Planning so the IRS doesn't peek under the hood

Southern Arizona Estate Planning Council

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Chris Siegle is the Senior Wealth Advisor and Executive Director in the Scottsdale office of J.P. Morgan Private Bank. He is a member of the global Wealth Advisory group, offering clients and the professional community the insights gathered from extensive law practice, tax expertise, and exposure to the most interesting and innovative estate and tax planning techniques in the United States and internationally.

Chris works with clients and their advisors to educate on the operation and efficiency of federal estate, gift generation-skipping transfer and income tax techniques. He blends his advice with teammates in the financial and lending practices of the Private Bank to bring the families he works with the most innovative solutions and benefits to the families over generations. Before joining the J.P. Morgan Private Bank in 2010, Chris was a partner in a Phoenix regional law firm where he practiced for over 13 years in trust and estate, tax and business planning practices.

Chris has spoken and written nationally on tax and estate planning matters through the USC Tax Institute, the Notre Dame Tax and Estate Planning Institute; Matthew Bender Books/LexisNexis *Major Tax Planning 2020*, Aspatore Books *Inside the Minds of Family and Business Succession Planning*, Thomson Reuters' *Estate Planning Journal*, Strafford CLE, and numerous seminars for Bar Associations, Estate Planning Councils, Community Foundations, law firms, CPA firms, and other professional organizations throughout the United States. His teachings in GSTT planning, qualified small business stock planning, charitable planning with trust income tax planning, crypto currency, selling remainder interests and promissory notes, planning with retained interests and Code §§ 2036, 2038, 2043 and 2703, securities laws for estate planners, income tax planning, and planning with life insurance have assisted professionals in elevating their practices. He is an Adjunct Professor of Law in the Graduate Tax Program's online LL.M./M.T. program at the Villanova University School of Law.

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LL.M. (taxation), Villanova University School of Law, 2019; M.S.S. (Master of Strategic Studies), The United States Army War College, 2011; J.D. (with Honors), University of Tulsa College of Law, 1997; A.B., University of Illinois at Urbana-Champaign, 1990.Chris is a member of the State Bar of Arizona, and the Maricopa County Bar Association. He is an Accredited Estate Planner®.

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The scrutiny facing clients and the estate planners who work for them has never been higher. With increased economic volatility and social unrest, business owners and other wealthy clients are less willing to lose control of either their wealth or income streams, pay the taxes on income and capital gains generated from assets earned by existing or contemplated grantor trusts, or face a Treasury Department looking for greater revenues in a straitened fiscal condition.

On the other side of the equation, focusing on the thesis of this paper, collections are becoming a greater priority of taxing authorities at all levels of government. For example, the U.S. government expended over $3 trillion in stimulus in fiscal year 2020 alone in response to the effects that COVID-19 has had on Americans and the global economy. The current American Rescue Act portends another Six Trillion Dollar deficit. Relatedly, the Internal Revenue Service (the "Service") is accelerating its pursuit of tax revenue. In the slowdown in business and income tax collections following the COVID-19 pandemic, the excess of extraordinary spending over lower tax receipts means the hunt inevitably will accelerate.

In June 2020, the Service announced a renewed, focused effort to conduct comprehensive audits of wealthy taxpayers by the Global High Wealth Industry Group (GHW) within its Large Business and International (LB&I) division[1]. Even before the 2020 pandemic caused the spending spree and drop in revenue, the Service showed increased collections from auditing gift tax returns. In 2019 collections from gift tax return (Form 709) audits netted $1,516,044,000, a one-year increase of over $100% (from $715,499,767) in 2018.[2] There can be little doubt that the need for revenue at the federal level will lead to more aggressive Service collection efforts. Planning efforts will have to adapt accordingly. This paper is intended to put in perspective an axiom of a friend of mine, "an estate planner's job is not to win at audit; rather, it is to accomplish client intent without audit."

I. The issue: how to reduce vulnerabilities to audit

In this paper, I will first address the key planning defenses to a common Service challenge in the wealth transfer context: its search for retained interest "strings" under Internal Revenue Code (U.S.C. Title 26; hereinafter, the "Code") §§ 2036(a) and 2038(a).

Then, I will address a second prong of the Service's attack in the wealth transfer context: intra-family transfers that might implicate Chapter 14 of the Code.

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[1] INTERNAL REVENUE SERVICE, I.R.M 04-052-001 (December 26, 2019). Background: GHW was formed to take a holistic approach in addressing the high wealth taxpayer population; to look at the complete financial picture of high wealth individuals and the enterprises they control. A GHW enterprise case consists of a key case, generally an individual income tax return, and related income tax returns where the individual has a (1) controlling interest and significant compliance risk is deemed to exist. Controlling interest can include significant ownership of or significant influence over an entity or multiple entities within the enterprise. The enterprise case may include interests in partnerships, trusts, subchapter S corporations, C corporations, private foundations, gifts, and the like. GHW personnel work with other personnel from other business operating divisions within the IRS to address noncompliance across the entire enterprise. GHW consists of two functions, Workload Services (WLS) and the field examination groups.

[2] INTERNAL REVENUE SERVICE, PUB 55-B (REV. 6-2020), DATA BOOK 2019, OCTOBER 1, 2018 TO SEPTEMBER 30, 2019, P 3; INTERNAL REVENUE SERVICE, SOI Tax Stats - Total Gifts of Donor, Total Gifts, Deductions, Credits, and Net Gift Tax, 2018, https://www.irs.gov/statistics/soi-tax-stats-total-gifts-of-donor-total-gifts-deductions-credits-and-net-gift-tax.

Third, I will explore how planners can use defined value or price adjustment clauses to mitigate risk, mindful that the Service's audits are often prompted by not only perceived overly aggressive claims for valuation discounts but also contractual agreements claimed to be violative of public policy.

Next, I will highlight the need for qualified appraisals prepared by qualified appraisers where a transfer of illiquid assets is contemplated or has been made, and discuss the most common of the bases for discounts that are attacked by the Service.

Finally, I will suggest that a claiming a more modest valuation discount, coupled with the well-designed use of the often-misunderstood grantor trust, can effectively outpace the benefits of a more aggressive asserted discount not combined with the use of a grantor trust, both intrinsically and on an audit-risk adjusted basis.

Analysis shows that exploiting the "income tax burn" of a grantor trust (whether a "standard" grantor trust under the terms of which the grantor has retained powers described in Code §§ 671-677, or a BDIT or BDOT[3]), can readily produce highly tax-efficient outcomes for families within very flexible, and legally easily defensible, structures. In fact, showing a client the effectiveness of making income tax payments on behalf of a long-term grantor trust compared with a shorter-term grantor trust with a steeper (and certainly more audit-attracting) valuation discount can be a planner's solution to more risky planning. Ultimately, of course, the risk is borne by the client.

The Service, when presented with the opportunity to review the propriety of a taxpayer's wealth transfer planning, will look for use of the lifetime exclusion amount ($11,580,000 in 2020). In many cases, a taxpayer has structured the transfer of business interests as a sale of that interest to a grantor trust in exchange for a note, or as a contribution to a controlled partnership. If the Service is able to either recharacterize a sale or contribution as a gift, and the gift proves to be greater than the taxpayer's available exclusion amount at the time of transaction, the taxpayer would owe gift tax. Similarly, if the Service can prove, at the taxpayer's death, that the earlier sale or contribution was not a *bona fide sale for adequate and full consideration*, then at least some and perhaps all of the transferred assets would be included in the grantor's/decedent's estate, resulting in increased estate taxes due.

The Service's pursuit of transfers to revalue for estate tax purposes is unrelenting. But the context of the transfers, when viewed as examples of valuation discounts, is instructive because, depending on the facts, that context can be differentiated to the taxpayer's benefit.

II. The issue: mitigating the "strings" of Code §§ 2036 and 2038

The Service often cites, to attack many transfers of interests in privately-held businesses and other illiquid assets, Code § 2036(a), dealing with lifetime transfers with retained interests, and Code § 2038(a), dealing with transfers with respect to which the grantor held an ability to alter, amend or revoke the interest prior transfer at death. Those sections provide as follows:

Code § 2036- Transfers with retained life estate

(a) General Rule.- The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (*except in the case of a*

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[3] *See* Code § 678(a)(1) regarding beneficiary deemed ownership trusts ("BDOT") and Code § 678(a)(2) regarding beneficiary defective inheritor's trust ("BDIT").

bona fide sale for adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death-

(1) the possession or enjoyment of or the right to income from the property, or
(2) *the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom*.[4] (Emphasis added).

The statute's consideration of both actions actually taken, and those that could be taken, by the taxpayer, as well as unspecified and unlimited others, is explained in Treasury Regulations (the "Treas. Regs.")

Treas. Reg. § 20.2036-1(b)(3):

> With respect to such power, it is immaterial: (i) whether the power was exercisable alone or in conjunction with another person or persons, whether or not having an adverse interest; (ii) in what capacity the power was exercisable by the decedent or by another person or persons in conjunction with the decedent; and (iii) whether the exercise of the power was subject to the contingency beyond the decedent's control when did not occur before his death (e.g., the death of another person during the decedent's lifetime)."[5]

The property of the decedent that is pulled back into the estate for estate tax purposes after the lifetime transfer under this Regulation is the value of the entire property, even if the interest in the property does not represent control of all the property. Thus, for example, if the decedent transfers property worth $100 during life, but retains a right to designate where the income from the property will go, and he holds that right at death, the entire value of the property will be included in the decedent's estate (i.e., $100 plus appreciation or minus declines in value as of the date of death).

