GIFTING ASSETS
WITHOUT TAX CONSEQUENCE

presented by

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Gifting Assets Without Tax Consequence

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I. Introduction.

Clients often wish to transfer assets to their children or other beneficiaries while paying no gift tax, or paying only a known and definite amount of gift tax. Many assets, however, are difficult to value. This outline discusses techniques that can be utilized to make gifts and other transfers without paying gift tax, and to reduce or eliminate the immediate tax impact of an IRS valuation challenge.

II. Gifts Below Exemption Amount.

Section 2501 of the Code imposes a federal gift tax upon gratuitous *inter vivos* transfers of property, subject to certain exclusions and deductions. Section 2505(a) of the Code allows a credit against the gift tax resulting in the exclusion of up to $1,000,000 of taxable gifts made over an individual's lifetime. A simple way to reduce the immediate tax impact of an IRS revaluation of gifts to which valuation discounts have been applied is to limit the aggregate amount of taxable gifts made to that which would be below the $1,000,000 lifetime gift tax exclusion if the valuation discounts were not applied.

Example 1:

> Donor 1 makes lifetime taxable gifts totaling $1,000,000 as valued by Donor 1. The gifts consist of transfers of limited partnership interests valued after taking a 35% discount for lack of marketability. If the IRS is successful in challenging the applicability of the valuation discount, the value of the limited partnership interests could be increased to over $1,500,000. Gift tax would be payable on the amount exceeding the lifetime gift tax exemption.

Example 2:

> Donor 2 makes lifetime taxable gifts totaling $650,000 as valued by Donor 2. The gifts consist of transfers of limited partnership interests valued after taking a 35% discount for lack of marketability. If the IRS is successful in challenging the applicability of the valuation discount, the value of the limited partnership interests would be increased to $1,000,000. Because the total amount of lifetime taxable gifts by Donor 2 does not exceed the lifetime gift tax exemption amount, the increase in value would not result in any gift tax payable by Donor 2.

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While this technique is a simple way to reduce the immediate impact of an IRS challenge to valuation discounts, its limitation as to the size of total gifts that can be made reduces this technique's attractiveness for many clients.

III. Gifts Using Formula Clauses.

One technique that is attractive to estate planners in the gift tax setting involves defining the portion of assets transferred by a formula based on the value of the assets as finally determined for federal gift tax purposes, often called a "formula clause" or "defined-value clause." The use of a formula clause to define the value of the gift would prevent an increased gift tax liability in the event the value of the asset is later increased by the IRS. The use of formula clauses have historically been challenged on public policy grounds by the IRS except where expressly authorized under certain contexts by Treasury regulations. The IRS's public policy argument is based on the Fourth Circuit's decision in *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944). Recent court decisions have cast doubt as to the viability of the IRS's public policy argument and have upheld formula clauses under certain circumstances.

A. Commissioner v. Procter.

In *Procter*, a trust instrument provided that in the event it is determined by a federal court of last resort that any part of the transfer to the trust is subject to gift tax, the portion subject to gift tax shall automatically be deemed not to be included in the conveyance and shall remain the sole property of the transferor. *Id.* at 827. The Fourth Circuit held that the provision was a condition subsequent to the transfer that was void as a violation of public policy for three reasons: (1) it has a tendency to discourage the collection of tax by public officials since its enforcement would defeat the gift; (2) it would obstruct justice by requiring the court to pass upon a moot case; and (3) the final judgment would be upset. *Id.* at 827.

Some have distinguished the savings clause in *Procter* from a formula clause defining the value of a gift because the savings clause changes a provision expressly given in the instrument requiring a subsequent remedial action while a formula clause merely defines the amount of the original transfer. *See* L. Paul Hood, Jr., *McCord and TAM 20024503: A Setback for Defined Value Transactions*, 30 Est. Plan. 432, 434 (2003). Nonetheless, the IRS has challenged formula clauses on the same public policy grounds as set forth in *Procter*.

B. McCord v. Commissioner.

McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006) involved a gift of limited partnership interests pursuant to an assignment agreement containing a formula clause that allocated a portion of the gift having a fair market value of $6,910,933 to the donors' children and trusts for the children. The excess was to be allocated between two

charities. The assignment agreement defined fair market value in language very similar to the definition in the Treasury regulations for gift tax purposes. After the assignments, the assignees executed a confirmation agreement allocating the interests among themselves based on an appraisal. The Tax Court held that the total value of the assigned interests was larger than that in the appraisal and construed the assignment agreement as leaving the assignees the task of allocating the gifted interests among themselves. 120 T.C. 358 (2003). Although the Tax Court concluded that the confirmation agreement (rather than the formula clause) bound the parties as to the percentage interests each assignee received, the Tax Court specifically stated it might have reached a different result if the assignment agreement had allocated percentages based on federal gift tax values.

