Defined-Value Clauses

They can be used to cap gift tax exposure. The key is to avoid similarity to judicially condemned formula clauses, and avoid running afoul of state property ownership laws

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Whenever a client wants to cap gift tax exposure, planners should consider using a defined-value clause implemented by use of an escrow trust.

A defined-value clause limits the quantity of assets gifted or sold until a final determination of value is made. Because of the Tax Court's 2003 decision in *McCord v. Commissioner*[1] and recent rulings by the Internal Revenue Service, practitioners are worried that courts might not respect these formula clauses. On the one hand, they might be lumped in with "price-adjustment clauses"—which most courts have condemned as against public policy. On the other hand, a defined-value clause used to limit gift tax exposure in gift and sale transactions may be validated, as are other value definition formulas used in similar tax contexts.

I believe that defined-value clauses are a reasonable, nonabusive method to limit gift tax liability. But proper implementation may be crucial to their judicial acceptance. Careless use creates confusion with respect to basic state law property ownership concepts. Worse, without proper implementation, a defined-value clause in operation can appear dangerously similar to price-adjustment clauses.

I suggest that an escrow trust be used to implement a defined-value clause. Such escrow trust implementation is consistent with state law

property ownership concepts and clearly differentiates such clauses from price-adjustment clauses.

ADJUSTMENT CLAUSES

First, it is important to understand the reasoning behind the courts' condemnation of price-adjustment clauses. These formula clauses were the initial attempts to cap gift tax liability in gift or sale transactions. They provided that, if it was determined that a portion of the transfer would be subject to payment of gift tax, the transaction would subsequently be adjusted either by transferring the excess that produced the gift tax back to the donor or seller, or requiring the donee to pay for the excess.

Proper implementation may be crucial to judicial acceptance of defined-value clauses.

In *Commissioner v. Procter*,[2] the U.S. Court of Appeals for the Fourth Circuit invalidated a price-adjustment clause stating, "This is clearly a condition subsequent and void because contrary to public policy."[3] The court was concerned that the adjustment might not be respected by the parties, stating: "Such holding, however, being made in a tax suit in which the donees of the property are not parties, would not be binding upon them and they might later enforce the gift notwithstanding the decision of the Tax Court."[4]

The Fourth Circuit concluded that the adjustment clause was contrary to public policy for three reasons: (1) It discourages the collection of tax by the tax agency, because the only effect of an attempt to enforce the tax would be to defeat the gift; (2) the effect of the clause would be the obstruction of the administration of justice by requiring the courts to pass on a moot case; and (3) the final judgment of a court would be rendered meaningless because of the consequence of the clause. The Fourth Circuit pointed out that it's not possible to obtain a declaratory judgment from a federal court about whether the gift in question is subject to the gift tax.

The condition-subsequent defect, which requires the after-the-fact adjustment of the transaction by a transfer of assets back to the donor or seller, or requires the donee to pay for the excess, has been at the core of additional court decisions invalidating price-adjustment clauses.[5] There is only one case that has sustained a price-adjustment clause, the Tenth Circuit's 1976 decision in *King v. United States*,[6] which involved an arm's-length sale transaction. The Internal Revenue Service has focused on this condition-subsequent characteristic in subsequent rulings that challenge the validity of price-adjustment clauses.[7]

THEORY

In contrast to price-adjustment clauses, a properly implemented defined-value clause avoids the condition-subsequent adjustment of the transaction.[8] Instead of fixing both value and quantity up front, a defined-value clause fixes only the value of the gift or sale transaction. The exact quantity of assets transferred remains uncertain until values are finally determined for federal gift tax purposes.

(1) **Final Determination of Quantity**—This finality is achieved either when the federal gift tax statute of limitations expires or when the IRS challenges the value and that challenge is resolved. The gift tax limitation period runs for three years from the filing of the gift tax return.[9] Resolution of an IRS challenge may occur through negotiation, appellate division review or litigation, which may take longer than the expiration of the limitations period.[10] When the value of the asset is finally determined, the correct quantity is transferred. If the transfer is properly implemented, there is no after-the-fact change of the transaction, either theoretically (the value transferred) or practically (the implementation of the transfer.)