In contrast, the amount included under Code § 2038 is the interest in the property that the decedent had transferred during life, but over which the decedent held the power to alter, amend or revoke the interest at death, or had transferred with three years of death. For example, assume the decedent in the previous paragraph died with the power to revoke the existing income interest of a beneficiary. Under § 2038, the gross estate would include not the value of the entire property, but, rather, just the value of the income interest that could be revoked.

Code § 2038 – Revocable transfers

(a) In general.- The value of the gross estate shall include the value of all property-

(1) Transfers after Junes 22, 1936-To the extent of any interest therein of which the decedent has at any time made a transfer (*except in the case of a bona fide sale for adequate and full consideration in money or money's worth*), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change though the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any person

[4] Code. § 2036(a).

[5] *See* Treas. Reg. § 20.2036-1(b)(3)

(without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.[6] (Emphasis added).

Treas. Reg. § 20.2038-1

(a) In general. A decedent's gross estate includes under section 2038 the value of any interest in property transferred by the decedent, whether in trust or otherwise, if the enjoyment of the interest was subject at the date of the decedent's death to any change through the exercise of a power by the decedent to alter, amend, revoke, or terminate, or if the decedent relinquished such a power in contemplation of death. However, section 2038 does not apply -

. . . .

(2) If the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law.

The exception in Treas. Reg. § 20-2038-1(a)(2) to estate tax inclusion created by requiring the consent of all interested parties for someone to enjoy the property is indeed a difference in the statutory reach of one the two provisions (Code §§ 2036, 2038) most often used by the Service to include retained interests in the decedent's estate. Taxpayers can use this exception to escape what might on their face seem to be facts that would trigger estate tax inclusion under Code § 2038.

One common feature of the §§ 2036 and 2038 "string" provisions is that the grantor must retain (or gain) some power. Often this power is associated with a retained, fractional equity interest.[7]

The key to escaping or shortening the audit cycle in §§ 2036 and 2038 cases is to demonstrate that the transaction in question was not a gift, but that rather a *bona fide sale for adequate and full consideration*. Therefore, creating a fact pattern to show such a sale is critical.

In the now-well-known Tax Court cases of *Powell* and *Cahill*[8], which reignited concern among donors of interests in privately-held businesses about the efficacy of bona fide sales for adequate and full consideration, the apparent failure to assert the existence of such a sale harmed the taxpayers' position. By contrast, *Kimbell v.United States*[9]and *Estate of Murphy,*[10] cases involving arguably less egregious fact patterns, provide a roadmap for thoughtful planners wishing to fall within the exceptions spelled out in both Code §§ 2036 and 2038. [11] Successfully navigating the turbulent waters of §§ 2036 and 2038 is

6 Code. § 2038(a).

[7] Note that no equity interest is required to be possessed by the power holder to then include property in a decedent's estate, if the grantor has or gains a general power of appointment. *See* 26 U.S.C. § 2041.

[8] *Estate of Powell v. Comm'r,* 148 T. C. 18 (May 18, 2017); *Estate of Cahill v. Comm'r*, 115 T.C.M. (CCH) 1463 (June 18, 2018); *see also Morrissette v. Comm'r*, 114 T.C. 11 (April 13, 2016).

[9] *Kimbell v. United States*, 371 F. 3d 251 (5th Cir, 2004).

[10] *Estate of Murphy v. United States*, No. 07-CV-1013, 2009 U.S. Dist. LEXIS 94923 (W.D. Ark. Oct. 2, 2009).

[11] *See Estate of Moore v. Comm'r*, T.C. Memo. 2020-40 (April 7, 2020). In *Moore*, the decedent (who died in 2005) engaged in aggressive estate planning including uses of a family limited partnership. The Tax Court determined that the convoluted transactions did not meet the bona fide sale for adequate and full consideration exception to

especially important for taxpayers who transfer their equity interests in pass-through entities, such as general partnership (GP) and/or limited partnership (LP) interests in limited partnerships, or managing membership interests of limited liability companies (LLCs), while retaining other equity interests. (Of course, limited liability companies can elect to be treated in various fashions for income tax purposes, though more often than not they are treated as partnerships for such purposes.[12]) These entities are used when transfers are made to allow taxpayers to claim valuation discounts from the apparent, nominal value of the underlying asset. Many times, the Service challenges the value ascribed to the interest transferred. Thus, defensible valuation reports, discussed later in this paper, are key to heading off an audit in those circumstances.

III. The issue: The Four Horsemen of Chapter 14 that add complexity to valuations, and provide ammunition to the Service

The severe rules of Chapter 14 of the Code (§§ 2701-2704) apply to determine the value of a non-public security transferred to (or in trust for the benefit of) family members. Depending on the facts and circumstances of a particular transfer, these sections can allow the Service to effectively increase the value of the assets transferred well beyond a taxpayer's expectations. Interests held by the grantor are called "applicable retained interests:" equity interests in controlled corporations or partnerships to which there is a defined right to distributions from the entity to the interest holder.[13]The assertion of these rules in cases in which valuation is an issue can be negated by involving a third party (even a charity, or trust) in the capital structure and management of the entity. Each of these Code sections defines family member differently, and that provides a seam to be used by the artful planner.

Section 2701 requires a subtraction method of valuation in cases in which an interest is held by the members in a transferor's family"[14] if, following the transfer, the transferor, or an "applicable family member,"[15]holds proscribed interests in the property transferred. An ironic aspect is that the word

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Code § 2036(a)(1), determining no significant non-tax reason for the contribution to the partnership, no bargained for exchange or formation of the partnership, and the facts including the decedent's continued uses of his residence post-transfer. Citing *Estate of Bongard v. Comm'r*, 124 T.C. 95 (2005), the Tax Court included the value of the assets transferred to the partnership in the decedent's estate. The court also applied Code § 2043(a), relying on *Powell* to establish a formula applied to the valuation resulting in the estate's value expressed as the property contributed to the partnership by the decedent at date of death – assets that had been transferred out of the estate through: 1) unpaid attorney fees (substantial) (denied); 2) transfers to the decedent's children (allowed), and 3) a $2 million ostensible loan (denied)). The Tax Court analyzed each of these elements and determined inclusion.

[12] *See* Treas. Reg. § 301.7701-3. Entities with two or more members can elect to be taxed as a C Corporation, an S Corporation, or a partnership. If the entity with two or more members makes no election, the entity is taxed as a partnership. This default tax treatment is sometimes referred to as LLC tax treatment, although there is no section of the Code containing LLC tax provisions. There are of course partnership tax provisions, acknowledged as some of the most complex rules in the Code. *See* Code Subchapter K.

[13] *See* Treas. Reg. § 25.2701-2(b)(3).

[14] *See* Code § 2701(e)(1); Treas. Reg. § 25.2701-1(d)(1). A member of the transferor's family includes the transferor's spouse, lineal descendants of the transferor or the transferor's spouse, and the spouses of such lineal descendants, including adoptions.

[15] *See* Code § 2701(e)(2); Treas. Reg. § 25.2701-1(d)(2); meaning the transferor's spouse, any ancestor of either the transferor or the transferor's spouse, and a spouse of any such ancestor.

“transfer” includes many actions that are considered “deemed transfers,” including a sale for full and adequate consideration that would not otherwise be considered a gift under Chapters 11, 12 and 13 of the Code.[16] For example, a transfer is deemed to have occurred under Code § 2701 when a grantor trust is terminated and trust property is transferred to the beneficiaries. Further, the interest of an indirect holder[17] terminates to the extent that the interest would have been included in the estate of the indirect holder if the holder had died immediately before the termination.[18]However, transfers of marketable securities are not subject to Code § 2701.

The subtraction method used in computing the value of a gift under § 2701 dictates that the gift is the excess of (1) the total of the fair market value of all family-held interests in the transferred entity immediately before the transfer over (2) the sum of the value of all of the family-held senior equity interests in the transferred entity immediately after the transfer.[19]

Section 2702 addresses, among other things, valuation in the context of transfers in trust under the terms of which the grantor retains an income or annuity interest for a term of years, with the remainder going to children or other family members at the end of the term.[20]Code § 2702 also applies to non-trust transfers under the terms of which there are one or more term interests,[21]as well as to joint purchases of property by family members.[22]

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[16] *See* Treas. Reg. § 25.2701-1(b)(2). A “transfer” includes: 1) a contribution to the capital of a new or existing entity; 2) a redemption, recapitalization, or other change to the capital structure of an entity if – A) the transferor or an applicable family member receives an applicable retained interest in the capital transaction, B) the transferor or applicable family member holding a applicable retained interest prior to the capital structure transaction surrenders and that is junior in the capital structure to the applicable retained interest and receives other property; or C) the transferor or applicable family member holding a applicable retained interest prior to the capital structure transaction surrenders an equity interest that is junior in the capital structure to the applicable retained interest and the value of the applicable retained interest is increased; or 3) the termination of an indirect holding in an entity to the extent an individual indirectly holds an interest in the entity if – A) the individual is treated as a grantor under the grantor trust rules; or B) if the termination or contribution is not treated as a transfer and the interest would be includable in the indirect holder’s taxable estate if the individual had died immediately before the termination or contribution.