The donors appealed to the Fifth Circuit and, while the Commissioner relied on the public policy argument before the Tax Court, he abandoned such argument on appeal. 461 F.3d at 623. The Fifth Circuit reversed the Tax Court decision and held that the gift was to be valued based on the formula clause, explaining that the Tax Court "used the after-the-fact Confirmation Agreement to mutate the Assignment Agreement's dollar-value gifts into percentage interests in [the partnership]. It is clear beyond cavil that the Majority should have stopped with the Assignment Agreement's plain wording." *Id.* at 626. While the Court did not discuss *Procter* or the public policy argument, the tone of its opinion suggests that it would have rejected that argument. Both the dicta in the Tax Court opinion and the Fifth Circuit's holding support the validity of formula clauses, at least where the excess of the stated dollar amount passes to charity.

C. Christiansen v. Commissioner.

In the recent case of *Christiansen v. Commissioner*, 130 T.C. 1 (2008), the Tax Court addressed the public policy issues of using a formula disclaimer that operates much like a formula clause in an *inter vivos* gift. In *Christiansen*, the decedent owned various limited partnership interests. The decedent's will left her entire estate to her daughter, and provided that if the daughter disclaimed any part of the estate, a percentage of the disclaimed portion would go to a charitable foundation.[2] The daughter executed a disclaimer with the following language:

> "Christine Christiansen Hamilton hereby disclaims that portion of the Gift determined by reference to a fraction, the numerator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001, less Six Million Three Hundred Fifty Thousand and No/100 Dollars ($6,350,000.00) and the denominator of which is the fair

[2] Another percentage of the disclaimed portion was to go to a charitable trust, but the disclaimer as to the portion passing to the trust was determined not to be a "qualified disclaimer" and a charitable deduction was not allowed as to that portion for purposes beyond the scope of this outline.

> market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001 . . . ."

The disclaimer defined the fair market value of the Gift as its fair market value as finally determined for federal estate tax purposes. The estate obtained appraisals of the limited partnership interests and took a minority interest discount. The IRS determined that the value of the limited partnership interests should be increased and argued that the formula clause violated public policy so that no estate tax charitable deduction would be allowed for the increased value of the estate that passed to the foundation as a result of the disclaimer. The Tax Court unanimously upheld the formula disclaimer as to the portion passing to the foundation and rejected the IRS's public policy argument, stating "[w]e are hard pressed to find any fundamental public policy against making gifts to charity – if anything the opposite is true." In distinguishing the facts of this case from *Procter*, the Court explained,

> [t]he contested phrase would not undo a transfer, but only reallocate the value of the property transferred among [the daughter, the trust and the foundation.] If the fair market value of the estate assets is increased for tax purposes, the property must actually be reallocated among the three beneficiaries. That would not make us opine on a moot issue, and wouldn't in any way upset the finality of our decision in this case.

The Court acknowledged that the IRS's incentive to audit returns affected by this type of disclaimer language will decrease if the increased charitable deduction were allowed, but stated that IRS estate tax audits are far from the only policing mechanism in place to keep people from lowballing the value of gifts to cheat charities, pointing to the fiduciary duties of executors and directors of foundations, and possibly state attorneys general.

D. Conclusion.

The availability of formula clauses in transferring gifts of limited partnership interests (and other difficult-to-value property) would significantly reduce the immediate tax impact of an IRS adjustment on audit. The *McCord* and *Christiansen* decisions provide greater optimism that formula clauses will be upheld by the courts if challenged by the IRS, particularly if the excess in value under the formula clause passes to a charitable beneficiary. However, there is still a degree of uncertainty in this area, and the reasoning in *Christiansen* regarding the public policy argument does not apply as strongly where the excess in value under a formula clause passes to a non-charitable beneficiary.

IV. Gift to Zeroed-out GRAT.

One area where the use of a formula clause is specifically authorized by the Treasury regulations is in the context of the grantor retained annuity trust ("GRAT"). A grantor retained annuity trust ("GRAT") is a type of trust where the grantor retains an interest in the property transferred in the form of an annuity that meets the requirements of a "qualified annuity interest" under Section 2702 of the Code. The qualified annuity interest is subtracted from the value transferred to the trust in determining the value of the gift for federal gift tax purposes. Treas. Reg. § 25.2702-1(b). The grantor is treated as having made a gift of the actuarial value of the remainder interest, which is determined based on annuity tables prescribed by the IRS and using an interest rate under Section 7520 of the Code. I.R.C. § 2702(a)(2)(b). If the annuity payments are set high enough so that the actuarial value of the annuity interest almost equals the value of assets contributed to the GRAT, the resulting gift is nominal and the GRAT is said to be "zeroed-out."