(2) **Excess Beneficiaries**—The "excess beneficiary" is the beneficiary who receives any excess of assets transferred greater than the value specified in the defined-value formula. Types of excess beneficiaries for a defined-value clause include: a charity; an inter vivos qualified terminable interest property (QTIP) trust; a spouse; an incomplete gift trust; a grantor retained annuity trust (GRAT); a revocable trust; and a donor/seller.

A transfer to one of these beneficiaries will produce either an equivalent deduction or be

nontaxable. A transfer to a charity, QTIP trust, incomplete gift trust or spouse avoids the appearance of the donor retaining the interest. Such retention is to be avoided because it's arguably similar to the condemned price-adjustment clauses' transfer back to the donor as a result of the condition subsequent.

(3) **Double-Tax Problem**—Transfers to charity or an inter vivos QTIP trust avoid a potential double-tax problem, as recently described in the quarterly journal, *Practical Drafting*.[11]

Assume that the Service and the courts refuse to recognize the validity of the defined-value clause and treat the entire amount transferred as a gift to the taxable beneficiaries. While this would be the result for federal gift tax purposes, state law still might require that the defined-value clause beneficiaries be recognized. As a result, the excess beneficiaries would receive that beneficiary's appropriate share. If this excess beneficiary is a charity or a QTIP trust, the share will not again be taxed at the donor or donor's spouse's death.[12] However, if that beneficiary is an incomplete gift trust, the spouse, a zeroed-out GRAT or a revocable trust, the excess beneficiary's share would be taxed again when either future gifts are made or upon the death of the donor or donor's spouse. This is the double-tax portion for which *Practical Drafting* has suggested a solution.[13]

(4) **Add a Taxable Gift**—To create an additional argument to counter the *Procter* public policy reasoning, commentators have suggested adding a taxable gift whenever using a defined-value clause.[14] For example, a taxable gift equal to 10 percent of the excess amount.

APPROVED USES

In the transfer tax area, defined-value concepts are established and accepted. For decades, the IRS has administratively accepted defined-value formulas dividing assets between a bypass trust and the marital share or trust so as to avoid any out of pocket estate tax liability.[15] Similarly, the regulations allow zero-tax formula QTIP elections structured as a defined fraction, percentage or specific portion.[16] Disclaimers are expressly allowed to be structured in terms of a fixed dollar or pecuniary amount or a fractional share.[17] Indeed, disclaimers using defined valuation formulas arguably can accomplish the same type of capping of gift tax liability that's accomplished more directly with defined-value clauses in gift or sale transactions.[18]

> Recently, the Service has been claiming that both defined-value and price-adjustment clauses violate *Procter's* public policy concerns.

The value of the annuity in a GRAT may be stated in terms of a fraction or percentage of the initial fair market value (FMV) of the trust's assets. The applicable regulations allow the quantity to remain uncertain until a final determination is made concerning FMV for federal tax purposes, then appropriate reallocations are directed that correct the annuity and substantially reduce gift tax liability.[19]

Similarly, the annuity in a charitable remainder annuity trust (CRAT) may be defined in terms of a fraction or a percentage of the FMV of the property initially contributed to the CRAT or owned by a charitable remainder unitrust (CRUT.) The IRS has expressly approved the use of such a formula that leaves the exact quantity uncertain until the trust assets' FMV is correctly determined for federal tax purposes. Then, if necessary, allocations by the trustee are required to correct the annuity.[20] These corrections may substantially reduce gift tax liability if the annuity is being paid to, for example, a child of the settlor.

Finally, the generation-skipping transfer (GST) tax regulations allow GST exemption to be allocated by using a formula to produce an inclusion ratio of zero.[21] One effect of such formula allocation is to allow the donor to avoid unintended GST tax liability upon a taxable termination or taxable distribution if gifted assets were undervalued.

IRS VIEW

In Private Letter Ruling 8611004, the taxpayer used a defined-value formula clause to make small, primarily annual exclusion, gifts of partnership interests. Evidently, the formula did not expressly state what would happen if the value of the gifted partnership interest percentages exceeded the numerator of the fraction. Nevertheless, the Service approved the defined-value gifts, stating: "To the extent that the fractional interests indicated in the agreement and returns exceeded the fractional interests properly attributable to the fair market values stated by the decedent in the assignments of gifts, the excess fractional portion was receivable by the decedent and the right to it could have been asserted by him at any time."