[17] *See* Treas. Reg. § 25.2701-6. Indirect holding of an interest occurs to the extent the person owns a partnership interest wherein the partnership holds an interest, and to the extent of the larger of their profits interests or capital account; to the extent the individual owns an interest in a corporation (or any an entity taxed as an association) to the extent their interest bears to all interests; to the extent of they are a beneficiary of a trust or devisee of a trust in proportion of their beneficial interest and to the extent that their interest can be satisfies by the entity’s equity interest held in the trust or estate or the income or proceeds therefrom, assuming maximum discretionary exercise by the fiduciary. To the extent the beneficiary or devisee cannot receive any distribution they are not considered a holder of the entity’s equity. There are several instances of attribution explained in the regulations at Treas. Reg. § 25.2701-6(5).

[18] *See* Treas. Reg. § 25.2701-1(b)(2)(i)(C).

[19] *See* Treas. Reg. § 25.2701-1(a)(2).

[20] *See* Treas. Reg. § 25.2702-2(a)(1). A member of the family means an individual’s spouse, any ancestor or lineal descendant of the individual or the individual’s spouse, any brother or sister of the individual, and the spouse of any of the forgoing.

[21] *See* Treas. Reg. § 25.2702-4(a).

[22] *See* Treas. Reg. § 25.2702-4(c).

Retained interests usually can be easily valued under Code § 2702,[23] as those values are calculated by reference to Code § 7520. However, if the retained interest is, in effect, ineligible to be valued pursuant to Code § 2702, then the value of any interest retained is zero, making the value of the interest transferred equal to the entire fair market value of the transferred property, thus exposing the grantor to increased transfer taxes.

Importantly, many transfers are not subject to Code § 2702: 1) an incomplete gift; 2) a transfer in trust if the remainder interest qualifies for a charitable deduction under Code § 2522; 3) a transfer to a charitable lead trust; 4) a transfer to a pooled income fund; 5) the transfer of certain term interests in tangible personal property (such as art); 6) certain transfers in trust under property settlement agreements incident to a divorce; 7) transfer of a remainder interest in trust if the only retained interest by the grantor or a family member is that of an income interest determined in the sole discretion of an independent trustee; and 8) a transfer of personal residence in trust if the residence is that of persons holding a term interest in the trust (a personal residence trust or a qualified personal residence trust).[24]

Section 2703 focuses on the nuanced relationship between, on the one hand, a privately-held business and its members or shareholders, and, on the other, any agreements that may exist that bear on value, such as agreed-upon or other formula values in a buy-sell agreement. In valuing the interest held in a gift, estate or generation-skipping transfer tax context, § 2703 requires that any option, agreement, or other right to acquire, use or dispose of the property for less than fair market value be disregarded. Likewise, any restriction on the right to use or dispose of the property is also disregarded. Most commonly, these options, agreements and rights are contained in buy-sell agreements, which can lead to planning opportunities. An important exception to the Code § 2703 rules of disregarding options, agreements, rights and restrictions arises where what are found to be bona fide business arrangements are involved.

Somewhat different from the bona fide sale for full and adequate consideration exception mentioned *infra* in the discussion of Code §§ 2036 and 2038, the bona fide business arrangement in the § 2703 context has three requirements. First, the option, agreement or other right has to be the product of a bona fide arrangement.[25]Second, it cannot be a device to transfer property to family members[26] for less than adequate and full consideration in money and money's worth. Third, it must have terms comparable to other agreements entered into at arm's length.[27]

To the extent a taxpayer can structure the agreement to fall within the bona fide business arrangement exception of Code § 2703, the Service will be less inclined to argue that a gift has been made when a

[23] *See* Treas. Reg. § 25.2702-3. Qualified interests are considered an annuity or unitrust interest.

[24] *See* Treas. Reg. §§ 25.2702-1(c)(2); 25.2702-5(a).

[25] *See* Report of Senate Finance Committee Report on Section 2703, 136 Cong. Rec. S15.629, S15.683 (daily ed. Oct 18, 1990). The Committee adopted the reasoning and result in *St. Louis County Bank v. United States*, 674 F.2d 1207 (8th Cir. 1982) in which the proffered reason of maintaining family control was not, by itself, enough to show bona fide business arrangement and could not be said to be other than a device to transfer wealth to family members for less than adequate and full consideration.

[26] *See* Treas. Reg. § 25.2703-1(b)(1)(ii). The term in the regulation is "natural objects of the transferor's bounty" instead of defining the family as in other regulatory provisions. This can be viewed as a more expansive definition and thus the reach of the exception is narrowed.

[27] *See* Treas. Reg. § 25.2703-1(b)(4)(i).

transfer takes place. A taxpayer would also avoid the reach of § 2703 if he or she owns less than 50% of the business entity (computed after accounting for the relevant family attribution rules).[28]

The rights and restrictions of Code § 2703 can arise based on articles of incorporation or organization, operating agreements, bylaws, or partnership or shareholder agreements found in most common buy-sell agreements.[29]Thus, if the value of a shareholder's, member's, or partner's interest that would be governing during life, such as on retirement, or on the disability of the active participant, the restrictions on transfer in the agreement would not be effective to reduce the value on a decedent's estate tax return unless the three exceptions mentioned two paragraphs ago apply.[30] This dynamic presents another trap for the valuation professional and the attorney who hires him or her.

A final valuation restriction is found in Code § 2704. Section 2704(a) deals with lapses of voting or liquidation rights in privately-held entities, held either directly or indirectly, and applies where the holder and the holder's family[31]control the entity both before and after the lapse. A lapse occurs when a presently exercisable voting right or liquidation right is restricted or eliminated.[32]If a lapse under Section 2704(a) occurs during the life of the holder, *the lapse is considered a gift*. A lapse at death results in estate tax inclusion (and could trigger imposition of a generation-skipping transfer tax).

A lapse creates a gift or is includable in the taxable estate of the holder under Section 2704(a) only if the right – whether a voting or liquidation right – would have been includible in the holder's estate had he or she died with the right. Voting rights include voting on any issue of the entity. General partners who can participate in management have a voting right. A liquidation right is defined as the ability to compel the entity to acquire all or any portion of the holder's equity in the entity. This includes the holder's aggregate voting power and regardless of whether the acquisition by the entity would cause a liquidation of the entity.[33]

The ambiguity of this concept as well as its effect on valuation is illustrated in Example 5:

> D and D's two children, A and B, are partners in Partnership X. Each has a 3 1/3 percent general partnership interest and a 30 percent limited partnership interest. Under State law, a general partner has the right to participate in partnership management [*a voting right under Code § 2704]*. The partnership agreement provides that when a general partner withdraws or dies, X must redeem the general partnership interest for its liquidation

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[28] *See* Treas. Reg. § 25.2703-1(b)(3).

[29] In the Tax Court's analysis of Code § 2703(a)(2) in *Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000), *aff'd on this issue*, 293 F.3d 279 (5th Cir. 2002), the Tax Court examined a decedent whose agent, the decedent's son-in-law, created a Texas limited partnership and transferred to it substantial amounts of the decedent's property including home, securities, and cash in exchange for a 99% LP interest shortly before the decedent's death. The Service argued that the transfer to the limited partnership was a restriction on the use or sale of the partnership's property under Code § 2703(a)(2). The Tax Court disagreed in finding that the Texas statute could not be seen to include the partnership assets in the decedent's estate when, in fact, the decedent owned the 99% LP interest that was included in the estate.

[30] *See* Treas. Reg. § 25.2703-1(b)(1).

[31] *See* Treas. Reg. § 25.2702-2(a)(1). The Code § 2704 regulations apply the definition of member of the family from S 2702; namely, "the holder's spouse, any ancestor or lineal descendent of the individual or the individual's spouse, any brother or sister of the individual, and any spouse of the forgoing."

[32] *See* Treas. Reg. § 25.2704-1(b) and (c).

[33] *See* Treas. Reg. § 25.2704-1(a)(2).

> value. Also, under the agreement any general partner can liquidate the partnership. A limited partner cannot liquidate the partnership and a limited partner's capital interest will be returned only when the partnership is liquidated. A deceased limited partner's interest continues as a limited partnership interest. Then D dies, leaving his limited partnership interest to D's spouse. Because of a general partner's right to dissolve the partnership, a limited partnership interest has a **greater fair market value when held in conjunction with a general partnership interest than when held alone. Section 2704(a) applies to the lapse of D's liquidation right because after the lapse, members of D's family could liquidate D's limited partnership interest.** D's gross estate includes an amount equal to the excess of the value of all D's interests in X immediately before D's death (determined immediately after D's death but as though the liquidation right had not lapsed and would not lapse) over the fair market value of all D's interests in X immediately after D's death. Treas. Reg. § 25.2704-1(f), Ex 5. [Emphases added.]

Senior generation family members typically hold on to what § 2704 defines as a liquidation right. Perhaps someone in that generation believes it is necessary to retain control of the business (a very common objective), or to retain access to income from the business' operations (same). In these cases, sound, defensive planning may involve ensuring that the senior generation's voting or liquidation rights eventually become devalued. If it is intended and agreed that the next generation is not going to control the business, an estate planner *can recommend the addition of a non-family member as a manager (or a general partner).* If that were done, members of senior generation would not have control of the business when they die, thereby reducing the value of that generation's interest in the business for estate tax purposes. Care should be taken to determine the extent to which the members of the senior generation can liquidate their own interests (perhaps governed by buy-sell agreement then implicated under Code § 2703).

