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'Wandry-ing' About Defined Value Clauses?

By Lou Vlahos

Taxpayers sometimes employ so-called "defined value clauses" in connection with gifts of property that are difficult to value, such as an equity interest in a closely-held business. In the case of such a gift, the value of the business interest – the amount of the gift – is never really "established" for tax purposes unless the IRS audits the gift tax return. Defined value clauses ("DVC") are aimed at such audits.

What is it?

A DVC may be used where the donor seeks to keep the value of the gift at or below his remaining gift tax exemption amount. It provides, in the event the IRS successfully determines that the value of the shares of stock (or partnership units) gifted by the taxpayer exceeds the taxpayer's available exemption amount, that some of these shares or units would be "returned" to the taxpayer, as if they had never been transferred.

The IRS has challenged DVCs as being against public policy, on the grounds that they enable the donor-taxpayer to retroactively adjust the number of shares transferred, depending upon an IRS challenge years after the transfer.

However, a number of courts have found that DVCs are acceptable where the "excess" amount was not returned to the donor but, rather, was redirected to a charity. (Alternatively, some taxpayers have directed that the excess be used to fund a zeroed-out GRAT.)

Wandry

More recently, however, the Tax Court in *Wandry,* T.C. Memo. 2012-88, approved a DVC where the "excess" was returned to the donor, and not to a charity. In that case, the taxpayers gifted LLC interests to their issue, but instead of stating the number of LLC units being transferred, they phrased the gift in terms of "that number of units which had a value equal to the taxpayers' remaining exemption amount" (in other words, a fixed dollar amount). If the appraised value of the LLC interests was successfully challenged by the IRS as too low, then the number of units originally calculated as having been gifted (on the basis of the taxpayer's appraisal) would be adjusted downward, to reflect the greater value per unit determined by the IRS, and the donor's relative interest in the LLC (post-gift) would increase. The Tax Court ruled that what the taxpayers had gifted was LLC units having a specific dollar value — the exemption amount — and not a specific number of LLC units.


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Other consequences

The *Wandry* decision may encourage more taxpayer-donors to employ DVCs, notwithstanding that the IRS did not acquiesce in the decision. Before doing so, however, it is important that taxpayers look beyond the immediate transfer tax consequences of such an arrangement. They also need to consider various income and other gift tax consequences that may result from an adjustment triggered by a DVC.

The closely-held businesses, the transfers of which are the usual target of DVCs, are often formed as pass-throughs, such as partnerships, LLCs or S corporations. A gift transfer of an interest in such an entity carries with it certain "tax attributes." For example, every member, including the recipient of the gift, must include his allocable share of the partnership's income on his income tax return, whether or not the entity distributes such income. If the donor-member had contributed built-in gain property to the partnership, a portion of the donor's income tax liability as to such built-in gain shifts over to the donee-member as a result of the gift; on a subsequent sale of the property, a portion of the built-in gain would be taxed to the donee. In addition, if the pass-through entity makes cash distributions to its owners, the donor and the donee would each receive an amount in accordance with their respective pro rata shares (before any *Wandry*-adjustment). What if the original transfer was treated as a part-sale/part-gift because it resulted in a reallocation of partnership debt among the members?

It is unclear how the operation of a DVC interplays with these tax rules. In other words, what happens if the IRS successfully challenges the valuation of the gifted business interest? Pursuant to the DVC, a lesser number of units or shares is deemed gifted than was initially thought; the donor-taxpayer only gifted a value amount, not a percentage or number of units. The income tax consequences to the members of the entity were based on this initial figure. Now, a couple of years later, how are they to be "corrected" where the donor-taxpayer, in retrospect, may have been allocated too little of the entity's net income and may have received too little in the way of distributions.

How should these inconsistencies be planned for or addressed? For example, should the gift transfer be made in trust for the benefit of the donee-family members, with the trust structured as a grantor trust? In the case of a grantor trust, the donor-taxpayer is treated as the owner of the trust property for income tax purposes and, so, is taxed on the income and gains therefrom, regardless of whether the ultimate number of shares is adjusted.

If a grantor trust is not feasible, the donees will have reported the income or gains allocated to the equity and paid the tax thereon though, by operation of the DVC, these should have been reported by, and taxed to, the donor. Should amended returns be filed? Should the donees file protective refund claims for the "excess" income taxes paid, pending the resolution of the gift tax matter? Failing these, have the donees, themselves, made a gift to the donor by satisfying his income tax liability?

What about distributions made to the donees in respect of the equity interests that were later "returned" to the donor pursuant to the DVC? Presumably, these amounts should have been paid by the entity to the donor. Must they be returned by the donee? If so, should they be returned with interest (as in the case of a loan)? If the distributions are retained by the donee, it may be that the donor has made gifts thereof. What if the distribution itself were taxable to the donee-recipient?

What if the gifted equity interests carried voting rights, and the gift caused the donor's equity in the family business to fall below 50 percent? This is not an uncommon reason for the donor's having made the gift in the first place. Assume the donor then passes away owning, he believed, a minority interest. In valuing this interest for estate tax purposes, a lack of control discount is applied. During the course of the estate tax audit, the IRS challenges the earlier gift valuation and, consequently, part of the gifted equity ends up back in the donor's estate, causing him to hold more than 50 percent of the business. In the resulting revaluation of the donor's equity for purposes of the estate tax, a premium may be applied, rather than the discount he had intended to achieve by virtue of the gift.

The foregoing highlights some of the issues that need to be considered before embarking on a gifting program which depends upon the use of DVCs. While a DVC is a useful estate planning tool, it does not lessen the need for a solid appraisal. Moreover, as with all estate planning in the context of a closely-held business, the donor and his beneficiaries have to consider the possible ancillary consequences of their gifting decisions.

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