Recently, though, the Service has had a change of heart. All subsequent rulings have been adverse to taxpayers. While recognizing the differences between defined-value clauses and the price-adjustment clauses, the Service now claims both violate *Procter's* public policy concerns and therefore are invalid.[22] The IRS emphasized the fact that the ruling situations required a transfer of assets back to the donor or seller (as did the price-adjustment clause situations.)[23]

The Service has relied on several courts' concerns that the donee (or buyer) would not transfer assets back to the donor (or seller) after a final determination of FMV.[24]

In its rulings, the Service admits that some assets are difficult to value (such as real estate and closely held stock) and that marital deduction and GRAT formula clauses are acceptable methods to deal with this problem. Then, the Service attempts to distinguish the defined-value formulas used in marital deduction transfers and GRATs as "congressionally authorized." This attempt to explain the long-established use of defined-value clauses in the transfer tax area is unsatisfactory. Certainly, in Internal Revenue Code Chapter 12, Congress also has amply sanctioned lifetime gifting.[25]

The Service's recent opposition to the use of defined-value clauses in gift and sale transactions may be rooted in its frustration with discounts allowed in connection with family limited partnerships (FLPs),[26] and the use of defined-value clauses as part of complex plans that the Service considers overly aggressive.

MCCORD

Although long-awaited, the Tax Court's first consideration of a defined-value clause in a gift or sale transaction failed to clarify whether such a clause may be used to limit gift tax liability.[27] In *McCord*, the defined-value clause in the assignment agreement provided that a certain value of FLP interests would be given to children and GST trusts, and that the excess would go to two charities. Two months later, the donees entered into a confirmation agreement in which they agreed to the percentages to be used to allocate the gift until its value was finally determined. The partnership was given a call right to purchase the charities' interests, and this right was exercised within six months, after arm's-length negotiations with the charities. One consequence of such a quick buy-back was that when the values of the gifted interests were increased on audit, the charities did not receive those increases. Rather, the increases ended up with the partnership that had "called" and bought back the charities' interests, and that was now owned by the children and the trusts. On these facts, the Tax Court avoided giving effect to the defined-value clause. The Tax Court majority held that the confirmation agreement determined the quantity of the assets transferred.

The Tax Court majority opinion in *McCord* did not mention or base its decision on *Procter's* public policy reasons. Judge Maurice Foley (the trial judge in *McCord*), in his dissenting opinion, rejected the public policy argument because of the difference between a defined-value clause and a price-adjustment clause. In contrast, one judge would have applied a public policy doctrine similar to that used in *Procter*,[28] and another thought the doctrine was broad and flexible enough to apply to overly aggressive planning.[29]

> The Fifth Circuit in *McCord* explicitly recognized the defined-value clause and did not find its use abusive.

Nevertheless, the majority held out hope for a properly drafted and implemented defined-value clause, stating: "Had petitioners provided that each donee had an enforceable right to a fraction of the gifted interest determined with reference to the FMV of the gifted interest as finally determined for federal gift tax purposes, we might have reached a different result."[30]

The Fifth Circuit Court of Appeals reversed the Tax Court and held for the taxpayer.[31] The appellate court was very critical of the Tax Court majority's violation of the "firmly established maxim that a gift is valued as of the date that it is complete; the flip side of that maxim is that subsequent occurrences are off limits."[32] Instead, the Fifth Circuit used the dollar value stated in the defined-value clause as the amount of the taxpayer's taxable gift.

The Fifth Circuit recognized that the defined-value clause was "at the heart of" the *McCord* case.[33] The appellate court pointed out that the defined-value clause had been controversial in the Tax Court.[34] This explicit recognition of the defined-value clause, plus the Fifth Circuit's use of the dollar amount stated in the defined-value clause as the value of the taxable gift, directly support the use of this type of formula clause. Further, the Fifth Circuit did not find the use of the defined-value clause abusive.[35]