Code § 2704(b) deals with the potential increase in gift tax value of an entity with a valuation that is less than the liquidation value of the entity. This is often the case, as the cash on hand is frequently minimal, profits having been reinvested in the company to improve performance, recapitalize property, plant and equipment (PPE), or support acquisitions. The value for § 2704 purposes increases because restrictions on transfers and a hypothetical liquidation[34] may be disregarded in family-owned businesses. Such "applicable restrictions" are those in which a limitation on the power to liquidate the entity is more restrictive than the restrictions provided in the State law.[35]Not every restriction will be ignored, such as a limitation on liquidation imposed by an unrelated investor in the entity demanded as a condition to investing in the entity, regardless of whether the investment constitutes debt or equity.[36]Further, a

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[34] The Service and the Tax Court take a differing position on whether liquidation refers to the individual's equity (in a redemption, which is the Service's position) or liquidation of the entity, which is the Tax Court's view. *See* I.R.S. Tech Adv. Mem. 97-35-003 (May 8, 1997); *see also Kerr v. Comm'r*, 113 T.C. 449 (1999), *aff'd* 292 F.3d 490 (5th Cir. 2002).

[35] *See* Treas. Reg. § 25.2704-2(b).

[36] *See* Treas. Reg. § 25.2704-2(b), defining "unrelated person" as the term is defined in Code § 267(b), which includes members of the family; namely, brothers and sisters (whole or half-blood), spouse, ancestors, and lineal descendants, an individual and a corporation in which 50 percent of the value is held directly or indirectly, by or for the individual, two controlled corporations, a grantor and fiduciary of a trust, a fiduciary of a trust and a fiduciary of another trust if the grantor of the trust is the same, a fiduciary and beneficiary of a trust, a fiduciary of a trust and beneficiary of another trust if the grantor is the same, a fiduciary of a trust and a corporation where over 50% in value is owned by the trust or the grantor of the trust, a person and a section 501(c)(3) organization controlled directly or indirectly by the person or members of the family of the person, a corporation and partnership if the same person owns more than 50% of the outstanding stock of the corporation and more than 50% of the capital or

restriction imposed by the federal or a state government is not an applicable restriction, nor is an option, right to use property, or agreement subject to Code § 2703 an applicable restriction.

One way to overcome an assertion by the Service on audit that withdrawal or liquidation rights held by an individual is an applicable restriction, and thus would be ignored for Section 2704 valuation purposes, is to *include a non-family member in the capital structure*, with the ability to vote on redemption or withdrawal. That approach could be coupled with s requirement that withdrawals or redemptions of an individual must be unanimously approved. Using a charitable entity, rather than an individual, as an owner with voting powers regarding redemption or liquidation has been another successful planning tool to avoid the applicability of Code § 2704(b) in this context.

IV. Using "must have" valuation adjustment clauses

With the Service's focus on valuation of privately held business interests and taxpayers' desire to avoid an audit, planners are more and more often including the key language of *value as finally determined for federal gift or estate tax* associated with a value adjustment that has been found acceptable by the courts. Simply providing a formula clause in a transfer document, with consistent facts and reporting, that has passed muster in prior litigation has been effective in quickly ending an audit.

A formula clause of this kind used in transfer documents is typically called a defined value clause, two of which have historically been used regularly: a defined value *transfer* clause (which are more problematic), or a defined value *allocation* clause.

With a defined value transfer clause, a formula in the trust (or contract) provides that if the value is later, upon audit, determined to be greater than the value originally determined, thus subjecting the donor to potentially unexpected gift tax, the excess portion will revert to the donor, or otherwise be ignored as a taxable transfer.

With a defined value allocation clause, any "excess" equity, as determined on audit, is diverted to an entity such as a charity. The amount thus transferred to the non charitable beneficiary is the exactly the amount intended to be transferred.

Some defined value clauses are formula defined value clauses and others are savings clauses. These clauses have been treated differently by the Service and the courts and extreme care needs to be used in advising clients on how to structure their defined value clauses, as careful navigation of the law is necessary to produce outcomes desired by the clients.

Simply put, if the transfer is stated or considered as a transfer of a specific dollar amount it is likely to be upheld if challenged in court;, on the other hand, if the transfer is of a specific amount of an entity interest, the "condition precedent" issue is likely to be raised, with some success, by the Service, leading to unanticipated tax liabilities for the transferor.

Then there are price adjustment clauses. Such as clause provides that the price of an interest, or share, ascribed to a transaction may be adjusted if the value is later determined to be greater than what had originally be computed. Price adjustment clauses are commonly found in commercial contracts, as well as in the wealth transfer context. Price adjustment clauses are more likely to be upheld as proper in a

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profits interest in the partnership, two S Corps if the same person owns more than 50% of the value in each corporation, an S Corp and a C Corp if the same person owns more than 50% of the value in each corporation, an executor and beneficiary of an estate except in a sale or exchange in satisfaction of a pecuniary bequest.

commercial context, or even an intra-family context – as long as there is evidence of some arm's-length negotiation – than in a purely donative context, where no negotiation has occurred.

One implication arising from the common fact pattern that a gift intended to be below both the gift and generation skipping transfer tax exemption amount turns out, later, to be valued at amounts that exceed those exemption amounts, is that, in *every* case, provision should be made for funding a GST-exempt and a GST non-exempt portion of a trust to which transfers are made.

A. Defined value transfer clauses

The enforceability of defined value clauses has for a long time been uncertain. In the end, it depends on how the clause, exactly, is drafted.

The two main elements to such a clause are: 1) the direction to transfer "excess" value to either a charity or to another estate planning structure (thus allowing the grantor to escape imposition of an unexpected transfer tax, and in theory demotivating the Service from auditing)[37] and 2) the use of a later-determined (as in, after the transfer itself) value for transferred interests as a *condition subsequent* of the actual transfer.

In the well-known and long-ago decided case of *Comm'r v. Procter*,[38]the Service appealed the Tax Court's decision that there is no gift tax liability when the taxpayer sought to gift remainder interests in two trusts of which he was a beneficiary to trusts for the benefit of his children in such a way that they would receive the corpus of the trusts when he died. In the case the Fourth Circuit Court of Appeals established and applied *doctrine of condition subsequent*, and that *the condition subsequent violates public poli*cy.

The trust of which his children were the beneficiaries provided: "in the event it should be determined by final judgment or order of a competent federal court of last resort that any part of the transfer in trust hereunder is subject to gift tax, shall automatically be deemed not to be included in the conveyance in trust hereunder and shall remain the sole property of [the taxpayer]**. . . .**"[39]

The Fourth Circuit found against the taxpayer, basing its decision on the fact that the quoted provision constituted a "condition subsequent" that violates public policy.[40] The "condition subsequent" doctrine has resource allocation and "Catch-22" underpinnings, as condition subsequent clauses require taxing authorities, and perhaps courts, to engage in factual determinations of the gift after the transaction (and Service audit) has taken place.

The problem with the condition subsequent clause of *Procter*, the court decided, was that it would put taxing authorities in a no-win position from a revenue perspective – either they would find that no taxable gift had been made in the first place, or they would find a taxable gift of some amount – with the agreement then directing that that amount would be paid back to the taxpayer, resulting in, again, no taxable gift. The Fourth Circuit decided that putting a court in a position of determining that, no matter the outcome, the taxpayer wins, was violative of public policy.

[37] *See* Code § 7802(a)(3) for a list of taxpayer rights including "the right to pay no more than the correct amount of tax."
[38] *Comm'r v. Procter*, 142 F.2d 824 (4th Cir. 1944).
[39] *See id.; see also* Rev. Rul. 1986-41; 1986-12 I.R.B. 9.
[40] Note that in 1939, there were separate gift and estate tax systems, with different rates and rules.

Later cases show the taxpayer was able to successfully able to argue that the present gift of a present interest, with the value being the only unknown, can be distinguished from the principle enunciated in *Procter*, where the court determined that the present gift of a future interest, where *the value and even the existence of a gift* would later be finally determined only with, perhaps, the decision of a federal court, was a *condition subsequent* that invalidated the defined value provision.

In *Procter*, the Fourth Circuit identified three deleterious public policy effects. First, if use of condition subsequent clauses became widespread, the Service would be discouraged from ever trying to collect tax in situations involving such clauses. Second, the determination of value by a federal court of last resort would require that those courts to engage in other than adversarial hearings in wasteful substantial controversies, a violation of the constitutional mandate that federal courts are designed to designed only cases and controversies. Finally, the court noted the circularity of a process in which the court proceeding fixing the liability on the taxpayer would also be charged with determining the final value.[41] These condition subsequent and public policy issues have subsequently been used by courts to invalidate defined value transfer clauses.

Forty-two years after *Procter,* the Tax Court decided *Ward v. Comm'r*.[42]

In that case, the taxpayers (husband and wife), along with their adult sons, formed a corporation for the orderly transfer of ranch property to the sons, and to ensure that the operations would be conducted in consolidated manner after the taxpayers' deaths. The stock purchase agreement provided for transfer restrictions and a buy-out at the death of a shareholder, a right of first refusal, and a right of repurchase by the corporation.

