finally determined for transfer tax purposes, which generally won't occur until the audit period runs on the taxpayer's transfer tax return.

That said, there are some ways to mitigate the effects of a potential reallocation. For instance, Taxpayer, in the above example, may wish to structure the Children's Trust and the overflow trust, whichever type is used, as grantor trusts (within the meaning of Subpart E of Subchapter J of Chapter 1 of the Code) for income tax purposes.

In this case, Taxpayer would report all income from the entire transferred partnership interest, regardless of allocation, on her individual income tax return. Accordingly, the parties would not have to bear the time and expense of amending their income tax returns in the event of a successful valuation challenge and the reallocation of the amounts passing to the respective recipients.

Despite its administrative challenges, a *Christiansen*-type clause seems less susceptible to the Service's public policy argument.

Under the Fifth Circuit decision in *McCord*, if the court had determined that the value of the transferred interest was more than the reported value, then, presumably, the taxpayer would have received an offsetting gift tax charitable deduction, despite the fact that the charity would have actually received, under the Confirmation Agreement, property with a value less than the amount of the deduction. This disconnect between transfer tax effect and economic effect may, with good reason, give some taxpayers pause.

Before trial, the Service issued Field Service Advice 200122011 to the taxpayers in *McCord*. That document rejected the use of the taxpayers defined value clause, emphasizing that the charity "would not receive any additional value should the Commissioner successfully determine that the value transferred was greater than that reported."[32]

Likewise, Judge Laro, dissenting from the Tax Court's opinion in *McCord*, repeatedly stressed his objection to the taxpayers' receiving a charitable deduction in excess of the value of the property passing to charity.[33]

By contrast, a formula clause like the one used in *Christiansen* allows the residue transferee to share in any increase in value as a result of a successful valuation challenge.

As previously noted, the *Christiansen* court stressed the public benefits of charitable contributions in rejecting the Service's public policy argument.

Given such emphasis, the Tax Court may have come to a different conclusion had the charitable residue transferee not benefited from the revaluation.

In fact, one could argue that, even if the residue transferee was a noncharitable individual or organization, the linkage of the transfer tax and economic effects serves to legitimize the substance of the transaction.

As a practical matter, taxpayers may have an increasingly difficult time finding a charitable organization to agree to accept a residual interest under a *McCord*-type defined value clause.

Judge Foley's dissenting opinion in *McCord* suggests that, because the Community Foundation entered into an agreement that effectively resulted in the Community Foundation transferring property to which it was entitled to the noncharitable transferees, the Community Foundation may have committed an act that could result in excise tax and, perhaps, even the loss of its status, colloquially speaking, as a charitable organization, and, in so doing, may have also jeopardized the taxpayer's charitable deduction under Section 2522.[34]

While these contentions do not seem to have much legal merit,[35] the mere specter of such adverse consequences may make charitable organizations (and, perhaps, even some taxpayers) gun shy about participating in transactions involving defined value clauses calling for a subsequent independent agreement among the donees.

Other Planning Considerations

A taxpayer should strive to be able to demonstrate that any agreement between or among two or more of the parties to a defined-value-based gift transaction, such as the Confirmation Agreement in *McCord*, was made at arm's length.[36] Accordingly, each transferee should have:

1. independent representation,
2. the opportunity to review and contest any appraisal and
3. the ability to engage an independent appraiser.

This should apply to the transfer itself, as well as to any pre or post-transfer dealings. If the agreement defines the property rights given in terms of values as finally determined for federal transfer tax purposes, the parties should consider inserting a clause in the agreement requiring the transferor to notify the transferees of any valuation challenge and the outcome of such challenge.

The *Christiansen* court stressed the importance of fiduciary duty as a policing mechanism against underreporting. Accordingly, the parties should attempt to avoid even the appearance of fiduciary conflict.

For instance, if a transfer is made to two or more trusts, a taxpayer may wish to consider naming separate trustees for each such trust, despite the fact that a single trustee's fiduciary duties would require that she act in an impartial manner.

Summary and Conclusion

Estate planners should regularly employ defined value clauses when transferring hard-to-value assets, so long as such clauses are carefully structured. A defined value clause may serve as a red flag to the Service on audit. However, the presence of such a clause should not have a negative impact on any valuation challenge and could potentially provide a taxpayer with substantial transfer tax savings.

At the very least, a taxpayer should find that a defined value clause will give him or her a certain degree of leverage in negotiations with the Service.