However, disappointingly, the Fifth Circuit opinion does not address the IRS' public policy challenge to defined-value clauses. The court expressly stated its conclusion that the Service had waived the public policy issue in its briefs.[36] As a result, the Fifth Circuit's opinion in *McCord* has not gone far enough to settle the issue surrounding defined-value clauses. On the one hand, an argument can be made that the Fifth Circuit would not have used the defined-value clause amount to resolve *McCord* if the circuit court had concluded that such a clause was against public policy. On the other hand, it can be argued that procedural tactics or error have resulted in the court not considering the public policy argument so that this argument is still open for consideration in a future case.[37]

EXAMPLE

Here's an example of a situation in which it's appropriate to use a

defined-value clause for gifts and sales to a grantor trust:

Grandparents and their children previously have formed an FLP that owns commercial real estate and interests in several other closely held businesses. Grandparents own 90 percent of the partnership interests. They want to transfer interests in the FLP to a family trust for their children and grandchildren, but don't want to pay out-of-pocket gift tax.

They obtain an independent appraisal indicating that a 45 percent FLP interest has an FMV of $3 million. Their estate-planning attorney advises each of them to gift $1 million of their FLP interest and to sell the balance to a "grantor trust." Their $1 million gift will be offset by their applicable credit. However, the type of assets owned by the FLP and the discounts used by the appraiser create significant valuation uncertainty.

The grandparents will owe federal gift tax if they use the percentages of the FLP determined by the appraiser to be equal to the desired gift and sale amounts and the appraiser's value is ultimately determined to be too low. Their attorney advises them that the gift and sale transaction can be structured using a defined-value clause. Each grandparent will gift a fraction of 15 percent of the couple's interest. The numerator will be $1 million, and the denominator will be the FMV of the 15 percent FLP interest as finally determined for federal gift tax purposes. Similarly, each grandparent will sell a fraction of 30 percent of the grandparent's interest. The numerator will be $2 million and the denominator will be the FMV of the 30 percent FLP interest as finally determined for federal gift tax purposes.

As a result, there will be an interim period, when the exact quantity of FLP interests transferred will be unknown. That is, if the appraiser's value is correct, the entirety of the grandparents' FLP interests will have been gifted and sold to the trust. On the other hand, if the appraiser's value was too low, then by virtue of the use of the defined-value clause, only a portion of each grandparent's 15 percent interest will have been gifted and only a portion of the 30 percent interest sold to the trust. The excesses will be transferred to the grandparents' fund at the local community foundation.

This period of uncertain quantity ownership can create inconsistencies with state law property concepts that are prerequisites to desired tax results. Moreover, the manner in which the uncertain ownership is handled may affect a court's conclusion about whether the formula clause is significantly different from a price-adjustment clause.

STATE PROPERTY LAW

During this interim period, until values are finally determined, a number of practical property ownership requirements exist:

(1) title to the transferred property will need to be held;
(2) specific property interests may need to be managed: expenses paid, repairs made, leases negotiated, and similar tasks;
(3) voting rights may need to be exercised;
(4) income received must be accounted for and invested;
(5) tax reporting and payment must be accomplished;
(6) records must be kept;
(7) trust beneficiaries may need advance distributions;
(8) GST-exempt and non-exempt assets will need to be segregated; and
(9) if the transaction involves a sale, payments may have to be made.

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ownership matters to be accomplished during the interim period when ownership of the assets is uncertain? The donor could retain title and accomplish all of these matters. However, such retention would cast considerable doubt as to whether a completed gift or sale transaction had occurred.

Alternatively, title could be transferred to the donee, who could accomplish all of these tasks. Then, if it is determined that an FLP interest was undervalued, at the end of the interim period, the donee could return to the donor the portion of the assets "owned" by the donor. Title to some of the assets would need to be transferred back to the donor, a portion of the income earned would need to be similarly transferred and an accounting of activities would need to be made. Moreover, the donee would be responsible for the manner in which the donor's portion of the assets was managed during the interim period.

This alternative solution of transferring all assets to the donee, coupled with the donee's management of assets, a portion of which are still owned by the donor, casts a shadow of unreality on the gift or sale transaction. This is not how arm's-length transactions are usually structured. Further, the requirement that when value is finally determined, the donee must reconvey a portion of the assets back to the donor, along with a portion of the income, and an accounting for interim management, makes the defined-value clause structure uncomfortably similar to that of the price-adjustment clauses and their condemned condition subsequent transfer back.