Gifts of corporation shares, with valuation discounts (33 1/3%) applied, to the children were reported on gift tax returns for several years. The Service took note of a valuation adjustment clause in the shareholders agreement. The Tax Court found that one provision in the shareholders agreement, granting the other shareholders and the corporation a right of first refusal at a contract price, was not determinative of value in a gift tax context.[43]

Based on the language of the valuation adjustment clause in the shareholders agreement, the taxpayers argued that they intended to give each son a certain dollar amount ($50,000) and not a specific number of shares. Further, the taxpayers reserved the right to revoke the gift of 25 shares to each to the extent the value was *"finally determined for Federal gift tax purposes"* <u>if the gift of property exceeded $2,000</u>. The Tax Court noted that the taxpayers' revocation right was contingent on events beyond their control. In the end, the analysis of *Procter* as to public policy and effect of such a clause on tax policy controlled. The Court emphasized that when a limitation on the excess value is in place, the court would be in a position to have to issue, in effect, a declaratory judgment. Therefore, the Court held that the gift adjustment clause was void as to public policy and had no effect on the gift taxes that would be owed by the taxpayers as to the gift of corporate shares.[44] For estate planners, the limitation of value, even using the key phrase *"value as finally determined for federal gift or estate purposes"* will result in a strong auditable case the Service.

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[41] *See id.* at 828; *see also Belk v. Comm'r*, 774 F.3d 221 (4th Cir. 2014), in which the court heard appeal from the Tax Court on a qualified conservation easement issue in which the taxpayers transferred the easement to a trust with a savings provision as against the exercise of a substitution power in the trustee. Based on the condition subsequent aspect and relying on *Procter*, the Court held that the easement was not qualified under Code § 170(h)(1).

[42] *Ward v. Comm'r*, 87 T.C. 78 (1986).

[43] See discussion of Code § 2703 at page 12.

[44] *See id.* at 116.

Examining a marital deduction formula clause, the Service in TAM 8632004 came to a different result. In that situation, the Service reviewed a decedent's last will, which empowered the executors to transfer only those estate assets that would qualify for the marital deduction transfer to a martial trust, thus in effect exercising a "savings provision" in the will that allowed a non-transfer of assets to the extent the transfer would not qualify for the martial deduction. Although citing *Procter* regarding public policy, the Service determined that, in this case, because the discretion of the executors rested on their determination that the amounts transferred would not disqualify the trust as a martial deduction trust, the provision at issue did not fail the public policy test.[45] This ruling demonstrates that a formula transfer valuation clause will not necessarily fail in the context of transfers intended to qualify for the marital deduction.[46]

In PLR 200245053,[47] the Service analyzed the tax consequences of a sale of a limited partnership interest to an irrevocable trust, in exchange for a note, made pursuant to a valuation formula.

The taxpayer asserted on a timely filed Form 709 that there was no gift because the value of the property sold equaled the face value of the promissory note received.[48] Citing *Procter* and *Ward*, the Service highlighted the specific language of the value adjustment clause: "[I]f the Service, or the courts, determined that the property subject to the transfer exceeds the value initially placed on the property by the donor, then the portion of the property sufficient to eliminate the imposition of any additional tax liability is transferred back to the transferor."

The Service noted that "the legitimate and accepted uses of formula clauses as a practical way to implement congressionally sanctioned tax benefits are in stark contrast to the situation presented in the instant case," and made reference to several factors it considered important in making a decision:

1. The LP was formed almost exclusively to achieve discounted valuations for the interest sold.

2. The use of the defined value transfer formula was also a motivation for the formation of the LP.

The Service deemed these reasons as other than bona fide, and the taxpayer received an adverse ruling. Interestingly, the Service did not examine this ruling request under a Code § 2036 analysis, although it could have done so.

To mitigate audit risk, and in light of the Service's posture as expressed in this PLR, estate planners should take care to ensure that there is substance in the entities, and demonstrating that a bona fide sale for full and adequate consideration has taken place should be prioritized as an evidentiary matter.

[45] *See* I.R.S. Tech. Adv. Mem. 86-32-004 (April 23, 1986).

[46] *See also* Rev. Proc. 64-19, 1964-1 C.B. 682 as to marital deduction allocations; *see also* Treas. Reg. §§ 26.2632-1(b)(2)(ii); 26.2632-1(d)(1) as to formula GST allocation; *see also* Rev. Rul. 72-395; Treas. Reg. §§ 1.664-2(a)(1), 20.2055-2(e)(2)(vi)(a) as to split interest charitable trust allocation provisions; *see also* Treas. Reg. § 25.2702-3(b)(1)(ii)(B) regarding formula transfers to GRAT.

[47] PLR 200245053 ((July 31, 2002).

[48] *See* Treas. Reg. § 25.2512-8 providing that gifts reach sales, exchanges, and other dispositions of property where the value of the property transferred exceeds the value of the consideration given for the property.

An important exception to the Service's success in defeating the intent of many defined value transfer clauses is the 2012 decision in *Wandry v. Comm'r*.[49] In that case, the Tax Court contrasted a *savings* clause, which is void as against public policy, from a *formula* clause, which is valid.

The court found that a savings clause is void because it creates a gift by a donor who may wish to get property back, while a defined value transfer formula clause is valid because it merely transfers a "fixed set of rights with uncertain value."[50] This new approach to valuation adjustment has allowed donors to retain excess value, rather than to transfer the excess via charitable beneficiaries or using GRATs to transfer to non-charitable beneficiaries other than the grantor.

The *Wandry* decision is a landmark holding, creating a roadmap that many estate planners have now successfully followed. Factual considerations must be measured against the requirements of the holding to ensure that the taxpayer has a strong legal position in case of an audit.

In the case, the taxpayer had in 1998 formed a limited partnership called the Wandry Family Limited Partnership ("Wandry FLP") and made annual exclusion gifts of LP interests to children and grandchildren. The taxpayer and his children thereafter formed another entity, the Norseman Capital, LLC. The taxpayer transferred all of its ownership interest in the Wandry FLP to Norseman Capital. The taxpayer then made a $1 million gift of LLC membership interests to children and grandchildren.

Counsel advised the taxpayer that any gifts of Norseman Capital units could not be valued adequately before the gifts were made, and that the gift documents should state dollar amounts and not percentage interests intended to be given. The gift agreement recited that:

> Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service (IRS). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if, after the number of gifted Units is determined based on such valuation, the IRS challenges such final valuation and a *final determination of value is made by the IRS or a court of law*, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law.[51] [Emphasis added.]

When the gift tax returns were audited, it was found that the taxpayer had indicated on IRS Form 709 that he intended to transfer a percentage of Norseman Capital equivalent to a fixed dollar amount to each donee. The IRS argued that the adjustment clause created a condition subsequent to completed gifts and, pursuant to *Procter*, was void for U.S. tax purposes as contrary to public policy.

The Tax Court applied *Petter*[52] standards to determine the validity of the transfer clause: the donees were always entitled to receive a predefined *numerical value*, evidenced by a number of Norseman Capital

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[49] *Wandry v. Comm'r*, 103 T.C.M. (CCH) 1472 (March 26, 2012), *nonacq.* Action on Dec. 2012-04, 2012-46 I.R.B.
[50] *Id.* at 1477.
[51] *Id*. at 1473-1474.
[52] *Estate of Petter v. Comm'r*, 98 T.C.M. (CCH) 534 (December 7, 2009), *aff'd*, 653 F.3d 1012 (9th Cir. 2011).

LLC units, which the documents essentially expressed as a mathematical formula. The formula had one unknown: the value of an LLC unit at the time the transfer documents were executed. Though unknown, that value was a constant. At all times, the donees were to receive the same number of units. As it turns out, without the audit described in the clause, the donees may never have received all the units they were entitled to. The audit results simply ensured the donees would receive those units they were always entitled to receive.[53]

The Tax Court observed that the taxpayer consistently intended to gift an amount of money that could only be determined by understanding the value of the company. Because there were specified dollar amounts for the gifts, there could be no excess gift. The formula did not require that the taxpayer "take back" the excess amount; rather, there was no excess amount ever conveyed. The formula simply adjusted the relative ownership percentages when the fair market value of Norseman Capital was later established.

In the recent Tax Court case of *Nelson v. Comm'r*,[54] the taxpayer made a gift, and subsequently sold, LP interests to an irrevocable trust. The formula in each of the transfer or sale documents defined the transferred property as: "her right, title and interest in a limited partner interest having a fair market value of $ (amount) as of (date) as determined by a qualified appraiser within __ days of the effective date of this agreement." The Tax Court determined that there was no language either "defining fair market value or subjecting the limited partner interests to reallocation after the valuation date."[55]This absence eliminated the condition subsequent argument fatal to the taxpayer's case in *Procter*. So far, so good, as far as the taxpayer was concerned.

However, the Tax Court determined that the formula did not convey a certain dollar amount; rather, the taxpayer transferred LP interests to be determined by an appraisal after the transfer, and a value not qualified as defined as subject to a final determination of gift or estate tax values. This is a manifestation of a savings clause proscribed by *Procter*. Without defining the value in terms of finally determined gift tax values, the taxpayer's determination of value was not necessarily of fair market value.

With the lack of adequate reference to a final determination of fair market value, the Tax Court distinguished this case from previous defined value transfer cases, in which the formulas were respected based on subsequent events/valuation determinations.[56] The Tax Court reviewed the subsequent valuation against the standards of the Code's Chapter 12 gift tax provisions and determined that gift tax was due on an understatement of $4,547,916 as to two transfers of LP interests.[57]

The absence of a properly structured defined value transfer formula was fatal to the taxpayer's case. This decision is another clarion call to the estate planners to get on board with the nuanced distinctions between savings and formula clauses, and to be careful in structuring the transfer agreements. Given the basis of this decision, one can readily expect the Service to look for similar ill-constructed defined value clauses.