Notes:

1. This article is adapted from an article titled: "'Reallocating' Wealth after Christiansen: A Fresh Look at Formula Clauses" with the permission of the American College of Trust and Estate Counsel. We sincerely appreciate ACTEC granting *Insights* permission to adapt this article.
2. See e.g., *McCord v. Commissioner*, 461 F.3d 614, 625 (5th Cir. 2006) (citing, as an example, *Caracci v. Commissioner,* 456 F.3d 444 (5th Cir. 2006)).
3. *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006).
4. *Christiansen v. Commissioner*, 130 T.C. No. 1 (2008), appeal docketed, No. 08-3844 (8th Cir.).
5. Rev. Proc. 64-19, 1964-1 C.B. 682.
6. Treas. Reg. §§ 26.2632-1(b)(4) (for lifetime transfers) and 26.2632-1(d)(1) (for testamentary transfers).
7. Treas. Reg. § 25.2518-3(d), Ex. 20.
8. Treas. Reg. § 1.664-2(a)(1)(iii).
9. Treas. Reg. § 25.2702-3(b)(1)(ii)(B).
10. Treas. Reg. §§ 1.664-2(a)(1)(iii) (in the case of a CRAT) and 25.2702-3(b)(2) (in the case of a GRAT). Note that the Regulations anticipate late payment, requiring that any such repayment must be made within a reasonable time after the final determination of such value. Treas. Reg. § 1.664-2(a)(1)(iii).
11. I.R.S. Tech. Adv. Mem. 200245053 (July 31, 2002).
12. *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944).
13. See *Ward v. Commissioner*, 87 T.C. 78 (1986) (ignoring a formula adjustment clause reserving the right to revoke a gift of stock to the extent value of the stock exceeded a set amount determined by the parties because the clause violated public policy); *Harwood v. Commissioner*, 82 T.C. 239 (1984); *aff'd,* 786 F.2d 1174) (rejecting a formula adjustment clause in the gift tax context); *see also* Rev. Rul 86-41, 1986-1 C.B. 300 (stating that the Service will not approve of formula adjustment clauses).
14. *King v. Commissioner*, 545 F.2d 700 (10th Cir. 1976).
15. The Service, however, did not acquiesce in the decision. Rev. Rul. 86-41, 1986-1 C.B. 300.
16. *McCord v. Commissioner*, 120 T.C. 358 (2003).
17. *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006).
18. Ibid. a 626.
19. Ibid. at 628.
20. Ibid.
21. *Christiansen v. Commissioner* 130 T.C. No. 1 (2008).
22. Note that the Service successfully argued that no charitable deduction should be allowed for the additional property passing to the CLAT for technical reasons associated with the qualified disclaimer rules under Section 2518 and the regulations thereunder. The taxpayer did not appeal that issue, and it will not be considered by the Eighth Circuit.
23. *Christianson*, 130 T.C. at 30 (emphasis added).
24. Ibid. at 32.
25. Ibid. at 33.
26. Some estate planners employ defined value clauses to transfer a fractional portion of an asset to a single transferee rather than to allocate a transferred asset to one or more transferees. These types of formula clauses may seem to have the effect of returning property to the transferor in the event of a successful revaluation challenge. Therefore, these formula clauses may be distinguished from the formula adjustment clauses used in *Procter* and *Ward*. This is because they do not involve a condition subsequent—i.e., the "returned" property never passed to the transferee at all.
27. Section 2523.
28. Treas. Reg. Section 25.2511-2(c).
29. See Section 2702 and the regulations thereunder.
30. Estate planners will often structure a GRAT so that the remainder interest will have little to no value, relying on the literal language of the Regulations and the absence of any minimum remainder interest requirement. However, if the GRAT is used as a residue transferee under a defined value clause, estate planners may want to consider structuring the GRAT to have a somewhat higher remainder value, in light of the additional public policy arguments involved with defined value clauses.
31. I.R.S. Tech. Adv. Mem. 200245053 (July 31, 2002).
32. I.R.S. Field Service Advice 200122011 (Feb. 20, 2001).
33. See *McCord v. Commissioner*, 120 T.C. 358, 425-30 (2003) (Laro, J, dissenting).
34. See id. at 418, n. 6 (Foley, J., concurring in part and dissenting in part).
35. While the threat of excise taxation may be more realistic, the loss of any organization's exempt status and charitable classification stemming from an inaccurate appraisal incorporated into a good faith agreement seems rather extreme, at least in the absence of repeated violations. In any event, the taxpayer would have transferred property to such organization before it entered into the offending agreement and, therefore, the organization should qualify as a Section 2522 charity at the time of the transfer.
36. *McCord v. Commissioner*, 461 F.3d 614, 620 (5th Cir. 2006) (emphasizing that there was "not so much as an implicit, 'wink-wink' understanding" among the parties that one or more of the charitable donees would agree to an inaccurate valuation or accept a lesser interest).

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