These solutions both create another problem: They ignore state property law ownership concepts. Courts have repeatedly refused to approve tax planning in situations in which state property law requirements were not respected.[38] Examples of such failed planning can be found in recent FLP cases,[39] and in situations in which a donor or seller of a residence improperly retains use.[40]

ESCROW TRUST

The best solution to the practical ownership dilemmas is to use an escrow trust.[41]

(1) **Settlors**—At the closing of the gift and sale transactions, the donor/seller (a grandparent in our example) and the donee/seller (the trustee of the family trust in our example), as settlors, form an escrow trust. The donee/buyer contributes the fraction of the total assets which the donee/buyer is entitled to as a result of the gift and sale transactions. The donor/seller contributes the excess assets, which ultimately will go to the excess beneficiary.

The best solution to the practical ownership dilemma is an escrow trust. With an independent trustee, it helps create an arm's-length transaction.

(2) **Trustee**—This trust has an independent trustee who will hold title to the gifted assets during the interim period. The trustee will manage the assets, exercise voting rights, receive and invest income, accomplish all tax reporting and payments, keep records, make payments as directed by the trustee of the buyer trust, make advance distributions to beneficiaries of trust assets as directed by its trustee and segregate GST-exempt and non-exempt assets.

(3) **Division of Assets**—At the end of the interim period when the values of the gifted and sold FLP interests are finally determined for federal gift tax purposes, the trustee of the escrow trust divides the escrow trust's assets between the donee/buyer (trust) and the excess beneficiary pursuant to the fractions stated in the defined-value clause. At that time, title is transferred, accumulated income is divided and transferred, and an accounting is provided to both the donor/seller and the donee/buyer. During the interim period, the trustee of the escrow trust will have performed the trustee's duties pursuant to fiduciary standards.

(4) **Advantages**—This use of an escrow trust, with an independent trustee, is consistent with implementation of arm's-length transactions between unrelated parties. It is a practical solution to the uncertainty of the quantity of assets gifted and sold. The gift and sale transactions are completed when closed with respect to the pecuniary amounts stated in the defined-value clause. The implementation of state law ownership matters is accomplished by an independent fiduciary who's equally responsible to donor/seller and donee/buyer. There is no transfer back by the donee/buyer to the donor/seller, as is condemned by the price-adjustment clause cases and rulings.

(5) **Income Tax Consequences**—From a planning standpoint, there are two important income tax goals. First, the full "grantor trust" status of the donee/buyer trust needs to be maintained so that there is no gain recognition nor interest

income recognized by to the seller.[42] Second, correct income tax reporting supports the structure of the transaction. If the escrow trust is a grantor trust with respect to the donor/seller, then this reporting can be easily accomplished.

First, consider the assets contributed to the escrow trust by the independent trustee of the donee/buyer. These assets consist of the fraction of the assets that were gifted to the donee/buyer and the fraction of the assets that were sold to the donee/buyer. After expiration of the interim period, these assets revert back to the donee/buyer. Therefore, the donee/buyer is treated as the owner of these assets for income tax purposes pursuant to IRC Section 673.

Next, because the donee/buyer has been designed to be a grantor trust with respect to the donor/seller, this has the effect of treating the donor/seller as the owner for income tax purposes of the fraction of the assets gifted and the fraction of the assets sold to the donee/buyer.

The remaining assets are the excess assets, if any, once the value of the assets have been finally determined for federal gift tax purposes. The donor/seller contributed such assets to the escrow trust. If the excess beneficiary is the donor, then IRC Section 673 treats the donor/seller as the owner of these assets. If the excess beneficiary is the donor/seller's revocable trust, then again IRC Section 673 should treat the donor/seller as the owner of these assets. If the excess beneficiary is the seller's spouse, Sections 672(e) and 673 should treat the donor/seller as the owner of the assets. If another choice of excess beneficiary has been made, then the escrow trust needs a provision that will treat the donor/seller as the owner of the excess assets. For example, consider adding a provision to the escrow trust that will allow the independent trustee to make loans to a settlor without adequate security, pursuant to IRC Section 675(2). Therefore, the donor/seller should be considered the owner of all of the assets of the escrow trust, for income tax purposes.[43]

DRAFT, IMPLEMENT

The settlors of the escrow trust are the donor/seller and, in our example, the donee/buyer grantor trust. An independent trustee would be chosen. The escrow trust would be irrevocable during the interim period. For clarity, a purpose provision would describe the function of the escrow trust for implementation of the defined-value clause. The gift to the donee trust may be only partially exempt from GST tax. Therefore, the escrow trust should create three separate trusts: (1) a GST-exempt escrow trust; (2) a GST non-exempt escrow trust; and (3) an excess beneficiary trust to hold any excess assets that may need to be transferred to the beneficiary of any excess assets.