B. Defined value allocation clauses

A second type of defined value clause is one in which the total amount of property is actually transferred, but the property is then allocated between two recipients: one of the transfers to whom would be subject

[53] *Wandry v. Comm'r, 103 T.C.M. (CCH) at 1477-1478.*

[54] *Nelson v. Comm'r*, T.C. Memo. 2020-81 (June 10, 2020).

[55] *Id.* at 11.

[56] *See Estate of Petter v. Comm'r,* note 52, at p.17*; Procter,* note 38, at p. 14.

[57] *Nelson v. Comm'r*, T.C. Memo 2020-81 at 50.

to gift tax and one to whom transfers would not be subject to gift tax. In these allocations, as well as with defined value transfer clauses, it is clear that when describing value in the formula, the use of the term *"as finally determined for federal estate and gift tax purposes*" has been shown to be a determinative, binary element in the successful formula.

An early Tax Court Division Opinion[58] involved a partial disclaimer from a decedent's estate in *Estate of Christensen v. Comm'r.*[59] There, the decedent's daughter executed a partial disclaimer[60] of her inheritance from her mother's estate with a portion going to charity, and a portion being retained by the daughter. The formula in the case was:

> 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 market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001 ("the Disclaimed Portion"). For purposes of this paragraph, the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001, shall be the price at which the Gift (before payment of debts, expenses and taxes) would have changed hands on April 17, 2001, **between a hypothetical willing buyer and a hypothetical willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts for purposes of <u>Chapter 11 of the [Internal Revenue] Code</u>,** ***as such value is finally determined for federal estate tax purposes*****.**[61] [Emphasis added.]

The impact of the formula was to increase the allocation of an increased in the estate tax value among the taxpayer, a foundation and a testamentary charitable lead trust. The Service argued condition subsequent (meaning that the formula only became effective if there was a challenge of value on audit), as a violation of public policy. The Tax Court held that the question of value was not one of whether or not the transfer was to talk place; thus, the Procter-style condition subsequent simply did not exist. Further, the court noted that it is regularly accustomed to determining value for charitable gifts, for income, gift and estate tax purposes, meaning that there was no public policy inefficiencies at work in this case. The Tax Court distinguished this case from *Procter*,[62] and sustained the partial disclaimer, on the grounds that the formula allowed for a definitive determination, at the time of death, and not a contingent transfer; rather, the court would determine the value of the amount being disclaimed for estate tax purposes.

Petter v. Comm'r[63] was a Tax Court memorandum decision that involved a judicial construction of a potential savings clause versus a defined value allocation formula. The Tax Court determined that

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58 The Tax Court issues three types of opinions: namely, Division Opinions, Memorandum Opinions, and Summary Opinions. Only Division Opinions have precedential value and are officially published. The Chief Judge determines if a case will be reported as a Division or Memorandum Opinion. Division Opinions often are the court's first decision on a legal issue, while the Memorandum Opinion generally applies existing law to the new facts of the case. *See* Code § 7460.

59 *Estate of Christensen v. Comm'r*, 130 T.C. 1 (2008), *aff'd* 586 F.3d 1061 (8th Cir. 2009).

60 *See* Code § 2518(c)(1); Treas. Reg. § 25.2518-3(a); *see also* Treas. Reg. § 25.2518-3(b) dealing with partial disclaimers and their validity. The *Christensen* court notes that this regulation is key to the decision in FN. 4, and highlights the case of *Wilshire v. United States*, 288 F.3d 342 (8th Cir. 2002), which upheld the regulation, but would not have been known by the estate planners for Christensen because of the timing.

61 *See Estate of Christensen v. Comm'r, 130 T.C.* at 5.

62 *Id*. at 17. "This case is not Procter."

63 *See Estate of Petter v. Comm'r*, note 52 at p. 17.

because of the reference to a specific dollar amount in the formula, the Service's argument that this case involved a savings clause was not given weight. The related issue of public policy violation was also dismissed, in that charity was the beneficiary that would enjoy a higher valuation determination.

In *Petter*, a Washington state resident, one of the initial investors in what later became United Parcel Service (UPS), received her deceased uncle's shares of the privately-owned company, which was valued at $22.6 million when UPS went public. As part of her estate plan, her attorney established a revocable trust, an irrevocable life insurance trust (ILIT), the Petter Family LLC (PFLLC), and two irrevocable grantor trusts (IGTs). The taxpayer engaged in gift-sale transactions with both IGTs. The taxpayer intended to apportion the value between her children and the Seattle Foundation. The defined value allocation clauses in the gift agreements:

> 1.1.1 assigns to the Trust as a gift the number of Units described in Recital C above that equals one-half the minimum dollar amount that can pass free of federal gift tax by reason of Transferor's applicable exclusion amount allowed by Code Section 2010(c). Transferor currently understands her unused applicable exclusion amount to be $907,820, so that the amount of this gift should be $453,910; and
>
> 1.1.2 assigns to The Seattle Foundation as a gift to the A.Y. Petter Family Advised Fund of The Seattle Foundation the difference between the total number of Units described in Recital C above and the number of Units assigned to the Trust in Section 1.1.1.
>
> 1.2 The Trust agrees that, if the value of the Units it initially receives *is finally determined for federal gift tax purposes* to exceed the amount described in Section 1.1.1, Trustee will, on behalf of the Trust and as a condition of the gift to it, transfer the excess Units to The Seattle Foundation as soon as practicable.[64] (Emphasis added).

The Tax Court first determined the nature of the transfer: a gift of an ascertainable dollar value of interests, or, instead, a gift of a specific number, or percentage, of interests? Citing *Christensen*[65] and distinguishing *Procter*, Court focused on understanding *what* was given by the taxpayer. It said, "[t]he distinction is between a donor who gives away a fixed set of rights with uncertain value—that's *Christiansen*—and a donor who tries to take property back—that's *Procter*."[66]

The Court suggested to estate planners a method for creating a favorable fact pattern when it noted that, similar to *Christiansen*, in which the excess amount went to charity, the taxpayer in this case allocated to charity. "[T]here is a general public policy in favor of encouraging gifts to charity."[67]

The Fifth Circuit Court of Appeals in *Succession of McCord v. Comm'r*[68] took a deep dive into the condition subsequent (the speculative nature of the future performance of a present obligation) nature of valuation activities after the gift. The court was reviewing the Tax Court and offered a *de novo* determination of how much speculation is too much in determining whether estate inclusion under Code § 2035 could be credited as an element in the valuation of the transfer.

[64] *Id.* at 537.
[65] *Estate of Christensen v. Comm'r*, 130 T.C. 1 (2008), *aff'd* 586 F.3d 1061 (8th Cir. 2009).
[66] *Estate of* Petter v. Comm'r, 98 T.C.M. (CCH) at 542.
[67] *Id.*
[68] *Succession of McCord v. Comm'r*, 120 T.C. 358 (2003), *rev'd*, 461 F.3d 614 (5th Cir. 2006).

In *McCord*, the Court determined that the taxpayers, partners in a Texas family limited partnership ("MIL") in 1996 gifted all of their collective class B LP interests to GST-exempt trusts. The valuation of those class B interests was the issue, in that their value either was within or outside of the GST exemption of the donors. The language of the assignment agreement was:

> 1. First, to the Generation A dollar amount of fair Skipping Tax market value in interest Trusts ("GST of MIL equal to the trusts") dollar amount of Taxpayers' net remaining generation skipping tax exemption, *reduced by* the dollar value of any transfer tax obligation owed by these trusts by virtue of their assumption thereof.
>
> 2. Second, to the Sons $6,910,932.52 worth of fair market value in interest of MIL, *reduced by* the dollar value of (1) the interests in MIL given to the GST trusts, and (2) any transfer tax obligation owed by the Sons by virtue of their assumption thereof.
>
> 3. Third, to the $134,000.00 worth of Symphony such in interest of MIL.
>
> 4. Last, to CFT The dollar amount of the interests of the Taxpayers in MIL, *if any*, that remained after satisfying the gifts to the GST trusts, the Sons, and the Symphony.[69]

Importantly, because the amount of the gifts was specified in dollars, the willing buyer/willing seller standard in the assignment agreement was used for fair market value. Further, allocation under the assignment agreement provided that the gifts were conditioned on the assignees' bearing the responsibility for payment of any gift taxes, and of course, any future estate taxes. The parties used a "confirmation agreement" that was shared with the assignees who had the responsibility under the "net gift" strategy. The agreement was not shared with the donor/taxpayers following the valuation occurring two months after the transfer. The Tax Court, *sua sponte*, determined that the post-transfer events could be considered in the process.

The Court determined that the taxpayers irrevocably transferred their entire remaining LP interests, with an unknown value. The Court confirmed that the gifted LP interests qualified for valuation discounts, computed in this case using a variation of "net gift" methodology.[70]

The Tax Court had described the post-transfer confirmation agreement as a condition subsequent and declined to consider a Code § 2035(b) discount under the net gift principle, which allows a discount for the inclusion of gifts made within 3 years of death and the estate tax liability of that inclusion. The Tax Court did consider the possibility of the death of the donor within three years as a condition subsequent.