The IRS previously took the position that the grantor's retained interest must be valued as if the grantor had the right to receive the stated annuity amount only until the *earlier* of the grantor's death or the end of the trust term. Using this method of valuing the retained interest, it was not possible to zero-out a GRAT completely. In *Walton v. Commissioner*, 115 T.C. 589 (2000), a unanimous Tax Court rejected the IRS's position as an unreasonable and invalid interpretation of Section 2702. The IRS later revised the relevant Treasury regulations to be consistent with the court's holding. Treas. Reg. § 25.2702-3(e), *Example 5*.[3] In light of the *Walton* decision, if structured properly, a GRAT can produce a zeroed-out gift.

The Treasury regulations specifically authorize the retained annuity interest to be described as either a stated dollar amount or "[a] fixed fraction or percentage of the initial fair market value of the property transferred to the trust, *as finally determined for federal tax purposes*." Treas. Reg. § 25.2703-3(b)(1)(ii) (emphasis added). The latter method is often described as a "formula clause" or "defined-value clause." *See* general discussion of uses of formula clauses in Section II.B. If a formula clause is used to define the retained annuity interest, the annuity payments are automatically increased if it is determined that the transferred property was originally undervalued, and the amount of the taxable gift is not increased.

Example:

Grantor owns interests in a family business organized as a limited partnership. Grantor obtains an appraisal of the limited partnership interests with a combined

[3] Despite this concession and change in the regulations, the IRS obstinately refuses to issue private letter rulings on whether the grantor's interest in a properly structured zeroed-out GRAT is a "qualified" interest under Section 2702. Rev. Proc. 2008-3, 2008-1 I.R.B. 110, § 4.01(51). While *Walton* and the conforming changes to the Treasury regulations do not *expressly* address this issue, it seems most unlikely that the IRS could prevail on this point or that the IRS will even attempt to do so.

discount of 40% for lack of marketability and lack of control. Grantor transfers the limited partnership interests to a two-year GRAT that defines the annuity interest as the percentage of the initial fair market value of the limited partnership interests that is as near as possible, but lower than, the fair market value of the limited partnership interests, as finally determined for federal gift tax purposes. The discount is later determined to be too high and the value of the limited partnership interests is increased accordingly. As a result, the amount of the annuity payments would be increased without significantly increasing the amount of the taxable gift.

By transferring limited partnership interests to a zeroed-out GRAT with a formula clause, there is very little risk of making an excess gift if it is later determined that the interests were undervalued. Therefore, the use of formula clauses, expressly authorized by the Treasury regulations, reduces the immediate impact of an IRS valuation adjustment on audit.

One important limitation on the use of a GRAT is that if the grantor dies during the GRAT term, a substantial portion, if not all, of the trust assets may be included in the grantor's estate for federal estate tax purposes. I.R.C. §§ 2036(a)(1).

V. Gift to QTIP Trust with Partial QTIP Election.

One technique for gifting property that reduces the immediate impact of an IRS adjustment on audit involves the use of an *inter vivos* QTIP trust for the benefit of the donor's spouse accompanied by a partial QTIP election utilizing a formula clause.

Section 2523(a) of the Code allows a gift tax deduction for the amount of qualifying *inter vivos* gifts to, or for the benefit of, the donor's spouse. Section 2523(f) allows a donor to elect to treat certain transfers of life interests in property to a trust for the donor's spouse as "qualified terminable interest property" (a "QTIP" trust) for which a gift tax marital deduction is allowed.

The Treasury regulations specifically provide that the QTIP election may be made as to a portion of the qualified terminable interest property transferred and the portion may be defined by formula. Treas. Reg. § 25.2523(f)-1(b)(3). The QTIP election can define the portion to which the election applies as an amount equal to the amount necessary to reduce the federal gift tax payable to zero (or some other specified amount). The regulations under the corollary estate tax provisions regarding the estate tax marital deduction for QTIP property describe specific examples involving formula elections of this nature. In one example, the election specified that "the numerator of the fraction is the amount of deduction necessary to reduce the Federal estate tax to zero (taking into account final estate tax values) and the denominator of the fraction is the final estate tax value of the residuary estate (taking into account any specific bequests or liabilities of the estate paid out of the residuary estate)." Treas. Reg. § 20.2056(b)-7(h), Ex. 7. The regulations explain that this formula election is of a fractional share and the value of the share qualifies for the estate tax marital deduction. In another example, the election used the

following formula: "I elect to treat as qualified terminable interest property that portion of the residuary trust, up to 100 percent, necessary to reduce the Federal estate tax to zero, after taking into account the available unified credit, final estate tax values and any liabilities and specific bequests paid from the residuary estate." Treas. Reg. § 20.2056(b)-7(h), Ex. 8. This formula election was also acceptable under the example.

By transferring property to an *inter vivos* QTIP trust and making a partial QTIP election by formula defining the portion to which the QTIP election applies as the amount necessary to reduce the federal gift tax payable to zero (or some specified amount), the immediate impact of an IRS adjustment on audit is greatly reduced. An increase in the valuation would not result in an increase in gift tax payable; instead, it increases the portion of the trust that will ultimately be included in the spouse's estate. It should be noted, however, that this technique has not yet been tested in the courts.