A provision describing ownership of the transferred assets during the interim period contains the defined-value clause, and describes how ownership of the trust assets is divided among the GST-exempt escrow trust, the GST non-exempt escrow trust and the excess beneficiary trust. The gifted amount may include a small percentage gift in addition to the defined-value gift. This small percentage gift is designed to counter *Procter* public policy arguments.

The escrow trust also needs a provision describing the administration of the three trusts' assets during the interim period. Finally, a provision is needed describing the distributions that will be made among the three trusts, once there is a final determination of FMV of the gifted and sold assets.

In addition to the escrow trust, each grandparent needs to execute a certificate of gift stating the assets that are the subject of the gift transaction, and using the defined-value clause to describe the gift. Similarly, in a sale transaction, the sale and purchase agreement states the assets that are the subject of the sale transaction, and uses the defined-value clause to describe the assets sold. Examples of these provisions are in the sources cited.[44]

The donor/seller should assign the gifted and sold interests to the donee/buyer who will assign such interests to the escrow trust. The donor/seller should assign any excess of the gifted and sold interests to the escrow trust. A gift tax return that adequately discloses the

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gift and sale transactions is filed for the grandparent, so as to begin the three-year limitations period.[45] If the donee or buyer is to be a trust, it should have a provision authorizing its trustee to form an escrow trust.

The advisor should draft an information letter describing the concept of the defined-value clause, its implementation using the escrow trust, and the uncertain state of the tax law concerning such formula clauses. This letter should be given to, and discussed with, the clients well before the contemplated transaction is closed.

During the interim period, the independent trustee must accomplish all of the property ownership duties allocated to the trustee in the trust instrument. Care must be taken to avoid having either the donor or donee accomplish such duties. At the close of the interim period, the independent trustee transfers the subject assets and net income among the three trusts and provides a final accounting.

IT SHOULD WORK

Use of a carefully implemented escrow trust should provide substantial support for the position that a defined-value clause is a reasonable and nonabusive method to control gift tax liability. When a defined-value clause is implemented in an escrow trust, state law property ownership concepts are respected and observed. Reality and arm's-length qualities are provided to the defined-value transaction. The escrow trust clearly differentiates the use of a defined-value clause from a price-adjustment clause by eliminating the condition-subsequent transfer back from the donee or buyer to the donor or seller. The escrow trust eliminates the Fourth Circuit's *Procter* concern that an untaxed gift might occur because a donee may refuse to return the excess untaxed amount determined by a court decision.

Finally, in our present unified transfer tax climate, a properly implemented defined-value clause should not run afoul of the Fourth Circuit's *Procter* public policy concerns. Amounts not transferred by gift or sale ultimately will be included in the donor's or seller's gross estate at death, or contribute to charitable purposes that generally are the same as many governmental purposes. Hence, the IRS continues to have a strong incentive to audit and enforce the proper valuation of the assets transferred. Correction of excessive valuation will reduce the quantity of assets transferred and either will increase the ultimate federal estate tax liability or contribute to charitable goals.[46]

If the court refuses to give effect to the defined-value clause, the client is no worse off than if the clause had not been used. The only downside to an effective defined-value clause is that it does limit the quantity of assets transferred. If certainty of quantity outweighs the risk of increased gift tax liability, then a defined-value clause should not be used. ❚