However, the Fifth Circuit Court reversed the Tax Court on this point. It found that the assignees properly allocated the gift between the charity and the non-charitable beneficiary trust, and thus validated the defined value allocation formula as a viable planning tool.

In yet another defined value allocation case, the Tax Court, in *Hendrix v. Comm'r*,[71]examined, in a memorandum opinion, the arms-length nature of the valuation allocation clauses and the public policy impact of valuation clauses in general. Finding indicia of arms-length negotiation between the taxpayer and the charity, the Tax Court upheld the validity of the valuation clause. On the public policy argument,

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[69] *Id.* at 618-619.
[70] *See id.* at 628; *see also Steinberg v. Comm'r*, 145 T.C. 184 (2015).
[71] *Hendrix v. Comm'r*, 101 T.C.M. (CCH) 1642 (June 15, 2011).

the Tax Court emphasized that the public policy in this case is supported by the firmly-held policy of promoting gifts to charity.

In *Hendrix*, the taxpayer established S Corporation, creating voting and non-voting shares in the process. The taxpayers then formed a donor advised fund, and created a number of trusts for the benefit of family. Then the taxpayers made gifts and sold assets, for a note, to the trusts and a community foundation, with a formula allocation in the assignment agreements stating:

> (1) A portion of the assigned shares having a fair market value as of the effective date equal to $10,519,136.12 was assigned to the trustees to be held in equal shares for the benefit of the daughters, and (2) any remaining portion of the assigned shares was assigned to the Foundation for the benefit of the donor-advised fund.

The assignment agreements defined fair market value using the standard hypothetical willing buyer/willing seller construct, and required that the trusts pay proportionally any gift taxes imposed as a result of the transfer, in a net gift structure. The assignment agreements required that the trustees sign promissory notes obligating the trustees to pay $9,090,000 to each petitioner.

The Tax Court determined that the trustees and the donors operated at arms' length, despite the family relationships, and thus that a gift had been made. Similarly, the Court determined that the foundation and the transferors operated at arms' length. These determinations were foundational for the evaluation of the extent to which the donor included property in his estate. Under the allocation formula, the portion that would otherwise exceed the gift tax exclusion would be allocated to the donor advised fund. Significant for the estate planner in this case is the use of arms'-length negotiations, particularly in light of the close family relationships. This is likely more readily achievable with the charity, and more challenging with the trusts. Using an independent, unrelated or non-subordinate trustee could help factually to establish the arms'-length nature of the transaction in the event of audit.

With the Tax Court's (and Fifth Circuit's) willingness to respect and uphold well-drafted and factually consistent defined value allocation formulas in a variety of cases, the planner can be of great assistance helping clients with hard-to-value assets achieve meaningful tax-efficient wealth transfer, with or without charitable intent.

C. Price adjustment clauses

In contrast to defined value formulas and clauses, price adjustment clauses change the price at which property changed hands. Thus, if the property in the hands of the donee or purchaser is established to be more (or less) valuable than originally stated, the transferor must use more (or less) gift tax exclusion, or adjust the notional amount of any promissory notes due. Of course, price adjustment clauses are quite common in a commercial context. Perhaps that is why they have been upheld more successfully in the sale, rather than the purely donative context.

In *King v. United States*[72], the seminal case on sales-related price adjustment clauses and a taxpayer victory, the Court of Appeals for the Tenth Circuit, on appeal from the district court, addressed the validity of a clause found in four trusts created by a donor for the benefit of each of his children and their issue, and funded with privately-held stock:

[72] *King v. United States,* 545 F.2d 700 (10th Cir. 1976).

> ". . . However, if the fair market value of The Colorado Corporation stock as of the date of this letter is ever determined by the Internal Revenue Service to be greater or less than the fair market value determined in the same manner described above, the purchase price shall be adjusted to the fair market value determined by the Internal Revenue Service."[73]

The issue before the Court was "[*w]hether a clause in an agreement for the sale of the debtor's corporate stock to his children's trusts requiring a price adjustment in the event the Internal Revenue Service determined the stock was sold for less than its fair market value may be enforced to defeat a gift tax assessed under § 2512(b) of the Code*."[74]

In each sale to the trust, King retained the shares as security for the payment of the note by the respective trust. The initial value was the price set by the Corporation's qualified stock option plan (now known as the "'409A value") and each note had a face value of $2,000,000. The district court had found that King intended to transfer the shares for full value and to make adjustments of the price paid when the value was determined later by the Service.[75]The Service thereafter determined that the initial value of $1.25/share should be restated at $16/share and asserted that gift tax should be assessed.

The Colorado Corp. had subsequently been adjudged bankrupt. The Tenth Circuit used this and other facts to determine that the taxpayer intended to transfer the shares for full and adequate consideration. It reviewed the Service's argument that honoring the price adjustment clause would violate public policy (*Procter*), and that the lack of donative intent (as this situation involved a sale, not a gift) does not remove the transaction from the purview of gift tax rules. The Court determined that instead of assessing gift tax, the price adjustment clause operates to effectuate the intent of the sale transaction and ensures that full value is paid.[76] The notional amount of the promissory notes would be modified for the trusts, but no gift tax was assessed. In modifying the notional value of the promissory notes, and honoring the structure of the sale to irrevocable grantor trust, the taxpayer had no risk of triggering transfer tax. Using a price adjustment clause had optimized the strategy. For estate planners, the simplicity of the structure and the lack of consequence for the taxpayer make this a valuable planning tool.

V. The focus: valuation discounts

The Service on examination or audit will often, initially and perhaps exclusively, focus on the valuation of the transferred asset. As a result, for a taxpayer to avoid an unhappy audit, the need for a qualified appraiser to prepare a qualified appraisal would be fundamental to impressing on the Service the futility of hoping for meaningful success by pursuing an audit.

Valuation is a key element in wealth transfer planning of any asset other than cash or most publicly-traded securities. The fair market value of any asset transferred for gift and estate tax purposes, is, of course, the price at which a hypothetical willing buyer and a hypothetical willing seller, each with knowledge of relevant facts and neither being under a compulsion to buy or sell, would exchange the asset.[77]

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[73] *Id.* at 703-704.
[74] *Id.* at 703.
[75] *See id.* at 704.
[76] *See id.*
[77] *See* Treas. Reg. § 25.2512-1.

A valuation professional's conclusion as to the fair market value of an illiquid asset is informed by, among other things, a view of comparable sales in the area or market, the unique feature of the asset, liabilities, the sales or distribution systems and the cash flows. Then, projecting those features into the viewpoint of a willing buyer, discounts can be claimed for lack of marketability, lack of control, blockage, and other features. The resulting value is reported, with justification provided in an appraisal report, on a gift or estate tax return.

The valuation industry is robust, particularly for valuations of both privately-held businesses and of interests in limited partnerships and LLCs.[78]

In the end, the conclusion in the valuation professional's report is an opinion. It is informed by the nature of the interest transferred, and the reason for the report. It is within these valuation reports that discounts are claimed to determine fair market value, and those discounted values are the most obvious and commonly challenged by the Service. The basis of determining the initial value is established under Rev. Rul. 59-60 and has been accepted by most courts.[79]

The most common bases for a discount from the apparent, nominal fair market value of the interest are (1) that it is a minority interest (based on the inability of a minority partner to put the shares or compel a liquidation of the entity so as to realize proceeds equal to the partner's capital account) and (2) that there is no public established or viable market for the interest (a lack of marketability).[80] Blockage discounts permit a discount when valuing, among other assets, large blocks of public securities, large blocks of art, and even art and real property.[81]It is these elements of discounts that can result in a visceral reaction that something must be wrong with this transfer.[82]Ensuring the uses of a qualified appraiser with a track record of defending their opinion can be the first level of defense to a valuation claim by the Service.

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[78] In *Estate of Aaron U. Jones v. Comm'r*, T.C. Memo. 2019-101 (August 19, 2019), the decedent taxpayer had made lifetime gifts to his 3 daughters of non-voting shares in an S Corp and a limited partnership that conducted timber operations. The IRS issued a notice of deficiency in the gift tax context. In the analysis of the valuation, Judge Pugh accepted "tax effecting" the valuation (considering the difference between S Corporation pass-through and C Corporation double taxation) despite the IRS' assertion that prior cases had rejected tax effecting. Additionally, Judge Pugh accepted a valuation based on an income-based approach (versus a net asset value approach) to value this operating business interest.

[79] *See* Rev. Rul. 59-60. The ruling identified the following factors: 1) the nature of the business and history of the business; 2) the overall economic outlook and the outlook of the industry at the time of the valuation: 3) the book value and financial condition; 4) the earning capacity; 5) the dividend history and capacity; 6) goodwill and other intangible property; 7) previous sales of the stock and the current block to be valued; and 8) comparable market price of other stacks in the same industry and that are publicly traded whether on an exchange or OTC.

[80]*See Estate of Newhouse v. Comm'r*, 94 T.C. 193 (1990), *nonacq*. 1991-2 C.B. 1.

[81] *See Estate of Folks v. Comm'r*, T.C.M. (CCH) 427 (January 29, 1982). The Tax Court determined a 20% blockage discount on the value of 5 lumberyards each subject to short term leases. The court reasoned in that case that "blockage" relates an oversupply of goods that the market cannot absorb at an optimum price. Because of the contemplated sale of 5 unique properties in a limited geographic area, the Tax Court determined an economic effect of a price depression of 20%.