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Endnotes

1. *McCord v. Commissioner*, 120 T.C. 13 (2003).
2. *Commissioner v. Procter,* 142 F.2d 824 (4th Cir. 1944).
3. *Ibid.*, at p. 827.
4. *Ibid.*
5. *Estate of McLendon v. Comm'r*, TCM 1993-459, *rev'd on another issue,* 77 F.3d 477 (5th Cir. 1995); *Ward v. Comm'r*, 87 T.C. 78 (1986); *Harwood v. Comm'r*, 82 T.C. 239 (1984), *aff'd*, 786 F.2d 1174 (9th Cir. 1986).
6. *King v. United States*, 545 F.2d 700 (10th Cir. 1976).
7. Technical Advice Memoranda 9309001 and 9133001; Revenue Ruling 86-41, 1986-1 C.B. 300; TAMs 8549005 and 8531003. These cases and rulings are thoroughly discussed in Carlyn S. McCaffrey, "Tax Tuning the Estate Plan by Formula," 33 *U. Miami Heckerling Inst. on Est. Plan.*, at pp. 4-7 through 4-10 (1999); Norm Benford, "Valuation Principles and Recent Developments," Special Session Materials, App. A, 33 *U. Miami Heckerling Inst. on Est. Plan.* (1999); and *Practical Drafting*, July 2006, at pp. 8564-8597 (U.S. Trust).
8. Apparently, defined-value formula clauses for gift and sale transactions were first proposed by Carlyn S. McCaffrey and Mildred Kalik in "Using Valuation Clauses to Avoid Gift Taxes," *Trusts & Estates, October 1986,* at p. 47.
9. Internal Revenue Code Section 6501.
10. Treasury Regulations Section 2001-1(c); *see also* Treas. Regs. Section 25.2504-2(b).
11. *Practical Drafting*, October 2006, at pp. 8687, 8688 (U.S. Trust).
12. *Ibid.* No amount will be included in the spouse's gross estate under IRC Section 2044(b)(1)(B), because no marital deduction was allowed for this amount.
13. *Ibid.*, at p. 8690. This additional

dispositive provision may present marital deduction qualification issues. Therefore, it should probably not be used if the excess beneficiary is the spouse or a marital trust.

14. Carlyn S. McCaffrey, "Tax Tuning the Estate Plan by Formula," 33 *U. Miami Heckerling Inst. on Est. Plan.*, at p. 4-14 (1999); *Practical Drafting*, October 2006, at p. 8686 (U.S. Trust).
15. Treas. Regs Section 20.2056(b)-4(d)(5), Exs. (5) and (6); Treas. Regs. Section 1.663(c)-5, Ex. (4); Treas. Regs. Section 20.2056A-4(b)(2); and Treas. Regs. Section 20.2056A-4(d), Ex. (2).
16. Treas. Regs. Section 25.2523(f)-1(b)(3)(i); Treas. Regs. Section 20.2056(b)-7(b)(2); Treas. Regs. Section 20.2056(b)-7(h), Exs. (7), (8) and (9).
17. Treas. Regs. Section 25.2518-3(c) and 25.2518-3(d), Ex. 20.
18. *See* Carlyn McCaffrey, "Tax Tuning the Estate Plan by Formula," *supra* note 7, at p. 4-13; Stephen Akers, "Worth the Effort Even Beyond the Grave—An Update of Post Mortem Planning, Formula Disclaimer as a Defined-value clause for Lifetime Transfers," Special Session Materials, 37 *U. Miami Heckerling Inst. on Est. Plan.* (2003), at p. III-c-13.
19. Treas. Regs. Sections 25.2702-3(b)(1)(ii), 25.2702 3(b)(2) and 25.2702 3(c)(2).
20. Treas. Regs. Section 1.6642(a)(1)(iii) (CRAT) and 1.664-3(a)(1)(iii) (CRUT); Revenue Procedure 90-32, 1990-1 C.B. 546.
21. Treas. Regs. Section 26.2632 1(b)(2).
22. FSA 200122011 (the *McCord* case); TAM 200245053; and TAM 200337012.
23. TAM 200337012.
24. TAM 200245053.
25. *See* Paul Hood, "McCord and TAM 200245053: A Setback for Defined Value Transactions," *Est. Plan.,* Vol. 30, Sept. 2003, at p. 434; *see Practical Drafting*, Oct. 2006, at p. 8682 (U.S. Trust).
26. *See* TAM 200245053.
27. Thorough analysis of the Tax Court's *McCord* case may be found in Paul Hood, "*McCord* and TAM 200245053: A Setback for Defined Value Transactions," *supra* note 25, and in *Practical Drafting*, July 2003, at p. 7324 (U.S. Trust).
28. *See* Judge David Laro's opinion in *McCord*, 120 T.C. 358, at pp. 427-428.
29. *See* Judge Steven J. Swift's opinion in *McCord*, 120 T.C. 358, at pp. 404-410.
30. *McCord*, *supra* note 1, at p. 397. Interestingly, the majority noted that defined-value clauses are expressly authorized for use in charitable remainder trusts, marital deduction formulas, and GRATs. *Ibid*.
31. *McCord v. Comm'r*, 461 F.3d 614 (5th Cir. 2006).
32. *Ibid.*, at p. 626.
33. *Ibid.,* at p. 618.
34. *Ibid.*, at p. 624.
35. Carlyn McCaffrey, Stephen Akers, Ronald Aucutt, Stacy Eastland, "Hot Topics in Estate Planning After McCord: New Life for Defined-value clauses or the Same Old Rules?" *ABA Section of Real Property, Probate and Trust Law* (Oct. 10, 2006).
36. *McCord*, *supra* note 31, at p. 623. Interestingly, the commentators (*see* note 35) state that in footnote 18 of the Service's brief, the commissioner did mention the public policy argument, cited *Procter*, and requested the U.S. Court of Appeals for the Fifth Circuit to remand the case back to the Tax Court to consider this argument if the court determined not to accept the Tax Court's holding.
37. The Fifth Circuit's *McCord* opinion and the present status of defined-value clauses have been analyzed in: Practical Drafting, October 2006; Carlyn McCaffrey and Stephen Akers, *supra* note 35, *American Bar Association* (2006); and Jeffrey Pennell and Stephen Akers, "Advanced Estate Planning Practice Update," *ALI-ABA Video Law Review* (Fall 2006).
38. For a discussion of this problem with respect to a transferor's improperly retaining enjoyment of assets, *see* James Casner and Jeffrey Pennell, *Est. Plan.*, Vol. II, ' 7.3.4.1. *See also* Stacy Eastland, "New Tax Court Cases; Developments in Planning With Family Limited Partnerships," 29 *ACTEC J.* 69, at pp. 69 and 71 (2003), for legislative history in support of the concept that estate and gift tax liabilities are dependent upon the ownership of property under state law.
39. *See Estate of Strangi*, TCM 2003-145; *Estate of Harper*, TCM 2002-121; *Estate of Thompson*, TCM 2002-246; *Estate of Reichardt*, 114 TC 144 (2000); *Estate of Schauerhamr*, TCM 1997-242.
40. *See Estate of Maxwell*, 98 TC 594 (1992), *aff'd*, 3 F.3d 591 (2d Cir. 1993).
41. The use of a trust to solve such ownership requirements was first suggested by Carlyn McCaffrey in "Tax Tuning the Estate Plan by Formula," *supra* note 14, at p. 4-15.
42. Rev. Rule 85-13, 1985-1 C.B. 184; *see* Michael Mulligan, "Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note "An End Run Around Chapter 14?" 32 U. *Miami Heckerling Inst. on Est. Plan.*, para. 1500 (1998).
43. It should be noted that there is a theoretical untidiness when the excess beneficiary is a charity. If there is an excess amount, any income earned by these assets during the interim period should be considered tax-exempt because the assets are owned by the tax exempt excess beneficiary (the charity.) However, during the interim period (which extends over several income tax reporting periods), the amount of this tax exempt income is unknown. Therefore, to avoid unreported income, the grantor trust status is retained. As a result, all income is reported by the grantor, even though some may be tax-exempt.
44. *See* David Shaftel's outline presented at the ALI-ABA course entitled "Advanced Estate Planning Techniques" (February 2007) and online at *http://d2d.ali-aba.org* (go to *ALI-ABA Estate Planning Course Materials Journal.*)
45. IRC Section 6501(c)(9); Treas. Regs. Section 301.6501(c)-1(f).
46. *See* discussion in Paul Hood, "Defined Value Gifts: Does IRS Have It All Wrong?" *Est. Plan.*, Vol. 28, No. 12, December 2001, at p. 584; *Practical Drafting*, July 2006, at pp. 8565-8566 (U.S. Trust).