[82] *See Estate of Streightoff v Comm'r*, 116 T.C.M. (CCH) 437 (October 24, 2018). In the case, experts battled and the tax court ultimately ruled for the taxpayer. That was despite the funding of an LP by the decedent with marketable securities, muni bonds, mutual funds, and cash. But the cost of limitation following the audit and assessment of $491,750.

VI. Use grantor trusts more often

Despite the defensive value of using valuation adjustment clauses with the right facts to support the valuation formula, there may be another perspective to determine the best approach. If the transaction is being reviewed by the Service causing counsel to defend and point out the nuance of the valuation formula and the support under cases, the taxpayer has already popped up on the radar, and is being tracked. But what if we could help our clients fly under the radar? Perhaps by using a much less aggressive valuation coupled with a long-term grantor trust.

Certainly in the past 30 years, irrevocable grantor trusts have become a staple of estate planning. The characteristics of grantor trusts in Subchapter J of the Code[83] at Sections 671-679 are renowned in their flexibility and use in shifting wealth. One of the true values in large estates is the ability for the grantor to pay the taxes on trust income, including recognized gains. Because this payment of tax is not considered a gift under Subtitle B of the Code,[84] the estate of the grantor is reduced, and trust assets can grow essentially tax-free (as the trust is effectively subsidized by the grantor). Of course, the flexibility offered by an independent trustee or trust protector who has the power to reimburse the grantor for taxes paid attributable to trust income cannot be overlooked.[85]

With that understanding, consider the audit risk of another common practice: taking deep valuation discounts. A broader understanding of valuation includes the standards of value. The four standards of value are (1) liquidation value reflecting the value of the entity through a forced or planned disposition of the company, often through an auction process; (2) fair market value (FMV), with the familiar willing-buyer/willing-seller construct;[86] (3) fair value, which is the pro rata value of a portion of the property (say 20%); and (4) investment value, where a buyer or buying group is targeted to buy the seller's business (the investment banking process).

There are three basic approaches to valuation: the asset-based; income-based; and market-based. Valuation discounts and premiums are applicable for minority interests, interests with lack of control over distributions or liquidation (think Code § 2036(a)(2)), blockage (in which putting assets on the relevant market all at once would have the effect of driving the price of the assets placed on the market down), and other bases.[87]

At times, the taxpayer wishes to drive an asset's fair market value down, particularly if the taxpayer's goal is to shift as much wealth to the next generation as tax-efficiently as possible. If the fair market value of a gifted assets is lower than its apparent value, then benefit of wealth transfer can be magnified. For example, if a 49% interest in a $100 million business is to be transferred to an irrevocable trust, the valuation of the 49% interest could legitimately be asserted as follows: 49% of $100 million = $49 million (its fair value, as discussed above), reduced by 15% for lack of marketability, and another 20% for lack of control. The lack of marketability discount would reduce the value 15%, to $41,650,000. The

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[83] *See* Code §§ 641-692.

[84] *See* Code § 674(a) stating that the grantor is treated as the owner of the trust if the grantor or a non adverse party, or both, have the power to affect the beneficial enjoyment of the trust corpus or income without the approval or consent of an adverse party.

[85] *See* Rev. Rul. 2004-64 authorizing reimbursement of the grantor's income taxes attributable to the trust realization without inclusion in the grantor's estate under Code § 2036(a)(1).

[86] *See* Treas. Reg. §25.2512-1.

[87] *See* note 27, p. 10.

minority discount would further reduce the value by 20% of $41.65 million, or to $33,320,000. With those discounts, the amount being transferred to the trust is $33,320,000. When that business interest is sold to the trust, the trust immediately has increased in value to $49 million at the "cost" of only $33,320,000. But that discount may expose the transfer to undue audit risk when disclosed on, presumably, a gift tax return, especially if the trust is initially funded with assets subject to a valuation discount.

The Service can audit a transaction (or a gift), and, as we have seen, there is potential value we can offer clients by structuring those transfers to include *Wandry*-style or *King*-style clauses (particularly to sale transactions, as in *King*).

There are three types of audits: a correspondence audit; an office audit, or a field audit. Each generally starts with the receipt of an initial data request (IDR) from the Service office conducing the audit. Despite the breadth of the request for information and documents in the IDR and succeeding requests, generally a correspondence audit can be the most benign, and can be settled if the taxpayer gives the requesting Service campus employee a satisfactory response. In any event, the result of the audit is that a Revenue Agent may determine that there is a deficiency. Normally, the Service will send a Revenue Agent Report ("RAR") with a cover letter, known as a 30-day letter. The letter explains that the taxpayer can request a meeting with the Service Appeals Office. Importantly, unlike Revenue Agents, the Appeals Office can consider the hazards of litigation in deciding whether to pursue a settlement. If there is no settlement achieved through that process, then the Service will send a statutory Notice of Deficiency.[88] At that point the taxpayer has 90 days to either petition the Tax Court, or the taxpayer can pay the asserted deficiency and seek a refund from the Service. If that refund clam is denied, the Service will issue a notice of disallowance. The taxpayer can then elect to sue the Service in U.S. District Court for a refund.[89] For the client, this process may be daunting, and may involve great costs.

As an alternative to taking anything close to a deep discount, but still achieving the grantor's intent to transfer substantial wealth, let's compare the amount of the valuation discount claimed (with the attendant audit and litigation risk and cost), against the simple use of an unexceptional grantor trust to reduce the estate of the grantor. The chart below (produced by Mr. Martin Siow of J.P. Morgan's Advice Lab) describes the relative growth that can occur based on the two factors of discount and grantor trust income tax payment. Observable in this chart is the relatively muted difference that can be achieved in the difference between risk-laden discounts by simply keeping the grantor trust status for 20-40 years rather than taking more than a 20% valuation discount at the time of the initial transfer into the trust.

[88] *See* Code § 6212(a).

[89] *See* Code § 6511. The Taxpayer has up to 3 years from the time the return was filed or 2 years from the time the tax was paid to sue for a refund.

Total Wealth Transferred (in $MM)								
		Valuation Discount						
		0%	10%	20%	30%	40%	50%	
Note Term	3	1.73	1.85	2.01	2.22	2.49	2.87	
	9	6.23	6.86	7.66	8.68	10.04	11.56	
	15	11.29	12.56	13.82	15.09	16.36	17.63	
	20	17.84	19.26	20.69	22.11	23.53	24.96	
	30	38.34	40.25	42.16	44.07	45.98	47.89	
	40	65.83	68.42	71.02	73.61	76.21	78.81	
Cumulative Income Tax Paid by Grantor (in $MM)								
		Valuation Discount						
		0%	10%	20%	30%	40%	50%	
Note Term	3	0.33	0.33	0.33	0.33	0.33	0.33	
	9	1.73	1.74	1.74	1.74	1.75	1.75	
	15	4.05	4.07	4.1	4.12	4.15	4.17	
	20	7.04	7.1	7.16	7.21	7.27	7.33	
	30	17.63	17.82	18.02	18.22	18.41	18.61	
	40	35.91	36.4	36.9	37.39	37.88	38.37	
Cumulative Income Tax Paid by Grantor (as a % of Wealth Transferred)								
		Valuation Discount						
		0%	10%	20%	30%	40%	50%	
Note Term	3	19%	18%	16%	15%	13%	11%	
	9	28%	25%	23%	20%	17%	15%	
	15	36%	32%	30%	27%	25%	24%	
	20	39%	37%	35%	33%	31%	29%	
	30	46%	44%	43%	41%	40%	39%	
	40	55%	53%	52%	51%	50%	49%	

VII. Where do we go from here?

Many clients are concerned about giving up too much control too early if they implement well-established estate planning techniques. For that and other reasons, they like to retain control as long as possible. They also like to claim the maximum valuation discounts reasonably obtainable.

Those concerns and wishes are valid and must be measured against the Service's focus on retained interests under Code §§ 2036(a) and 2038. Aggressive claimed valuation discounts are inviting targets for attack by the Service.

With the request and the initial vulnerability known, the issue almost always turns to, and on, valuation.[90] It is there that the planner and client can thoughtfully insert a *Wandr*y-style or a *King*-style clause into the transfer documents to "soak up" any discrepancy in the valuation that could otherwise cost the client gift tax exclusion or result in payments of gift or estate tax. Of course, any such use of a valuation clause should describe the ultimate determination of value be "such value as finally determined for federal gift or estate tax purposes." Using such clauses can be particularly helpful and necessary for hard-to-value interests in privately- held business. Finally, consideration should be made as to the extent of valuation discounts when the client's objectives may otherwise be fulfilled using a long-term grantor trust.

With so many tools at the disposal of the planner, a great deal of strategic consideration is required. Starting with the desired ends (secure family, lifetime activities, safety net, philanthropic goals), the ways (sales, GRATs, CLATs, loans, distributions, etc.), and the means (attorneys, CPAs, insurance, financial planning and execution, capital and the related expenses) should be understood. The final aspect is risk, and this what we can help our clients mitigate.[91]

[90] *See Grieve v. Comm'r*, T.C. Memo. 2020-28 (March 2, 2020) in which the Service attacked the valuation and existence of a taxable gift when the taxpayer transferred a fractional privately held business interest through a GRAT structure.

[91] This ends, ways, means, and risk analysis is derived from US military strategic planning paradigms. Thanks to the United States Army War College Master of Strategic Studies program (M.S.S. 2011).